Chief Investment Office

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Index House View

A US recession might be coming, but we are not there yet

The economic cycle we are heading into is clear, but its effects have not begun to unfold.

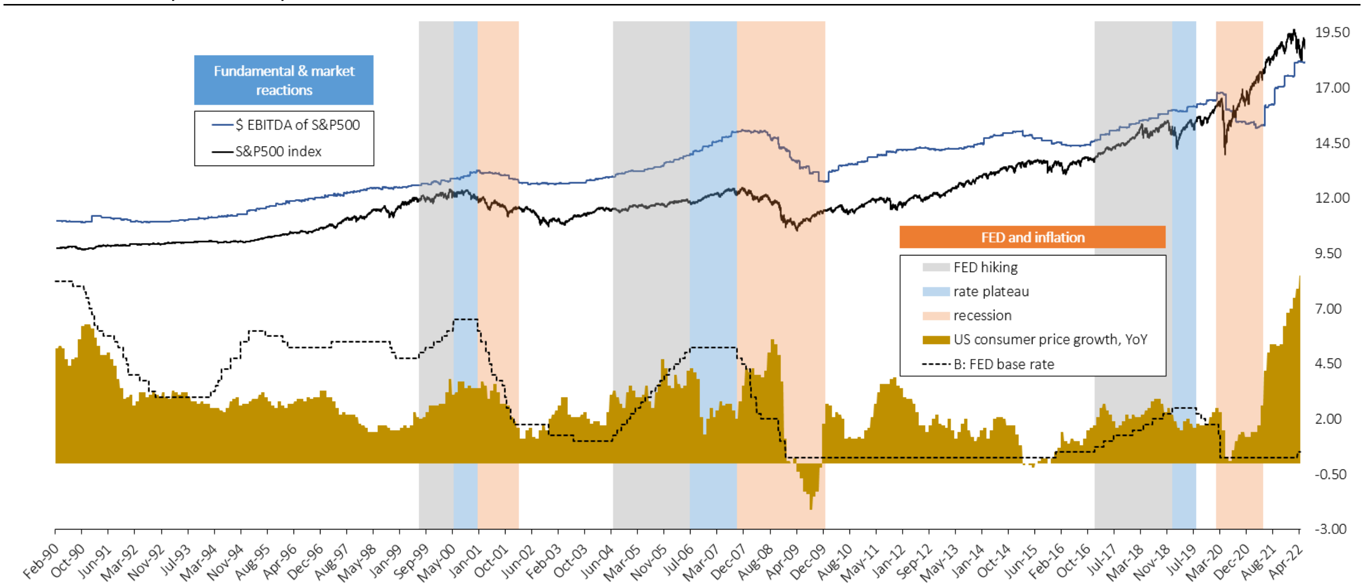
In the main three inflationary periods over the past 23 years, when the FED cooled down the economy by hiking rates, the time and financial performance trends have been the following:

	Phase 1	Phase 2	Phase 3
Length in months	*Fighting inflation*	*Rate plateau reached*	*The economy adjusts*
Monetary cycles	Rate hikes by the FED[1]	Rates stabilize at the top[2]	Corporate EBITDA decreases (recession)[3]
1999-2002	19.17	13.83	23.33
2005-2009	43.50	26.42	49.83
2016-2021	43.75	13.33	37.67
S&P500 Index performance			
1999-2002	+6.80%	-12.47%	-18.32%
2005-2009	+11.57%	+16.25%	-26.63%
2016-2021	+13.00%	+20.19%	+27.27% / (-31.13%)[4]

Notes: 1. Months from the day the FED began and stopped raising rates; 2. Months once the FED stops raising and began cutting rates; 3. Months of decreasing EBITDA for S&P500 companies until reversal; 4. The FED intervened with an unprecedented 100bps cut, before which the S&P500 lost about 31%, only to correct back to positive territory in a matter of days.

Graphically, these numbers look like this:

Fundamentals, markets, economics



Source: Bloomberg, Index & Cie own calculations

Data points are not enough to extrapolate statistically significant and predictive trends, and each monetary cycle and market reaction are slightly different from the others. However, we can comfortably say the following:

1. Equity performance during times of rate increases and rates plateauing (phase 1 and 2) is positive. This is because the economy is still going strong, with growing fundamentals, helped by strong consumer demand, all of which reflects into a rising inflation. This is exactly the situation we find ourselves so far into 2022;
2. The length of phases in the observed monetary cycles also suggests that 2022 might be a year of continued strength in fundamentals, that we would cap conservatively at nine months (instead of 19 or 43). This gives ample chance to companies to surprise markets with growth and business model resilience;
3. Inflation should continue to grow, although up to what point seems difficult to foresee. This will happen as consumer demand remain strong and as the disruption of Russian offline commodities remains. Our forecast is that inflation will remain sustained throughout 2022, waiting to be counteracted by rising rates.

These forecasts are supported by many other macro indicators. Consumer demand (retail sales, new orders), saving ratio, disposable income, unemployment and default rates on loans are currently solid. Inflation itself tells a clear story of energy prices and consumer demand pushing it higher, moving away from the supply chain bottlenecks that emerged in 2020. This week's readings were 6.5% from 6.4% for CPI ex food and energy, and 8.5% from 7.9% for total CPI. The effects of Ukraine's war are therefore felt quite broadly also in net exporter countries such as the US, an effect that is by definition transitory, not permanent, although the length of it is unknown.

Difference in views

There is a time mismatch between what markets expect and the time it takes an economy to adjust to rising rates.

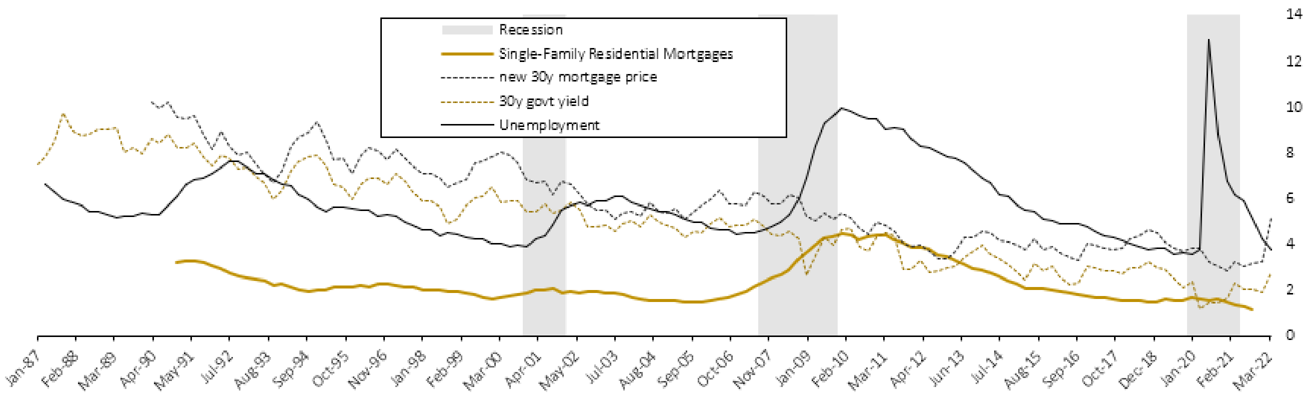
In the meanwhile, uncertainty is causing a substantial increase in market volatility and has already produced a rapid depreciation of the most exposed industries. The predominant narrative among investors and investment banks is one of rotation into conservative assets from risky assets. Investors are preparing for a protracted future of higher rates and lower corporate earnings. The 10-year govt benchmark yield is about 2.70% from 1.64% in January 2022. Bond prices have adjusted downward at unprecedented speed only in 2022. Equity valuations have come down considerably in certain sectors – see our previous paper on US tech – but not so much for the S&P 500 Index (at one point down 12.50% in March). Commodities and other cyclical assets have performed quite well on the back of Ukraine's invasion – countries like Brazil should see at least two years of great returns and currency appreciation.

But as it happened in past instances, fears tend to overblow in the very short term, as the connection between monetary policy and real economy is usually lagged in terms of months. The numbers presented above show that we quite probably are several months away from major changes in macro and corporate fundamentals.

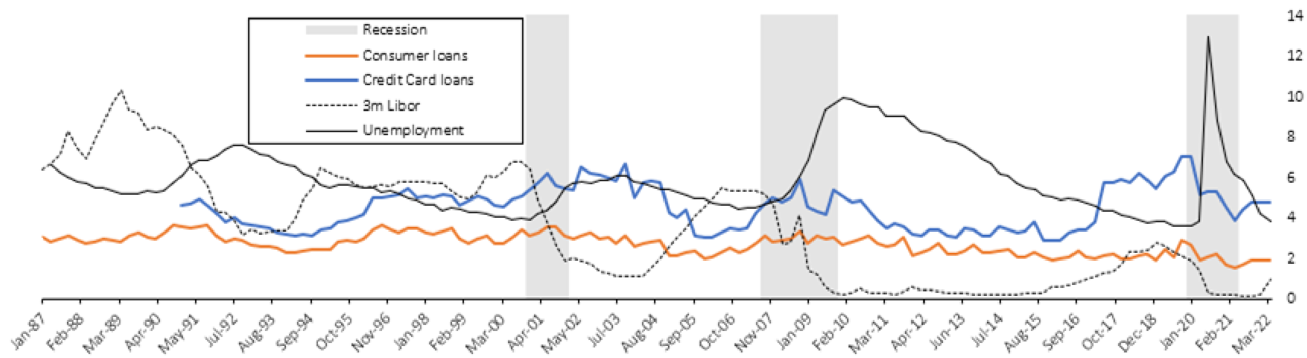
From a corporate perspective, businesses have already begun passing the increased prices on to customers, while 30-year mortgage rates have grown above 5% for new loans. These are early moves that signal a rise in cost of living for households and consumers across the board. However, the full effect on disposable income and eventually consumer demand has not yet manifested itself. For instance, loan default rates are a major indicator of household and consumer distress. Consumer demand is strictly correlated with these rates, and so far there is no sign of trouble – even among the loans issued by banks outside the top 100 in assets managed. These would be the national and local banks managing small nuclei of families in medium to small American towns, exactly the same population segments that originated the housing subprime loan crisis in 2006-2008. The graphs below put these default rates in historical perspective. The main consideration here is that although reference rates are increasing, they did not transfer meaningfully into the real economy yet. Sure, consumer staples consumption is already affected by growth in prices, but many other expensive items, such as mortgages and new cars, have yet to hit the average consumer. Therefore, default rates have no reason to begin worsening just yet – if one assumes they will worsen in the future.

Banks Not Among the 100 Largest in Size by Assets

Default rates on single-family residential mortgages (collateralized by real estate)



Default rates on consumer and credit card loans



Source: Bureau of Economic Analysis, Mortgage Bankers Association

Accordingly, we expect corporate earnings to continue going well in at least the next nine months. If true, this trend could surprise markets on the upside, as it has already happened in a couple of names this week. The tech sector is a good example: while the predominant view is that higher rates will kill growth, earnings surprises produced +20% price move in at least one case (Sprinklr). We believe this trend is not unusual or specific to the company. In fact, the US tech trade received third place in the top-10 trades in a recent Bank of America survey of fund managers managing close to $1 trillion in client assets. There is a camp of investors that recognize the extent of the discount on certain tech names, and their growth and business model resilience in the long-term.

Our view

For long-term investors like ourselves, this market overreaction produced large discounts to great businesses in various industries and geographies.

This kind of discounts are not without precedent. When lockdowns began in 2020, markets had basically left aviation for dead (Boeing, Airbus, Rolls Royce, MTX). Same story for large commodity conglomerates (Anglo American, Glencore, Trafigura) and many other industries. Was there really any meaningful chance that entire sectors would be permanently reduced? While possible, it is very unlikely. Single company bankruptcies are much more likely in a recession, but there are ways to mitigate this risk too. For industries that are nascent, innovative and with a small to medium average size of companies (i.e. tech) one should go for a diversified exposure (5 to 15 companies). For established industries, the choice should go to global, entrenched and profitable companies with solid balance sheets. Again, the much-reduced market valuations provide a defensive entry point for a long-term holding period.

The concept of long-term investing and buying at a discount to the real fundamental power are driving our selection. We remain confident that today's prices of certain businesses are a great entry point, if one can stomach the volatility and is willing to wait at least two years.

The best alternative to entering equity markets now is to stay in cash. However, at some point towards to end of 2022 we would not be surprised to see investment grade bonds yielding 5% to 7% for 10-year maturity. These would not be a bad choice if one wants to switch to a more conservative stance while getting income as we ride the US recession.

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