Asset Allocation Bi-Weekly

By the Confluence Asset Allocation Committee

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We publish asset allocation thoughts on a bi-weekly basis, updating the report every other Monday, along with an accompanying podcast.

Where's the Recession? A Recap

September 25, 2023

Precise recession forecasting is really difficult. Most recessions occur during periods of tightening monetary policy; however, history shows that monetary policy works with "long and variable lags," meaning that the impact of rising interest rates doesn't lead to consistent timing of downturns. It's a bit like wanting to schedule an outdoor event over the next 10 days, and the weather forecaster tells you it could rain in an hour or over the next 30 days. It's highly likely that he will be correct, but that forecast is useless for your scheduling purposes. For investors, the key time frame for a recession warning is probably six to nine months. Financial markets can continue in a "risk-on" mode for a year to 18 months before a recession and so getting overly defensive can hurt returns. On the other hand, getting a very late warning may not give an investor enough time to adjust portfolios.

In our 2023 Outlook, we suggested a recession this year was "highly probable." We could still be right, but it is clear that the clock isn't in our favor. In recent *Asset Allocation Bi-Weekly* reports, we have discussed various reasons why the economy has avoided a recession. For the most part, the economy has been less sensitive to higher interest rates, and these reports discuss why. In this report, we will recap those reports to create a guidepost of what could bring about a recession. For example, if a factor is still in place, it likely would suggest the recession could be further delayed. On the other hand, if that condition is changing, a recession might be on its way.

"The Case for New Home Sales" (May 22, 2023): One of the primary conduits of tighter monetary policy to slow the economy is through the housing market. Given the sharp rise in mortgage rates when we wrote our outlook, we were worried about a decline in home prices as such declines have historically been tied to serious downturns. However, as mortgage rates rose, existing homeowners have stayed put. Homebuyers are buying more new homes and homebuilders are accommodating these buyers with less expensive homes and by helping with purchases. Until some factor, such as rising joblessness, forces current homeowners to sell, this situation is likely to continue. ***Our take: This factor will likely continue to delay the recession***.

"The Green Shoots of Re-Industrialization" (July 3, 2023): As the world deglobalizes, the U.S. is reindustrializing. Far-flung supply chains, often in nations now deemed hostile, are leading companies, supported by policymakers, to build industrial capacity in the U.S. Private non-residential construction has been rising sharply. Given that various policies, such as the CHIPS Act and the Inflation Reduction Act, are just starting to have an effect, this support is in its early stages. ***Our take: This factor will likely continue to delay the recession.***

"Are Higher Interest Rates Bearish for Risk Assets?" (July 17, 2023): Higher interest rates are expected to slow borrowing. We are starting to see rising delinquencies for credit card debt and auto loans. However, there has been a rise in interest income for savers. After years of chasing yields in the more risky and esoteric parts of the financial markets, savers are now getting attractive interest rates on low-risk assets, such as T-bills. This factor may not delay the recession, but it may reduce the downside risk for risk assets. Why? The primary beneficiaries of this rising interest income are the wealthy, who also are the majority owners of equities. ***Our take: This may not delay the recession but could reduce the risk from one to markets***.

"Where's the Recession? Examining Employment" (August 14, 2023): In this report, we note that the labor markets received a shock from the pandemic. The 55+ labor force and employment fell well below trend. COVID-19 is particularly risky for older people, and we estimate that if this part of the labor market had remained on its pre-pandemic trend, the unemployment rate would be 4.9%. There is no evidence yet to suggest these workers are returning at a pace equal to the pre-pandemic trend. The impact on the labor market could be mitigated through immigration, but labor markets over the next few months will likely remain tighter than they otherwise would have been. ***Our take: Employers are adjusting to the lack of labor. Although strike activity is elevated, there are also reports of wage cuts which would suggest employers are adjusting. This factor should remain in place, but its impact does appear to be waning. Thus, it may not delay a downturn much longer***.

"Fiscal Tightening Looms" (September 11, 2023): The level of fiscal support has delayed the recession. The fiscal deficit has widened because of higher spending and falling tax revenue (partly due to the indexing of marginal tax rates; as inflation rose, the tax brackets shifted up). However, the moratorium on student debt repayments is coming to an end this month. The Biden administration has tried to soften the blow, but borrowers will be servicing their student loans again, which will reduce the spending power of the affected households. ***Our take: This is a worry. There is some evidence to suggest that these households assumed that the loan payments would never return and thus borrowed to fund other purchases. If that is correct, this issue could accelerate a downturn***.

Overall, the factors that we have highlighted in recent weeks suggest that the recession probably is an issue for 2024. Tightening fiscal policy is the only real worry, although some of this tightening will likely be offset by re-industrialization. The metrics on homes is not good; affordability is weak, but without a factor that forces sales of existing homes, we are probably looking at a mostly soft housing market. It's worth noting that residential real estate has had a negative contribution to GDP for nine consecutive quarters. So, it's not like residential housing is boosting the economy; instead, it is mostly not causing balance sheet problems for households.