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The stock and bond markets continue to act as if a recession is imminent. "Why might a recession come upon us?" you might ask. "Isn't the unemployment rate very low?" Yes, it is. While rising inflation has caused folks to defer purchases, the economy is still doing rather well. The markets are fearing recession because they're worried the Fed will cause one. The Fed is obviously raising interest rates, specifically, the fed funds rate (which is the overnight money rate between banks). They're doing this because they believe that, by doing so, they can reduce inflation. Unfortunately for the economy, they can only do that by reducing demand for economic goods to the point that prices come back down. That sounds like a recession, which is what probably would occur if they continued this activity.

As we pointed out in our April letter, the Fed thinks it can reduce inflation without causing a recession. Their track record isn't very good. I like to use the analogy of trying to put a nail in a wall upon which to hang a picture. One should use a rather small tack hammer for this job, so that if you make a mistake, you won't damage the wall. The Fed thinks it has a tack hammer; in reality, it has a sledgehammer. It might get the nail in the wall, but the chances the wall is damaged are high. This is what the financial markets are worried about. They've seen this situation before.

After hitting a low of 24.5% off its January high, the S&P 500 has risen a little and is hovering about 20% below its high as of this writing. This is normal behavior for a stock market anticipating a recession; it's what I call a "cyclical bear market." Should this scare us? No. The market is telling us that a recession is likely. If a recession occurs, its effects have been largely discounted by the market. If a recession does not occur, the market would begin a recovery. The sell-off improves the short-term risk/return probabilities for investors.

Long-term investors shouldn't worry at all. Outstanding businesses with healthy balance sheets should ride out a recession quite well, even though their stock prices are also declining. In fact, many such businesses emerge from the recession in better shape because their weaker competitors may be damaged by the recession, helping the stronger businesses' market power. Strong businesses can also often make smart acquisitions at good prices in times like these. It's often that the strong get stronger during a recession.

How bad could a recession get? We doubt the recession, if we get one, becomes terribly deep like the 2008-09 recession. The reason is that consumers' balance sheets are much stronger now than they were then. Likewise, the financial system's balance sheets are in better shape, especially the banks. I don't expect the sort of financial melt-down we had then. I would expect any such recession would only last about six months. Since the stock market tends to anticipate major economic moves by about six months, I wouldn't be surprised to see it hit bottom and start back upward about the time the recession begins. Again, that would be rather normal stock market behavior.

"Normal!" one might exclaim, "What's normal about a recession and a 20-30% decline in the stock market?" It's true that recessions have typically come along about once a decade for the last thirty-plus years, but we think that's going to change. Back in the "old days," when I was a young stock analyst, recessions were expected to occur about every four years. And they did! In a rising inflation environment, the Fed is inclined to get out the sledgehammer every few years to stop inflation. They never completely killed inflation, but they did cause recessions on a regular basis. Investors became accustomed to cyclical stock market behavior as well as to rising inflation.

We pointed out last quarter how globalization, technology, and deregulation did much to depress inflation and keep the Fed quiet over the last several decades. Thus, recessions became more rare. As we have oft noted, globalization is receding along with deregulation. This means inflation will likely rise cycle to cycle, and those cycles will probably be shorter.

There are some advantages to growing old, though the list gets shorter every year. One advantage is that there isn't much you haven't seen before. Shorter cycles and rising inflation are examples. We'd like to see neither, but, as I like to say, "You don't get to invest in the world you wish you had, rather you can only invest in the world you have." If this is the world we have, so be it. It isn't foreign to us.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

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