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RECESSION IN 2023?

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Most economists and the financial gurus in various large financial firms are predicting a recession in 2023. The gamut runs from Goldman Sachs' chief economist, John Hatzius, that the US may avoid a recession entirely, to almost all others that say recession is virtually inevitable.

> ***"So, what constitutes a recession?***
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> *In short, a period of significant decline in economic activity. A recession typically leads to drops in output and investment, falling profits for businesses and rising unemployment. The global financial crisis of 2007-09 shaved almost 4% off economic growth worldwide. In some countries, including Britain, France and Germany, the convention is that two quarters of negative GDP growth indicates a recession. But many economists believe this definition is too narrow."*
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> *Excerpt from The Economist, "What is a Recession?"*

The US experienced two consecutive quarters of negative GDP (Gross Domestic Product) growth in the first two quarters of 2022. Although this is the technical definition of a recession, most Americans did not suffer an economic downturn because of the strong labor market and increasing wages. Additionally, the cash accumulated during the pandemic when there weren't many opportunities to spend money, along with the money given out by the government, enabled people to continue their standard of living in many cases without being employed. So, if it is to be classified as a recession, it was very mild. Then the real culprit arrived – inflation.

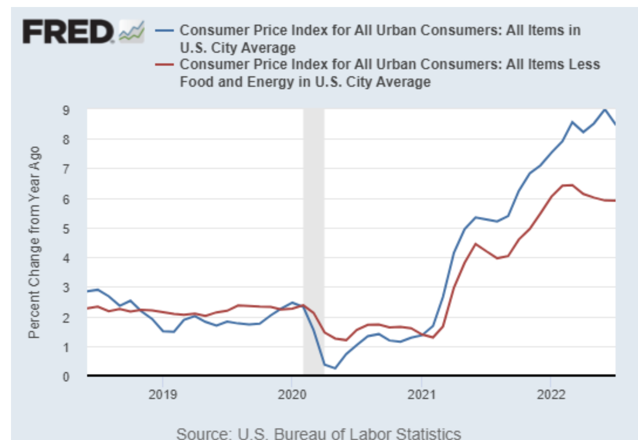
The great economist, Milton Friedman, famously said: "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." The politicians of both political parties along with the support of the Federal Reserve Board (Fed) bear the responsibility for unleashing this hardship upon the American people.

Arguably the massive waves of money created by the Fed and sent out by the government during the pandemic could possibly be justified because of dire need and the unknown nature of the problem and its consequences. However, continuing to send out trillion-dollar spending tsunamis, one after another, and dispensing them in a careless indiscriminate manner inevitably triggered the inflation which the USA is suffering under.

The inflation rate in 2022 reached a high of around 9% and the Fed was forced to take a strong stand. Chairman Powell resolved to tackle a problem that ironically, he took part in creating. He decided to follow the path of Fed Chairman Paul Volker who took a "no holds barred" approach to stopping the inflation from the 1970's.Volker was forced to raise interest rates to the 20% area in order to reverse the mistakes made in the 70's that led to double digit inflation. The strong Fed actions did lead to a difficult recession in 1981-1982. In fact, at that time, this recession was considered the worst since the Great Depression. Unemployment reached 11%. However, Volker's resolve did pay off – the backbone of inflation was broken, and we enjoyed two decades of prosperity with declining inflation. *(See chart below)*

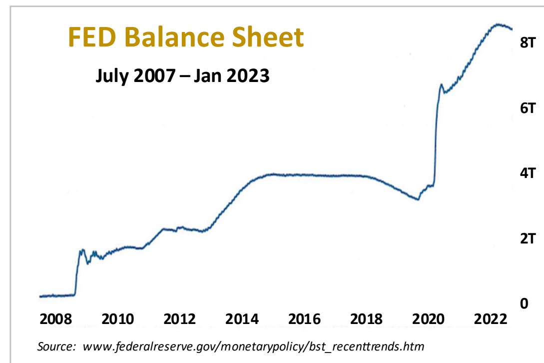
Chairman Powell is attempting to follow Volker's lead by raising interest rates by 4.25% from March through December. His efforts have had some success, the inflation rate has fallen to the 7% range. Nevertheless, it is still very far from his 2% goal.

The inflation monster has two distinct elements, commodities costs and wage costs. Inflating commodity prices are easier to deal with because the demand will drop off as prices



continue to rise; whether it is food, energy, lumber, metals or others. Wage inflation is much stickier because once a salary increase is given, it is very difficult to take it back, especially in a tight labor market like we have been experiencing. The primary weapon for fighting wage inflation is the painful process of recession where people lose their jobs resulting in rising unemployment. Oddly enough, it is not the inflation itself that causes most of the pain; it is the Fed induced economic slowdown caused by rising interest rates and restrictive money supplies.

Paul Volker faced a higher inflation rate, and it was more firmly entrenched over a longer period of time, but in other respects Jerome Powell's task is more difficult. One big difference is the size of the US federal debt: in 1980, it was less than one trillion dollars and now it is over $31 trillion. The consequences of that much debt are very dramatic. When Volker added 1% to the interest rate, it would add about $10 billion to the federal budget (1% of $1 trillion = $10 billion). When Powell adds 1% to the interest rate the cost is 31 times greater or about $310 billion. Clearly, Powell cannot raise rates to the level that Volker did without adding trillions to the budget deficit.



Powell does have one tool at his disposal that Volker did not have, the Fed balance sheet. There are 8.5 trillion dollars on the balance sheet as a result of all the money created primarily in the last 20 years. The Fed has begun the process of shrinking its balance sheet - roughly defined as being equivalent to the total US dollars in circulation - by taking money out of the system, which helps to slow the economy and bring down inflation. This process, called quantitative tightening (QT), like increasing interest rates contributes to the probability of bringing on a recession.

Another major difference between what the Fed faced in the 1970's and what the Fed is facing today is the role that the Administration is playing. Volker had the Reagan Administration that was assisting him in his inflation battle. Reagan cut taxes and regulation which was stimulative to the economy, supporting employment and increasing productivity (producing more goods and services which increases supply to bring prices down). This helped to soften the harsh effects of rising interest rates and actually helped to reduce inflation.

Today, Powell is faced with an Administration that is increasing taxation and regulation and, along with both parties in Congress, have pushed through massive spending bills (like the most recent $1.7 trillion boondoggle). These policies increase inflationary pressures by lessening the supply of goods and services due to greater government regulation and taxation resulting in increasing unemployment. At the same time demand increases due to all the money being spent. This will necessitate the Fed pushing rates higher for longer, which in turn increases the probability of a recession.

It is likely that the economists and experts are correct and that a recession will come upon us in 2023. It is an important distinction that market downturns and recessions do not necessarily occur together. In 2022 we had a sharp market downturn but no significant recession. 2023 may experience a flat or even an upmarket while the economy suffers with a recession; it is too difficult to call at this time.

OUTLOOK

2022 was a difficult year for the stock market, but the fourth quarter rallied and trimmed some of the losses. Stock values retreated from their lofty P/E levels (Price to Earnings ratio) to historically normal levels. If the P/E multiples remain in the 16 to 17 range, then the changes in the share prices will be driven by changes in the "E" or corporate Earnings. These earnings will be affected by the Fed's inflation response and whether it produces a recession or not.

Assuming that we do experience a recession (even a significant one) that will not rule out a positive year for the stock market. The market is a forecasting mechanism that will turn up or down, usually months before the circumstances which cause the movement to happen. At this time, we are remaining in our value-oriented cautious mode deploying some buffered ETFs (see the Oct. 2022 newsletter) and some inflation hedges. We are watching the inflation reports and the Fed's action and comments to determine if a change in policy is in the works and then to change our investment stance. Until then we intend to stay fairly defensive while still participating to some degree in any positive movement in equity prices. As always, when circumstances change so do plans and actions.

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