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*advice; judgment; resolution; wisdom

Turbulence Continues, But Clearer Skies Ahead

The BLUF (or "bottom line up front" in military parlance): the Federal Reserve's campaign against inflation has been more intense and longer lasting than we anticipated a year ago, and it will continue in the new year. But there are now abundant signs that the Fed has already done more than enough to quell the post-pandemic inflation surge, and it is likely that monetary policy will reverse course before the end of 2023. This will set the stage for a recovery in both the equity and fixed income markets as the year progresses. Considering the damage that has already been done, we are probably closer to the end of the bear market in risk assets than commonly believed.

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There are three key questions on the minds of investors entering 2023: Is a recession coming? If so, when, and how bad might it be? And what could or should be done about it?

Due to the pandemic, we are living through an economic and market cycle unlike anything in anyone's memory. For that reason alone, we should be prepared for the possibility that things truly will be different this time and we will sidestep a downturn. But based on an array of historically reliable indicators and strong anecdotal evidence, a recession now seems likely in the year ahead. Among the sources of concern:

- broad measures of money supply and bank deposits are falling meaningfully for the first time in over 40 years; excess household savings, built up during the pandemic, have been liquidated, and reliance on credit card borrowing is rising sharply.
- bank lending standards are tightening, bank CEOs are openly worried about business conditions, and bank reserves for future credit losses are rising.
- unemployment trends, beneath the surface, are starting to worsen, with household measures of employment showing significant job losses for the last three months, and initial jobless claims rising steadily since the spring.
- stock market sector behavior is consistent with a poor outlook, with traditional, staid "defensive" groups (such as utilities and consumer staples) outperforming, and pro-cyclical, growth-oriented sectors (such consumer discretionary and technology) underperforming.
- most tellingly, current bond market behavior is historically predictive of a recession, with the "yield curve" (the spread between long-term rates set in the market and short-term rates set by the Fed) now deeply negative. Such a condition is the market's way of saying "short-term rates will be lower, not higher, in the years ahead", invariably because the Fed has gone too far in its inflation fight, is about to cause a downturn, and will have to reverse course.

Although we were too optimistic about it a year ago, inflation has almost certainly peaked, and this may hold the key to the severity of any recession. Commodities and goods prices are already declining, services inflation is flattening out, and the yearlong nationwide decline in housing prices is just starting to show up in official inflation statistics. Indeed, it appears that the Fed is now "driving by looking out the rear-view mirror", with a relentless focus on curing what has already happened, and with little concern for what may be coming. It is noteworthy that the Fed believes a less robust labor market is critical to holding down wage growth and achieving its inflation goals – but a "less robust labor market" is merely another way of saying "higher and/or rising unemployment" – which is part of the very definition of a recession.

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recognizes the changed environment and pauses or reverses course. Although words matter less than actions, the Fed's public statements suggest they are prepared to keep short-term interest rates high for an extended period. This is a recipe for a deeper and longer period of contraction, and we hope their rhetoric is nothing more than "jawboning".

Finally, is there an obvious response to these conditions? Yes, and no. What is clear is that for the first time in more than 15 years, and following one of the largest surges in interest rates since the 1700s, fixed income securities have enough income and return potential to meet or exceed investors' needs. At current levels, we believe preferred securities and other credit instruments represent particularly good value and could deliver equity-like returns. While the Fed's approach may cause stress in certain pockets of the credit markets, our core fixed income strategy, with its emphasis on high quality issuers, is poised to be rewarding.

By contrast, major changes to equity portfolios should be considered with caution. We believe a true Fed "pivot" away from its tight monetary policy is likely in 2023, and risk assets will rally in anticipation of a better economic and corporate profits outlook into 2024. There is a very good chance markets will be higher a year from now notwithstanding the possibility of economic pain in the interim. Should investors move to the sidelines, hoping for a more obvious buying opportunity? Or reposition equity portfolios away from growth companies and toward defensive holdings? The record here is clear: it is extremely difficult to reverse course from bearish to bullish in a timely manner, perhaps just months or weeks later, because – as one veteran Wall Street trader puts it – "when the time comes to buy, you won't want to". Every equity market cycle is strongest at its earliest stages, and mis-timing portfolio changes can and will significantly limit an investor's potential subsequent returns.

Put differently, markets are always forward-looking. But in 2022, equities took this to an extreme and began to reflect the impact of Fed tightening and a possible recession a year ago, well before even a hint of economic weakness was visible, and far earlier than has been the case in prior cycles over the last 75 years. Given that the market's principal obsession in 2022 was inflation, and inflation has almost certainly peaked, isn't it possible that stock prices might begin to discount *improving* conditions equally far in advance of their arrival? Fed policy, and the economy's likely response, is so well understood that predicting an upcoming recession is now a mainstream, consensus view. Therefore, *it is entirely plausible that the markets already largely reflect that outcome*. It is said that "no bear market ever ended before a recession had begun", but the uniqueness of our current cycle argues for keeping an open mind about first time-ever events.

We have reminded readers of *Consilium* many times over the years that accurately predicting economic and corporate events is not a sure-fire path to investment success, because no one can confidently predict how the markets will respond to these events. But we *can* say with confidence that the worst economic outcomes rarely occur; that the market rebound, when it arrives, could be uncomfortably quick; and that the precisely correct time to buy will only be clear well after the fact.

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On behalf of everyone at Mid-Continent Capital, we would like to thank our clients and readers of *Consilium* for their support, and we offer our best wishes to everyone for a healthy and prosperous 2023.

Sources: Federal Reserve Bank of St. Louis, FactSet, MKM Partners