MARKET COMMENTARY

RECESSION; MORE LIKELY THAN NOT.

Nothing encapsulates the current economic crossroads so precisely as the word ‘dilemma.’ A dilemma is a choice between two equally unattractive alternatives. Since neither outcome is desirable, they often feel like no choice at all.

Allow us to explain. Would you rather:

a. Maintain a growing economy, albeit with unacceptably high inflation, declining purchasing power, persistent shortages and a drum-tight labor market?

b. Tame inflation, trigger a recession, reduce asset prices and increase unemployment?

When confronting these supposed alternatives, many would say ‘is there a third option?’ There is, the so-called soft-landing, but given the differential between where interest rates are and where interest rates need to be, we would ascribe this a low probability. Add a hawkish Fed, sour investor sentiment and the deterioration in real-time economic data and we believe a recession is highly likely. In fact, we may already be in one.

US Real GDP is estimated to have declined -1.6% in the first quarter and the Atlanta Fed currently estimates second quarter GDP at -1%. The definition of a recession is two consecutive quarters of negative growth.

The market is repricing risk assets both for higher interest rates and a recession which explains why the S&P 500 has declined 11 out of the past 13 weeks, on its way to one of the worst first halves in more than 50 years. Not to be outdone by its equity counterpart, the fixed income market is having its worst year since 1788. So much for diversification…

In the past 12 months, only four sectors have positive returns. Energy is up strongly because of the sharp rise in oil and natural gas prices. Sectors traditionally perceived as defensive (and thus more recession-resistant) like utilities, staples and health care have positive returns, while economically sensitive sectors like consumer discretionary wallow in a bear market. Economic hatches are currently being battened and business confidence is eroding fast.

As frequent readers can attest, owning risk assets during a recession isn’t just likely, it’s inevitable. The inexperienced and overconfident (frequently one in the same) may think they can pivot in and out of markets or tilt towards defensives at just the right time. While some may have successfully market-timed, those who think they can vastly outnumber those who have, reminding us that all investing involves risk.

We know that owning equities through recessions and sell-offs are part and parcel of being an investor. There have been 11 since 1948 and by our measure, equity returns since have been acceptable. It’s one of the eternal conundrums of investing; investors ‘should’ like low prices and the potential for higher returns that they imply, yet no one wishes for a bear market.

While it’s pure conjecture to opine how long or deep the next recession will be, there are signs it may be a manageable one. Our nation’s banks are currently well-capitalized suggesting ample wherewithal to absorb credit losses. Many consumers have strong balance sheets and there are few signs of excessive leverage in the system. The labor market remains sufficiently tight so that a modest deterioration may not be the worst outcome. Corporations have high margins which suggest the ability to absorb profit headwinds and debt appears manageable. If anything, we think systemic risk is more likely to emanate from emerging markets who have borrowed extensively in US dollars (which have dramatically appreciated, making them more difficult to repay).

We have no special insight into how long the current rate-hiking regime will last. We would describe the situation as 'fluid.' Nothing illustrates this as much as the Fed raising rates 75 basis-points in June, six weeks after saying a 75 basis-point hike was not being actively considered. We do know there's an unavoidable lag to economic data and central banks often over-correct in their search for a neutral rate.

Regardless of what happens with interest rates or the economy, our process and discipline remain consistent. We seek to identify companies with competitive advantages, a reasonable expectation of growth and a decent probability of creating shareholder value over a business cycle. At the beginning of 2022, we said we didn't expect the 'everything rally' to continue. While neither of the choices confronting central bankers seem palatable, we do believe that higher interest rates will eventually slow economic growth and subsequently inflation. Should a recession result, we believe the Fed would likely temper rate increases. Stock prices may continue to decline in the interim, so we continue to be measured in our approach, weighing the relative risk and return potential of each prospective investment.

Thank you for your continued support and as always, if you have any questions, please don't hesitate to reach out to your Bridges Trust Relationship Manager or any representative here at the Firm.

Sincerely,

Bridges Trust Investment Committee

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Sources: Bureau of Economic Analysis 5/26/22 estimate; Atlanta Federal Reserve 6/16/22 estimate; FactSet; Bloomberg; Deutsche Bank (Measured by Total Return of U.S. 10 Year Treasury); FactSet as of 6/27/22; Bloomberg Finance LP, JP Morgan; & 13Board of Governors of the Federal Reserve System; Federal Reserve Economic Data–St Louis Federal Reserve; US Bureau of Labor Statistics; yardeni.com; Vitor Gaspar and Ceyla Pazarbasioglu; Investopedia; Reuters; Bridges Trust 1/3/22.

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