# MARKET COMMENTARY

## THE SLOW ROLL RECESSION

Regular readers may recall that we said the 'everything rally' was unlikely to continue in January 2022. We'd been calling for higher interest rates since 2021 and as inflation went from transitory to entrenched, we expected a significant policy response from the Fed. Rate hiking cycles tend to slow economic growth (which is why they do them) but they also tend to trigger recessions. Consequently, the titles of our Market Commentaries over the past 18 months have been rather glum.

> *"2022: Less of a Sure Thing."*
> *"The Hits Keep Coming."*
> *"Bad News Travels Fast."*
> *"Recession: More Likely Than Not."*
> *"Revenge of the Hawks."*
> *"A Puddle of Muddle."*
> *"The Only Way Out is Through."*

Flash forward to July and we find ourselves in the midst of a bull market. The S&P 500 is up more than 20% from its October low and has recovered much of what it lost in 2022. The Nasdaq Index is up 30% year to date and is having its best first half ever. While our cautious stance served us well in 2022, it's been less helpful in 2023.

Thankfully, our process isn't reliant on us making accurate macro-economic forecasts. In our industry, there are two types of people: the humble or those who are about to be. It's important that we do not anchor to prior views and that we consistently test our hypotheses as data unfolds. It's true that economic data has held up better than many expected and meaningful progress has been made on inflation. The Consumer Price Index (a popular inflation indicator) has dropped from 9% to 4%, job openings are off their peak but remain healthy and even the housing market is showing signs of life. The pause (or was it a skip?) in June when the Fed opted not to raise rates lent credence to the 'peak Fed' narrative. Could it be possible that Jay Powell has pulled off that rarest of feats, the so-called soft-landing?

Sure. But we still don't think it's likely.

We're willing to concede that this economic cycle has more than its share of idiosyncrasies. The US consumer accumulated almost $5 trillion of savings during the pandemic. These additional funds helped blunt (or at least postpone) the demand destruction that typically accompanies higher prices. The Fed also suppressed mortgage rates which resulted in 80% of US homeowners with mortgages having a mortgage rate below 5%. This created a step-change decline in debt service as a share of personal income, freeing up additional borrowing capacity. Add in three years of student loan forbearance and the consumer has earned his moniker and then some.

These additional measures helped keep the US economy humming and numbed much of the impact of higher rates. As we've remarked previously, a well-heeled consumer is a good thing, unless you're trying to curb inflation. Most central bankers will admit that fiscal policy acts with a long and variable lag. Given the delta between where inflation was when they began (almost 8%) and where rates were (near 0%), the Federal Reserve had a lot of catching up to do. We would argue the first

half of rate hikes were merely the removal of accommodation, and rates have only been restrictive for a few months. In other words, the lag could be longer than expected.

There are a number of explanations for the new bull market. Inflation is moderating, the bank crisis appears contained, the debt ceiling is resolved (at least temporarily), the Fed is close to done, etcetera. All are valid. But students of history will point out two things.

The first is that the yield curve has been inverted since last July. While its predictive power varies based on what part of the curve you measure and provides no guarantee of future results, the yield curve has inverted before every recession of the past 50 years. Not only has the inversion been longer than average, it’s also been deeper, neither of which gives us confidence that this signal is a false alarm.

The second is that the equity risk premium (a measure of the valuation of equities relative to bonds) is at its lowest level in about 20 years, suggesting that equities are not currently priced for a softening economy. There are three likely ways this premium could normalize. The first is that bond yields could fall (and the yield curve suggests they will), S&P earnings could grow (and the market suggests they will) or S&P valuations could contract (which pretty much no one is saying).

In short, we think bonds are priced for a recession while equities aren’t. At 19 times the next twelve months’ earnings, the S&P 500 is currently more expensive than any time in the past 10 years, absent the pandemic. The consensus estimate is for 12% earnings growth in 2024, which exceeds the 10-year average of 8.6% (a period that included major tax reform and the largest stimulus in history). Perhaps this time *is* different, but we don’t think the odds are favorable.

Of course, our process isn’t dependent on our ability to forecast the macro-economy. We are long-term investors who assess the risks and rewards presented by various asset classes. Our caution over the past 18 months may have left a few basis points on the table, but year to date, we’ve been pleased with our core security selections. Consequently, we continue to maintain our defensive stance, waiting for better opportunities to put your capital to work. We thank you for your continued trust and should you have any questions, please don’t hesitate to reach out to your relationship manager.

Sincerely,

Bridges Trust Investment Committee

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