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July 31, 2022

MARKET UPDATE

This is not a pipe.
(It's not a recession either.)

What is a recession?

Could the "official" definition of a recession be any more subjective? Keep in mind that we are only in a recession when the National Bureau of Economic Research says so. This is the same organization that announced at the end of 2008 that we entered a recession a year earlier in Dec 2007.

As we discussed last month, the widely used definition of a recession is a fall in GDP for two consecutive quarters. There has only been one time in the late 1940s when this was not the case. But following the -1.6% GDP print for Q1 and ahead of the first estimate of GDP for Q2, the White House Council of Economic Advisers posted a blog on how a recession is determined, citing:

"What is a recession? While some maintain that two consecutive quarters of falling real GDP constitute a recession, that is neither the official definition nor the way economists evaluate the state of the business cycle.

Instead, both official determinations of recessions and economists' assessment of economic activity are based on a holistic look at the data—including the labor market, consumer and business spending, industrial production, and incomes. Based on these data, it is unlikely that the decline in GDP in the first quarter of this year—even if followed by another GDP decline in the second quarter—indicates a recession."

The timing seems suspicious. With personal consumption already weakening and consumption being the most significant component of GDP, the last thing the White House wants is for people to pull back on spending due to recession fears.

Treasury Secretary Janet Yellen also joined in ahead of the Q2 GDP estimate, saying, "This is not an economy that's in a recession, but we're in a period of *transition* in which growth is slowing." So no worries, the slowdown is only transitory! Just like inflation?

The first estimate of Q2 GDP did come in negative, with the economy contracting 0.9% after falling 1.6% in Q1. The yield curve is almost completely inverted from 2-year rates to 10-year rates, which has been an almost perfect indicator of an upcoming recession.

We won't debate whether we are in a recession or heading towards one, but the two data points above have a stellar batting average when it comes to forecasting a recession.

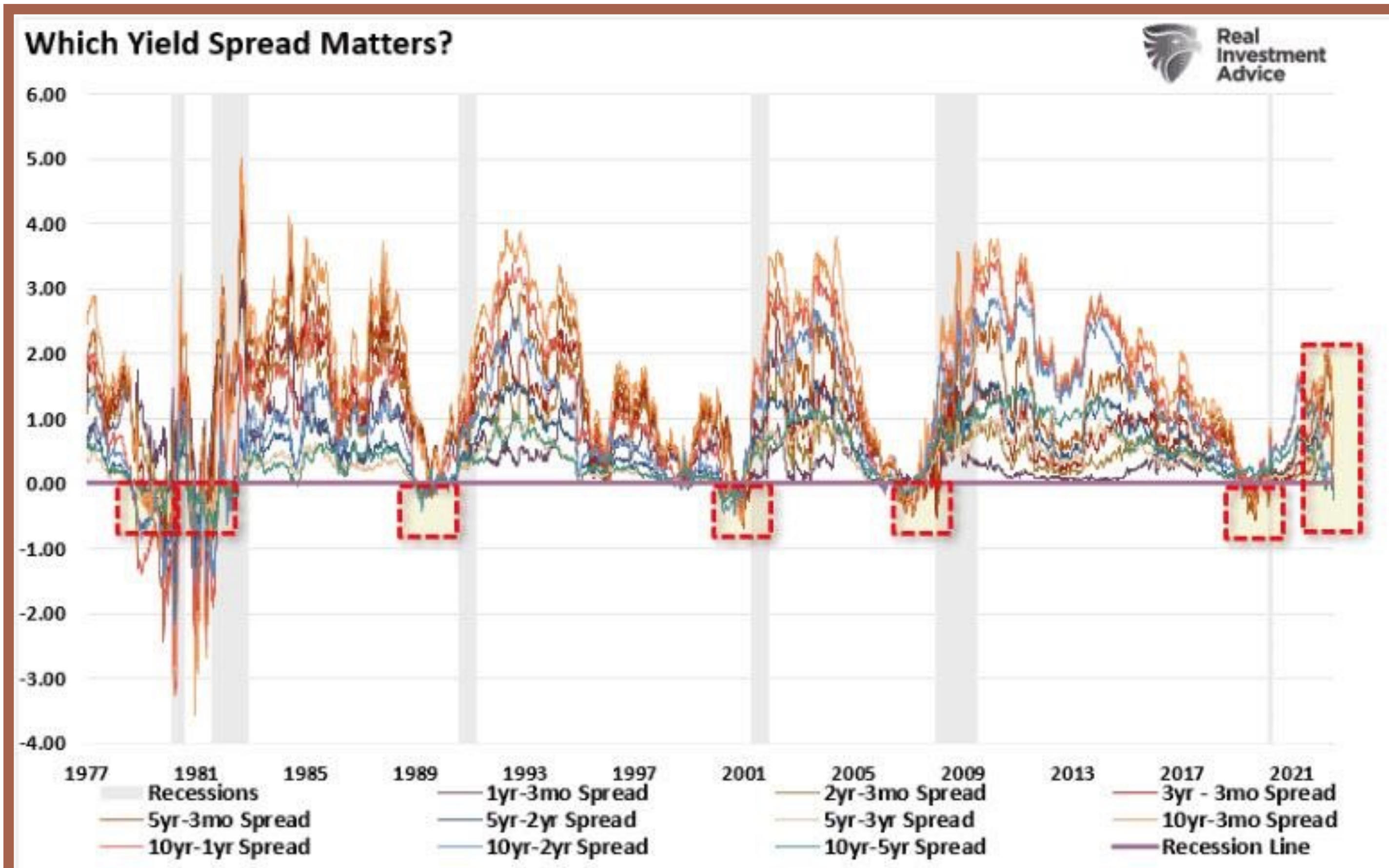
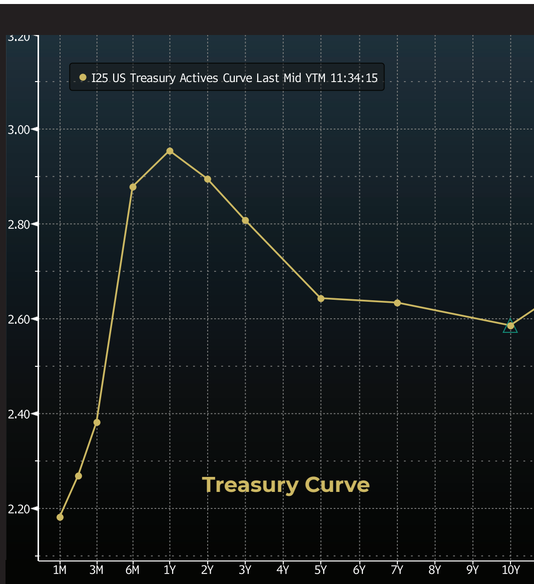
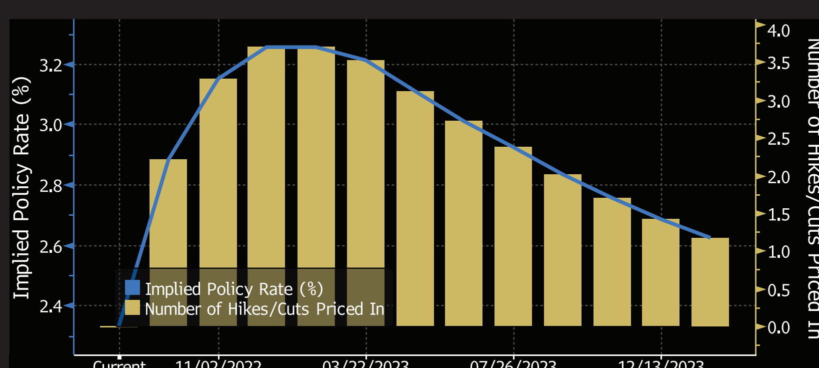


Chart Source: Real Investment Advice, July 26, 2022





Graphs from Bloomberg Finance LP

The meat of the Fed meeting.

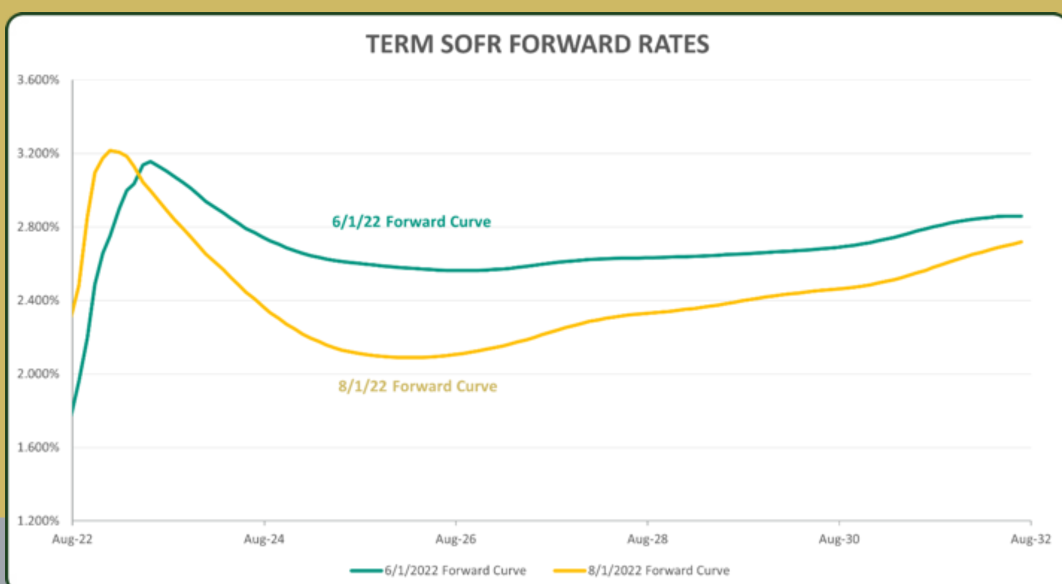
The Fed hiked rates by 75bps, in line with market expectations. Since we did not get an updated Summary of Economic Projections at this meeting, the focus was on the Fed's statement and Powell's press conference following the meeting. While the Chairman didn't say anything earth-shattering, he certainly made clear the Fed is determined to bring inflation back in check, even at the risk of slowing the economy further, admitting that the "path has clearly narrowed" to stem inflation while avoiding a recession.

But what does that mean moving forward? Unfortunately, the Fed doesn't have a clue. This was clear as Powell said the Fed isn't going to offer any more forward guidance this year. That gives them maximum flexibility to figure it out as they go, harkening back to former Chair Yellen's favorite guidance, "The Fed will remain data-dependent." In Powell's words, "we think it's time to just go to a meeting-by-meeting basis, and not provide the kind of clear guidance that we did on the way to neutral."

Powell was asked repeatedly whether the US was in a recession and shot the idea down each time… pointing out that too many areas of the economy are performing too well, specifically the labor market. Again, the correct answer is probably "depending on how you define a recession."

Market Reaction

Rates across the curve have moved lower since the Fed meeting, and GDP print on fears the economic slowdown will be further exasperated as the Fed continues to tighten financial conditions. Rate expectations spiked following July's 9.1% CPI print but have settled as recession concerns plague markets. The peak rate is back down to roughly 3.30%, while the pace of the rate hikes and subsequent rate cuts has been accelerated, with the market pricing in rate cuts to begin by Q2 2023.



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