Insights
Market Outlooks

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Tightening “Tsunami” Increases Recession Risk

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Monetary tightening is increasing the risk of a technical recession, i.e., two quarters of negative economic growth, but we don’t see substantial risk of a recession that is longer than that.

Last month our Global Market Outlook warned of the risk of a policy mistake. Today, risks are even more skewed to the downside. As central banks navigate inflationary impulses and markets react to the daily news cycle, we are assessing the implications for longer-term growth prospects and the ways in which investors should respond. Given persistent inflation prints and the commitment by central bankers to “get ahead of the curve,” prospects for avoiding a technical recession are declining.

Despite the feedback loop between inflation, wage pressures, and corporate earnings, the past decade has shown us that central bankers do have the tools they need to stimulate growth. We still remain constructive on select risk assets, favoring higher-quality companies that can drive bottom-line growth. We see increasing opportunities in fixed income, given higher yields and the potential for capital appreciation. And we believe that diversification is key, including exposures to assets that are uncorrelated to equities.

Below, answers to six of the most urgent questions we’re receiving from clients help explain our rationale for these views.

1. What is your take on the macro environment and the Fed's recent actions?

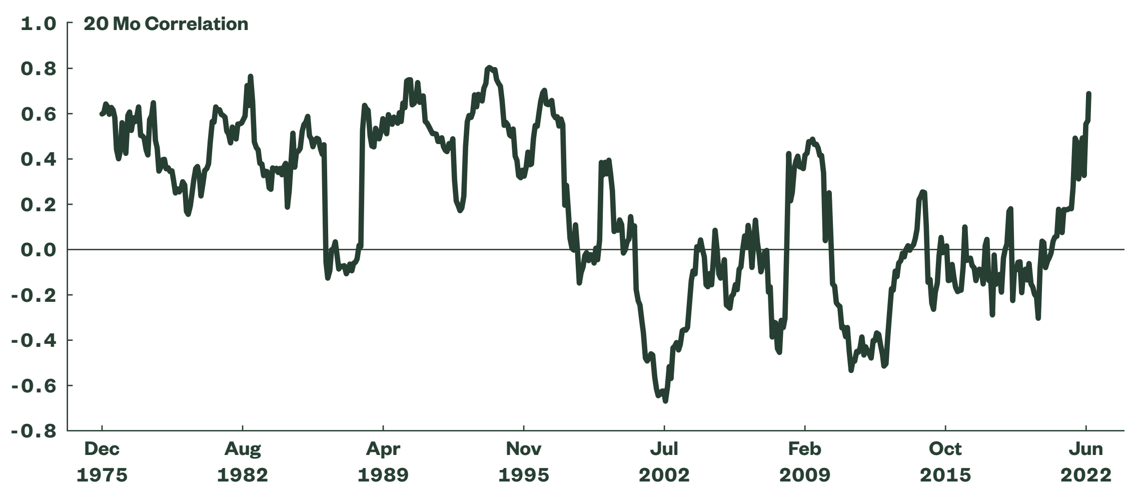
The Fed's brisk walk toward policy normalization has turned into a veritable sprint with June's 75 bps hike. The FOMC[1] has made a "whatever it takes" pledge to bring inflation down and that, unfortunately, means serious headwinds for growth. In fact, we seem to be just a hairbreadth away from a technical recession already. Whether the final Q2 data plays out that way or not, the reality of a sharp growth slowdown is upon us. We look for below-potential growth in 2023 and the possibility of even worse outcomes if the Fed proceeds with all of the hikes it has penciled in. We continue to believe that the data flow over the next few months may allow the FOMC to slow the tightening pace in time to avoid a worst case scenario, but risks are clearly skewed to the downside.

2. What is most concerning to investors about an inflationary environment?

In addition to the macroeconomic effects of higher prices, what concerns us most is the way in which inflation is putting pressure on corporate earnings — i.e., it challenges companies to maintain their margins in a much more fluid business landscape.

From a portfolio management standpoint, inflation is also concerning because it makes stocks and bonds much more correlated, especially in a slower-growth environment, which limits the options that investors have for portfolio diversification.

Figure 1
Correlation of S&P500 and Bloomberg U.S. Aggregate Total Return
December 31, 1975–June 14, 2022



Source: FactSet, S&P, Bloomberg. 20-month correlation shown.

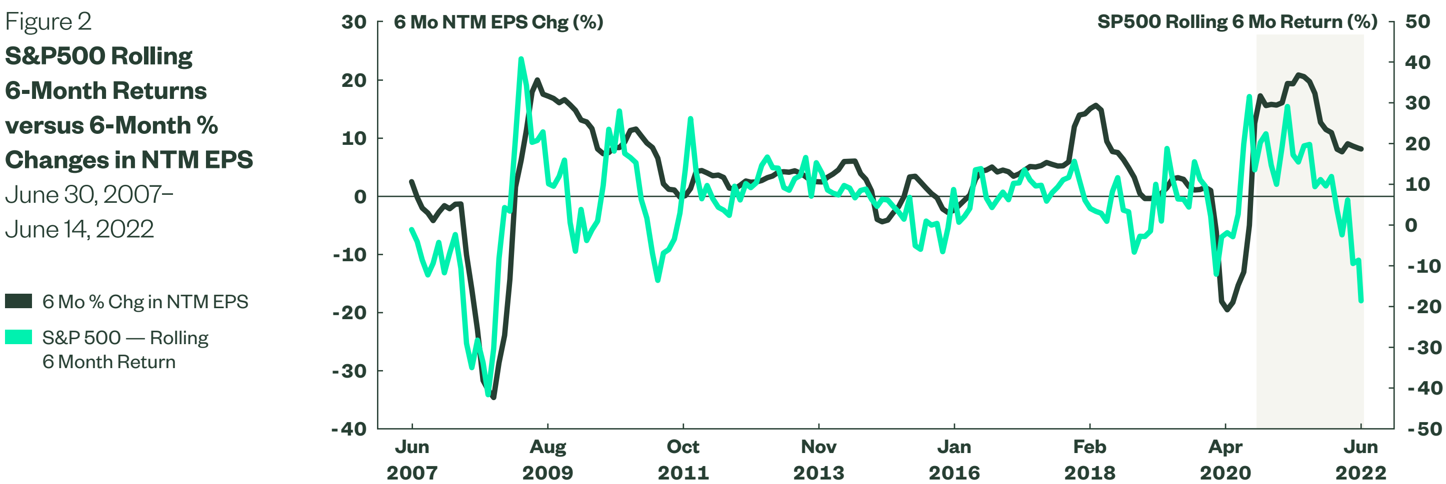
3. Are we approaching a market bottom?

We may be close to a bottom, but close to a bottom is not calling a bottom. Macro concerns are unresolved, and there is likely still more pain to be felt by investors in the immediate future. Looking beyond the near term, though, equity markets do display several resilient signs.

Valuation multiples are below long-term averages and are in-line with the higher rates we are seeing. Earnings have not slowed, and earnings expectations show a continuing upward trajectory. The disconnect between earnings per share (EPS) estimates and market performance is as large as we have seen over the last 10 years (see Figure 2). And while analyst estimates often lag markets, this historically large gap suggests that markets may have over-corrected for an earnings decline.

Current analyst expectations for Q2 EPS is +5.2%, and +9.2% for full-year 2022. In a typical recession, we would see an EPS decline of about 26%, and this level of decline seems unlikely given our expectations for a relatively short technical recession. Conversely, a ~20% decline in the S&P500 is closer to what we expect to see in protracted recessions. The S&P500 declined by 29.7% in 1974 (recession lasted 16 months) and by 38.5% in 2008 (recession lasted 18 months). Since 1990, for a typical recession (10 months) the decline is 8.8%.

Figure 2
S&P500 Rolling 6-Month Returns versus 6-Month % Changes in NTM EPS
June 30, 2007–June 14, 2022

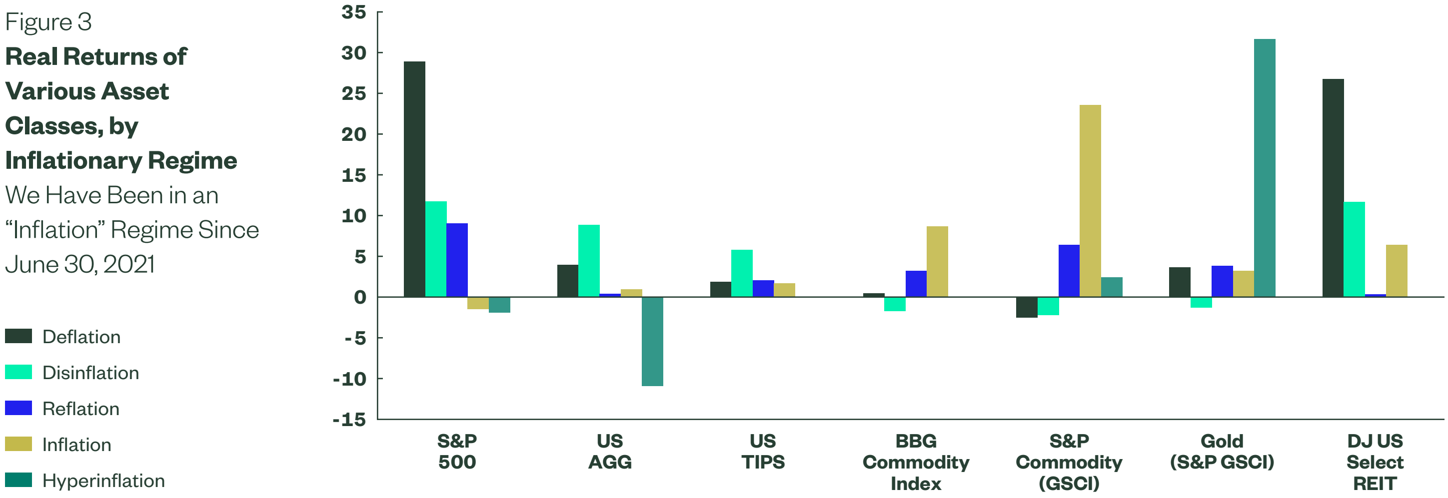


Source: FactSet, S&P. NTM = next twelve months.

4. How should I think about portfolio allocation in inflationary times?

Investors should expect equity assets to underperform in the near term. Figure 3 shows the real returns of various asset classes during different types of inflationary regimes.[2] Given the current high correlation between the returns of stocks and bonds, investors should build hedges. Based on the performances shown in Figure 3, today's investors might be well advised to hold onto their real assets, which provide the best real returns in inflationary times.

Figure 3
Real Returns of Various Asset Classes, by Inflationary Regime
We Have Been in an "Inflation" Regime Since June 30, 2021



Source: State Street Global Advisors, FactSet, US Bureau of Labor Statistics; Data: S&P 500 from 03/31/1970 to 03/31/2022, Bloomberg Barclays U.S. Aggregate from 12/31/1975 to 03/31/2022, Bloomberg Commodity Index from 03/28/1991 to 03/31/2022, S&P GSCI from 03/31/1970 to 03/31/2022, S&P GSCI Gold from 12/30/1977 to 03/31/2022, Dow Jones U.S. Select REIT from 03/31/1987 to 03/31/2022, Bloomberg Barclays U.S. Treasury Inflation Protected Notes (TIPS) from 03/31/1997 to 03/31/2022.

State Street's current tactical allocation reflects this thinking as well. We are marginally underweight equities, with our view supported by the earning trends and valuations noted earlier. We maintain an underweight to bonds, but are watching cyclical developments and market technicals that might shift that view. We remain overweight to cash and commodities as a hedge to inflation.

5. Where do you see opportunity?

Though we would still expect most investors to be underweight fixed income, strategic investors with longer time horizons should consider buying. Specifically, income-oriented investors are now able to lock in quite attractive yields. Corporate DB[3] pension plans may want to take the opportunity to liability-hedge given high funded ratios, and public pensions can now approach their long-term return targets using only diversified fixed income.

While it is unclear whether we've seen a peak in the US 10-year Treasury yield, we're certainly not too far from it. So it may make sense for investors to consider buying duration. Corporate borrowers remain in strong shape from a balance sheet and earnings standpoint. With regard to High Yield, the potential for recession — and rising defaults — gives us pause. Lastly, valuations in Emerging Market Debt are attractive but are threatened by US Treasury rates and the strength of the dollar.

In sum, while there is value emerging in lower credit, for the time being we would encourage investors to stay invested or add to higher-quality issuers.

6. What indicators are you watching?

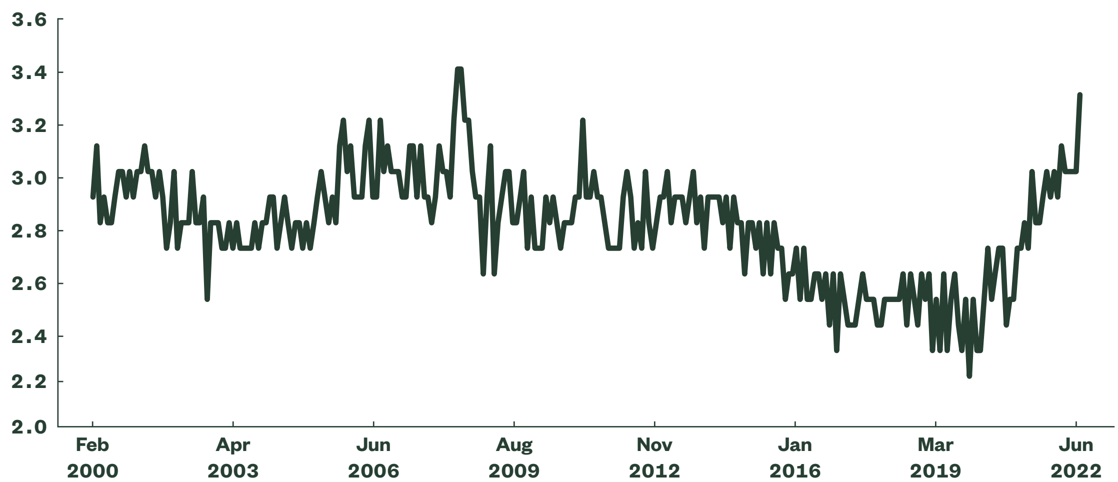
There are many, but three indicators are top-of-mind at the moment.

- University of Michigan's tracking of the expected changes in prices during the next 5–10 years suggests whether inflation expectations are getting anchored. A recent move up of 30 bps suggests that increased inflation expectations are likely to persist (see Figure 4).

- As we enter Q2 earnings season, we are firmly focused on management's response to policy tightening, as this will indicate companies' confidence in their ability to manage their margins in the context of higher inflation and higher rates. We expect confidence levels to be reflected in EPS revisions leading into, and getting out of, the earnings season. We look to see if EPS downgrades catch up to the downtrend in equity markets.

- China's policy path remains a key driver of global risk assets, as it has the ability to provide an easing of supply constraints and a demand stimulus. China's Covid response has exacerbated supply chain distortions — a "softer touch" on Covid would signal an easing of supply constraints. Unlike other large central banks, the PBOC has been on a easing path, thereby providing a balance against global tightening and stimulating demand.

Figure 4
Expected Changes in Prices During the Next 5–10 Years
Monthly, February 29, 2000–June 30, 2022



Source: University of Michigan, Bloomberg.

Bottom Line

The FOMC felt that June 15 was their "whatever it takes" moment and wanted to leave no doubt in anyone's mind that they will do what's necessary to bring inflation down. We believe that central bankers' actions will create a steady drag on economic growth, which will likely lead us into technical recession. We do trust that central bankers will limit their actions as necessary to make sure that any such recession is not a protracted one. The "tightening tsunami" is upon us, and we continue to look for hopeful signs, in the markets and from central bankers, that a steady hand is at work.

Chris Sierakowski, Matt Nest, Chris Carpentier, and Keith Snell contributed to this article.

Endnotes

1 Federal Open Market Committee.

2 Annual percentage rate of return on an investment, adjusted for inflation.

3 Defined benefit.

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- Build from breadth
- Invest as stewards
- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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