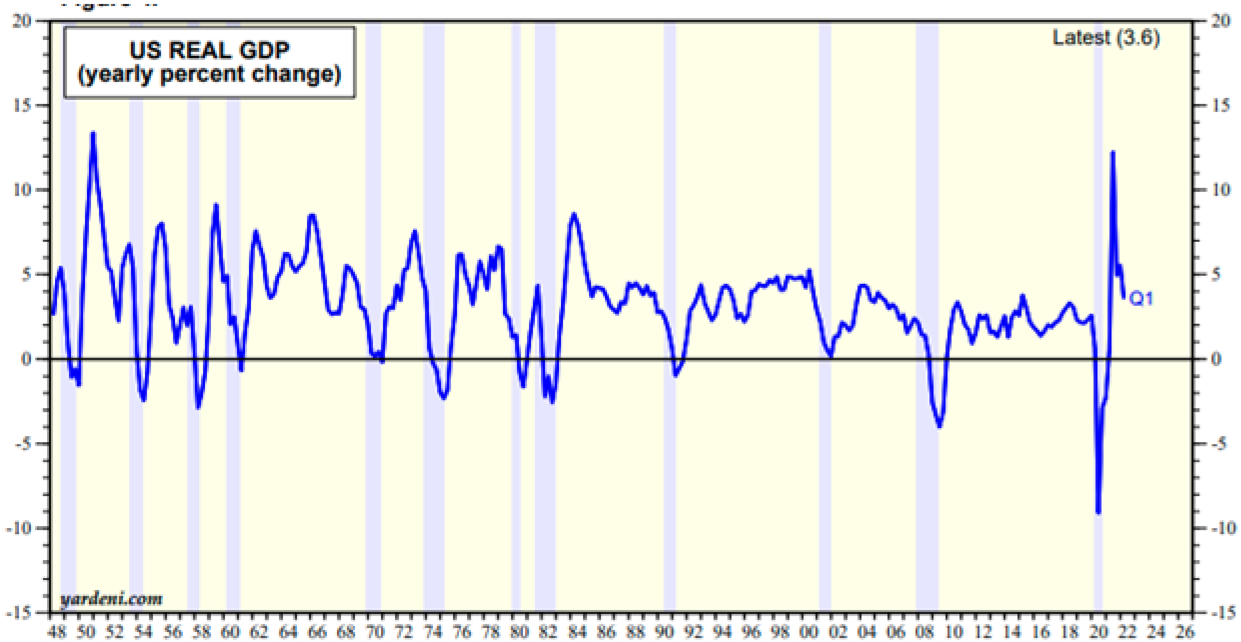
Week in Review

Friday, May 20th, 2022

1. Financial Markets are Pricing in a High Probability of Recession

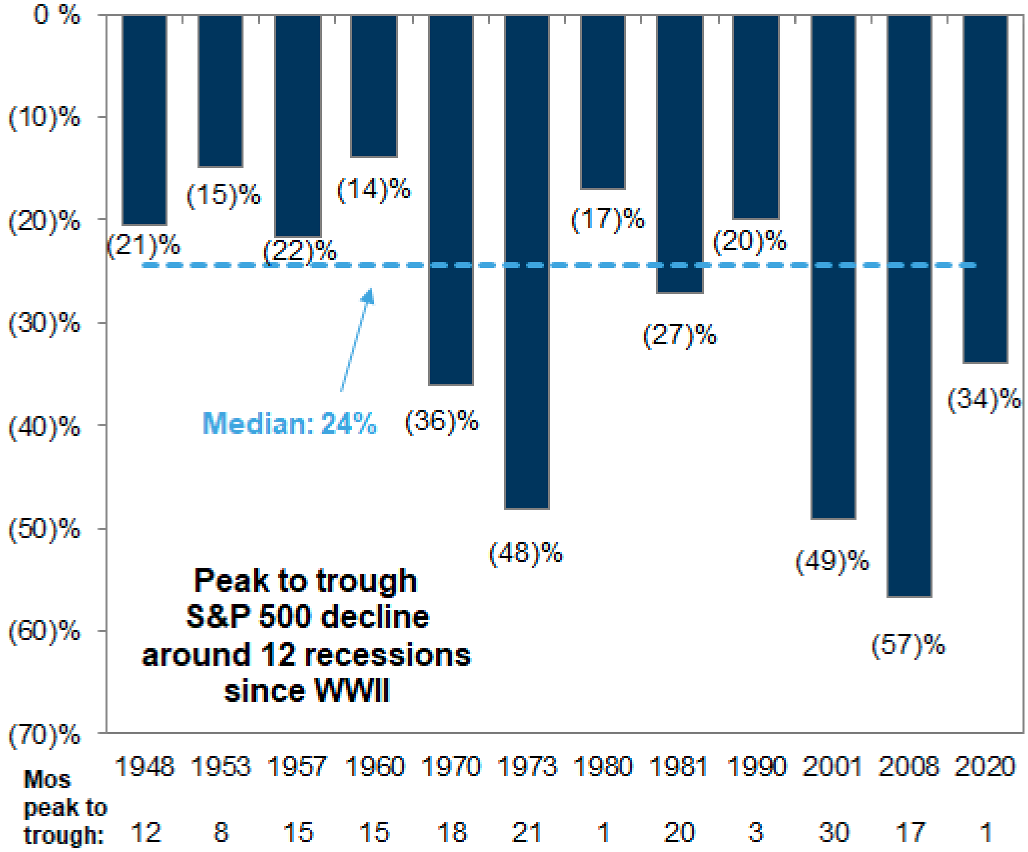
Equity markets are now pricing in a high probability of recession risk. Technically that means two back-to-back quarters of negative growth in U.S. real gross domestic product (GDP) which is the combined value of all finished goods and services less inflation made within the U.S. and used to estimate the size and growth rate of the economy. GDP has typically been in the 2% to 4% range over the past 40 years with recessions starting in 1981, 1982, 1990, 2001, 2007, and 2020 in which growth rates dipped into negative territory.



Note: Shaded areas are recessions according to the National Bureau of Economic Research. Dotted line is 2% "stall speed."
Source: Bureau of Economic Analysis.

Source: Yardeni Research

In terms of equity markets, recessions have caused meaningful pull backs from peak to trough levels in the S&P 500 index with the greatest impact typically realized at the front end going into a recession. The long-term average drawdown in the S&P 500 index has been 24% from peak to trough, although the past three recessions occurring in the past 20 years have seen more pronounced drawdowns.



Source: Goldman Sachs Global Investment Research

The drivers of recession drawdowns in the equity markets are two-fold, the valuation multiple compression and negative aggregate earnings growth. Multiple compression often occurs at the outset of a recession and is reflective of slower expected growth rates and generally negative sentiment. In the past 5 recessions, the average change in one-year forward P/E multiples from the peak to the trough has been -21%.

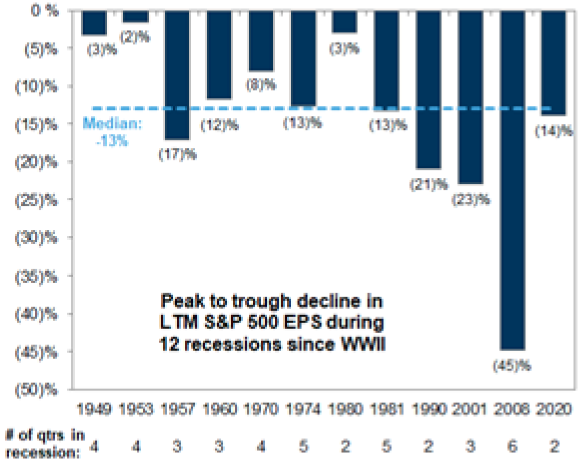
	Level of forward P/E									Change in forward P/E		
Year	Date	Peak	Date	Peak + 3 mo	Date	Start of recession	Date	Trough	Months peak to recession	Peak to 3 months	Peak to recession	Peak to trough
1981	Nov-80	7.7 x	Feb-81	5.9 x	Aug-81	5.6 x	Mar-82	5.0 x	9	(23)%	(27)%	(34)%
1990	Dec-89	11.6	Mar-90	11.0	Aug-90	9.9	Sep-90	9.5	8	(5)	(15)	(18)
2001	Aug-00	23.8	Nov-00	20.8	Apr-01	21.2	Sep-01	18.7	8	(13)	(11)	(21)
2008	May-07	16.0	Aug-07	14.8	Jan-08	14.5	Oct-08	10.8	8	(7)	(10)	(33)
2020	Dec-19	18.6	Mar-20	15.3	Mar-20	15.3	Mar-20	15.3	3	(18)	(18)	(18)
Median									**8**	**(13)%**	**(15)%**	**(21)%**

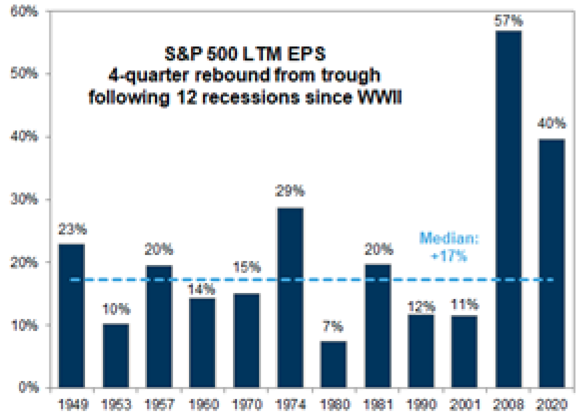
Note: Valuation trough defined as trough reached during the recession period.

Source: Goldman Sachs Global Investment Research

Multiple compression in recessionary periods has also followed a consistent pattern. Across the 12 recessions that have occurred since World War II, equity markets began to price in recessions on average seven months prior to the official start of a recession through multiple compression which tends to bottom and then expand prior to the end of the recession. The recession of 2020 was the exception to this trend, with average multiples remaining lower for an extended period due to the elevated multiple levels associated with the dot.com bubble proceeding the recession, although excluding the "new economy" names, the "old economy" segment of the market followed the historical trend experiencing less multiple compression and a more rapid recovery.

The second driver of recession drawdowns is lower earnings. Since World War II, S&P 500 earnings per share have dropped by a median of 13% from peak to trough during recessions. However, once hitting the trough which has typically been approximately 2 quarters or six months from the commencement of the recession, earnings have rebounded by a median of 17% in the following 12 months.





Source: Goldman Sachs Global Investment Research

When considering the interaction between earnings multiples and earnings, forward multiples tend to compress more rapidly during a recession than the actual earnings decline to suggest the overlay of negative sentiment as well as a lag in forward estimate changes on both the downside and upside entering and then exiting a recession.

As we stand today, it is unclear whether we will experience a recession. Economists at Goldman Sachs reported this week that there is a 35% probability that the U.S. economy will enter a recession during the next two years. While Goldman Sachs has lowered their growth forecasts, they remain positive for both 2022 and 2023. However, the financial markets appear more certain that the U.S. will enter a recession with J.P. Morgan publishing this week that they believe the U.S. equity markets are pricing in a 70% probability of recession.

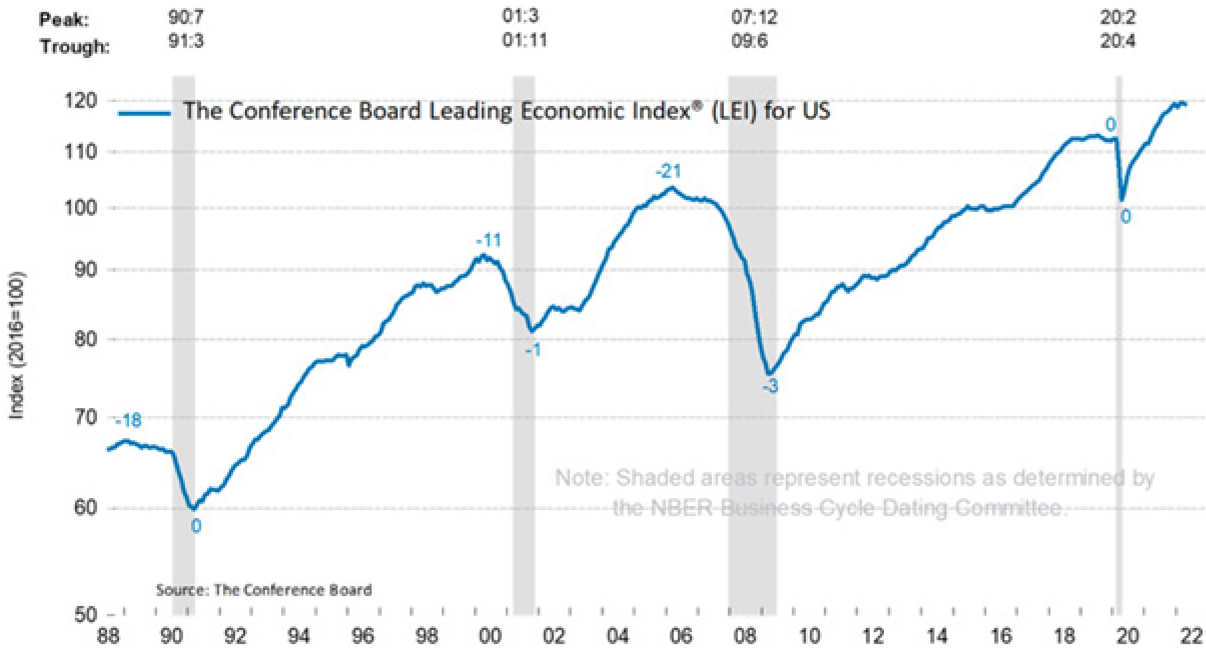
Since peaking at a forward P/E multiple of 21.1X in the first week of January this year, the S&P 500 has fallen to 16.6X, a decline of 21% - equal to the peak to trough recession multiple compression of the past five recessions. Meanwhile, forward earnings estimates for the S&P 500 have increased on a year-to-date basis. The combination of the two factors suggests the market is ignoring the current economic data and likely anticipating a recession.

While multiple compression has already moved in a manner consistent with expectations for a recession, there could be more downside in the S&P. The average recession has seen a 24% retracement in the S&P 500 peak to trough whereas we stand today the decline is 18%. The market could pull back more if high inflation were to drive interest rates higher than current expectations pressuring multiples lower or if significant negative earnings revisions for the S&P 500 were to occur.

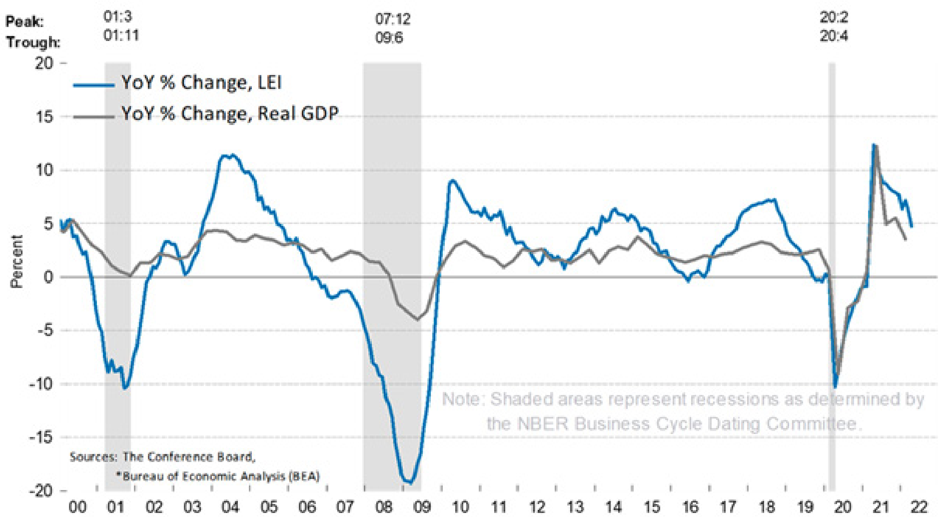
In any case, the pullback in valuation multiples has dampened the risk to the market if a recession were to materialize. A shallow and not long-lived recession might well be welcome to tame inflation and the risk of higher rates and position the market on firmer footing for the subsequent recovery and resumption of earnings growth on the other side.

2. Leading Economic Indicators Support Moderating Growth

The Conference Board Leading Economic Index (LEI) for the U.S. decreased by 0.3 percent in April to 119.2 (2016 = 100), following a 0.1 percent increase in March. The LEI is now up 0.9 percent over the six-month period from October 2021 to April 2022. The slowing trajectory of the LEI suggests more moderate growth in the near term but is not yet indicative of a recession.



The year-over-change in LEI is now more in-line with the long-term average and consistent with the long-term year-over-year change in real GDP.



The Conference Board indicated that the LEI declined in April largely due to weak consumer expectations and a drop in residential building permits. Overall, the U.S. LEI was essentially flat in recent months which is in line with a moderate growth outlook in the near-term. The Conference Board economists project the U.S. economy should resume expanding in Q2 following Q1's contraction in real GDP and despite downgrades to previous forecasts, The Conference Board still projects 2.3 percent year-over-year U.S. GDP growth in 2022.

Thinking Ahead

This week saw ongoing concerns about recession elevated as a number of retailers reported disappointing trends. While recession is a clear risk and associated with drawdowns in the market, the current market correction has already priced in a high probability of recession risk from a historical perspective. A potentially greater market risk remains elevated inflation - its impact on demand, interest rates, and pressure on valuations. While causing short-term growth pain, a recession might be beneficial for curbing the risk of unabated inflation. In any case, economic data continues to support economic growth, albeit at a slower pace. Despite fears of recession, hope remains that curbing inflation may be achievable with a soft landing.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.