

WEEK IN REVIEW

FRIDAY, OCTOBER 28, 2022

MARKET SIGNALS A RECESSION FOR 2023 - WHAT ARE WE WATCHING?

This week saw the yield on the 3-month Treasury exceed that of the 10-year Treasury. Such an inversion is rare but has historically predicted that a recession is either on the way or already here.

Every recession in the last 40 years has been preceded by yield curve inversions.

Spread between the Yields on 10-year and 3-month Treasury Debt



Source: Tradeweb ICE Closes.

Analysis of additional data suggests that the U.S. economy may not be in a recession yet. While many of the conditions for recession have already been met, employment and year-over-year corporate profit growth have not yet met recessionary conditions. Unemployment has yet to rise, and corporate profits remain positive, albeit growth estimates have been meaningfully reduced.

RECESSION CHECKLIST ALMOST COMPLETE – WATCHING UNEMPLOYMENT AND PROFITS

RECESSION CHECKLIST

Indicator	Description	Tech Bubble (1999)	Housing Bubble (2007)	COVID-19 (2020)	Current	Note: Current
Primary Indicators ("Sufficient Conditions")						
Unemployment ("Sahm Rule")	<ul style="list-style-type: none"> Signals the start of recession when the 3-month moving average of the unemployment rate rises 0.5% or more relative to the trailing 12-month period 	✓	✓	✓	✗	Unemployment fell in Sept. 2022, and Sahm Rule indicator is at zero
Leading Economic Indicators Growth	<ul style="list-style-type: none"> Growth in LEIs peaks and turns negative before recession 	✓	✓	✓	✓	LEI growth turned negative in July 2022 and fell to -1% in August 2022
Yield Curve: 10Y/2Y Spread	<ul style="list-style-type: none"> Inversion preceded each of the last six recessions, with no false positives 	✓	✓	✓	✓	Spread was inverted by an average of 34 basis points in Sept. 2022
Secondary Indicators ("Necessary Conditions")						
Average Hourly Earnings Growth	<ul style="list-style-type: none"> Growth of 4%+ creates concern of a wage-price spiral The Fed hikes to front-run inflation, and overtightens 	✓	✓	✓	✓	Wage growth currently 5%+ YoY; Fed Chair Powell calls labor market "extremely tight" in Sept. 2022
Corporate Profit Growth	<ul style="list-style-type: none"> Year-over-year growth always turns negative before recession 	✓	✓	✓	✗	Profits growth remains positive and estimates for earnings growth in 4Q'22 and CY2023 remain positive
Consumer Confidence	<ul style="list-style-type: none"> The spread between consumer confidence on "future expectations" less "present situation" turns negative and troughs before recession 	✓	✓	✓	✓	Consumers are highly pessimistic about future expectations relative to their current situation

Source: Blackstone Investment Strategy, represents latest available data for each measure as of 10/18/2022.

Looking forward to 2023, a number of factors appear to make a recession in 2023 inevitable – including rising interest rates to combat inflation, global geopolitics, global trade, and the strength of the dollar straining U.S. corporate profits. A recession in 2023 will likely see the final unmet conditions on the recession checklist succumb.

What should investors do?

From an investment perspective, lower earnings and potential rising credit risk are key concerns that could weigh on markets going into 2023. On the bright side, we believe a recession could be the necessary clearing event to bring inflation under control, wring out speculation and focus companies and investors on sustainable and profitable capital allocations. Such an outcome could form the foundation for a stronger earnings base, renewal of growth, and stabilization of valuation metrics moving into 2024.

Investors should adhere to their financial plans as the most optimal way to achieve their goals. While past performance is not indicative of future results, history suggests that downturns are temporary. Unwarranted risk aversion, especially during times of volatility, may lead to sub-optimal returns.

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

WANT MORE INSIGHTS ON THE ECONOMY AND CAPITAL MARKETS?

Join us this Thursday, November 3 at 3:00 PM EST for a go - everywhere conversation on the markets and economy with investing legend Byron Wien and Pallas Capital CIO Mark Bogar.

Register Here:

https://blackstone.zoom.us/webinar/register/WN_MZO-NRL0TtuRH_Y_1i-WKw

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