MARKET COMMENTARY

Most economists defer to the National Bureau of Economic Research (NBER), a private, nonpartisan organization, for dating business cycles in the United States. The Business Cycle Dating Committee at NBER reviews a wide variety of data series in determining peaks and troughs in the business cycle and maintains a lot of discretion (i.e., there is no set formula) in making their determination:

The NBER's definition emphasizes that a recession involves a significant decline in economic activity that is spread across the economy and lasts more than a few months… In our interpretation of this definition, we treat the three criteria—depth, diffusion, and duration—as somewhat interchangeable… Because a recession must influence the economy broadly and not be confined to one sector, the committee emphasizes economy-wide measures of economic activity... These include real personal income less transfers, nonfarm payroll employment, employment as measured by the household survey, real personal consumption expenditures, wholesale-retail sales adjusted for price changes, and industrial production…

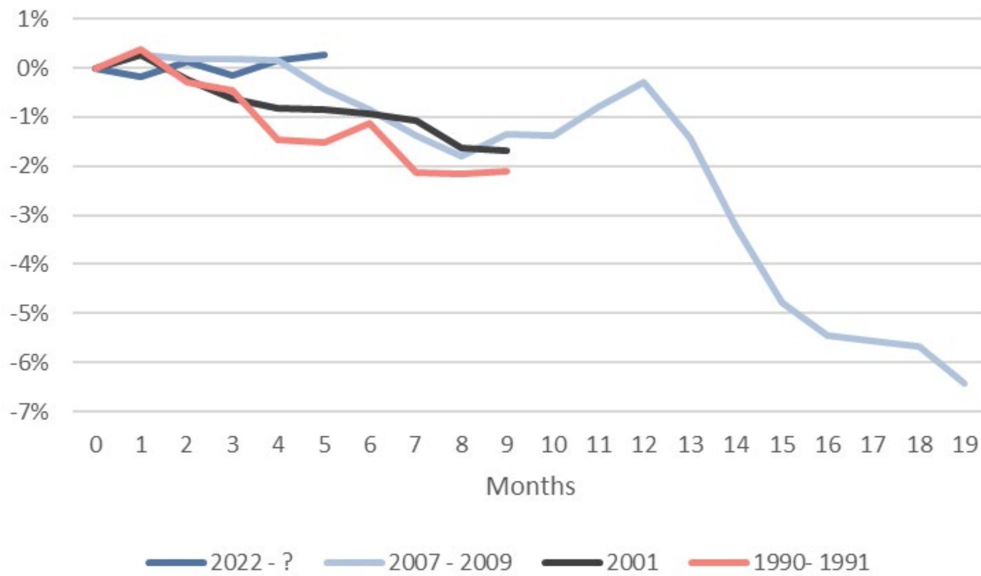
In recent decades, the two measures we have put the most weight on are real personal income less transfers and nonfarm payroll employment.

The NBER Business Cycle Dating Committee works like most committees — very deliberately. It's an academic exercise that is not meant to be a contemporaneous measure of economic conditions. NBER business cycle dating announcements generally come out 12 months or more after the fact. A simple heuristic is sometimes used for real-time recession dating instead: two-quarters of negative real GDP growth.

Our current reality is that we have had two-quarters of negative real GDP growth, but we probably haven't met the NBER threshold for a recession since real incomes less transfers are flat (Fig. 1), and nonfarm payrolls expanded by almost 3mn during the first half of the year (Fig. 2). Hence the political "we're in a recession" versus "we're not in a recession" bickering.

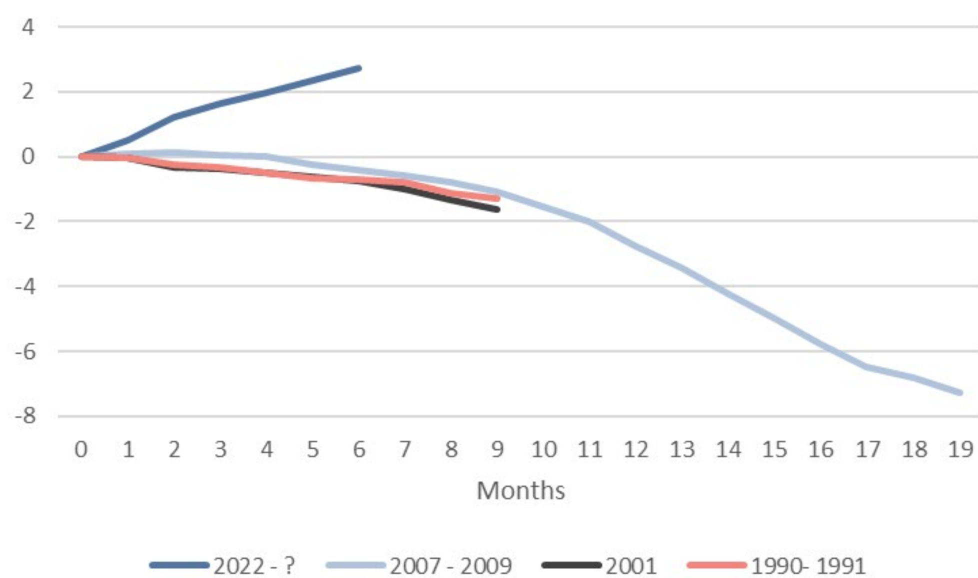
Our economic view remains that (1) the US economy continues to slow, (2) the labor market remains very tight, and (3) the negative GDP prints for Q1 and Q2 were mainly due to inventory buildup as consumers (finally) shifted from goods to services. As far as a recession is concerned, the current tightness in the labor market will have to subside to reduce inflationary pressures, which means we are likely to have at least a mild recession before this tightening cycle is over.

Fig. 1: Real Personal Income Less Transfers (% Change)



Source: Bloomberg, Mill Creek.

Fig. 2: Nonfarm Payrolls (Cumulative Change)



Source: Bloomberg, Mill Creek.

HOUSE VIEW SUMMARY

Global Economy

- Global real GDP growth peaked in 2021 at around 6% and will gradually decline to 3–5% for 2022–2024.
- Most major central banks have begun tightening cycles to combat inflation, but we expect inflation to remain elevated through at least 2023.
- US economic growth remains above trend but is slowing quickly. The Fed has communicated a policy path that will push growth below potential and raise unemployment. We expect the Fed to continue hiking aggressively, and an eventual recession, potentially shallow, is more probable than not.
- International developed markets face a range of challenges, including energy shortages due to the Russia-Ukraine war. Inflation and central banks will be forced to follow the Fed in tightening policy.

Market Perspective

- We believe Powell is following the 1979–1982 Volcker playbook. The Fed won't ease, regardless of economic growth concerns, until inflation has suitably declined over a sustained period.
- Stocks and bonds face headwinds, but market repricing has begun to create some opportunities.
- Bond valuations are no longer as concerning as they were at the end of 2021, but despite higher yields, bonds are not yet cheap. We continue to see opportunities in certain private debt strategies as a bond complement.
- High yield corporate debt spreads are not yet wide enough for us to add a tactical position, but we anticipate finding an attractive entry point for high yield corporate debt as economic growth slows.
- US large-cap and international developed markets are fairly valued based on forward earnings expectations. US growth remains somewhat overvalued, whereas US value, small-cap, and emerging markets are undervalued.

Portfolio Positioning

- We are neutral duration in our taxable and tax-exempt fixed income portfolios.
- We are overweight high yield municipal bonds in our tax-exempt FI portfolios.
- Within equities, we are overweight US versus international, large-cap value versus growth, and global small-cap equities.
- We are overweight private debt and absolute return hedge funds versus fixed income.
- We recommend allocating a portion of equity exposure to private equity.

Risks We're Watching

- Sustained oil prices above $150 per barrel
- A sharp rise in inflation expectations or inflation that is unresponsive to 2022's Fed action. Either outcome would force the Fed to hike into a deep, 1981-style recession
- Exacerbated geopolitical tensions spilling out of the Russia-Ukraine war or China

QUICK LINKS

- What an Inverted Yield Curve Could Mean for US Economic Conditions
- Updating Our Capital Markets Assumptions
- What Did 1Q 1980, 2Q 1984, and 2Q 2022 Have in Common?
- Q3 2022 Outlook

This week's contributor: *Michael Crook, CAIA*