HIGHTOWER

FARR MARKET COMMENTARY

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Making a Tough Call

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I often get asked whether or not I see a recession coming. I have no crystal ball, but my answer has been that the likelihood is high. The evidence supporting that call is accumulating by the day, and it seems to more than offset the factors that could keep us out of a technical recession. In recent presentations I have shared the following slide with my audiences. It shows some pretty compelling reasons for either side of the argument. Most of the arguments for no recession are centered around the financial health of the consumer. And it is true that in the aggregate, the consumer is in pretty good shape. Debt levels are moderate, debt servicing costs are very low, home equity has skyrocketed, the job market is very strong, and large balances of excess savings have been built up over the past couple of years. But these aggregate indicators of consumer financial health ignore the fact that the income, wealth and savings are heavily concentrated at the top, leaving low- to moderate- income folks in a precarious state and most exposed to the inflation surge.

The arguments in favor of a recession, on the other hand, are more encompassing and include, most notably, the deleterious effects of inflation and rising interest rates. As inflation and interest rates continue to climb, more Americans are having difficulty making ends meet as non-discretionary expenses continue to climb a lot faster than incomes. And if the Fed fails to get inflation under control, the numbers of Americans getting squeezed will only get bigger.

So, is a recession coming or not, Michael?

No!

- Strong labor demand
- Best wage growth in decades
- Very low Debt Service Ratio
- $2 trillion in excess savings (though concentrated at the top)
- Pent-up demand for services/business investment
- Supply-chain repairs

Yes!

- Fiscal cliff
  - Extended unemployment
  - Student loan moratorium
  - Child tax credits
  - Tax increases?
- Inflation rising faster than incomes
- Negative wealth effect (stocks, bonds)
- Rising interest rates
- Economic inequality (incomes, wealth, savings)
- Cooling housing market

To a certain extent, the timing and severity of any economic contraction will be dependent on one gigantic unknown, and that is the extent of the monetary (interest rate hikes) and fiscal (tax increases, reductions in government spending) tightening that will be required to bring inflation down to more acceptable levels. That is inherently unknowable at this point. Another slide in my presentation sought to identify all the factors that have contributed to the rapid acceleration in inflation over the past year-plus. Some of these factors are demand-related, meaning that they have caused the demand for goods and services to rapidly increase, thereby causing upward pricing pressures. Those factors are listed on the left in the slide below. You will also notice that I have crossed out only two of the factors: the spike in home equity and stock prices and outsized wage growth. Asset prices are no longer surging, and wage growth is not keeping up with inflation. As such, I don't see those factors as continuing upside threats to inflation. The remaining factors, though, continue to be supportive of rising prices.

Critically, the supply-side factors listed on the right side will be more troublesome, in my opinion, because they will be dependent on factors largely beyond the control of governments and central banks. More specifically, a resolution to most of these pressure points will require both an end to the Ukraine War and an end to the COVID-related economic closures, especially in China. But there are other factors on the list that are not related to the war or COVID. The housing shortage, in particular, has been many years in the making and will require a big surge in investment (in the face of rising interest rates) to remedy. Likewise, the lack of energy investment began well before COVID's arrival and will require a concerted response to fix. And finally, one contributing factor to the labor shortage is simply demographics, as more and more baby boomers reach retirement age. So, suffice it to say, the supply-side factors are more varied, more unpredictable and harder to address.

Demand-related	Supply-related
• Low unemployment	• COVID-related supply-chain & transportation bottlenecks
• High consumer savings	• Ukraine War-related inflation in food, energy & metals
• ~~Spike in home equity and stock prices~~	• Semiconductor shortage
• Large consumer borrowing capacity	• Housing shortage
• ~~Outsized wage growth~~	• Lack of sufficient investment in energy production
• Pent-up demand, especially for services	• Widespread labor shortages

Can sufficient progress be made on the issues above such that inflation recedes *enough* to minimize the fiscal and monetary response, thereby avoiding a recession (two quarters in a row of negative growth)? It's possible. But there is not enough information right now to make that call right now. It seems much more likely, for now, that the Fed errs on one side or another, tightening too much and thrusting the economy into recession or moving too slowly and failing to reduce the painful effects of sky-high inflation. Until there is more clarity on the effects of the Fed's actions, it probably makes most sense to take stock-market rallies, like the current one, with a grain of salt.

Peace,
Michael

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