ECONOMY

Is a recession imminent?

THINK STRATEGICALLY:

The Benchmarks the Fed Must Contend With

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The Biggest Juggling Act in the World

Investors are concerned about the outcome as the Federal Reserve juggles interest rates, the gross domestic product, inverted yield curves, inflation and jobs growth, all without taking the U.S. economy into a recession.

The norm is that numbers do not lie; they usually tell the tale for you. With every media outlet and dozens of experts proclaiming that a recession is imminent, we decided to analyze the critical economic and financial issues affecting our environment. While we do not dismiss the possibility that a recession may occur, our view is that the pessimistic tone of some is blurring the outlook.

Let us take a look at the seven benchmarks that the Fed must juggle.

Interest Rates Outlook

As the Fed sees inflation as persistent, it details that an increase of 50 to 75 basis points will be needed during the next meeting. As the Fed continues tackling inflation, having already risen rates by 75 basis points to a range of 1.5 percent-1.75 percent in June, and as indicated, a 50 to 75 basis point increase in July, taking rates to a range of 2 percent to 2.5 percent, we could see rates climbing above 3.5 percent in 2023

GDPNow

Allow me to present the Federal Reserve Bank of Atlanta's GDPNow. The GDPNow is a running estimate of real GDP growth based on available economic data for the current measured quarter. The model mimics the Bureau of Economic Analysis methods to estimate real GDP growth. The GDPNow forecast is built by aggregating statistical model forecasts of 13 subcomponents that comprise the GDP.

The GDPNow estimates have gone from limited growth to contraction:

Date	GDPNow
June 27	0.3 percent
July 1	-2.1 percent
July 8	-1.2 percent

Should a contraction materialize, it would be the second quarter in negative territory, which would technically prove that the economy is in recession.

Inverted Yield Curve

The dreaded inverted yield curve remained for three consecutive days this past week, with the 10-year U.S. Treasury note closing at 3.09 percent, below the two-year U.S. Treasury note, which closed at 3.12 percent.

An inverted yield curve is a historical warning sign that the economy will fall into recession.

We have two scenarios that could point to the U.S. falling into recession before determining it effectively has; we need the official numbers from the Bureau of Economic Analysis.

The U.S. Labor Market

Last week, the big news was the jobs reports, which came in better than expected. The U.S. Nonfarm Payrolls fell to 372,000 from 384,000, or 3.12 percent, but delivered continued, solid growth in the labor market, for a three-month average gain of 375,000 new jobs; meanwhile, the labor-force participation rate fell to 62.2 percent, compared to 62.3 percent last month.

The unemployment rate remains at 3.6 percent for the fourth straight month.

Before the U.S. economy falls into a recession, the unemployment rate has increased by half of 1 percent, a situation that we have yet to see. As a counterpoint, initial jobless claims rose 1.73 percent last week to 235,000, which may indicate weakness in hiring trends. Another figure to consider is job openings, nearly 11.3 million nonfarm jobs, but only a few more than 5.5 million job seekers, for a 50.94 percent deficit, hardly a weak labor market.

While positive, the jobs data can be seen as problematic as investors are now trying to understand how such solid growth may affect the Fed's interest rate outlook and size.

Inflation Rate, CPI & PCE

The Fed's inflation target is 2 percent; currently, its preferred inflation reading, Personal Consumption Expenditures (PCE), is at 6.35 percent, and the reading is 217.5 percent above target, and the other indicator, the Consumer Price Index (CPI), is at 8.58 percent, or 329 percent above the target rate.

Why does the Fed prefer the PCE over the CPI? For two principal reasons: It is more comprehensive in scope and allows a better consideration of how U.S. consumers change their buying patterns depending on price increases.

If beef rises dramatically, households may buy less expensive proteins to reduce costs; the CPI also considers these parameters at a less dynamic speed.

Deconstructing the Recession

As we have seen, there are some signs that the U.S. economy could face a recession, while we still think a downturn is avoidable. Since World War II, there have been 12 official recessions, or once every six and a half years, lasting on average 10 months more or less.

We feel it is prudent to evaluate at least the last two recessions we have encountered:

– 2007-2009 (The Great Financial Crisis): Fuelled by the subprime bubble, it lasted 18 months, and at its worst point during the fourth quarter of 2008, U.S. GDP fell 8.5 percent.

2020 (The COVID-19 pandemic): The worst since the Great Depression. The U.S. economy contracted a record 31.2 percent in the second quarter after falling 5.1 percent the previous quarter. The U.S. economy lost 20.5 million jobs, and unemployment rose to 14.7 percent. In Puerto Rico, we lost 240,996 jobs or 37 percent of the labor force.

What should Investors consider?

In conclusion, while some key indicators may be pointing to a recession, Birling Capital forecasts that the U.S. will be able to avoid a recession. Furthermore, in our view, the pessimistic outlook has already priced the market downwards. With so many investment opportunities, we feel investors must change their mindset towards a more opportunistic approach while looking for hidden value.

With so much wealth created immediately following the 2007-09 and 2020 recessions, investors have the data to feel optimistic and opportunistic towards the future. If history repeats itself, most stock markets have bottomed out close to four months ahead of the recession's end, allowing investors to make opportunistic investments at sharply reduced prices ahead of time. Usually, stock markets gain momentum as downturns finish, with the S&P 500 posting an average gain of close to 20 percent in the 12 months following the end of a recession.

Lastly, we expect Wall Street to close out 2022 with gains.

The Week in Markets: Rates rise 50 to 75 basis points, strong jobs growth and Wall Street is up

The U.S. Stock market ended the week with gains after a very active and volatile week; the U.S. delivered strong jobs growth, and the Fed minutes call the out-of-control inflation a substantial risk for the economy. As the Fed sees inflation as persistent, it points to an increase of 50 to 75 basis points will be needed during the next meeting.

Weekly Wall Street Summary for July 8:

– Dow Jones Industrial Average closed at 31,338.15, up 240.89 points, or 0.77 percent, for a year-to-date (YTD) return of -13.76 percent.

– S&P 500 closed at 3,889.38, up 64.05 points, or 1.67 percent, for a YTD return of -18.19 percent.

– Nasdaq Composite closed at 11,635.31, up 568.46 points, or 4.57 percent, for a YTD return of -25.63 percent.

– Birling Puerto Rico Stock index closed at 2,640.21, up 42.09 points, or 1.62 percent, for a YTD return of -8.3 percent.

– The U.S. 10-year Treasury note closed at 3.09 percent.

– The U.S. 2-year Treasury note closed at 3.12 percent.

Weekly Market Close Comparison	7/8/22	7/1/22	Return	YTD
Dow Jones Industrial Average	31,338.15	31,097.26	0.77%	-13.76%
Standard & Poor's 500	3,889.38	3,825.33	1.67%	-18.19%
Nasdaq Composite	11,636.31	11,127.85	4.57%	-25.63%
Birling Puerto Rico Stock Index	2,640.21	2,598.12	1.62%	-8.30%
U.S. Treasury 10-Year Note	3.09%	2.88%	7.29%	1.50%
U.S. Treasury 2-Year Note	3.12%	2.84%	9.86%	1.50%

Francisco Rodríguez-Castro is president and CEO of Birling Capital LLC. Think Strategically© is a publication by Birling Capital LLC that summarizes recent geopolitical, economic, market and other developments. This report is intended for general information purposes only and does not represent investment, legal, regulatory, or tax advice. Recipients are cautioned to seek appropriate professional counsel regarding any of the matters discussed.