DOUCET ASSET MANAGEMENT, LLC

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# The Coming Market: Roman Holiday or Greek Tragedy?

*"For many men value appearances more than reality-thus they violate what's right."*
~*Agamemnon*, Aeschylus

According to Aeschylus's Greek tragedy *Agamemnon*, the god Apollo loved the beautiful Cassandra. If she agreed to comply with his desires (I missed this nuance in High School English class), Apollo promised Cassandra the power of prophecy. Cassandra accepted the gift, but refused to grant 'favors' to the god. Apparently, Apollo did not take rejection well. From then on, Cassandra was fated by him to utter true predictions but they were never to be believed.

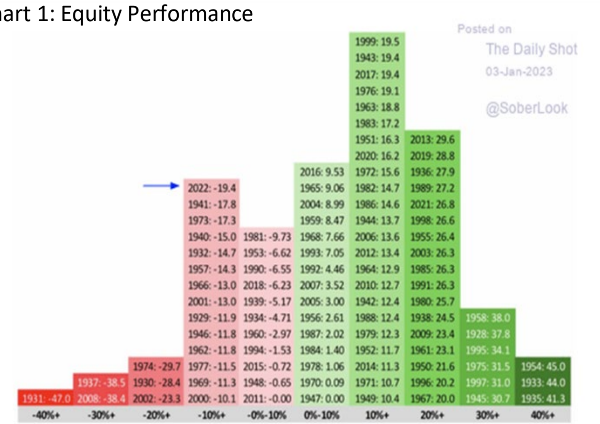
Today, there are Cassandras galore prophesying the future of the economy, the market, corporate earnings, and interest rates. But much like Cassandra's predictions 3200 years ago, few market analysts or even the members of the Federal Reserve believe them.

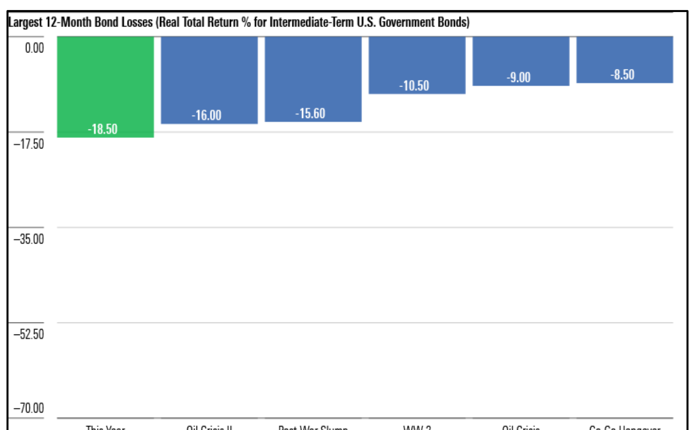
Most market experts believe there will be one of the mildest recessions in history in 2023 along with positive corporate earnings. However, there have been multiple economic and market indicators which have proved reliable in the past that suggest otherwise. Several of these indicators are loudly shouting downbeat prophesies about the coming recession and the decline in corporate earnings this year. So, who is right - Cassandra or economists and market experts?

## The *Red* Brick Road of 2022

At the beginning of 2022, we boldly pronounced how historically expensive the stock market was "on practically every fundamental metric" in our newsletter entitled [“The Great Unwind: Navigating the Rocky Road to the Emerald City.”] We also warned of the Fed's plan to unwind the stimulus of the previous 22 months in a 'fast and furious' manner. These factors combined to create a challenging investing climate for investors last year. While the equity market had its seventh largest down performance year since 1929 (and its worst since 2008), the bond market experienced a Greek tragedy of its own, resulting in its worst year *ever*, in just about every fixed income category …*by a long shot*.

Chart 1: Equity Performance



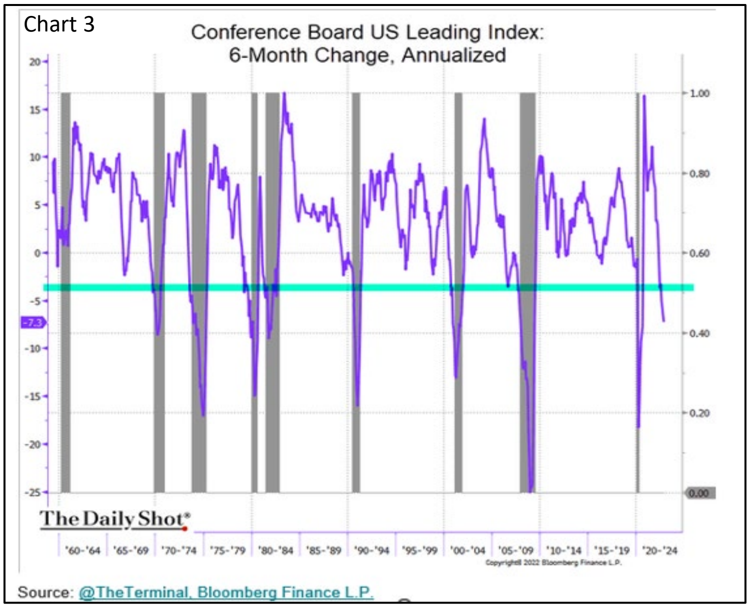




Source: Sources: Morningstar Direct, author's calculations.

Chart 2: Fixed Income Performance

2022 began with rising inflation, money supply on the rise, and a Fed who had not yet begun tightening. In contrast, the dawn of the economic and investing landscape for 2023 is highlighted by declining liquidity, falling inflation and a Fed nearing the end of its rate hiking cycle (but with less than expected progress on the Quantitative Tightening front). Despite signs that their policies could force the economy into a recession and provide lingering headwinds to many asset classes, the Fed continues to focus its decision-making on two *lagging* indicators-employment and inflation. In the interim, there are multiple Cassandra-like prophecies which suggest an economic recession is near, and risk assets may suffer as a result.

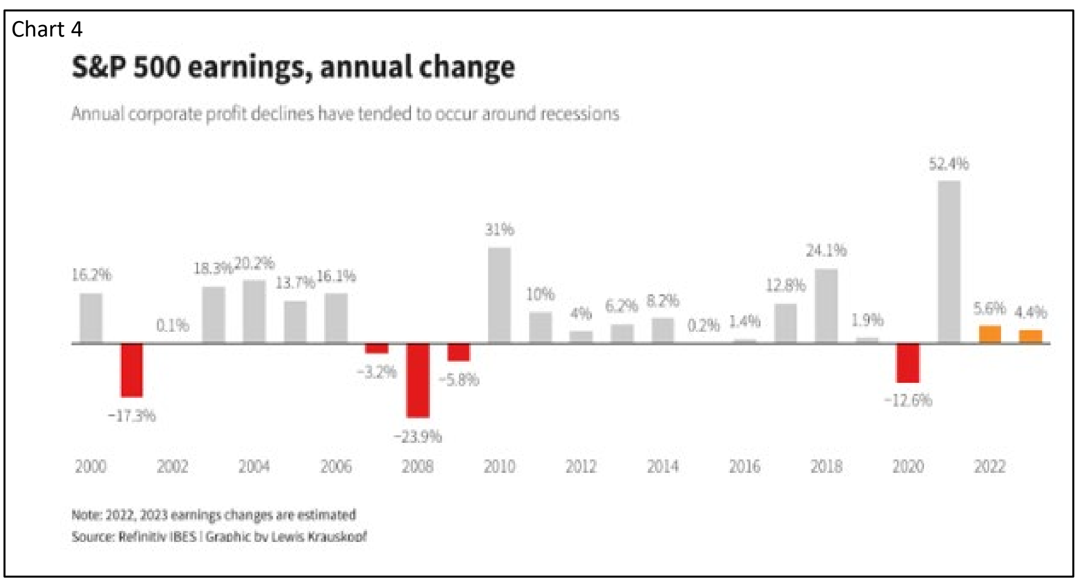
### Prophesy #1: Leading Economic Indicators Suggest an Economic Recession Is Imminent




The newswires are replete with the US Conference Board's Leading Economic Index (LEI) headlines. LEI is a piece or set of economic data that corresponds with future movements or changes in the economy. It is composed of 10 economic components whose fluctuations tend to foreshadow changes in the overall economy before they happen. The Index components range from new orders on goods to the number of building permits on new residential construction. All eight times the Index has declined six successive months, as illustrated in Chart 3, the US economy plunged into a recession. Currently, according to Dave Rosenberg of Rosenberg Research, the LEI has dropped nine straight months, suggesting a recession is imminent. Perhaps if Cassandra would have batted eight for eight many years ago, the City of Troy would not have fallen for that wooden horse trick!

### Prophesy #2: Corporate Earnings Decline in an Economic Recession

Many economists are saying a recession is already 'priced into the stock market.' But Ned Davis Research recently stated that S&P 500 corporate earnings generally "fall an average of 24% during recessions," as evidenced in Chart 4. The S&P 500 is currently trading at over 19 times trailing 12-month earnings and a survey of equity analysts by Refinitiv IBES predicts a 4.4% rise in the earnings of the S&P 500 in 2023, on the heels of an estimated 5.6% earnings increase in 2022. If this is correct, the financial markets are probably *not* fully factoring in what an economic recession might do to corporate earnings and the negative impact declining earnings could have on financial assets and markets.

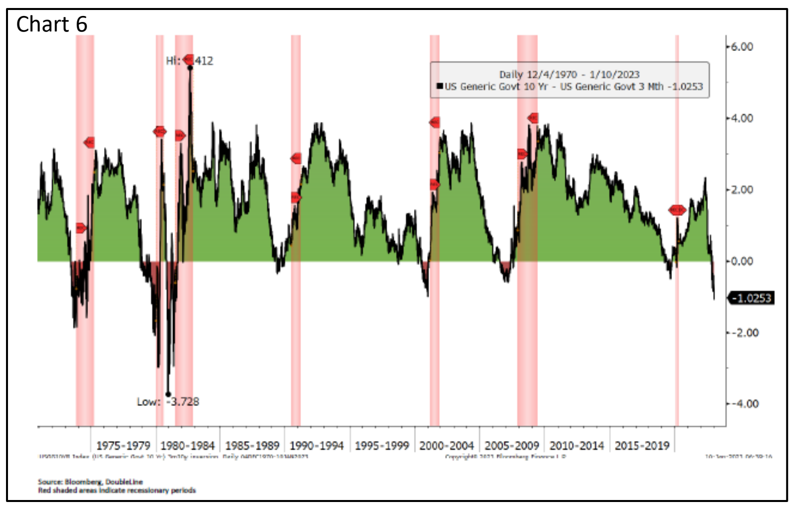


## Prophesy #3: Evaporating Liquidity Foreshadows Declining Corporate Earnings


The largest ***rise*** in the money supply in US history occurred in response to COVID. Conversely, since the Fed began raising interest rates, the US has experienced the most rapid ***decline*** in the money supply since the Great Depression! A decrease in the money supply adversely impacts the economy for several reasons. Among them, interest rates may become elevated with a corresponding reduction in consumer spending on goods and services.

At the moment, liquidity is not just declining in the US, but also worldwide as most central banks around the world are either raising short-term interest rates, reducing their balance sheets or both. According to Chart 5, this reduction in liquidity around the world may result in a significant drop in corporate earnings over the coming months.

## Prophesy #4: Inverted Treasury Yield Curves are Predictive of Recessions



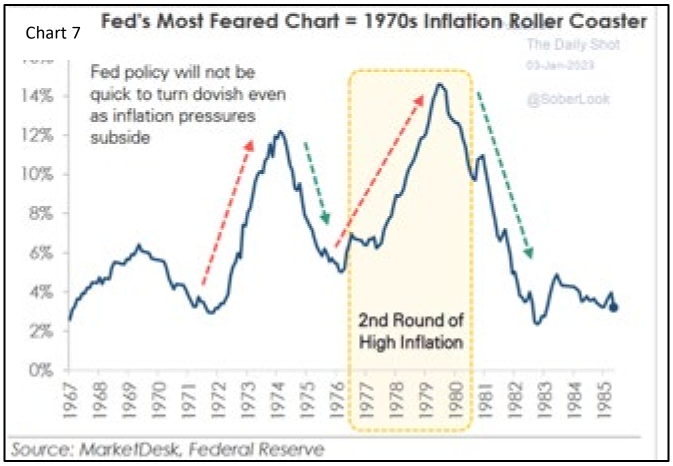

A yield-curve spread is the difference between yields on debt instruments of varying maturities. Central bankers heavily influence short-term rates in their attempt to stimulate (by lowering interest rates) or dampen the economy (by raising interest rates). With a positively-sloped yield curve, investors get paid more interest for buying bonds with longer maturities because of the extra risk associated with tying their money up for a more extended period of time. However, the yield curve may invert (short-term bonds yield more than long-term bonds) when investors believe economic activity is slowing.

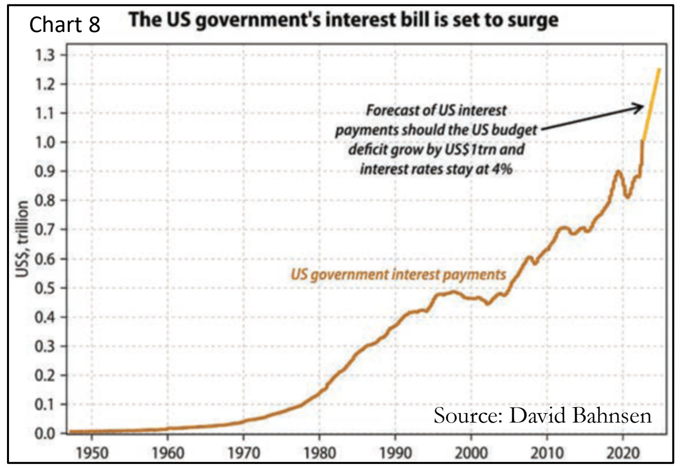
As evidenced in Chart 6, since 1970, there have been seven times when the 3-month Treasury Bill has yielded more than a few basis points over the 10-year Treasury note. In all seven previous inversions, a recession followed. The 3-month/10-year yield curve inverted about two months ago and now the spread stands at about 138 basis points or a full percentage point, the most in over 40 years. Could 2023 make the success of this indicator eight for eight?

## Non-Believers: Agamemnon & The Fed

In the Aeschylus play, Agamemnon ignores Cassandra's predictions because he thought she was nuts. Similarly, the Fed is NOT a Believer as it continues to ignore historically accurate prophesies of a slowing economy. It also seems to be ignoring the signs. In fact, the Fed continues to be hawkish and they are even expected to raise short-term rates by another 25 basis points at February 1st meeting. However, at the same time, the markets believe the Fed is just two meetings away from ending its rate hikes. Further, investors actually believe the Fed will begin *cutting* rates later this year.

While there are Cassandra prophesies galore which would suggest the Fed is once again behind the curve, there are a plethora of *unspoken* reasons why the Fed may actually remain more hawkish than investors think they should be. According to Chart 7, the Fed believed it had inflation under control in the 1970s. However, it was the second surge of inflation that killed the US economy and produced the largest spike in interest rates. If this were to happen again today, Chart 8 suggests the result would create a spending bill the US simply could not fund without significant negative consequences for the US dollar and the economy.




## 2023: Will Cassandra's Curse Be Lifted?

According to a survey conducted by Bloomberg, 80% of economists believe there will be a recession this year. However, the majority of the respondents also believe it will likely be "shallow" in severity. But whether the downturn in the economy is tepid or more severe, corporate earnings have fallen during every previous recession, by an average of 24%. If the US does enter an economic slump this year and earnings do not decline, it will be the first time this phenomenon has occurred in our history.


This is one of the reasons why we believe stocks begin 2023 with a slightly less constructive risk/reward outlook than bonds. The S&P 500 is currently trading at over 19 times trailing 12- month earnings with the expectation that corporate profits will increase 4.4% in 2023. The bond market, on the other hand, just experienced a 100-year storm and the investment grade bond index posted consecutive back-to-back annual losses for the first time. But it also begins the year with inflation going ***down*** and a base rate of about 5.15% on investment grade bonds versus ***rising*** inflation and a 2% starting point in 2022.

The cacophony of noise created by what actions the Fed may or may take will certainly make the markets more difficult to handicap this year. There are additional risks which have the ability to further roil financial markets in 2023. A potential debt ceiling stalemate and multiple geo political issues may become bigger and significantly impact asset values this year. But perhaps Apollo's curse will be lifted once these repeated prophecies of Cassandra come true again. Only, let's hope she is wrong this time and 2023 will look more like a Roman holiday than a Greek tragedy!

Sincerely,

Chris L. Doucet

Chris Doucet

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