

In the Markets Now

What happened to the recession?

We believe in the old saying: a picture is worth a thousand words. Here, we aim to recap recent market action and provide some perspective to investors.

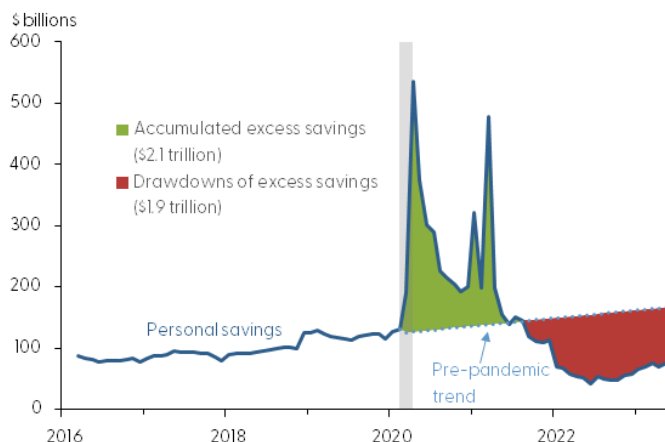
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LOOKING AT REASONS THE WIDELY FORECAST RECESSION HASN'T (YET) OCCURRED

Near the end of 2022, things didn't look great. Interest rates were rising rapidly, the yield curve was deeply inverted, stocks were down, and inflation – though on the decline – remained generationally high. Based on these and other factors, [forecasters were as confident in a near-term recession as they'd ever been](#). Of course, that recession has not materialized, and in some ways, the economy is even stronger today than it was then. So, what happened? It's not that the analysis was bad – Fed hiking cycles often do end in recession, especially when inflation gets so high – but rather, that it underestimated the idiosyncrasies of a post-Covid, post-stimulus economy. With that in mind, we thought it might be useful to examine some key reasons for why a recession has been avoided, and then ask whether they can (or need) to persist into the future to avoid a downturn.

Stimulus. Trillions of dollars in consumer-facing fiscal stimulus (enhanced unemployment and SNAP benefits, student loan payment moratorium, cash, etc.) kept the economy afloat in 2020, while the resultant excess savings helped propel consumer spending to new heights in the last few years. Given that the U.S. economy is roughly 70% consumer spending, this has been critically important. However, inevitably, those Covid-related policies had to end. And any excess savings left is in the process of being drawn down (estimates vary, but some suggest it's already gone). The length and degree of the stimulus impact was perhaps underestimated by those forecasting recession, but those policies were always ultimately going to end, and the U.S. economy would eventually have to stand on its own. The interesting twist is that non-Covid stimulus – the Inflation Reduction Act, the Bipartisan Infrastructure Bill, and the CHIPS & Science Act – may provide an economic boost that is only just beginning. But the consumer stimulus is fading, and that one-time tailwind will soon shift to a headwind.



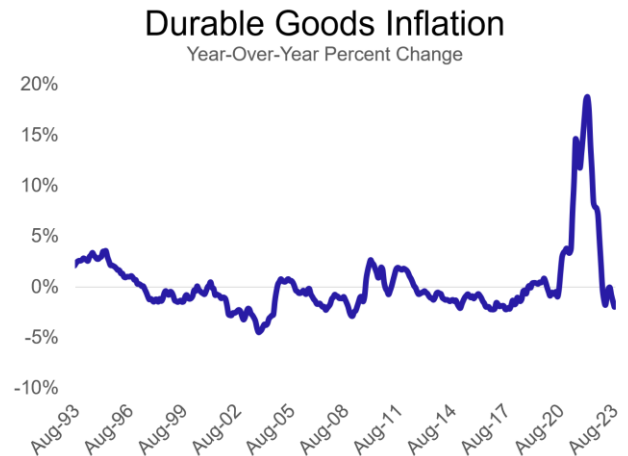
Source: [Federal Reserve Bank of San Francisco](#)

Revenge spending. While harder to quantify, it's clear there's been a massive post-Covid boom in spending on services: live events, travel, leisure, etc. Just look to the Taylor Swift and Beyoncé tours, the "Barbenheimer" phenomenon, or the boom in air travel for examples. And while the persistence of this trend is dependent on the ability of people to spend (i.e., how much money do they have, how's their employment situation), it's clear that the months of lockdown had a fundamental effect on how and where people are choosing to spend their money. The consumer's strength and willingness to spend big in these sectors was clearly underestimated, but like the Covid-era stimulus, it is likely to normalize over time. Now, normalization doesn't mean recession, but it does mean a slowdown from [YOLO summer](#) could be expected.

Normalization looks different. Take the U.S. money supply. Many expected a recession because there's been a big year-over-year drop in M2 money supply (the likes of which we've not seen since the Great Depression). On face, a contraction in the money supply implies less liquidity, less spending, and overall weaker economic growth. But relying on a year-over-year percentage change can be flawed if the denominator is out of whack – and in this case, the massive spike in money supply during the Covid stimulus era is warping the whole idea. **Things are normalizing from a historically un-normal environment, and some recession indicators that worked in the past may have less use in the current environment.**

Labor market. In the decades prior to Covid-19, there were consistently enough workers to meet employer demand. The story in the post-Covid world is the opposite: one of a persistent imbalance in the labor market, to the level that unfilled job openings topped 9 million for 27 straight months. Early retirements, subdued immigration, medical issues (e.g., long-Covid), etc. all helped reduce the civilian labor force significantly in 2020 and 2021. Then, amid the stimulus-fueled reopening boom, companies couldn't hire enough workers. This imbalance put upward pressure on wages and inflation overall. While this has begun to normalize, there's a sense now that companies are choosing to hoard labor – i.e., resist layoffs even during a tougher economic environment – because the cost of getting them onboard in the first place was so exorbitant. Further, demographics are not exactly favorable when it comes to growing the labor force organically. While this could keep pressure on inflation, it's also difficult to tip a consumer-based economy into a recession if the labor market is tight and wages are growing.

Idiosyncratic inflation. While the Fed's labeling of inflation as "transitory" in 2021 was ultimately proven incorrect, it's clear that some of the inflation actually was temporary (it just took longer than they'd hoped to settle). That is to say, as Covid-19 bottlenecks and restrictions eased, price pressures in certain sectors also eased. Freight rates from China to the U.S. spiked to historic highs in 2021, only to revert back to pre-Covid levels this year; raw materials like lumber followed similar paths; prices for goods (physical stuff) had been flat-to-down for decades before spiking during the pandemic (see to the right). Supply pressures will always exist (e.g., OPEC+ restricting oil output and putting upward pressure on gas prices), but the pandemic was a unique beast when it came to their effect on overall inflation. Today, many of these supply pressures easing has allowed overall inflation to come down without needing massive demand destruction to do so. That's a win for consumers and the Fed.



Rising rates impact. In theory, higher interest rates only affect new borrowers or people with adjustable-rate debt (which, after its central role in the '08 Crisis, sits right near long-term lows). And, after a decade zero percent interest rate policy (with one last bite at the apple in 2020), a cavalcade of consumers AND corporations were able to borrow at low, long-term, fixed rates. For example, nearly 60% of homeowners have a mortgage rate under 4% (market rates are above 7%). In the corporate world, a not-so-dissimilar story – per Goldman Sachs, roughly half of S&P 500 debt isn't set to mature until after 2030, and only 6% is adjustable-rate. So, for these borrowers, rising rates haven't had the same impact on their ability to spend and invest as they've had in the past. Still, as our partners at Strategas note, higher-for-longer rates, "are like holding your breath under water: it can be done for a short period, but it becomes more dangerous the longer you stay in that position." Higher rates eventually weigh, and if the Fed chooses to stick to a higher-for-longer policy, the economy will slow as a result.

Artificial Intelligence. AI has boosted the stock market (particularly the big Tech stocks that dominate the S&P 500) and has brought some renewed animal spirits to corporate operators and investors alike. While the hype may be overstated in the near-term, the enthusiasm for the revolutionary technology – and the potential boosts to earnings, productivity, and growth – has companies willing to spend and invest (some in a very big way). At a more basic level, a rising stock market (which has undoubtedly benefited from AI enthusiasm) is liable to boost consumer confidence and spending via the wealth effect. So, again, while potentially overhyped in the very near-term, the excitement, the promise, and the investment is there to make this a long-term, durable trend.

There's a common market saying that the four most dangerous words in investing are "this time is different." Now, they're still probably dangerous most of the time, but I think it's safe to say that, in many ways, this time really was different. The Covid-19 pandemic and policy response were unlike anything we'd seen before; a once-in-a-generation event. Now, that's investing – we have to play the ball as it lies. But it also means that the typical playbook for thinking about the larger economy might not have been suited as well to the post-Covid world. **And that's why the most-forecast recession in history has yet to occur.**

Since 1945, the U.S. has averaged one recession every six years. Avoiding one over the past 12 months doesn't mean the next 12 won't hold one. If anything, the lesson from this year is to be very careful timing investments around an economic forecast – especially one made amid deeply uncertain conditions. But as of today, the labor market and consumer remain fairly healthy, the economic momentum has been to the upside, and the stock market's 27% rally off the October 2022 lows has reflected it. Stay the course, stick to the plan, and work closely with your Baird advisor – especially as recession talk heats up.

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