The Quarterly Perspective

AUTHOR

Christopher Riggs, JD, CFP®

Christopher Riggs leads portfolio strategy and research for Harman Wealth Management. He writes extensively about the economy and markets. His responsibilities include macroeconomic analysis, portfolio construction, and leading the HWM investment committee.

Along with the founder of Harman Wealth Management, Dean Harman, Riggs also heads Alphalytics Research, a subscription-based research service to investment professionals across the U.S. The service emphasizes rigorous and robust data analytics in the context of the U.S. business cycle.

ABOUT

Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to insightful, objective solutions, and always working solely for the best interest of our clients.

CONTACT US

HARMAN
1725 Hughes Landing Boulevard
Suite 1250
The Woodlands, TX 77380
Phone: (281)719-8601

ww.harmanwealth.com

Unpacking the Recession Question

Conflicting data feeds the debate on the U.S. economy.

Pronounced market volatility? Check.

Menacing inflation? Check.

Two-quarters of negative GDP growth? Check.

Therefore, it's an official recession, right? Well, not necessarily, let me explain.

It's the leading inquiry on the minds of investors everywhere: "are we in recession or not?" The question is so pertinent because it has everything to do with judging the interventionist policies of 2020 and the lack of response in 2021. The question is also deeply political since the economic backdrop can heavily influence elections. If you find yourself in a state of confusion over the recession talk, you have plenty of company. So, with that in mind, let's unpack the real difficulties with answering this question.

"For many, the GDP report only confirmed what they seemingly already knew. Afterall, it sure feels like a recession."

The "Recession is Here" Argument.

It's a widely held belief for a recession to be identified as realizing two consecutive quarters of economic declines. This layman's definition was seemingly fulfilled in last week's GDP report. Following the surprising -1.6% contraction in the first quarter, the second quarter also shrank by -0.9%.[1]

For many, the GDP report only confirmed what they seemingly already knew. After all, it sure feels like a recession. While Americans may have higher incomes, they are falling behind due to the climbing cost of goods and services. Moreover, when all their spending is adjusted for inflation, it shows consumers are buying less stuff compared to a year ago.

The "We're Not in Recession" Argument.

To the dismay of some, the "two negative quarters" approach is not the official definition of a recession to the National Bureau of Economic Research (NBER) Business Cycle Dating Committee. This body of U.S. economists works from a more nuanced framework. To simplify, according to the committee, a recession is a sizable, broadscale, and persistent contraction in (1) incomes, (2) consumer spending and retail sales, (3) employment, and (4) industrial production. It must be longer than a few months and go beyond a slowdown in a single category.[2] To their credit, their definition has been in place for decades. So far, there is a strong argument for the first two elements – inflation-adjusted incomes and retail sales, but there is no measurable decline in jobs or production.

Federal Reserve leaders have repeatedly pointed to the jobs market as evidence the economy is sidestepping a recession. Since January, the unemployment rate declined from 4.0% to 3.5% as more than 3.2 million jobs were added.[3] Historically, the U.S. economy has never incurred a recession while job growth remained steady.

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Likewise, the numbers for industrial production have climbed, too.[4] How can this be so if consumers appear to be buying less? The answer lies in supply chain improvements. For example, last year supply chain problems set back auto production by ten years, to levels last seen in 2011. The slow resolution of those bottlenecks means auto producers are achieving output levels 12% higher than a year ago.[1]

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What Does it Mean for Investors?

So, are we in recession or not? Essentially, the question is unresolvable as long as two different definitions remain. The more important question is, "are more recessionary forces on the way?"

While the Fed continues to reinforce an intent to steer the economy clear of a recession, this is the same group that last year classified inflation as "transitory." Plus, a host of other problems are still at work. Inflation has yet to peak, and core components like food and housing are clearly still climbing. Additionally, higher interest rates, which only started accelerating in the last three months, have a strong lagging effect. Therefore, a serious risk of substantial slowing still lies ahead. Emerging signs are also suggesting employment may not be on as solid ground as originally thought.

Whether one wants to declare a recession in the first half of 2022 or not, the future is still very unclear in the back half.

Source:
1 Bureau of Economic Analysis
2 nber.org
3 Bureau of Labor Statistics
4 Board of Governors of the Federal Reserve System

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"Slowing food-related inflation isn't easily resolved by rising interest rates."

Shrinking Inflation Relies on Three Key Factors

Inflation Spikes Hitting Households Where It Hurts.

The menacing impact of inflation is hitting households hard. Where past inflationary episodes commonly resulted from spikes in oil and gas prices, this year's version is including necessities like food and housing. Each component is currently at 40-year highs, and each has their own unique challenges when trying to bring inflation back down.

For housing, climbing price momentum for new sales plus rising mortgage rates make a hostile mix. In fact, the average monthly mortgage payment (including the premium and interest) is up a whopping 52% from last June. (Source: National Association of Realtors). The Fed's plan to cool demand through lifting interest rates may work, but it usually has a lagging effect. Early signs have shown the number of homes sold going down, but prices have continued to climb.

Slowing food-related inflation isn't easily resolved by rising interest rates. Ukraine was a major exporter of agricultural goods, including fertilizers. Their ongoing absence will continue to keep U.S. and global prices high. Secondly, many fertilizers are derived from natural gas, which is also suffering from elevated prices. It is an illustration where well-meaning energy policy can have harsh and unintended effects on economic spending.

So, when can consumers expect inflation to go back to normal? Remember, the inflation metrics measure the rate of change in prices from a year ago. With prices not likely to go backward, the best bet is price stabilization. If achieved, it could lead to a near-term peak in the growth rate soon and an eventual slow decline into 2024.

Source: U.S. Bureau of Labor Statistics

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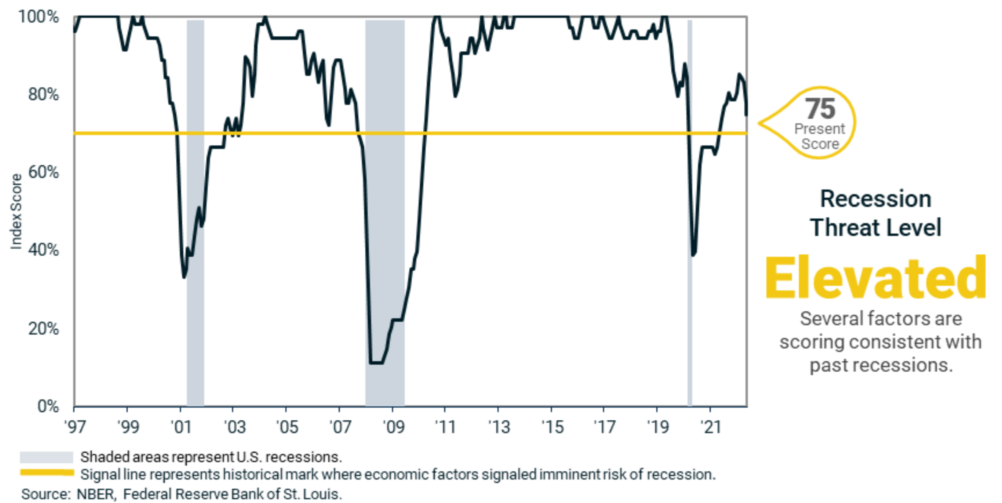
"With more than 3.2 million jobs added to the economy in 2022 and an unemployment rate at 3.5%, the labor market is the strongest contra-indicator of a recession."

Business Cycle Risk Profile

- GDP recorded two consecutive negative growth quarters. While consumption remained positive, the report was pulled down by declining business investment and exports.
- Persistently elevated inflation is weighing on consumer spending. In real terms, consumers are spending more dollars but buying fewer goods in 2022.
- The Fed is moving aggressively to combat runaway inflation and is expected to raise the base interest rate to 3.4% by year-end.
- With more than 3.2 million jobs added to the economy in 2022 and an unemployment rate at 3.5%, the labor market is the strongest contra-indicator of a recession.
- At its current level, the index value reflects an elevated risk of a recession.



Interpreting the Index Score:

- The index score measures nine economic factors that have demonstrated co-movement with the deteriorating conditions of the past seven recessions dating back to 1970.
- When the index score is at 100, it means all nine of the factors are measuring at levels consistent with past economic expansion.
- When the index score is below 100, it means that one or more of the weighted factors has moved to a level consistent with past economic contractions.
- In aggregate a score of 70 or higher is interpreted as a composite profile consistent with past economic expansion. A score lower than 70 is interpreted as a composite profile consistent with past economic contraction.
- Markets can, and sometimes do, demonstrate volatility even though the economic factors are measuring consistent with expansion.

Interested in Adaptive Business Cycle Investing?

Today's markets, economies, and policies are more complex than ever, challenging investors on what to watch and when to take action.

At Harman Wealth Management, we understand sound investments are uniquely supported by the conditions that favor them. And, when conditions change, so do the investments that benefit.

That's why we conduct rigorous and disciplined tracking of the U.S. business cycle. We also track the cyclical factors that shape our investing environment, like currencies, commodities, and rates. We embrace a world where investing dynamics are constantly evolving and believe it's imperative to have an investment strategy that adapts with it.

With Adaptive Business Cycle Investing we invest consistent with business cycle forces, aligning investments with the conditions driving returns in the present, rather than chasing what worked in the past.

About Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to integrative advanced planning by aligning investment objectives with business cycle opportunities and risks.

At Harman Wealth Management, our aim is to help clients realize their goals within a disciplined, insightful, and rewarding relationship.

For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

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In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. Bonds are also subject to other types of risks such as call, credit, liquidity, interest rate, and general market risks.

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