BLOG POST
Flashing Red Indicators
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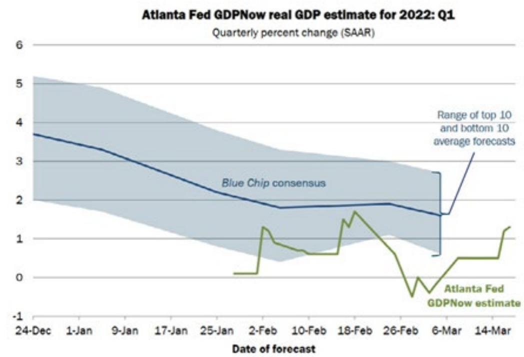
Trouble appears to be brewing at the macroeconomic level while investors appear to be hiding their heads in the sand. Volatility was expected entering 2022 with the Fed signaling they would finally stop quantitative easing and begin hiking rates in response to the highest inflation readings in nearly 50 years. That alone would be plenty for investors to account for. But then Russia decided to invade Ukraine, not only leading to pundits suggesting we are on the brink of WWIII, but causing an energy shock with oil hitting $120/barrel.

The S&P 500 fell around 12% from the beginning of 2022 until early March but has since rebounded 7% as investors appear to shrug off geopolitical and economic risks. The Atlanta Fed publishes a real-time gauge of where GDP will be for the quarter with their GDPNow survey. The forecast had GDP in negative territory in late February before rebounding to suggest growth of around 1% in 1Q2022. Russia invaded Ukraine on February 24th and countries began announcing economic sanctions on Russia that include agricultural and energy products. The economic impact of those sanctions are just beginning to be seen in the data used by the Atlanta Fed, so I would not be surprised to see the chart turn lower at the end of the quarter.



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Source: Federal Reserve Bank of Atlanta

One of the most accurate recession indicators over the last 60 years is the ratio of Leading Economic Indicators to Coincident Economic Indicators. As the titles suggest, the LEI is forward looking using what economists expect to happen, while the CEI measures what is taking place in the economy today, such as employment and real wage data that is collected weekly. When the forecasted future economic indicators fall below the coincident indicators it suggests the economy is in the process of slowing, and suggests we could be in the early stages of recession. The LEI/CEI ratio fell in January and again in February and appears to be headed for a drop in March. There are very few instances since 1960 where this ratio fell for three consecutive months without signaling a recession was approaching.

Rising energy prices are also concerning as it relates to consumer spending, which represents nearly 70% of US GDP. The issue of $5 or $6 per gallon gas prices and high home heating oil prices may be as much psychological as economic. Consumer savings is strong right now after record-breaking government stimulus spending, so gas prices would likely have to remain elevated for an extended period before actual economic damage is done. However, consumers often spend based on how they feel or their confidence in the future than their actual economic condition. This is particularly true of non-durable items like cars, appliances, and home improvements that are often financed at increasing interest rates.

The residual inflationary impact on supply chain disruptions from COVID remain while the inflationary impact of sanctions against Russia are just beginning to be felt. The Fed is going to have very little wiggle room to try and manufacture a soft landing with the economy when rates move higher. The market shrugged off the initial 25 basis point hike in rates by the Fed and even took in stride Chairman Powell's insinuation that the hike in May is likely to be 50 basis points. The Fed already knows they will have to overshoot on interest rates to quell inflation, and the yield curve would be inverted today if you factored in another 50 basis points of hikes. What is surprising, in my opinion, is that the markets do not seem to be worried about the impact a recession will have on equity prices. Market valuations came down from near-record setting levels in 2021 but the trailing P/E ratio is still more than 50% above its long-term average of 15.5. Not exactly where you would expect to see stocks priced when the risk of recession is high.

Russia's actions in Ukraine are creating economic challenges outside of the impact of sanctions that most countries have imposed on Russia. Wars often result in battle lines being drawn with different countries taking sides. While that is unlikely in terms of military conflict, there are economic battle lines being drawn, predominantly by China. The Asian economic power is increasingly aligning itself with Russia economically (and with military aid) that could result in even greater supply chain disruption, rising prices, empty shelves, and chaos.

Portfolios tilted towards tactical management, real assets, non-correlated yielding assets, and other hedges will likely outperform market beta in the coming months.