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MARKET SIGHT*LINES*

Are We In a Recession?

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For markets, 2022 has been defined by volatility, much of that triggered by events like the Russia-Ukraine war, higher-than-expected inflation reports, and surprise moves by the Federal Reserve (Fed). This was a big week for investors and the potential for more volatility. We're right in the middle of the second quarter earnings season, the Fed concluded its July policy meeting, and we learned the advance estimate of second quarter GDP.

In this week's Sight|Lines, we touch briefly on second quarter earnings, report on the Fed's July policy action, share some details on second quarter GDP, and offer a view on volatility and markets looking forward.

SECOND-QUARTER EARNINGS SEASON

Investors are worried about an economic slowdown and its impact on company earnings. We're seeing many negative headlines. Just this morning, I am reading: *Alphabet Reports Slowest Sales Growth in Two Years, Microsoft Earnings Dented by Cloud Slowdown, Videogame Sales Drop,* and *General Motors' Income Tumbles 40% on China Loss, Parts Shortages*. But so far, earnings overall have been better than expected. Over 200 S&P 500 companies have reported with 71% beating expectations by a median of 7%. The consensus growth forecast has S&P 500 earnings growing 5.4% quarter over quarter. While we expect an economic slowdown and some impact on earnings, earnings are holding up so far.

THE JULY FED MEETING

The Fed has been laser-focused on the "stable prices" dimension of its dual mandate, committed to tightening monetary policy to help reign in sustained, elevated inflation. And at its July meeting, the Fed took another step, hiking its benchmark fed funds rate by 0.75% to 2.25%-2.50%. The Fed's statement affirmed that "the Committee is strongly committed to returning inflation to its 2% objective."

In his press conference, Chair Jerome Powell signaled that the tightening policy is working: "Are we seeing the slowdown in economic activity that we think we need? There is some evidence that we are at this time." He also explained that the rate hikes have yet to have their full impact: "These rate hikes have been large, and they've come quickly. And it's likely that their full effect has not been felt by the economy, so there's probably some significant additional tightening in the pipeline." This also suggests that the Fed may be less aggressive in its tightening campaign in future meetings as it waits for the incoming economic and inflation data to show the effect of higher rates. Chair Powell also said that the Committee will now make its decisions on a meeting-by-meeting basis rather than providing the kind of guidance it provided in the previous two meetings. Traders of fed funds futures are pricing in four more 25-basis-point rate hikes through the end of the year.

THE ADVANCE ESTIMATE OF SECOND QUARTER GDP – SLOWING GROWTH

The advance estimate of second quarter earnings growth came in well below expectations, estimating that the U.S. economy contracted at an annualized real rate of -0.9% over the quarter. Many had been concerned about a decline, especially since growth declined in the first quarter by -1.6%, annualized. When we unpack the components of the second quarter result, we see two primary drivers of the negative result. First, the residential component, meaning housing, contributed -0.7% of the negative growth. This is due in good part to higher mortgage rates triggered by Fed rate hikes. Second, inventories, a volatile category, contributed -2%, the result of companies having depleted inventories after building them up in the recent past. Personal consumption and net exports were both positive in the quarter, together adding 2.1% of growth to the estimate.

While the popular definition of a recession is two consecutive quarters of negative growth, the National Bureau of Economic Research (NBER) more formally determines when we are in a recession. The NBER defines a recession as a "significant decline in economic activity spreading across the economy, lasting more than a few months," drawing on numerous measures to gauge the decline. Many of these measures continued to expand in the first half of the year. Importantly, the NBER has focused on employment in this process, so one can infer that officials may not consider us to be in a recession given the strong employment environment.

MORE VOLATILITY…AND SOME HOPE LOOKING FORWARD

In June's Market Volatility: More Storms, Clear Skies, or Both?, we shared the idea that, in this kind of environment, it may be helpful to define and evaluate scenarios based on what might happen, how likely it is to happen, and the corresponding economic and market implications. Last week, we developed the positive scenario further in Second Half 2022 and Beyond: Part 2: Reasons for a Positive Outlook. While uncertainty remains elevated and there is some chance of a recession and more market declines, we see a greater chance of slower but positive growth, continued earnings growth from stocks, and the potential for markets to go higher from here.

CONCLUSION

Markets have been volatile in 2022, especially given things like the Russia-Ukraine war, higher-than-expected inflation reports, and dramatic moves by the Fed. But this month, as we navigate second quarter earnings season, the Fed's July policy announcement, and the advance estimate of second quarter GDP, volatility has fallen some, and markets have posted positive returns in July. We remain cautiously optimistic looking forward.

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