The US Recession Debate

CHARTBOOK – May 2023

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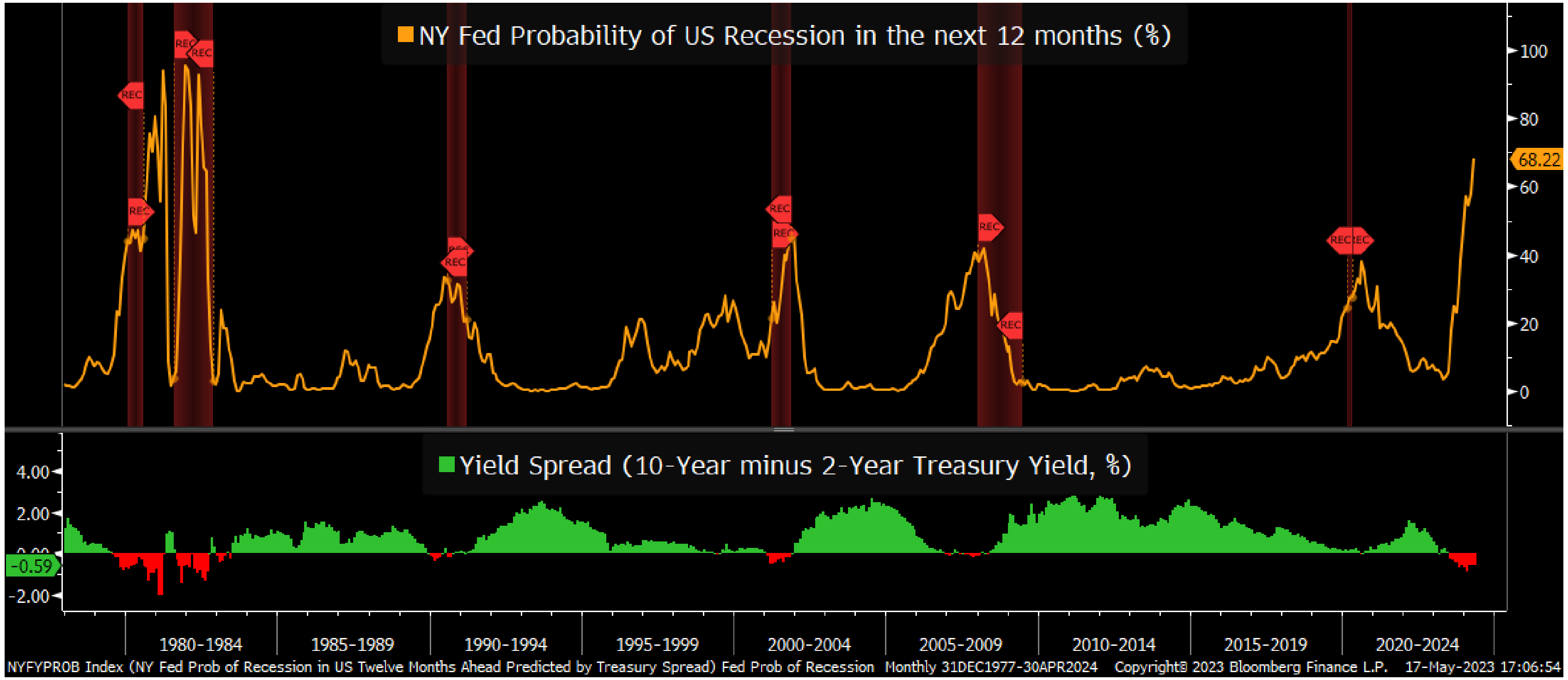
See important disclosures following the presentation.

Chartbook Preview

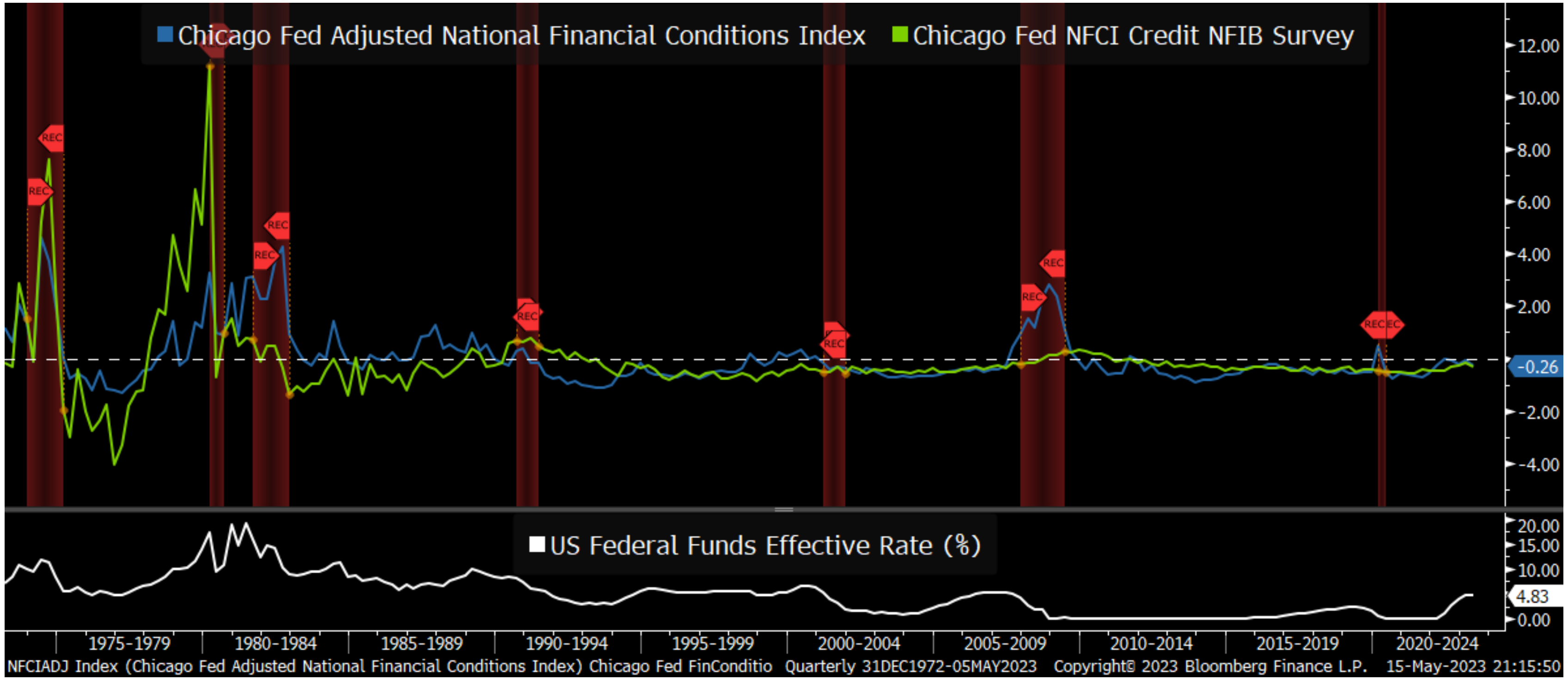
In this edition of *Evergreen Chartbook,* we will examine both sides of the debate surrounding whether the US is headed towards a recession. These charts will highlight how conflicting many of the data points are, and help explain why the Fed’s Tod Barkin described this as “*the most predicted potential recession in memory*”. Ultimately, while we believe the US will slip into a recession in the next 12 months, we think it will be shallow, and that we will avoid a deep, prolonged downturn.

NY Fed's Recession Probability at Recessionary levels



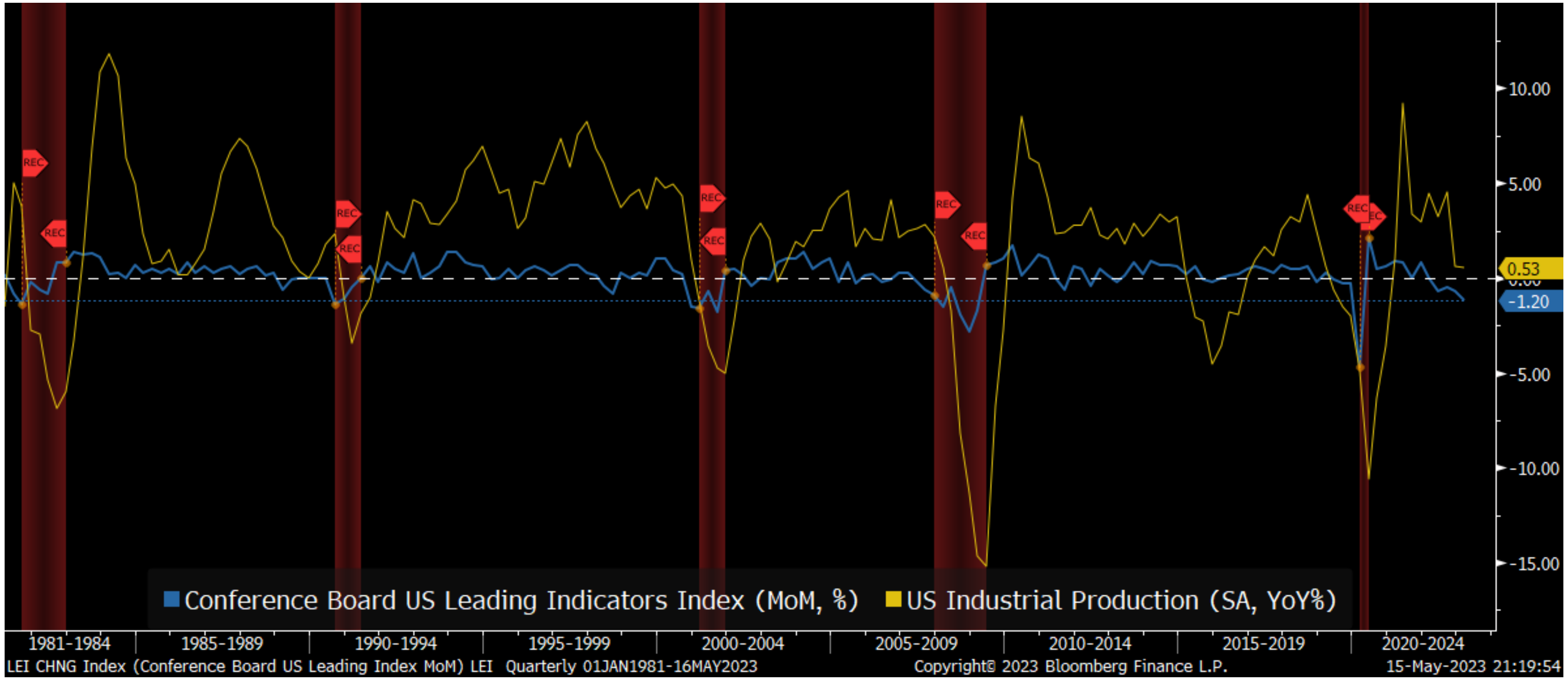
- The Fed's model estimates the likelihood of a US recession using the Treasury spread (the difference between the 10-year and 3-month Treasury rates).
- This indicator is currently saying there is a 68% chance of a recession within the next 12 months, a level that has not occurred outside of recessionary periods.

Financial Conditions not Signaling Recession



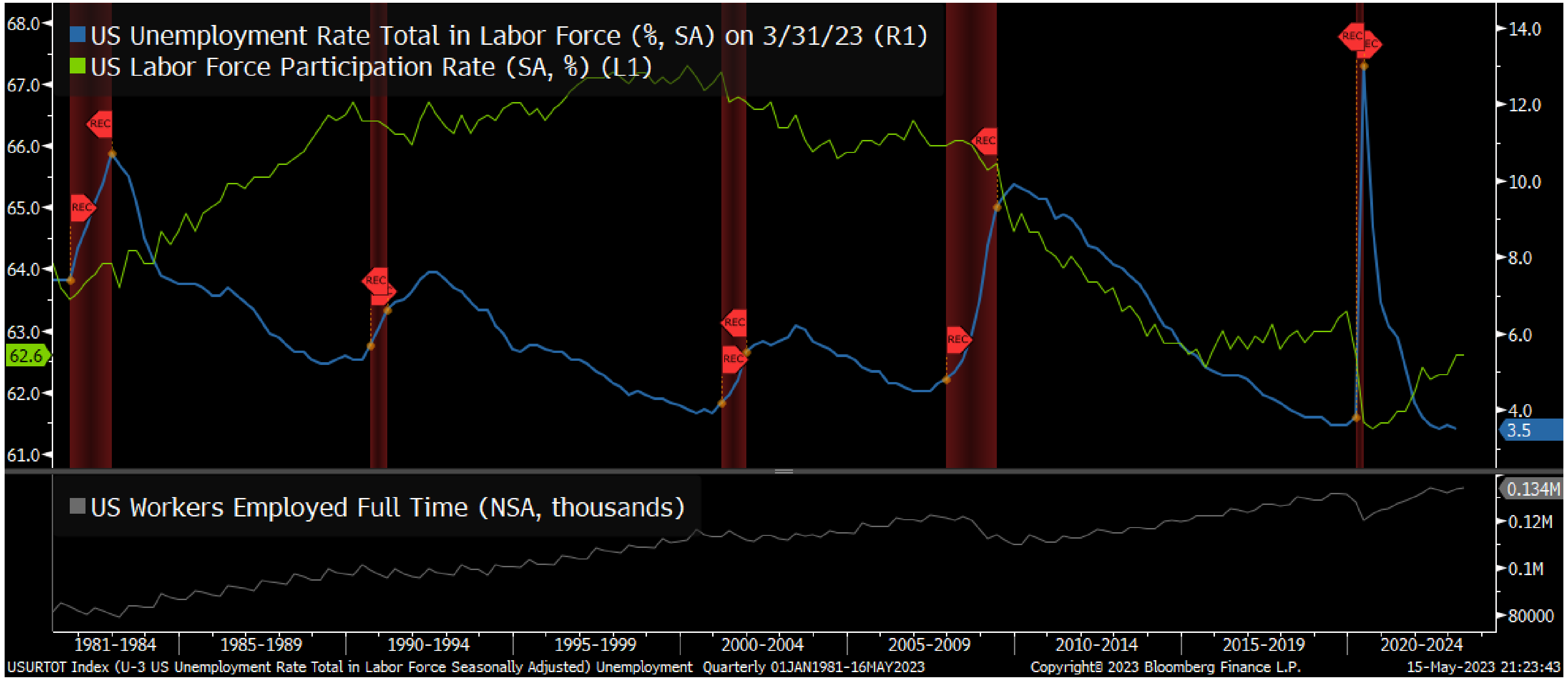
- Despite the Fed's aggressive tightening campaign in 2022, the Chicago Fed's Financial Conditions Index and Credit Survey suggests that monetary policy remains relatively easy.
- As you can see on the chart above, the US has not been in a recession without the Financial Conditions Index having flagged monetary policy as "restrictive", or above zero.

Long Slide in Leading Indicators Appears Ominous



- The Conference Board's Leading Economic Indicator (LEI) Index has now seen a sequential decline for 13 straight months.
- This is a clear warning sign for the economy and worth highlighting that this metric's predictive power tends to be stronger the more persistent, and severe the decline.
- While currently positive, US Industrial Production (IP) has been heading lower in recent months.
- IP will be an important measure to watch since a negative reading combined with a negative LEI reading, has only occurred during US recessions.

Labor Market Has Remained Resilient, Participation Normalizing

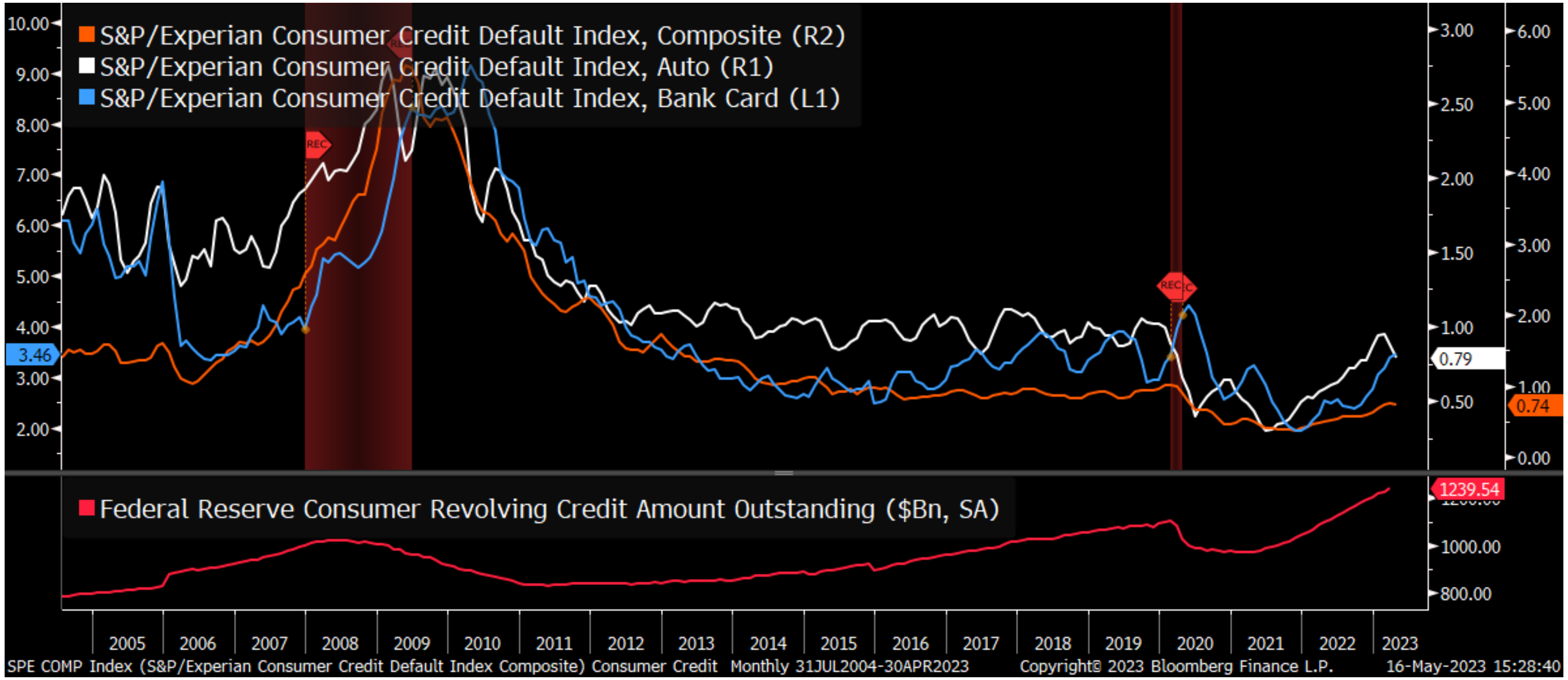


- The unemployment rate has certainly shown a remarkable recovery since the Covid highs and has added more than 2 million jobs thus far in 2023.
- However, any increases in jobless claims should be watched and scrutinized closely, as the unemployment rate is back near record lows.
- Another bright spot for the jobs market is the gradual increased in the labor force participation rate.
- This improvement has been driven by people in their prime working age, from 25–54, which is a sign of a healthier labor market.

Real Disposable Income and Consumer Leverage in Reasonable Shape

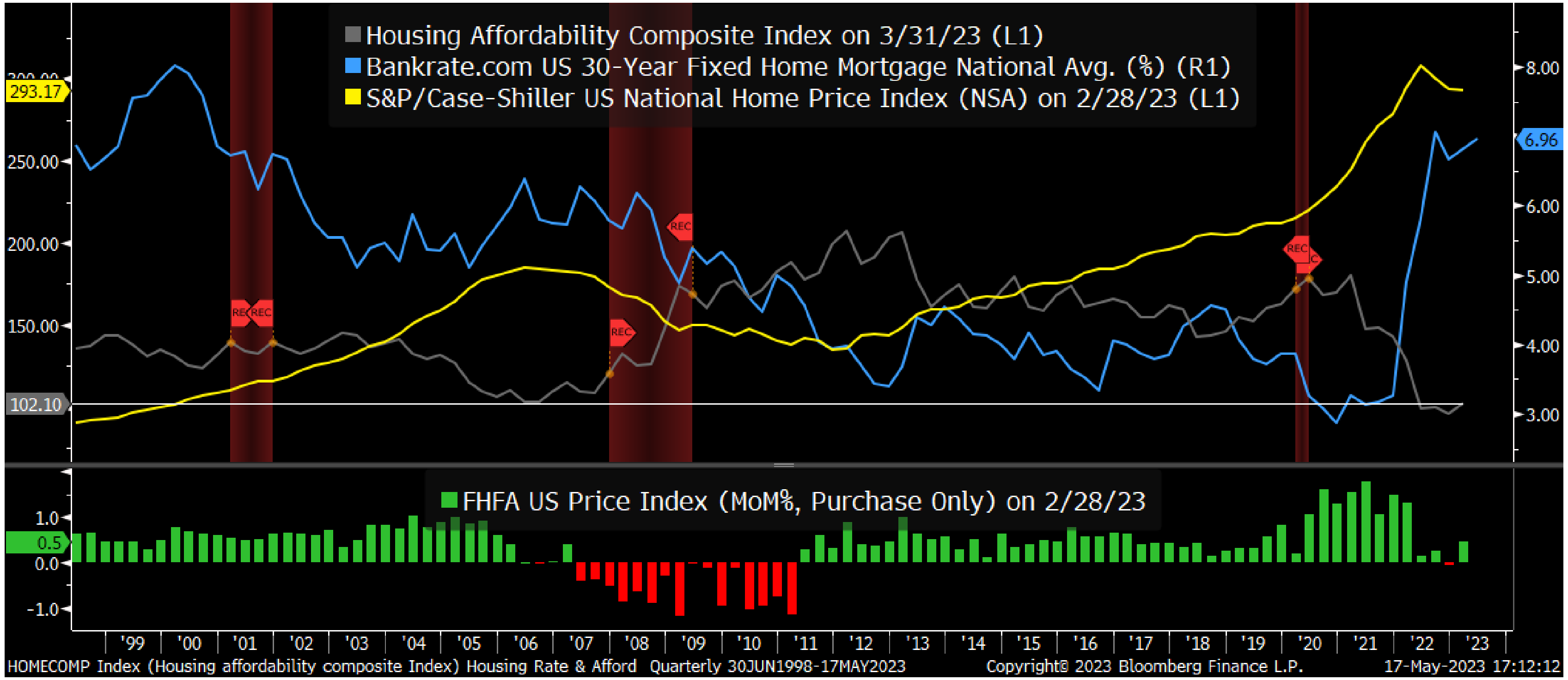
- We have seen a strong recovery in real disposable income driven by healthy wage gains, lower unemployment, and more recently cooling inflation.
- Consumer balance sheets are also in good shape with the Fed's Financial Obligations Ratio at a very low level relative to history.
- With that said, excess savings built up during Covid have largely been spent, so consumer trends appear to be softening.

Consumer Default Rates Trending Higher



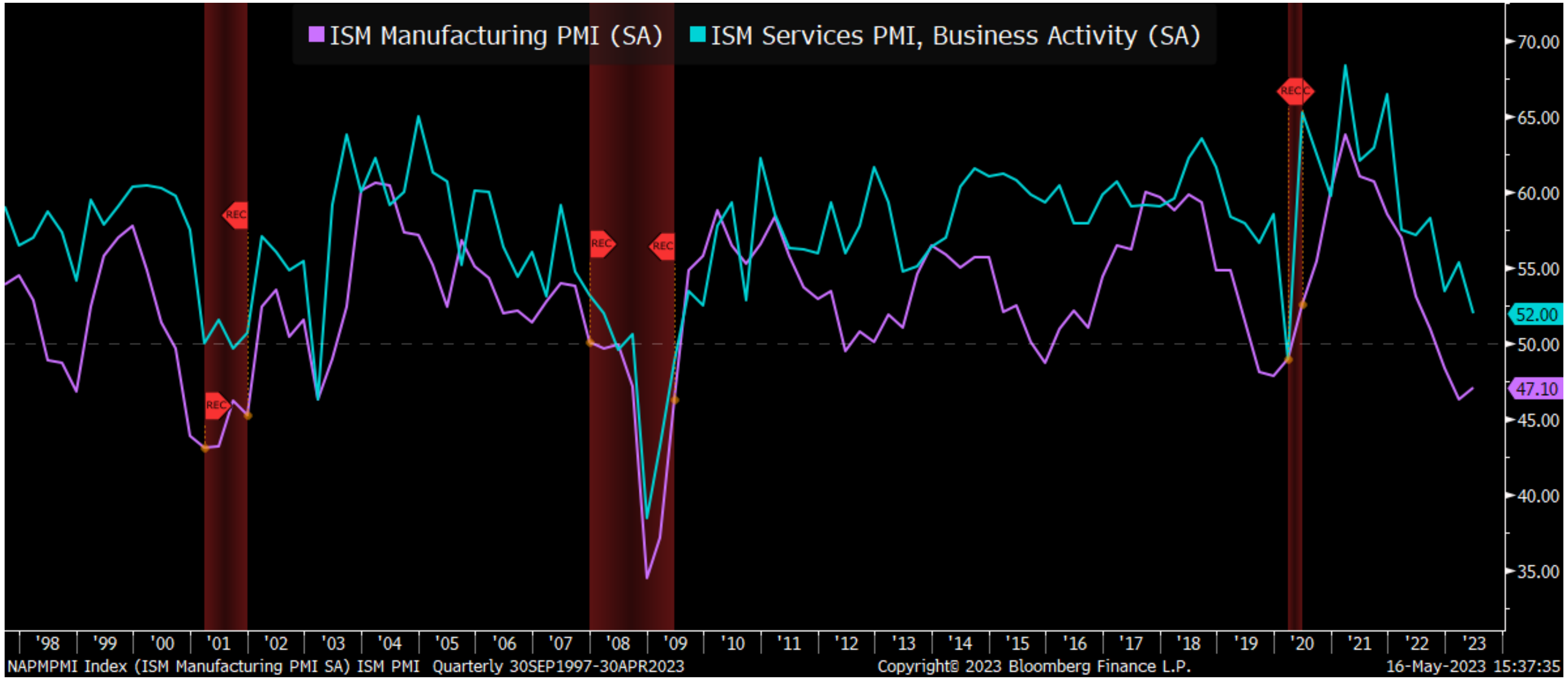
- While up significantly off the lows, consumer default rates are simply at or below pre-pandemic levels and aren't overly concerning on their own.
- These trends are more concerning given record levels of consumer debt. Total consumer revolving credit balances stand today at a record $1.24 trillion.
- These balances carry a hefty 21% interest rate, or $260Bn in annualized interest costs for consumers.

Housing Unaffordability and Lower Home Prices Hinting at Recession



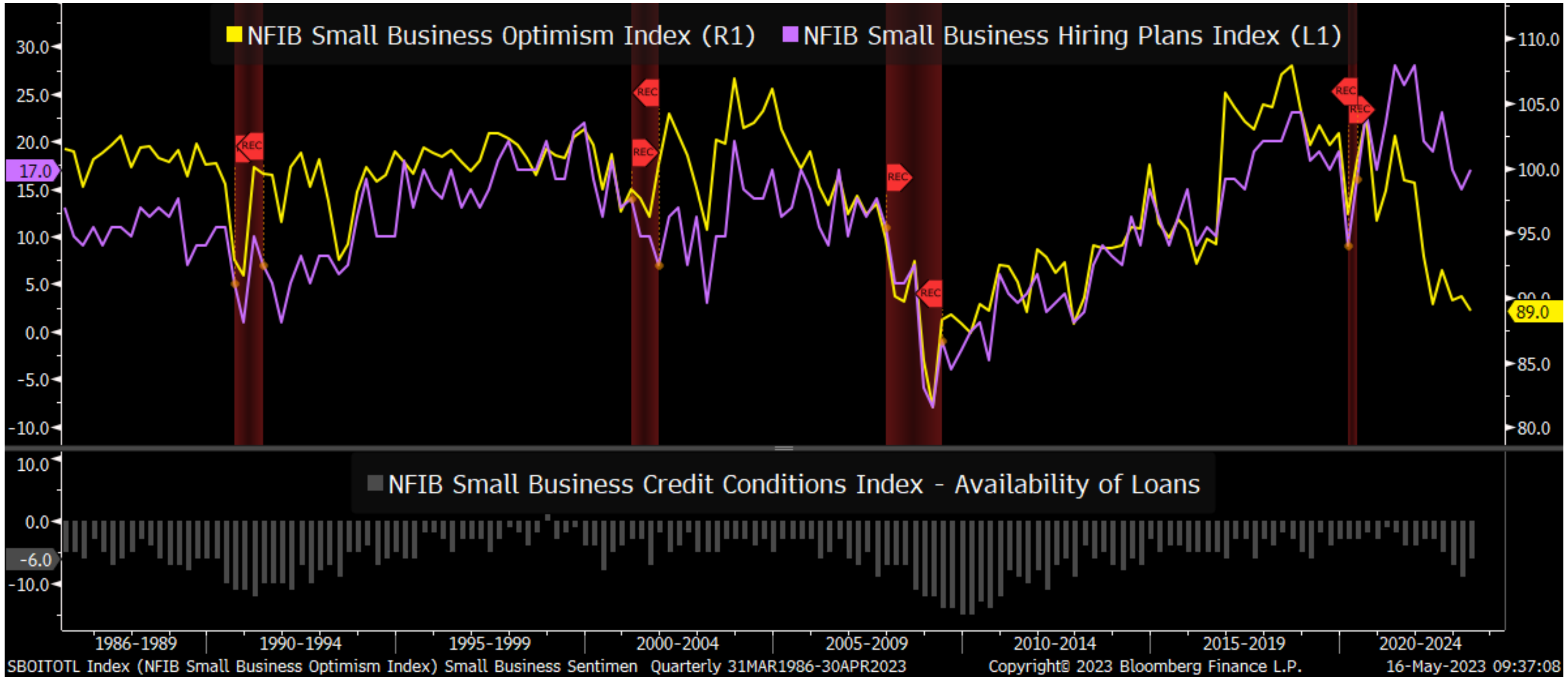
- The US housing market has been suggesting some historical caution, as housing unaffordability sat at an all-time low at the end of 2022.
- As you can see in the chart above poor housing affordability has preceded recessions in the past.
- Pricing has also been soft, but has held in decently well given very low inventory levels caused by nearly a decade of under building following the great financial crisis.

ISM Surveys Uninspiring, but Not Recessionary… Yet



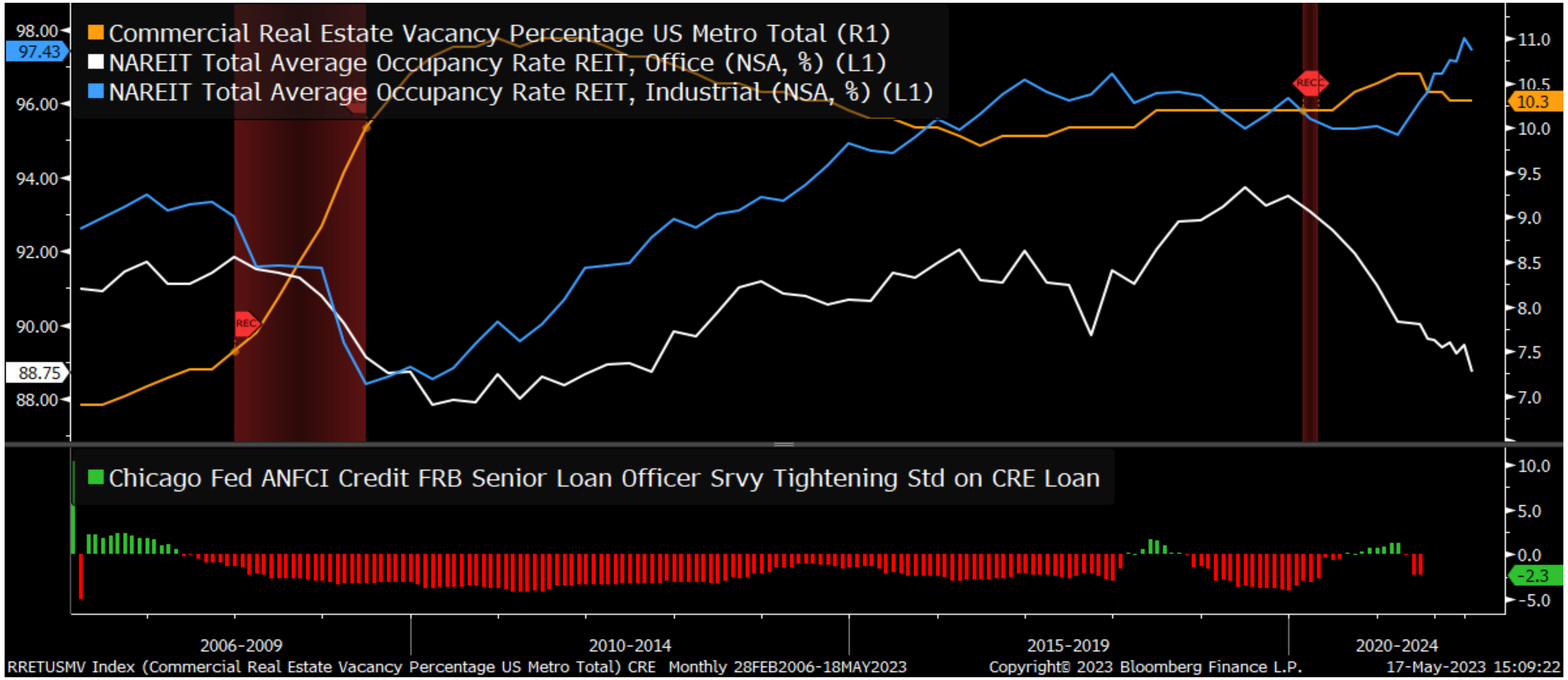
- The ISM PMIs have continued to deteriorate but aren't quite at the critical point where both of these indices dip below 50 (i.e. bearish indicator), a dynamic that has only occurred during recessionary times.
- It is worth noting that the ISM Services PMI doesn't typically to contract from extremes like it has recently without dipping into contractionary territory before returning to any sustained growth.

NFIB Index (Lacks) Optimism, Yet Hiring and Credit Access have Bounced



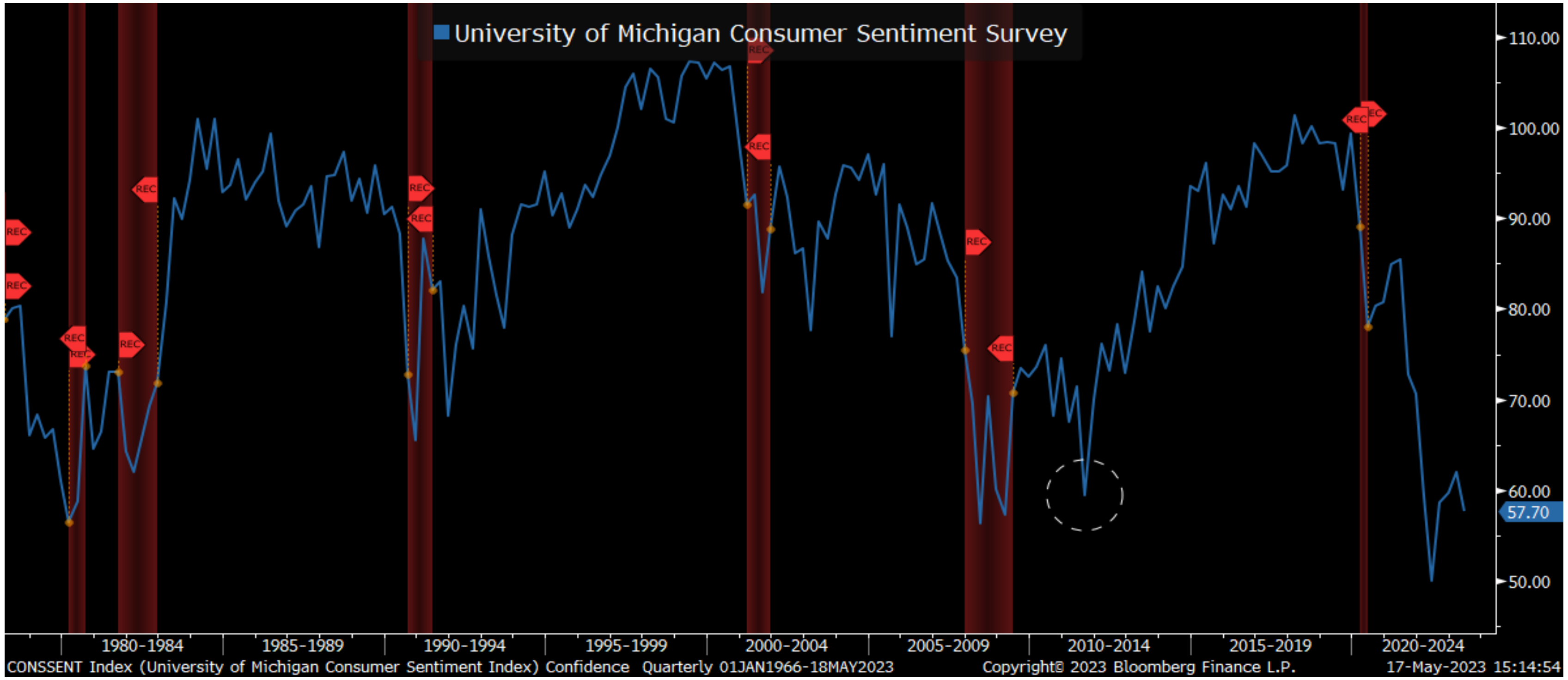
- Small Business Optimism has continued to slide since its peak in late 2019, and is currently at a level typically only seen during recessionary periods.
- However, we have continued to see hiring plans remain resilient and small businesses actually reported easier access to credit.
- This is a bit surprising since the Senior Loan Officer Survey from the Fed suggests lending standards have been tightening, which could start dragging on these metrics later this year.

Pockets of Commercial Real Estate Showing Cracks



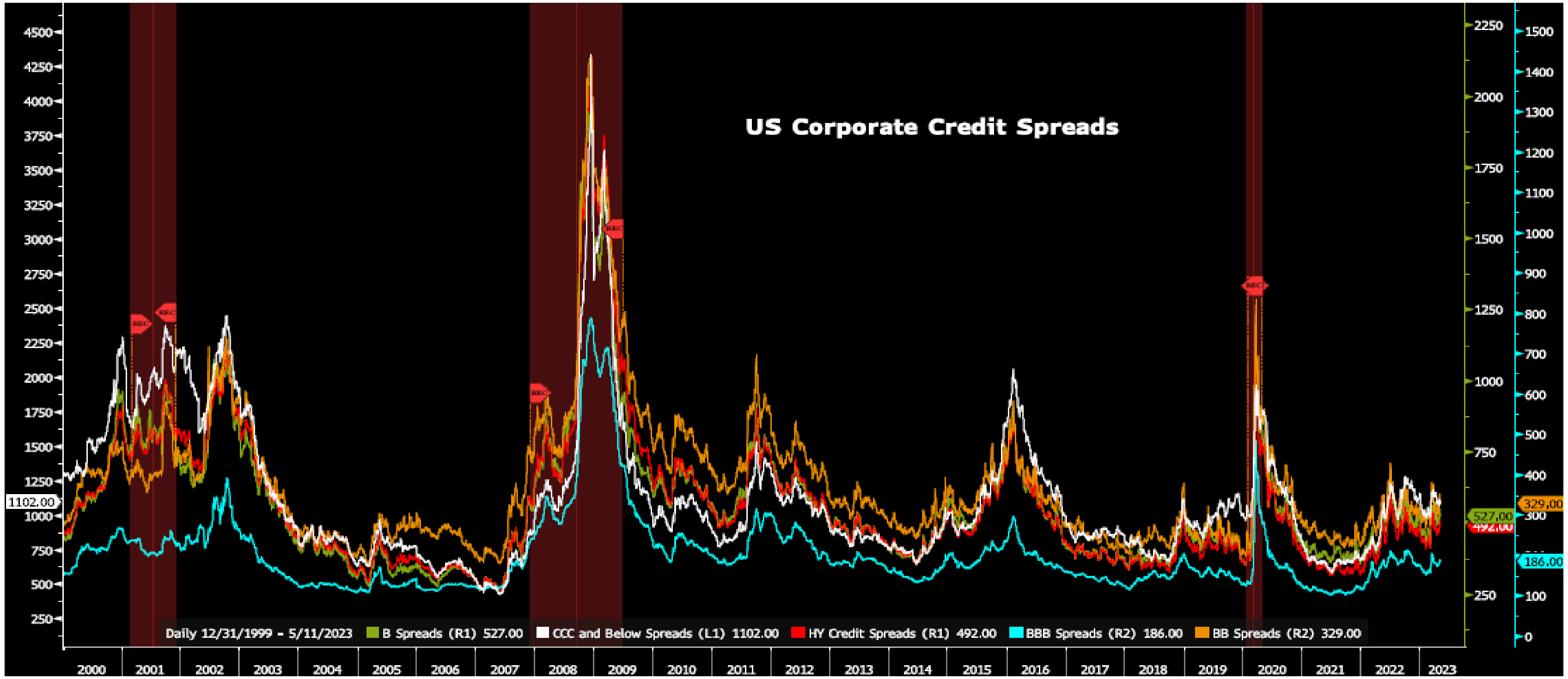
- Commercial Real Estate continues to pop up in the headlines, and for good reason, but we caution against painting with a broad brush.
- As you can see from the chart above occupancy rates across commercial real estate have been relatively stable, but it's not a universal picture.
- While office occupancy rates have continued to slide since 2019, we've also seen industrial properties make fresh highs in occupancy.
- We continue to believe that investors should be selective when it comes to commercial real estate, particularly in the office segment.

Consumer Sentiment Off the Lows, but still Glum



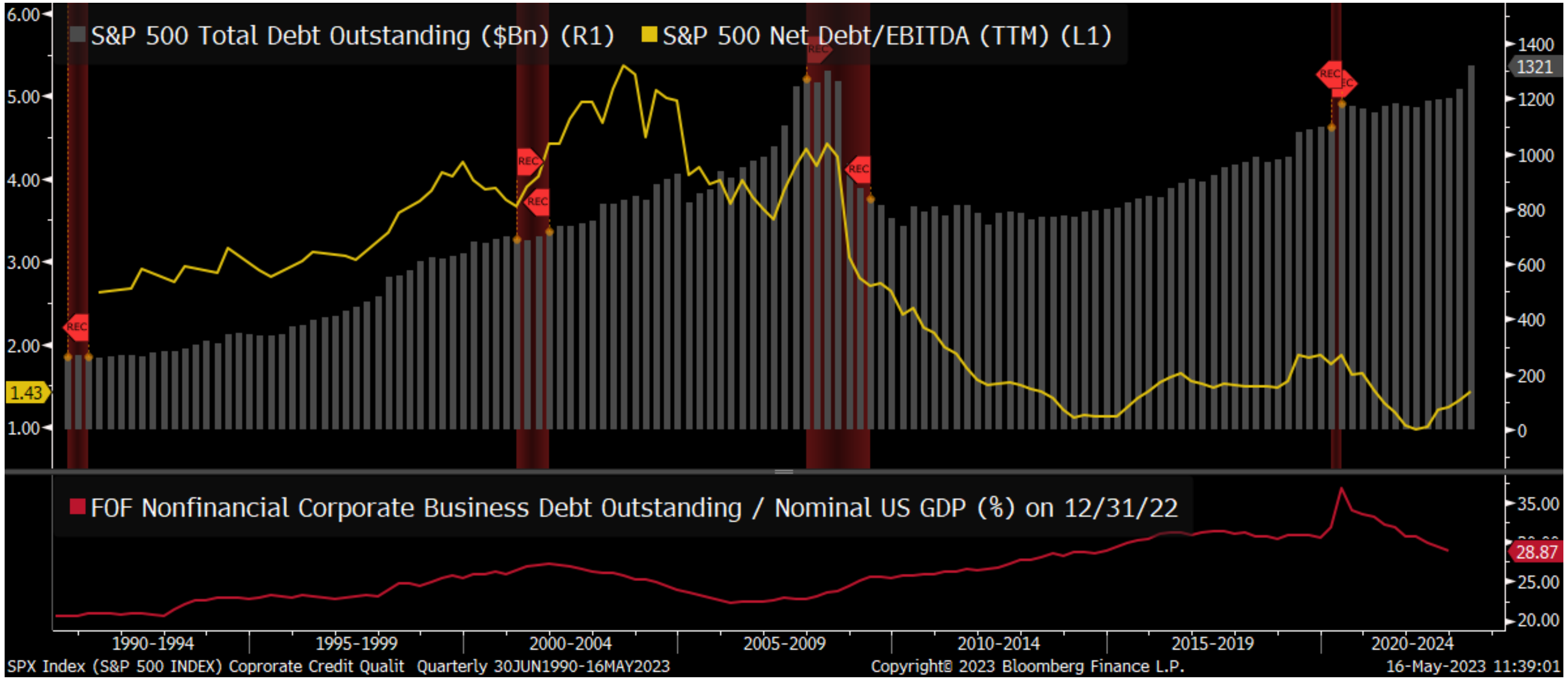
- Consumer Sentiment remains depressed, and the University of Michigan survey points out that the most recent declines can be attributed to negative headlines in the press regarding the standoff over the US debt ceiling.
- The last US debt ceiling standoff ended in August 2011, where a similarly depressed Consumer Sentiment reading quickly bounced and ignited a strong market rally.
- This is important, because beyond today's reading, that 2011 period was the most depressed Consumer Sentiment reading to occur outside of a recession in the US.

Credit Spreads Certainly Not Screaming Recession



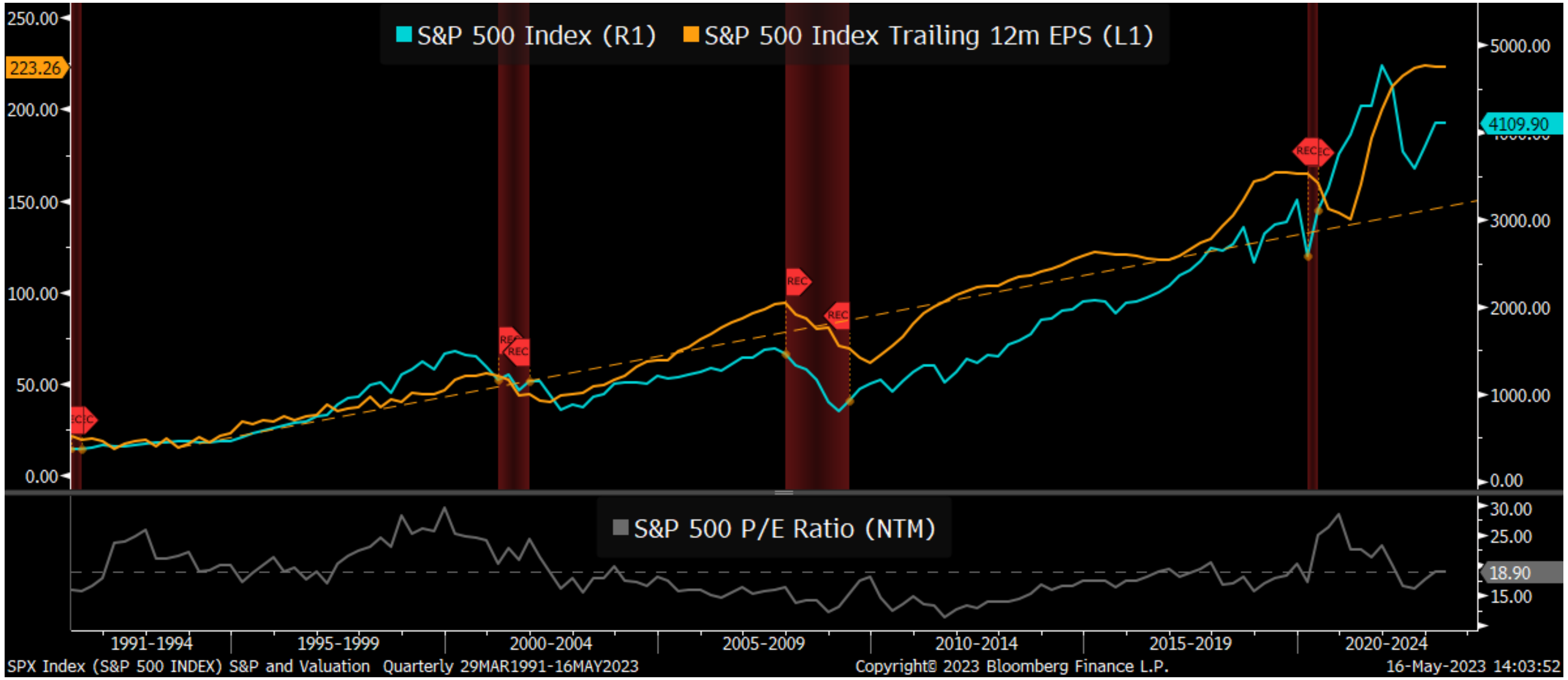
- Credit spreads are currently not showing signs of stress with BBB-rated spreads at +186 basis points, and high-yield spreads at 492bp.
- Both of these are firmly in the middle of their historic trading ranges, and do not appear to be signaling a recession on the horizon.
- While spreads are fairly subdued at the moment, we worry that lower rated junk bonds could see spreads widen considerably even during a mild recession so recommend being cautious on lower rated issues.

Company Balance Sheets in Decent Shape, Albeit with Record Debt



- A potential driver behind muted credit spreads are the relative health of corporate balance sheets in the US (as shown by the yellow line). This trend line illustrates that the net debt (total debt net of cash) to EBITDA is far lower than any readings in previous recessionary periods.
- Additionally, many companies took advantage of rock-bottom rates post-Covid and extended their maturity profiles, lessening their near-term debt obligations.
- That being said, a new all-time record in corporate debt outstanding should certainly be monitored, nonetheless.

S&P 500 Pullback Leans Recessionary, but Earnings Strength Persists



- Meaningful S&P 500 pullbacks have generally preceded recessions and accompanied by a deterioration in earnings.
- However, while we've had a decent-sized pullback, S&P 500 earnings are only expected to drop by 1.5% in 2023 and remain significantly above trend.
- That being said, valuation on the S&P is right around its long-term average, and could mitigate some of the pain from any potential deterioration in future earnings.

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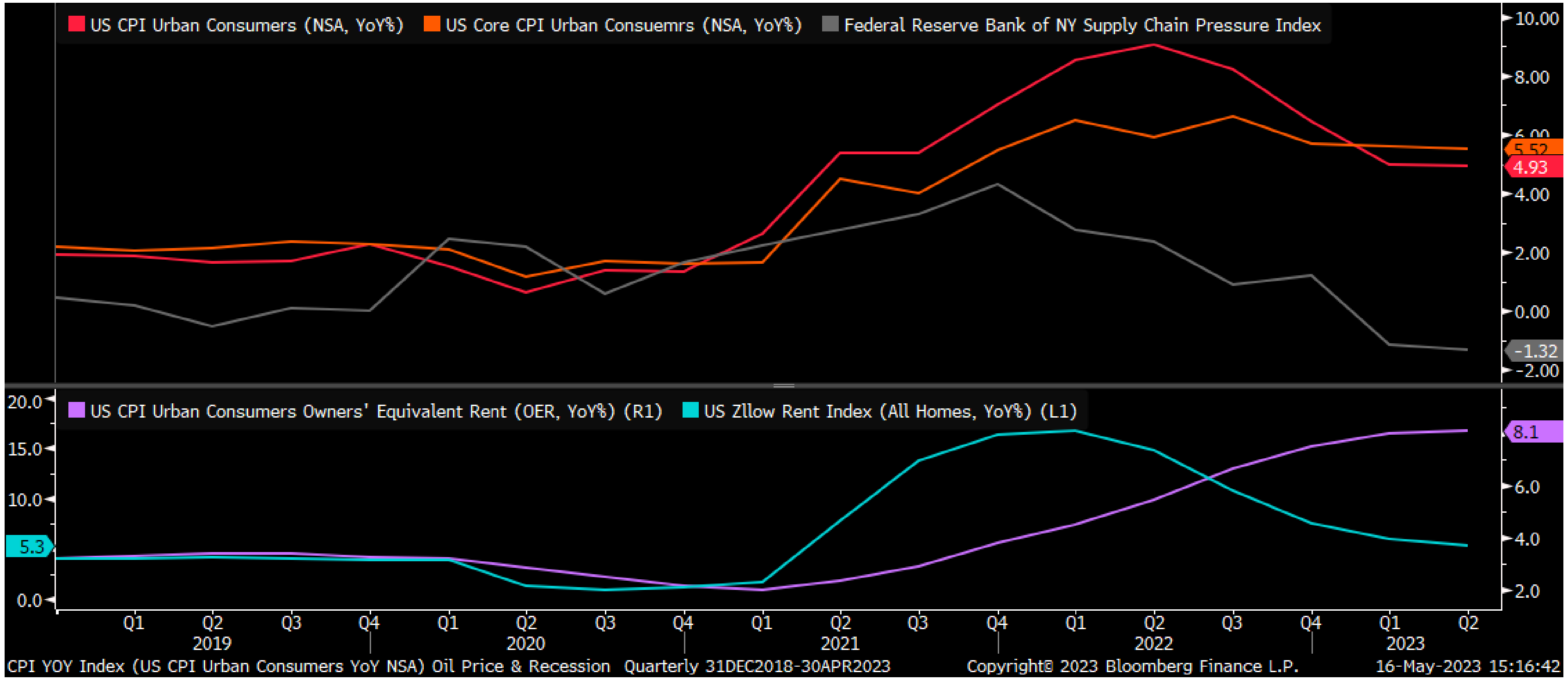
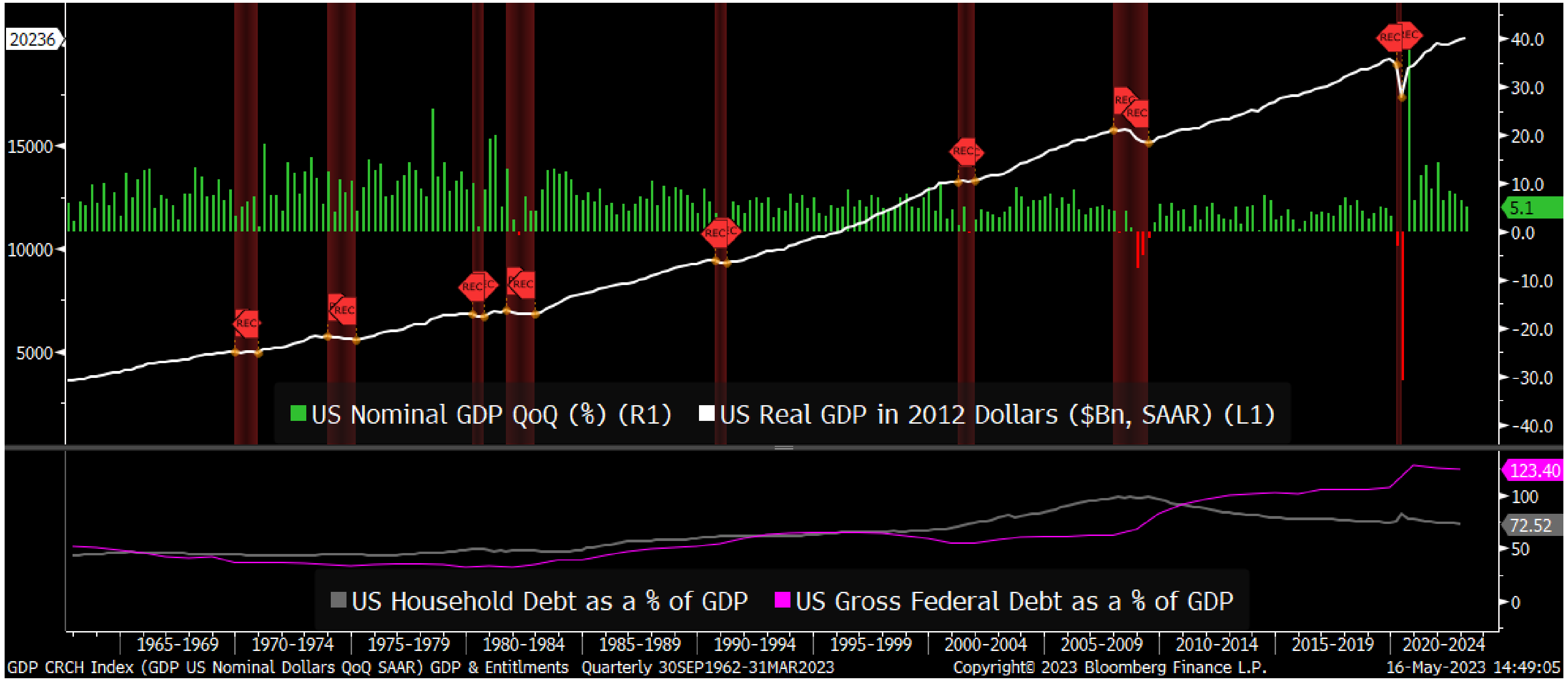
Inflation Rolling Over Should Continue to Relieve Pressure on Economy



- The US CPI has appeared to roll over significantly, down to a roughly 5.5% increase year-over year (4.9% excluding Food & Energy) from a 9.06% peak in the second quarter of 2021.
- Inflation could continue its downward trend since several components operate on a lag. Specifically, owners equivalent rent (OER), in the bottom pane above, has yet to respond to broadly decelerating rent (Zillow Rent Index in blue).

Any Potential Recession Could be Shallow, and Short-Lived



- Recessionary periods that saw positive nominal growth have tended to be much shallower and more short-lived than their double-negative counterpart.
- The Federal government's balance sheet continues to be a big vulnerability to the US economy. The impact of this ballooning liability would only be exacerbated if the stalemate over the debt ceiling ends in a disastrous US default.
- We believe that due to the many cross-currents in the American economy and opposing data across sectors, a recession would likely be fairly shallow and short-lived.

Index Definitions

- NY Fed Probability of Recession uses the treasury spread (10-year minus 3-month) to determine the probability of a recession in the US within the next 12 months.
- Chicago Fed National Financial Conditions Index (NFCI) is a weighted average of 105 measures of financial activity, each expressed relative to their sample averages and scaled by a simple standard deviation.
- Chicago Fed NFCI Credit NFIB Survey collects information about business performance, financing needs, capital sources, and borrowing experiences with 500 or fewer employees.
- Conference Board US Leading Indicators Index encompasses 10 leading indicators whose changes tend to precede changes in the overall economy.
- Federal Reserve US Obligations Ratio the sum of total quarterly mortgage payments and total quarterly scheduled consumer debt payments divided by total quarterly disposable income.
- S&P/Experian Consumer Credit Default Index measures default rates across autos, first and second mortgages and bankcard combined into one index.
- Federal Reserve Consumer Revolving Credit Amount Outstanding encompasses revolving credit outstanding, primarily credit card loans, but also includes things like prearranged overdraft plans.
- Housing Affordability Index measures whether or not a typical family earns enough income to qualify for a mortgage loan on a typical home at the national and regional levels based on the most recent price and income data.
- Bankrate.com US 30-Year Fixed Home Mortgage Rate National Average uses weekly mortgage applications submitted to Freddie Mac from lenders across the country.
- S&P/Case-Shiller US National Home Price Index measures the value of single-family housing within the US using a composite of single-family home price indices for all nine US Census divisions, calculated monthly.
- FHFA US Price Index is a weighted, repeat-sales index, measuring average price changes in repeat sales or refinancings on the same properties using data provided by Fannie Mae and Freddie Mac.
- ISM Manufacturing PMI is a monthly indicator of US economic activity based on a survey of purchasing managers at more than 300 manufacturing firms.
- ISM Services PMI is a monthly indicator of US economic activity based on a survey of purchasing managers and supply executives at more than 400 non-manufacturing firms.
- NFIB Small Business Optimism Index is a composite of 10 seasonally-adjusted components calculated based on the answers of around 620 NFIB members.
- NFIB Small Business Hiring Plans Index is calculated based on the percent of respondents who plan to “increase” their number of employees minus those who plan to “decrease” the number of employees in the next three months.
- NFIB Small Business Credit Conditions Index – Availability of Loans is based on the percentage of respondents who say that loans are “easier” to get today than they were three-months ago minus those who say it was “harder” to get the same loan today versus three months ago.
- Conference Board Consumer Confidence Index a monthly report detailing consumer attitudes, buying intentions, vacation plans, and consumer expectations for inflation, stock prices, and interest rates. Data available by age, income, nine regions, and top eight states.
- University of Michigan Consumer Sentiment Survey a monthly 50-question survey assesses how consumers view prospects for their own financial situation, how they view prospects for the general economy over the near-term, and their view of prospects for the economy over the long-term.
- FOF Nonfinancial Corporate Business Debt Outstanding includes data on transactions and levels of financial assets and liabilities, by sector and instrument spanning all private for-profit domestic nonfinancial corporations, including partnerships, LLCs, and sole proprietorships.
- S&P 500 Index is a stock market index tracking the stock performance of 500 of the largest companies listed on the stock exchanges in the US.
- US CPI (and Core CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Core CPI eliminates any food and energy-related expenses from the basket prior to calculating the price level.
- US CPI Owners Equivalent Rent is made up of two surveys, the consumer expenditure survey which asks households the share of their budget which goes towards different categories of goods and services, and the housing survey which collects price observations of rental housing units across the US.
- Federal Reserve Bank of NY Global Supply Chain Index is measured by data from the Baltic Dry Index, Harpex Index, and airfreight costs from the BLS as well as several supply-chain related components from PMI surveys focusing on manufacturing firms across China, Europe, Japan, S. Korea, Taiwan, the UK, and the US.
- US Zillow Rent Index is a dollar-denominated mean of listed rents that fall between the 40^{th} and 60^{th} percentile for all homes and apartments in the US.

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