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AN UPDATE FROM PAUL DIETRICH

IS IT REALLY POSSIBLE TO STOP A RECESSION?

Ever since the Dutch created the first modern stock market 412 years ago in 1611, there have been expanding economic business cycles called bull market/ expansions, immediately followed by contracting economic business cycles called bear market/ recessions.

These natural cycles were like night follows day and the summer follows spring. They are natural laws and cycles that are hard to repeal.

What Does A "Soft Landing" Have To Do With A Recession?

Nothing really!

A "Soft Landing" is when the Federal Reserve tightens monetary policy by raising interest rates to fight inflation but does not cause a recession (which would be a "hard landing"). Soft landings are very difficult to achieve and extremely rare.

According to most economists, the Federal Reserve has managed to achieve only one soft landing in the past 60 years—in 1994–1995.

Was there even the possibility of a recession in 1994-1995?

In 1994-1995, we were in a normal bull market. The U.S. economy had recovered strongly after a brief recession in 1991. Unemployment was falling quickly, consumer spending was increasing, and manufacturing was steadily expanding. All of these were approaching levels that were starting to trigger higher inflation.

Alan Greenspan's Fed raised rates seven times in 13 months in 1994 and early 1995 in an effort to prevent an overheating economy from driving up inflation.

The 1994-1995 U.S. economy was the exact opposite of our economy today. They were in a booming, expanding economy a few years after the last recession.

Today, the U.S. is in a slowing and contracting economy, and after a 13-year bull market, is headed for a short cyclical recession.

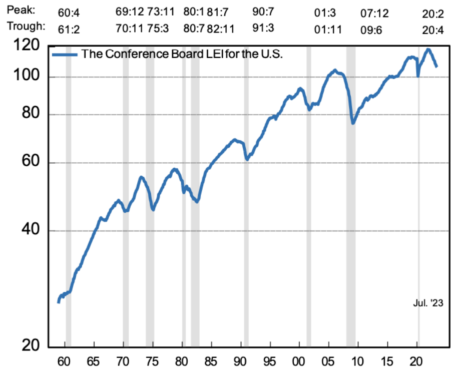
Historically, the two best known recession indicators would have signaled a recession in advance of the 1994 -1995 rate increases.

Was The Conference Board's Composite Index of Leading Economic Indicators Signaling A Recession Before 1994-1995?

No! The Conference Board's Composite Index of Leading Economic Indicators (LEI) usually signals a recession 9-to-12 months before a recession starts.

As you can see by the chart below, the LEI was expanding and going up in 1994-1995. The LEI did not signal a recession in 1993 as it should have done if the economic business cycle was changing from an expanding economy to a contracting slowing economy.

U.S. Composite Economic Indexes (2016=100)



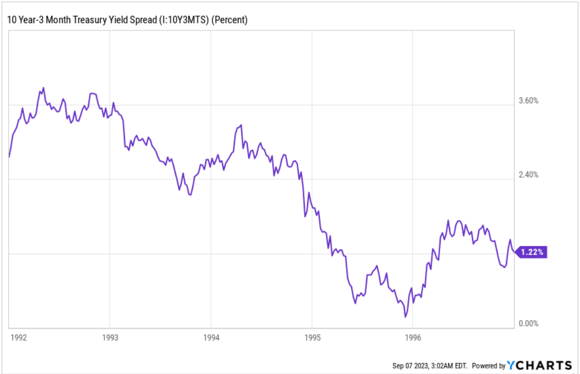
That didn't happen because we were in a strong bull market that was expanding rapidly.

Was There An Inverted Yield Curve in 1994-1995 Signaling A Recession?

No! The 10 year-3 month Inverted Yield Curve is the other major recession indicator that has a 100% record in predicting a recession in advance.

This indicator usually signals a recession 9-to-18 months before a recession starts.

As you can see by the chart below, the 10 year-3 month Inverted Yield Curve never declined below zero in 1994-1995, which is the definition of an inverted yield curve. The 10 year-3 month Inverted Yield Curve did not signal a recession in 1992-1993 as it should have done if the the economic business cycle was changing from an expanding economy to a contracting, slowing economy.



Soft Landing Summary

What Alan Greenspan did was simply nip in the bud higher inflation by raising rates during a too strong economy coming out of the 1991 recession.

It is like comparing apples and oranges to our economy today, which has been slowing and contracting since early 2022 after a 13-year long bull market/expansion.

Unless the natural laws of cycles have been repealed, we will have a recession late this year or early next year. This time will not be different!

Is The U.S. Economy Slowing Or Turning Up?

According to some journalists in the business media and "happy talk analysts," they are describing some recent U.S. government economic reports as "better than expected." That is another way of saying that the reports still show the economy slowing from their highs in 2022, but they did not slow as much as analysts and economists expected.

It should be pointed out that there is a very large difference between the economy slowing less than expected and an economy that is growing and expanding.

Many of the headlines stated, "The Economy Gains Strength." But a strong, yet "cooling economy," is still a contracting economy.

The Stock Market Seems Directionless

It used to be when there was "good news" the market went up, and when there was "bad news" the market went down.

Today it is just the opposite. Good news is bad news for the stock market.

This confusing investor behavior is not uncommon during business and economic cycle changes from bull market/expansions to bear market/contractions. Investors are now carefully navigating this transitional period.

The markets are erratic—characterized by bursts of momentum or news event-driven trading by the market mob, and this has investors jumping from one sentiment to another.

Former Secretary of the Treasury Robert Rubin said last month that he has "never in his life seen so many major risks in the global economy as he does now."

What happens to America's debt rating, tax rates, and unsustainable government debt levels if Congress fails to fund the government and forces an October shutdown? How will the stock market react?

What happens to markets, and geopolitical stability, if China descends into an economic "doom loop" of its own creation? Would China invade Taiwan to regain control of its domestic political troubles?

Will Russia start World War III as Western powers increasingly arm Ukraine? Some military strategists think Russia might use tactical nuclear weapons to establish mastery of its losing situation.

Questions like these make it hard to have conviction about establishing new stock positions when the market trades at historically overvalued price earnings valuations.

The Major Trends & Issues That Will Influence The Stock Market Through The End Of 2023

JOBS: Last month saw a gradual slowdown in the labor market. The unemployment rate climbed from 3.5% to 3.8%.

INFLATION: Inflation reversed a year long decline and edged up this past month.

The Personal Consumption Expenditures (PCE) index is the favored inflation gauge of the Federal Reserve.

US Core PCE Price Index year-over-year is at 4.24%, compared to 4.09% last month and 4.70% last year. This is higher than the long term average of 3.24%.

OIL PRICES: Oil prices soared after Russia and Saudi Arabia both said they would extend their voluntary production cuts through the end of the year.

The two countries' decision to extend oil production cuts caused oil prices to spike. Brent Crude climbed above $90 a barrel for the first time since November 2022. The international benchmark has now risen 23% since the start of June.

This could increase inflation through the end of this year and makes it more likely the Federal Reserve will raise rates once more in 2023 and possibly one more time in early 2024.

Fed rates will remain higher for longer than many investors expect.

The national average price for a gallon of unleaded gasoline last week reached $3.87. The price is still below the $3.93 people paid one year ago, but there is the potential for prices to rise above that before Fall ends.

CORPORATE EARNINGS: For the second quarter of 2023, the year-over-year earnings decline for the S&P 500 is -4.1%. The second quarter will mark the third straight quarter of earnings declines reported by the index.

The stock market is overvalued in that the forward 12-month P/E ratio for the S&P 500 is 18.8. That P/E ratio is above the 5-year average (18.7) and above the 10-year average (17.5).

CONSUMER CONFIDENCE: A recent survey of consumers by Morgan Stanley showed that consumer confidence in the U.S. economy is not improving. Inflation remains the top concern, and the only category where consumers expect to spend more money over the next six months are essentials like groceries, gasoline and household supplies.

CONSUMER SPENDING: Consumer spending on goods like small appliances, consumer electronics and durables is in steep decline.

Consumer spending for services like airplane travel, restaurants and hotels is also starting to slow.

REGIONAL BANKS: A survey of commercial real estate exposure by U.S. regional banks reveals increasing risk and potential credit losses as loans mature over the next 18 months, according to Moody's Investors Service.

With U.S. banks providing more than 70% of U.S. commercial real estate debt financing, a survey of 55 banks by Moody's shows that lenders have faced higher interest rates and a structural shift in demand as more people remain working from home after the COVID 19 pandemic.

This has caused a credit crunch at many regional banks. Strained banking conditions have caused many banks to tighten underwriting, and limit commercial real estate lending activity.

Commercial real estate debt may be the biggest risk to the U.S. economy right now.

POTENTIAL UAW STRIKE: The UAW is likely to authorize a strike against all three of Detroit's automakers at the end of the month. That could depress the economy depending on how long it lasts and drive up car prices.

U.S. GOVERNMENT SHUTDOWN—AGAIN? Republican hardliners aligned with the Freedom Caucus are playing a game of chicken with more moderate Republican conservatives and Democrats over the federal budget. Instead of a short-term compromise, the result could be a government shutdown, possibly by the end of the month, but more likely in October.

What Do Warren Buffett & "The Big Short" Investor Michael Burry Know That We Don't?

Warren Buffett's Berkshire Hathaway sold almost $8 billion in stocks last quarter. He bought U.S. Treasury bonds.

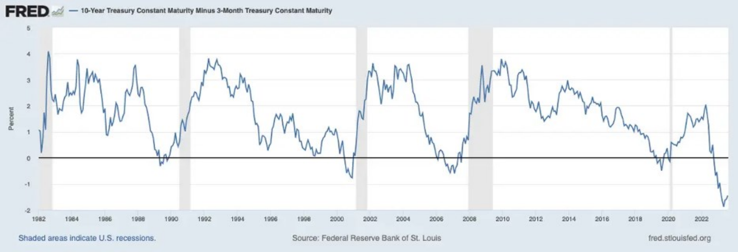
Michael Burry, "The Big Short" investor who became famous for correctly predicting the collapse of the housing market in 2008, also made a gigantic bet last quarter on a stock market crash. Burry's fund, Scion Asset Management, shorted the S&P 500 Index worth $866 million. He also shorted the Nasdaq 100 Index for another $739 million.

What Are The Recession Signals Saying Right Now?

The Inverted Yield Curve

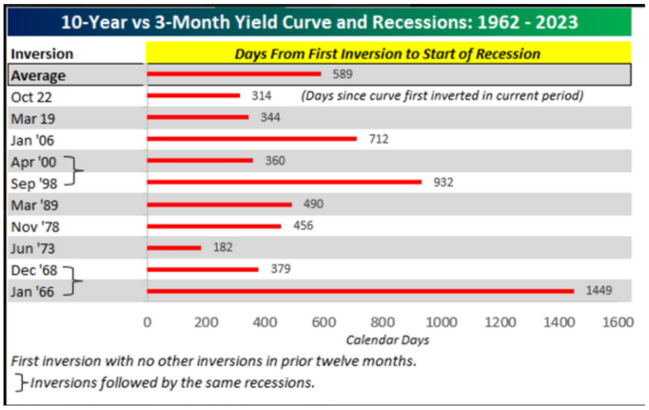
In October 2022, the 10 year-3 month Inverted Yield Curve, which is the preferred recession signal used by the Federal Reserve, started flashing a recession signal for the U.S. stock market.

When inverted, the Yield Curve usually signals a recession signal 12 months to 18 months before a recession begins. Like Leading Economic Indicators, it has a 100% record of accurately calling recession in advance, like an early warning system.



Analysts at Bespoke Investment Group think the next recession could start between October 2023 and early June 2024.

That's because past recessions took an average 589 days to materialize after the 10-year and 3-month yield curve first inverted, based on data since the early 1960s.



Source: BESPOKE INVESTMENT GROUP

Past recessions took almost 600 days on average to start after a key recession gauge first flashed.

Their data also shows June 1973 was the only time in the past six decades when a recession arrived within 300 days of the 10-year and 3-month yield curve first inverting.

The Conference Board's Composite Index of Leading Economic Indicators (LEI)

The Conference Board's Composite Index of Leading Economic Indicators (LEI) is the other major recession signal.

The LEI tracks 10 forward-looking measures, including permits for future home construction; stocks, which anticipate future earnings; upcoming orders for manufactured goods; consumer expectations; and new unemployment applications.

Basically what it does is tell us where the economy is heading in the near term.

It is kind of like athlete rankings — the LEI crunches 10 different performance stats that hint at future economic activity.

The Leading Economic Indicators Are STILL Signaling A Recession

The Conference Board's Leading Economic Index® (LEI) — which measures U.S. business cycles—again dropped to its lowest level since November 2020, consistent with worsening economic conditions ahead. Its 16th consecutive monthly decline is the longest since the 2007-2009 recession.

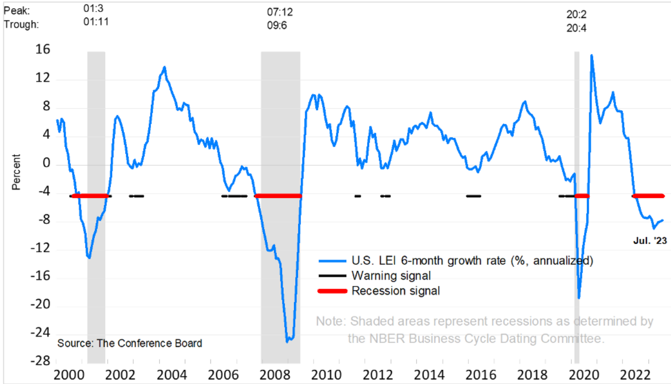
The LEI is a crucial barometer for the economy's health. It continues to flash a recession warning sign, indicating an economic downturn in the U.S. will start in the near future.

The importance of the Leading Economic Index is that it has historically signaled a recession 9-12 months before a recession starts. This is an extremely valuable early warning system as to when a recession is about to begin.

That would mean we should be able to expect the recession to start sometime between now and October 2023.

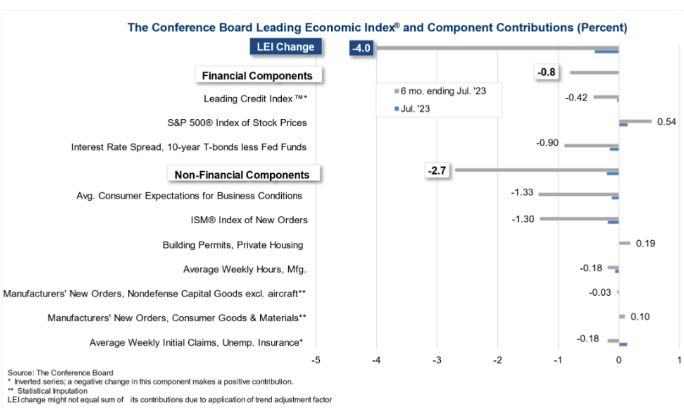
Following is The Conference Board's U.S. Composite of Leading Economic Indicators.

On average, this index signals a recession when it declines below the red bar about nine months to a year ahead of a recession, according to The Conference Board. They announced their recession signal in September 2022.



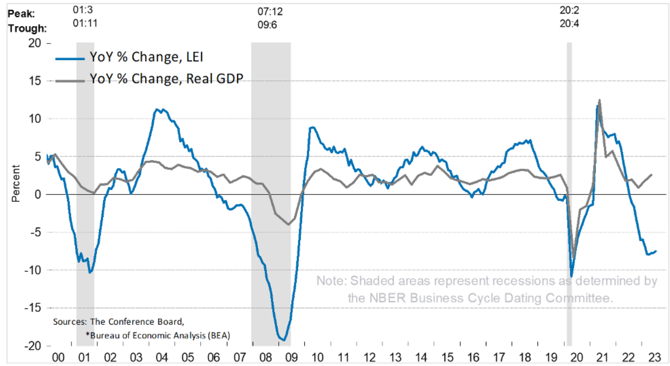
"The US LEI—which tracks where the economy is heading—fell for the sixteenth consecutive month in July, signaling the outlook remains highly uncertain," said Justyna Zabinska-La Monica, Senior Manager, Business Cycle Indicators, at The Conference Board. *"On the other hand, the coincident index (CEI)—which tracks where economic activity stands right now—has continued to grow slowly but inconsistently, with three of the past six months not changing and the rest increasing. As such, the CEI is signaling that we are currently still in a favorable growth environment. However, in July, weak new orders, high interest rates, a dip in consumer perceptions of the outlook for business conditions, and decreasing hours worked in manufacturing fueled the leading indicator's 0.4 percent decline. The leading index continues to suggest that economic activity is likely to decelerate and descend into mild contraction in the months ahead. The Conference Board now forecasts that the U.S. economy is likely to be in recession from Q3 2023 to Q1 2024. Elevated prices, tighter monetary policy, harder-to-get credit, and reduced government spending are poised to dampen economic growth further."*

The chart below shows that seven out of the ten LEI components contributed negatively to the Composite.



The following chart illustrates year-over-year changes.

The annual growth rate of the LEI remained negative, confirming weaker economic activity ahead



Putting The Recession In Perspective: When Will The Recession Finally End?

Historically, the stock market bottoms before the recession ends. Typically, the market bottoms in 'capitulation selling' (remember March 9, 2009?) about 70% through the actual recession.

Since recessions generally last 9 to 18 months, if the recession were to begin during the third quarter of 2023, a nine-month recession could see a stock market bottom during the first quarter of 2024. If this turns out to be an 18-month recession, we could see a market bottom in the summer of 2024.

The good news is that this recession is not the world's end. Because of the strong jobs market, this is not 2008. Yes, revenues will be off. Earnings will be off. The U.S. economy will slow because of inflation and Fed rate increases, resulting in a good old-fashioned earnings recession with inflation.

With patience, we will get through this.

While I still expect the S&P 500 Index to trade down to the 3200 level, representing a potential downside of about -25% from now, I also expect an eventual recovery sometime in early 2024 through the third quarter of next year.

Investors Need To Be Patient—And Realistic

As an analyst, I am not a permanent Bull or Bear. I am neither optimistic nor pessimistic.

I look at the facts and data and see where I am now within the larger business economic cycle.

We are entering into a global recession and a contracting business economic cycle. These are natural economic cycles like the day follows night, and spring follows winter.

It is time to be defensive in your investing. Don't take any risks. Hunker down and try to preserve all the capital you have.

Acting appropriately to what you are facing is like battening down the hatches during a storm or hurricane. This is just common sense.

Investors need to take a deep breath and realize they are living through a natural cycle that has played out for hundreds of years in world economies and stock markets.

When Should We Get Back Into The Stock Market?

The leading economic indicators will show us when the next bull market is starting.

The table below provides current data on the two major composites of U.S. leading economic indicators and their composite indicator components. I've included a column to show the trailing 12-month directional trends and whether each is currently declining, plateauing, or recovering.

This updated monthly table shows investors the long-term directional trends of the significant composites and individual indicator components of the leading economic indicators.

U.S. LEADING ECONOMIC INDICATORS (AUGUST 2023)

U.S. Leading Economic Indicators	Trailing 12-Month Directional Trend	Declining / Plateauing / Recovering
Conference Board Composite of Leading Economic Indicators	Recession Signal	Declining
ECRI Composite of Weekly Leading Index	Recession Signal	Declining
Major Leading Economic Indicator Components		
10 Year-3 Month Treasury Yield Spread	Directional Trend Down	Declining
US ISM Manufacturing New Orders Index	Directional Trend Down	Declining
US ISM Services New Orders Index	Directional Trend Down	Declining
S&P 500 Real Price	Directional Trend Down	Declining
US Index of Consumer Expectations	Directional Trend Down	Declining
US 4-Week Moving Average of Initial Claims for Unemployment Insurance	Directional Trend Down	Declining
US Consumer Goods New Orders	Directional Trend Down	Declining
US Construction Materials and Supplies New Orders	Directional Trend Down	Declining
US Manufacturing Average Weekly Hours	Directional Trend Down	Declining
US Manufacturing New Orders	Directional Trend Down	Declining
US Nondefense Capital Goods Excluding Aircraft New Orders MoM	Directional Trend Down	Declining
US Building Permits (SAAR)	Directional Trend Down	Declining
US Weekly Economic Index (NSA)	Directional Trend Down	Declining

Source: YCharts

On a personal note: As an investment manager, I have relied on this table through three previous recessions and will do so again in this upcoming fourth recession. It has never let me down.

I have been managing investment strategies for over 25 years and through three recessions, not counting the one that will start this year. I have benefited most from dispassionately focusing on data based not on the stock market but on the underlying U.S. and global economy. The data is what it is.

The good news is, at some point, when the U.S. leading economic indicators start to turn up again—as they always do—I expect that as I retire my defensive investment strategies and let my offensive strategies take the field once again, my investments will be worth more as the economy recovers and corporate America resumes another expansionary path.

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Paul Dietrich is focused on managing investments for private investors, retirement funds and private institutions throughout the United States. He also serves as an on-air commentator and contributes market analysis to business and financial media including *CNBC, Fox Business, Bloomberg TV, CNN, The Wall Street Journal, Yahoo! Finance, Reuters* and *The Washington Post.*