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6/8/2022

AN UPDATE FROM PAUL DIETRICH

TRYING TO SLOW A SPEEDING TRAIN. WHAT COULD GO WRONG?

Jamie Dimon, the CEO of JPMorgan Chase, said a few weeks ago, the U.S. economy was headed for a "hurricane." Tesla CEO Elon Musk said he had a "super bad feeling" about the economy. Goldman Sachs President John Waldron said the current "shocks to the system were unprecedented." A very bearish warning from St. Louis Federal Reserve Bank President James Bullard helped contribute to the recent sell-off in stocks.

Many of these executives suggested that a **"recession"** was now on the horizon.

Investors are now asking the key questions: what is the probability of a recession, when will it start, and what are the investment implications for an investor's retirement investments?

After his comments, when pressed by reporters, Jamie Dimon said he believed we could see the "hurricane" hit in 6 to 9 months.

Why Has All This Recession Talk Intensified Over The Past Few Weeks?

About ten days ago, one of the most reliable U.S. recession indicators flashed its "recession signal."

The *Economic Cycle Research Institute* (ECRI) maintains a proprietary composite of leading economic indicators. It has an impressive record, going back decades, of signaling recessions and business cycle changes 6 to 9 months before they occur.

The *Economist* wrote in 2005: "ECRI is perhaps the only organization to give advance warning of each of the past three recessions; just as impressive, it has never issued a false alarm."

Here is a chart of their current *ECRI U.S. Weekly Leading Index:*

THE BOTTOM LINE: In May, the growth rate of their proprietary composite of leading economic indexes turned negative. Historically, that has indicated that in the next 6 to 9 months, we may see a recession and sustained negative GDP growth in the U.S. economy.

Other Composites Of Leading Economic Indicators Are Not Signaling A Recession—Yet!

Remember, composites of leading economic indicators are the "early warning systems" that give advance warnings of a recession or business cycle downturn. They also give positive early warning signals that the economy is about to recover from a recession and start a new bullish business cycle recovery.

Most of the composites of leading economic indicators claim to forecast a business cycle turn (both up and down) about 6 to 24 months before they happen.

This gives investors time to ensure they do not miss the usual stock market upturns before a recession. And it helps investors plan when to re-enter the stock market as it recovers after a recession.

2001-2002 Recession & 2008-2009 Recession

Like many insurance, hedge fund, and institutional investment managers, I use a combination of leading economic indexes and very long, moving averages to get my investment management clients out of the stock market during long-term bear market recessions. So far, I have a pretty good record.

In 2001, I appeared on the Financial News Network, which is now CNBC, and announced that I was moving all of my clients out of the stock market and into bonds. The recession hit about three months later. Peak-to-trough, during the 2001-2002 Recession, the *S&P 500 Index* went down -49%.

In 2008-2009, I appeared on both CNBC and Fox Business News in one week. I again announced that both my leading economic indicators and my long-term moving averages were signaling a recession and that I was moving my clients out of the stock market. About a month later, the recession started. Peak-to-trough, during the 2008-2009 Recession, the *S&P 500 Index* went down -57%.

Suppose an investor can miss most of a -49% or -57% decline in the *S&P 500 Index* and then get back into the stock market when the leading indexes and long-term moving averages indicate the recession is over. In that case, I think most investors would consider that a successful investment strategy.

What Are The Other Recession Indicators Signaling?

Now that we are formally on "**Recession Watch**," I will regularly review changes in the various recession indicators for readers of my monthly *Market Commentary*. As we move from a 13-year bull market to an entirely new economic environment of high inflation and a Federal Reserve aggressively raising interest rates to slow the economy, I believe this will help both investors and advisors in identifying when we will be entering a recession—if that is what is going to happen.

The Federal Reserve is raising interest rates to slow the economy and bring down inflation. It hopes to do this without significantly raising unemployment and to have, what it calls, a "soft landing" for the economy.

The Fed has its work cut out for it. Trying to navigate an economic soft landing given Covid, the war in Ukraine, oil price shocks, supply chain backups, severe political risk, and increasing food prices will be very hard.

On the positive side, the U.S. economy remains fundamentally strong. Americans have record savings, their homes are at historical valuations, there is full employment for anyone who wants to work, and corporations are posting record earnings.

Many economists believe that is enough to withstand a series of interest rate increases to slow the economy and tamp down inflation. They believe the strong economy and job growth will be a buffer to absorb the slowdown.

At worst, if we eventually have a recession, the economy's underlying strength should be enough to keep that recession relatively shallow and short-lived—if not to fend it off entirely.

Even if the Fed raises rates faster than expected, the most pessimistic **serious analysts are not forecasting a recession based on the Fed overcorrecting until sometime in 2023.**

I hope the Fed will succeed. However, in the past 11 recessions, eight of them have been caused by the Fed raising rates too high and causing a recession. The history of Fed rate increases has not instilled a lot of confidence among professional investors that they will be able to engineer a "soft landing" without causing a recession.

Following is a look at where other major recession signals are today.

The Conference Board's Leading Economic Index

This non-profit economic research institute's leading economic index is the most prominent and well-known compiler of leading economic indexes. It is the index primarily used by the Federal Reserve in its deliberations.

It also has a long, excellent track record of identifying recessions and long-term bear markets well before they initially occur. The most recent report, issued May 19 2022, of *The Conference Board's Leading Economic Index* for the U.S. decreased by 0.3% in April following a 0.1% increase in March. The leading economic index is now up 0.9% over the six months from October 2021 to the end of April 2022. This recent decrease may indicate the start of a slowing of the U.S. economy.

Their report warned that the decline was mainly due to "weak consumer expectations and a drop in residential building permits. Overall, the U.S. LEI was essentially flat in recent months, which is in line with a moderate growth outlook in the near term. A range of downside risks—including inflation, rising interest rates, supply chain disruptions, and pandemic-related shutdowns, particularly in China—continue to weigh on the outlook. Nevertheless, we project that the U.S. economy should resume expanding (GDP) in Q2 following Q1's contraction in real GDP. Despite downgrades to previous forecasts, The Conference Board still projects 2.3% year-over-year U.S. GDP growth in 2022."

THE BOTTOM LINE: *The Conference Board's Leading Economic Index* is not signaling a recession, even in 6 to 12 months. But it is forecasting moderate slowing growth.

The Yield Curve Has A Good Track Record Of Predicting Recessions—But You Have To Know The Rules

The yield curve is a leading indicator with a good track record in predicting recessions long before they happen. But few understand how to read and talk about this really useful indicator correctly.

Typically, bond investors demand a higher yield for committing their money for a more extended period. When yields for short periods exceed those of a longer duration, that creates an "inverted yield curve."

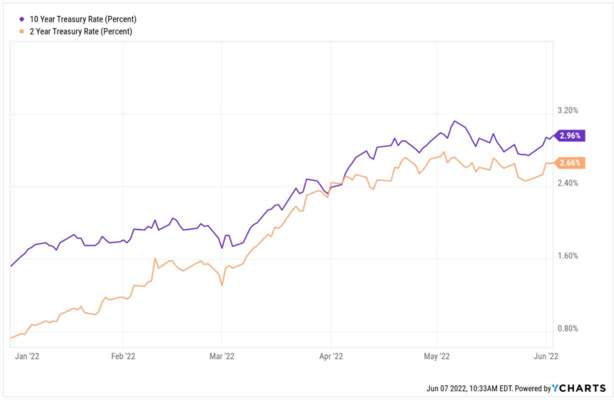
Investors watch for an inverted yield curve using the 10-year Treasury bond yield against the 2-year Treasury bond yield. The inversion of this indicator has forecast five of the past six recessions.

Here is how it works:

The 10-2 Treasury Yield Spread is the difference between the 10-year Treasury rate and the 2-year Treasury rate. A 10-2 Treasury spread that approaches 0 signifies a "flattening" yield curve. Historically, a negative 10-2 yield spread has been viewed as a precursor to a recessionary period. A negative 10-2 spread has predicted every recession from 1955 to 2018 but has occurred 6-24 months before the recession and is thus seen as a leading indicator. For an inversion to count, the yield curve MUST STAY CONSISTENTLY INVERTED for at least two to three months before it can be said to be sending a clear leading economic signal.

Below is the year-to-date chart of the 10-year and 2-year Yield Curve as of June 7, 2022.

THE BOTTOM LINE: You can see in the chart that the yield curve has not inverted and is therefore not signaling a recession in the next 6-24 months.

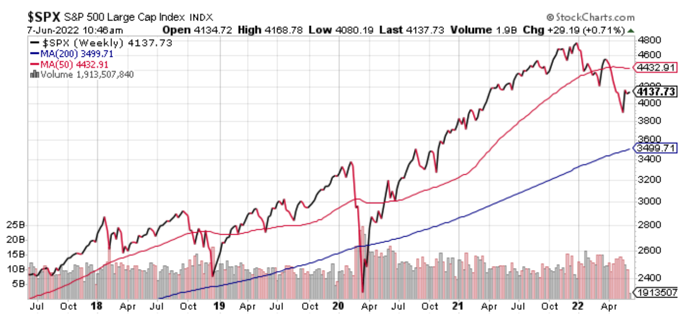


Very Long Moving Averages

As I mentioned above, as an investment manager, I use a combination of leading economic indexes and very long, moving averages to determine when it is time to get my investment management clients out of the stock market during long-term bear market recessions.

With regard to the very long moving averages, I use a 200-week (about 4 years) moving average, along with a composite of leading economic indexes. It should be noted that "weekly moving averages" are very different than "daily moving averages" that are more familiar to many investors.

Below is the current chart as of June 7, 2022, of my very long-term moving average recession indicator.



The red line above is a 50-week (about one year) moving average. I use the red line as a signal to notify me that I need to watch for a possible recession signal every week when the chart is updated. When the *S&P 500 Index* drops below the blue line (the 200-week moving average), it is time to take clients out of the stock market if that is confirmed by a negative signal from the composite of leading economic indexes.

THE BOTTOM LINE: As you can see from the previous chart, the *S&P 500 Index* is far from crossing over the blue 200-week moving average. **The chart is not signaling that a bear market/recession is imminent**.

Where Do Investors Go From Here?

The U.S. economy and the U.S. stock market are facing an unprecedented number of risks over the next 12 months:

- An escalation of the Ukraine-Russia war.
- Continuing shocks to oil and food supplies.
- Potential policy mistakes where the Federal Reserve could tighten too quickly or too slowly. Negotiating a "soft landing" for the economy has never been easy.
- An outbreak of a new, more transmissible COVID-19 variant that causes more severe disease.
- The heightened geopolitical risk with China, and problems with Taiwan.
- Unforeseen new inflation risks.

While most Wall Street analysts believe there is a low probability of these risks occurring, who could foresee that Russia would invade Ukraine a year ago? We all need to be appropriately humble in our ability to predict the future accurately.

That is why risk management and being able to objectively review economic facts –neither from the perspective of panic nor wearing rose-colored glasses – is so critical.

Today, there is much positive news in the economy, but how does an investor balance that good news against all the risks and negative trends like a slowing economy, high oil and food prices, inflation, etc.?

Let's Take A Look At The Good Economic News

If you look at cable business news and newspapers, you would think that high oil prices, stock market volatility, supply chain problems, and inflation are hiding the reality that the U.S. economy is working out pretty well for most Americans.

Home values: It's hard to buy a new house, but the 66% of investors who own their own homes have seen their values climb to historic highs.

Retirement accounts: Despite the recent stock market sell-off, retirement accounts have reached record highs over the past year.

Jobs: For the first time in U.S. history, approximately two jobs are open for every unemployed person in America. The unemployment rate is 3.6%, which is back to pre-pandemic lows.

Wages: Wages continue to grow. The average hourly earnings for employers on private non-farm payrolls rose 5.6% from the year before, Labor Department data show.

Safety nets: Analysts estimate that U.S. consumers accumulated excess savings of about $2.5 trillion during the pandemic.

Corporate Earnings & Revenue: Earnings are expanding, even with inflation. For 2022, FactSet analysts are projecting earnings growth of 10.2% and revenue growth of 10.3%.

The American Economy Is Moving Into A Transitional Period

In polls, most investors think everything is okay for them financially, but they believe the stock market, the world, and the U.S. economy are falling apart. According to Federal Reserve data, 78% of Americans are confident in their financial well-being, but just 24% are satisfied with the economic well-being of the United States.

The economy is currently being pulled in multiple directions at once, weighed down by soaring energy, food, and housing prices, while being strengthened by a spectacular labor market, pent-up consumer demand, high personal savings, and continued substantial business investment. The next few months could determine which economic forces prevail and shape the future of households and businesses heading into the end of the year.

Stock Market Outlook

Over the past month, the stock market seems to be bouncing around the bottom. If trends continue, we could see the stock market move up and back into positive territory before the end of the year. But the big question is—by how much?

Here are some of the factors that will affect stock market performance —

INFLATION

Looking to the end of 2022, I believe we will start to see overall inflation slowly begin to go down. Many analysts believe the inflation rate could come down to 4% to 4.5% by the end of the year. That is still double the inflation rate as of this past January, but the U.S. has lived with 4% inflation for long periods.

Some inflation will also go down because the China lockdown is starting to end now, and many of the supply chain and shipping issues are projected to be worked out by late Fall. This could bring down inflation by 2% to 3%.

Also, the 2% of the current inflation rate that many analysts attribute to President Biden's $1.9 trillion American Rescue Plan has started working its way out of the economy. There will be no more payments going forward, which could bring inflation down by 1% or 2%.

FEDERAL RESERVE RATE HIKES WILL CONTINUE

The Federal Reserve will continue to raise rates by 0.5% later in June and another 0.5% again at their July meeting. That will bring the Fed rates to about 2% by this Fall—which are still historically low and about where they were pre-pandemic.

The Fed, in the past, has not raised interest rates right before a national election. The question on investors' minds now is what will happen at the Fed meeting in September. Will it be another 0.5% hike, or might the central bank make a shift in raising rates to lower in 0.25% increments? Or will they pause until after the election?

The answer will depend a lot on what is happening with inflation and whether recent signs of moderating hold up.

Fed officials have said they could continue raising rates if they don't see clear signs of slowing inflation. But many analysts have expressed optimism that inflation will ease enough to justify a pause in September.

STOCK MARKET 2022 PREDICTIONS

While most Wall Street analysts have downgraded their 2022 stock market predictions, the consensus is that the *S&P 500 Index* **will end the year up 7% to 10% from January 1 to December 31, 2022**.

Historically, based on data going back to 1896, the Dow *Jones Industrial Average* has gained 8.7% within a year after a severe stock market pullback.

Of the past 20 corrections, the Dow has been positive 12 months later 15 times, or 75% of the time.

THE RUSSIA-UKRAINE WAR

Global markets usually weaken as wars approach, and then strengthen long before wars end, and treat human tragedy with breathtaking indifference.

We know how that happens because television coverage at the beginning of the Iraq and Afghanistan conflicts had wall-to-wall coverage of the invasions. The stock markets were negatively impacted until the media started to ignore the wars. Unfortunately, even though fighting and dying continued for the next 20 years, the wars were largely ignored by the American people. The stock markets returned to normal. The same will probably happen in the Ukraine-Russia war.

History Suggests Stocks Have More Room To Run

The anticipation of Federal Reserve rate hikes has often caused stock market volatility. But history shows that stocks typically rise after the Fed starts raising interest rates. The Federal Reserve began to raise rates about two months ago.

In the five rate-hiking cycles since 1990, the *S&P 500 Index* tumbled a month after the first rate increase but typically recouped those gains to rally six months later. After one year, the *S&P 500 Index* and *Nasdaq Composite* were up 80% of the time, according to Dow Jones Market Data.

Let's keep our fingers crossed!

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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 a frequent on-air commentator and regularly 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.*

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