CITY NATIONAL ROCHDALE
AN RBC/CITY NATIONAL COMPANY

JULY 29, 2022

ON THE RADAR

FAQs on the Markets and Economy

Is the U.S. economy already in recession? — Updated

After contracting 1.6% in Q1, preliminary estimates now show U.S. gross domestic product (GDP) fell another 0.9% in Q2, matching a popular rule of thumb that defines recessions as two or more consecutive quarters of negative GDP growth.

While we recognize that recession risk has risen significantly, for us it nevertheless seems premature to make a call that we are already in one. The weakness in GDP over the first half of the year was due to several unusual pandemic artifacts, including slower inventory growth, fading government spending, and a growing trade deficit that combined to offset ongoing strength in consumption and investment.

The official arbiters of recession dates at the National Bureau of Economic Research (NBER) are likely to see it the same way. Using a variety of different indicators, the NBER defines a recession as a significant decline in economic activity that is spread across the economy and lasts more than a few months. Most of these indicators are still in expansion territory, with labor market conditions and job growth continuing to be particularly robust.

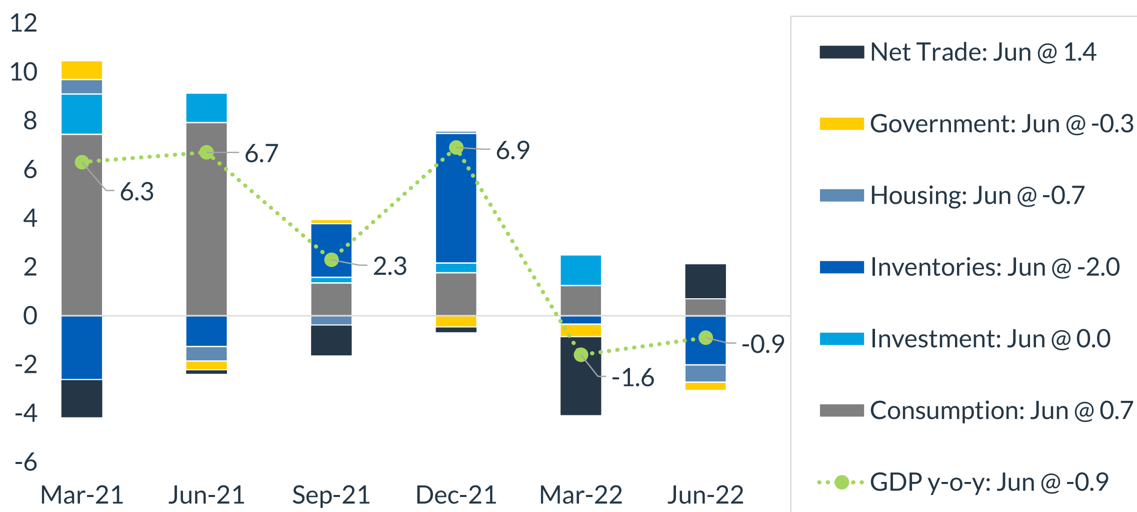
Much of this debate, though, can be seen as a question of semantics. The one thing everyone can agree on is that the economy is slowing sharply and that the risks of a more severe downturn have risen.

As investors, we think this is a good enough reason to remain cautious. With inflation's upward ascent still in motion, the slowing economic momentum is unlikely to deter the Fed from its aggressive track. Policymakers remain committed to bringing down price pressures regardless of the costs — even if such repercussions include an indisputable recession by any definition.

KEY QUESTIONS

- **Is the recent rally in equity prices sustainable?**
- **Will the inflation rate begin to decline?**
- **Has the low level of consumer confidence caused consumers to cut back on spending?**

Contribution to GDP
% quarterly change, annualized



Source: Bureau of Economic Analysis (BEA)

Is the recent rally in equity prices sustainable?

Despite a string of data showing signs that the economy is slowing, U.S. equities have held up reasonably well recently, with the S&P 500 up about 9% over the past month.

The rebound has been driven by second quarter corporate earnings results that have been better than feared, as well as a view amongst investors that weaker economic data will lead the Fed to tighten less than previously thought. While the rally is encouraging, we think it's too early to signal the all clear. It's important to remember that bear market rallies are common and major bottoms tend to see a retest of previous lows.

Although sentiment appears to be bottoming and valuations have adjusted, for a sustained recovery to take place, a number of conditions likely must be met. Firstly, we continue to believe consensus estimates for future earnings growth remain too high and have not yet discounted an increasing risk of an economic downturn. We also think weakening economic data will not be enough to deter the Fed from hiking aggressively this year.

Policymakers remain committed to reining in price pressures, and it will take several months of declining inflation readings before the Fed will begin to contemplate taking its foot off the brake. Such an outcome would probably mean rising discount rates and disappointing growth in corporate profits, a negative combination for equity prices. And while falling expectations for the fed funds rate have likely supported valuations recently, we doubt this would hold during a severe slowdown. In such periods, valuations have tended to fall further, as appetite for risk deteriorates.

Given this, we continue to recommend caution over the near term. Markets are likely to remain highly volatile, and further downside is possible until we have better clarity on both the path of inflation and Fed tightening, and prospects for economic and corporate profit growth.

Bull Market Peak	Bear Market Bottom	Months	S&P 500 Return	Max Bear Market Rally
Aug-56	Oct-57	15	-22%	16%
Dec-61	Jun-62	7	-28%	7%
Feb-66	Oct-66	8	-22%	7%
Nov-68	May-70	18	-36%	10%
Jan-73	Oct-74	21	-48%	11%
Nov-80	Aug-82	21	-27%	12%
Aug-87	Dec-87	3	-34%	15%
Mar-00	Oct-02	31	-49%	25%
Oct-07	Mar-09	17	-57%	27%
Feb-20	Mar-20	1	-34%	-
Jan-22	**?**	**7**	**-23%**	**9%**
	Average	**14**	**-36%**	**15%**
	Median	**16**	**-36%**	**12%**

Source: FactSet

Please note: Past performance is no guarantee of future results.

Will the inflation rate begin to decline?

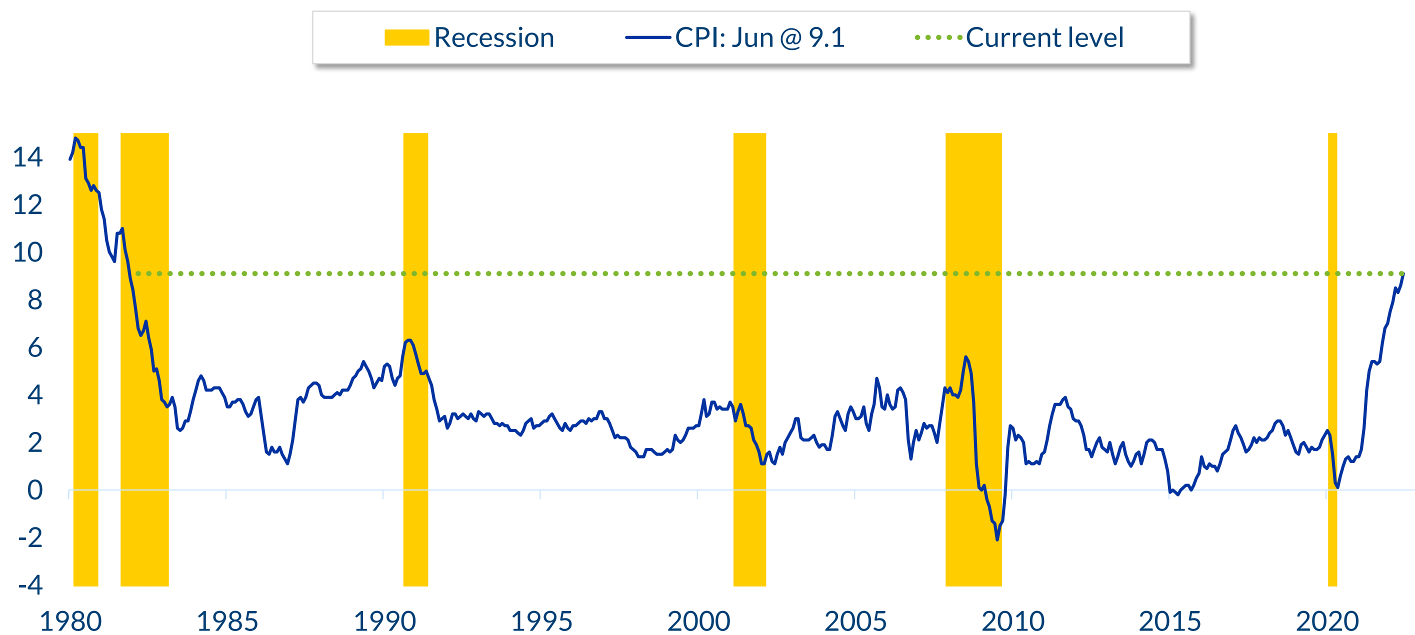
The yearly change in the consumer price index broke through 9% last month, landing at 9.1%.

It is the first time above 9% since 1981. In addition, the monthly increase was a surprisingly strong 1.3%. The monthly number has rarely been higher: only once in 2005 because of Hurricane Katrina and just a handful of times back in the 1980s and 1970s.

Looking ahead, the yearly change in inflation may have peaked. The energy sector has been one of the driving forces behind the annual change in overall inflation. Inside the energy sector, gasoline prices hit their cycle high in mid-June and have since fallen 11.5%. If prices hold or decline more, that should alleviate some upward pressure on overall inflation.

That said, inflation is still a big problem for the Fed. As a result, they have recently moved up their expectation of the year-end federal funds rate above the neutral level into the economically restrictive range. This will help slow the pace of economic growth and bring down inflation. Over the next few months, we will see how the economy responds.

Consumer Price Index
percent change, y-o-y, seasonally adjusted



Source: Bureau of Labor Statistics

Has the low level of consumer confidence caused consumers to cut back on spending?

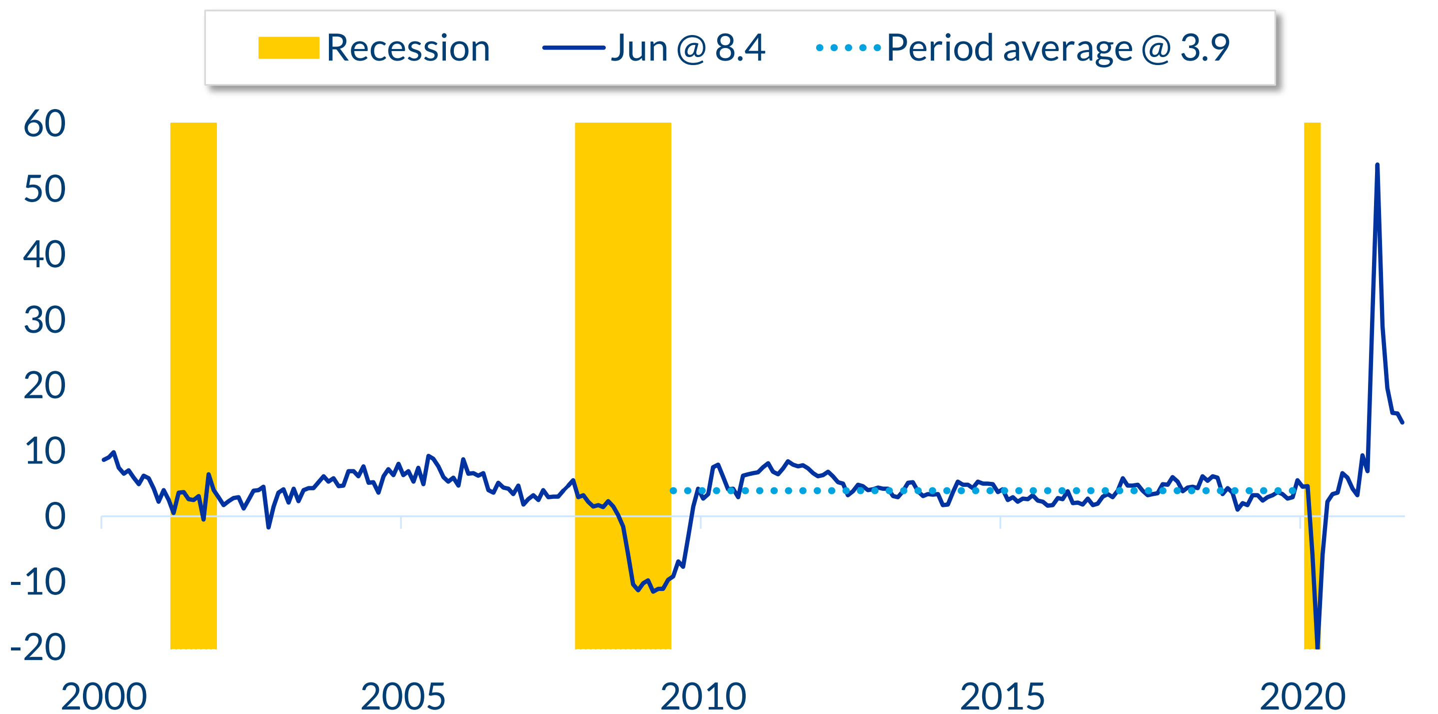
Interestingly, some consumer sentiment indicators are near recession levels, but consumers are not holding back.

They are still spending based on their financial condition (which is strong). The retail sales report is another example illustrating that consumers do not always do what they say. Retail sales jumped 1.0% in June and are up a solid 8.4% in the past year. That is much stronger than the average 3.9% growth rate in the past expansion *(see chart)*.

It is important to note that retail sales data are reported in nominal dollars; the data are not adjusted for inflation, unlike most other reports. Adjusted for inflation, real retail spending has been declining.

There is one place consumers are changing their spending habits. Gasoline sales rose 3.6% in June, but gas prices rose over 11%, so inflation-adjusted gasoline spending plunged this past month. This is interesting. Gasoline demand is typically inelastic, meaning price changes do not materially impact demand. But according to this data, the volume of gasoline purchases was down. Maybe people are taking advantage of working from home as a way of dealing with the higher prices.

Retail Sales
percent change, y-o-y, seasonally adjusted



Source: U.S. Census Bureau

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the USD denominated, high yield, fixed-rate corporate bond market.

CalPERS: The California Public Employees' Retirement System, also known as CalPERS, is an organization that provides numerous benefits to its 2 million members, of which 38% are school members, 31% are public agency members and 31% are state members.

CPI: A consumer price index (CPI) is a price index, i.e., the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.

4P: The 4P analysis is a proprietary framework for global equity allocation. Country rankings are derived from a subjective metrics system that combines the economic data for such countries with other factors, including fiscal policies, demographics, innovative growth and corporate growth. These rankings are subjective and may be derived from data that contain inherent limitations.

MOVE Index: Bloomberg Ticker "MOVE" – statistic is computed by ICE BofA

FOMC: The Federal Open Market Committee (FOMC) consists of 12 members — the seven members of the board of governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis.