LNWM Quarterly Commentary – Q3 2022

WILL THE FED SLIP ON A BANANA?

> "Between 1973 and 1975 we had the deepest banana that we had in 35 years..."
>
> — **Alfred Kahn**, head of Carter administration's task force on inflation

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Ron Albahary is Chief Investment Officer at Laird Norton Wealth Management. He determines the firm's investment strategy, directs the investment selection process, and works in tandem with LNWM's client services teams to deliver investment solutions structured to attain each client's unique goals.

Bananas and recessions have been synonyms since the 1970s, thanks to economist Alfred Kahn. Told by the President of the United States to stop scaring Americans with the term "recession," he subbed "bananas" (and eventually "kumquats" when United Fruit Co. protested). Why the silly runaround? For the not-so-silly reason that just talking about "bananas" can make them happen.

Recessions are a multi-dimensional phenom: psychological, behavioral and economic. And no matter how much we try to avoid bananas, they happen. In fact, fear of a banana is a major reason the stock market just had one of its worst half-years in history (see chart bottom of page 2).

There is reason for concern: The U.S. is now more likely to experience a recession this year or next[1], with market forces slowing things down via plummeting equity prices, rising interest rates, and higher costs for goods and services. On top of that, the Federal Reserve's aggressive comments and actions to squeeze out excessive inflation are adding to the recessionary momentum.

IN BRIEF

- The U.S. economy is teetering on recession (or already in one), as inflation and interest rate increases are slowing down demand and hitting consumer confidence.
- Increasing concern about recession is likely to keep a lid on yields and could provide support for bond prices.
- Inflation is high currently but commodity prices have started to drop and consumer long-term expectations for inflation remain well anchored.
- We are maintaining diversified long-term portfolio allocations and seeking new opportunities in parts of the capital markets with attractive risk-reward tradeoffs.

How We Got Here

Recessions typically arise from economic imbalances. Currently, the imbalances are manifesting as higher inflation. The type of inflation that develops and its aggressiveness depend on what is driving it: Is it mostly caused by too little supply or too high demand? The answer is often not obvious.

[1] A committee at the National Bureau of Economic Research (NBER) is responsible for officially declaring when U.S. recessions start and end, based on various factors. Typically, economists call a recession when GDP has declined for two consecutive quarters.

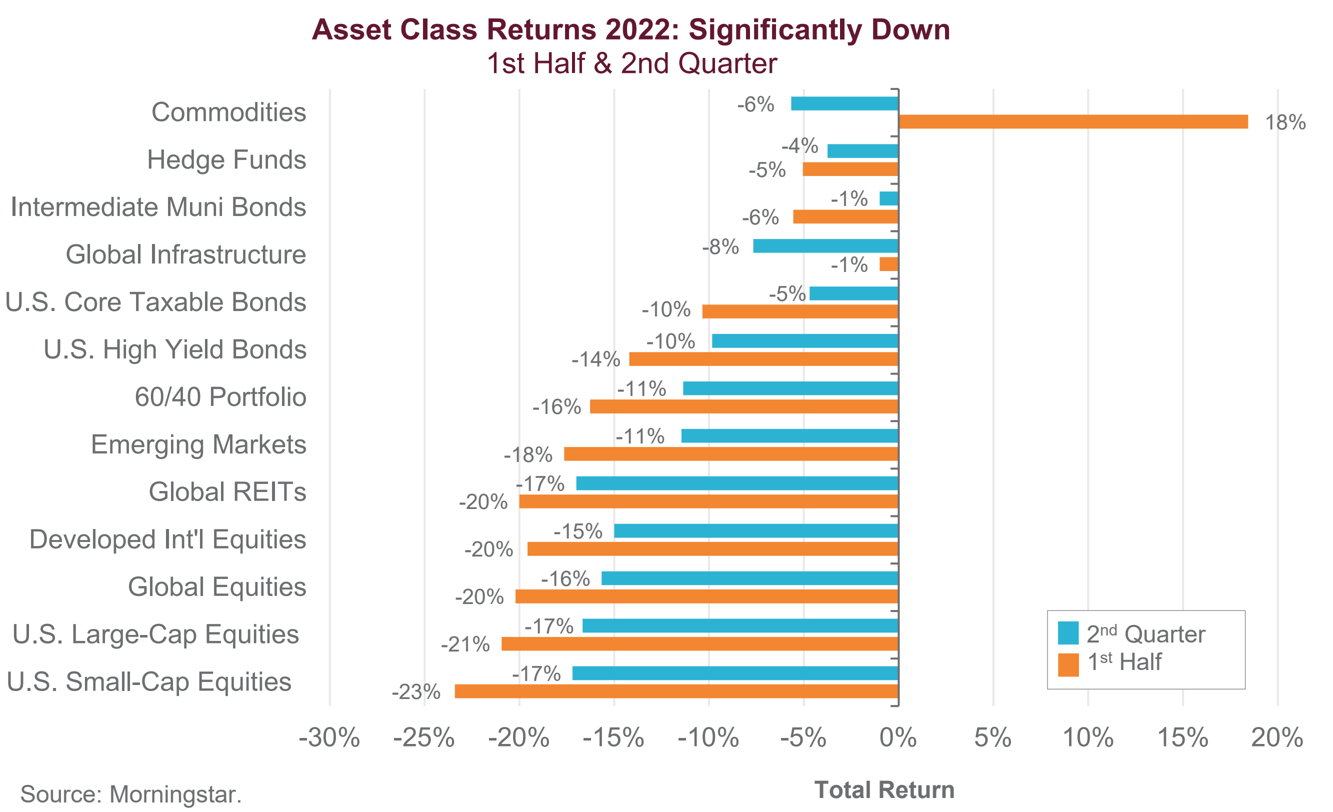
Most people think inflation in the 1970s was caused by the OPEC oil embargo. Yes, the U.S. economy was much more dependent on oil back then, much of it imported, and 25% of GDP was manufacturing (vs. 11% now). But that is only part of the story.

In the 1970s, other forces drove inflation higher: The Fed, concerned that higher oil prices would cause job losses, expanded the money supply substantially; labor unions had more power, creating an upward wage spiral; and millions of Baby Boomers were in their prime spending years and forming households thereby driving demand higher. Another unique factor to that era: President Nixon had surprised the world by decoupling the U.S. dollar from gold (each dollar was no longer convertible into gold), allowing for free-floating exchange rates.

WHAT ABOUT STAGFLATION?

You hear a lot about stagflation these days, but this is not actually apparent in the U.S. economy currently. We do have two of the three conditions for stagflation: high inflation (check) and low or slowing growth (check) but we do not have high unemployment. In fact, the U.S. job market is at or near full employment.

Fast forward to 2022. Today's inflation, we think, is predominantly caused by COVID-induced supply constraints exacerbated by the war in Ukraine. It's been estimated, and we agree, that inflation today is 50% due to supply constraints, 25% due to higher demand, and 25% due to other factors, including opportunistic pricing. Weighing on demand are long-term deflationary forces that are opposite of the 1970s: an aging population, historically high debt levels, technological advances, and relatively weak bargaining power for labor. Also, the U.S. government is no longer funding COVID relief so there is less money in consumers' pockets.



Source: Morningstar.

The Present Dilemma

If in fact today's inflation is supply-driven, this presents a dilemma: The Federal Reserve has limited ability to address supply-driven inflation other than by crushing demand.

Because the Fed came to the inflation fight late, they seem more focused on making up for their past mistake than on the wide swath of evidence that the bond and commodity markets have already done most of the heavy lifting to reduce demand (more on this later). Unless the Fed's aggressive narrative is part of a sophisticated slight-of-hand to get markets to do the tightening work for them, risk continues to rise that the Fed is willing to thrust the economy into recession to preserve their reputation instead of following the data.

Hopefully, if inflation data start to stabilize more broadly or trend down in the 2nd half of 2022, the Fed may pause interest rate increases. But that may not happen. So we have to be prepared for still higher interest rates and thereby higher risk of recession.

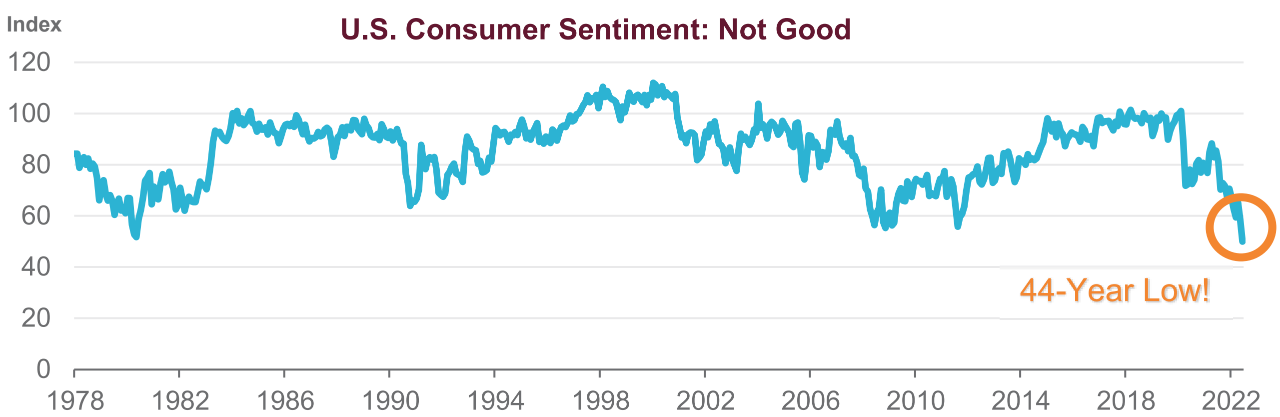
"The Fed has never before raised interest rates in a recession and bear market."

It is important to realize that the Federal Reserve has never before raised interest rates in a recession and bear market. If indeed we are in a recession currently, we may be in unchartered waters about what comes next. What we do see is the following:

Higher inflation expectations are not embedded. For inflation to become pernicious, consumers must expect it to continue spiraling upward. That is not currently the case. A careful look at the University of Michigan's latest U.S. consumer survey shows that, yes, consumers expect inflation to remain elevated at around 5.3% over the coming year. However, consumer expectations for inflation two to five years out drop to 2.6%. And believe it or not, 17% of survey respondents actually expect *deflation* over the next five years—a new record; let's hope the Fed is taking this into consideration.

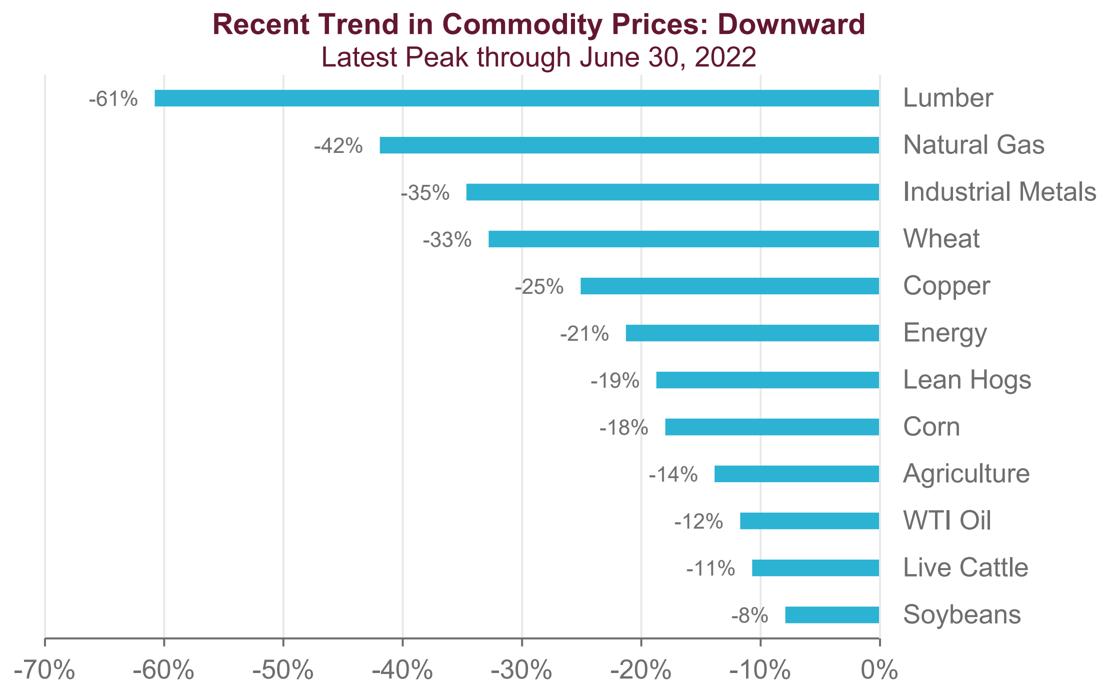
Higher prices and higher interest rates are dampening demand, even as the Fed continues with policies that push demand lower. Some of the indicators currently flashing yellow:

- **U.S. consumer sentiment is at its lowest level since 1978,** when the University of Michigan began its consumer surveys. A lot has happened in 44 years—wars, pandemic, stagflation, terrorist attacks, etc. Yet consumers have not been this pessimistic, a clear indicator of the heightened risk that we are in a recession or near one.



Source: University of Michigan, Bloomberg.

- **A broad range of commodity prices are declining from their peaks,** indicating inflationary pressures may be subsiding.

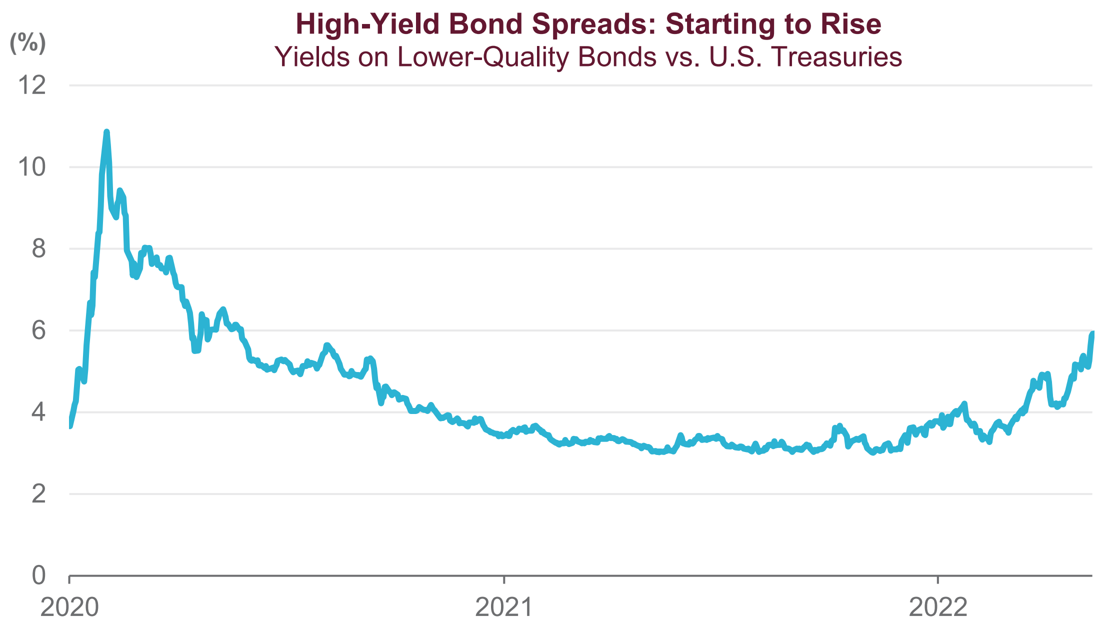


Source: S&P Global, Goldman Sachs, Bloomberg.

- **Fewer small businesses are planning to increase worker wages in the next three months,** an indication that wage pressures may be subsiding.

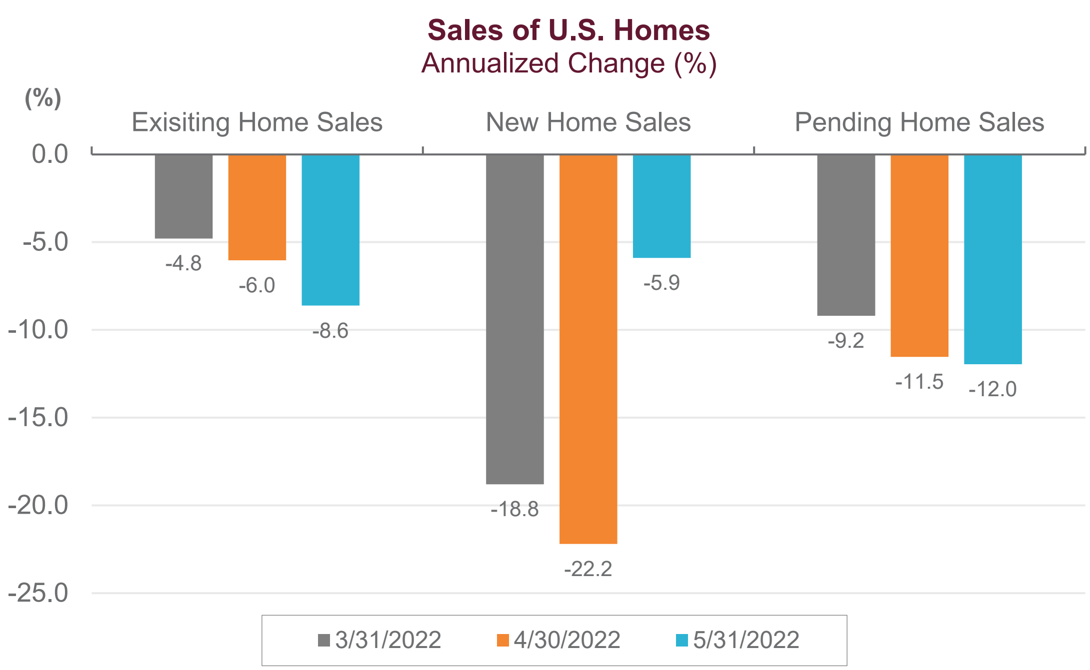
Source: Nat'l Federation of Independent Business.

- **The credit spread on high-yield bonds is rising** (how much more riskier bonds are yielding vs. U.S. Treasuries). While higher credit spreads are often an indicator of weakening capital markets, rising defaults and recession, they can also signal attractive return opportunities for investors willing to provide liquidity in more difficult market environments.



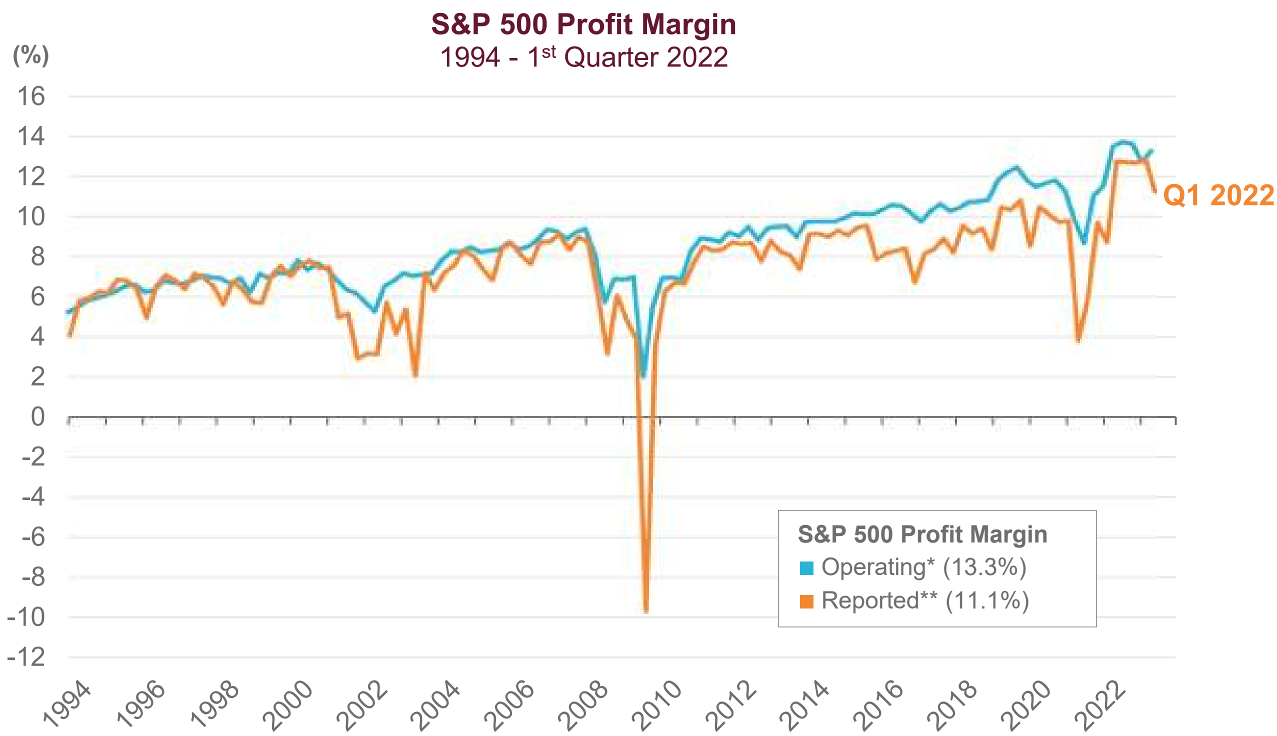
Source: Federal Reserve Bank of St. Louis.

- **The U.S. real estate market is slowing down**, with new, existing and pending house sales declining year-over-year for three months in a row.



Source: Nat'l Association of Realtors, U.S. Census Bureau, Bloomberg.

- **U.S. corporate profits are being squeezed.** Companies have been passing on price increases to consumers, something that has not been possible for decades, as evidenced by S&P 500's 13% operating profit margin, a level reached only once during the previous seven decades[2]. Consumers, however, are starting to balk at rising prices, and they are either reducing purchases or opting for generic brands. A number of major U.S. retailers, including Target and Walmart, have said they are stuck with extra inventory they will have to mark down to sell. For U.S. retailers overall, inventories have grown twice as much as revenue in the past year.



*S&P 500 operating earnings per share (I/B/E/S data) divided by S&P 500 revenues per share.
**S&P 500 reported earnings divided by S&P 500 revenues per share.

Source: Standard & Poor's Corporation and I/B/E/S data by Refinitiv.

- **Strength of U.S. dollar.** A strong dollar causes U.S. products and services to become more expensive for foreign buyers, hurting competitiveness of U.S. multinationals and therefore, earnings. This July, the dollar achieved parity with the euro for first time in more than 20 years.

The "Fed Put" may be off the table for a while. This is basically the Fed cutting interest rates to put a floor under equity market drops. The drop in stocks and bonds so far in 2022 has been relatively orderly, with no apparent systemic consequences aside from wealth destruction, although the impact of the cryptocurrency collapse remains to be seen. Therefore, the Fed does not appear poised to step in as market savior. The grind downwards could continue, especially if the economy slows down further.

[2] https://www.cbsnews.com/news/inflation-corporate-profits-record/

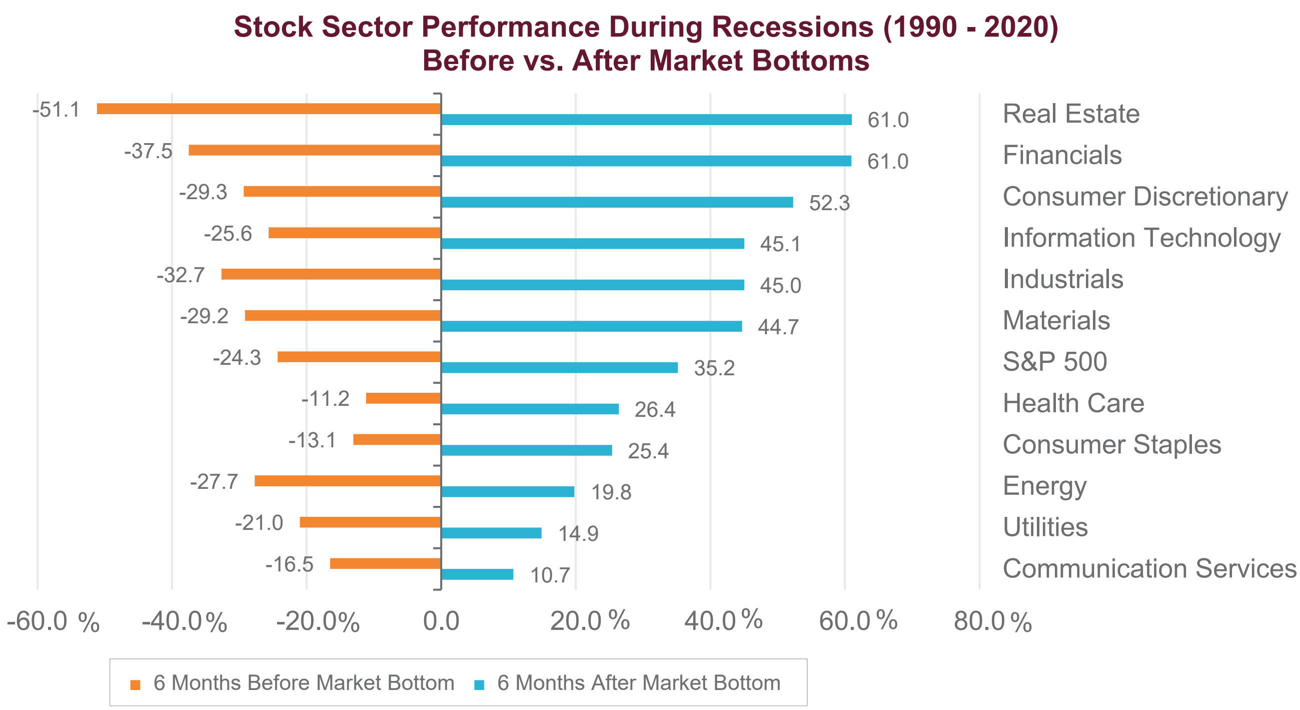
Impact of Recessions

While the media may lead you to believe that recessions are cataclysmic, they are a very normal part of the business cycle. They reset the economy, wring out excesses and turn the focus back to inherent value and fundamentals.

The U.S. has experienced 48 recessions since the country began, with most of these happening before World War II. Since then, we have had 13 official recessions, or about one every six to seven years. How deep and long a recession is greatly depends on how the job market is affected. Most vulnerable are lower- and middle-income people looking for work or in unstable job situations.

Fortunately, post-World War II recessions have tended to be relatively short, averaging less than one year (11 months), while expansionary periods have lasted an average of five years. It is also important to remember that during times of economic stress, the world economy does not grind to a stop, as was proved during the global pandemic. While some companies get hurt or fail, the vast majority continue to operate and, in some cases, may thrive depending on their industry.

As the chart below shows, stock sector leadership changes going into a recession and emerging from it, supporting the case for well-diversified portfolios. Said another way, should we be headed into a recession, it is likely that many of the best-performing sectors lately will be among the worst and vice versa.



Source: Morningstar, S&P Global.

Eyes on the Prize: Long-Term Wealth Creation

The current market environment is one of the most challenging we have seen in a long while. If we are in fact in (or headed into) a recession, the probabilities increase for a deeper and more protracted sell-off in stocks and other risk assets. Such periods are inevitable and present a high level of behavioral risk: years of wealth accumulation can evaporate if holdings are liquidated out of fear, thereby locking in losses.

This is why we structure portfolios designed to navigate market cycles. We do this by establishing for each client an investment business plan whose framework should not change in response to which way the market winds are blowing. The framework, our long-term asset allocation, targets a level of risk and return that is realistic, necessary and/or desired to achieve client long-term goals and meet short-term needs.

Currently, we are: Rebalancing asset allocations to long-term targets; using tax-loss harvesting to enhance long-term *after-tax* returns; adding private market investments for enhanced diversification; verifying active managers are managing risk and taking advantage of price dislocations; and exploring timely opportunities with attractive characteristics, such as in corporate credit, renewable energy, and real assets. We continue to engage our network to determine if there are interesting opportunity sets materializing (or not) in those and possibly other areas of the capital markets.

All these actions combined keep your portfolio(s) from being knocked off the longer-term course we have set toward achieving your goals. As always, your advisory team and members of our investment team are available to discuss any concerns or questions you might have.

TOTAL ASSET STRATEGIES

If you have excess cash to invest, please talk to your LNWM advisor about the best way to do that for your situation. During high market volatility, it can be advantageous to average in, but the question is over what period. Your advisor can help determine a strategy.

If you have sold an asset for a major gain this year or intend to in the second half, please let your advisor know. It may be advantageous for us to realize some losses in your portfolio to offset some of that gain for tax reasons and replace assets sold with other investments with similar characteristics.

ABOUT THE AUTHOR

Ronald G. Albahary, CFA® is Chief Investment Officer at Laird Norton Wealth Management. As the head of LNWM's investment team (see below), Ron determines the firm's investment strategy, directs the investment selection process, and works in tandem with LNWM's client services teams to deliver investment solutions structured to attain each client's unique goals. Prior to joining LNWM, Ron served as CIO or CEO at regional investment firms focused on ultra-high-net-worth families and foundations. Earlier in his career, he held leadership positions in the private client business of major global financial institutions, including Merrill Lynch and Northern Trust Private Bank. Ron has a degree in economics from the Wharton School at the University of Pennsylvania and currently serves as advisor to the Center for High Impact Philanthropy at the University of Pennsylvania.

The investment team resulting from the combination of Laird Norton Wealth Management and Wetherby Asset Management is comprised of 12 analysts and strategists working together to design and implement investment solutions for client portfolios. Six analysts at the firm hold the Chartered Financial Analyst® designation, with expertise spanning macroeconomics, public and private asset classes across the global capital markets, and impact investing. Collaborating with each other and with client advisors, the investment team's overarching goal is to help clients and their families preserve and grow their wealth over many generations.

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