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Generations Winter 2023 - A Roundtable on Possibility of Recession

In February, Day Pitney International Trusts and Estates Partner Sarah Jacobson led a roundtable discussion on the possibility of a recession with Adam Kotz, a director and senior wealth advisor with Mariner Wealth Advisors in New York; Michael Meehan, a client adviser and shareholder at TFC Financial Management in Boston; and Terry Sylvester Charron, the team leader and senior investment strategist for BNY Mellon's Family Wealth Investment Adviser Group in Boston.

Sarah Jacobson (SJ): Briefly, I want to share a little more about our esteemed panelists. Adam Kotz works with individuals and families to provide an in-depth analysis of their portfolios and offer tax-effective strategies. He advises on charitable giving, stock options, tax planning, and retirement distribution strategies. Michael Meehan specializes in providing comprehensive financial planning to high net worth families. He is also involved in the firm's financial planning and review process. Terry Sylvester Charron regularly advises families and family offices and specializes in creating tailored wealth management solutions for her clients.

Thank you again, everybody, for joining us this morning. Terry, I want to kick it off with the big question of the day: Will the United States experience a recession in 2023? What's your outlook?

Terry Sylvester Charron (TSC): I hate to say it, but our outlook is that we are more likely than not to experience a recession this year. Globally, we put it between 60 percent and 70 percent probability; in the United States, 50 to 60 percent probability. We think the challenges of moving from a quantitative easing to a quantitative tightening position will make it really difficult for the Fed to pull off the proverbial soft landing. There's always a lag time between raising interest rates to bring inflation down and the actual impact to the economy. We've experienced peak inflation at this point, and inflation is definitely moving in the right direction.

The Fed is going to be very aggressive and avoid what we experienced in the late 1970s and early 1980s, where every time inflation came down a little bit, they took their foot off the gas in terms of interest rates. Inflation went up; they raised rates. Inflation came down; they lowered rates—and they did that throughout the course of 10 years. They don't want to experience that again, so they're going to be very, very aggressive in going after inflation. It's definitely moving in the right direction, but that balance, between raising rates and the impact on the economy, will be too challenging for the Fed to get it just right. So we think that it's going to be more likely than not that we will experience a recession sometime this year.

SJ: Thank you for that. Michael, what is your outlook? Do you share that view?

Michael J. Meehan (MJM): Unfortunately, we do share the general views that Terry expressed, that we are expecting a recession in 2023. If you look at the data, the leading economic indicators index has dropped in consecutive months for November and December year over year. It's contracted now by more than 7 percent. When you look at that, in conjunction with the inversion of the three-month and 10-year Treasury yield, that's generally been a very strong indicator of a recession.

The timing is always tough to predict. We often don't know until after the fact. And I agree with Terry's point about the lag effect of increased interest rates.

I think it was T.S. Lombard who said there's "pent-up demand destruction" right now. We've heard about pent-up demand when the economy is ramping up and people are ready to spend. I heard the term "pent-up demand destruction" and I took notice, because it does make sense, given how much spending has occurred over the last couple of years.

SJ: Adam, if you could also comment on that, and perhaps give us your view in terms of the global economy. Do you think the United States is going to fare better?

Adam Kotz (AK): I'm going to take a different stance here. I think we are a little bit more optimistic on the market, at least the stock market, for this year. You don't know we've been in a recession until after it's happened. When you look at the average recession, it's about a 25 percent pullback in the market. When you look from January of 2022 to some point in October of 2022, we hit the 25 percent pullback. So the question there is whether we may have already hit a minor recession. If we do have a recession, we think it's going to be a minor one. We do think there may be a lot of volatility in the market in this first quarter of 2023. January has been a very surprising month in terms of how positive it closed out.

I think the Fed is concerned whether this is inflation from the 1950s or the 1970s. If the Fed treats inflation like it is the 1970s, they're going to come down with an iron fist. I think we are more optimistic on the global market than the U.S. market right now, and that's purely from a technical standpoint. The valuations are more attractive. We are starting to increase our allocation to the international market.

SJ: Maybe you could give our readers a little bit more in terms of the comparison between the 1950s and the 1970s.

AK: In the 1970s, the Fed got it all wrong. They weren't aggressive enough. In the 1950s, they were more extreme and got it right. The question today is, have we been too aggressive? We don't know; it takes time before the markets play out. I do think part of the cause of inflation was all the money that was pumped into the economy with COVID relief. The money supply has come back down now, leading to rising interest rates. We're 60 percent positive on the market and feel that between the midterm elections from last year to the end of this year, we're going to see a positive return, which could be north of 10 percent.

SJ: Thank you. That was really helpful.

Mike, what are some of the signs that you're looking to? What are the signals that you're looking for in terms of where this is headed for 2023?

MJM: Inflation has been the big story. It's not something that I have experienced in my working career. If inflation continues to abate, the Fed will be able to temper the interest rate increases. Our hope is that the employment cost index data will indicate that wage pressures may be stabilizing. There's been some improvement there, so I think the Fed is going to notice that.

I think ultimately it's going to come down to an inflation story and what the Fed is going to do. Our view is that it's probably a 25-basis-point increase this month and then 25 basis points again in March, and then a pause. If that occurs, then even if we are in recession now or fading into one, it'll be shallow and likely fairly short.

SJ: Terry, what's your view? What are the early signs that you're looking for?

TSC: I don't think we are in a recession, and the reason is the employment market. The employment market is still really strong. We've got an unemployment rate of 3.5 percent. We have 1.7 job openings for every person looking for a job. We still have some wage inflation.

I think that's been the story. On the good side, we've definitely seen inflation come down, but on the services side, it's still an employment story. That's something that we're watching very closely. I agree with Mike. We think we are likely to see another 25 percent basis-point increase from the Fed this month and another 25 percent basis-point increase in March, and then the Fed is likely to pause.

The market is assuming that there's going to be a Fed pivot, that everything is going to be rosy and the Fed is going to stop raising rates. We just don't see that. Wage inflation tends to be sticky, and there's a real imbalance on the employment front. There are fewer workers. People took early retirement when they could, during COVID. There's been an underinvestment in employment, and I think that's going to take a bit longer to address. That's why I think the Fed is going to continue to be aggressive.

I think what we'll see at the beginning of this year is the economy will slow. The fourth quarter was really strong. We had a GDP number of 2.9. We're in the middle of earnings season and getting a lot of insight into companies, not only what their performance was in the fourth quarter, but their expectations for this year. That will give us a sense of the mood out there among businesses, which will be telling. We personally think the earnings estimates for this year are too high, and they need to come down, and I think we could retest the bottom. I know that's not what everybody wants to hear. I think inflation will continue to fall, but slowly. I think the Fed is going to hold in terms of keeping rates higher for longer, and toward the end of the year before we ever see a rate cut. That's our outlook.

SJ: Adam, I'll turn it over to you. What are you looking for in terms of signals from the economy?

AK: I agree with what Terry and Michael said in terms of the Fed and interest rate increases. I wouldn't expect any decrease until the fourth quarter of 2023, or perhaps not until 2024. The Fed at some point is going to have to spur on the economy again. Looking back at our technicals, we're neutral to positive on most. The only one that we're really neutral to negative on is earning trends. You may see companies hitting their earnings targets, but they're lowering their targets for the rest of the year. I think the labor market is softening. It's hard to see in the numbers, but reported private payroll growth numbers slowed in January. I just hired 15 people. There is a kind of 2-to-1 ratio for every job open, but every person I hired came in under what we budgeted from a cost perspective. That is very different than where things stood six months ago, where every position came in over budget. We're starting to see a change there, and again, with inflation, it takes months for everything to really work into the economy.

Again, on some of the technicals, the yield curve is negative and not going in the right direction. The spreads between U.S. Treasuries and corporate bonds are very tight right now, which is not typical. The market is very mixed on the signals we're seeing. On one hand, we may be seeing a recession coming, but I can see the opposite trend. From an allocation standpoint, we think international is more attractive than the United States. Within some of the market sectors, you could look at semiconductors as an area, we think, or small cap stocks as areas that might be something to jump into if you're trying to go into sector timing.

TSC: Sarah, if I may, when you ask what we are looking for, I don't want to forget that from a political perspective we are talking about raising the debt ceiling. How those conversations go will set a tone and could have an impact from both an economic and a market perspective. We're keeping a close eye on those negotiations, as well.

SJ: I think we're all watching that very closely. Michael, if we are entering a recession, when will we know when we're on the other side? Will that be in 2024, or perhaps even further out?

MJM: I think to answer that question, we have to know what the Fed's new true north will be on an inflation target. It has been our view that getting down from the heights of inflation that we saw, down to 5 percent or maybe 4 percent, can be done. We think the challenge could be getting back to a 2 percent inflation target that is the Federal Reserve is kind of

mandated to hit. If unemployment rises, that is going to be a challenge. At what point will the Fed be comfortable cutting rates? Where does inflation need to be before the Fed will cut rates?

If you go back to the last major recession, the global financial crisis, consumers were hurting. They didn't have money saved. You know about the kind of situations that got us there, with "no-income loans" and the like. The consumer is in a much different place today. There is lots of built-up savings, but consumers have been spending that down at a rate of about \$100 billion a month. Still, this represents a significant amount of savings. So the question is, when will the consumer stop spending?

I was at a restaurant recently for a special occasion, not some place I would go every week with the family, and it was absolutely packed. People were still coming in at 9 o'clock when we were leaving. You would have thought they were giving food away. Certain consumers are still spending, but we do know that there are other consumers that are really struggling. Will consumers be willing to spend their reserves down to zero? That's a question that we will have at some point. I think spending numbers will come down, and that's going to be related to inflation.

SJ: Terry, could you give our readers one big-picture takeaway for 2023?

TSC: We talk about a recession, and this will be the most anticipated recession on record. We're all looking for it. We're all watching the data.

This is a different period. We've never been in a situation where there was so much quantitative easing after the global financial crisis in 2008 and 2009. What the Fed is doing, they've never done before. So I think we have to be patient. It's going to continue to be volatile because we don't have a playbook for this. We're all watching very, very carefully. I think corporate balance sheets and consumer balance sheets are strong coming into this, and the labor market is strong. The U.S. dollar has weakened, which is great for people who are exporting goods to other countries. It is going to be tough, but it isn't all gloom and doom, at least from the beginning to the middle part of this year. I think it gets better in the second half. That's my takeaway.

SJ: Thank you. Adam, what's your takeaway?

AK: I think Terry hit the point head-on: Be patient. I would not be rushing money into this market right now, and dollar cost average probably makes sense. For this year, we could pull back 10 or 15 percent from where we are now. I do think at the end of this year we're going to have a positive year, and I look at that from when inflation typically peaks to 12 months out, the markets are positive on average by 21 percent. The market has generally been positive for the last 50 years. I'm taking those historical things together with healthy balance sheets and other things that were mentioned.

MJM: We think that volatility will be here for much, but not all, of the year. Making any major moves one way or the other, or any form of market timing, which we never do anyway, would not make a lot of sense. Investors should be taking a measured approach, particularly new investors or people who have experienced a big liquidity event. Putting money to work, over time, makes sense. We do think that there will likely be a stronger second half than the first half. But again, it's going to be volatile, so we recommend measured action versus dramatic changes.

SJ: Thank you. It's really helpful. Thank you to everybody for participating!

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