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RECESSION, TO BE OR NOT TO BE

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By Brahm Satov

Some of my good friends celebrate their birthdays this month, and if they read this I would like to wish them a very happy birthday. As a kid, I had few friends, and this has not changed much, but I have grown so very much more appreciative for those I call a friend. In terms of my appreciation, this change has been profound and I would be remiss if I did not mention, that the markets have seen profound changes as well.

The change in the stock markets is that we have entered what most would deem a bear market. In other words, most stock markets are down 20% or more from their recent peaks. For those who had the foresight to raise cash and be prepared, well done. However, you are only halfway there; at some point that cash should be reinvested, hopefully when markets are cheaper and timing more opportune. Many investors are only familiar with bull markets, those that see stock market rise. However for those of us that have been through bear markets we realize the stock market, like the economy, tends to move in cycles, and a recession is a normal part of the economic cycle.

In terms of the possibility of recession, many have been arguing that the economy may or may not fall into a recession over the next 12 months. When the U.S. Central bank raises interest rates, the chance of recession rises along with it. We have heard from Jamie Dimon, JP Morgan Chase's CEO, who said, "brace yourselves for an economic hurricane." It makes sense that higher food costs, oil costs and debt costs will negatively affect the consumer. We have already seen consumer sentiment plummet into recessionary levels. And given that the consumer represents 70% of the economy, then likely if consumer spending slows, then without "major" impetus from central banks or government, a recession would be likely.

CHART 14: Index of Consumer Sentiment

United States: *University of Michigan Surveys of Consumers*
(index)

Shading indicates recession
Source: Haver Analytics, Rosenberg Research

In recessionary times, the stock markets generally perform poorly, as they are fueled by two primary factors. 1) Earnings of the companies in the markets/indexes. 2) Growth in the amount of year-over-year sales increases of those same companies. If both turn down, then it is typical for the stock markets to suffer. For corporations, as their cost of debt, labour and transportation rise, they will likely see their gross margins and corresponding profits/earnings fall. If consumer spending trends are lower than corporations customarily see sales fall, this coupled with lower gross margins; would result in a double negative, which could lead to considerably lower stock prices.

What I am going to say will not be popular in the investment community, however I believe it is important for investors to consider. I recently had a conversation with someone who was looking to possibly invest some capital, however they had a fair sized mortgage at a fairly high rate. I told her that in my opinion, it made more sense for her to pay down her mortgage at this time than to invest. And if she wanted to make the same return, after fees and taxes, she would likely need to make a very high return on the markets. Now in some environments that is possible, even likely, but when central banks are raising rates, the chances are much less so. As she is paying down her mortgage, in effect saving herself that rate, that return has no risk. In these times, that makes more sense to me.

When it comes to cryptocurrencies, my opinion that all of them are worthless has not changed. They continue to remind me of the tulip craze in the 1700's, based solely on the greater fool theory. Unfortunately for crypto investors, as interest rates rise and QT takes hold, less liquidity in the markets, should translate into less real money being fueled into this sector.

With regard to home prices in the GTA, a housing market that according to some supposedly never comes down; prices are coming down. With transaction volumes plummeting, prices are down just over 9% from their February peak or from $1.33M to $1.21M (-120K). Let me be clear, I expect this downward trend in prices to continue as interest rates keep rising. As mortgage rates rise, affordability becomes an issue and the rent vs/ buy decision tips to the other side. Moreover, now that so many have moved into the real estate sector, whether than means realtors, home inspectors, etc. I can only surmise that lower transaction volume will make it more difficult for the many working in this sector. The banking sector is not immune, since January Canadian bank stocks are down 6% to more than 15% and most US banks are down considerably more with JP Morgan and Bank of America down over 25%. For the banks, we can see why they have performed poorly of late, as they really operate in four distinct areas, personal and commercial banking, wealth management, capital markets and insurance. Each of these sub-sectors do not perform as well when liquidity is constrained and markets are under pressure.

I am not an economist, although I am privileged to call one famous economist, my friend. Nonetheless, I believe that as the likeliness of recession rises, investors should adjust their portfolios correspondingly. We know that recessions are a normal part of the economic cycle and they should be expected periodically. I do think that given the current economic environment, investors should be asking themselves if they should be getting more defensive, and my friend, that is the question.

Sincerely,

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