

Here's a thought, buy the recession

written by InvestorNews | December 5, 2022

Recession, bear market rally, China zero covid policy, short covering, tax loss selling, Santa Claus rally, crypto nuclear winter, the markets have all the makings of a Netflix series at present. How do we dig through the weeds and figure out what is ahead for investors and will we like it or not? I certainly don't have all the answers (if any of the answers) but I will make a few comments that may or may not provide some clarity. Generally speaking, it looks like Central Banks (Canada & U.S.) are starting to taper their interest rate hikes. It feels like there is maybe 0.75% to 1.00% left to go, likely spread out over two or three more hikes, and then everyone will wait and see what happens next. The markets have been anxiously awaiting this signal for quite some time, with a few head fakes along the way. This should be good but only if it's not too late and the actions to date haven't already taken too much momentum out of the market.

Rising interest rates along with sky-high food inflation already has plenty of news agencies and market "experts" ringing the recession alarm bells. However, all recessions are not created equal. If it's short and shallow, then the second the statistics give the press all they need to go invoke fear into the hearts and minds of all who will listen, it probably means it's time to buy. Why would I say that? I'm hearing – moron, nut case, and perhaps a few other comments being muttered under people's breath (or possibly out loud), but hear me out. The actual data required to call a recession (generally identified as a fall in GDP in two successive quarters) is backward looking and arguably we will have been in a recession for 6+ months by the time it's

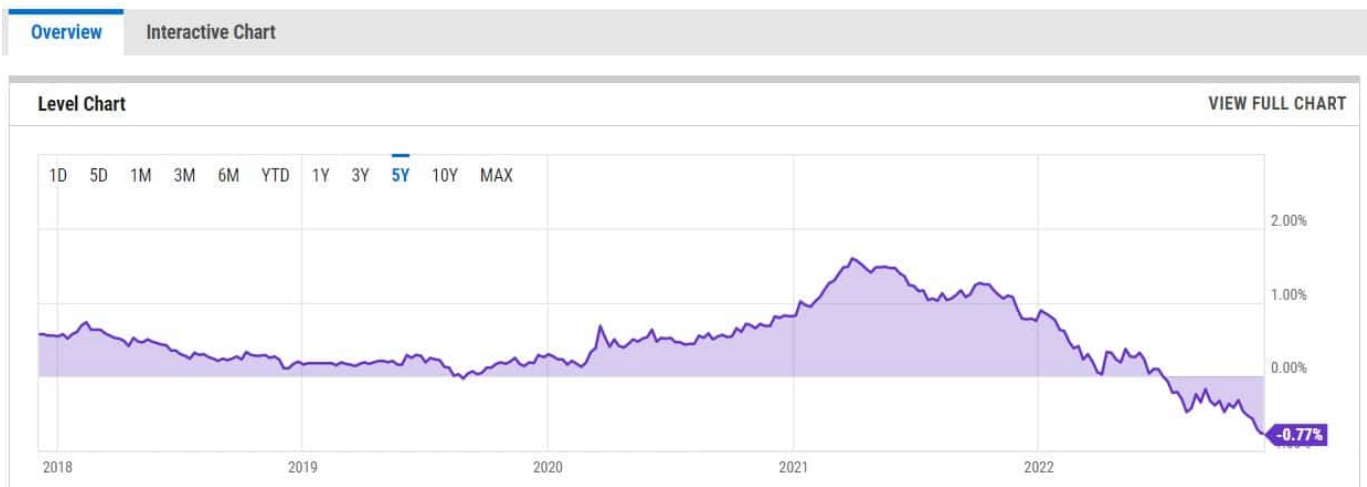
official. The market is forward looking, generally considered to be pricing equities based on the coming 6 months (give or take). That suggests at least an entire year between when the recession has officially started and where the market is looking. If inflation is truly coming off the boil and interest rates are close to hitting their near term peak, and may even start moving back down if the Central Banks panic about recession, then it could be the start of the next bull market.

Of course, it's not that simple. A very important factor on where equities go is earnings. Thus far earnings haven't been too bad overall, although there have been a few big companies that got soundly thrashed by the markets for misses and disappointments. As long as it is a sound business, with revenue and/or income growth, and modest levels of debt, then as the markets regain confidence, we could see multiple expansion (P/E, EV/EBITDA or whatever metric is most applicable) and all is good again. Another key item that the Central Banks watch is employment, which continues to be quite strong in Canada, albeit slightly weaker in the U.S. but still pretty solid. It's very difficult to foresee a deep and problematic recession when most key economic stats are progressing relatively smoothly.

However, there is one bogeyman out there and that is the spread between the US 2 year bond yield and the US 10 year bond yield, which when inverted can be a harbinger of tough times. A negative 10-2 yield spread has historically been viewed as a precursor to a recessionary period and is said to have predicted every recession from 1955 to 2018. I've also heard that this metric has predicted 12 of the last 5 recessions, so one has to be careful with buying into the doom and gloom that a recession is inevitable. With that said, this measure continues setting new 5 year low (or high) negative spreads.

10-2 Year Treasury Yield Spread

-0.77% for Dec 02 2022



Despite my cautious optimism, there is still likely to be some volatility ahead. It's entirely possible for the market to retest recent lows before my "buy the recession" theory is plausible. Especially given we aren't actually in a recession yet. However, if there is another test to the downside I'm looking at the 3,600-3,650 level on the S&P 500 as the key technical support level to signal a bottom might be in. If that doesn't hold, next support is 3,400 or possibly even down to 3,200 (which UBS analysts called for in early November). Wherever the S&P 500 finds its bottom, if the media is shouting from the rooftops that we are now truly in a recession, it could well be time to buy.