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FA ALPHA PULSE

You Have Been Booed by Ronald Reagan

The Missing Ingredient for FED's Recession

Credit Markets – Bent but not Broken, YET

October 2022 Edition

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Investors may be conflating this "earnings" recession for a real one

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"Recession is when a neighbor loses his job..."
Ronald Reagan

Across financial media, the discussion has centered around a looming recession.

Bloomberg Economics even appears to believe it's an inevitability. In its model for the U.S. economy, it just boosted the odds of a recession in the next 12 months to 100%.

That seems bleak, and yet, not everyone's panicked. Even after Bloomberg released its updated model, Goldman Sachs came out and said we could still see a soft landing.

The reason being – not all recessions are created equal.

Earnings growth is decelerating, but markets are not set up for a collapse (Page 4)

A traditional economic recession is based on a wave of credit destruction. It requires corporate and consumer balance sheets to be in trouble, leading to bankruptcies.

Credit markets dry up for everyone. Those with a lot of debt and no way to pay, go bankrupt. Others don't go bankrupt but lose access to capital to grow.

A chunk of the economy gets wiped out, and the rest stands mostly still. Corporate profits tank, and the market tanks too.

However, there's also such a thing as an "earnings recession." Importantly, an earnings recession is not an actual recession.

The "Chart of the Month" highlights the difference between an "earnings" and "real" recession (Page 5)

During an earnings recession, there isn't a credit crisis. There isn't the same massive wave of bankruptcies and default.

An earnings recession largely means corporations aren't investing as much. The credit markets tighten, but don't shut down.

That's enough to slow corporate earnings growth down to a halt... and currently we are

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almost definitely heading towards an earnings recession.

Many things can cause an earnings recession, but the most common culprit is the Fed.

Currently, the Fed recognizes the economy is overheating, and is trying to cool the economy down by raising rates.

Rising rates do not cause a recession. *Rates that are too high* (and people needing to borrow but being unable to afford higher interest rates) cause a recession.

However, rising rates can cause an earnings recession, because that's often exactly what the Fed wants to do when it hikes rates.

The goal of raising interest rates is to make the cost of borrowing high enough that people who don't need to invest, don't.

Unlike in a traditional recession, in an earnings recession both earnings and the market don't collapse. Generally, earnings growth just ends up hovering around 0%.

Contrary to Bloomberg's definitive declaration, right now, we don't have all the ingredients of a real recession. Rates are rising, but we don't have debt maturity headwalls that would cause a wave of defaults. That should save us from material negative economic growth.

That said, thanks to the Fed's aggressive hiking, we may already be in an earnings recession.

While this scenario is not ideal, it's likely why Goldman still sees a chance for a soft, or at least softer, landing.

This lines up with what we've seen the last few months. There is no catalyst to send the market much lower (like credit destruction) or higher (like earnings growth). Thus, we still see a sideways market on the horizon, and an earnings recession in the meantime.

Timetable Guidelines highlight the need for a tactical and patient allocation approach (Page 7)

100% *10-year money equity allocation*
16-month *dollar cost averaging*
50/50 Split *for 5-10 Year Money*

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This Month's Market Phase Cycle Inflections

Valens distills dozens of signals across four major categories that each contribute to market direction. These signals can be short-term or long-term in nature, and have varying degrees of importance when considering the equity market outlook. Here is the current status of each of these categories:

The dramatic 300-400bps rise in the cost to borrow across U.S. corporate markets and tightening bank lending standards put a governor on growth, but don't point to an imminent recession.

As credit markets reacted to the Fed's communication on interest rates and as inflation expectations adjusted, there was one of the fastest jumps in cost to borrow in history.

Banks have followed credit markets, tightening lending as well.

Even at these levels, with no debt maturity headwalls, and healthy consumer and corporate balance sheets, there's no catalyst for a wave of defaults that could turn this "recession" into a Recession.

However, these higher standards do limit the scope for borrowers to access markets and invest in growth.

U.S. corporate earnings growth is decelerating.

Margin and efficiency-driven earnings growth may be constrained in the near-term due to inflationary and demand-related issues.

Offsetting this, management teams that can access credit or finance growth internally are bullish about investing and deploying capital.

This may help earnings growth remain positive, so long as credit headwinds do not completely shut down investment.

The recent rapid sell-off has led to sentiment and valuation dropping to overly negative levels.

At current Uniform valuations, the market appears to be pricing in fundamental signals that are growing more concerning.

Sentiment levels are now at capitulatory levels, which may offer a floor to markets.

A combination of slowing fundamentals which limit upside, with negative sentiment and a lack of a credit analyst for a recession point to a continued sideways market.

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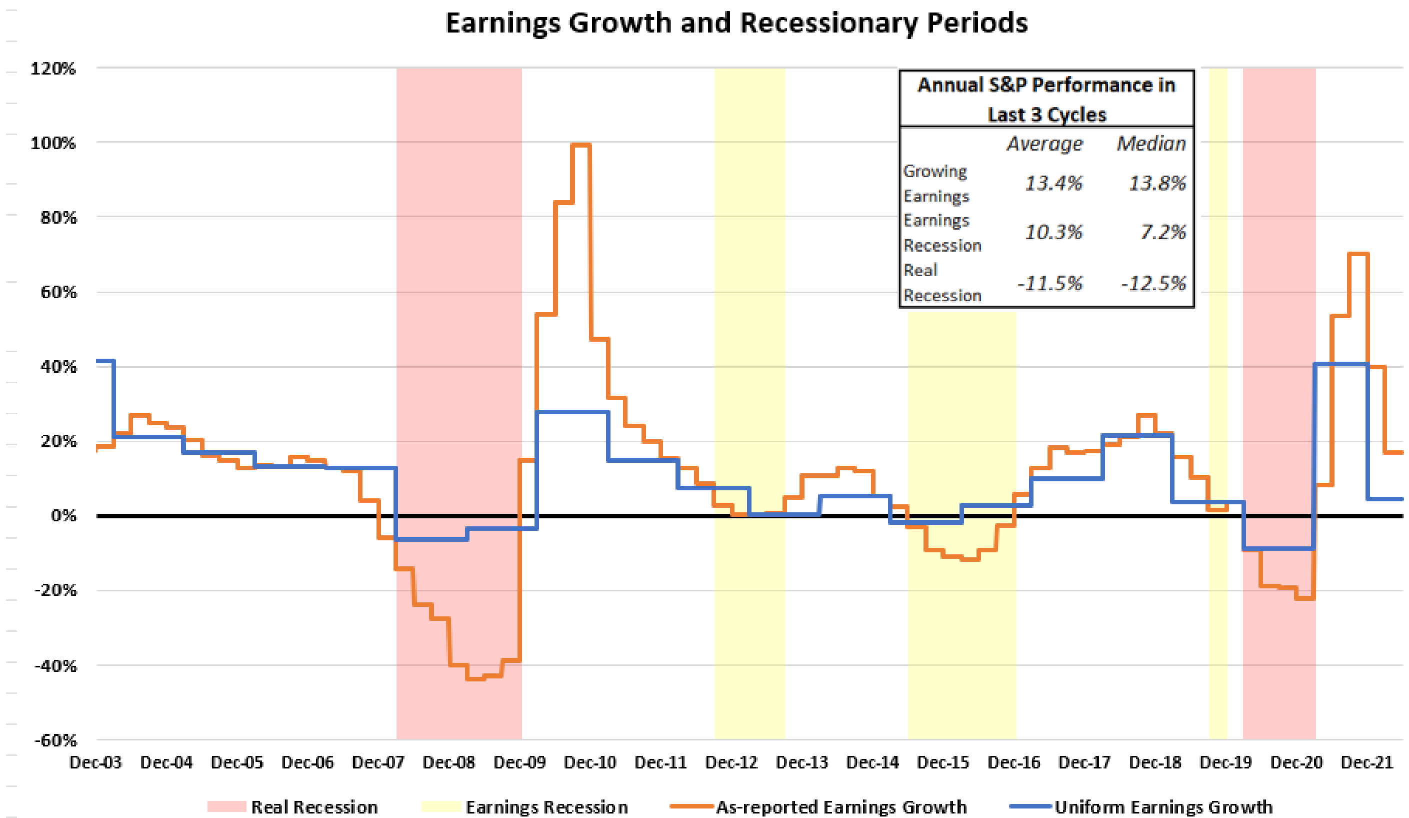
Macro Chart of the Month

While a recession may be imminent, it looks more likely to be an "earnings" recession than a "real" one

As earnings growth and earnings growth estimates trickle down to zero, on the heels of Fed interest rate hikes, an "earnings recession" and sideways market look increasingly likely.



"Real" recessions and "earnings" recessions are not created equal. And the difference between them can have significant ramifications for investors.

A traditional economic recession is based on a wave of credit destruction. In these periods, credit markets collapse, and earnings along with them.

Those with a lot of debt and limited liquidity, go bankrupt. Others don't go bankrupt but lose access to capital to grow.

During an earnings recession, while earnings fall off, there isn't the same massive wave of bankruptcies and default. Credit markets tighten, but don't shut down.

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In the last twenty years, the United States has witnessed two "real" recessions (highlighted in red in the chart) and three "earnings" recessions (highlighted in yellow).

While the real recessions ("The Great Recession" and the pandemic-driven recession) have grown infamous in financial circles and have been studied ad nauseum, the earnings recessions are much lesser known.

U.S. corporates had an earnings recession in 2012-2013 due to the Euro crisis.

Another soon followed in 2015-2016 due to the crash in the energy markets.

And in 2019, the US saw a two-quarter earnings recession due to the Fed's efforts to cool off a hot economy by raising rates.

As evident in the chart, in an earnings recession, earnings growth slows to near-zero.

When referring to earnings growth, we are particularly focused on Uniform earnings growth (blue line). As-reported earnings growth (orange line) can end up being far more volatile, due to the issues with GAAP accounting.

During an earnings recession, the market does not fall off by 30% or more like in a full economic recession.

If, like in 2012-2013, the market thinks the stalled earnings growth is transitory and isn't worried about further declines, stock markets can appreciate materially during those timeframes.

That said, this is typically the exception to the rule.

If earnings growth is flat, the market is likely to be flat too.

For instance, during the shale collapse in early 2015, markets rose by only 5%. In 2019 the market was up a lowly 4%.

While the average return for the market during an earnings recession may be positive, it is much lower than when earnings are growing, which should be expected.

Currently, on an as-reported basis, earnings have dropped for two quarters (soon to be three if we assume Q3 earnings are in line with estimates). On a Uniform basis, 2022 earnings growth is forecast to drop to levels in line with prior earnings recessions, hovering just above 0%.

As such, if history is going to repeat itself (as it often does when it comes to stock market cycles), we are likely in store for a sideways market ahead.

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The Timetable Guidelines

Contrary to popular investing trends, asset allocation decisions shouldn't depend on an investor's age. Rather, investors should always seek to keep their assets in the right type of investment depending on when they'll need access to cash.

Equity Allocation Outlook – 100% Equities for 10+ Year Money Remain at 50/50 split for 5-10 year Money

Money you won't need to touch for over 10 years should entirely be in the equity markets. There's almost never been a 10-year period over the past 150+ years in US markets when money in a diversified stock portfolio has lost value or underperformed any other asset.

For money between 5-10 years, normally we'd recommend you split that 50/50 between bond investments and equities. If the Market Phase Cycle is more bullish for the next few years, we might recommend you tilt this money slightly more towards equities, possibly 60/40. We might recommend the reverse if the outlook is more negative.

After a downgrade last quarter, driven in part by cost of borrowing headwinds, our 50/50 split recommendation remains in place due to relative stability in underlying fundamental macro indicators.

Cash you might need in 2-5 years can be in bond funds and other income investments.

Short-term (less than 1 year) cash demands should always be in cash, not in the market.

Spending Horizon	*Asset Class*
< 2 years	**Cash/money market**
2-5 years	**Bonds**
5-10 years	**50/50 Stocks/Bonds**
10+ years	**Stocks**

Dollar Cost Averaging Timeline – Remain at 16 Months

When deploying new money into the market, jumping in all at once can be dangerous. There are proven benefits to spreading out your investments over periods of time.

How long you should spread out that investment depends on weighing the opportunity cost of waiting to buy with the risk of short-term volatility making any individual entry point a bad one.

By weighing the Timetable Investor macro data, we can better figure out this risk-reward tradeoff.

Dollar cost averaging is just another way to say spreading out your investment over a set period of time, by buying a portion of your

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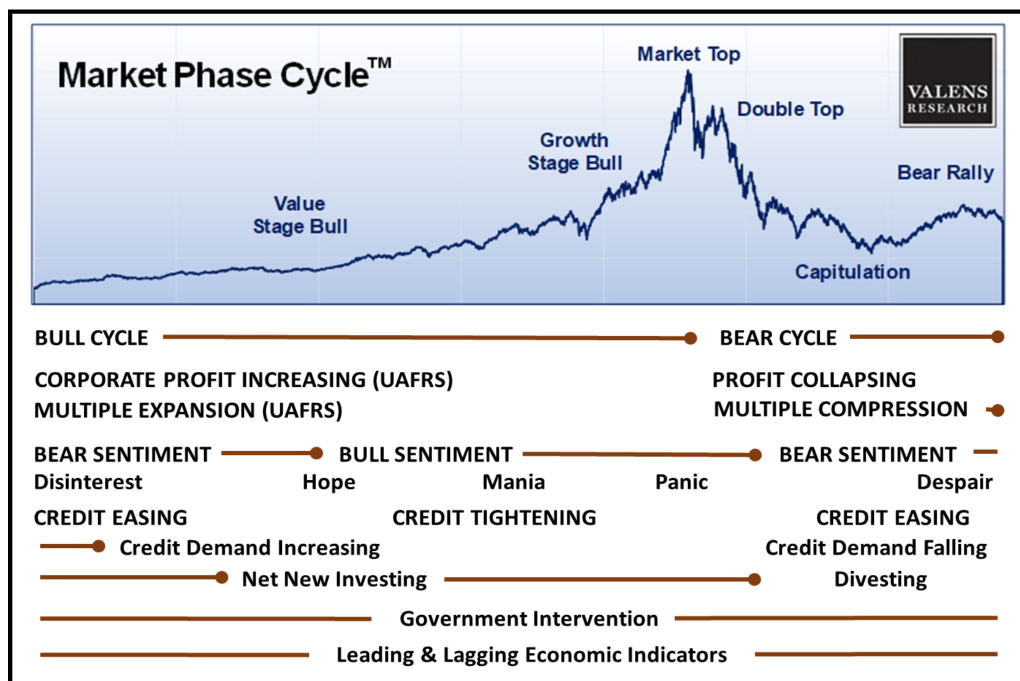
total planned investment on a regular schedule, no matter if the stock is up or down.
In general, we think the proper range is between three months and twenty-four months, depending on the market context.

If earnings, credit, valuation, and sentiment indicators are all aligned correctly, three-month dollar cost averaging might be right. On the other hand, if credit is flashing worrying signals, valuations are high, earnings growth is slowing, and sentiment is extended, we might recommend twenty-four-month averaging.

Following an upgrade last month, we remain at a slightly less conservative 16-month dollar cost averaging recommendation. This follows aggressive downgrades from a 6-month strategy over the past few quarters. Last month's change was caused, in part, from an upgrade in our sentiment and valuation outlooks from neutral to positive.

After the recent rapid sell-off, sentiment and valuation indicators are more negative. This may help reduce the risk of a further drop as we remain in a sideways market, necessitating a slightly less cautious, but still conservative strategy.

If you're interested in the exact math for your own use - click here to build your own Investors Timetable



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About this Report

Each month we produce our Market Phase Cycle™ report, where we review the key fundamental factors impacting the macro-economic outlook. By analyzing a variety of signals in tandem, we can develop a more comprehensive view of the economy and determine where best to allocate assets in order to navigate the current macroeconomic business, or "market phase", cycle.

In this FA Alpha Pulse report, we provide an abridged version of our coveted Market Phase Cycle™, covering some of the key signals we are keeping an eye on and how to effectively act on them. Ultimately, the goal of this report is to help investors understand how they should position their clients' wealth.

Part of understanding the best way to position investments is applying a thoughtful framework in a concrete and consistent way. If you know the right signals to watch, building and managing an overall portfolio becomes as easy as following a railroad timetable. Our goal is to distill all the signals we're looking at for you, to give you not just the insights, but also the conclusion.

For more information about the full Market Phase Cycle™ report, which provides a detailed view into the broad range of signals we analyze on a month-to-month basis, please contact you client support representative.

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