WHAT IF?

BY JAMES H. DRYDEN

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Welcome to May! Every month, we like to impart some perspective on the financial markets or shed light on a current headline or two, all in an attempt to help our clients sift through the noise and become slightly more educated investors. We welcome your comments and suggestions, and as always, we invite you to share this piece with anyone you believe may find it of interest.

For months now, much of the investing world has been screaming that the weight of the evidence suggests the economy is inevitably headed toward recession. It's imminent, the analysts and economists have said. Then the employment data steadily improved and consumer spending remained firm and they told us, well…it's likely in the next five or six months….we swear.
But where is it?

The confusion isn't surprising. But looking past the headlines and digging a bit deeper into the economic weeds, we're not seeing a lot of sunshine. Manufacturing is contracting, the commercial real estate market is a mess, turmoil in the banking sector is stalling loan growth, falling corporate profits are placing a lid on capital expenditures and hiring, and so on. It all has us wondering….what if everyone's gotten it wrong these last few months and we're already in a recession?

This is a notion that is not at all farfetched. History tells us that stocks decline well before recessions begin and start recovering well before they end[1], so it begs us to ask whether last year's -19% decline in the S&P 500 was the market simply doing its job as a leading indicator and projecting the economy's future decline. But more important, since the S&P 500 has made its lows during, and not after, seven of the last eight recessions[2], perhaps the market's bottom in this cycle has already been set…or at least is well on its way.

How will we know whether this is the case? We will carefully watch the market. According to Birinyi Associates, 4,292 is the level the S&P 500 needs to hit to reach a 20% rally from the market's low in October and signal a new bull market has begun (as of this writing the S&P is at 4,061). Is it possible? Of course. Is it likely? There are several indicators that suggest it may be. The first is technical in nature: the market's 200-day moving average is in an uptrend, offering long-term support. The second is contrarian in nature: the level of pessimism is at extreme levels – only 24% of investors believe now is a good time to invest, the lowest reading in 17 years[3]. A third is simple history: on Wednesday the Federal Reserve Bank raised interest rates for what is widely expected to be the final time in this tightening cycle. Over the last five Fed tightening cycles going back 34 years, the S&P 500 has been higher by an average of 7.55% three months after the final rate increase, 9.8% higher after six months and 16.2% higher after 12 months[4].

We need to add an important note of caution however. Just because the market may be in the bottoming process doesn't mean it's impervious to further declines. Especially at inflection points, investors tend to be highly sensitive to headlines, and volatility – already showing elevated levels of complacency – can quickly spike should confidence and risk appetite erode. The headline risk is varied but is important to watch. As we presented here last month, slowing corporate earnings, remaining questions around Fed policy, a lack of market breadth, the "which one is next" banking sector déjà vu, and of course, mounting frustrations over the continuing Debt Ceiling debates may all test investors' patience in the coming months.

So while we believe this "what if" scenario certainly holds merit, we will wait for mounting evidence before proclaiming our glass half-full. Until then we'll keep both hands on the wheel and will continue to advise our clients to remain true to our core investing principles of faith, patience and discipline.

As always, there is more to come.

Onward.

[1]Seeking Alpha [2]Birinyi Associates [3]CNBC [4]Federal Reserve Bank data

200 N. Westlake Blvd., Suite 202 · Westlake Village, CA 91362 · 818.436.6800 · www.WestlakePWM.com

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