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MACROCOSM

Recession? No Thanks, We've Already Had One

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Donald Luskin

Our reflections on a complex and difficult 2022. We had our wins, we had our misses.

It's that time – we have to look back over the year and judge what we got right and what we got wrong. That was easy and fun a year ago, after 2021, a boom year, in which we got everything right (see "Reflections on a Boom Year" December 29, 2021). For 2022, it's more complicated and less fun.

- It's hard to remember now that, just a year ago, the most important economic risk facing the world was still Covid, with the Omicron variant having made its terrifying debut only in late November 2021. *In our 2022 looking-ahead report* (see "Boom On..." January 4, 2022) *our Number One call was that Omicron would entail a record number of new cases, but very few deaths. That was a truly maverick view at the time, and it turned out to be decisively correct, marking the beginning of the end of the pandemic era and clearing the way for the next stage of economic re-opening.*
- That said, *we were too bullish on stocks*. This year being bullish at all was too bullish. From a market-timing standpoint, the most flattering thing we can say is that we've likely seen a double-bottom across June and October, and we never capitulated (see "Equity Risk Premium: Regime Change Accomplished" October 25, 2022).
- *From a sector allocation standpoint, we did much better*. We said value would outperform growth (it has, by about 23% as of this writing, something not seen in years), and we said that energy would be the best-performing sector (it was, up about 58% versus the S&P 500 down about 20%). We said US stocks would underperform non-US (they did on a local currency basis, with the exception of China; and on a USD basis with the exception of China and Jap an).
- *As the year began, we had no idea Russia would invade Ukraine* (Vladimir Putin wasn't returning our calls). We did, however, nail the panic top in energy and commodities right after the invasion, and that has proven to be the most consequential investment dimension in the whole matter (see, among others, "The Bear/Bull Case in the Russian Oil Ban" March 16, 2022).
- *We said bond yields would rise, but not enough to damage equities.* They rose, and more than we expected, but only to levels that were on the low side before the Global Financial Crisis. But at levels not seen for a dozen years, we said that bonds were an attractive buy – and without making stocks an attractive sell (again,

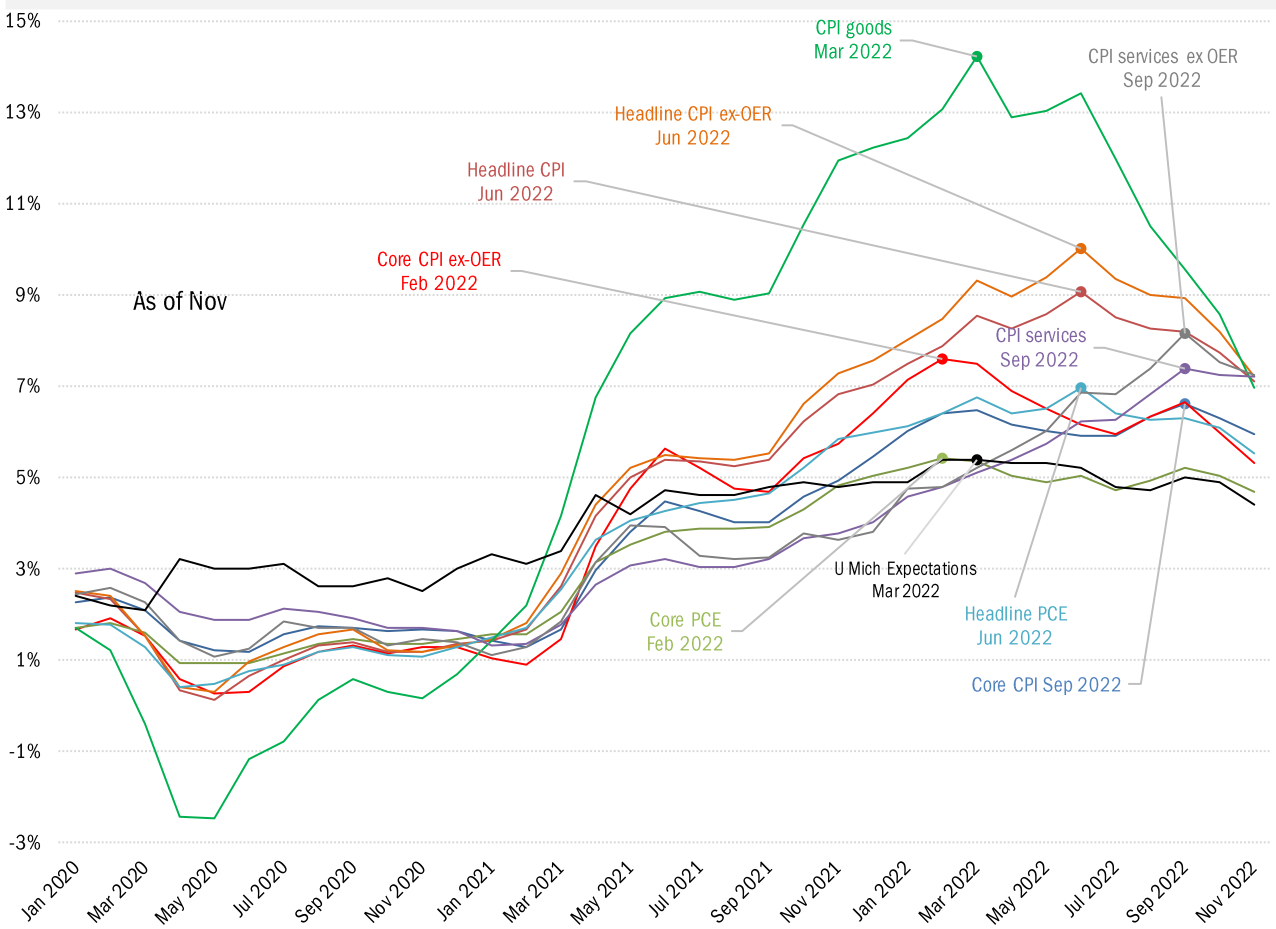
Update to strategic view

US MACRO, US STOCKS, US BONDS, FEDERAL RESERVE, OIL: We were right that the Omicron wave would be big but non-lethal and would spell the end of the pandemic panic. We failed to anticipate the Ukraine crisis but called the top in energy and commodities. We were very wrong to be bullish on stocks but didn't capitulate across the June/October double-bottoms. But we correctly called the outperformance of value over growth and non-US over US. We correctly called the back-up in yields but underestimated the magnitude. We correctly said inflation would prove to be transitory, with CPI peaking in February. But we very much underestimated the Fed's hiking cycle – our big miss of the year. Our productivity-led boom as continued after a recession in Q1 and Q2, with real GDP now 5% above pre-pandemic levels with no more people working. The growth rate in Q3 and Q4 is faster than the pre-pandemic trend, even as the Fed has tightened financial conditions. Recession in 2023 is not at all inevitable.

see [“Equity Risk Premium: Regime Change Accomplished”](). *In other words, this level of yields has reset the US equity risk premium into a new regime in which a relatively narrow spread is, in fact a new normal.*

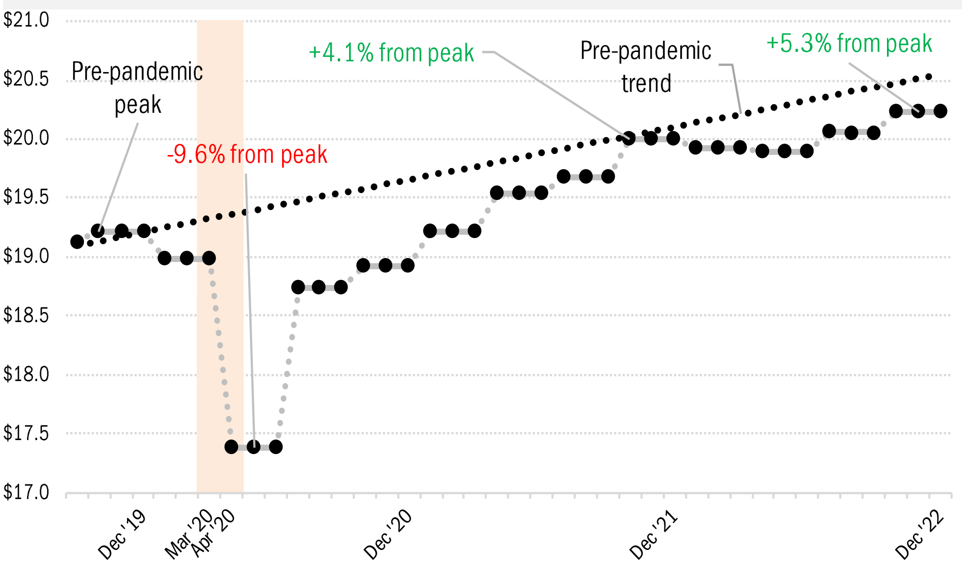
- We’re very happy with our mid-term election call. *A year ago we said with confidence that the GOP would take control of the House but had little confidence as to the Senate*. We were clear on “no red wave” – standing against the more enthusiastic predictions of our friends in the Vast Right Wing Conspiracy. And that’s how it turned out (see [“How Trump’s Red Wave Got Aborted”]() November 14, 2022).
- Our big miss in 2022: *we didn’t anticipate that the Fed would get so aggressive and talk so overtly of its willingness to deliberately cause a recession*. We don’t wish to spare ourselves here – we thought the Fed would lift off in May (it was March), and that there would be only two hikes (there have been, effectively, seventeen!). To be sure, the year-ago market consensus was three hikes – but we were very wrong, nevertheless, and we’re not proud of it.
- We think the Fed has made a big policy error, but be that as it may, our mission is to predict markets that are influenced by what the Fed *will* do, not by what we think the Fed *ought* to do.

Inflation measures, year-on-year change ● Peak month



Source: BLS, BEA, University of Michigan, TrendMacro calculations

- So we take only a little comfort that *we correctly predicted, as 2022 began, that inflation would prove to be transitory* (with the Fed already having repudiated the term at the December 2021 FOMC (see "On the December FOMC" December 15, 2021).
- You disagree that this was a correct call? Well, *transitory* is an ambiguous word, so it's hard to say. But the evidence shows clearly that, depending on your choice of metric, *inflation did in fact peak as early as February* (please see the chart on the previous page, and "On November CPI – Inflation Definitively Peaks" December 13, 2022).
- *But the reality for markets and the economy is that the Fed has only recently been showing any inclination to even begin to see it that way* (see "On Powell at Brookings" November 30, 2022).
- *It's not at all clear yet – and this will be the great decision point of the coming year – that what the Fed has done, right or wrong, will cause a recession* (we concede that the fear of it has already caused a bear market – but that's in the past, and may be more opportunity than cost).
- Here's the evidence so far…
- *Financial conditions tightened in late June in the immediate aftermath of the June FOMC, the first one of four with a 75 bp rate hike – and have been tight ever since. Yet the economy was weak in the first half before conditions tightened, and has strengthened after they tightened* (see "Video: What you're not hearing about Q3 GDP and the craziest damn economy you ever saw" October 27, 2022).
- Indeed, real US gross domestic product contracted in the first two quarters of 2022, arguably a recession based on the rough-and-ready definition (please see the chart below). Output recovered to new all-time highs in Q3 and, according to estimates, again in Q4. It's now 5.3% above the pre-pandemic peak level at Q4-2019.



Source: BEA, Atlanta Fed, NBER, TrendMacro calculations

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[About us]

Astonishingly, about the same number of people are working as pre-pandemic – a marker for the productivity-led boom we have talked so much about.

- But now, after the contraction of H1-2022, output is sill below the pre-pandemic trend by 1.5%. That said, the trend rate of growth in Q3 and Q4 is 3.5% at an annual rate – *faster* than the pre-pandemic trend rate of 2.4%.
- The evidence is scant that the Fed has already put an unavoidable recession on the tracks. And that brings us to 2023 – which we'll write about next week.
- Happy New Year, friends.

Bottom line

We were right that the Omicron wave would be big but non-lethal, and We were right that the Omicron wave would be big but non-lethal and would spell the end of the pandemic panic. We failed to anticipate the Ukraine crisis but called the top in energy and commodities. We were very wrong to be bullish on stocks but didn't capitulate across the June/October double-bottoms. But we correctly called the outperformance of value over growth and non-US over US. We correctly called the back-up in yields but underestimated the magnitude. We correctly said inflation would prove to be transitory, with CPI peaking in February. But we very much underestimated the Fed's hiking cycle – our big miss of the year. Our productivity-led boom as continued after a recession in Q1 and Q2, with real GDP now 5% above pre-pandemic levels with no more people working. The growth rate in Q3 and Q4 is faster than the pre-pandemic trend, even as the Fed has tightened financial conditions. Recession in 2023 is not at all inevitable.