SLOCUM, GORDON & CO. LLP
INVESTMENT COUNSEL • EST 1978
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VIEWPOINTS

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IN THIS ISSUE OF VIEWPOINTS, WE DISCUSS THE LIKELIHOOD OF A RECESSION.

Readers of the last few editions of *Viewpoints* will undoubtedly find this one somewhat repetitive. We believe we are in a period where reversion to the mean is the essential governing principle: reversion from the ultra and artificially low interest rates of the last 10 years; reversion from an overvalued, narrowing, and bubble-like stock market led by a handful of today's versions of glamour stocks; and reversion back to higher energy prices caused by extreme supply constraints. There are many more examples, but these highlight the themes that we have been pounding away at for the better part of the last few years.

The noted economist, John Maynard Keynes, once said: "When the facts change, I change my mind. What do you do, Sir?" We have been consistent in our views of the economy and markets, and so far, the facts on the ground are supportive of this cautionary tale despite commentary from the press and politicians who are trying to paint a very different picture. Preserving capital often requires going against the popular grain of the market, particularly when we would prefer to be early rather than late in anticipating inevitable economic cycles.

We think we're very much in a late cycle environment. It is difficult to ascertain how late because things are okay until they're not. In the real world, risk happens slowly, and then all at once! We can't predict when the recession begins, and for all we know, we may be in one right now. Last year's bear market was all about interest rates. We haven't had the earnings damage yet, and that's still ahead of us.

Even before the regional banking failures we saw in the first quarter of 2023, credit tightening was already headed in a bad direction. To us, this would suggest that the earnings recession is going to get much more severe, and revenue surprises on the downside are going to be all about weakening pricing power. We already have negative unit growth in many businesses, and if we get negative revenue growth, earnings growth will be impacted as well.

The previously strong labor picture is beginning to slow, and the reason it's slowing is because the profit cycle is slowing. Profit cycle leads the employment cycle, and the employment cycle is all that matters for the economy and the recession call. And what is significant is that there have been downward revisions after the initial announcements of the non-farm payroll numbers for seven consecutive months.

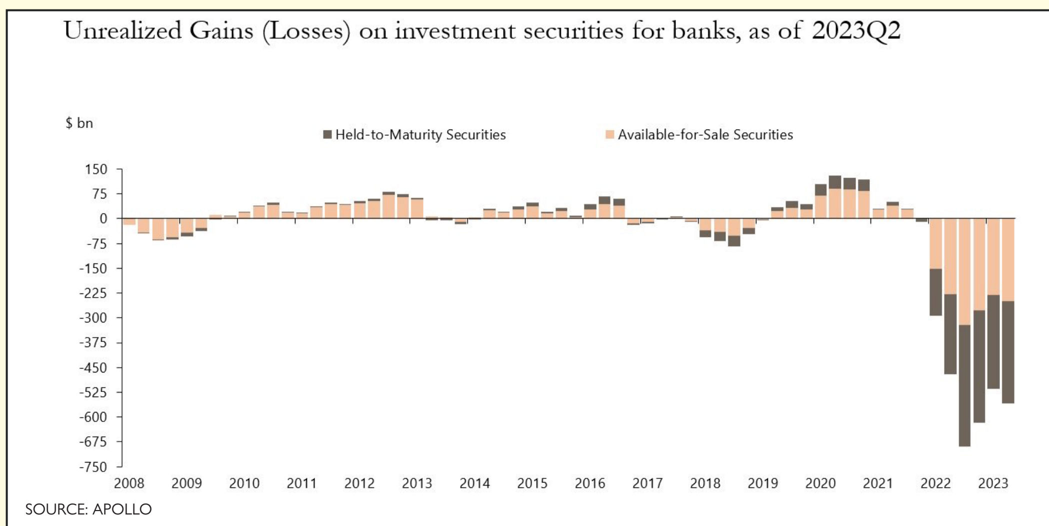


CHART 1

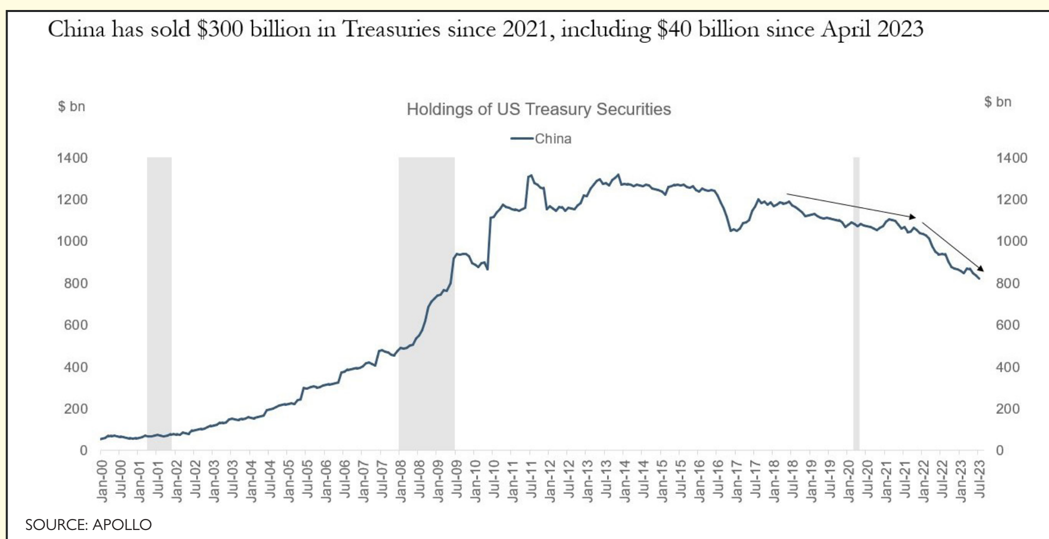


CHART 2

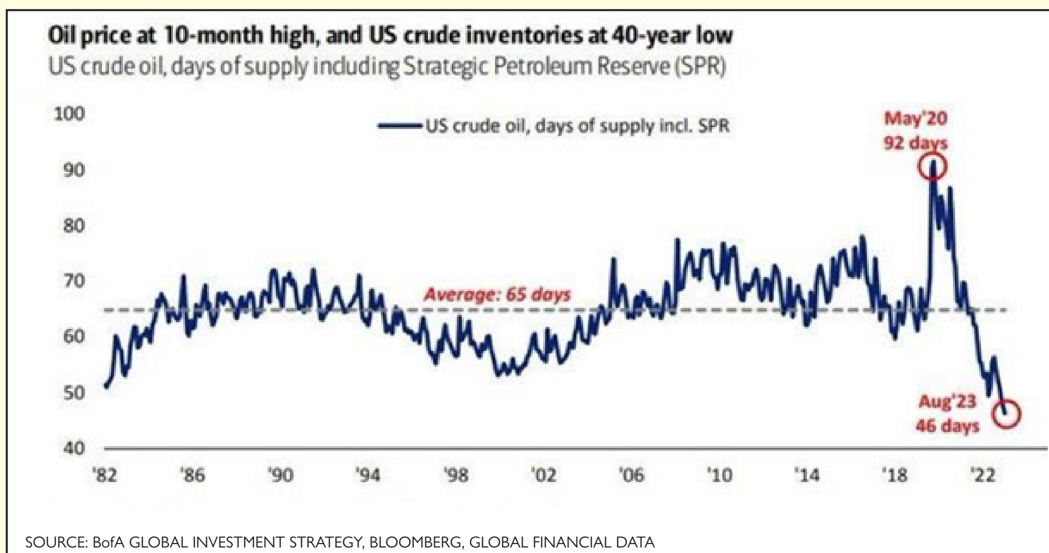


CHART 3

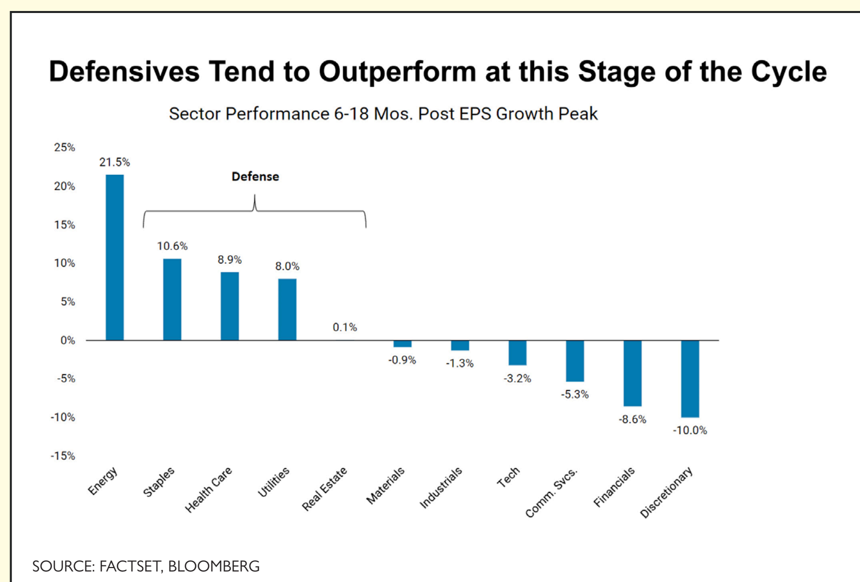
Where are the skeletons in the closet right now? The obvious one is office and commercial real estate. The office market, over $1 trillion in debt, needs to be refinanced over the next three to four years. Most of it is on regional banks' balance sheets, and many of them are already impaired *(CHART 1)*.

Number two would be the enormity of the US treasury issuance coming down the line soon. Over $1 trillion needs to be raised, and we are running out of traditional buyers, like the Chinese, who are now sellers of US treasuries *(CHART 2)*.

And finally, the indicator of impending recession is all about oil right here. Every recession is preceded by one final spike in oil prices that tips over the consumer. The chart *(CHART 3)* indicates the extent to which supply has dwindled in the face of higher oil prices. Capital investment in new supply has been politically disincentivized, and that creates the essential problem of a major supply and demand imbalance. This is good for energy companies' stock prices.

So, where do we go for preservation of capital with some degree of growth?

That's what the chart below shows. At the end of a cycle, aside from having increased cash reserves, the traditional place to go is into defensive sectors, and usually energy does well because oil prices are up at the end of the cycle. This worked beautifully last year, however, this year, we've had a renewed frenzy back towards the growth narratives. The defensive stocks got too expensive in the context of rates moving up, and they'd already been over-owned and over-bought last year. We think the defensive investment preference will come back into favor as growth concerns start to resurface again.



SOURCE: FACTSET, BLOOMBERG

> "When the facts change, I change my mind. What do you do, Sir?"
> John Maynard Keynes

Additionally, fundamental to our investment philosophy is our focus on companies that pay dividends. This is a theme we have stressed since our founding in 1978! The chart below illustrates the excess performance of total return from the noted S&P 500 Dividend Aristocrats over the S&P 500 index since 1990. While these stocks have outperformed the averages, they generally have lower risk and lower volatility, attributes that we value in our work as an investment adviser.

IN CONCLUSION

The picture ahead is certainly muddy. The influences of election year politics on the markets and on the Fed should be epic this time around. Shrinking demographics globally are not supportive of long-term growth, and the turn to more populist governments suggest higher taxes to pay for more social programs. And finally, under the heading of reversion to the mean, all markets eventually succumb to this force. So, our investment caution seems warranted at the moment, and when the facts change, we will change our mind.

Jeffrey L. Gordon
Managing Partner

S&P 500 Dividend Aristocrats
S&P 500 Total Return
Log Scale
10,000
1,000
100
Normalized to 100 on Jan 1, 1990
1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012 2014 2016 2018 2020 2022

SOURCE: MORGAN STANLEY

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