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If the 2022 prognostications by the talking heads on financial television were correct, the U.S. economy would be in the thick of a recession by now. They argued the Federal Reserve's furious pace of interest rate hikes, paired with soaring inflation, were sure to slow the rapidly growing economy. Stocks priced in that eventuality as evidenced by the S&P 500 index's 18% drop last year. Growth stocks fared even worse. The S&P Pure Growth index plunged 28% (almost as much as long-term treasury bonds), while the flight to Value was apparent in the S&P Pure Value's comparatively modest 1% retreat.

Money was on the move, no doubt, as equity market uncertainty and attractive risk-free yields in Treasuries gave income-hungry investors a choice after more than a decade of very low cash returns. Yet, for all the shuffling, handwringing and stress, investors who flee equities typically do so after the damage is already done and have little to show for it. The aforementioned indexes actually posted modest gains in the first two months of this year. The S&P 500 index rose 4%, while the Pure Growth and Pure Value subindexes gained 0.4% and 5%, respectively. Importantly, the recession has yet to officially begin, and in fact it may not come at all in 2023.

ALWAYS ON THE DOORSTEP

Economic forecasts are often fraught with uncertainty. Figure 1 shows the prognosticators now forecast a 60% chance of a U.S. recession occurring in the next year, down from 65% two weeks ago and 67.5% in January. We interpret the pullback as lowered conviction of an imminent recession because, in large part, underlying indicators used by the National Bureau of Economic Research (NBER) to determine the timing of a recession have actually improved this year. Of course, we aren't arguing that Jerome Powell, Chair of the Federal Reserve, has achieved his intended 'soft landing', but it does seem few suspected the economy would continue to be as strong as it is with risk-free interest rates approaching 5%.



Figure 1: Recession Probabilities Have Actually Ticked Lower

From 04.30.2008 through 02.28.2023. SOURCE: Kovitz using data from Bloomberg Finance L.P.



THE INTEREST RATE CONUNDRUM

Late last year, Wall Street forecasts suggested the Fed Funds Rate would peak around 5% (Figure 2). Remarkably strong economic data seems to have caused some folks to realize rates may move higher still, a belief reinforced by Chair Powell's peddling of the Fed's data-dependent path. Even if rates continue to rise, they remain much lower than the target implied by the Taylor Rule (Figure 3), a monetary policy formula developed by economist John B. Taylor in 1992 which helps central banks set short-term interest rates by considering the equilibrium interest rate, the price level and GDP growth changes. While the Taylor Rule's target often differs from the actual rate and the Federal Reserve does not consider its outputs in its current decision-making, it does seem to offer some directional information for investors and does well to explain Federal Reserve actions under chairs Volcker and Greenspan. Interestingly, it suggests the decade-plus of low rates following the Great Recession was not ideal, and several academics believe departing from the Taylor Rule exacerbated the housing bubble.

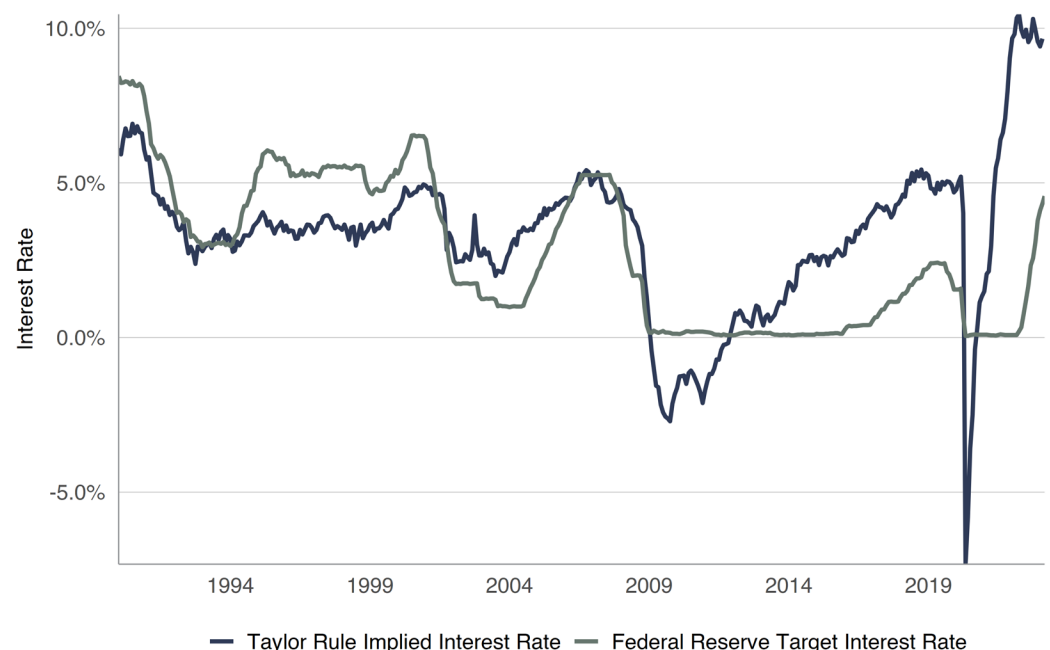
Figure 2:
Interest Rate
Expectations Have Risen

From 06.24.2022 through
02.28.2023. SOURCE: Kovitz
using data from Bloomberg
Finance L.P.



Figure 3:
The Taylor Rule Suggests
Rates Should Be Higher

From 12.31.1989 through
02.28.2023. SOURCE: Kovitz
using data from Bloomberg
Finance L.P.





TO BAIL OR NOT TO BAIL

We suspect readers may soon tire of reading *the hardest part of market timing is getting the timing right* in these pages. But, once again, number crunching nearly a century of data suggests the quip is as pertinent as ever. In Figure 4, we retrieved all of the NBER's declared recessions since 1929 and calculated the S&P 500's return preceding, during and following each recession. Equity returns in the lead-up to the recessions are generally good (averaging 12%) and we would tend to think one wouldn't want to miss out on those returns. Not owning stocks during recessions would save an investor from a loss averaging 9%, but the NBER doesn't determine recessions in real time, meaning the recording lag significantly complicates timing this type of trade. And the numbers are stellar coming out of recessions, with the average recession-is-over rally averaging a gain nearing 24%, while equities nearly double five years out. Plus, this daily series for the S&P 500 excludes the impact of dividends, meaning an investor's realized returns would have been even better than those we have calculated below.

Figure 4:
Timing Recessions

From 12.31.1927 through
02.28.2023. Price return series.
Returns are not annualized.
SOURCE: Kovitz using data from
Bloomberg Finance L.P.

S&P 500 Index Returns & Recessions							
Recession		Return Prior To Recession Start		Return During	Cumulative Return After Recession End		
Start Date	End Date	1 Year	6 Months		6 Months	1 Year	5 Years
08.01.1929	03.01.1933	49.7%	12.5%	-80.2%	94.6%	85.8%	120.7%
05.01.1937	06.01.1938	24.0%	-2.8%	-38.0%	35.3%	24.6%	71.5%
02.01.1945	10.01.1945	19.9%	8.3%	24.7%	12.5%	-4.9%	67.4%
11.01.1948	10.01.1949	14.3%	11.1%	2.1%	17.9%	38.5%	191.5%
07.01.1953	05.01.1954	2.1%	-6.2%	21.5%	15.2%	40.7%	148.8%
08.01.1957	04.01.1958	0.4%	9.1%	-9.5%	21.5%	37.5%	88.4%
04.01.1960	02.01.1961	2.9%	-1.0%	14.6%	10.5%	15.3%	74.4%
12.01.1969	11.01.1970	-11.2%	-8.4%	-7.0%	26.9%	15.1%	27.8%
11.01.1973	03.01.1975	-1.5%	2.2%	-19.6%	8.7%	27.7%	76.8%
01.01.1980	07.01.1980	18.6%	7.8%	9.5%	21.0%	18.6%	114.2%
07.01.1981	11.01.1982	18.6%	-2.0%	12.7%	24.2%	26.4%	127.1%
07.01.1990	03.01.1991	16.5%	3.1%	6.0%	8.4%	14.9%	100.3%
03.01.2001	11.01.2001	-9.0%	-17.9%	-11.9%	0.9%	-15.6%	37.7%
12.01.2007	06.01.2009	8.1%	-2.6%	-33.9%	18.9%	15.9%	126.7%
02.01.2020	04.01.2020	21.5%	10.3%	-23.1%	38.1%	65.5%	
	Average	11.7%	1.6%	-8.8%	23.6%	27.1%	98.1%

STICK WITH IT

It's impossible to know for sure when the next recession will arrive, only that invariably one will. And a body of evidence suggests that there's limited value—especially after considering taxes, trading costs and uncertain timing—in positioning a portfolio to avoid a recession in the first place. Therefore, we prefer to consider the sometimes-violent gyrations in market prices to be purveyors of tremendous opportunity, particularly for those like us who are willing to be patient and look far down the road. The folks in the press might make a convincing pitch to get investors to think trading activity is better than sitting on their hands, but the evidence demonstrates portfolio activity attempting to exploit short-term trends often succeeds in interrupting the power of compounding capital over the long term.



We offer a wide array of thoughts on the [Insights](#) page of our website. For more information on working with our financial professionals, contact us at wealth@kovitz.com or 312.334.7300.

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The description of products, services, and performance results contained herein is not an offering or a solicitation of any kind. Past performance is not an indication of future results. Securities investments are subject to risk and may lose value.

All returns are geometric average unless otherwise stated. The geometric average is calculated using the mean of a set of products that takes into account the effects of compounding.

The federal funds rate is the rate banks charge on loans to each other.

The quoted forward yield for the S&P 500 uses the iShares S&P 500 ETF (ticker: SPY) as a proxy. The quoted forward yield for the S&P Core Value uses iShares Core S&P U.S. Value ETF (ticker: IUSV) as a proxy. The quoted forward yield for the S&P Core Growth uses iShares Core S&P U.S. Growth ETF (ticker: IUSG) as a proxy.

The factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth portfolios are monthly averages of the two returns.

The Standard & Poors 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index. The S&P 500 Growth Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Growth Index. The S&P 500 Value Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Value Index.

Growth stocks = 50% Fama-French small growth and 50% Fama-French large growth returns rebalanced monthly. Value stocks = 50% Fama-French small value and 50% Fama-French large value returns rebalanced monthly. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Dividend payers = 30% top of Fama-French dividend payers, 40% of middle Fama-French dividend payers, and 30% bottom of Fama-French dividend payers rebalanced monthly. Non-dividend payers = Fama-French stocks that do not pay a dividend. Long term corporate bonds represented by the Ibbotson Associates SBBI US LT Corp Total Return index. Long term government bonds represented by the Ibbotson Associates SBBI US LT Govt Total Return index. Intermediate term government bonds represented by the Ibbotson Associates SBBI US IT Govt Total Return index. Treasury bills represented by the Ibbotson Associates SBBI US 30 Day TBill Total Return index. Inflation represented by the Ibbotson Associates SBBI US Inflation index.

The Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of Securities represents approximately 98% of the investable U.S. equity market. The Russell 3000 Index is comprised of stocks within the Russell 1000 and the Russell 2000 Indices. Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI ACWI Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31 1987. It includes both emerging and developed world markets. The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The DJ US Real Estate Index represents REITs & other companies that invest directly or indirectly in real estate through development, management or ownership, including property agencies. The index is a subset of the Dow Jones U.S. Index, which covers 95% of U.S. securities based on float-adjusted market capitalization. The S&P GSCI Total Return Index in USD is widely recognized as the leading measure of general commodity price movements and inflation in the world economy. Index is calculated primarily on a world production weighted basis, comprised of the principal physical commodities futures contracts.

From 1927 to present, we utilized the dividend-weighted portfolio data from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers).

Figure 1 and Figure 2 definitions are as follows: Commodities: S&P GSCI TR Index. REIT: MSCI U.S. REIT NR Index. Long-Term Bonds: Bloomberg US Treasury: 20+ Year Index. Short-Term Bonds: Bloomberg Barclays U.S. Treasury: 1-3 Year TR Value Unhedged USD Index. Cash: Bloomberg Barclays U.S. Tr Bills: 1-3 Months TR Value Unhedged USD Index. High Yield Bonds: Barclays VLI High Yield TR Value Unhedged USD Index. Domestic Small Cap Equity: Russell 2000 TR Index. Domestic Large Cap Equity: S&P 500 TR Index. Emerging Markets: MSCI Emerging Markets NR USD Index. Developed Markets: MSCI EAFE NR USD Index. Aggregate Bond: Barclays U.S. Agg TR Value Unhedged USD Index. Generic 70/30 blend: 70% S&P 500 Index, 30% Barclays U.S. Aggregate Bond Index. Expanded Blend: 60% S&P 500 Index, 25% Bloomberg Barclays U.S. Aggregate Bond Index, 10% HFRX Equity Hedge Index and 5% Dow Jones U.S. Real Estate Capped Index (USD) TR.

Figure 3 definitions are as follows: Value Factor: MSCI USA Value Net Total Return USD Index. Growth Factor: MSCI USA Growth Net Total Return USD Index. Minimum Volatility: MSCI USA Minimum Volatility Net Total Return Index. High Dividend Yield: MSCI USA High Dividend Yield Net Total Return Risk Premia Index. Quality: MSCI USA Quality Net Total Return USD Index. Momentum: MSCI USA Momentum USD Net Total Return Total Return Index. Size: MSCI USA Size Tilt USD Net Total Return Index.

Figure 5 definitions are as follows: Short-Term Corporate Bonds is represented by Vanguard Short-Term Corporate Bond ETF (VCSH). Municipal Bonds is represented by iShares National Muni Bond ETF (MUB). Aggregate Bond Market is represented by Vanguard Total Bond Market ETF (BND). High Yield Bonds is represented by SPDR High Yield Bond ETF (JNK).

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