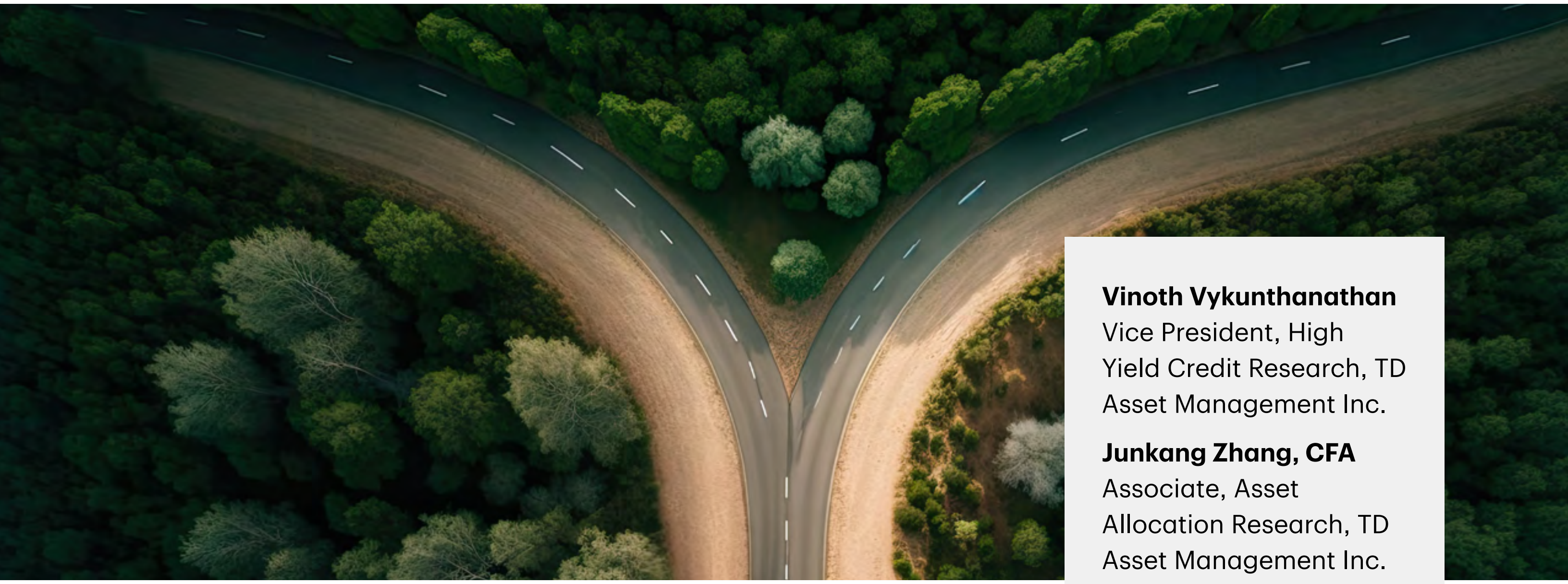

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Approaching a Fork in the Road

Is the economy going to experience a recession or a soft-landing?

At a glance

- **The much-anticipated recession of 2023 still isn't here, and many are beginning to wonder if it will come at all.**
- **On one hand, the pandemic era trends and policies are expected to continue to be more important over the next 12 months when compared to the aggressive rate increases, which could lead to a soft landing for the economy.**
- **On the other hand, a weaker labour market ahead together with excess savings fading away, may spill over into households and constrain spending which could steamroll into a recession**
- **In both recession and soft-landing scenarios, security and sector selection will be very important and income generating assets like fixed income and value equities, are expected to outperform growth assets in the near-term.**

The much-anticipated recession of 2023 still isn't here, and many are beginning to wonder if it will come at all. Today, economists' predictions for a recession have yet to materialize as data continues to paint a picture of a resilient U.S. economy, despite pressure from high inflation and steep interest rate hikes. The economy could come down from the interest rate hikes with a 'hard landing', where the U.S. Federal Reserve (Fed) induces a recession and unemployment jumps significantly, or a soft landing, where the U.S. economy only slows down slightly. So, what will it be?

A tale of two outcomes

In this article, we are not going to try and predict what will happen – there is no crystal ball here. What we aim to do is discuss the two possible outcomes - a recession or a soft landing – as seen through a 12-month lens. We will focus on the U.S. economy and evaluate the different scenarios and provide our thoughts on what assets may perform well in either environment.

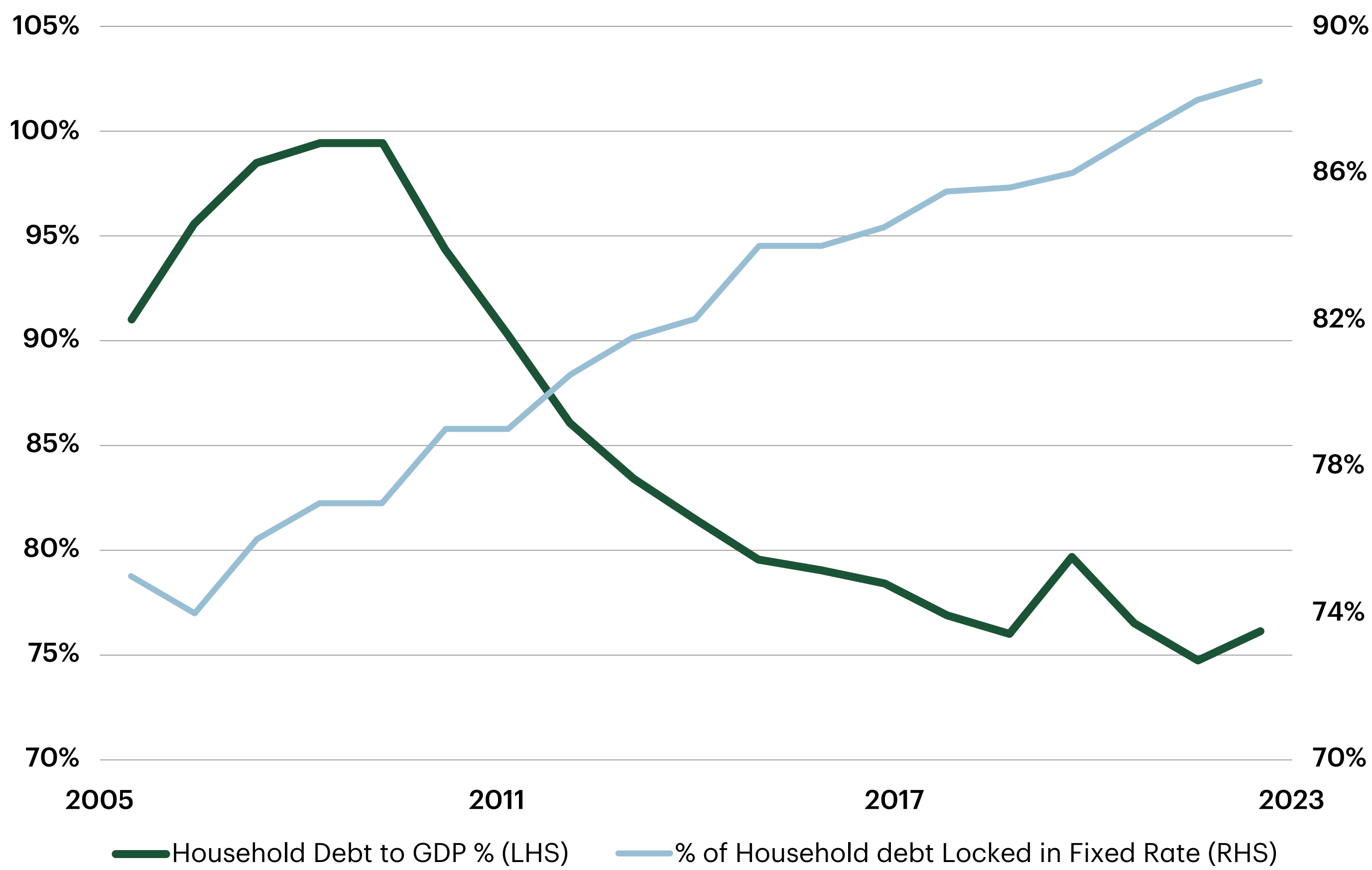
The soft landing

What exactly is a soft landing when it comes to the economy? It can be described as a cyclical slowdown in economic growth, but one that avoids a recession. This is often the goal of central banks when they raise interest rates just enough to stop an economy from overheating and experiencing high inflation, but without causing a severe downturn. This would be an ideal outcome. Is a soft landing easy to achieve? No, but it is possible. You need a few key factors to play out for it to be a possibility.

A healthy U.S. consumer: At this juncture, the U.S. consumer has shown significant financial discipline since the 2008/09 Global Financial Crisis (GFC), deleveraging their balance sheet and reducing their exposure to variable rate debt. The variable rate exposure in the U.S. is significantly lower than other developed countries and areas (Canada, Australia, United Kingdom) which in turn is far less impacted by the rise in interest rates since 85% of U.S. household debt being locked into fixed rates.

Pandemic era policies and trends have limited maximizing output in several sectors, leaving many companies still on a path to recovery, while others who are in a down cycle may start an upcycle soon. These unsynchronized industry cycles may extend the larger economic cycle.

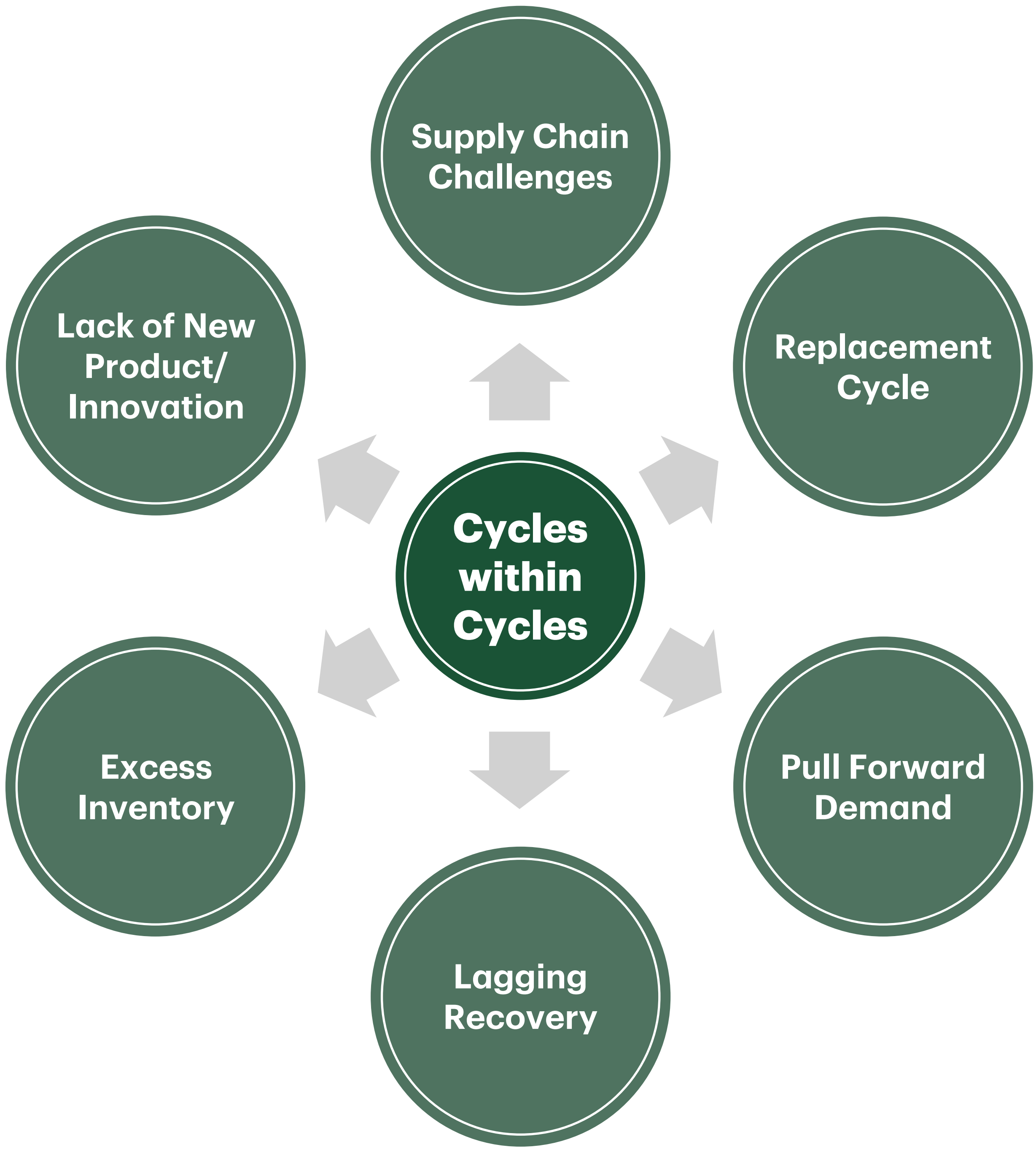
Lower household debt and high % of locked fixed rates



Source: St. Louis Federal Reserve, UBS. Data as of Jan 1, 2023.

To expand on this, the larger economic cycle is made up of many smaller sector level cycles. Typically, in a recession, we see most sectors go through a downcycle together. However, due to the pandemic and pandemic era policies, each industry was impacted differently and created different starts and stops, supply chain issues and demand differences which ultimately led to unsynchronized industry cycles or "cycles within cycles". This dynamic supports a soft-landing scenario.

Cycle within Cycles



For illustrative purposes only.

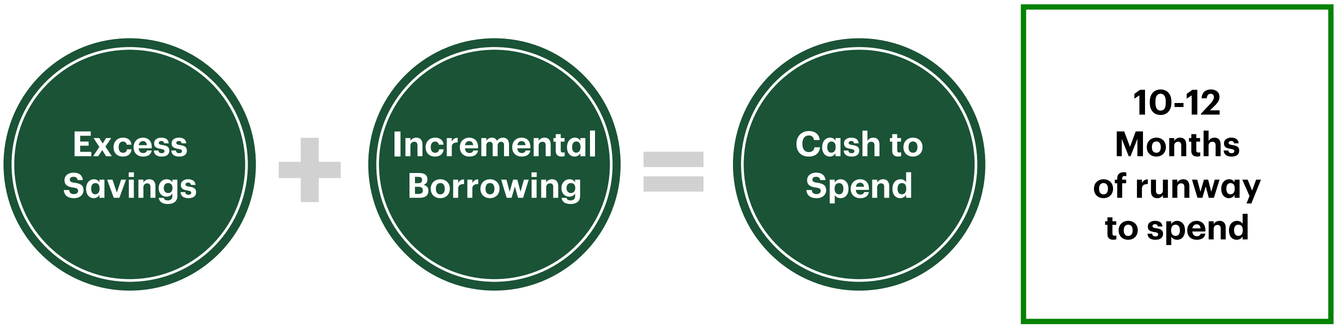
Another key point to support the idea of a soft landing is that the U.S. consumer is significantly wealthier due to a decade of strong asset price appreciation. From the period right before the pandemic to the first quarter of 2023, aggregate household wealth has increased $33 trillion[1]. This new found wealth has a significant effect on the economy and spending.

[1] U.S Federal Reserve, Data as of June 8, 2023.

U.S. Consumers' excess savings accumulated during the pandemic along with access to unused credit provide the ability to spend those savings and borrow on credit to continue their spending into next year, which could be enough time to weather higher rates and inflation and experience a soft landing for the economy.

Savings effect & credit availability

A healthy amount of cash and credit still available to deploy significantly above pre-covid levels



Source: U.S. Federal Reserve, TDAM. Data as od Dec 31, 2022.

A recession

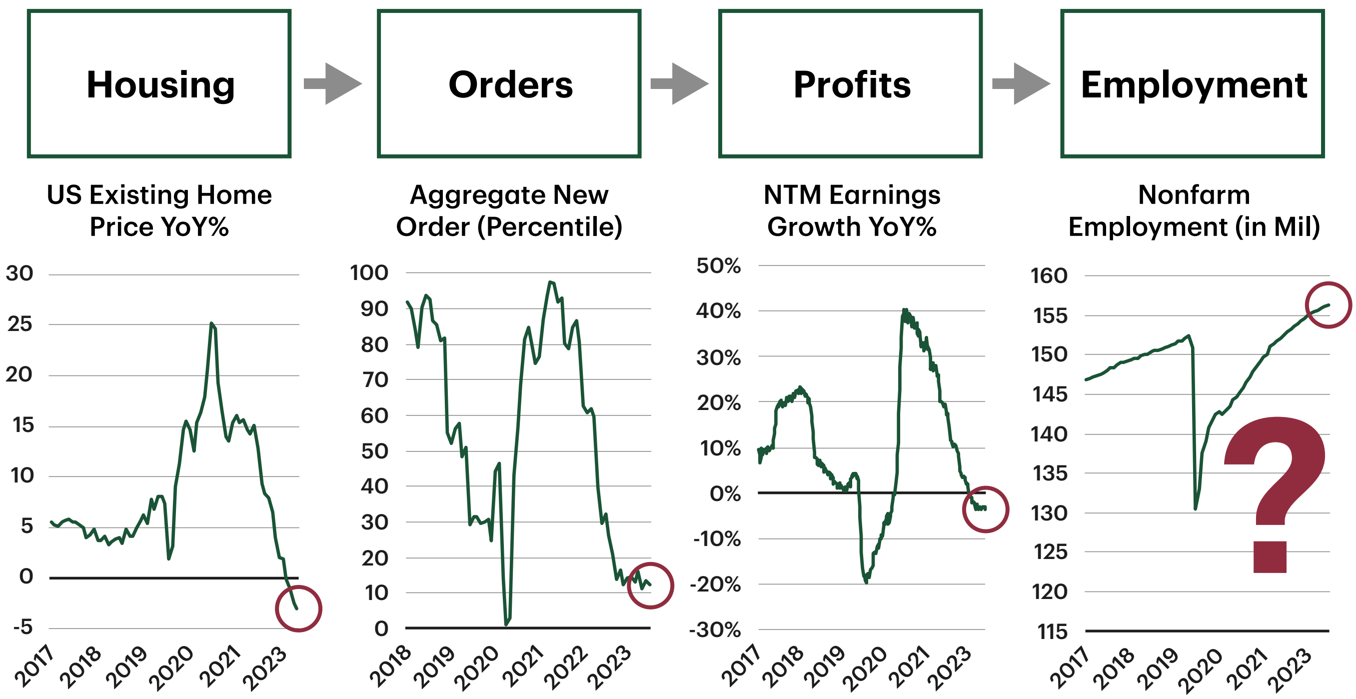
The other potential outcome is a recession. A recession is a significant, widespread, and prolonged downturn in economic activity.

The economy has so far been sustained by a tight labour market, extra cash being saved, and robust demand for services. Essentially the three economic legacies from the period of the pandemic. However, to assess where the economy is heading, it is crucial to understand the connections behind and how each of these drivers may evolve in the near-term.

The labour conundrum: Historical shows the way the economy reacts to policies is consistent during downturns. The restrictive effect of higher rates manifests first in the highly "rate-sensitive" housing sector and is followed by broader deterioration in other sectors, and eventually weighs on employment.

What have we seen so far? The following chart shows that housing as an early-cycle industry has slowed down materially over the past year and a half. The manufacturing new order composite index also fell dramatically in 2022 and has remained at a low level. Tighter financial conditions weighed on corporate earnings, where 12-month growth estimates have seen a streak of downgrades and ended up in a negative territory since the beginning of this year. However, employment remains a conundrum as we witness one of the tightest job markets ever by various measures.

Slowdown in housing, followed by new orders and earnings



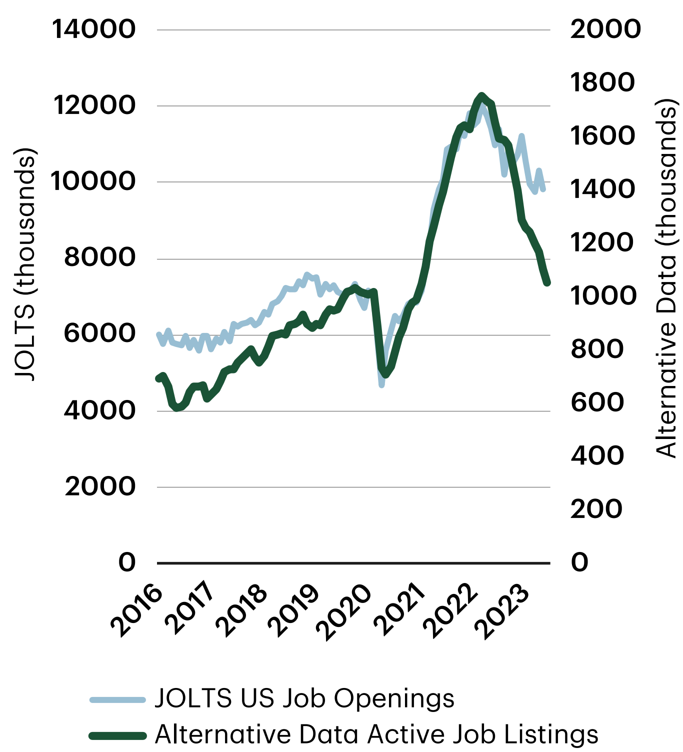
Source: TDAM, Bloomberg Finance L.P, Piper Sandler. Data as of April 30, 2023.

Today, labour market signals are showing cracks beneath the surface which are all pointing to a weaker position down the road. Over the past two years we have observed a rapid accumulation of labour by U.S. public corporations, sometimes referred to as "labour hoarding". Nevertheless, the sentiment regarding future hiring plans suggests a substantial decrease in hiring momentum, with headcount reduction plans being implemented concurrently.

When looking at job vacancies, they serve as a reliable indicator for the tightness in the labour market. One well-known indicator that receives a lot of attention is the JOLTS job openings data. However, in isolation the data has some limitations. To gain a more accurate perspective, we compare it against an alternative job listing data series that we at TD Asset Management Inc. (TDAM) track.

This alternative data indicates that employment imbalances can be resolved more quickly, returning to pre-pandemic levels by Q3 of this year. Existing job openings are being filled rapidly, with a decrease in job postings. Consequently, when job openings decrease, individuals may face intensified competition for available positions, resulting in a potential rise in the overall unemployment rate as more people struggle to secure employment.

JOLTS vs Alternative Data Job Openings

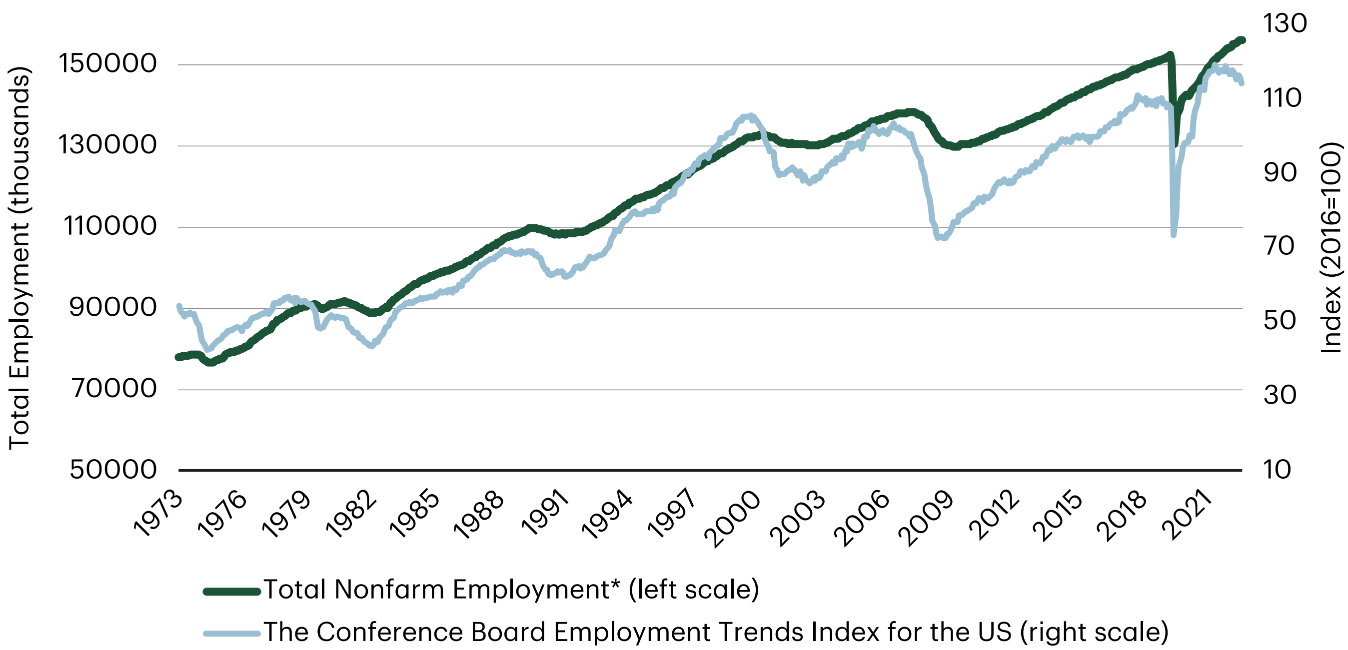


Source: Bloomberg Finance L.P, UBS Evidence Lab. Data as of June 30, 2023.

Another valuable indicator is the Conference Board Employment Trend Index, composed of 8 leading economic indicators, which has a proven track record in predicting fluctuations in the total non-farm employment level. Currently, the index has been significantly stretched, as it has been 16 months since its peak in March 2022. Despite this, it implies that a turnaround in employment may be imminent or possibly already underway.

Today, a labour market driven downturn and the depleting excess savings legacy (more on this below) is playing out. These challenges will likely spill over into U.S. households and constrain their spending.

The Conference Board Employment Trends Index and turning points, November 1973 to Present

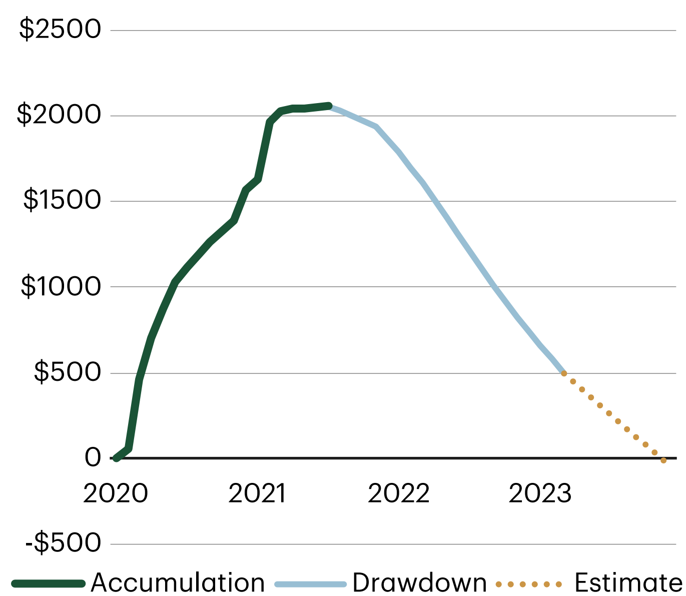


Source: Conference Board, Datastream. Data as of June 15, 2023.

Excess savings being depleted: Excess savings during the pandemic provided a considerable cushioning effect, kept spending strong and delayed the timing of a recession, but are now facing headwinds. These savings accumulated very fast and are now being depleted very quickly. Our estimates are that the 500 billion in remaining excess cash may only support households to the end of this year, with a run rate of 80 billion per month.

A weaker labour market, together with excess savings fading away, could likely impact U.S. households to constrain their spending and have a trickle effect on the economy, potentially triggering a recession.

U.S. household excess savings (billions)



Source: TDAM, Bloomberg Finance L.P. Data as of April 1, 2023.

Investment opportunities in both paths

Despite the two very different paths on which way the economy may travel, there is common ground on what strategies and assets may perform well in either environment. Security selection and sector selection will be very important. Less market breadth is expected to continue due to higher rates and low growth. In addition, income generating assets like fixed income and yields remain well above the lows of the past decade and offer attractive, risk-adjusted potential returns.

If a recession fails to materialize, we expect consumer-facing Financials, profitable growth Technology, Consumer Discretionary and cyclicals to do well. We would avoid over levered staples, defensives and secular decline stories. Under the scenario of a potential recession in 12 months, we recommend allocating investments toward assets that demonstrate lower sensitivity to economic growth. Within the equities market, we prefer an overweight Staples & Utilities sectors over the Consumer Discretionary sector. When considering equity factors, focus on companies that consistently generate stable free cash flow yield and exhibit lower revenue volatility. Moreover, exercising caution with Financials is prudent due to exposure to commercial real estate, strict capital requirements, and uncertainties arising from tighter credit conditions, which all pose significant challenges for the banking sector.

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