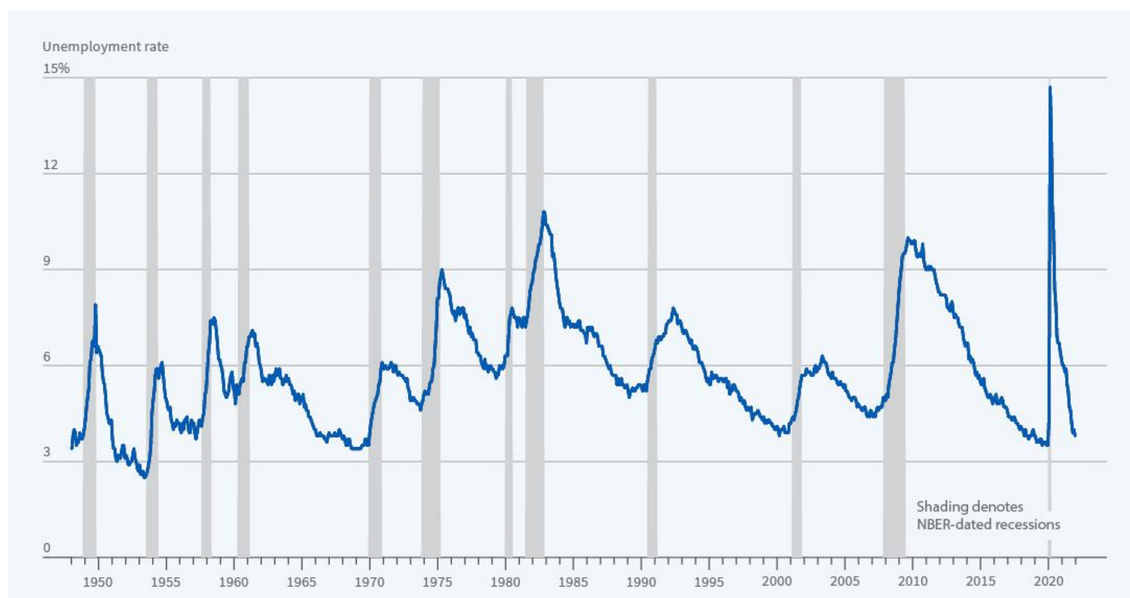
Alley Company Quarterly Letter
More to the Question

July 13, 2022

According to the National Bureau of Economic Research (NBER), the U.S. economy has experienced twelve recessions since the end of WWII. While not easy to predict, these declines in economic activity happen every 6 years on average and are truly an inherent part of the business cycle and investment landscape.

Exhibit 1: NBER-Dated Recessions Shaded in Gray



Source: NBER.org and Bureau of Labor Statistics. Note: NBER's definition of recession emphasizes a significant decline in economic activity that is spread across the economy and lasts more than a few months. Three criteria – depth, diffusion, and duration – are somewhat interchangeable. That is, while each criterion needs to be met individually to some degree, extreme conditions revealed by one criterion may partially offset indications from another. For example, in the case of the February 2020 peak in economic activity, NBER concluded that the subsequent drop in activity had been so great and so widely diffused throughout the economy that, even if it proved to be quite brief, the downturn should be classified as a recession.

In 2022, with the Federal Reserve hiking interest rates to fight against persistent consumer price inflation, market pundits and the financial media have no doubt become preoccupied with trying to answer the question: when will the next recession begin? While understandable and

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academically stimulating, this level of focus misses the mark for investors. As Nobel Prize winning economist Paul Samuelson famously quipped, *"Wall Street has predicted nine out of the last five recessions."*

Over the long-term, healthy economies *grow* and corporate profits follow. Hence, a broader analysis of the underlying health of the U.S. economy is likely more useful than trying to predict the precise timing of a temporary decline in GDP. The next recession could happen this year, next year, or at a later point in time, but it will undoubtedly happen and the structural underpinnings of the economy will be important to understand as a buffer against the downturn and for the foundation of the next expansion cycle.

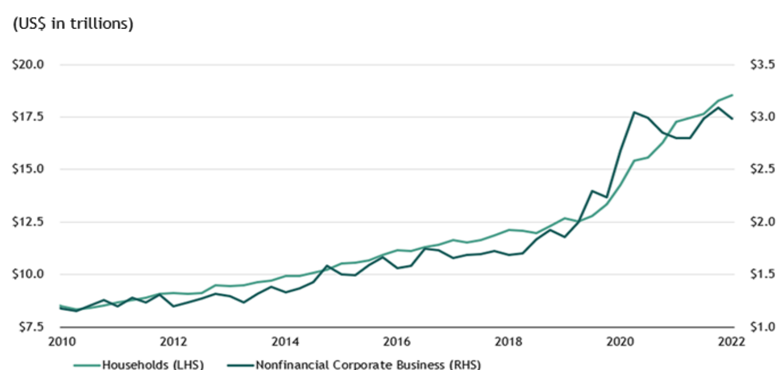
In the four sections that follow, we look at some of the key economic pillars – consumer and corporate health, banking system strength, housing, and innovation – that appear to be in good standing and supportive of long-term economic growth.

Consumer and Corporate Health

The balance sheets of both consumers and corporations are in a good position with elevated liquid assets (Exhibit 2). In addition, corporate profit margins are presently running at healthy levels and household debt payments as a percent of disposable income are near multi-decade lows. Both consumers and corporations, generally speaking, are in strong financial condition to weather near-term economic uncertainty and spark future growth.

Exhibit 2: Consumer and Corporate Balance Sheet Health

Liquid Financial Assets on Household and Corporate Balance Sheets



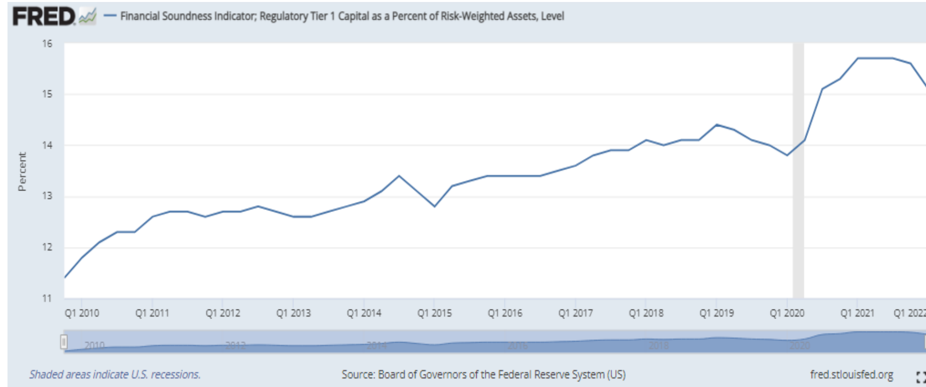
Source: Blackstone, Federal Reserve, Haver Analytics, as of 3/31/22.

Banking System

A stable, liquid, and well-capitalized banking system is critical for the foundation of a healthy economy. U.S. banks have steadily improved their regulatory capital and financial soundness since the 2008-2009 Global Financial Crisis. Earlier this month, the Federal Reserve released the results of its annual "stress test," which was performed on the 34 largest banks. Each of the

banks passed the rigorous test, which suggests that the U.S. banking system is in extremely strong financial condition.

Exhibit 3: Banking System Financial Soundness Indicator

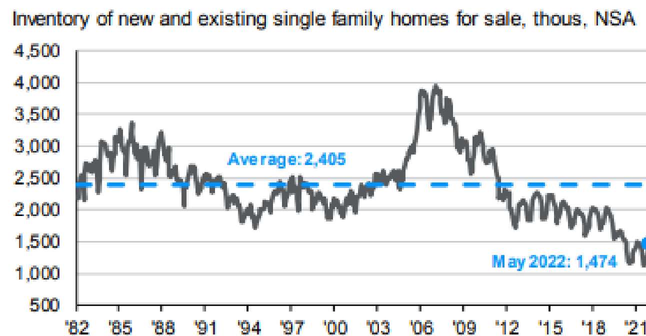


Source: Federal Reserve Economic Data (FRED). Q1 2022 observation is 15.1.

Housing

As Exhibit 4 depicts, the inventory of new and existing homes for sale is near a 40-year low. While higher mortgage rates will curtail turnover *activity*, the overall health of the housing market is on firm footing with low inventory, strict lending standards, and strong homeowner equity. It is worth noting that the housing market today is in the exact opposite position as prior to the Global Financial Crisis.

Exhibit 4: Housing Inventories



Source: JPM Guide to the Markets, as of 6/30/22.

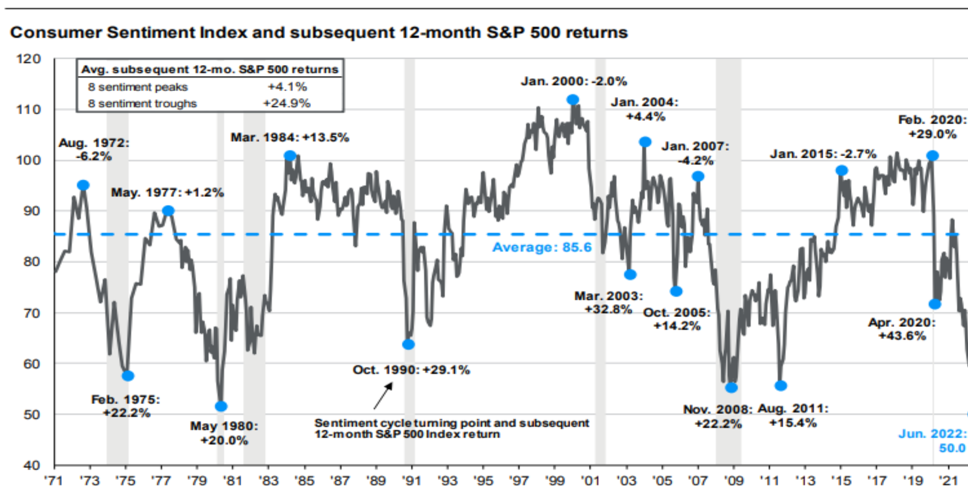
Innovation

Innovation is the lifeblood of economic growth and productivity. While commonly thought of in terms of breakthrough products, innovation also manifests itself in basic process improvements, new services, and simply staying relevant to customers in a rapidly changing world. Talented

management teams across the U.S. drive innovation with the benefit of a market-based system that rewards thoughtful risk taking. According to the U.S. Patents and Trademarks office, patents granted in the U.S. have been on a sharp rise for many decades – in 2021, over 375,000 patents for invention were granted compared to less than 50,000 per year prior to the 1960s.

Despite the aforementioned underpinnings (as well as a low unemployment rate of 3.6%), the closely followed University of Michigan Consumer Sentiment Index has recently plummeted to record lows. The primary culprit for this is elevated consumer price inflation. To be sure, this has the Fed's attention and they are raising interest rates to combat inflationary pressures in the economy. As Exhibit 5 below depicts, extreme sentiment readings have a considerable impact on subsequent 12-month performance in the stock market. (To read the chart, notice the 8 sentiment peaks with an average forward 12-month return of +4.1% while the 8 sentiment troughs average +24.9% subsequent 12-month performance.)

Exhibit 5: Consumer Confidence and the Stock Market



Source: JPM Guide to the Markets, Standard & Poor's, and University of Michigan, as of 6/30/22. Peak is defined as the highest index value before a series of lower lows; trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price only, which excludes dividends.

Whether the U.S. economy technically enters into the next recession this year or a few years from now, the structural underpinnings as noted look strong on many fronts and may serve to limit the depth or duration of economic contraction and continue to provide a foundation for Corporate America to prosper.

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