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What sectors are priced for recession?

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- **Review: QE3 is not a done deal**
  Data in the past week continue to add-up to 1.5% real GDP growth in Q2, slightly below the 1.8% Bloomberg consensus. More importantly, while the consensus sees growth above 2% in H2, the latest FOMC minutes noted that the Fed Staff marked down their near- and medium-term growth projections. We think the consensus will ultimately follow-suit – the end of the summer seems most likely, in our view. Thus, the risk-off trade likely continues.

  Nevertheless, QE3 is not a done deal. We all know the Fed has a bias to ease, but the latest FOMC minutes make clear that additional accommodation is contingent on more weakness in the economy. The minutes also make clear the limited benefit from additional easing, implying a higher threshold for action. Indeed, recent data are consistent with stabilization at a low growth rate, not a *sufficiently pronounced* materialization of the downside risks to growth.

- **Macro-mantra: What sectors are priced for recession?**
  We calculate the recession probabilities of across several equity sectors. Our analysis shows that energy, industrials, and materials are the only sectors that have even remotely come to grips with the weakening growth backdrop. There is more downside to discretionary, financials, and technology.

- **Preview: Bernanke heads to The Hill**
  Bernanke is unlikely to signal a change in policy at his semi-annual monetary policy testimony next Tuesday. On the data calendar, we'll sift through retail sales, housing starts, and regional manufacturing surveys. The tone of the data will likely be weak, but consistent with stabilization at low growth.

The week ahead: 13 July to 20 July

Date	Time	Event	Period	Consensus	RM Estimate	Prior
07/13/2012	08:30	Producer Price Index (MoM)	Jun	-0.5%	--	-1.0%
07/13/2012	08:30	PPI Ex Food & Energy (MoM)	Jun	0.2%	--	0.2%
07/13/2012	09:55	U. of Michigan Confidence	Jul P	73.5	--	73.2
07/16/2012	08:30	Empire Manufacturing	Jul	5.0	2.0	2.3
07/16/2012	08:30	Advance Retail Sales	Jun	0.2%	0.2%	-0.2%
07/16/2012	08:30	Retail Sales Less Autos	Jun	0.0%	0.1%	-0.4%
07/17/2012	08:30	Consumer Price Index (MoM)	Jun	0.0%	--	-0.3%
07/17/2012	08:30	CPI Ex Food & Energy (MoM)	Jun	0.2%	--	0.2%
07/17/2012	09:15	Industrial Production	Jun	0.4%	0.5%	-0.1%
07/17/2012	10:00	NAHB Housing Market Index	Jul	30	29	29
07/17/2012	**10:00**	**Bernanke Senate Testimony**				
07/18/2012	08:30	Housing Starts	Jun	743K	--	708K
07/18/2012	08:30	Building Permits	Jun	773K	--	784K
07/19/2012	08:30	Initial Jobless Claims	14-Jul	--	--	350K
07/19/2012	10:00	Philadelphia Fed.	Jul	-7	-10	-16.6
07/19/2012	10:00	Existing Home Sales	Jun	4.64M	--	4.55M

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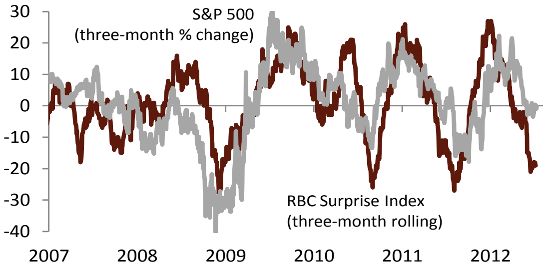
Macro Mantra

What sectors are priced for recession?

More downside to equities



Source: Haver Analytics

George Soros quipped, "financial markets have a very safe way of predicting the future. They cause it." The truth is bit more nuanced. A lingering question for market participants is whether the markets will drive the economy – through financial conditions – or will the economy and corporate earnings ultimately move the market? Market expectations can be self-fulfilling in the short-run, but tend to move off the fundamentals – earnings and the economy – over the long-run.

Stock market and economy ultimately converge

Under our forecast, the probability of recession likely hits one-in-three by the end of the summer.

We believe we are approaching a point where the market will begin to price in a softer economic growth backdrop. While we do not expect a recession in the second half, recession risks always build as economic growth slows. Under our forecast, the probability of recession likely hits one-in-three by the end of the summer. For investors then, the task is weighing what a particular is market pricing-in vs. what the likely outcome will be.

Recession risks always build as economy slows

Investors must weigh what the market is pricing in vs. what the probable economic outcome will be.

Below, we illustrate the recession probabilities of several financial market indicators. Our methodology uses a "probit-model" framework to calculate the implied probability of recession (NBER defined). The purpose of this exercise is to asses where the most downside risk is in the capital market in a weakening growth environment. Thus, asset classes already priced for recession will have less downside risk than assets not priced for recession.

Stock market, and most sectors, not priced for recession

The US stock market is pricing in below average recession risks – wishful thinking, in our view.

Even with Q2 US GDP growth tracking around 1.5% with downside risks to growth, the US Dollar hitting a multi-year high, and the 10-year Treasury yielding 1.5%, the S&P 500 is discounting just a 7% chance of recession. Historically, the US economy is in recession about 15% of the time. In other words, the US stock market is pricing in below average recession risks – wishful thinking, in our view.

More downside to discretionary, financials and technology

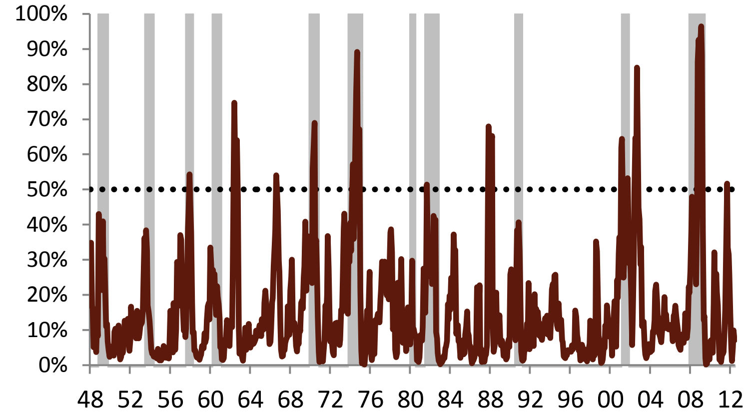
We see more downside to consumer discretionary, financials, and tech.

Our analysis shows that energy, industrials, and materials are the only sectors that have even remotely come to grips with the weakening growth backdrop. That is, they are flagging recession risks consistent with the historical average. There is more downside to discretionary, financials, and technology. Staples, utilities and healthcare seem relatively safe. These results are broadly consistent with Degraaf's market view of preferring noncyclicals over cyclicals.

Equities are too upbeat

The probability of recession based on the six-month change in the S&P 500 is just 7.1%, well below the historical average. Our forecast for a one-in-three chance of recession by September is consistent with a level of 1200 on the S&P 500 of 10% more downside from current levels.

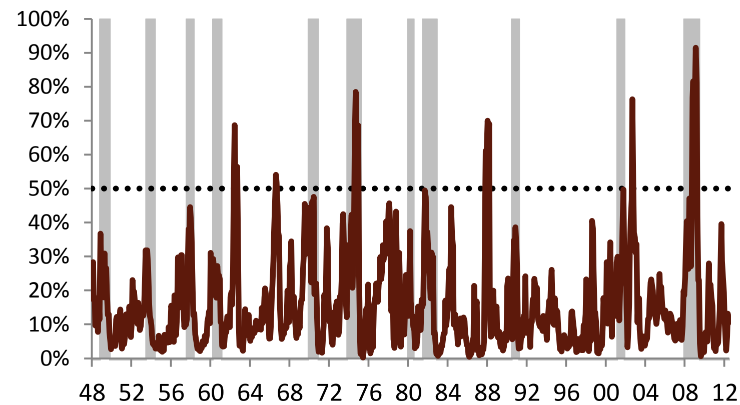
Recession probability: Six-month change S&P 500 (percent)



Source: Renaissance Macro Research, Haver Analytics

The implied probability of recession from the six-month change in the Dow Jones Industrials Average (DJIA) is just 10.5% – below average recession risks. Using our recession probability estimate (~33%) implies a level of 11,700 on the DJIA or 7.5% down for current levels.

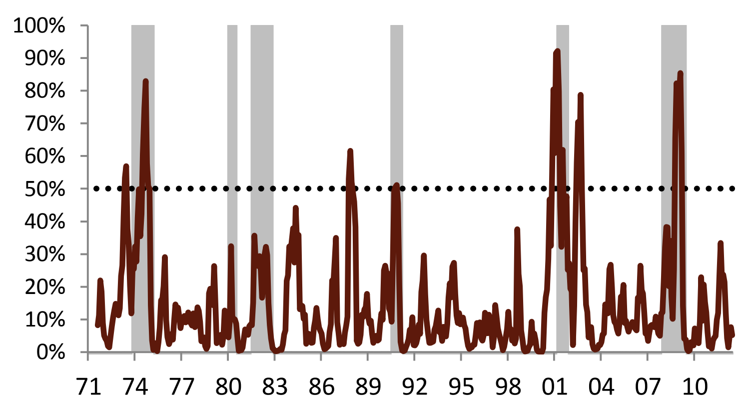
Recession probability: Six-month change DJIA (percent)



Source: Renaissance Macro Research, Haver Analytics

The implied probability of recession from the six-month change in the NASDAQ is just 10.5% – below average recession risks. A one-in-three chance of recession means 2,690 on the NASDAQ or 6.5% down from the current level.

Recession probability: Six-month change NASDAQ (percent)

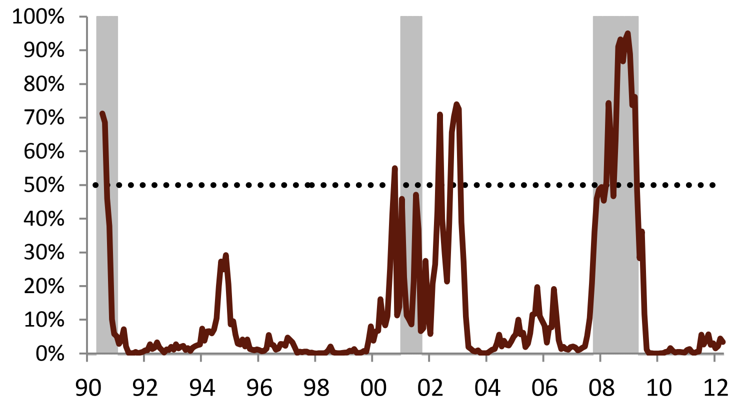


Source: Renaissance Macro Research, Haver Analytics

Sectors with more downside

Our sector specific work goes back three cycles – limited by the data available. The implied probability of recession from the six-month change in the Discretionary sector is under 5%. We expect the risk of higher taxes on the rich next year, will have a negative consumption impact on high-income households now. That should put downward pressure on discretionary names that cater to high-end households.

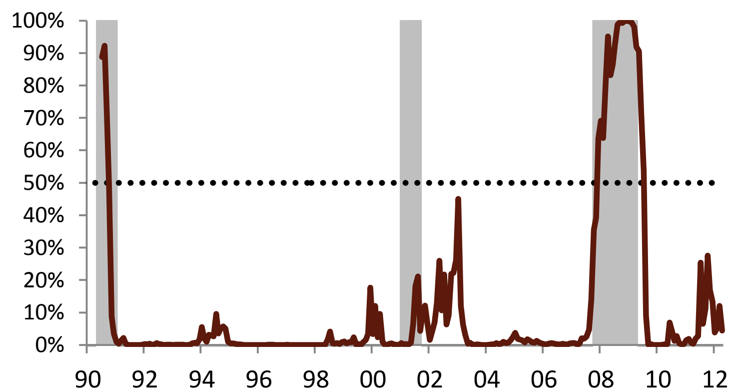
Recession probability: Six-month change Discretionary (percent)



Source: Renaissance Macro Research, Haver Analytics

The implied probability of recession from the six-month change in Financials is under 5% as well. The financial industry is particularly sensitive to swings in the economy. A softer economy implies tighter lending conditions, hardly a positive for the banking industry.

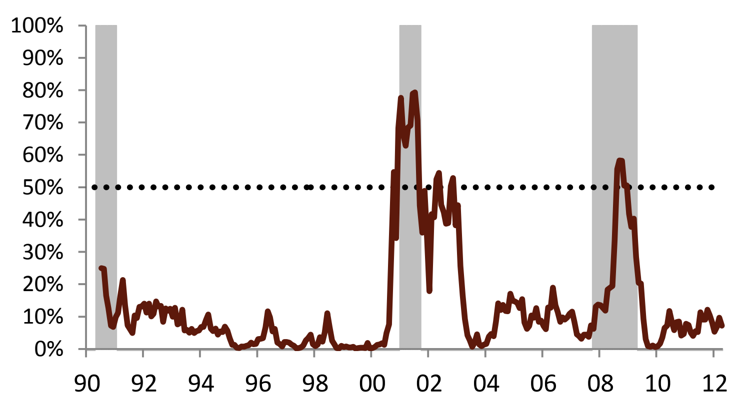
Recession probability: Six-month change Financials (percent)



Source: Renaissance Macro Research, Haver Analytics

The technology sector is discounting just a 7.2% chance the economy is in recession. From our view, the tech sector is particularly vulnerable for at least two reasons: (1) weaker consumer spending, (2) more budget cuts from state and local governments, and (3) high growth expectations.

Recession probability: Six-month change Technology (percent)

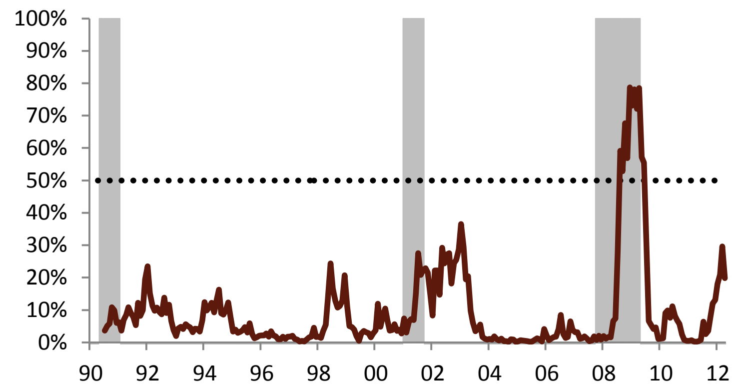


Source: Renaissance Macro Research, Haver Analytics

Sectors with less downside

Sectors that are more exposed to the global economy have tended to sell-off the most during the second quarter. This is not a surprise given the slowdown across Asia and the recession in Europe. With demand for commodities easing, the Energy sector is pricing in about a one-in-five chance of recession, slightly ahead of the historical average.

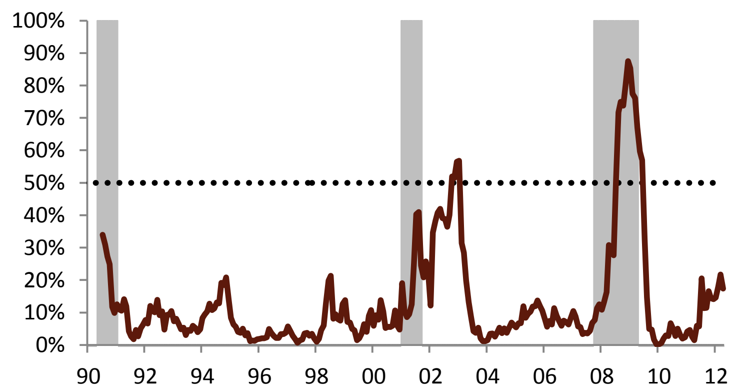
Recession probability: Six-month change Energy (percent)



Source: Renaissance Macro Research, Haver Analytics

Industrials are discounting roughly a one-in-five – or 20% – chance of recession. The recent drop in the ISM Manufacturing Index to 49.7 was a catalyst for higher recession risks. Note that a level of 43 on the ISM – not simply below 50 – is consistent with outright contraction in the economy.

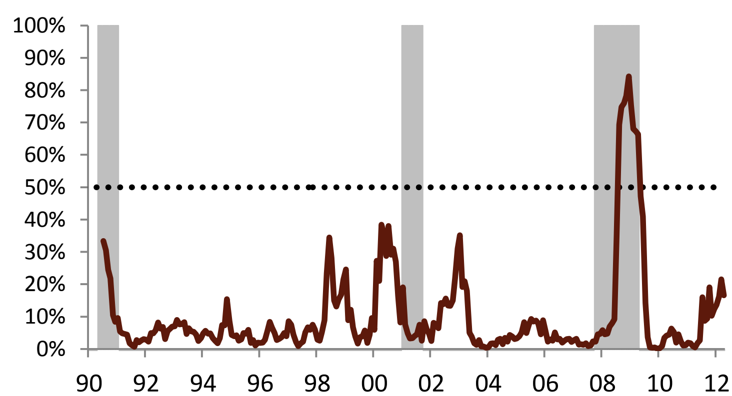
Recession probability: Six-month change Industrials (percent)



Source: Renaissance Macro Research, Haver Analytics

The Basic Materials sector is discounting a 16.6% chance of recession, close to where it was this time last year. With industrial demand weakening globally, prices for raw inputs like copper will moderate, weighing on mining production and the resource sector.

Recession probability: Six-month change Materials (percent)

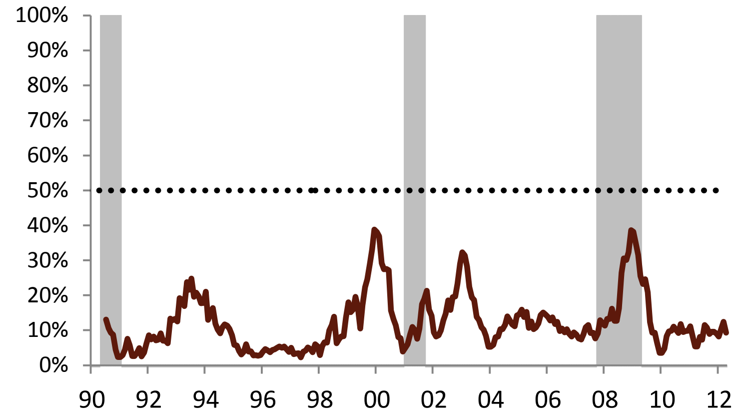


Source: Renaissance Macro Research, Haver Analytics

Sectors to hide

Households have to eat, even in a recession. Consumer Staples are discounting a 9% probability the economy is in recession. What's more, staples are relatively insulated from swings in the economy. Even in the 2008-09 recession, staples were not even 50% priced for a recession risk.

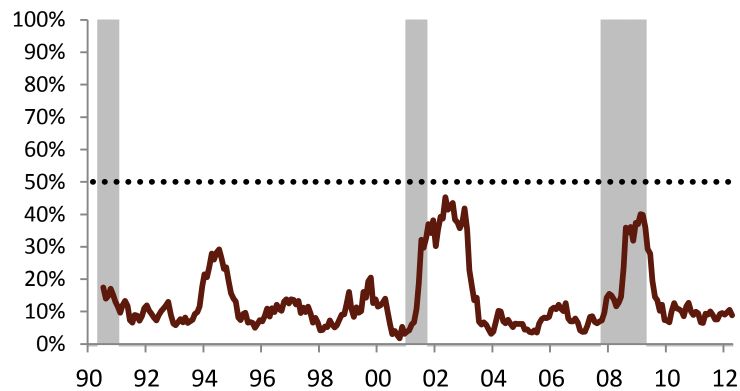
Recession probability: Six-month change Staples (percent)



Source: Renaissance Macro Research, Haver Analytics

Stable, dividend-yielding investments have been relatively insulated from volatility in the economy and financial market. Thus, it is no surprise to see the appreciation in the utilities space. The sector has been steadily pricing in a roughly 10% chance of recession since 2010, slightly below the historical average.

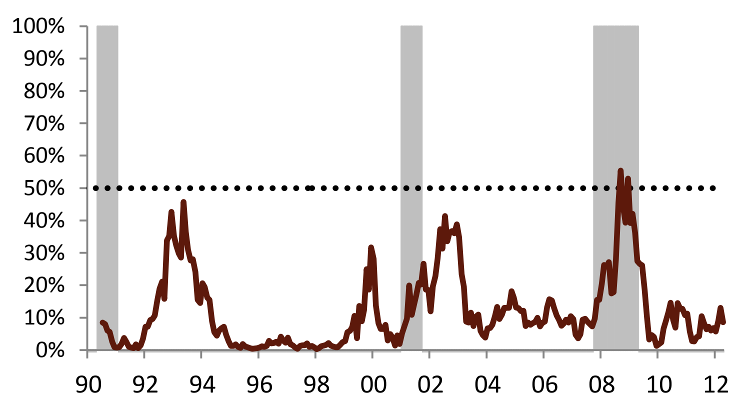
Recession probability: Six-month change Utilities (percent)



Source: Renaissance Macro Research, Haver Analytics

Similarly, the Healthcare sector is pricing in an 8.5% chance of recession. No one is going to delay getting a flu-shot because of uncertainty ahead of the fiscal cliff.

Recession probability: Six-month change Healthcare (percent)



Source: Renaissance Macro Research, Haver Analytics

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