INVESTMENT PERSPECTIVES

MAY 2025

Key Takeaways —

- What matters most in defining a recession?
- Insights on bond market volatility experienced in April.
- Earnings reports vs. the first 100 days.

WHAT'S IN A RECESSION?

Mark Luschini, Chief Investment Strategist

Over the last several months, the non-trivial risk of a recession has surfaced partly due to moderating economic activity but mostly related to the prospective impact tariffs would have on prices and export growth. However, the probabilities that forecasters have assigned to one have gyrated wildly, predicated upon the latest twist to developments in trade policy. While we do not believe a recession is inevitable or even imminent, the possibility is high enough to monitor advance warning signs and understand the likely market impact.

Fortunately, recessions occur rather infrequently. The last one was in 2020 amidst the COVID-induced lockdowns and lasted a historically brief two months. Before that, it had been more than a decade since the deep recession caused by the Great Financial Crisis of 2008/2009.

The unofficial arbiter of declaring a recession in the U.S. is a body known as the National Bureau of Economic Research (NBER). The Business Cycle Dating committee members of the NBER consist of experts from academia who assess a variety of variables to determine when a slowdown or contraction in economic activity conforms to the NBER's definition of a recession. Since the committee does not solely rely on GDP as a determinant, the often quoted and crude definition of "two consecutive quarters of negative GDP" is dismissed. Instead, the NBER considers the definition more broadly as a widespread and significant decline in economic activity generally lasting more than a few months. The committee uses such measures as personal income, employment, and business activity such as retail sales and industrial production.

Most recessions last between six and 12 months, although more have lasted longer than 12 months than recessions that were shorter than six. In a recession, the stock market declines by 30% on average. It's those two unknowns—1) the duration and 2) the depth of the stock market's correction—that make identifying one in advance so important. To be sure, pursuing it is a worthwhile endeavor; however, it is error-prone. There have been many occasions, including as recent as 2022, where the consensus called for a recession that never materialized. Also, consider that, on average, it takes over seven months for the NBER to declare a recession has started. Why? Because the committee wants to be near certain that a sustainable change in the economy's usually positive momentum is underway.

The challenge for investors is that, given the average duration of a recession of six to 12 months, the lagged declaration by the NBER offers limited efficacy since much of the damage to stock prices, which typically peak well in advance of one, has already happened. Also notable is that, on average, the NBER can take over a year to confirm a recession has ended. For investors, that has little utility because the stock market usually begins to rally approximately four months prior to the end of a recession. Therefore, patiently waiting for the NBER to declare a recession's end, which may have occurred many months before, could mean a lost opportunity to have participated in an advance of stock prices already on its way.

Using the principle of Occam's Razor, stripping the many inputs down to what matters most in defining a recession comes down to jobs. After all, personal consumption generates almost 70% of our country's total output. If unemployment rises, which in turn curtails household spending, the economy will slow or contract.

Currently, the job market is not giving off recessionary signals. The unemployment rate has been stable at a low 4% level, and weekly jobless claims remain well within their trailing range of the last three years, with near historic lows as a percentage of the labor force. If we detected evidence that job cuts from private companies, or that which may occur from the federal government, were about to surge, our position on a recession would lean toward more concerned.

Admittedly, the material decline in stock prices and the leadership in the stock market shifting to defensive sectors such as Consumer Staples and Utilities, while factors such as low beta and dividends are outperforming, provide a flashing yellow signal. However, we may have passed the peak uncertainty on the tariff and trade front, although much needs to be resolved. Since markets move on the news, being just shades better than the day before, de-escalating worries around trade, even as it may take months to gain full clarity about where policy lands, will soothe market participants' anxieties. In sum, investors should not be derailed from their investment plans by what is likely to be a bumpy path forward for the stock market, recession or not. Stay tuned. ■

FIXED INCOME POSITIONING

Guy LeBas, Chief Fixed Income Strategist

In the intermediate term, the level of interest rates in the U.S. is a function mainly of economic conditions. When growth is strong, or inflation is rising, interest rates tend to go up; when growth is weak, or inflation is falling, interest rates tend to go down. One major reason is the influence of the Federal Reserve, which sets overnight interest rates, and those rate hikes or cuts "echo" out the yield curve from overnight to 2-, 5-, 10-, and even 30-year interest rates. An economist might call this phenomenon "monetary dominance," and most large developed markets share this feature to varying degrees.

Monetary dominance is also one reason stocks and bonds in the U.S. usually move in opposite directions: when growth is slowing, stock prices often fall, and bond prices usually rise. That is what makes April's financial market swings all the more unusual. The experience was especially frustrating for investors, as bonds normally cushion equity losses, but on many days in early April, long-term bond values were more volatile than the S&P 500! About one in four trading days in April had the bond market experiencing a wider trading range than the stock market, which is not unheard of but is about double the typical incidence.

Table 1: Market Range

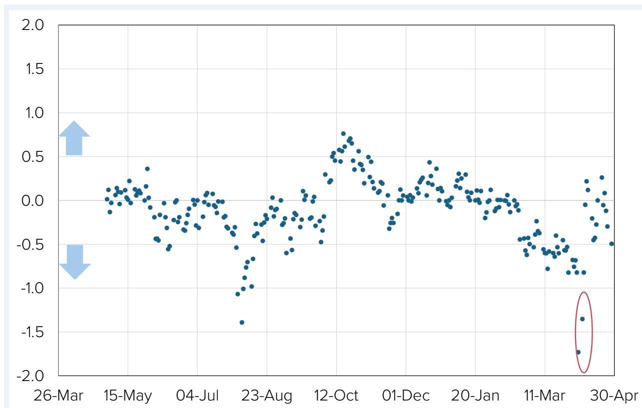
Period	Days Bond Market Range > Stock Market Range
FY2024	14%
Jan-25	5%
Feb-25	25%
Mar-25	13%
Apr-25	25%

Source: Bloomberg; Janney ISG

The fundamental causes of this bond market volatility coincide with the April 2 "Liberation Day" tariff announcements, but the story is not just about fundamentals. Usually, when interest rates diverge violently from monetary dominance, the reasons are not just about economic change but about swings in who owns what in the bond markets, a concept known as "positioning" from active fixed-income investors. It might sound like a niche group of investors, but this group holds trillions of bonds. It can include everything from pensions (low leverage), sovereign wealth funds (moderate leverage), and hedge funds (variable but sometimes high leverage). There are many nuances, but generally, when this group of active investors deleverages, they reduce their short and/or long positions, creating sometimes violent swings in bond prices.

Whether those violent swings are negative for bonds or positive depends largely on how this group is positioned. We can only obtain indirect evidence about positioning. One piece of evidence is from models that use history and price trends to estimate whether these holders are long or short. A second piece of evidence is the relative demand in the options markets for calls or puts on bonds. That second piece of evidence, known as "skew," hinted in early April that many leveraged funds were weighted heavily to the long side. The rather violent deleveraging and selling that followed caused bond prices to fall despite evidence of economic slowing.

Chart 1: "25 Delta" 10yr Call Skew Back to Normal



Source: Bloomberg; CME; Janney ISG

As April wound to a close, the good news for bond markets is that the same indirect evidence suggests positioning is no longer stretched. Most models of trend-based strategies indicate close to flat positioning. Bond call option pricing is no longer extreme, and demand looks roughly balanced between puts and calls. Finally, daily market functioning is smoother, with realized volatility falling and bond markets no longer gapping in price by wide margins. The upshot here is that with positioning signaling an "all clear," bond markets are more likely to follow the trajectory of the economy in the summer months, be that continued slowing or, in a more optimistic scenario, a private sector rebound.

THE FIRST 100 DAYS—WHAT'S NEXT?

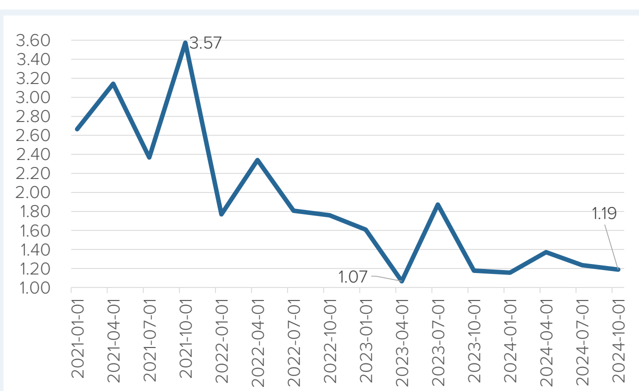
Gregory M. Drahuschak, Market Strategist

As April ended, many press outlets detailed what had happened during President Donald Trump's first 100 days of his second term in the White House. His first 100 days left the S&P 500 down about 7.7%, which was the second-worst performance since President Richard Nixon when, during the first 100 days of his second term, the S&P fell 9.9%. Nixon had the distinction of ending that year with the largest loss among the 20 possible periods since 1944 (-17.4%).

The Nixon administration faced enormous headwinds mostly out of its control, like the 1973 oil embargo, the budget deficits from the Vietnam War, and the fall of the Bretton Woods system. Of course, Nixon's biggest problem was self-inflicted when the Watergate incident doomed his administration. Many have argued that self-induced problems resulted in Trump's first 100 days of lackluster equity market performance as tariffs overwhelmed almost everything else.

Like Nixon, Trump faced problems that were laid at his feet by others. The economy was moving along, but GDP growth was slipping. Massive federal spending rocketed the inflation rate higher. Interest rates jumped. The 10-year Treasury note yield from August 21, 2021, to the most recent high, more than quadrupled. Numerous Federal Reserve district activity measures slumped. Then tariffs arrived. Despite Trump's repeated warnings that tariffs were coming, the market ignored the potential consequences until they could ignore them no longer.

Chart 2: GDP% 2021–2024



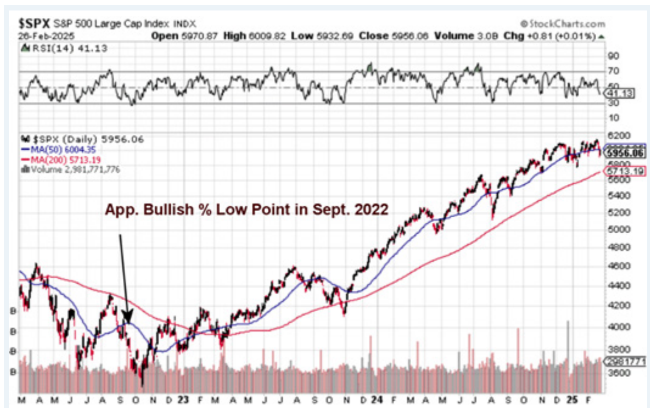
Source: St. Louis Federal Reserve; Janney Investment Strategy Group

After a robust start to this year and a new all-time high at 6147.43 on February 19, 2025, by April 7, the S&P 500 was 21.3% below the high for one of the most rapid pullbacks in a period this short, and volatility rocketed higher.

The Volatility Index (VIX) reached its third-highest level in the last 10 years and the fourth-highest since 2005.

Uncertainty prompted investor sentiment gauges to plummet. However, the consensus S&P 500 earnings estimate ended April only 5.2% below the peak set six months ago, but estimates appear destined to slip further. Not even the S&P 500, recovering more than 50% of the pullback, could assuage nervous traders.

Chart 3: Volatility



Source: Stockcharts.com; Janney Investment Strategy Group

The "sell in May" cliché will undoubtedly be part of all financial publications this month, but like many market clichés, it is often not totally reliable. From 1950 through 2024, the S&P 500 ended May higher 46 times (61.3%). It also was higher at 56.0% and 61.3% in June and July, respectively.

Data assembled by CFRA-Standard & Poor's show that the S&P 500 ended lower in the first 100 days of President Harry Truman's only term, Dwight Eisenhower's first term, Nixon's second term, Jimmy Carter's only term, and George W. Bush's first and second terms. Among these occurrences, the index then ended a full-year lower with Eisenhower (-6.6%), Nixon (-17.4%), Carter (-11.5%), and Bush (-13.0%) in the White House. However, 65% of the time, the S&P 500 rose an average of 3.2% during the first 100 days of a presidential term. On the other hand, a below-average result, like the result in the first 100 days of this year, often led to a full-year decline.

Instead of stressing over the often-wrong "sell in May" cliché or the 100-day history, focus on the more than 1,100 first-quarter earnings reports due in May. The actual results and guidance could help to remove much of the uncertainty weighing on stocks, but above all else, clarity on tariffs is essential for stocks to challenge the high reached by the S&P 500 on February 19, 2025.

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