Touch and Go

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The old Naval Air Station in Charlestown, RI was right next to the summer house we lived in as kids. Aviators would fly training patterns over our heads, so close we could see their orange flight suits. They would circle back to the airfield, touch wheels down, then come back around.

Though we couldn't see the planes land, we could hear their engine pitch wind down, cough to a stall, then rev up as they climbed. The airfield was closed in 1974 and is now a park with ball fields and tennis courts. But fragments of the air strips remain.

As the Memorial Day weekend brought up summer memories, the Fed also aims for a touch-and-go landing. Can it calm down inflation, yet keep growth and employment going?

Economists say that's unlikely given recent history. Only the 1994-95 period of rate hikes to 6% managed to slow inflation without a downturn and higher unemployment. Arguably the 2018-19 period – when the Fed raised rates to 2.5%, then lowered them to 1.75% – would have kept the growth engine from stalling. Until Covid-19 entered the picture.

Our friends at Natixis point out that defining recessions is tricky. As our *Chart of the Week* highlights, real GDP was *higher* at the end of the mild 2001 downturn than it was at the beginning. This year's first quarter declined 1.4% but was dismissed as indicative of any trend because much of the contraction was due to a slower inventory investments.

Interestingly, while surveys of economists have signaled increased recession risk, it's hard to find experts going on the record with downturn forecasts. Deutsche Bank seems to be one of the few with an officially pessimistic view. The CBO's projections – 3.1% GDP this year and 2.2% next – are more of a consensus view: moderate growth that will slow.

Worries of a recession at the end of this year or sometime in 2023 have roiled markets, sending public equity indices to near-bear market corrections in mid-May, before regaining ground in recent days. Both leveraged loan and high-yield bond issuance have suffered as riskier debt instruments are perceived as heading towards higher defaults and losses.

Private credit practitioners, on the other hand, have built portfolios to withstand the negative shocks associated with uncertain economic crosswinds. Being secured, top-of-the-capital stack (for senior debt) and armed with financial covenants (for middle market borrowers), these all-weather structures are well-equipped in case of a downturn.

The advantage of less correlated, less liquid asset classes is their resistance to market devaluations. The real values are in the borrower fundamentals and the quality of the financing structures. In a well-structured portfolio, an economic downturn has already been anticipated.

And if that downturn lingers, the worst market excesses are often wrung out, turning crisis into opportunity for the most experienced private credit managers and their investors.