

April 11, 2025

EQUITY INSIGHT

INCREASING RECESSION RISK WARRANTS A DEFENSIVE BIAS

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Executive Summary

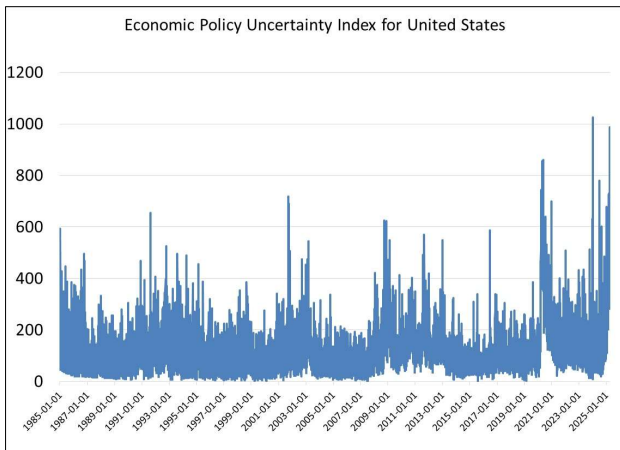
- ❑ Aggressive tariff policies from the new U.S. administration pose significant risks to global trade, potentially dampening economic growth and undermining investor confidence.
- ❑ Rising policy risks and evolving investor sentiment have created increasing uncertainty in both economic and market conditions.
- ❑ Key indicators like the Leading Economic Index (LEI) and the prolonged yield curve inversion highlight vulnerabilities in the economic outlook, despite some recent positive trends.
- ❑ Credit Spreads, which had remained subdued initially, spiked to 4% from a low of 2.6% in February.
- ❑ The full impact of the developing trade war on corporate earnings remains uncertain, as its effects are unlikely to appear in financials until at least Q3–Q4 2025.
- ❑ Current EPS estimates, are overly optimistic, failing to account for the unstable economic landscape. As these estimates are revised downward, stock valuations will likely face increased pressure.
- ❑ A clear shift away from highly sensitive sectors and high-beta portfolios toward more stable, defensive investments signals heightened caution and a broader flight to safety amidst market volatility concerns.

The Economic Environment and Probability of Recession

The possibility of a U.S. economic slowdown has heightened the risk of a global recession due to extreme U.S. policies. The new U.S. administration's aggressive tariff policies may trigger a large-scale global trade war, unprecedented in history. Ironically, rather than boosting U.S. manufacturing and foreign investment, these tariffs risk creating a no-win scenario. Higher costs for imported goods, inflation, fragile trade relations, reduced trade volumes, and declining economic growth could erode investor and consumer confidence worldwide.

The Economic Policy Uncertainty Index, calculated by assessing the frequency of newspaper articles containing keywords related to the economy, policy, and uncertainty, has reached a level typically linked to periods of recessions (Figure 1).

Figure 1. Economic Policy Uncertainty Index



Source: Federal Reserve Bank, as of April 8, 2025

Global business confidence (Figure 2) plummeted last week, weighed down by the intensifying global trade war. Negative survey responses outnumbered positives, marking the weakest reading since the U.S. banking crisis two years ago and the steepest decline since the COVID-19 pandemic five years ago. Positive sentiment on overall business conditions dropped below 20%, a level historically associated with recessions. Additionally, sales turned net negative, and layoffs, though still modest, are clearly increasing.

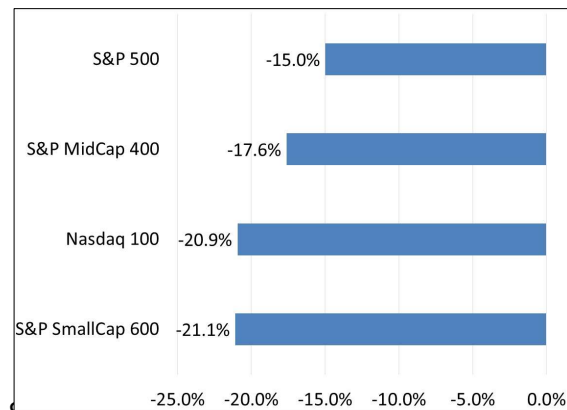
Figure 2. Business Confidence



Source: Moody's, as of April 8, 2025

Consumer sentiment has also experienced a sharp downturn with pessimism about future business conditions and employment prospects reaching a 12-year low. Inflation expectations also climbed to 6.2%, driven by concerns over high prices for essentials and tariff impacts. Year to date, as of April 8, equity indexes are significantly lower, amid rising policy uncertainty (Figure 3). Notably, both the technology-dominated Nasdaq 100 and the SmallCap 600 Index were down over 20%.

Figure 3. Returns of Selected Indexes

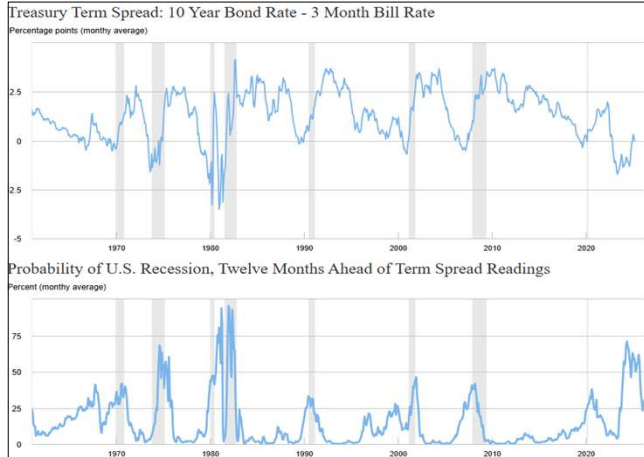


Source: S&P Global, as of April 8, 2025

It's unclear if this marks an event-driven, sharp correction or the onset of a prolonged bear market. Historical trends show that prolonged bear markets often coincide with recessions. Tracking selected economic and financial indicators is helpful for evaluating the economy's direction. We review now some indicators to gain valuable insights into everchanging conditions.

The Treasury Spread

Figure 4. Yield Spread And of Recession Probability



Source: Federal Reserve Bank, as of April 8, 2025

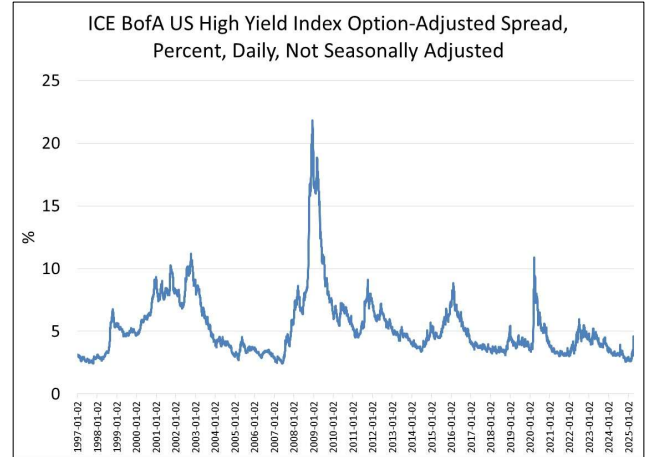
One crucial indicator is the Treasury Spread, defined as the yield gap between the 10-year Treasury bond and the 3-month T-bill. Historically, a yield curve inversion—where short-term rates exceed long-term rates—has often preceded a recession by 6 to 24 months, with the average lag being approximately 12 months. Inverted yield curves are widely viewed as signals of a future economic slowdown, representing investors' anticipation of declining economic growth and falling long-term interest rates.

Figure 4 highlights that the most recent yield curve inversion began in November 2022 and persisted until December 2024, marking one of the longest and most pronounced inversions since 1960. According to the recession probability-based model graphed in Figure 4, the likelihood of recession reached its peak at 71% in November 2024. Since then, as the treasury yield spread has “dis-inverted,” the probability has decreased to approximately 30%.

While 30% might seem relatively low, historically, an increase in recession probability to 20-30% has often been sufficient to prompt a recession within a few months. Therefore, despite the recent steepening of the yield curve, the economy remains vulnerable to potential challenges ahead.

Credit Spread

Figure 5. High Yield Spread



Source: Federal Reserve Bank, as of April 8, 2025

Credit spreads are another useful indicator of future economic weakness and market volatility. Credit spreads, which measure the yield difference between bonds of similar maturity but varying credit quality, are key to analyzing market sentiment and forecasting stock market downturns.

Typically, this involves comparing risk-free Treasury bonds to corporate bonds with high default risk. The “junk to Treasury bond” spread highlights investor willingness to speculate, as junk bonds demand a higher premium over Treasury bonds' risk-free rate to compensate for their default risk.

When credit spreads widen, it reflects a decrease in risk appetite among investors and may indicate growing market stress, often serving as a precursor to stock market corrections.

Figure 5 shows that after a prolonged period of compression to historic lows, credit spreads have surged dramatically, signaling heightened corporate distress and reflecting broader concerns about the financial health and stability of businesses.

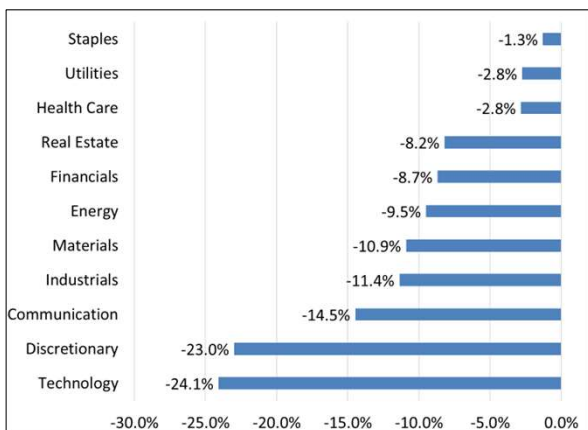
Sectors and Factor Portfolios Performance

Another method to gauge the economic outlook is by comparing the relative performance of different economic sectors such as cyclical versus defensive sectors.

This approach captures the aggregate sentiment and actions of investors, providing valuable insights into their perspectives on the business cycle and anticipated economic growth.

Figure 6 shows the relative performance of economic sectors in year-to-date (as of April 8), with all sectors posting year-to-date declines. Consumer Discretionary and Technology—two cyclical growth sectors—were hit hardest, while defensive sectors such as Staples, Utilities, and Health Care offered some downside protection due to their resilience during market corrections.

Figure 6. Sector Returns Year-to-Date



Source: S&P Global, as of April 8, 2025

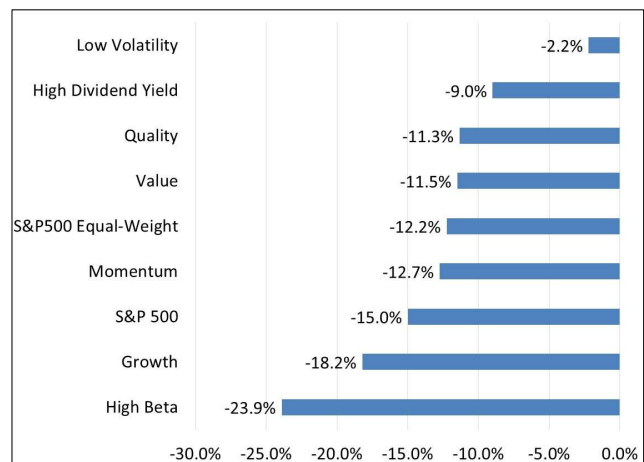
This sharp contrast highlights a shift in investor sentiment. Concerns over tariffs' impact on growth and weakening consumer confidence have led to a retreat from cyclical stocks, with investors favoring defensive sectors as fears of an economic downturn loom.

Figure 7 illustrates that year-to-date, the performance of factor portfolios closely reflected sector trends.

Low Volatility was by large the best performing factor with a small decline of 2.2%. Dividend Yield, Quality and Value offered decent downside cushioning at least in relative terms versus the S&P 500. In stark contrast, High-Beta and Growth portfolios suffered deep losses, with returns of -3.9% and -18.2%, respectively.

This striking disparity underscores heightened market anxiety, as investors shifted away from highly economically sensitive assets (high beta) toward more profitable, income-generating stocks with lower risk profiles. This movement reflects a broader flight to stability amidst market uncertainty.

Figure 7. Factor Portfolios Returns Year-to-Date



Source: S&P Global, as of April 8, 2025

Corporate Earnings Risk

Tariffs impact corporate earnings in multiple, interconnected ways.

Tariffs—taxes imposed on imported goods—can have far-reaching effects on corporate earnings, disrupting cost structures and altering market dynamics. By increasing the price of essential raw materials, components, and finished products, tariffs raise production costs, leaving companies with limited options. Businesses must either absorb these higher costs, which erodes profitability, or pass them on to consumers in the form of price hikes. However, elevated prices often discourage buyers, reducing demand and driving customers toward cheaper domestic alternatives or competing imports.

This combination of inflated costs and declining sales exerts significant pressure on profit margins, forcing companies to grapple with tough decisions. Many are compelled to scale back investment, reduce operations, or accept reduced profits as they navigate these challenges.

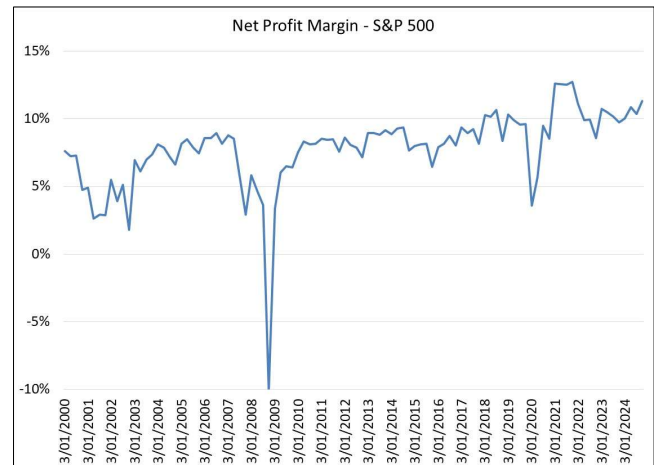
Additionally, tariffs frequently disrupt global supply chains, requiring businesses to find alternative suppliers. This shift introduces logistical hurdles, increases costs further, and sometimes compromises quality.

The situation is often exacerbated by retaliatory trade measures, as countries respond to tariffs by imposing their own. These trade conflicts intensify uncertainty and weaken cross-border commerce, further impacting corporate earnings.

The broader economic consequences are equally concerning. Tariffs dampen business confidence, leading to hesitation in hiring and expansion efforts, which in turn slows economic growth. The ripple effect is felt across industries and consumers alike, underscoring how tariffs reshape entire markets and contribute to economic instability.

Figure 8 highlights the steady upward trend in net profit margins for the S&P 500, which, despite following a cyclical pattern, has been a major driver of the stock market's long-term growth. This trend reflects a confluence of favorable factors that have shaped corporate profitability over the past few decades.

Figure 8. Net Profit Margin for The S&P 500



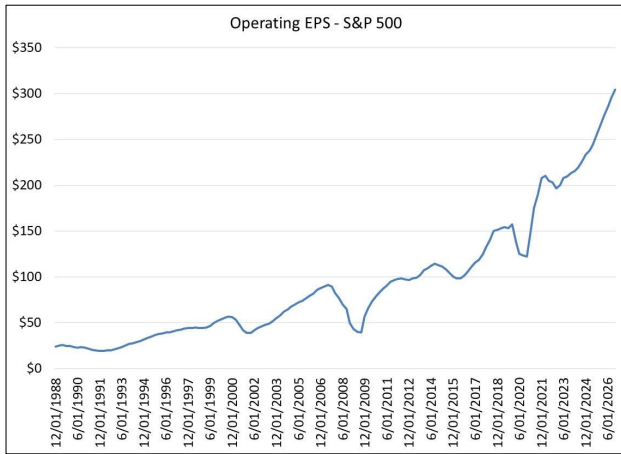
Source: S&P Global, as of March 30, 2025

Key contributors include the reduced input costs achieved through globalization, lower corporate tax rates, declining interest expenses due to historically low borrowing costs, and a structural shift from labor-intensive manufacturing industries to high-margin services and technology sectors.

However, this era of rising profitability now faces significant headwinds. Emerging protectionist trade policies threaten to reverse the benefits of globalization, increasing costs for imported goods and disrupting supply chains.

Simultaneously, rising interest rates driven by a ballooning fiscal deficit are making borrowing more expensive, adding further strain to corporate balance sheets. Elevated inflation, which has pushed up operating expenses across sectors, is compounding these challenges.

Figure 9. Operating EPS – S&P 500



Source: S&P Global, as of April 5, 2025

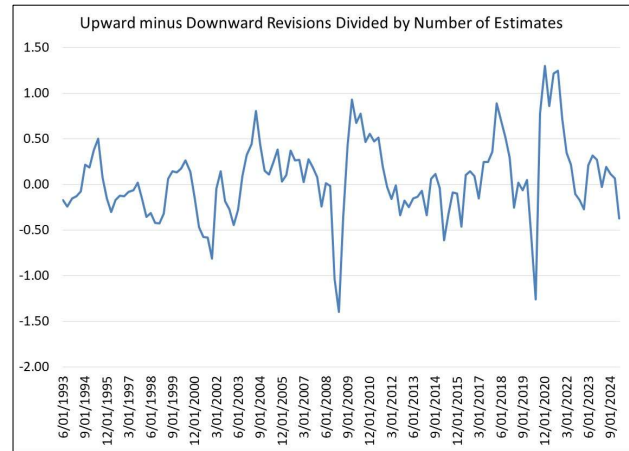
Additionally, a renewed focus on revitalizing domestic manufacturing sectors signals a shift in economic priorities that could divert resources away from high-margin service and technology industries.

Together, these converging forces point to a potential reversal of the trends that have underpinned the S&P 500's profitability, raising questions about the future trajectory of corporate earnings and stock market performance.

Given these dynamics, we believe current earnings estimates are overly optimistic, as they fail to account for the full extent of tariffs' impact on corporate profitability.

Quantifying this impact remains a significant challenge, requiring not only an understanding of how tariffs disrupt supply chains and inflate costs, but also insight into long-term shifts in consumer demand and market share. It may take several quarters for analysts to develop reliable models that fully incorporate these factors and capture the true implications for corporate earnings.

Figure 10. EPS Estimates Revisions Diffusion Index



Source: Factset, as of March 30, 2025

Figure 10 illustrates the trend in bottom-up earnings estimate revisions for S&P 500 companies, where negative values indicate that downward revisions outnumber upward ones. Recently, the index has turned negative, signaling that earnings estimates are beginning to reflect the impact of tariffs. Historically, aggregate EPS estimates have moved in tandem with the business cycle, making them a valuable indicator of both economic activity and corporate profitability.

Monitoring this trend in the coming months is vital, as a bottoming of the index may signal a turnaround in equity markets. However, structural and cyclical challenges—like tariff uncertainties and global trade tensions—continue to pressure equities, while management struggles to adjust to these new conditions, clouding future earnings visibility.

Under these circumstances, a defensive equity strategy appears prudent. Emphasizing non-cyclical, high-quality, and profitable stocks could provide stability during this period of heightened uncertainty. Such an approach may help investors weather the ongoing economic challenges while awaiting clearer signs of recovery in both earnings and broader market conditions.



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