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Market Update: Recession Watch

If the current U.S. economic expansion and its associated equity bull market continue for a few more months, it will exceed the longest such periods since 1900. This long expansion, combined with threatening trade war rhetoric, is causing many to call for an impending recession and an equity bear market. It would be wise to monitor objective evidence that the economic/market environment is deteriorating before making substantial changes in asset allocation. Some are closely watching U.S. Treasury yields and are ready to sell equities if the yield curve inverts (i.e. when longer-term interest rates (10-years and beyond) fall below short-term rates (3-month to 1-2 years)). This has been a somewhat reliable indicator in the past, but it is not foolproof, and its reliability may be impaired by the central bank intervention that has occurred within the fixed income markets across the globe over the past cycle. Therefore, it might be prudent to take a closer look at a few indicators we monitor for the onset of the next recession.

When U.S. Treasury yields invert, it may have less to do with real interest rates and more to do with expected inflation. When an economic expansion reaches its latter stages, companies find that available labor, resources and production capacity become scarce. Prices for finished goods and/or services will tend to rise either due to rising input costs or an inability to produce at a level to meet the current demand. The rising inflationary pressures may prompt the Federal Reserve to tighten monetary policy by raising interest rates. Higher interest rates discourage investment and consumer spending. The fixed income markets are likely to respond by demanding higher yields for lending in the short-term. That said, fixed income investors are also aware that as short/intermediate-term borrowing costs begin to dissuade consumption and investment, economic activity may begin to decline. As a result, longer-term interest rates may eventually begin to decline, even as short/intermediate rates rise. This increase in short term interest rates and decline in longer-term interest rates may eventually result in an inverted yield curve. It is important to remember that it isn't the inversion that causes a recession. The inversion is just reflecting that fixed income investors are anticipating an economic peak and that an economic slowdown, possibly a recession, is becoming a greater likelihood.

Historically, an inverted yield curve predicted the last seven recessions with lead times ranging from 8 to 23 months. However, the yield curve remained positive during the recessions of 1954–1965, 1957-1958, and 1960-1961. Why did it miss predicting those recessions? Other factors affected the yield curve during those times. Our current circumstance is significantly different than most prior expansions. The Fed is shrinking its balance sheet while the Treasury is expected to issue $1.1 trillion in new issuance at the shorter maturities over the next few quarters to fund a growing budget deficit. This increased supply needs to attract investors by offering higher yields in those shorter maturities. With inflation at two percent, investors have kept the long term yields flat relative to a year ago. It is also this new supply which is partially causing the flat yield curve which is worrying some investors.

Four Indicators that are Helpful in Identifying an Approaching Recession

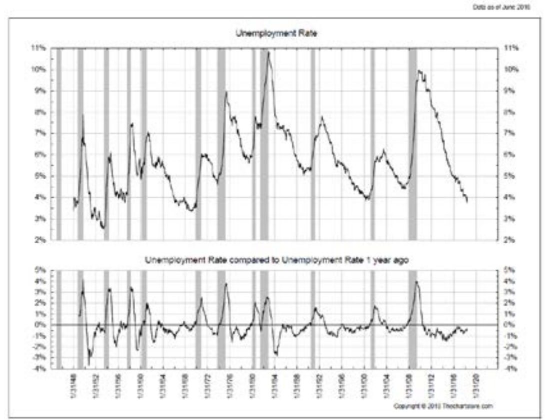
To help clients become familiar with how we look for impending recessions, we provide four useful indicators which we closely monitor to determine the likelihood of a recession. They are as follows:

1) Housing costs typically rise above 4%;

2) One-year change in the unemployment rate turns positive (i.e. unemployment begins to rise).

Neither of these circumstances have come to pass yet, but they are getting closer.

(the below grey bars represent recessionary periods)

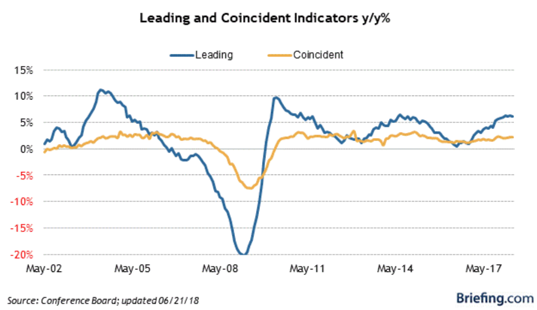


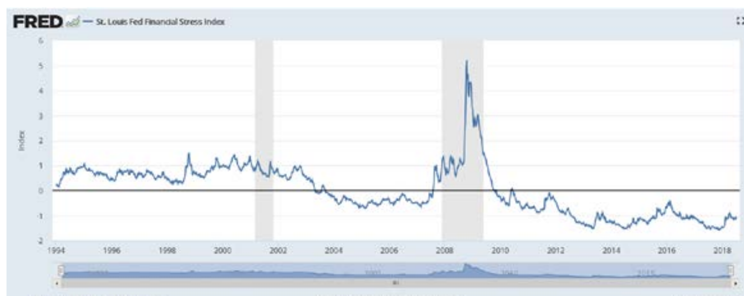
3) The Leading Economic Indicator typically falls below the “0%” change line (currently above +5%);

4) The St. Louis Fed Financial Stress Index usually is giving a reading at or above the “1” level (currently below “-1” which indicates below average financial market stress).

Neither of these circumstances have come to pass yet and the indicators are a safe distance from their “red flag” levels.

(the below grey bars represent recessionary periods)





As the next recession approaches, the U.S. Treasury yield curve may in fact invert, but given the degree of global central bank intervention, one should probably look for confirmation from other indicators before making substantial asset allocation changes. Current levels of housing inflation and the slowing decline in unemployment are both approaching less constructive levels. Yet, businesses and financial market investors are not indicating that they are ready to let this economic expansion and bull market end. It is also important to remember that while the U.S. has the largest economy, it no longer dominates global economic growth to the degree it did prior to the rise of China and the other major emerging market economies.

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