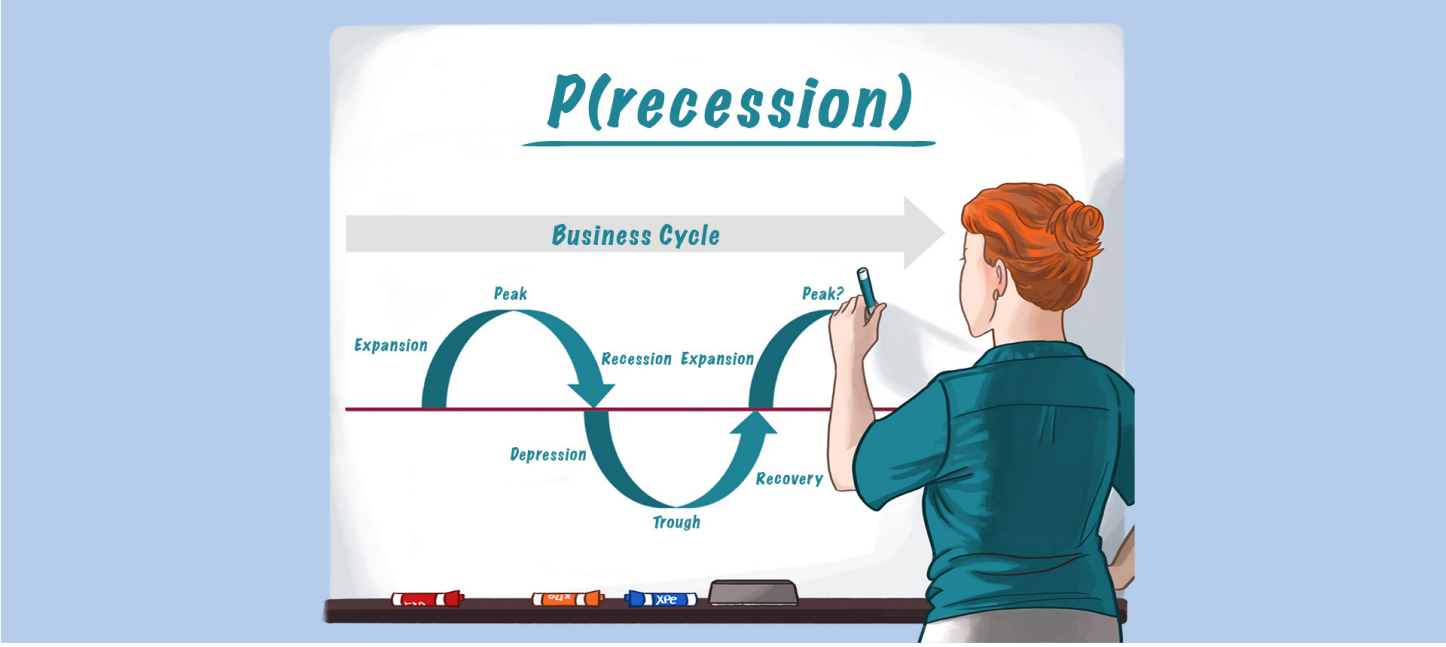


P(recession)

By Sam Kirby

In our conversations with clients over the past few months, the main question has been remarkably consistent: Are we on the brink of a recession?

Are our clients just a pessimistic bunch? We donâ??t think so! To be sure, we examined Google search trend data and found that searches on the topic of recession reached a level of popularity in December more than triple that of mid-2017. As shown in Figure One, searches on the term â??recessionâ?• reached peak popularity in early 2019.

What has caused this recession obsession? We can think of several contributors, including:

- The calendar. It has been a decade since we emerged from the recession triggered by the global financial crisisâ??a period of expansion that, this summer, will become the longest in U.S. history.
- Our memories (and scars) from the last recessionâ??the most severe since the Great Depressionâ??are lasting.

- The media has initiated a steady drumbeat of headlines and news clips on the topic.
- Stock market volatility, a measure of future uncertainty, suggests that investors are having some trouble reading the tea leaves. The signals are mixed.

In this article, we will take a closer look at the procession of events that often occur before economic downturns and, in so doing, seek to answer our clientsâ?? questions on the probability of a recession in the near termâ??or as a statistician would say, the P(recession).

Recessions and Bear Markets

Given the importance of the topic, you would think there would be a consistent definition of a recession. Anecdotally, we think of recessions as periods of economic slowdown when more people are out of work. The ultimate umpire of recessions, the National Bureau of Economic Research, does not use a fixed definition for recessions; rather, it uses a range of economic measures to mark the beginnings and endpoints of recessions. Generally, it does so well after the fact, when they are easier to see.

Within the investment community, the most common definition is two consecutive quarters of declining gross domestic product (GDP). If we translate the phrase â??declining GDPâ?• into tangible terms, it means lower levels of consumption and production of goods and servicesâ??everything from homes, cars, and chai tea lattes to software licenses, hotel stays, and airline flights. This decline translates into fewer jobs; lower pay, tips, and bonuses; and reduced corporate profits.

Notice that declining stock prices isnâ??t included in this list. Recessions and bear markets are two distinct economic events, even if they often coincide and reinforce one another.

In classic chicken-or-egg fashion, reduced levels of economic activity can cause stock prices to drop, and stock price declines can erode both confidence and wealth, leading us into recession.

But that is not always the case. For example, in late 2018, U.S. stocks experienced a 20 percent price declineâ??the technical definition of a bear marketâ??even as GDP growth continued at a healthy pace. Stock prices quickly rebounded in the first quarter, reaching new all-time highs in April.

Pre-cession

There is no checklist to identify when the next recession will occur. If recessions were predictable, theyâ??d be preventable. However, there are a number of signals that have commonly occurred before or at the onset of past recessions.

Below, we review seven signals used to gauge our current position within the business cycle. Some of them appear all clear, while others are beginning to flash yellow. While these signals are not conclusive on the timing or severity of the next recession, they can help us keep our expectations (and emotions) in check.

Asset Bubbles

A common occurrence near the end of a business cycle is the emergence of market excesses, or price bubbles. With the benefit of hindsight, these bubbles often seem obviousâ??such as the high-flying prices of technology stocks in the late 1990s or real estate prices in the mid-2000s, when the growth in home prices far outpaced income (as shown in Figure Two).



Today, we donâ??t see asset price bubblesâ??at least nothing so obvious. Home price appreciation has moderated, and the price level of U.S. stocks is near its long-term average (relative to earnings). We have not seen irrational exuberance in the form of dramatic inflows of investor money into stocks, and investors have received recent high-profile initial public offeringsâ??such as Uber and Lyftâ?? soberly.

One area that bears watching is corporate credit. Fueled by an extended period of exceptionally low interest rates, corporations have issued large amounts of bonds, and investors have been quite comfortable bearing the credit risk, given the strength of the economy. However, if investors become fearful of future risks and rising rates, or a weakening economy impairs the issuersâ?? ability to repay, the price of these securities could suffer, with an uncertain impact on the economy.

Leading Economic Indicators

The most commonly cited forecast of future conditions is the basket of economic indicators published by the Conference Board, a nonprofit think tank. The index includes data across 10 categories, including employment, manufacturing activity, construction activity, stock prices, lending conditions, and consumer sentiment. The most recent release indicated a modest improvement in conditions during the first quarter of 2019, with an overall balance between positive and negative indicators although a longer-term softening trend remains in place.[1]

Bad Credit

On the topic of credit, another economic warning sign is consumer loan delinquency. With higher interest rates, we have seen credit card and auto loan delinquency rates tick up in recent years. The New York Federal Reserve estimated that 4.6 percent of all outstanding debt was delinquent at the end of March, and serious delinquencies for credit cards have been trending upward since 2017. Auto loan delinquencies have been inching up since 2012, as seen in Figure Three. In contrast, delinquency rates on mortgages remain low and healthy, supported by an exceptionally strong jobs environment.[2]



Inflation

Inflation is so important to the economy that keeping it under control is one of the two primary policy objectives of the Federal Reserve. The other is maintaining full employment. Inflation is like heat within an engine. Too little, and it stalls; too much, and it overheats. A little inflation provides consumers with the ability to spend through higher wages and a belief that tomorrowâ??s prices will be higher than todayâ??s rising wages, which can create the willingness to spend. If wage growth cannot keep pace with rising prices, it equates to reduced consumption.

Today, inflation remains moderate and very close to the Fedâ??s 2 percent target. However, an extended trade conflict could introduce inflation pressureâ??perhaps reducing the Fedâ??s ability to cut rates if it becomes necessary to stimulate a weakening economy.

Interest Rates

The Fedâ??s primary tool is the ability to set the interest rate charged to commercial banks for short-term loans. When this rate is lower, banks are encouraged to lendâ??an expansionary policy that stimulates the economy. Conversely, a higher discount rate makes it more expensive for banks to borrow funds, constricting lending and dampening growth. In the aftermath of the financial crisis, the Fed lowered its target rate to effectively 0 percentâ??an exceptional move to restart the U.S. financial engine. Since then, the Fed has raised rates nine times to reload this policy weapon in preparation for the next recession.

An often-cited recession warning sign is the difference between short-term rates, which are highly influenced by the Fed, and longer-term rates, which are more market-driven. When this relationshipâ??known as the yield curveâ??flattens and then inverts, the market is showing concern over future growth prospects. This phenomenon has preceded every recession for the past 60 years, and we witnessed one in Marchâ??although it lasted just four days. While this is not necessarily an omen for a recession in the near term, it is a powerful signal worth watching. In fact, the New York Fedâ??s economic model based upon this relationship places the odds of a recession in the next 12 months at 27 percentâ??the highest level since mid-2008.[3]

Employment

The jobs picture stands out as the strongest argument that the U.S. economy remains on sound footing. An economy at full employment means there is a job for everyone willing and able to work. Income stability improves spending power and confidence and means that the nationâ??s labor resources are being used efficiently. However, there can be too much of a good thingâ??labor shortages can trigger wage inflation, and if companies arenâ??t able to find and hire qualified people, they are not able to fulfill their maximum growth potential. While the current employment picture is strong, we will be watching it closely for signs of weakening or overheating.

Confidence

When it comes to money, our behavior is driven by confidenceâ??which can be fickle and fragile. Confidence is influenced by tangible eventsâ??a healthy pay raise, the loss of a job, the number of new orders and salesâ??as well as our degree of uncertainty. A chief financial officer is less likely to

fund a new project if his or her view of future business conditions is less clear.

Today, the confidence picture is mixed. Buoyed by a strong jobs picture, consumer confidence remains high. Business confidence, on the other hand, has softened in recent monthsâ??likely affected by the waning effects of the Tax Cuts and Jobs Act and uncertainty surrounding China trade talks.

Is Another Crisis Looming?

We can say with confidence that another recession is coming. We just canâ??t say when or how severe it will be. Recessions are hard to spot. As one economist recently recounted, during the 2001 recession, only 7 percent of economists surveyed thought a recession was underway two months after it began. Today, 25 percent of economists surveyed expect a recession within the next year.[4]

Recessions are a normal and healthy, if painful, part of the business cycle. They are a way for economies to heal, rebalance, and emerge strongerâ??although this provides little comfort to displaced workers or pre-retirees watching the value of their savings decline when they need them most. Historically, the U.S. has experienced recessions in about one of every seven years, or 15 percent of the time.

Over long periods of time, the trend of the U.S. economy is positive. Expansions have been greater in duration and magnitude than slumps; as Warren Buffett has often said, it does not pay for the long-term investor to bet against the U.S. economy. And as difficult as it is to correctly predict the onset of a recession, itâ??s even harder to see the daylight when itâ??s darkest and reinvest in time to benefit from a rebound. Market timing is a greater threat than market volatility for long-term investorsâ??itâ??s far better to stay the course with a sound strategy and a steady hand.

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1 â??Global Business Cycle Indicators,â?• The Conference Board, 2019.

2 â??Quarterly Report on Household Debt and Credit,â?• Federal Reserve Bank of New York, 2019.

3 Estrella, Arturo and Trubin, Mary R., â??The Yield Curve as a Leading Indicator: Some Practical Issues,â?• Federal Reserve Bank of New York, 2019.

4 Goolsbee, Austan, â??You Never Know When a Recession Will Sneak Up on You,â?• *The New York Times*, 2019.

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