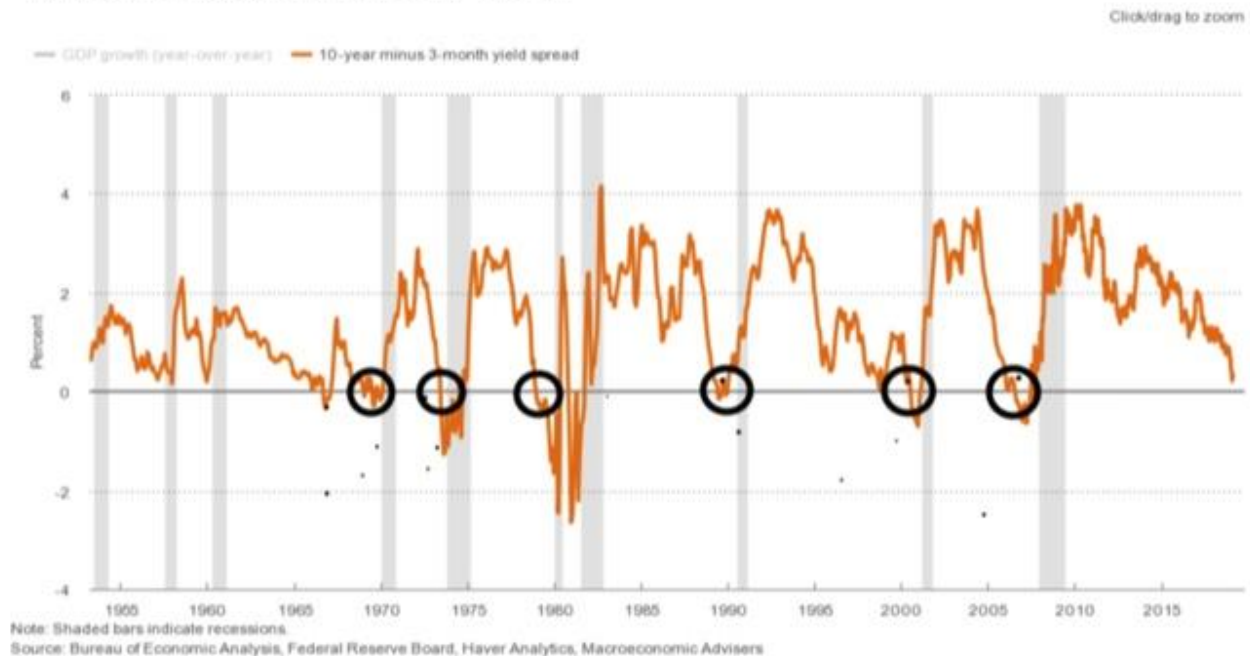
MARKET INSIGHTS: RECESSION OR SLOWDOWN

The near-record length of the economic recovery that began in June 2009 is increasing concern among anxious investors that a recession is imminent. Recoveries and recessions, however, do not follow a predetermined timeline. As Ben Bernanke joked in January, “expansions don’t just die of old age...they get murdered.’’

Often, they are ‘murdered’ by an aggressive Federal Reserve (Fed) that raises rates too quickly. Higher inflation also frequently precedes recessions and is often the cause of aggressive Fed policy. At other times, an economic shock, such as a jump in oil prices, causes a reduction in discretionary spending – thus reducing demand and slowing the economy. And finally, recession can be closely tied to financial imbalances, such as the excessive equity valuations that led to the ‘dot com’ crash of 2001 or the irresponsible lending practices and related leverage associated with the mortgage/housing crisis of 2007. It is never obvious what will cause the next recession.

Still, some investors are eager to suggest the next tipping point may be at hand. Fears of a Fed policy mistake, rising inflation, economic shocks, and financial imbalances all seem to be justifiable causes of a potential downturn, but, so far, the market has successfully climbed the associated wall of worry. Examination of these concerns suggests that, while they may be reasonable, they are not at levels that historically signal economic contraction.

Federal Reserve monetary policy is very frequently cited as the cause of recessions. After all, tighter monetary policy intended to slow economic growth and reduce inflation typically produces one of the most reliable indicators of recession: the inverted yield curve. An inverted yield curve comes about as aggressive Fed-policy raises short-term rates to the point where consumption or business spending is impaired, therefore reducing pressure on rising prices. At this point, because longer-term interest rates largely reflect expectations of future inflation, longer-term yields become lower than short-term yields – hence, an “inverted yield curve.” An inverted curve, defined in most Fed studies as a negative spread between three-month and ten-year Treasury yields, has preceded every recession since the late 1960s, as indicated in the graph below.



Note: Shaded bars indicate recessions.
Source: Bureau of Economic Analysis, Federal Reserve Board, Haver Analytics, Macroeconomic Advisers

Importantly, according to Fed studies, and as the graph shows, a flatter yield curve does not have such predictive power. The Cleveland Federal Reserve website puts it succinctly: “The rule of thumb is that an inverted yield curve…indicates a recession in about a year…a flat yield curve indicates weak growth…” If history is our guide, the current relatively flat yield curve suggests an economic slowdown, but not a contraction. Furthermore, if a yield-curve inversion does develop, a recession is still typically several quarters away. Notably, the current three-month/ten-year yield curve is not inverted.

Rising inflation has also been a precursor to recessions. In past economic cycles, economic strength frequently produced a “boom” phase prior to recessions, when excessive consumption pushed prices higher, encouraging the Fed to then adjust monetary policy. Missing from the current prolonged recovery is this boom phase of economic growth and the accompanying rise in prices. While tax policy produced above-average GDP growth of about 2.9 percent in 2018, it was far from excessive and inflation did not rise dramatically. Economic growth is expected to slow to 2.2 percent in 2019, likely dampening any inflationary pressures that might be building. Wages have recently risen at 2.9 percent year-over-year, but, so far, this shows no sign of translating into broader inflation increases. The core Personal Consumption Expenditures index (PCE), the Fed’s preferred measure of inflation, is the most relevant measure of inflation for investors to monitor. At 1.9 percent, core PCE is not likely to provoke additional tightening, especially with recent Fed concerns that U.S. economic growth could be impacted by a slowdown in global growth. However, factors such as tariffs, trade reprisals, and changes in currency values could unfold and coerce

U.S. inflation higher. Investors should be aware that several months of core PCE of 2.4 percent or more, while not alarming, could nudge the Fed to adjust rates slightly higher. As in December 2018, nervous investors could react by reducing holdings of economically sensitive assets, pushing equity prices lower in the process.

Economic shocks can also lead to recession. In the past, oil-price hikes have reduced consumer discretionary spending and curtailed business investment. A shock, by definition, is unforeseen, but given increased U.S. oil production and the reduced pricing power of OPEC, an oil shock today seems unlikely. Of course, economic shocks could unfold elsewhere. Trade wars and deteriorating relationships with allies hold some potential for an economic shock. A substantial escalation in tariffs or severe trade restrictions could produce unforeseen price increases or supply-chain disruptions. However, the fungibility of many products, along with corporate efforts to develop supplemental supply chains, suggests a disruption similar to past oil-price shocks will be hard to duplicate. Ongoing progress in trade talks with our North American neighbors and China should further reduce the threat of a trade-related external shock. However, investors would be wise to monitor U.S. trade talks – perhaps less for their impact on the total economy and more for their impact on specific sectors, such as technology or defense.

Financial imbalances are also frequently present at economic downturns, exacerbating a slowdown, if not initiating it. Widespread mortgage lending, poor underwriting standards, and related leverage created financial imbalances that bore much responsibility for the severity of the 2008 recession. Today, the level of outstanding corporate debt and the deteriorating underwriting standards of leveraged loans raise similar concerns. Importantly though, Janet Yellen points out that there is "…much less leverage in the financial sector now… [and] …most of these risky loans are owned by investors that are not leveraged." In addition, today's historically low interest rates mean that the ability to service that debt has actually improved. A January 2019 Fed study reveals that aggregate interest coverage ratios (ICR) have improved over the past decade, even as total corporate debt has risen dramatically. Thus, while corporate-debt levels are a justifiable concern, especially if rates rise, continued low interest rates suggest current aggregate debt levels will not yet create the financial imbalance that investors fear.

The shape of the yield curve, inflation, economic shocks, and financial imbalances are all important areas to consider for identifying a recession. If history is an effective guide, the associated data does not suggest an economic slowdown is imminent, but developments should be monitored closely. Increases in core PCE that might force the Fed's hand, rising interest rates that would make corporate debt-service problematic, trade negotiations gone awry, and especially an inverted three-month-to-ten-year yield curve would signal greater economic difficulties that could indeed spawn the downturn investors fear. Until then, a slowdown is possible, and time remains to adjust portfolios to reflect investor risk-tolerance and/or take advantage of changes in valuation.

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