JUN
06
2016

Featured G

Recessionary Fears, Dark Clouds that Won't Fade

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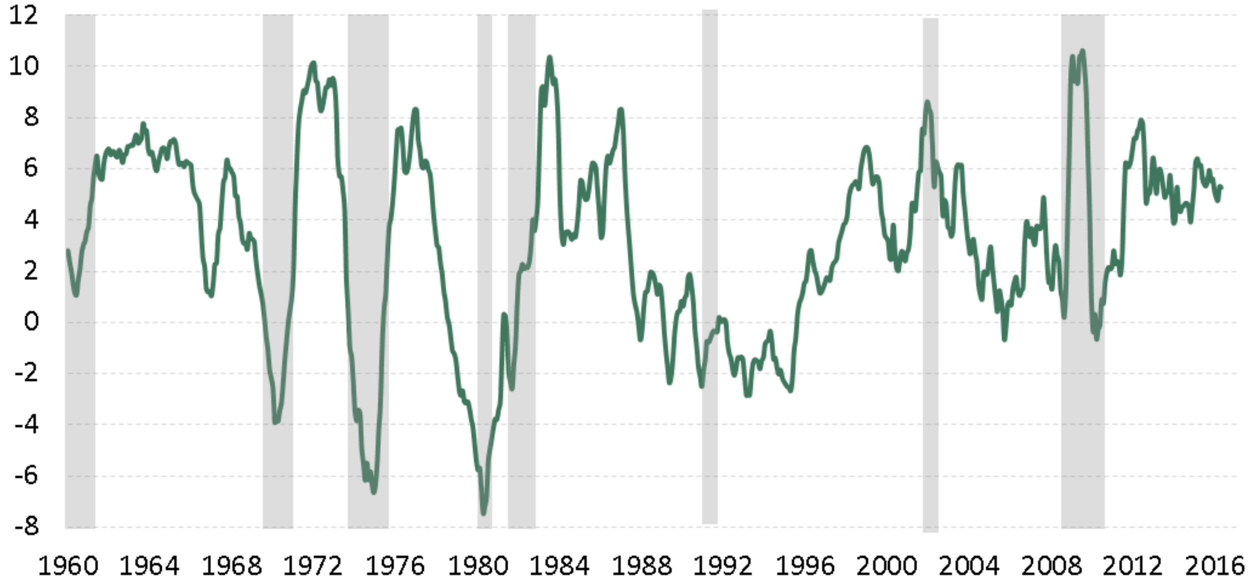
Despite a recent rally in risk assets, recession fears continue to linger, hanging like dark clouds over the markets. The current recovery in the U.S. economy appears to be getting a little long in the tooth. As *The Economist* points out in a recent "Free Exchange," economic expansions seldom die of old age, but economic risks do increase as the length of the expansion grows. What factors might we look at that could give us a warning of whether a real recession is headed our way? Some possible warning signs and leading indicators are reviewed below:

1. ***The Age of the Expansion.* The current U.S. expansion, which began in June 2009, is now 73-months old, the fourth-longest expansion in the post-WWII period. The longest expansion lasted 10 years from 1991-2001. The current expansion has lasted longer than the average expansionary phase, but is within one standard deviation of that average. There is nothing remarkable about the age of this expansion, yet recession fears linger.**

2. ***The Two Consecutive Quarterly Declines Rule.* Most investors cite the so-called two consecutive quarters rule to define a recession. According to this rule, a U.S. recession occurs when real Gross Domestic Product (GDP) posts two consecutive quarterly declines. Thus far, the U.S. economy continues to expand, even though the first quarter of 2016 recorded a rather dismal 0.8% pace for real GDP growth. The two-quarter rule though is not sacrosanct. The National Bureau of Economic Research (NBER), which validates and assigns dates to U.S. business cycles, points out that most recessions do include two quarterly declines in real GDP, but not all. It cites 2007-2009 as a recession that did not post two consecutive quarterly declines. The NBER does calibrate a business cycle in different ways, utilizing employment data, for example, to date the 2007-2009 recession. And, the NBER makes its proclamations only well after the economy is mired in a recession, and only when a preponderance of data supports the recession conclusion. That means the economy could be in a recession that is identified ex post, rather than ex ante.**

3. ***Monetary Conditions.* Historically, monetary conditions have provided early warnings of pending recessions. One indicator we've followed in the past has been the annual rate of change of real M2, the money stock that includes a broader definition of household financial assets beyond savings and deposits. At one time, M2 was a component of the Conference Board's index of leading economic indicators, but has since been replaced by a Leading Credit Index, reflecting the development of derivative markets and shadow banking. Nonetheless, real money supply behaves pro-cyclically and still has a minor role as an early warning signal of strain in the financial markets. Chart 1 shows the change in real money supply, with the shaded areas representing U.S. economic recessions. In the past, real M2 generally turned negative in advance of a recession. However, prior to the last two recessions, this indicator did not turn negative, although it did contract. In fact, during the Global Financial Crisis of 2008, M2 contracted rather dramatically. Currently, real M2 does not appear to be signaling a recession.**

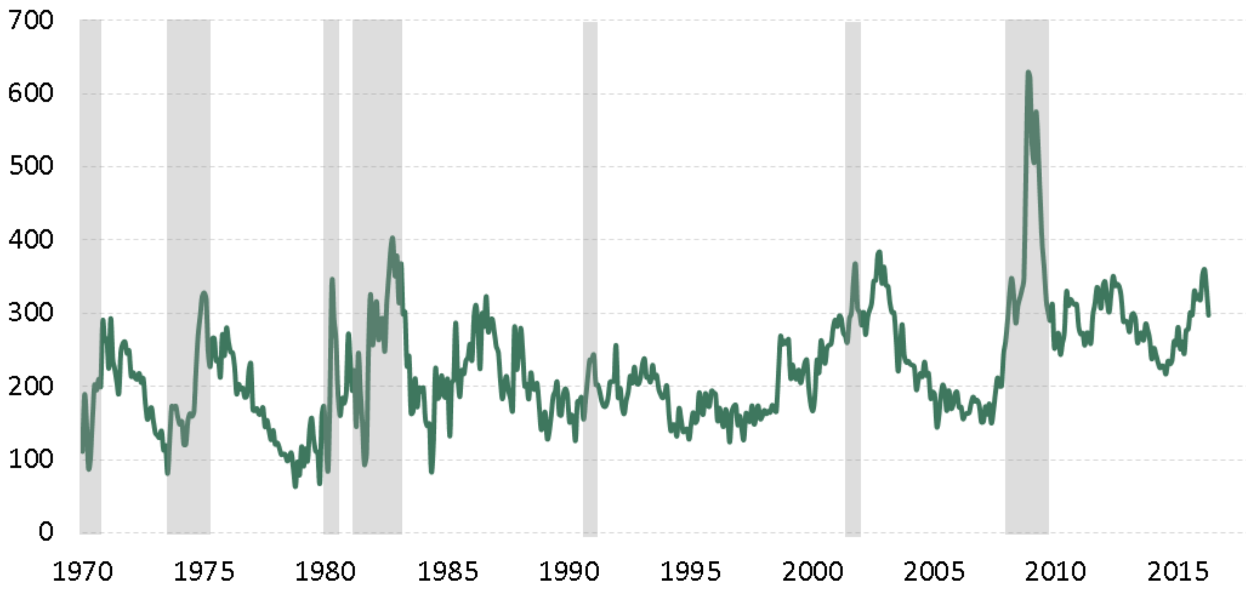
Chart 1: U.S. Money Supply – Real M2* *Annual % Change; As of 4/30/2016*



**Shown as 12-month rate of change, deflated by Headline CPI.*
Shaded gray indicates recession period.
Source: Thomson Datastream

4. ***Credit Spreads.*** **Credit spreads also can play a role in signaling an economic downturn. Credit spreads are a measure of financial market conditions, just like real M2. Chart 2 below depicts the difference—or spread—between the interest rate on BAA corporate bonds and that of the "riskless" U.S. Treasury note. A contracting spread indicates investors require a steadily lower premium over a comparable Treasury. In other words, they are requiring less compensation for investing in the riskier credit asset, conditions that suggest confident investors and ample financial market liquidity. The narrowing spread is a typical occurrence of the expansionary phase of the business cycle. As an expansion ages, credit markets tighten, and bond investors start worrying about being repaid. Eventually, investors begin to demand a higher premium for corporate debt relative to a riskless Treasury. Credit spreads, however, are not a leading indicator of a downturn, and just because spreads widen does not mean the economy is in a recession. However, spreads do widen during a recession, a necessary result though not a sufficient condition for qualifying a downturn. The most recent widening of spreads was not as dramatic as in previous cycles. Subsequently spreads have contracted rather dramatically as investors took advantage of the opportunity provided by widening spreads against a backdrop of falling government yields.**

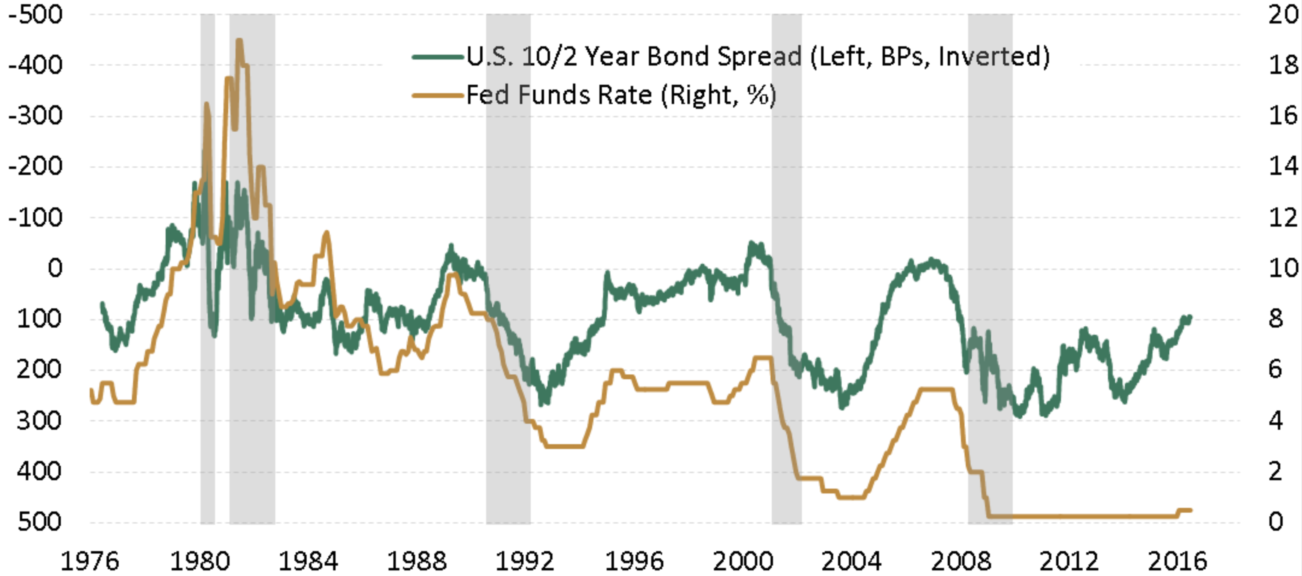
Chart 2: Moody's BAA Bond Spreads to U.S. 10-Year Treasury *BPs; As of 5/20/2016*



Shaded gray indicates recession period.
Source: Thomson Datastream

5. ***Yield Curve.*** **At the moment, one time-honored indicator does raise concern and is worth continued monitoring. That's the yield curve. Because of its predictive ability, it remains in the index of leading indicators. The yield spread can be calculated in any number of ways. We utilize the simple difference between the 10-year Treasury and the 2-year Treasury to measure the slope of the yield curve. A wide spread points to ample financial market liquidity conditions, while a tightening spread indicates deteriorating conditions. As the curve flattens, the profitable opportunity to borrow short and lend long diminishes. Its "forecasting" record is solid, typically inverting—a condition that occurs when the slope of the curve turns negative, or short-term yields rise above longer-term yields—prior to the onset of recession, as the chart below ably demonstrates (see Chart 3. Note the spread is inverted to show the relationship between the spread and the federal funds rate.). Recently, the spread has contracted but remains far from inversion. However, the spread appears to be tightening, driven by a rising 2-year Treasury yield. The flattening of the curve could be a sign, perhaps, that the market is anticipating a rising federal funds rate, meaning that expectations for the U.S. Federal Reserve to resume tightening monetary policy are increasing.**

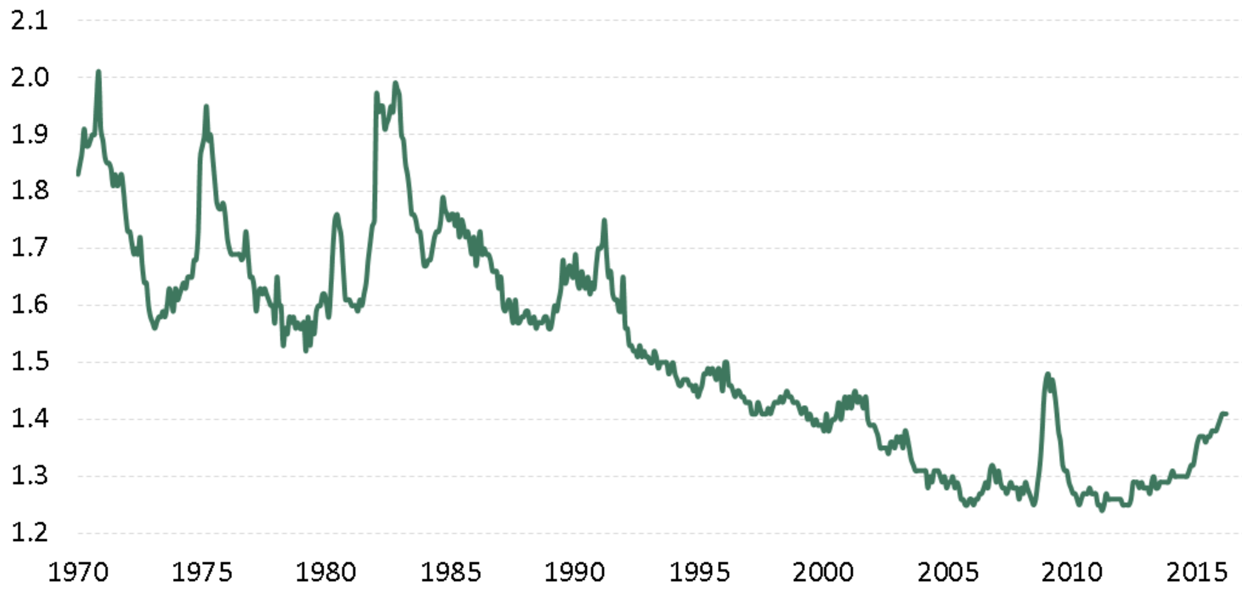
Chart 3: U.S. 10/2 Year Bond Spread and Fed Funds Rate *As of 5/20/2016*



Shaded gray indicates recession period.
Source: Thomson Datastream

6. ***Inventory-to-Sales Ratio.*** **Thus far, the discussion has mostly addressed financial market indicators as harbingers of recession. What about measures of economic activity? One measure with good cyclical properties involves monitoring business inventory relative to sales, as shown below (see Chart 4). Historically, the inventory cycle has been a key driver of the business cycle. Today, businesses have instituted various processes to manage inventory, like just-in-time inventory management, whereby production and demand are better matched. While an inventory cycle still persists, these process improvements have resulted in a more muted cycle, one that is less subject to wild swings than during past cycles. Usually, however, the rise in inventory relative to sales does not lead but is concurrent with a downturn. The recent rise in this ratio is troubling from a business cycle perspective; it serves as a possible explanation for weak manufacturing and the softness in business capital spending. This indicator suggests that businesses may have higher inventory than current sales warrant. Of all the indicators discussed up to this point, this indicator is most troubling, in my view, as it affects future manufacturing activity.**

Chart 4: Business Inventories / Sales Ratios *As of 3/31/2016*



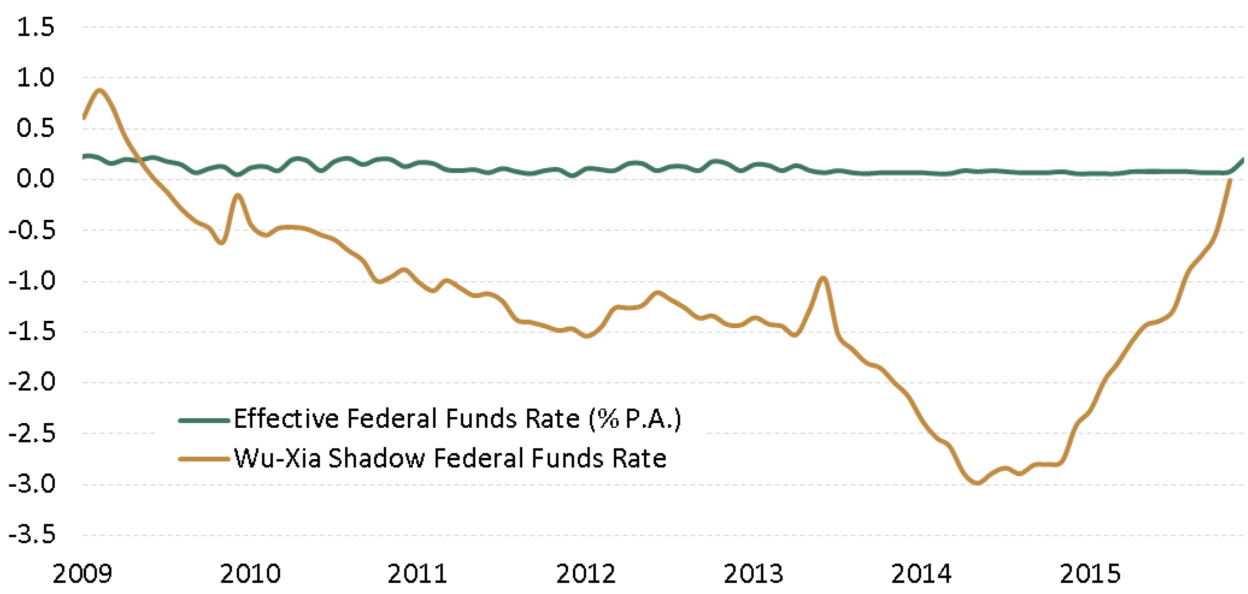
Source: Thomson Datastream

7. ***The Dreaded Policy Error.*** **While not a leading indicator, nor is it an event that is easily forecast, a policy error could be the penultimate factor that pushes the economy into a recession. Right now, the Federal Reserve (Fed) seems stubbornly fixated on raising, or "normalizing," interest rates. The Fed can point to its success in creating full employment as a justification for a rate hike, although its inflation target still remains elusive. Furthermore, growth could hardly be characterized as "robust." Yet, the probability of rising interest rates continues to creep higher, with markets putting the possibility of a July hike at over 55%. But, the most important question that persists: Is policy tight enough already? The Fed had been aggressively expansionary, enlarging its balance sheet to over $4 trillion from the end of 2008 through late 2014 (see Chart 5). That aggressive policy has ceased, evidenced by the end of quantitative easing (QE) and the absence of growth in the Fed's balance sheet. Additionally, the stronger U.S. dollar was tantamount to a tightening in monetary policy, as it slowed U.S. economic activity through the export channel, pressuring corporate profits lower. The Fed believes its current policy is accommodative. However, another measure of Fed policy suggests otherwise. The shadow federal funds rate, which models what short-term rates might be if not bound by zero percent, has risen some 300 basis points since around mid-2014. This trend in the shadow rate tracks the Fed as it tapered its securities purchase program and eventually ended it, an event coincident with the strengthening of the dollar. According to this model, current policy, rather than being accommodative, has been increasingly tightening, suggesting that the real recessionary risk could just be the Fed and its policies.**

Chart 5: Fed Balance Sheet *Billions of U.S. Dollars, As of 5/13/2016*

Source: Thomson Datastream

Chart 6: Effective and Wu-Xia Shadow Federal Funds Rates *As of 12/31/2015*



Source: Board of Governors of the Federal Reserve System and Wu-Xia

Conclusion

Investors' recessionary fears are not groundless, however, nor are all market and economic signs ominous. Similarly, investors who see only blue skies ahead may want to watch more closely the few clouds dotting the forecast. Instead of "nonexistent," the array of recessionary signals may best be characterized as "mixed." The indicators reviewed above do not suggest the U.S. economy is in any imminent danger of slipping into recession. However, some of the metrics are blinking a "yellow" caution signal. Credit spreads, while contracting a bit, still remain wide, and real M2 growth appears to have stabilized. However, the 10-year yield minus the 2-year Treasury spread continues to contract as the markets anticipate a tighter central bank. The inventory-to-sales ratio further suggests that businesses have more inventories relative to sales, and that number is building. Either demand has to pick up or the economy could be faced with still slower manufacturing, a trend that will eventually spill over into hiring. These latter two indicators remain troubling. But, the one wild card in the mix just might be the central bank and what it decides to do. And unfortunately, a policy error is not a forecastable event. The above review of specific indicators certainly suggests that policy has created some warnings. The cautioning yield curve is one. Tighter-than-anticipated policy could be another, as policy already appears to have tightened given the uptick in the shadow federal funds rate. Old age might not doom an expansion, but it does raise the stakes.

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