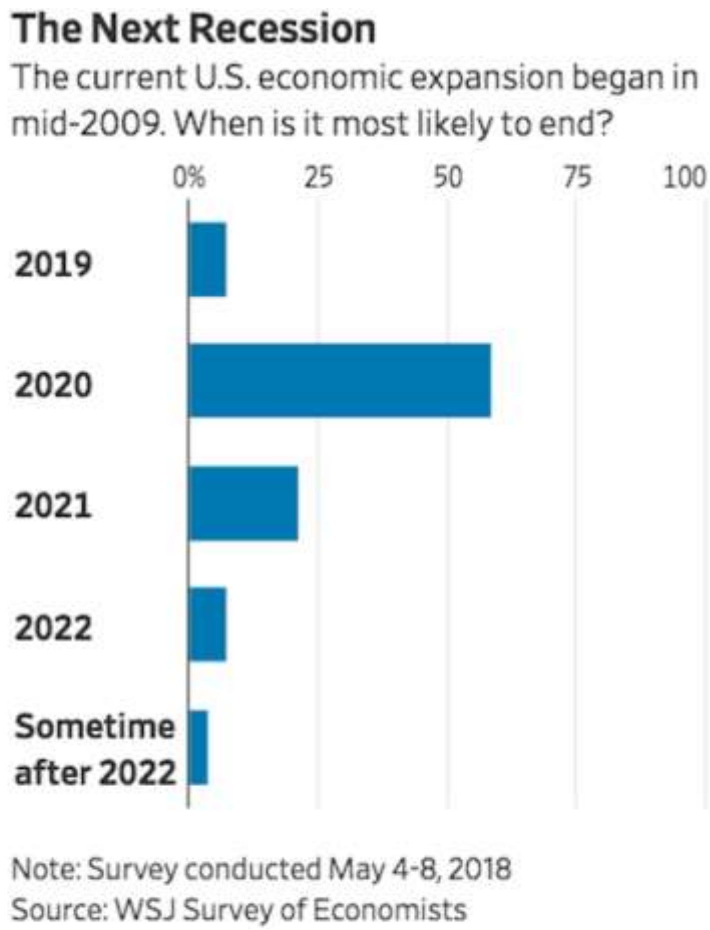
Timing the next Recession

"Prediction is very difficult, especially about the future." - physicist Niels Bohr

Last May 60 private-sector economists were surveyed by the Wall Street Journal, with 59% of them predicting that the current economic expansion would end in 2020. Tightening by the Fed to combat an overheating economy was cited by 62% as the cause of the next recession. At that time, BCA Research's Global Investment Strategy concurred. However, prior to that it had forecast the next recession beginning in 2019. Their view has again shifted, as detailed in Friday's Weekly Report:



The Long Shadow Of The Financial Crisis

"Stability begets instability" declared Hyman Minsky in his widely cited, seldom-read book. By this, Minsky meant that periods of economic tranquility often encourage excessive risk-taking, sowing the seeds of their own demise.

We would not quarrel with Minsky's assessment, but we would point out that the converse is also true: Instability begets stability. Following periods of intense financial stress, lenders become more circumspect about whom they lend to, while borrowers become reluctant to take on debt.

The result is economically bittersweet. On the plus side, the newfound caution of lenders and borrowers alike ensures that financial imbalances are slow to build up again. On the negative side, sluggish credit growth restrains spending. The net effect is a recovery that is often slow and uneven, but one which lasts longer than expected.

Few Signs Of Major U.S. Economic Imbalances

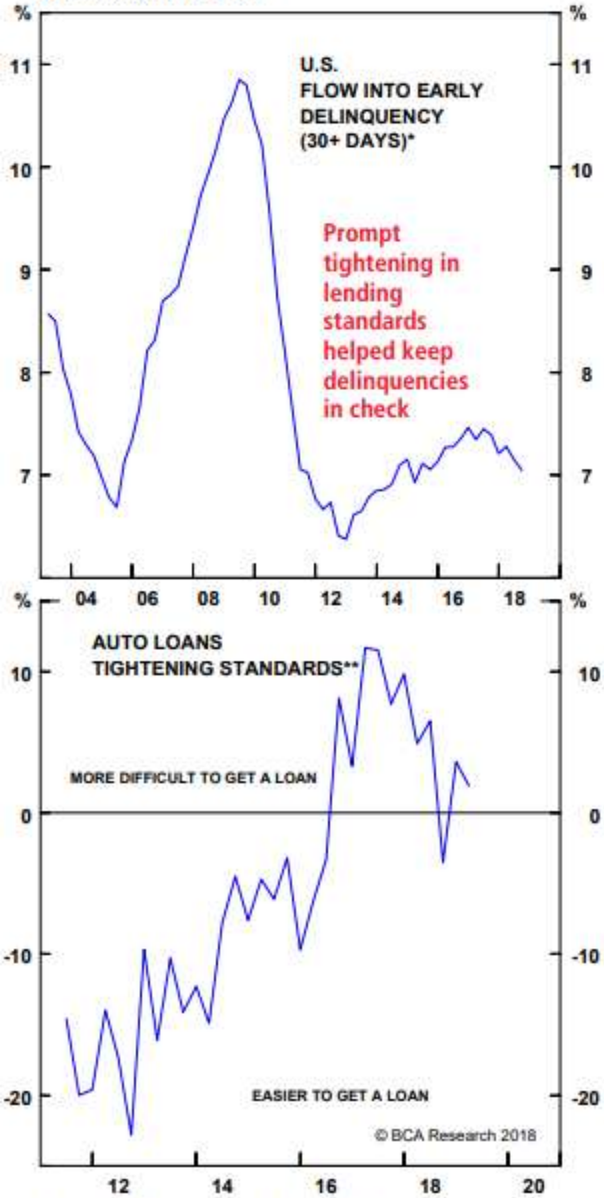
This is the world in which we find ourselves today. It took a decade following the subprime crisis for the U.S. to return to full employment. Much of Europe is not even there yet.

Lenders continue to take risks. However, they have been quicker than usual to scale back exposure at the first sign of trouble. For example, as U.S. auto loan defaults began rising in 2015, banks tightened lending standards. As a result, the share of auto loans transitioning into delinquency peaked in Q4 of 2016 and has since drifted down modestly (**Chart 1**).

A similar thing happened when corporate credit spreads blew out in 2015 following the crash in oil prices (**Chart 2**). Banks tightened lending standards starting in late 2015. Once defaults peaked in early 2017, banks started easing standards.

CHART 1

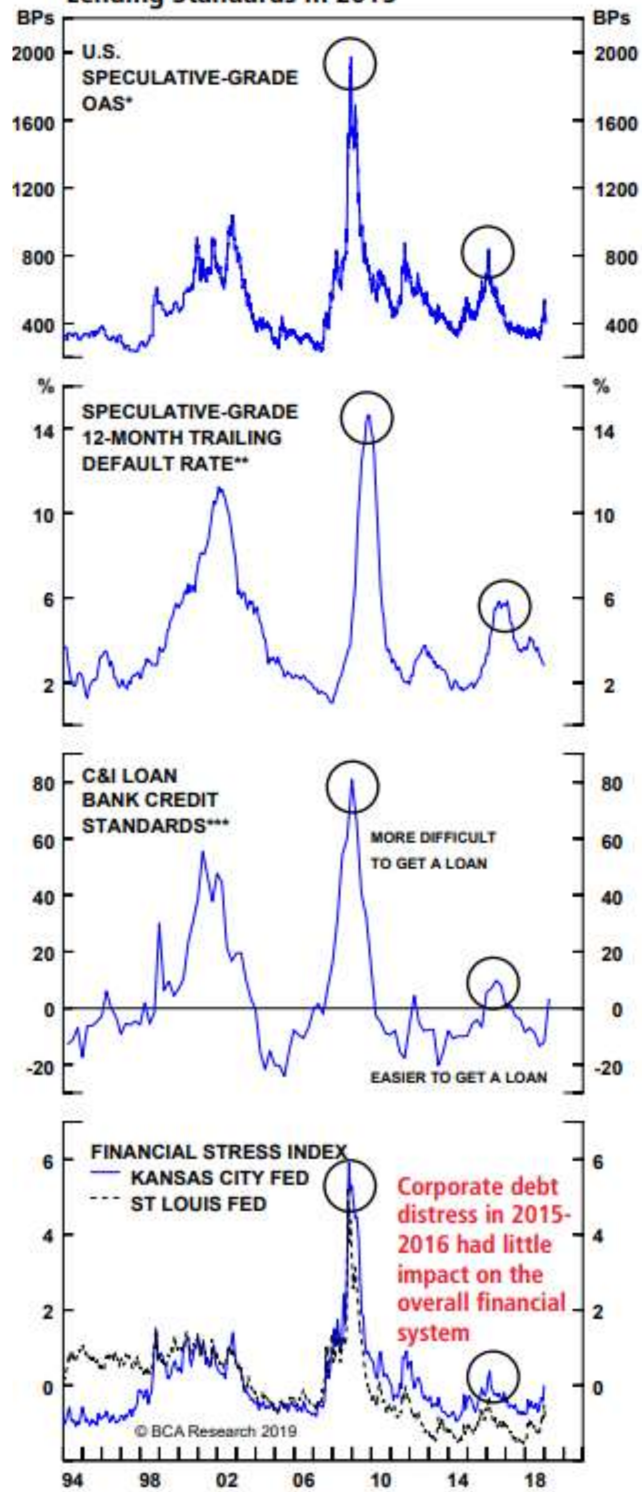
Lenders Are More Circumspect These Days: The Case Of Autos



* SOURCE: FEDERAL RESERVE BANK OF NEW YORK.
PERCENT OF OUTSTANDING BALANCE THAT IS 30 OR MORE DAYS PAST DUE.
** NET PERCENTAGE OF RESPONDENTS TIGHTENING STANDARDS.
SOURCE: SENIOR LOAN OFFICER SURVEY (FEDERAL RESERVE DATA).

CHART 2

Banks Were Quick To Tighten Lending Standards In 2015

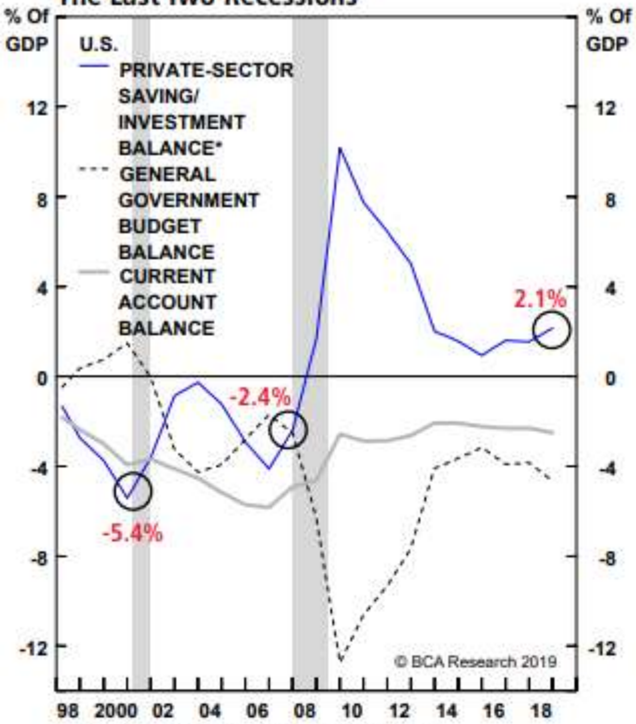


* SOURCE: BARCLAYS.
** SOURCE: MOODY'S INVESTORS SERVICE.
*** COMMERCIAL AND INDUSTRIAL LOANS. NET PERCENTAGE OF RESPONDENTS TIGHTENING STANDARDS.
SOURCE: FEDERAL RESERVE SENIOR LOAN OFFICER OPINION SURVEY.

Tellingly, the distress in corporate debt markets in 2015-16 did not cause the financial system to seize up, as evidenced by the fact that financial stress indices only increased marginally during that period. This suggests that financial imbalances never had a chance to rise to a level that threatened the overall economy.

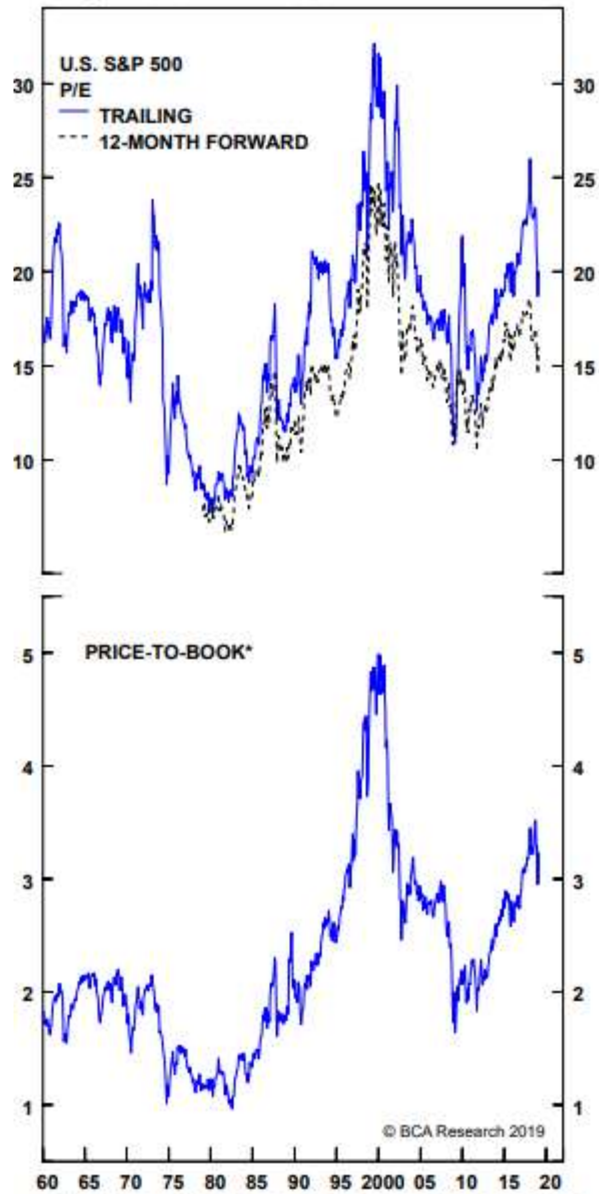
The Preconditions For The Next U.S. Recession Are Not Yet In Place

CHART 3
The Private Sector Is Not Living Beyond Its Means The Way It Was Before The Last Two Recessions



* CALCULATED AS THE CURRENT ACCOUNT MINUS GENERAL GOVERNMENT NET LENDING / BORROWING.
SOURCE: IMF.
NOTE: SHADED AREAS REPRESENT NBER-DESIGNATED RECESSIONS.

CHART 4
While U.S. Stocks Are Not Cheap, They Aren't In A Bubble



* EXCLUDING FINANCIALS, UTILITIES, AND TRANSPORTS PRIOR TO 1977.

Today, the U.S. private-sector financial balance – the difference between what the private sector earns and spends – stands at a healthy surplus of 2.1% of GDP. Both of the last two recessions began when the private-sector balance was in deficit (**Chart 3**).

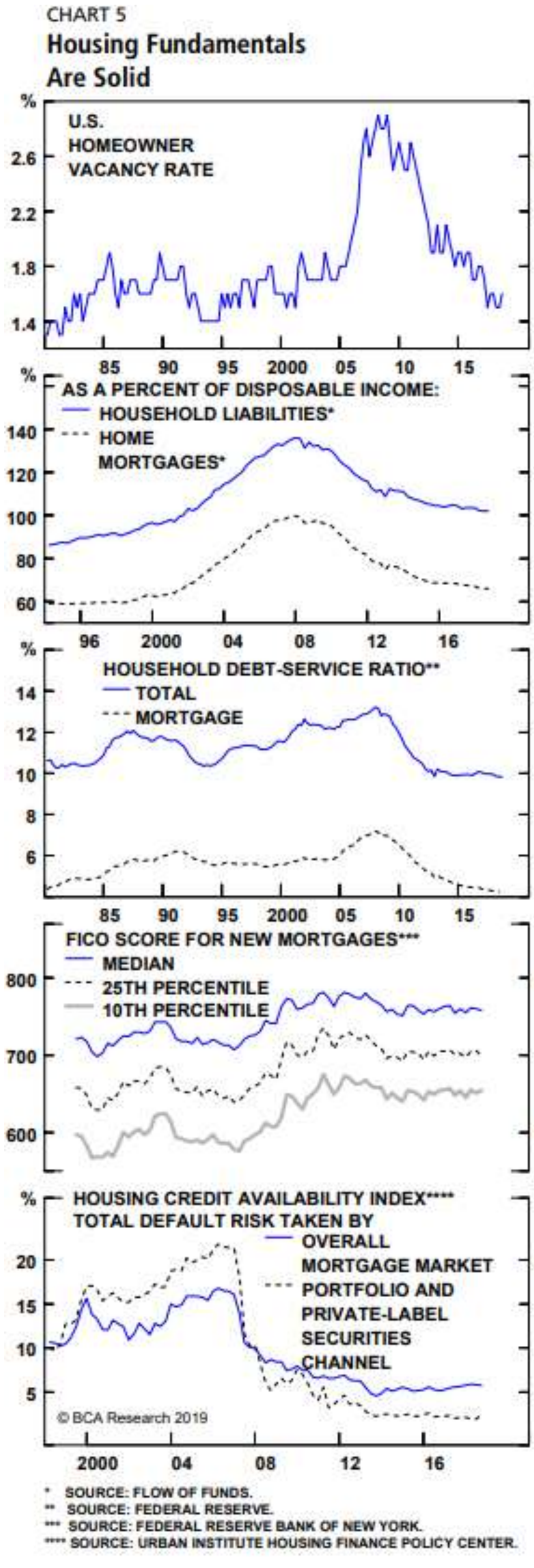
This raises an intriguing question: If the U.S. private sector is not suffering from any major imbalances, what is going to cause the next recession?

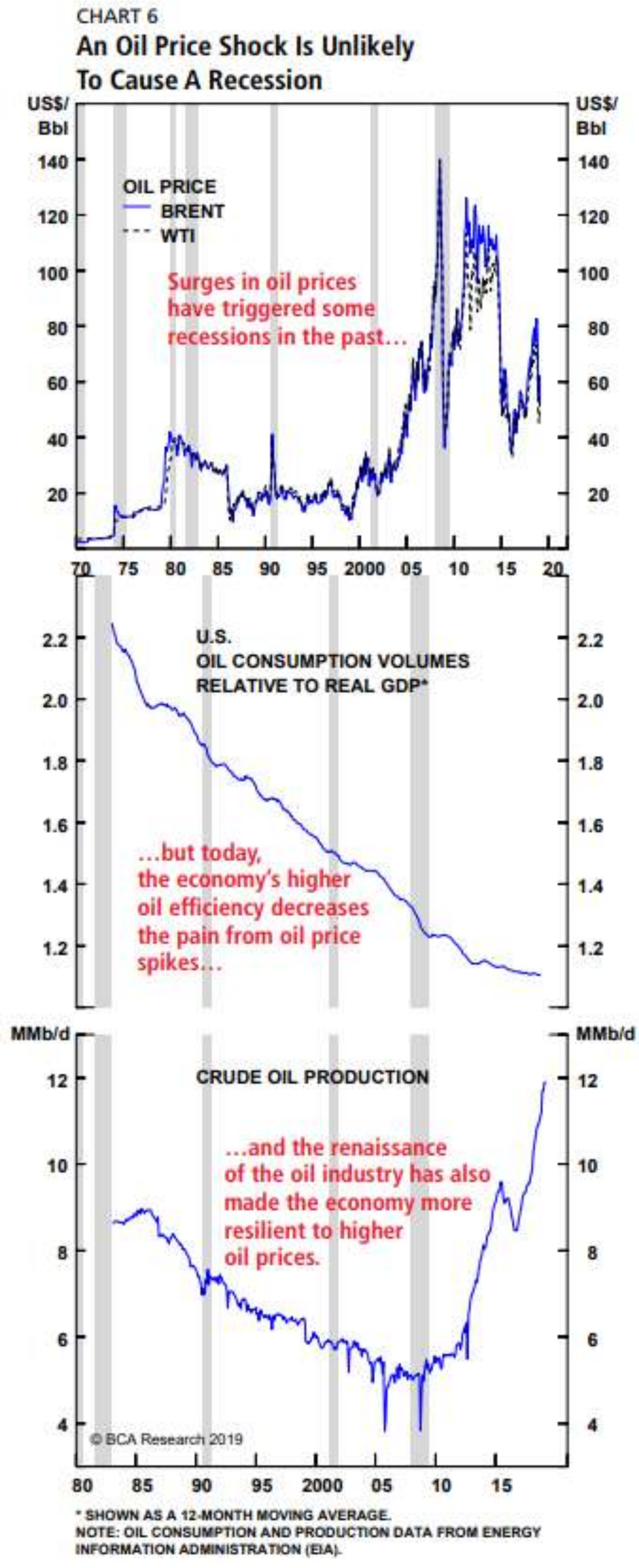
That's a very good question, with no obvious answer!

The past two recessions were triggered by the bursting of asset bubbles – first the dotcom bubble and then the housing bubble. Today, U.S. equities are far from cheap, but with the S&P 500 trading at 16.1-times forward earnings, they are hardly in a bubble (**Chart 4**).The housing market is also on much firmer footing: The homeowner vacancy rate is near all-time lows, while the quality of mortgage lending has been very high (**Chart 5**).

Of course, recessions can occur for reasons other than the bursting of asset bubbles. The 1973-74 recession and the recessions of the early 1980s were triggered by a surge in oil prices, requiring the Fed to hike rates aggressively. Luckily, such an oil-induced recession is highly unlikely today. Inflation expectations are better anchored, while oil consumption represents a much smaller share of GDP than it did back then (**Chart 6**).

In addition, the U.S. has become a major oil producer, which implies that the drag to consumers from higher oil prices would be partly offset by increased capital spending in the energy sector. At any rate, the ability of shale

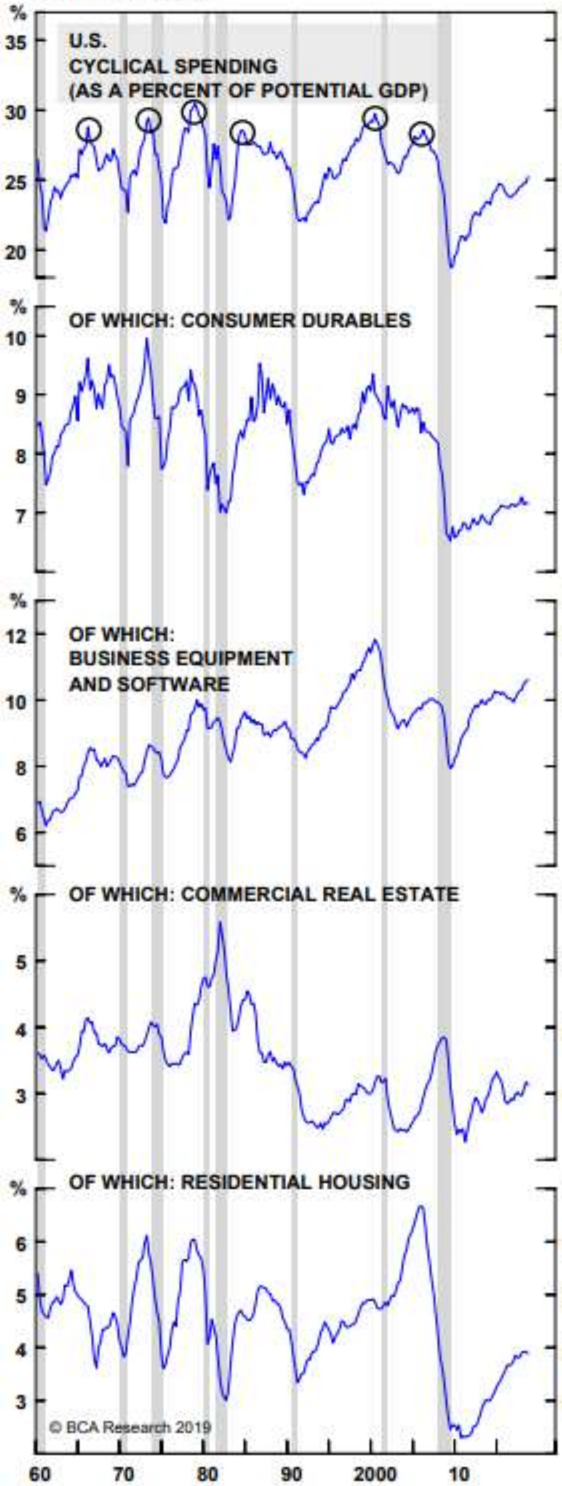




producers to respond to higher prices with additional output limits the extent to which prices can rise in the first place.

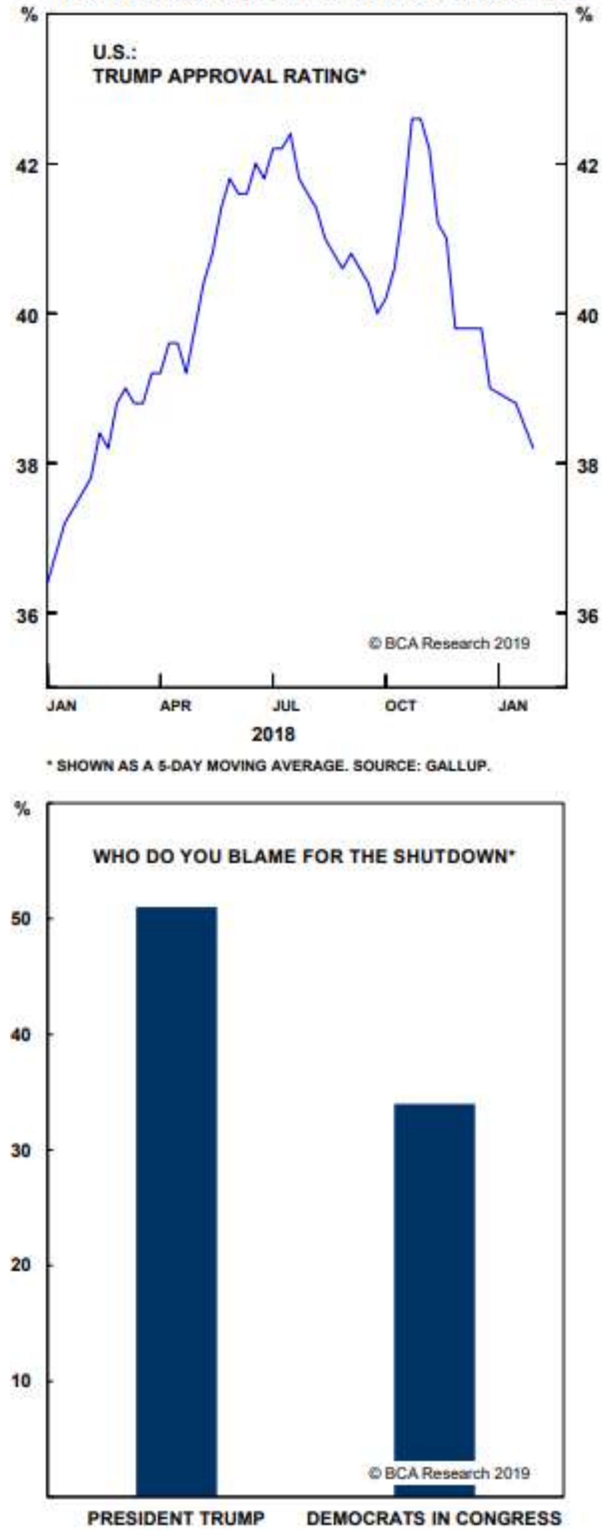
Past economic downturns have also been caused by major adjustments in the cyclical parts of the economy. As a share of GDP, cyclical spending is lower today than it has been at the outset of most recessions (**Chart 7**).

CHART 7
Cyclical Spending Is
Not Extended



NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

CHART 9
"I Am Proud To Shut Down The Government"



* SHOWN AS A 5-DAY MOVING AVERAGE. SOURCE: GALLUP.

* SOURCE: AVERAGE OF VARIOUS POLLS. INCLUDES A SAMPLE OF POLLS CONDUCTED FROM THE THIRD WEEK OF THE GOVERNMENT SHUTDOWN.

The proliferation of just-in-time inventory systems has also reduced the influence that inventory swings have on the economy.

A severe tightening of fiscal policy can also trigger a recession. Fortunately, the end of the government shutdown reduces the risk of such an outcome. Rightly ~~or wrongly~~, voters blamed President Trump for the recent closure (**Chart 9**). As we speak, the Trump administration is negotiating with Democrats to avert another shutdown slated to begin on February 15. The key item of contention concerns funding for a border wall with Mexico. Even if a deal falls through, rather than shuttering the government again, Trump will probably pursue funding for the wall by declaring a national emergency. Our geopolitical strategists believe such an action will be challenged by the Democrats, but is likely to be upheld by the Supreme Court.

Global Growth Should Improve

Admittedly, the external environment now has a greater influence on the U.S. economy than in the past. Nevertheless, given that exports are only 12% of GDP, it would take a sizeable external shock to knock the U.S. into recession.

We think that such a shock is not in the cards. The trade war is likely to go on hiatus as Trump seeks to take credit for a deal with China. In addition, as we discussed two weeks ago, China will scale back its deleveraging campaign now that credit growth has fallen close to nominal GDP growth.

Euro area growth should reaccelerate over the coming months thanks to lower oil prices, a revival in EM demand, modestly more stimulative fiscal policy, and the palliative effects from the decline in government bond yields across the region. We have also argued that the risks of a "Hard Brexit" should abate.

Waiting... And Waiting For Inflation To Rise

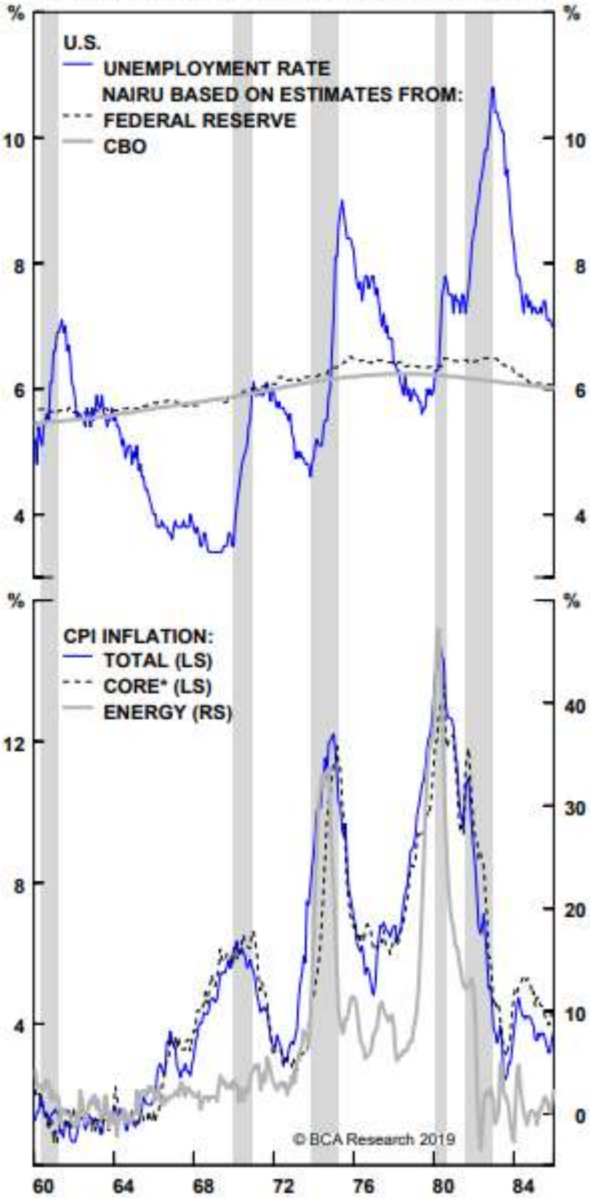
When the next recession rolls around, it will probably be sparked by a surge in inflation, which forces the Fed to raise interest rates much more rapidly than it has so far. Here is the thing though: Inflation is a highly lagging indicator. It usually only peaks long after a downturn has started and troughs after the recovery is well underway (**Chart 11**).

CHART 11
Inflation Is A Lagging Indicator

* EXCLUDING FOOD AND ENERGY.
NOTE: SHADED REGIONS DENOTE NBER-DESIGNATED PERIODS OF RECESSION.

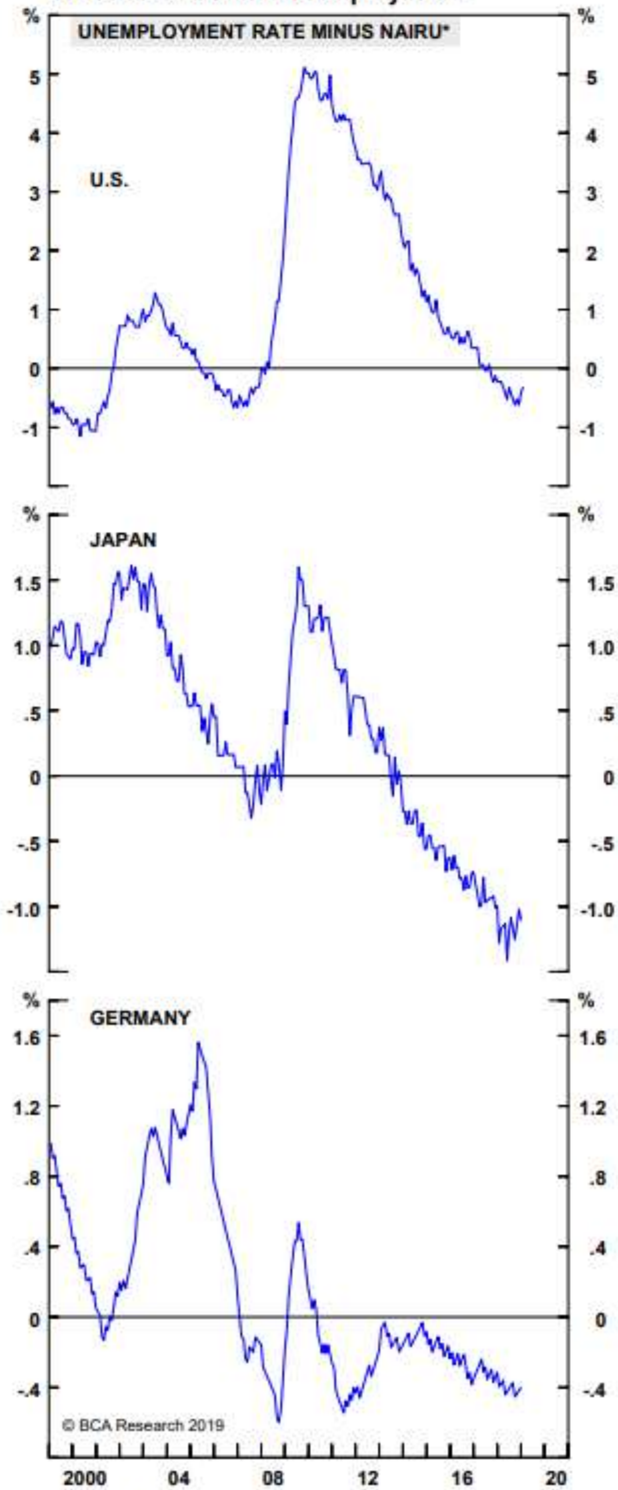
Consider the example of the 1960s. The unemployment rate fell below NAIRU in 1964, but it took another four years for inflation to break out in earnest (**Chart 12**). The U.S. unemployment rate has been below NAIRU only

CHART 12
It Took An Overheated Economy For Inflation To Take Off In The Late-1960s



* EXCLUDING FOOD AND ENERGY.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

CHART 13
The U.S., Japanese, And German Economies Are At Full Employment



* SOURCE: OECD.

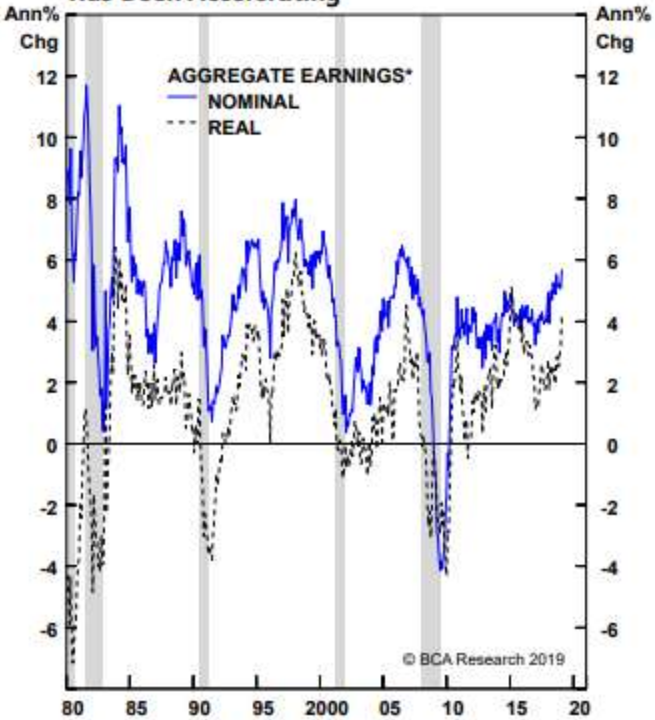
since 2017. The unemployment rate in Germany and Japan has been below NAIRU for much longer, yet inflation remains stubbornly low in both countries (**Chart 13**).

Cheer Up

This leaves us with a striking conclusion: Perhaps the next U.S. recession is not around the corner, as some grumpy economists seem to think. Perhaps this economic expansion can endure beyond 2020.

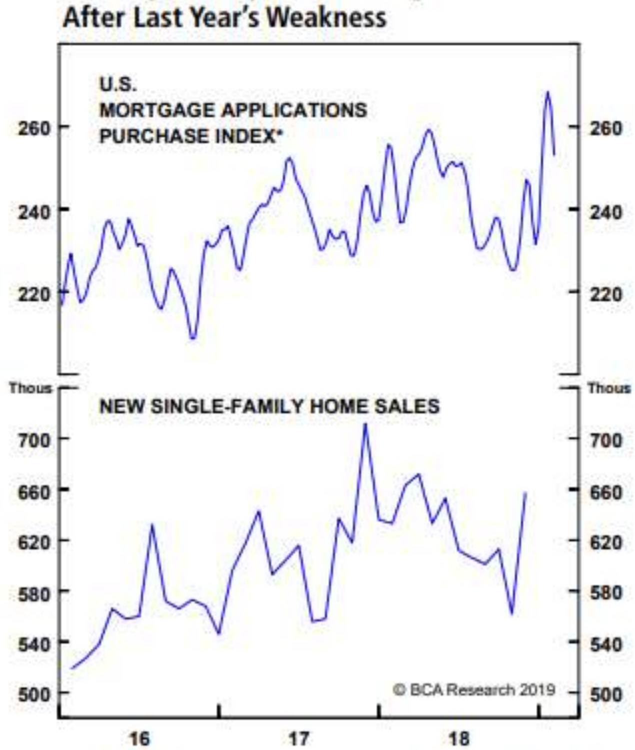
The recent U.S. data has certainly been consistent with that thesis. The ISM manufacturing index rose 2.3 percentage points to 56.6 in January. New orders jumped by 6.9 percentage points to 58.2. Payroll growth has

CHART 14
U.S. Labor Income Growth Has Been Accelerating



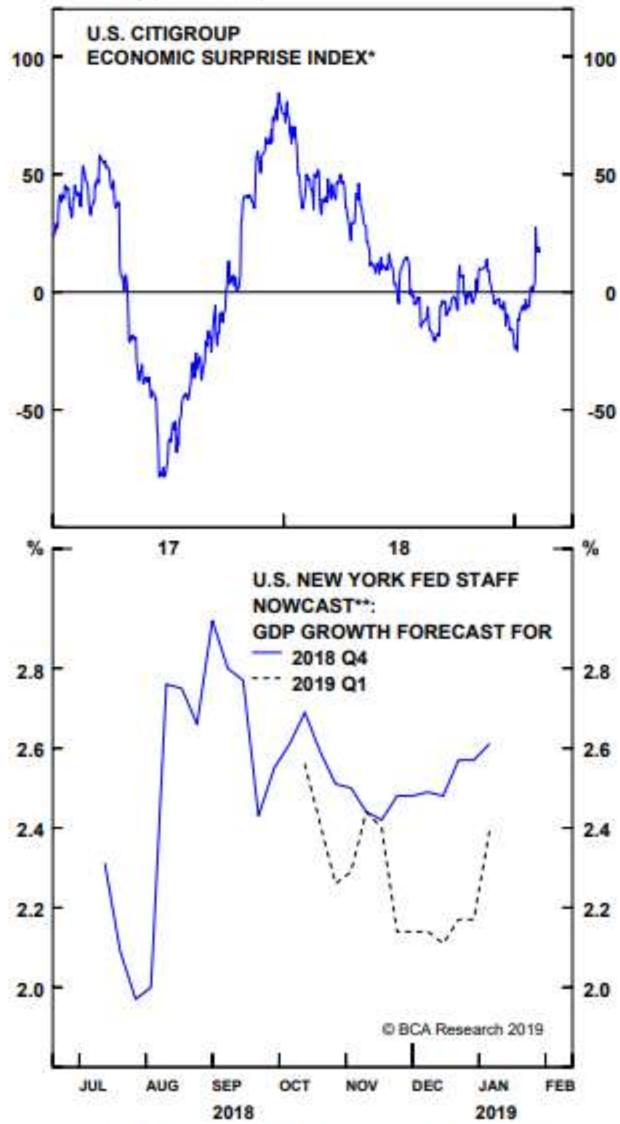
* CALCULATIONS BASED ON BLS DATA. JANUARY 2019 DATA POINT IS ESTIMATE.

CHART 15
Housing Activity Is Stabilizing After Last Year's Weakness



* SOURCE: MORTGAGE BANKERS ASSOCIATION. SHOWN SMOOTHED EXCEPT FOR LATEST DATA POINT.

CHART 16
U.S. Economic Data Are Beating Low Expectations



* ROLLING 3-MONTH STANDARD DEVIATION OF DATA SURPRISES. SOURCE: CITIGROUP GLOBAL MARKETS INC.
** SOURCE: FEDERAL RESERVE BANK OF NEW YORK.

also accelerated. Real aggregate earnings are up 4.2% from a year earlier, the fastest pace since October 2015 (**Chart 14**).

Housing data are showing tentative evidence of stabilization. New home sales are rebounding, while mortgage applications are back near cycle-highs (**Chart 15**).

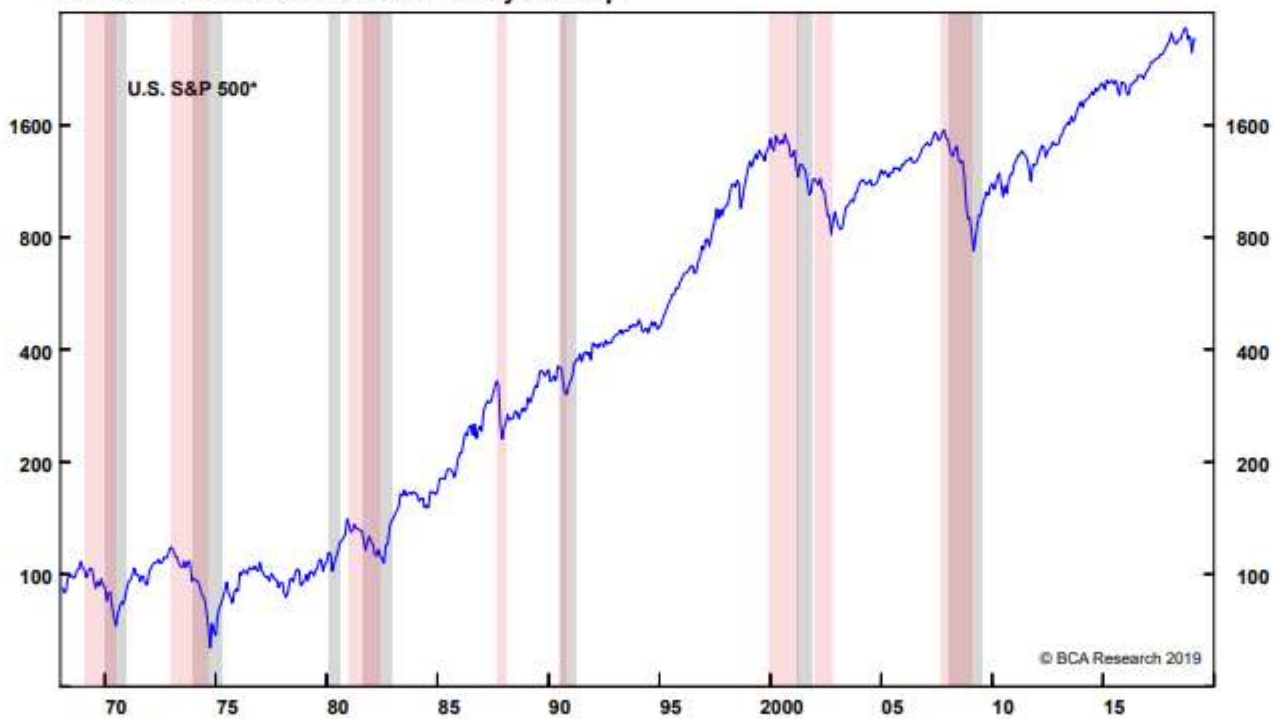
Reflecting these positive developments, the Citigroup economic surprise index has jumped into positive territory (**Chart 16**). The New York Fed's estimate for Q1 2019 GDP growth has also moved up to 2.4%.

Investment Conclusions

Recessions and bear markets usually overlap (**Chart 17**). With the next recession still at least 18 months away, it is premature to turn bearish on equities. We upgraded stocks in December following the post-FOMC sell-off. ... we continue to see global equities finishing the year 5%-to-10% above current levels. As global growth bottoms out mid-year, the leadership role in equity markets should increasingly move away from the U.S. towards EM and Europe.

CHART 17

Recessions And Bear Markets Usually Overlap



* SHOWN IN LOG SCALE.
NOTE: LIGHT RED SHADING INDICATES BEAR MARKETS; GREY SHADING INDICATES NBER-DESIGNATED RECESSIONS.

Bonds are a tougher call. We do not expect the Fed to raise rates again at least until June. This will limit the upside for bond yields, as well as the dollar, in the near term. Nevertheless, with the fed funds futures pricing in no rate hikes for the next few years, even a modest shift back to tightening in the second half of this year and beyond will push up bond yields, dampening total returns to fixed income.

Looking beyond 2019, the case for maintaining a short duration stance in fixed-income portfolios is very strong. The longer the Fed allows the economy to overheat, the greater the eventual overshoot in inflation will be. Inflation expectations have fallen over the past few months.

They should have risen. Ultimately, Gentle Jay Powell's decision to press the pause button on further rate hikes means that rates will end up peaking at a higher level during this cycle than they would have otherwise.

Our thoughts

Whether you agree with John Maynard Keynes, **"When the facts change, I change my mind. What do you do, sir?"**, or economist Joan Robinson, **"The purpose of studying economics is not to acquire a set of ready-made answers to economic questions, but to learn to avoid being deceived by economists.",** Peter Lynch, one of history's all-time top mutual-fund managers, was probably right: **"If you spend 12 minutes a year worrying about economics, you've wasted 10 minutes."**