

# The Recession Cometh (Eventually)

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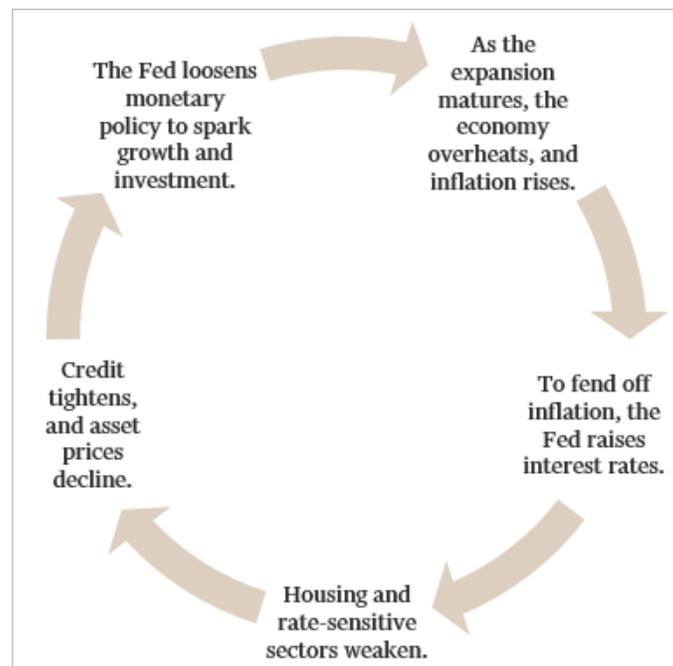
### Executive Summary

Should we worry about a recession in 2019? It's the question many investors are asking and one that can't be answered definitively. However, we can share our perspective based on current economic conditions, and at this point, we believe a recession is unlikely to occur this year.

While economic growth is slowing, slow growth is still growth, and signs do not point to a recession in the near term. The entire yield curve has yet to invert. The difference between the 10-year and 2-year Treasury rate remains positive. Additionally, the housing markets appear to be recovering. Lastly, the Institute for Supply Management (ISM) data, viewed as a leading economic indicator, is above 50 for manufacturing and services, a sign the economy is still growing.

Eventually, a recession will come, but there is no ironclad rule of when that day will arise. So we would argue a better question to ask is how could this recession be different from past ones?

Each cycle comes attached with a specific set of circumstances that define its shape, and no two recessions are alike in both duration and impact. For example, the 2001 recession only lasted eight months during which gross domestic product (GDP) dropped just 0.4%, and the market declined 49%. During the 2008 recession, the market was down 57%, and GDP fell 4%. And not all recessions follow the historical recession playbook:



To help assess the potential impact of the next recession, watch for developments in:

1. **Monetary policy.** Future Fed actions have the potential to spur or slow growth.
2. **Corporate debt.** Current debt levels are high, increasing the risk of defaults and reducing capital spending.
3. **China.** Slowing growth in China could have ripple effects here in the U.S.

We would also argue that the focus on the timing of the next recession is misplaced. Looking out over the next six months, we do not foresee a recession, but that can change unexpectedly. The more important consideration is the risk investors are taking in their portfolios. As the December equity market plunge reminded us, risk comes at us suddenly. Portfolios should be positioned appropriately to better weather whatever the markets and economy may bring.

## The Recession Cometh (Eventually)

Since the end of the global financial crisis, prognosticators have compared the economic cycle to that of a baseball game—constantly wondering what inning we’re in. In the last five months, the movement in stock prices has once again forced investors to reconsider their views on the next recession, and question whether we are indeed in the bottom of the ninth.

Investors were confounded by the swiftness of the market sell-off in December against the backdrop of strong fundamentals and could be forgiven for not fearing a recession three months ago. There was a laundry list of reasons to remain bullish heading into the fourth quarter: earnings growth of 20% plus, benign inflation, low corporate default rates, a strong consumer and the lowest unemployment rate in nearly 50 years.

However, despite the velocity of the market recovery and the retreat of the Fed, deteriorating economic data begs the question, should we worry about a recession in 2019?

### Bear Tracks

Recessions are most commonly defined as a contraction in economic growth and have historically been accompanied by bear markets in equities, which explains why people are obsessed with forecasting the next one.

Since World War II, there have only been three occasions where the S&P 500 entered a bear market without a corresponding recession (1961-1962, 1966, and 1987).

Bear Markets Since 1960			
Start	End	Decline	Days
12/12/1961	6/26/1962	-28.0%	196
2/9/1966	10/7/1966	-22.2%	240
11/29/1968	5/26/1970	-36.1%	543
1/11/1973	10/3/1974	-48.2%	630
11/28/1980	8/12/1982	-27.1%	622
8/25/1987	12/4/1987	-33.5%	101
3/24/2000	10/9/2002	-49.1%	929
10/9/2007	3/9/2009	-56.8%	517
<b>Average</b>		<b>-39.0%</b>	<b>512</b>
<b>Denotes during U.S. recession</b>			

Source: Yardeni Research, Factset

So while the market can (and does) go down without a recession, substantial and more prolonged declines tend to occur during one. Without an impending recession, the stock bull market is likely to continue. When one’s on the horizon, there is likely more downside to come. Our view has remained consistent over the past three months; we believe a recession is unlikely in 2019.

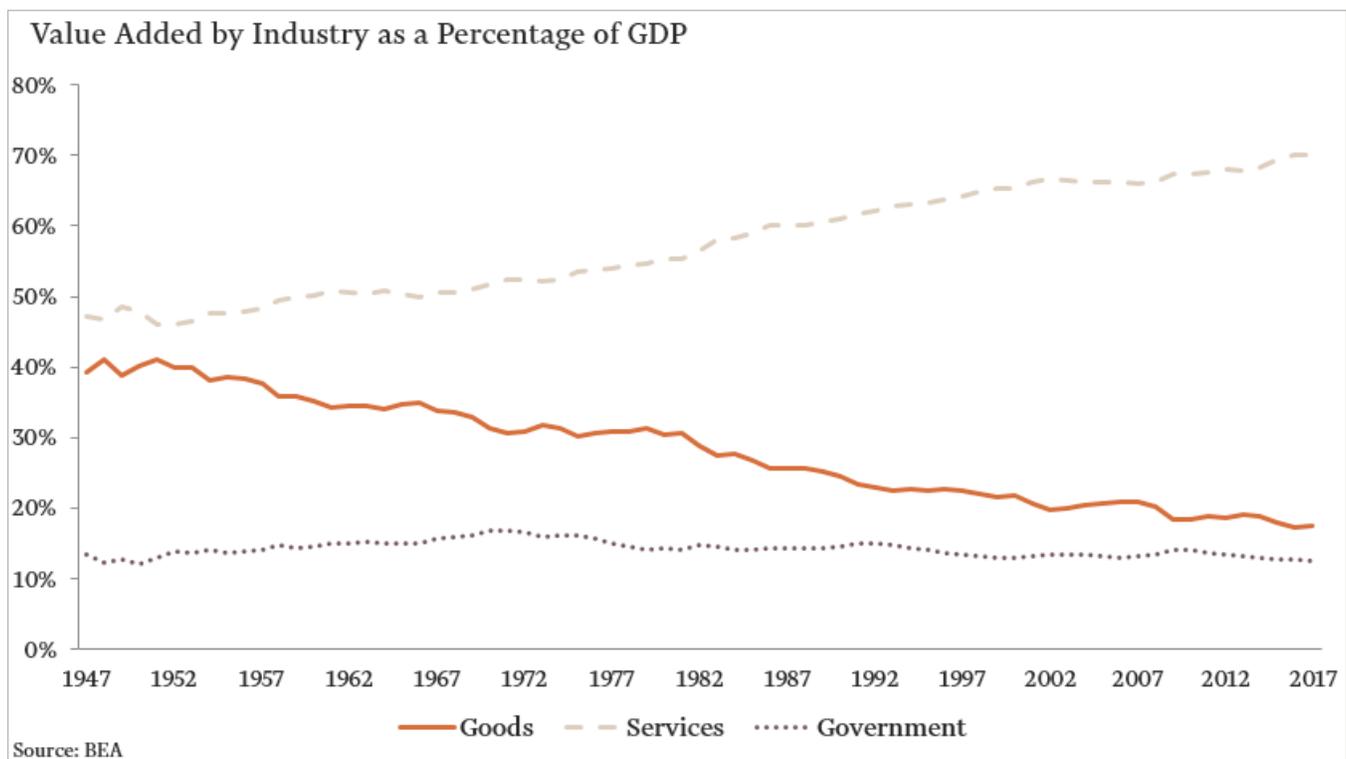
## Expanding Expansion Cycles

The history of American recessions can be simplistically broken into two eras: pre- and post-Great Depression. Up through the Great Depression, recessions were frequent and lengthy. There were 21 in all, averaging 21 months with four lasting more than 30. The average expansion during this time was 26 months.

There have been 12 recessions in the post-Great Depression era with an average length of 11 months and none lasting longer than 18. Additionally, expansions have become longer, persisting 65 months on average. At 117 months and counting, the current one is unusually long.

This change in the duration of the business cycle is primarily the result of:

- 1. The Fed and monetary policy.** The emergence of the Federal Reserve and a counter-cyclical monetary policy helped smooth the business cycle. While the United States had experimented with central banks previously, the Federal Reserve was not created until 1914. Even then, the Fed didn't achieve credibility until after the Great Depression. In the lead up to the 1930s, it frequently stumbled on how to introduce policy.
- 2. The changing composition of our economy.** For the first half of the 20th century, the U.S. was a manufacturing-based economy, producing merchandise such as cars, consumer appliances and industrial goods. Over the last 50 years, the economy has become more service-based. Better inventory management and the shift to services have helped expand the market cycle as capital flows more efficiently throughout the economy.



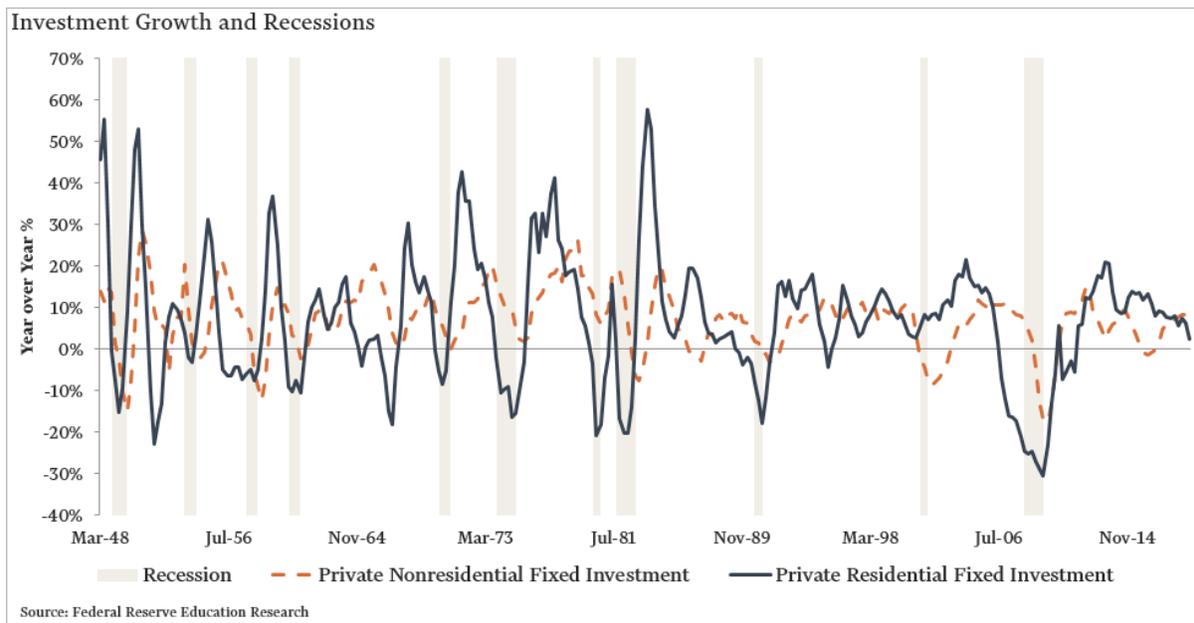
The expansion of the credit system, especially post-1971 when President Nixon de-pegged the dollar from gold, has also played a role in changing the business cycle. As a result of all these shifts, the U.S. is experiencing longer periods of growth and shorter recessions.

## The Recession Playbook

While personal consumption makes up approximately 70% of the U.S. economy, fluctuations in investment typically drive recessions. According to a Capital Economics study of 45 recessions in developed countries since 1960, tight monetary policy is the number one catalyst for recessions.

The story goes as follows:

- As the expansion matures, the economy overheats, and inflation pressures begin to rise. The Federal Reserve, attempting to fulfill its inflation-fighting mandate, tightens monetary policy.
- As interest rates rise, rate-sensitive sectors such as housing weaken and the economy begins to contract. You can see in the chart below that declines in residential investment (housing) have led to recessions.



- Credit conditions tighten leading to a feedback loop that restricts lending to borrowers, further depressing investment. The inversion of the yield curve (measured by the difference between the 10-year and 2-year Treasury rate) signals tightening conditions in the financial economy.



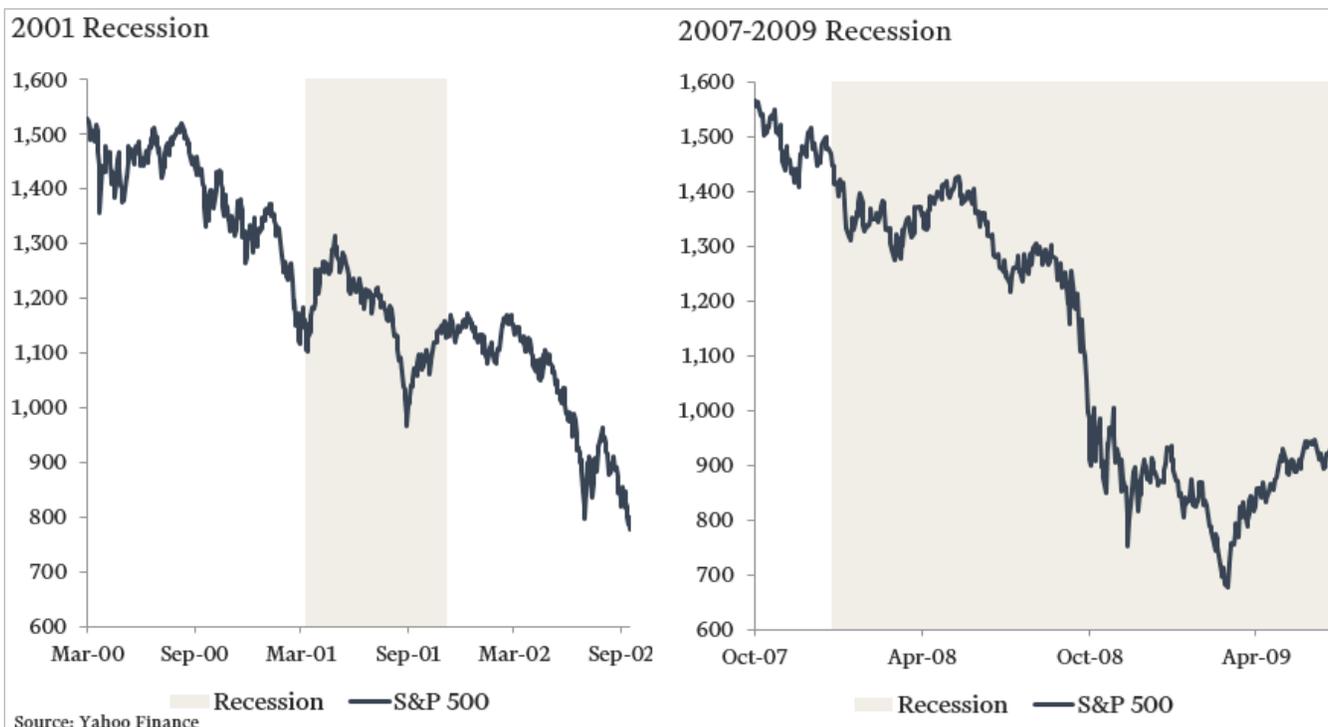
- Eventually, the process reverses itself as asset prices fall too far, and expectations become too pessimistic. Financial conditions ease as the Fed loosens monetary policy, investment picks up, and the economy starts to grow.

### Making Their Own Rules

When we talk about the prospect of a recession, we have to be mindful that, despite the playbook, not all recessions are alike or have the same impact on the markets. Take the last two recessions for example.

The 2001 recession was unique in that it did not involve a contraction in consumer spending or residential investment. The economy enjoyed a massive technology boom in the software and telecommunication sectors. Alongside the boom was a massive speculative bubble in technology and internet stocks. Ultimately, the over-investment led to a severe contraction in capital expenditures. The recession was shallow and short (8 months), and from beginning to end, gross domestic product (GDP) declined just 0.4%. However, the impact on the equity market was painful and lasting. The bear market from 2000 to 2002 persisted for more than 900 days and took the market down 49%.

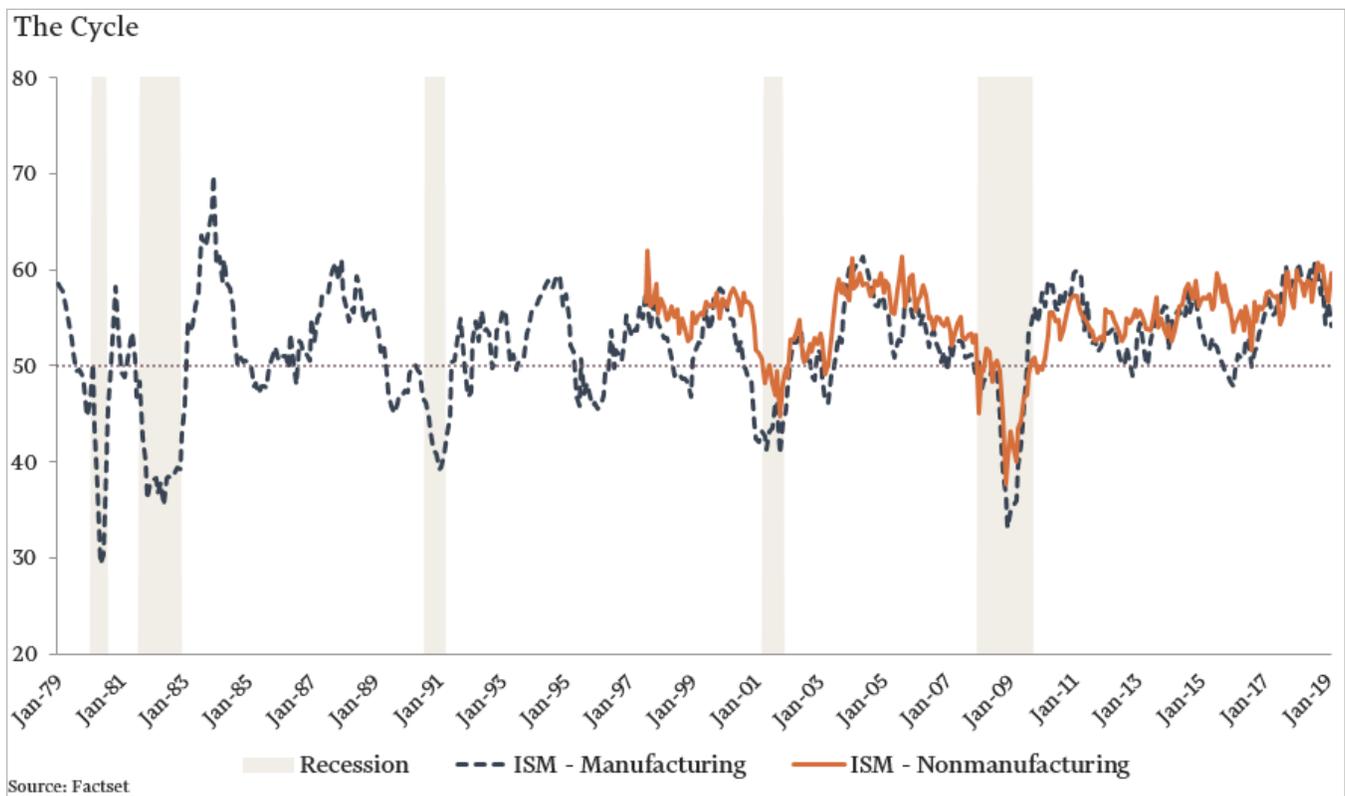
Contrast that with the 2008 recession, the largest financial crisis since the Great Depression. It followed the typical playbook of an over-build and contraction in the housing sector. The difference this time was that the weakness bled into the financial sector, causing a modern day banking panic. Like the 2001 recession, the equity market experienced a severe crash, dropping 57%. However, the economic impact was deeper; GDP contracted 4%.



## Today's Climate

U.S. economic data released over the last two months point to a slowdown in growth. Analysts have lowered estimates for S&P 500 Q1 earnings, now forecasting a decline in year-over-year growth. Of the biggest threats to the economy coming into the year, a Fed policy error now looks unlikely in the short term. The Fed has backed off its gradual tightening path and has now signaled it may be close to its neutral rate. Currently, inflation remains in control and below the Federal Reserve's 2% target. The rest of the global monetary and fiscal regimes are not far behind. China has introduced a series of fiscal initiatives to boost growth in the past three months, and the European Central Bank announced another round of its lending program to ease financial conditions.

Slow growth is still growth, and signs do not point to a recession in the near term. The entire yield curve has yet to invert, and the housing markets appear to be recovering. Lastly, the Institute for Supply Management (ISM) data, viewed as a leading economic indicator, is above 50 for manufacturing and services, a sign the economy is still growing.



### Three Areas to Watch

Rather than attempting to predict the exact timing of the recession, it may be better to ask the question, what could be different compared with the historical recession playbook? The answer will likely depend on any developments in:

- 1. Monetary Policy.** The Fed remains an ever-present threat to misstep by over-tightening. The unprecedented size and breadth of monetary policy make mapping out the duration of the economic cycle more complicated. It is unclear how large of an effect the historically aggressive policy has had in accelerating growth and in turn, what the economic consequences will be once these policies are fully unwound.
- 2. Corporate Debt.** While households have largely deleveraged and banks have strengthened their balance sheets, nonfinancial corporate bonds have exploded to \$5.7 trillion. This trend raises the risk of increased defaults from the corporate sector, impacting the broader economy and causing a reduction in capital expenditures.
- 3. China.** This country is not only struggling with the ultimate outcome of tariff negotiations with the U.S. but with the ongoing need to restructure its economy away from an investment focus. Over the last decade, China has played an important role in stabilizing the global economy alongside the U.S. While the U.S. continues to dominate the global economy, China's influence is gaining. The markets saw a glimpse of this during the 2015-2016 destabilization of the yuan, and during the latest market sell-off, reflecting renewed concerns about Chinese growth. Typically, U.S. recessions have spread outward to the rest of the global economy. This may be changing with slow Chinese growth impacting the U.S. economy.

None of this is to imply we are currently headed for trouble, but only to help investors think about how the next recession could differ from prior episodes.

### Forget Baseball

Perhaps investors have adopted the wrong analogy in likening the business cycle to a baseball game. Even though baseball games can go to extra innings, the majority only last nine. The business cycle, however, has no predefined length. The current expansion is noted not only for its longevity but also for its lackluster growth. Each cycle comes attached with a specific set of circumstances that define its shape. Eventually, a recession will come, but there is no ironclad rule of when that day will arise.

As investors, we accept the risk of cyclical risk whenever we invest in assets, such as stocks, that derive their value from future economic prospects. Since the global crisis, investors have become much more attuned to the macro-economic backdrop and have attempted to time and position their investments around shifts in the economic cycle. Many have tried their hand at calling market tops or even the next recession. There have been episodes (2011, 2015-2016) where the economy looked to be on the precipice of a recession but continued to chug along.

Looking out over the next six months, we do not foresee a recession, but that can change unexpectedly. The more important consideration is the risk investors are taking in their portfolios. As the December equity market plunge reminded us, risk comes at us suddenly. Make sure you are prepared.

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