Partner Talk®

PMA
PRUDENT
MANAGEMENT
ASSOCIATES

July 2019

Do Not be Distracted from Your Plan by Recession Talk

Keith J. Hardman, CFP

khardman@prudentmangement.com

The current U.S. economic expansion that started after the global financial crisis troughed in June of 2009 is now, as of July, the country's longest on record. Crossing the decade mark makes many analysts and policymakers think that this economic growth simply *must* be nearing its end. The very real possibility however is that this present economic expansion may linger on for a bit longer. Ironically, the current uncertainty in the markets (due to trade, etc.) might hold a silver lining by holding back investments and therefore possibly preventing, or at least delaying, the excesses that often occur in the late stages of an economic cycle. Banks, chief executives and investors are now more cautious about commitments of capital and this has actually helped reduce the market's normal boom-bust behavior.

As my PMA colleague Jonesy Lerch stated in last month's *Partner Talk*, "With inflation seemingly under control, the consensus is that a recession is unlikely in the near term." Indeed there is little indication that the U.S. economy is on the verge of falling into recession, although, of course, recessions can commence with no apparent warning. While volatility in the stock market may continue to increase with lingering threats of trade wars and recent weak employment data, there are real indications that the economy can continue to expand for a significant period of time. One particularly salient reason for this conclusion is a persuasive argument that "financial cycles" last longer than the more traditionally conceived "business cycle."

For example, Jon Sindreu (writing for the WSJ), states that, "When economists talk of the 'business cycle,' they usually refer to the ebbs and flows in gross domestic product. These swings are often thought to be the result of companies overestimating their future sales by investing too much and then going through a period of cutting costs that leads to lower output growth and employment. Business cycles have historically happened at intervals of between five and eight years, so the current expansion is indeed an abnormally long one." Mr. Sindreu then argues that these business cycles are themselves contained within longer cycles which economists call “financial cycles”. These cycles have typically lasted from thirteen to eighteen years. The natural conclusion of financial cycles are the result of companies and households taking on too much debt and being forced into defaults. As the famed economist Hyman Minsky hypothesized, “Economic stability breeds instability.” And we now have data (since 1985) to support the idea that business cycles have become smoother but these larger financial cycles more damaging.

While the risks are building, it is hard to say exactly what will cause the next recession because each one happens in its own different way. Sindreu points to one current example of a new risk being the astonishing amount of money flowing into private assets such as leveraged loans and direct lending. Fundraising in these private lending markets saw a record high of $5 trillion in 2018, double the amount from ten years ago. This build-up of illiquid assets by asset managers cannot be ignored. Still, the risk for investors of a near term recession does not appear to be high. Even if the Federal Reserve does not cut interest rates in the near future, they do seem prepared to do so if deemed necessary, increasing the possibility of an even more extended business cycle.

Another current debate is over not the timing of the next recession but its severity. In Guggenheim Investment’s April 2019 piece on “Forecasting the Next Recession”, they take a quantitative approach to forecasting recessions. Severity can be measured in several ways: magnitude (peak to trough decline in GDP), size of output gap (difference between real GDP and potential GDP), peak relative unemployment rate, or the simple length of time the recession lasts. Guggenheim points out that “the 2007-2009 recession was one of the worst of the post-war period, exceeded only by the ‘double dip’ recession of 1980-1981. In contrast, the 2001 recession was mild by comparison.” Guggenheim’s analysis indicates that the next recession should be about average. They note that the housing market is not currently overheated and the banking system is sound. Also, Fed policymakers will be scrutinizing each economic data point and may act quickly to avert any slowdown. A longshot certainly but there is even a possibility that we see a return of the infamous quantitative easing or ‘QE’.

Of the numerous recent articles published in the financial press on this issue, I recommend “What an Inverted Yield Curve Means for the Stock Market” by Larry Swedroe, included in this month’s mailing. While yield curve inversions (meaning short term bonds pay greater interest than long term bonds) have been seen by many as a signpost for a forthcoming recession, Swedroe argues that the current monetary policy remains supportive of economic growth and that fiscal policy is quite stimulative. And, as Swedroe points out, in periods following an inversion of the yield curve the U.S. stock market has experienced lower returns than historical averages, but returns were still positive. Swedroe convincingly argues that even if an inverted yield curve can be a sign that a recession is on the horizon, it is not a reliable enough indicator that one can prudently use to profitably time the markets. In many ways this talk of inverted yield curves and impending recessions just adds to the ‘noise of the market’ that can distract investors from sticking to their long-term strategies for meeting their investment goals.

The PMA investment committee meets again in July, we will review our allocations and weigh the risk and probabilities of a recession. While we remain optimistic about the economy and future corporate earnings, we do understand that the risks are building towards an eventual economic slowdown. We will continue to monitor these developments closely. PMA continues to stress the importance of diversification and controlling for risk. If you have questions about any of this, please do not hesitate to contact us to discuss.