



Recession Watch

Is the longest expansion in American history about to expire? A time-honored financial indicator recently sparked more interest in that question, but concerns over the economy's direction had been growing for several months. True, the headline data suggest there is little to worry about. After staging a deceptively strong 3.1 percent growth rate in the first quarter, gross domestic product slowed to a still-respectable 2.1 percent annual rate in the April-June period. Most private forecasters expected the economy to downshift from the vigorous pace seen in 2018, which was stoked by tax cuts and increased government spending. That fiscal thrust is now waning and will provide even less, if any, support next year. But until fairly recently it was widely believed that the economy could sustain growth in the neighborhood of 2.0 percent or so through at least next year, which would be consistent with the nation's growth potential.

But that perception of smooth sailing has been shattered in recent months as shockwaves from overseas fueled by mounting trade tensions have sent the financial markets into convulsions, including wide swings in stock prices, plunging bond yields and the brief inversion of an important segment of the yield curve, with the yield on the 10-year bond falling below that on the 2-year Treasury security in mid-August. That inversion has preceded six of the last six recessions, so its occurrence for the first time since just before the Great Recession understandably put investors on edge and coaxed many more recruits to join the recession-watch crowd.

While it would be a mistake to deny the ominous signals pointing to a downturn, it is far from clear that the economy is poised to fall of the cliff. It takes a lot to drag a \$19 trillion economy into recessionary waters, and the depressants seen so far are not powerful enough to do the job. That said, economists are notoriously bad at predicting when a recession will occur, so it's understandable that the more predictable signs of a looming downturn – such as the inverted yield curve – are receiving heightened attention. But just like humans, those signals are bad in predicting the timing of a recession. What's more, they may not be as relevant in these unusual times. Here's why.

A Reliable Barometer

On August 14th the yield spread between the 10-year Treasury bond and the 2-year Treasury note turned negative. It was the first time since June 2007, six months before the onset of the Great Recession and financial crisis that the yields on these two maturity sectors of the yield curve flipped. Not surprisingly, investors and traders also flipped out, sending stock prices into fits of convulsions as expectations of a looming profit-crimping recession gained

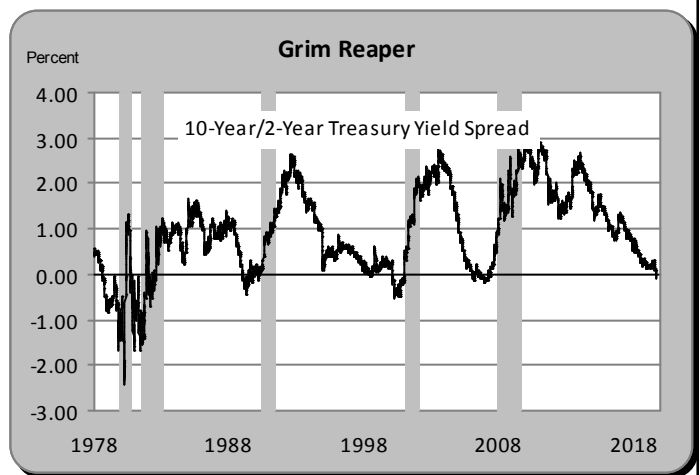
traction.

The slope of a yield curve is a time-honored barometer of investor expectations regarding the economic outlook. The more positive it is – i.e., the wider the spread between long and short-term yields – the more confidence investors have that growth will be stronger in the future and inflation will be higher. Conversely, when short-term rates exceed long-term rates, just the opposite mind-set prevails. Investors expect growth to weaken and inflation to move lower, which would prod the Federal Reserve to cut interest rates. The expectation of lower interest rates encourages investors to lock in the higher yield on longer-term bonds now. That, in turn, becomes a self-fulfilling prophecy, as the increased demand for longer-term bonds drives up their price and sends their yields lower.

The inversion of 10-year/2-year yields in mid-August only lasted a day, and the stock market rallied when the spread turned positive later in the week. But recession fears have not completely subsided, as the incremental yield on the long bond remains slim and fragile. Another modest increase in demand for longer-term bonds could well turn the curve negative again and shake up the markets. As it is, the New York Fed's yield curve model gives more than a 30 percent chance that the economy will contract in 2020, more than double the odds of a few months ago

Don't Blame the Fed

Given its reliable history as a predictor of recessions, it would be foolish to dismiss the recent inversion as giving off a false signal this time, notwithstanding its brief appearance. However, even if the curve inverts again – a very real possibility – there



are compelling reasons to curb your anxiety that a recession is just around the corner. Simply put, it is important to understand why yield curves inverted in the past and how the current situation differs.

In each of the previous episodes when the yield curve inverted, the Federal Reserve was pushing up short-term rates in an effort to slow growth and ward off inflation. During those periods, both long and short term rates were rising, but the latter rose faster and eventually exceeded long-term rates. The growth-dampening efforts by the Federal Reserve contributed to the recessions that followed, but they would not have toppled the economy alone without help by outside forces. In every instance the curve inversion was accompanied by some form of shock, such as a spike in energy prices, a dot.com bust or the bursting of asset bubbles, most notably the speculative housing and mortgage-credit boom that ushered in the Great Recession and financial crisis.

Those negative influences are not in evidence now. The Federal Reserve stopped raising short-term rates last December and started cutting them in late July. In the past, it would continue raising rates even after the yield curve inverted. This time, the markets started to anticipate the cut during the spring and sent short-term rates on a declining trend well before the Fed actually reduced its short-term policy rate. Importantly, the anticipation of lower rates encouraged investors to lock in yields on longer maturity bonds, sending bond yields lower. Indeed, bond yields led short-term rates down, thus inverting the yield curve, in contrast to earlier episodes that featured rising interest rates throughout all maturities.

Global Forces

Aside from the fact that the Fed is supporting, not retarding growth as in past inversions, the other shocks that previously battered the economy are missing this time. The stock market has rallied strongly during the expansion, but few analysts believe that it is in bubble territory relative to corporate profits, which have also increased sharply. Likewise, home prices are far from the nose-bleed levels they were in 2006 and, more importantly, have not generated the mortgage debt buildup that nearly brought down the financial system in 2008. Oil prices are falling, not spiking, as are many other commodity prices.

No doubt, the deep slide in bond yields that underpinned the atypical inversion of the yield curve has reflected growing pessimism regarding the economic outlook. That downbeat mindset as well as lowered inflation expectations has encouraged investors to lock up their funds for a longer time at prevailing yields, expecting still lower rates in future years. But the strong demand for U.S. Treasury notes and bonds is more than just a measure of how investors feel about the U.S. economy.

Keep in mind that as low as bond yields in the U.S. are, they are still comfortably higher than long-term rates overseas. Indeed, there are \$16 trillion of foreign bonds that are actually yielding less than zero, i.e. having negative interest rates. By comparison, U.S. Treasury securities are an attractive investment option and, hence, are luring in copious amounts of foreign capital. Nor is it just higher relative yields that are attracting overseas funds. The U.S. economy may be slowing but it still stands tall relative to those abroad. The German economy contracted in the second quarter and may be leading Europe into a recession, production in China is slowing dramatically, output in the U.K. also declined in the second quarter and Britain's struggles are only intensifying as a possible no-deal

Brexit is rapidly approaching in October. Simply put, the U.S. financial market is a compelling safe haven for global investors, and strong foreign demand for Treasury securities – the safest of all assets — is contributing mightily to the decline in rates.

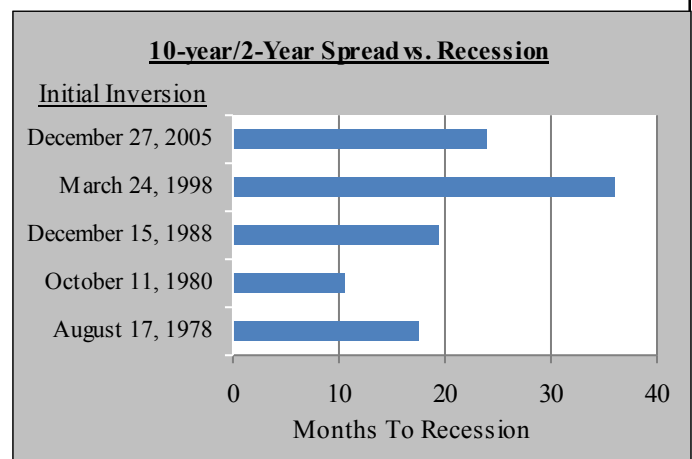
This Time May Be Different

Time will tell if the yield curve inversion is once again accurately foreshadowing a recession. Given its reliable history of doing so, the knee-jerk reaction in the financial markets is understandable. However, there are a few caveats that make the situation different this time. First, the inversion is being driven by an intense global flight to safety, which is more reflective of deteriorating economic conditions and geopolitical unrest overseas than in the U.S. This capital flight could subside, particularly if the additional stimulus that global central banks are either now or poised to implement steadies the global economic ship.

Second, the U.S. central bank is not sitting idly by as the signals from the financial markets flash recession warnings. Unlike in the past when the Fed continued to tighten after the yield curve inverted, it is now doing the opposite; following the July rate cut, it sent a strong message that further reductions are in the offing, the next as soon as mid-September. This ongoing monetary easing should provide a buffer against global headwinds that are crimping growth.

What's more, the extreme pessimism that has contributed to the sharp decline in bond yields in recent months appears to be overblown given the current state of the economy. The labor market continues to churn out new jobs at a healthy pace, wages are rising and consumers are spending freely, as evidenced by a solid retail sales report for July. Hence, if a recession is in the cards, the trigger won't be households, at least not in the foreseeable future. But trade tensions and global crosscurrents are taking a serious toll on business investment spending, which has been put on ice this year. That's not enough to send the economy into a downturn, unless the business retrenchment leads to worker layoffs that would undercut household confidence and spending, the economy's main source of strength.

That said, even if the inverted yield curve turns out to be prescient, it says virtually nothing about when a recession would start. In previous episodes when the 2yr/10yr yield inverted, the lead times to the next recession was long and variable, ranging from 10 months to 3 years, with an average lag of 21 months. .



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	<u>July</u>	<u>June</u>	<u>May</u>	<u>April</u>	<u>March</u>	<u>February</u>	<u>January</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
<i>Prime Rate</i>	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.00
<i>3-Month Treasury Bill Rate</i>	2.10	2.17	2.35	2.38	2.40	2.39	2.37	2.40	2.03
<i>5-Year Treasury Note Rate</i>	1.83	1.83	2.19	2.33	2.37	2.49	2.54	3.00	1.83
<i>10-Year Treasury Note Rate</i>	2.06	2.07	2.40	2.53	2.57	2.68	2.71	3.15	2.06
<i>30-Year Treasury Bond Rate</i>	2.57	2.57	2.82	2.94	2.98	3.02	3.04	3.36	2.57
<i>Tax-Exempt Bond Yield</i>	3.45	3.50	3.57	3.82	3.96	4.22	4.21	4.32	3.45
<i>Corporate Bond Yield (AAA)</i>	3.29	3.42	3.67	3.69	3.77	3.79	3.93	4.22	3.29
<i>Conventional 30-Year Mortgage Rate</i>	3.77	3.80	4.07	4.14	4.27	4.37	4.46	4.87	3.77
<i>Dow Jones Industrial average</i>	27089	26160	25745	26402	25723	25606	24158	27089	23806
<i>S&P 500 Index</i>	2996	2890	2855	2904	2804	2755	2607	2996	2567
<i>Dividend Yield (S&P)</i>	1.96	1.96	2.10	1.95	2.01	2.04	2.08	2.22	1.87
<i>P/E Ratio (S&P)</i>	19.4	19.2	18.0	19.3	18.7	18.3	17.8	21.0	16.6
<i>Dollar Exchange Rate (vs. Major Currencies)</i>	91.7	91.6	92.6	92.3	91.9	91.4	91.8	92.6	90.0

* Monthly Averages

ECONOMIC INDICATORS

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								<u>High</u>	<u>Low</u>
<i>Housing Starts (In Thousands)</i>	1191	1241	1264	1270	1199	1149	1291	1291	1142
<i>New Home Sales (Thousands of Units)</i>		646	604	658	693	669	644	693	557
<i>New Home Prices (Thousands of Dollars)</i>		310	304	337	310	321	305	337	304
<i>Retail Sales (% Change Year Ago)</i>	3.4	3.4	3.0	3.8	3.8	1.9	2.6	6.4	1.4
<i>Industrial Production (% Change Year Ago)</i>	0.5	1.1	1.7	0.7	2.3	2.7	3.6	5.4	0.5
<i>Operating Rate (% of Capacity)</i>	77.5	77.8	77.8	77.7	78.4	78.5	79.0	79.6	77.5
<i>Inventory Sales Ratio (Months)</i>		1.39	1.40	1.39	1.38	1.40	1.39	1.40	1.34
<i>Real Gross Domestic Product (Annual % Change)</i>		2.1			3.1			3.1	1.1
<i>Unemployment Rate (Percent)</i>	3.7	3.7	3.6	3.6	3.8	3.8	4.0	4.0	3.6
<i>Payroll Employment (Change in Thousands)</i>	164	193	62	216	153	56	312	312	56.0
<i>Hourly Earnings (% Change Year Ago)</i>	3.0	3.1	3.1	3.2	3.2	3.4	3.2	3.4	3.0
<i>Personal Income (% Change Year Ago)</i>		4.9	4.9	4.9	4.7	4.7	4.5	6.1	4.5
<i>Savings Rate (Percent of Disposable Income)</i>		8.1	8.0	8.1	8.3	8.8	8.3	8.8	7.2
<i>Consumer Credit (Change in Blns. Of Dollars)</i>		14.6	17.8	17.5	9.9	15.6	17.0	25.1	9.9
<i>Consumer Prices (% Change Year Ago)</i>	1.8	1.6	1.8	2.0	1.9	1.5	1.6	2.7	1.5
<i>CPI Less Food & Energy (% Change Year Ago)</i>	2.2	2.0	2.0	2.1	2.0	2.1	2.2	2.2	2.0
<i>Wholesale Prices (% Change Year Ago)</i>	1.7	1.7	1.8	2.2	2.2	1.8	2.0	3.2	1.7



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