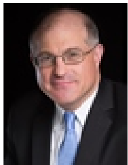
Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Could This Be the Catalyst for the Next Recession?



By Mitch Zacks
Portfolio Manager

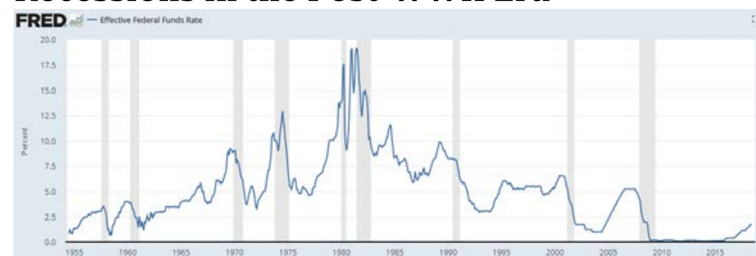
It may feel strange reading this, but it's been nearly a decade since the United States has endured a recession.[1] Economic growth rates have notably been modest throughout this expansion, and corporate earnings endured a whole year (2015) of negative growth.[2] But overall, millions of jobs were added, personal wealth has risen, the economy has grown, and stocks have delivered solidly positive cumulative returns. It's been an unloved economic expansion and bull market, but perhaps that's not a fair assessment. After all, growth is growth, and its been happening now for nearly ten years.

If the U.S. economy keeps growing for just 14 more months – which we expect that it will – it will become *the longest expansion in United States history.* Now that's something.[3]

Naturally, thoughts of the longest economic expansion have many thinking about **how long it can all really last**, and what the catalyst will ultimately be for the next recession. There are many possible causes of recessions, and the next cause may be one that no one anticipates. But in this piece, we want to explore one factor that has historically accompanied – and perhaps triggered – recessions in the post-WWII era: *rising interest rates.*

The chart below does much of the explaining for us. The blue line represents the effective federal funds rate, which is the interest rate set by the Federal Reserve in their management of monetary policy. The gray vertical bars in the chart represent recessions. Look closely at the chart and you'll notice a common trend: the blue line is generally rising in the lead-up to the gray bars. In other words, rising interest rates have preceded recessions in just about every instance since 1950.

Rising Interest Rates Have Preceded Recessions in the Post-WWII Era



Source: Federal Reserve Bank of St. Louis

Again, there are many causes of recessions, from sentiment-driven swings to financial crises to oil price spikes. But much research in the post-WWII era shows that perhaps the most frequent contributor to modern recessions has been monetary policy tightening, oftentimes in response to inflation that is caused by those other factors, like oil price surges.[4] While the Federal Reserve's intentions are almost always noble ones, the end result is increasing borrowing costs which hits the consumer and chokes off business investment and bank lending. Monetary policy is often a catch-22.

Perhaps the most memorable example of the relationship between interest rates and recessions comes from the experience in the 1980s. Many readers will remember that time, when buying a CD at a bank or taking out a mortgage meant double-digit interest rates. Inflation was a major concern at the time, and the Federal Reserve was actively raising interest rates in an effort to keep it in check. The argument follows that it was the Federal Reserve that triggered the July 1990 – March 1991 recession.[5] Raising interest rates too quickly choked off growth, in my view.

Why This Matters Now

As mentioned previously, we have an economic expansion now approaching ten years, with a Federal Reserve that has raised interest rates twice in 2018 and seven times since the end of the Great Recession. They have also issued guidance for two more rate increases before the end of the year, to the dismay of President Trump.

Perhaps the most notable difference to the 1980's is the inflation factor. Today, inflation has been steadily hovering around the target 2% and the labor market remains firm. The Federal Reserve appears to simply be using the opportunity of strong economic growth to normalize interest rates, since the nine hikes from the Great Recession have only served to pull interest rates off the zero bound.[6] The question is, how far will the Fed go, and will they go there too quickly?

Bottom Line for Investors

The Federal Reserve is likely to move even further into the public eye with President Trump weighing in on monetary policy, but in my view, it seems unlikely to shift their overall position – gradually raising interest rates assuming economic data remains firm and the U.S. economy remains at or close to capacity. With the Federal Reserve now issuing very clear and straightforward guidance, the element of surprise interest rate moves also seems more remote, which should help the market adjust expectations accordingly.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Bloomberg, February 6, 2018, https://www.bloomberg.com/view/articles/2018-02-06/don-t-forget-what-causes-a-recession

[2] FactSet, July 20, 2018, https://insight.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_072018.pdf

[3] Blomberg, February 6, 2018, https://www.bloomberg.com/view/articles/2018-02-06/don-t-forget-what-causes-a-recession

[4] ZeroHedge, June 24, 2017, https://www.zerohedge.com/news/2017-06-24/goldman-finds-most-modern-recessions-were-caused-fed

[5] The National Bureau of Economic Research, July 24, 2018, http://www.nber.org/cycles.html

[6] The New York Times, June 13, 2018, https://www.nytimes.com/2018/06/13/us/politics/federal-reserve-raises-interest-rates.html

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