Mitch on the Markets

Do You Know What Recession Indicator is on the Rise?

By Mitch Zacks
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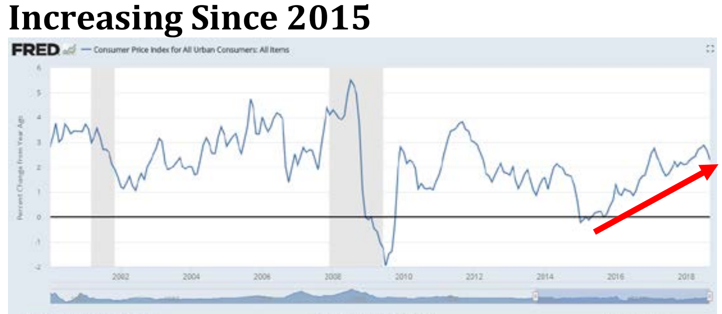
The signs are everywhere – inflation is on the move. The economy has been humming on the heels of the tax cut, labor markets are tight, and the consumer remains optimistic. I think these factors, combined with pricing pressures from wages and tariffs, are all contributing to the firming inflation we've been seeing – and may continue to see going forward.

The numbers bear it out. Corporations from every corner of the U.S. economy are raising prices on a range of goods from paint to plane tickets to Jimmy John's sandwiches (+6% for a turkey sandwich) and Starbuck's coffee (+8.9% for a "Grande"). Apple Inc. recently increased prices on their new MacBook Air and iPad Pro gadgets by about 20% and 25%, respectively.

In Q3 earnings reports, airlines reported paying about 40% more for jet fuel versus a year ago, and trucking companies saw a stout 7% jump in September from costs a year ago. In the private sector at large, the Labor Department reported a 3.1% increase in wages and salaries in the quarter ending September 30th. U.S. manufacturers reported paying roughly 8% more for aluminum and 38% more for steel than a year ago, a majority of which can be attributed to tariffs.[1] Companies ranging from JetBlue, to Chipotle, to Unilever, to Procter & Gamble and UPS have all indicated plans to raise prices in the future.[2]

All told, I could see core U.S. inflation rising to a post-recession high sometime next year, which could mean approaching the 4% level within twelve months.

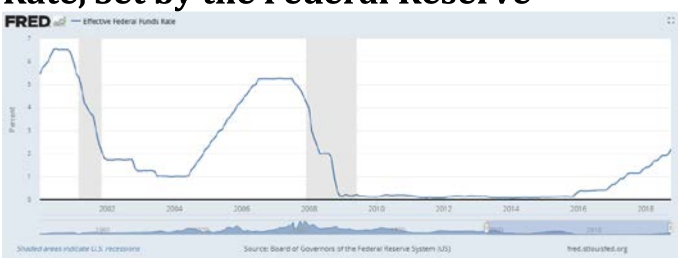
Figure 1. Inflation has been Steadily Increasing Since 2015



Source: Federal Reserve Bank of St. Louis

Inflation by itself is not necessarily a recession indicator. It's what comes with – and after – inflation that can hurt the economy. Most readers will probably know what I'm referring to: **rising interest rates.** By comparing the chart below to the chart above, you can see how rising inflation has spurred rising interest rates at the Federal Reserve, which has peaked before recessions in the past.

Figure 2. The Effective Federal Funds Rate, Set by the Federal Reserve



Source: Federal Reserve Bank of St. Louis

Much like inflation, rising interest rates alone do not necessarily cause recessions. But rising rates can lead to adjustments in consumer habits and business investment, which combined can be a drag on economic activity. Borrowing becomes more expensive for consumers, housing activity tends to soften, spending slows, and businesses become more reluctant to borrow and invest.

But perhaps most importantly, higher interest rates give investors another option in the search for yield. In the era of near zero interest rates that followed the Great Recession, investors were arguably left with little choice in their search for yield and capital appreciation. Bonds were of little use, and investors turned to equities instead. As that trend perhaps unwinds with rising interest rates, we could see less enthusiasm for equities in a world of higher rates.

Is It Time to Get Bearish?

Using the Consumer Price Index for all Urban Consumers (CPI) as the metric for inflation, we note that the September year-over-year reading came in at 2.3%, according to the Bureau of Labor Statistics.[3] At the end of October, the yield on the 10-year US Treasury was 3.15%.[4] The napkin math tells us that puts the inflation-adjusted yield at a meager 0.85%, which is far from a desirable return.

In the 20-year period preceding the financial crisis and the 2007-09 recession, the 10-year Treasury bond yield and the CPI averaged 6.1% and 3.1%, respectively, which gave investors an average inflation-adjusted yield of around 3% over that time.[5] In short, I expect the 10-year Treasury to keep going up and for the inflation-adjusted yield to keep rising with it, but I don't necessarily expect investors to ditch stocks and head for Treasuries right away.

Bottom Line for Investors

Many of the narratives surrounding rising inflation and rising interest rates tend to overly frame these two factors as imminently bearish, or at least right around the corner from being bearish. But I tend to think a bit differently about the issue, and consider the Federal Reserve's tightening regime as largely squared with economic growth and inflation trends. In other words, for the time being, I think there's a good balance between what's happening with interest rates, inflation, and growth.

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] The Wall Street Journal, October 31, 2018. https://www.wsj.com/articles/companies-raise-prices-betting-consumers-can-pay-more-1540978200
[2] The Wall Street Journal, October 26, 2018. https://www.wsj.com/articles/are-companies-price-increases-painting-them-into-a-corner-1540566598?mod=article_inline
[3] Bureau of Labor Statistics, November 6, 2018, https://www.bls.gov/cpi/
[4] U.S. Department of The Treasury, November 6, 2018, https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2018
[5] The Wall Street Journal. October 3, 2018. https://www.wsj.com/articles/a-looming-recession-look-at-interest-rates-1538603219