Mitch on the Markets

Are the Signs Pointing Toward a Recession?

By Mitch Zacks
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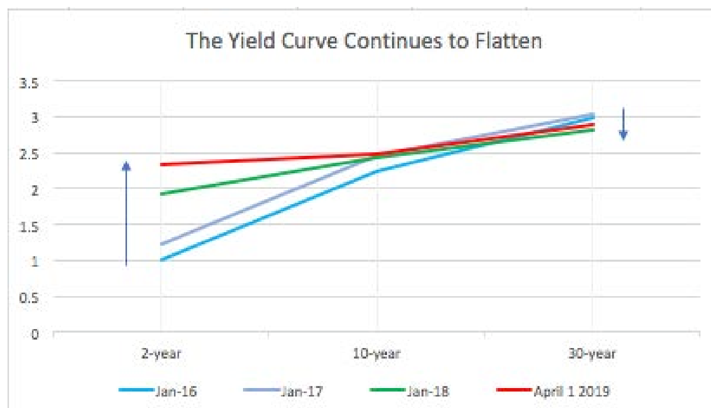
Investors were legitimately spooked in March, as a few of the most influential recession indicators were flashing SLOWDOWN.

1) The Yield Curve:

With the exception of a single instance, an inverted yield curve has preceded each U.S. recession in the last 50 years. On March 22, the yield curve inverted for the first time since mid-2007 (which, we needn't remind investors, was just before the biggest recession in a generation.)[1]

This most recent yield curve inversion was likely the result of a few factors, from the Fed's 2018 interest rate increases, to low inflation expectations (based on slowing global growth), to investors seeking out U.S. Treasuries as safe havens and as sources of yield, particularly as Brexit woes continue and German bond yields recently turned negative. In fact, I would argue that the European Central Bank's continued efforts to stimulate the European economy has played a not-insignificant in the current state of the US yield curve.

Even still, as you can see from the chart below, the yield curve has been flattening over several years, arguably as the expansion loses steam and as an inevitable end to the business cycle approaches:



Source: U.S. Department of the Treasury

On balance, however, it's also important for readers to note that an inverted yield curve *does not always* result in a recession, and we believe the current yield curve inversion looks more like a "U-shaped" curve (see red line in the chart) than an inverted one, which distinguishes it even further from 'traditionally' inverted yield curves of the past.

2) U.S. Corporate Earnings:

With earnings growth expectations for Q1 2019 already in negative territory, and estimates for Q2 2019 moving in that direction as well, there is growing talk of an impending earnings recession.

Earnings worries are coming at a time when many market participants are already wondering whether the current economic cycle can in fact become the longest in U.S. history, a milestone that could be reached later this summer. Earnings estimates have sown doubt on that possibility, as the chart below shows:[2]

To be fair, the baseline comparison for earnings this quarter are the Q1 2018 earnings that received a major boost from lower corporate tax rates. Perhaps a fairer comparison and/or measure of corporate health would be to look at revenue growth versus earnings growth, which when done shows that the corporate earnings "recession" may not actually be one after all. Even still, negative earnings growth can weigh on investor sentiment, which could ultimately matter to stock prices.

Revenue Growth Hasn't Dropped Off Meaningfully

3) Leading Economic Indicators:

The Leading Economic Index for the United States compiled by the Federal Reserve Bank of Philadelphia has been a reliable recession indicator for decades. The index measures data from state-level housing permits, state initial unemployment insurance claims, delivery times from the Institute for Supply Management (ISM) manufacturing survey, and the interest rate spread between the 10-year Treasury bond and the 3-month Treasury bill, among other factors. As you can see below, most of the time when the Leading Index dips below 1%, a recession has followed shortly thereafter. While the Leading Index is currently above 1%, it's also plain to see that it may have peaked in 2014 and is now drifting downward:[3]

Source: Federal Reserve Bank of St. Louis

On balance, however, it's important for readers and investors to note that at the end of the day, the stock market historically remains one of the best leading indicators of the economy. The key in terms of the market's movement relative to economic data is not whether the economic outlook is positive or negative, but rather *whether the economic expectations already being priced into the market are met or exceeded.* In my view, the market rallied during Q1 2019 not because the economic data was tremendously positive, but rather because the data was not as negative as the market was expecting at the end of 2018.

Bottom Line for Investors

I would take the recent strength in the market to indicate that the likelihood of a bad or disruptive Brexit and the potential for an increase in the magnitude of a trade war - both of which would weigh negatively on earnings materializing - are much less likely to materialize than previously believed. At the start of 2019, most of these fears – Brexit, trade war, etc. – arguably faded and dwindled, while valuations became more attractive with the sell-off. The end result were expectations being reset and investors realizing that equities were all of a sudden attractive again.

There's reason to believe positive sentiment towards equities could continue, as well. Policy makers in the U.S., Europe, and China appear to be tuned into the signals being given by the various indicators, as the Federal Reserve has essentially stopped its gradual interest rate increases, the European Central Bank has eased monetary policy, and China has engaged in fiscal stimulus in both forms – cutting taxes and increasing spending.

The next phase for investors will be to watch each indicator closely in the next quarter or two, and also to see if any of these monetary and fiscal efforts may shift market expectations about prolonging the expansion.

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] CNBC, March 25, 2019. https://www.cnbc.com/2019/03/25/the-us-bond-yield-curve-has-inverted-heres-what-it-means.html

[2] Zacks.com, March 20, 2019. https://www.zacks.com/commentary/362428/weak-earnings-growth-ahead

[3] Federal Reserve Bank of St. Louis, March 11, 2019. https://fred.stlouisfed.org/series/USSLIND

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