# Mitch on the Markets

## Recession Risk Factors No One is Talking About

By Mitch Zacks
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Most reporting I've seen on the risk of economic recession and market volatility continues to focus on U.S.-China trade relations, which I would agree is a big deal. But here's what I also believe: *Investors should assume that known risks are already reflected in stock prices*.

If we really want to identify a trigger for the next recession/bear market, I think we need to look for underappreciated risks that no one is talking about. So, while the U.S.-China trade dispute concerns me, I would today classify it as a known risk with fairly weak pricing power.

Below, I'll give three examples of underappreciated risks that we believe investors should keep an eye on when trying to identify factors that could end the cycle. This is not to say that any of these three risks will imminently end the expansion – it is more of an effort to guide investors for how to potentially identify risks that no one is talking about.

**Risk #1: Concentration of Power and the Risk of Regulation**

One risk I'm watching more closely is the concentration of power – and market capitalization – in just a handful of technology names. Within the technology sector alone, Microsoft, Apple, Google, Amazon, and Facebook comprise *about 50% of the entire sector's market capitalization.* Those five companies also make up about a quarter of the entire U.S. stock market.[1]

The last time that technology companies held so much clout in the stock market was, you guessed it, during the tech bubble in 2000. Back then, technology companies made up about one-third of the entire U.S. stock market, and most readers can remember what happened when investors bid-up valuations far too high.

In the current cycle, I would argue that the problem isn't that valuations are too high or that the biggest technology companies do not have stable, solid earnings – they are very profitable enterprises and investors can make a good case to pay-up for future earnings.

I would argue, however, that with so much market share concentrated in the hands of just five companies*, the risk of regulation* looms larger and has potentially bigger consequences on earnings than most market observers are acknowledging.

To date, making the case for more regulation on technology has been difficult. Many of the biggest technology companies either offer free services or are selling goods whose prices remain competitive. Old antitrust laws focused on preventing companies from growing so big that they could control pricing power and remove competition. Today, even as technology companies have gotten bigger, the hardware, software, and services have gotten better, and no one is complaining about price.

But even as consumers enjoy free services and improving products, there has been growing skepticism about other ways tech companies make money: by collecting data on your daily activity, interests, and even movements. In the modern economy, data is currency, and technology companies have scores of it (often unbeknownst to the consumer).

Regulation seems inevitable, and it's actually one of those rare areas in politics with bi-partisan support. Overseas, Europe has already taken formidable regulatory action with the enactment of the General Data Protection Regulation, or GDPR. GDPR covers everything from giving users much more control over their personal data, to setting standards for how corporations can collect and use user data, to setting fines for tech companies in violation of the laws (already in the hundreds of millions). It may also provide a template for future U.S. law.

**Risk #2: Sustained Weakness in the Cass Freight Shipments Index**

The Cass Freight Shipments Index[2] is one of those little known leading indicators that has historically been pretty good at predicting economic contractions. After all, tracking how much freight is moving across the country and across the world should offer good insight into demand trends across the global economy.

In December 2018, the index turned negative for the first time in 24 months, and has posted negative readings in every month since. At issue, too, is that the negative readings are fairly sizable: -6.0% in May, -5.3% in June, -5.9% in July.[3] The last time the Cass Freight Shipments Index had sustained negative readings was in 2015, which many readers may remember was a flat year for the S&P 500.[4] Shipments rebounded in 2016 (as did the stock market), but with the economy currently mired in a trade war during an economic cycle that is arguable stretched, it will be important to watch how shipments shape up in the back half of the year.

**Risk #3: Risky Mortgages are Back in Large Numbers**

The abundance of subprime mortgages and their inclusion into risky derivative products were at the root of the 2008 Financial Crisis. In short, banks were taking excess risk on borrowers with low income and poor credit, then hedging their risk through derivative collateralized debt obligations.

The subprime loans of 2007 are now referred to as "non-qualified" or non-QM loans, but they are just as abundant – and growing. Borrowers took out $45 billion in non-QM loans in 2018, which is the highest number seen since just before the crisis in 2008. The numbers are growing. In Q1 2019, $2.5 billion worth of non-QM loans were issued, which is more than double the figure for Q1 2018 and marks the highest level of issuance since the end of 2007.[5] To be fair, the biggest banks are shunning most of this loan business, leaving it to non-bank lenders. But this is still a trend worth watching.

## Bottom Line for Investors

As of now, the trade war with China has no end in sight, but it's been so widely disseminated at this stage that I believe the risk is priced into asset prices. The three examples detailed above should give investors a better idea of the types of risks that you should be looking for: little known, little discussed factors that could do harm to the broad economy if they got materially worse. These are the types of risks to keep a closer eye on.

**About Mitch Zacks**

Mitch is the CEO & Senior 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 Economist, August 10, 2019. https://www.economist.com/graphic-detail/2019/08/10/silicon-valleys-giants-look-more-entrenched-than-ever-before

[2] The Cass Freight Index uses January 1990 as its base month. The index is updated with monthly freight expenditures and shipment volumes from the entire Cass client base. Volumes represent the month in which transactions are processed by Cass, not necessarily the month when the corresponding shipments took place. The January 1990 base point is 1.00. The Index point for each subsequent month represents that month's volume in relation to the January 1990 baseline.

Each month's volumes are adjusted to provide an average 21-day work month. Adjustments also are made to compensate for business additions/deletions to the volume figures. These adjustments help normalize the data to provide a sound basis for ongoing monthly comparison.

[3] Cass Information Systems, Inc. July 2019. https://www.cassinfo.com/hubfs/Freight%20Payment%20/Transportation%20Indexes/Cass%20Freight%20Index/Reports/Cass%20Freight%20Index%20Report%20-%20July%202019.pdf?hsCtaTracking=5fde9be4-1dd0-462f-8c5f-b100aca52fc1%7C0990f099-885d-442a-972a-aeb259c5a188

[4] J.P. Morgan, Guide to the Markets, July 31, 2019. https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-the-markets/viewer

[5] The Wall Street Journal, August 21, 2019. https://www.wsj.com/articles/mortgage-market-reopens-to-risky-borrowers-11566379802

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