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Assessing Recession Risks

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"The report of my death was an exaggeration."

Mark Twain (Samuel Langhorne Clemens) wrote those words in a letter to a reporter who was responding to reports he was gravely ill while on a speaking tour in London in May of 1897. He clarified that his health was fine but that his cousin in London had been ill; that may have been where the mix-up originated.

Over the years, many have taken literary license with Twain's initial reaction, saying he quipped that, "Rumors of his death were greatly (or grossly) exaggerated." That may be more colorful, but the point is clear: The rumor mill got ahead of reality. Mark Twain was quite well and did not pass for another 13 years. The detail about his cousin is also important because it indicates that although the rumor was wrong, it did have some foundation in truth: Someone in the family was ill.

The quote and what led to it provide a useful metaphor for where we are in the economic cycle. Financial market participants got ahead of themselves, fearing a recession at the turn of the year. They weren't entirely wrong in their fears that a family member was ill. China's slowing economy was spreading to the rest of the world. Threats of a full-blown trade war initiated by the administration exacerbated those fears.

That was something Federal Reserve Chairman Jay Powell underestimated during his press conference following the December Federal Open Market Committee (FOMC) meeting. He assumed that the much anticipated downgrade to growth and rate hikes in the FOMC's economic forecast would be enough to calm financial

Tariff Threats Complicate Outlook

Real GDP surged a whopping 3.2% in the first quarter but for the wrong reasons. More than half of those gains can be attributed to yet another rise in already bloated inventories and a temporary improvement in trade. Imports dropped in response to weak domestic demand. Consumer spending slowed to a crawl. Business investment moderated. Government spending bounced back with a rebound in spending at the state and local levels.

Prospects for the second quarter are not as good. Manufacturing activity has slowed while inventories are drained. Consumer spending is likely to bounce back as long as the full spectrum of tariffs threatened by the administration does not take effect. Investment will remain subdued as firms wait for the outcome of pending trade negotiations with Europe and Japan. We expect the trade deficit to widen as imports return. Government spending should get an extra lift as the federal government finally catches up on delays created by the shutdown. Real GDP is expected to rise 1.7% in the second quarter, almost half the pace of the first quarter.

What Would Prompt the Fed to Cut? The Federal Open Market Committee (FOMC) currently sees no reason to raise or lower rates. A sharp increase in tariffs and the turbulence that would trigger in financial markets could prompt a preemptive cut, but not immediately. The FOMC has historically been quick to respond to extreme market turbulence, but has less room to maneuver than it once did. It is unclear that financial markets have fully priced in this constraint to market valuations. The Greenspan put is dead.

> “The bilateral nature of trade agreements, with tariffs as the only mechanism to enforce agreed upon rules, virtually ensures future trade wars.”

markets. What he didn’t expect, when he stated that the Fed’s balance sheet roll-off was on “autopilot,” was how tone-deaf his comments would sound in the context of what was happening in financial markets. Volatility was surging on growing uncertainty surrounding China, the world’s second largest economy.

Powell quickly pivoted and by early January clarified the FOMC’s intent. The committee would be “flexible” with regard to the balance sheet and “patient” with respect to rate hikes depending on the emerging headwinds.

Last week, Powell surprised markets again. The statement from the May meeting acknowledged that inflation has slowed to below the Federal Reserve’s target of 2%, something that has raised concerns that a rate cut may be necessary. Powell clarified during the press conference that we are not there yet. He saw nothing that would force the committee to lift or cut rates at the moment.

Then, as if on cue, the president threatened China with yet another round of tariffs on the eve of what many in financial markets saw as a deal emerging between the U.S. and China. We have long maintained that any deal would be temporary at best, given the divergent goals of the two countries. The bilateral nature of trade agreements, with tariffs as the only mechanism to enforce agreed upon rules, virtually ensures future trade wars. We have already seen ripple effects, which are global in scope.

This edition of ***Economic Currents*** take a closer look at the factors that could trigger a recession, where they exist on the spectrum of threats and what that suggests about the outlook for growth. The risk of a recession in 2020 remains elevated despite strength in the U.S. labor market. The outcome is totally avoidable and highly dependent on the actions of one individual, who is not Chairman Powell. If the Federal Reserve is forced to ease, it will not be due to overshooting but because of policy missteps.

Triggers

The following provides an assessment of potential triggers for a recession. The immediate threat of a recession has abated but not disappeared. The risks remain highest in 2020, at the height of the next presidential election. The financial crisis taught us that our elected officials would rather play politics than think critically about policy, especially in election years. Risk ratings are color coded like traffic lights: **GREEN**, **YELLOW** and **RED**.

Internal Shocks

Overshooting by the Federal Reserve

Risk Rating: YELLOW

Overshooting on interest rates is the most common trigger for a recession. The Fed would clearly like to avoid that blame this time around. Chairman Powell has even gone so far as to say that the goal of the Fed is to extend this economic expansion, given how low inflation remains. That is not an explicit part of the Fed’s mandate, which is to promote full employment and price stability, but unsurprising given the low level of inflation and the barrage of criticism the Fed has received from the White House. There is simply no reason to snuff out growth with inflation still well below the Fed’s 2% target.

Chairman Powell argues that the low level of inflation we are experiencing is transitory and due more to the residual of special factors and changes in the way inflation is measured than a rapid deterioration in the economy. He cited other measures of inflation that suggest the Fed is actually closer to its target than the Personal Consumption Expenditures (PCE) index suggests.

That said, the Fed would not hesitate to cut rates preemptively, but the threshold is extremely high. A 1.5% read on the core PCE or lower for the next three months, and/or a major escalation of trade tensions, added to a full-blown trade war with China, would likely prompt the FOMC to preemptively cut rates by September. That is not in our baseline forecast, given how many times the president has cried wolf with his threats to China.

It is, however, a real possibility considering other challenges he faces in Congress and his desire to stack up political, if not economic, wins ahead of the election. Trade wars are corrosive and take time to work their way through

> "Our trading partners are frustrated with the administration and its constant threats."

the economy. It is much harder to pin the blame for trade wars than it is to point fingers at Federal Reserve policy.

It is worth noting that the Fed is considering negative interest rates as a tool, should the economy falter. This was once considered taboo because of the impact that such a policy could have on the solvency of banks.

Overindebtedness

Consumer Debt Risk Rating: YELLOW

The mechanism by which higher rates tend to take a toll on the economy is debt. A surge in short-term debt reprices it at higher rates, which triggers defaults and in worst-case scenarios, bankruptcies. Then financial conditions tighten further in a vicious circle.

Consumer debt levels remain relatively well contained, at least for now, given the length of the expansion. The exception is student debt, which has already seen a jump in defaults. The good news is that the losses don't look as large or systemic as previous debt bubbles. The bad news is that the overhang of student debt is suppressing spending by millennials and generation Z. Together they account for more than 70% of the $1.4 trillion in student debt outstanding. That could magnify the next recession for younger households.

Corporate Debt Risk Rating: RED

Corporate debt is another story. It has not only surged to more than $9 trillion in recent years but the use of short-term and highly risky debt instruments has picked up. Almost one third of that debt is rated as junk; the next tranche is just above the level considered investment grade and could easily drop in status with the economy.

The Fed's most recent **report** on financial stability flags the vulnerabilities in the corporate debt market. Nonfinancial corporate debt has surged to $9 trillion, nearly one-third of which is rated junk. The next major tranche is investment grade but only just above junk status and at risk of a downgrade with a slowdown in growth. The use of short-term debt is on the rise again; this is where interest expenses have moved up the most. These are the markets that could seize up if financial conditions rapidly tighten.

Bubbles

Risk Rating: YELLOW

For several years, the Federal Reserve has worried that the commercial real estate market is showing signs of a bubble. The financial stability report emphasizes how rapidly prices have risen relative to rents. This is a red flag. Retail space is the most overbuilt with the restructuring from bricks to clicks triggering a surge in bankruptcies. Many have worried about the patience, or lack thereof, among private equity lenders.

Equity valuations are extremely rich, which makes them more vulnerable to small shocks. The turbulence we saw on fears of a full-blown trade war with China last December is a recent example.

There is substantial concern that low interest rates could fuel emerging bubbles. The Fed is walking a tightrope, trying to get inflation to its 2% target without triggering excessive risk-taking or additional bubbles.

Shadow Banking/Fintech

Risk Rating: YELLOW

Fintech is widely considered to be in its Wild West phase. Lending is opaque, which brings additional risks. The Fed worries that the new lending and payment platforms exist outside the purview of regulators and that consumers don't seem to appreciate the risks; they often do not differentiate between credit and cash applications.

Policy Missteps

Risk Rating: RED

Chaos across and within party lines and the policy missteps those could trigger are the greatest threats to the expansion. The number of forms they could take are mind-boggling and growing, mostly on the trade front.

The president could make good on threats to try to force the Chinese to step in line by further lifting and expanding tariffs on Chinese products. That would no doubt trigger

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retaliation, which has already taken a toll on everything from farming to manufacturing.

Even if the administration wins and manages to get the deal it desires from China, any ceasefire we see is likely to be temporary. Chinese negotiators will not give in to aspects of the agreement that they see as infringements upon Chinese sovereignty. China will likely violate terms. The bilateral (instead of multilateral) structure of the agreement has already left a void by the U.S. in its influence in Asia, which China has stepped in to fill.

The USMCA, which I have nicknamed NAFTA 0.5 for its regressive nature, is on thin ice. Even Republicans in Congress are threatening to abandon it. Republican Senator Charles Grassley of Iowa, who is a close ally of the president, drew a line in the sand in a recent **op-ed** he penned on the USMCA. He said the treaty is dead unless the president lifts current tariffs on aluminum and steel from Mexico and Canada. The president countered with threats of additional tariffs and quotas.

The result could be a reversion to the original NAFTA. That would not include much-needed upgrades to intellectual property rights. In a worst-case scenario, we could see an end to NAFTA entirely. That would almost immediately wreak havoc on global supply chains and idle plants on borders between the U.S., Canada and Mexico. It would also deal a severe blow to the rail and trucking industries.

Europe is weighing retaliation if/when vehicle and parts tariffs are levied. You can bet they will target American icons. Harley Davidson is already one of the most high-profile companies to suffer from retaliatory tariffs.

External Shocks

Brexit

Risk Rating: RED

The decision by the United Kingdom (UK) to leave the European Union (EU) is in a category of its own. Sometimes I have a hard time determining which of our two governments is more dysfunctional.

Uncertainty surrounding Brexit has taken a toll on the UK economy and produced high profile defections. Jaguar Range Rover recently announced plans to shift production to mainland Europe to avoid supply chain disruptions.

Our own in-house expert and former UK diplomat, Stephen Bridges, is hoping for a soft Brexit but not confident a hard Brexit can be avoided. A compromise would mean substantial costs for the UK, including the prospect of “leave” referendums in Northern Ireland and Scotland. A recent surge in violence in Northern Ireland, including the death of a journalist, underscores how important it is for the 1998 Good Friday peace deal to remain intact. An open border with Ireland is critical.

It is unclear how damaging the contagion from any form of Brexit would be for financial markets. Powell said the Fed is watching closely. Risks of contagion are not insignificant, given the close links we have with UK banks.

Overhang of International Debt

Debt levels across both developing and developed economies have surged since the crisis of 2008-09. That makes them more vulnerable to even small increases in rates and funding problems than earlier in the cycle. Italy offers a cautionary tale.

Bottom Line

We may have skirted a recession at the turn of the year but risks for 2020 remain high. Global uncertainty continues to rise in response to trade wars and geopolitical instability. China represents the greatest threat, as another round of tariffs could make it our sickest cousin.

China has already triggered a significant slowdown. Unlike Mark Twain’s cousin, who recovered and never infected the rest of the family, another round of tariffs of the magnitude the president is threatening could be contagious. The same is true of upcoming trade negotiations with Japan and Europe. Protectionism is a chronic illness that takes a toll over time and, if taken to extremes, can be lethal for the economies that engage in it.

Economic forecast — May 2019

	2018(E)	2019	2020	2018:4(A)	2019:1 (A)	2019:2	2019:3	2019:4	2020:1	2020:2	2020:3	2020:4
National Outlook												
Chain-Weight GDP*	2.9	2.5	0.7	2.2	3.2	1.7	2.0	1.7	1.7	-2.1	-1.2	1.6
Personal Consumption	2.6	2.4	1.4	2.5	1.2	2.6	2.4	2.3	2.2	-0.4	-0.5	2.1
Business Fixed Investment	6.9	3.2	0.2	5.4	2.7	0.8	2.7	3.0	1.8	3.8	-3.4	-0.3
Residential Investment	-0.3	-2.8	-1.2	-4.7	-2.8	-3.9	-0.3	2.1	-0.4	-3.7	-3.9	2.0
Inventory Investment	38.3	77.3	12.4	82.3	90.6	84.1	74.8	59.7	46.4	7.6	-19.4	14.9
Net Exports	-759.1	-753.2	-782.6	-797.3	-747.3	-752.3	-746.5	-766.8	-768.6	-779.5	-780.1	-802.4
Exports	4.0	2.5	2.5	1.8	3.7	1.8	5.2	5.0	4.3	0.3	-2.1	0.1
Imports	4.5	1.7	2.9	2.0	-3.7	2.0	3.1	6.5	3.5	1.6	-1.5	2.9
Government Expenditures	1.5	1.9	1.4	-0.4	2.4	3.2	1.5	1.3	1.3	2.4	0.0	0.3
Federal	2.6	2.5	1.7	1.1	0.0	6.9	2.4	1.5	1.3	4.0	-2.1	-1.8
State and Local	0.8	1.5	1.3	-1.3	3.9	1.0	1.0	1.2	1.3	1.4	1.2	1.5
Final Sales	2.7	2.3	1.1	2.1	2.5	2.2	2.4	1.9	2.0	-0.7	-1.0	2.9
Inflation												
GDP Deflator	2.2	1.8	2.3	1.7	0.9	2.2	2.3	2.2	2.4	2.4	2.4	2.1
CPI	2.4	2.2	2.1	1.5	0.9	4.4	3.0	2.2	1.8	1.5	2.0	1.2
Core CPI	2.1	2.2	2.3	2.2	2.3	2.1	2.3	2.3	2.3	2.4	2.2	2.1
Special Indicators												
Corporate Profits**	7.4	4.3	-3.0	7.4	7.7	7.1	4.5	4.3	3.0	-3.5	-5.5	-3.0
Disposable Personal Income	2.9	2.2	1.8	4.3	2.4	0.0	1.4	2.4	3.3	1.1	0.4	1.9
Housing Starts (mil.)	1.25	1.19	1.15	1.18	1.19	1.19	1.19	1.19	1.17	1.15	1.13	1.16
Civilian Unemployment Rate	3.9	3.7	4.1	3.8	3.9	3.7	3.6	3.6	3.6	3.9	4.3	4.6
Total Nonfarm Payrolls (thous.)***	2,394.0	2,034.0	-364.0	668.0	396.0	387.0	384.0	289.0	245.0	=293.0	-545.0	-428.0
Vehicle Sales												
Automobile Sales (mil.)	5.5	5.0	5.0	5.5	5.3	5.0	4.8	4.8	4.6	4.4	4.1	4.5
Domestic	4.0	3.6	3.3	4.0	3.9	3.6	3.5	3.5	3.4	3.2	3.1	3.3
Imports	1.5	1.4	1.2	1.4	1.4	1.4	1.3	1.3	1.2	1.2	1.0	1.2
Lt. Trucks (mil.)	12.0	11.7	10.4	12.5	12.0	11.8	11.2	11.2	11.0	10.3	9.8	10.4
Domestic	9.5	9.2	8.6	9.7	9.4	9.3	9.0	9.0	8.9	8.5	8.2	8.6
Imports	2.5	2.4	1.8	2.8	2.6	2.5	2.2	2.2	3.1	1.8	1.6	1.8
Combined Auto/Lt.Truck	17.5	16.6	14.8	17.9	17.3	16.8	16.0	16.0	15.6	14.7	13.9	14.9
Heavy Truck Sales	0.5	0.5	0.4	0.5	0.5	0.4	0.4	0.4	0.4	0.3	0.3	0.4
Total Vehicles (mil.)	17.9	17.1	15.1	18.4	17.8	17.3	16.4	16.4	16.0	15.0	14.2	15.3
Interest Rate/Yields												
Federal Funds	1.8	2.4	1.2	2.2	2.4	2.4	2.4	2.4	2.3	1.7	0.8	0.13
10-Year Treasury Note	2.9	2.6	2.4	3.0	2.7	2.6	2.7	2.7	2.5	2.5	2.4	2.3
Corporate Bond BAA	4.8	4.9	4.6	5.1	5.0	5.0	4.9	4.9	4.6	4.7	4.7	4.5
Exchange Rates												
Euro/Dollar	1.18	1.12	1.09	1.14	1.13	1.12	1.11	1.10	1.11	1.09	1.08	1.08
Dollar/Yen	110.4	109.6	108.6	112.8	110.1	109.8	109.5	119.0	108.9	108.7	108.6	108.0

[1] In 2017, GDP was $17148.8 billion in chain-

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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