Recession Risk Through Three Lenses

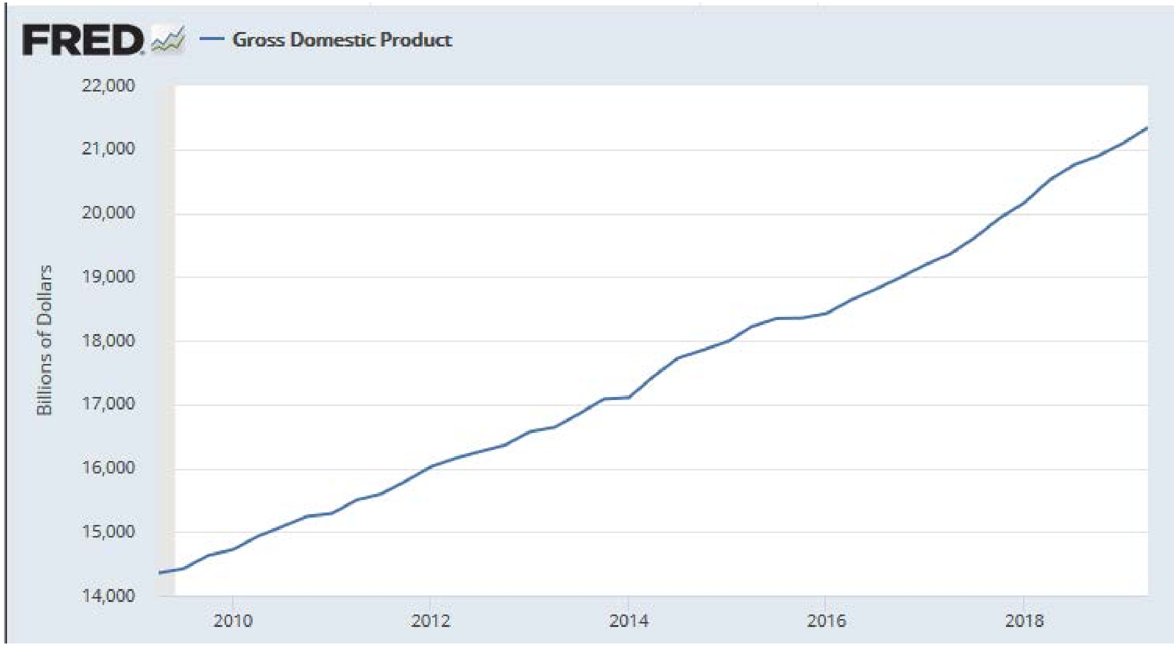
Presented by Dr. Dave Yeske, CFP®

Three Lenses

- Why do recessions occur and what are the warning signs?
- What is the impact on financial markets?
- What is the impact on your portfolio and finances (and how to manage it)?

The Longest Expansion on Record

- We're now in the 11th year of expansion in the U.S. following the Great Recession. Reason to be afraid?



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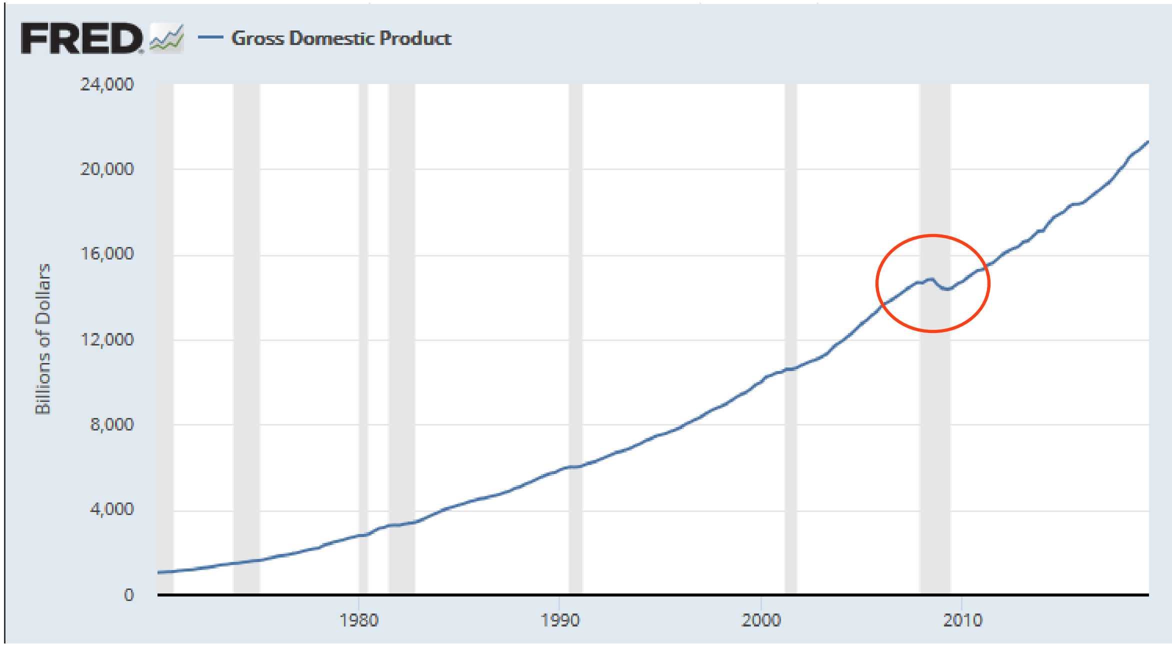


What is a recession?

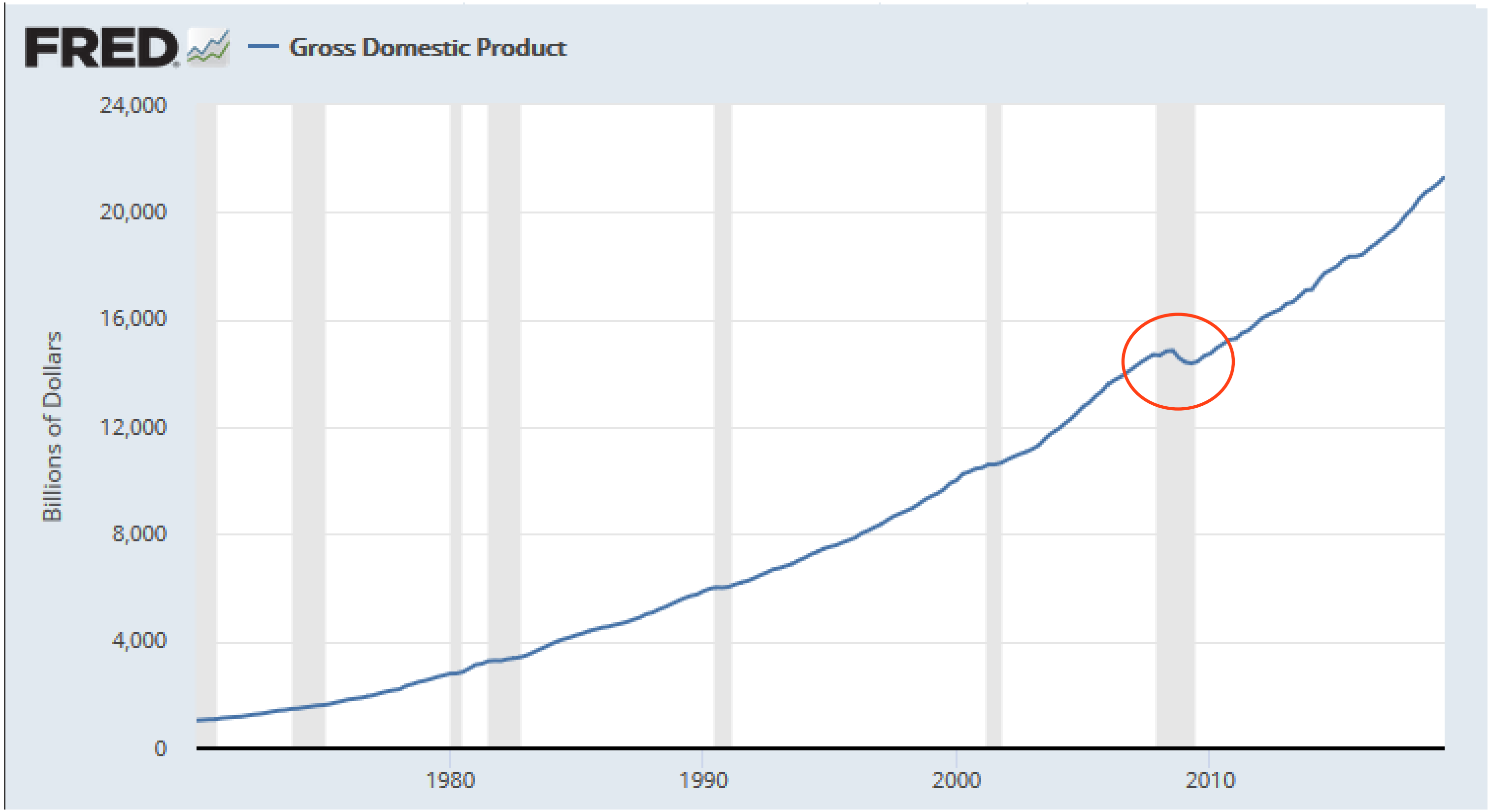
- National Bureau of Economic Research (NBER) definition:

  A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real ***GDP, real income, employment, industrial production, and wholesale-retail sales****.*

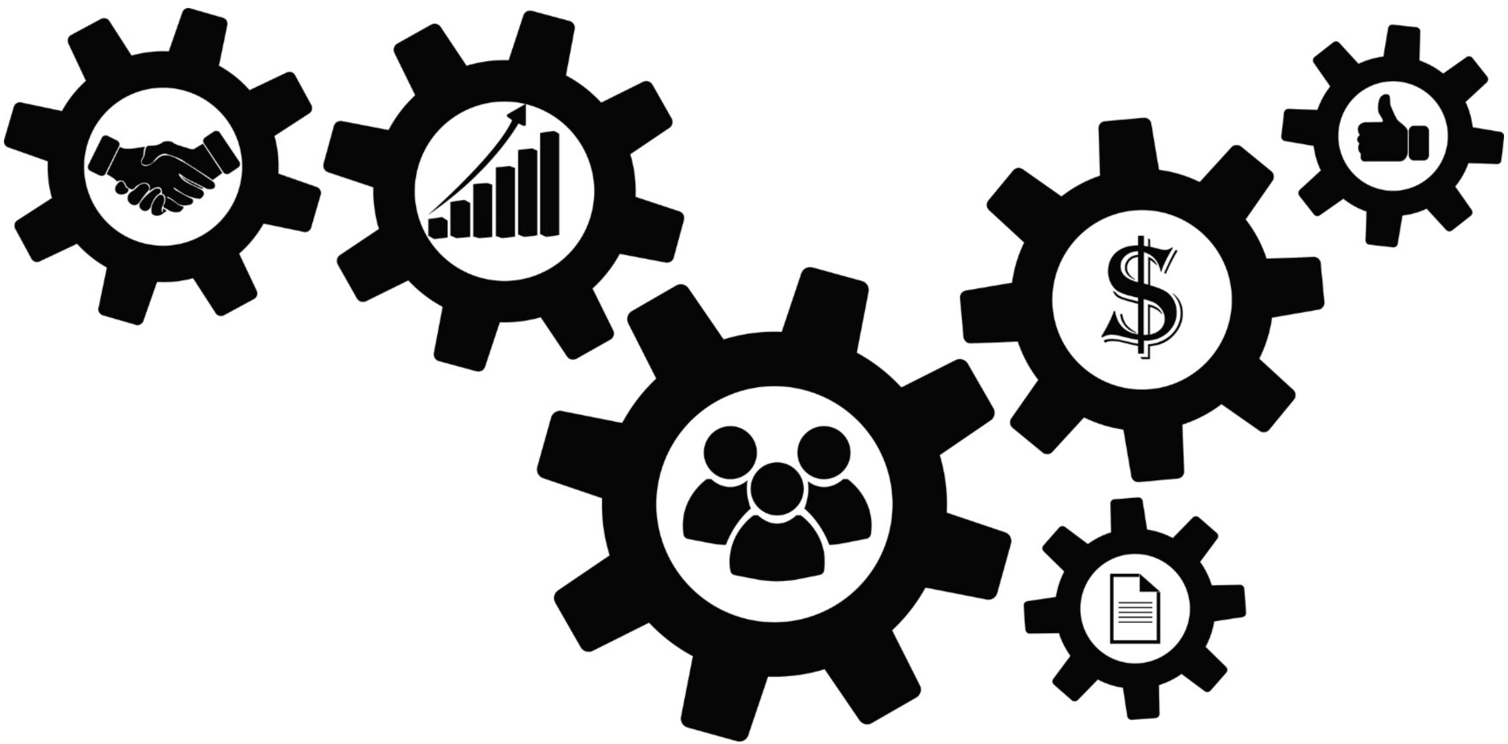
- Common definition:

  Negative economic growth for two consecutive quarters.

What is a recession?



What is “The Economy”?



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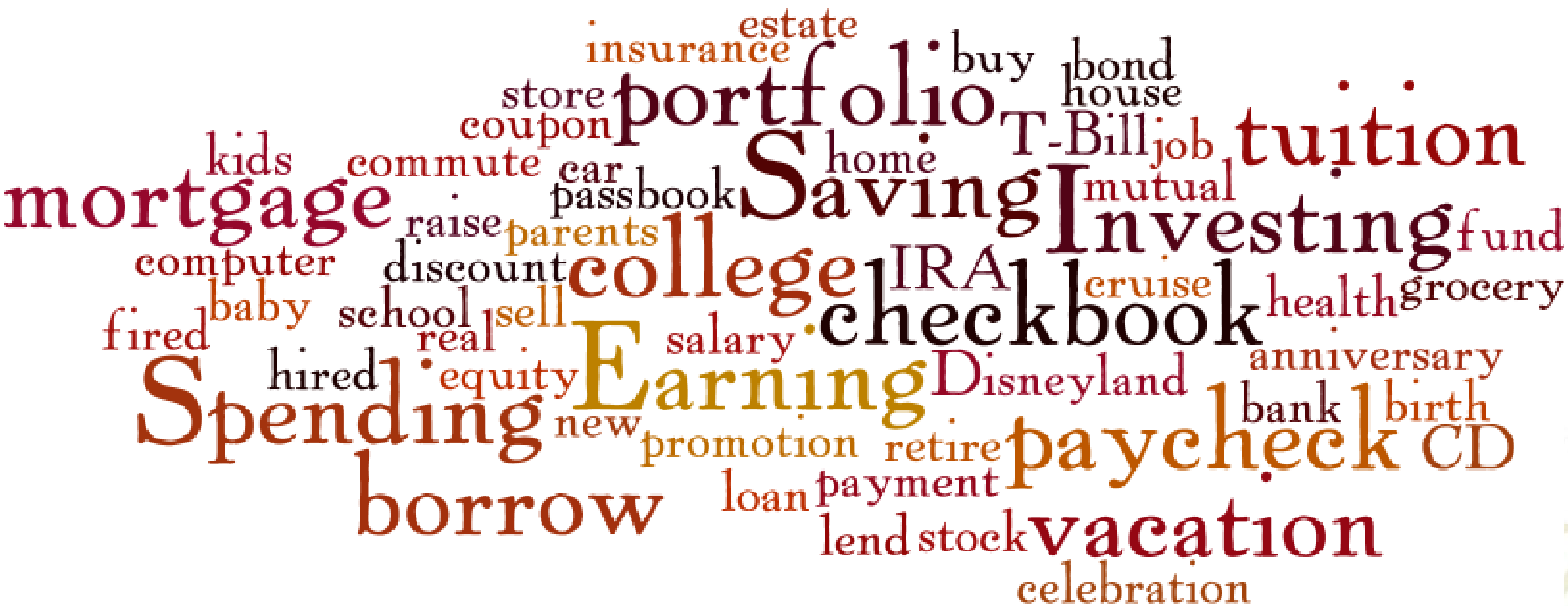

Why Do Recessions Happen?

Who creates a recession?

People Do!

Why Do Recessions Happen?

How do people create a recession?

Consumers buy less stuff, or

Businesses invest less, or

Both

Why Do Recessions Happen?

Why do consumers & biz spend less?

Higher interest rates, or

Change in sentiment, or

Both

Why Do Recessions Happen?

What causes higher interest rates?

The Federal Reserve, or

Bond investors, or

Both

Why Do Recessions Happen?

What causes a change in sentiment?

Shocks like a market crash, or

“Animal Spirits”, or

Both

Why Do Recessions Happen?

Or a trade war.

Why Do Recessions Happen?

What is the common theme?

Consumers & Businesses spend less, either

- Because higher interest rates, inflation, (or tariffs) made things more expensive.
- Or a shock (like a market crash) creates pessimism about the near future.

Why Do Recessions Happen?

Expansions do not die of old age

Can we see a recession coming?

- The economy is complex and chaotic and tends to offer only "noisy signals" about the future.
- We can get hints of what *may* happen but will only know for sure what the signals meant AFTER the outcome of interest has occurred.
- The difference between
  "statistical significance"
  and
  "predictive power."

What ARE those noisy signals?

- The Conference Board Leading Economic Index® (LEI)
  - Average weekly hours, manufacturing
  - Average weekly initial claims for unemployment insurance
  - Manufacturers’ new orders, consumer goods and materials
  - ISM® Index of New Orders
  - Manufacturers' new orders, nondefense capital goods excluding aircraft orders
  - Building permits, new private housing units
  - Stock prices, 500 common stocks
  - *Leading Credit Index*™
  - Interest rate spread, 10-year Treasury bonds less federal funds
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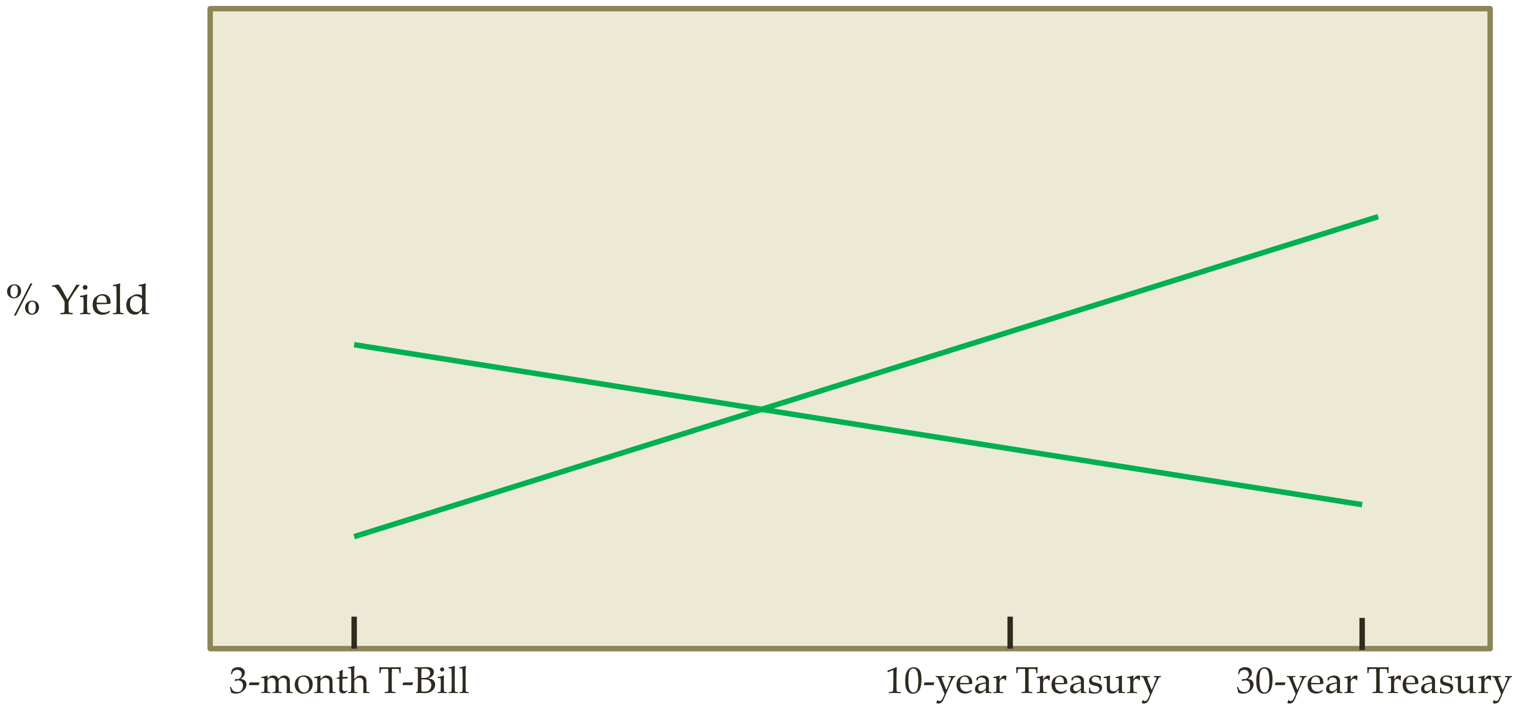
Inverted Yield Curve



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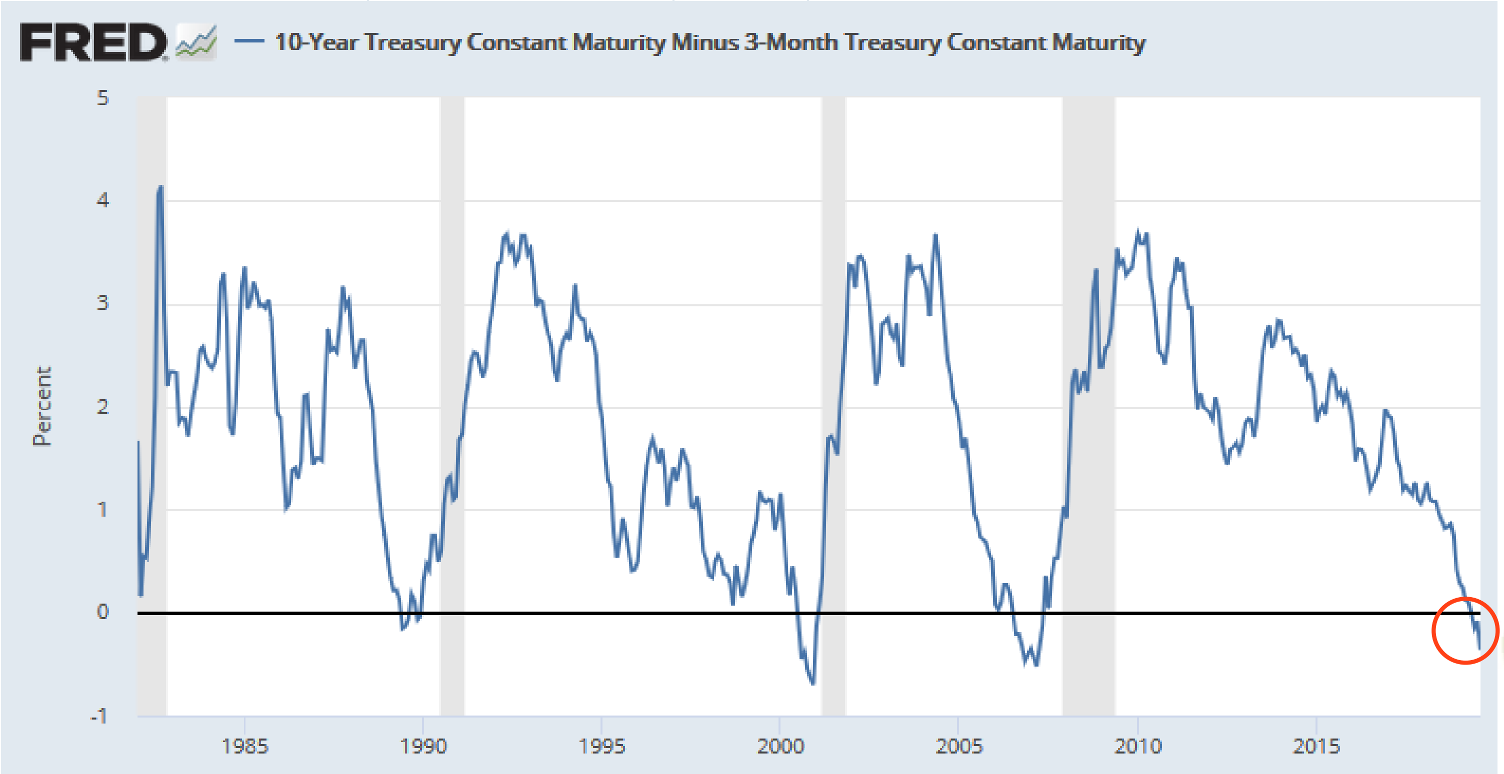

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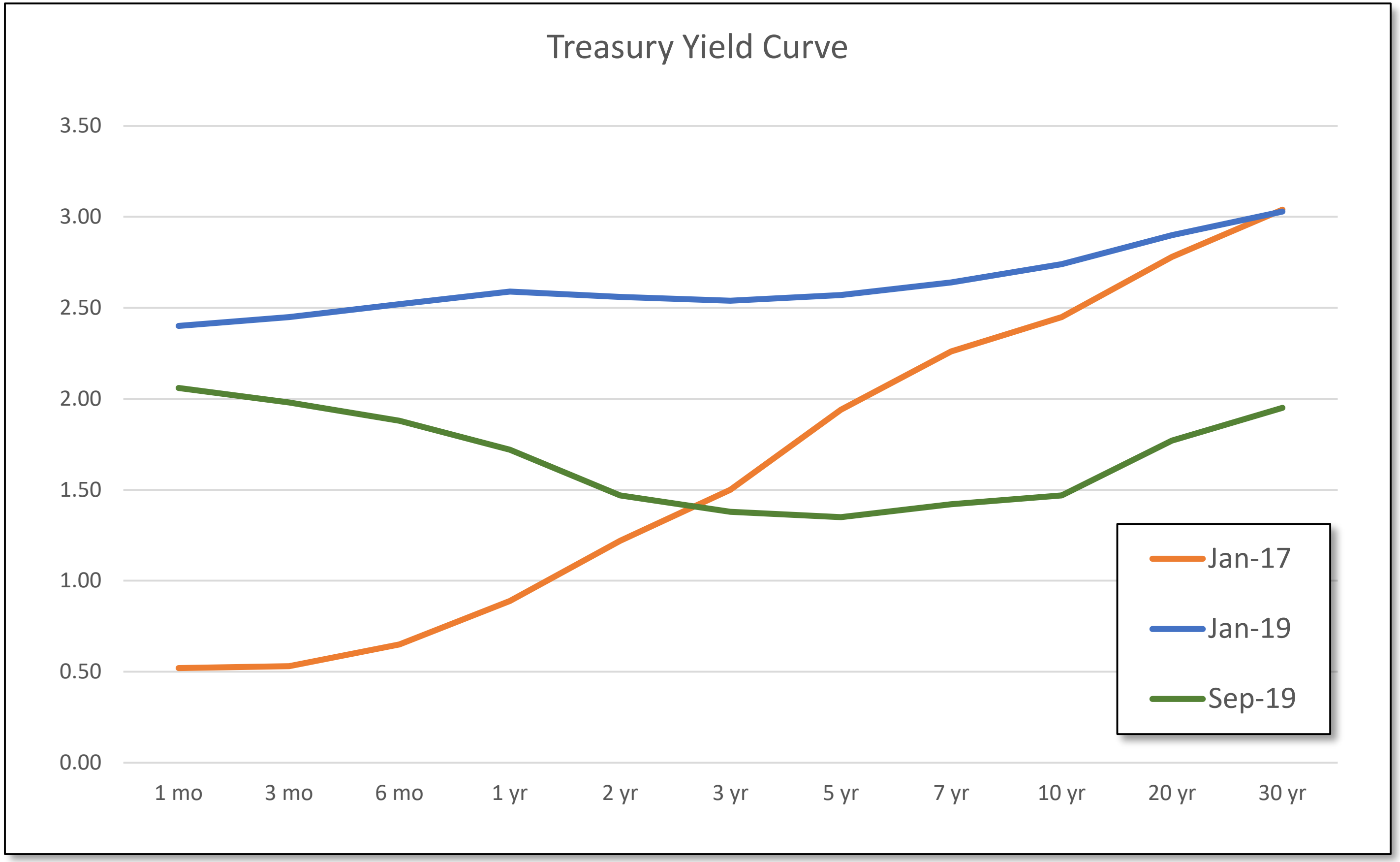

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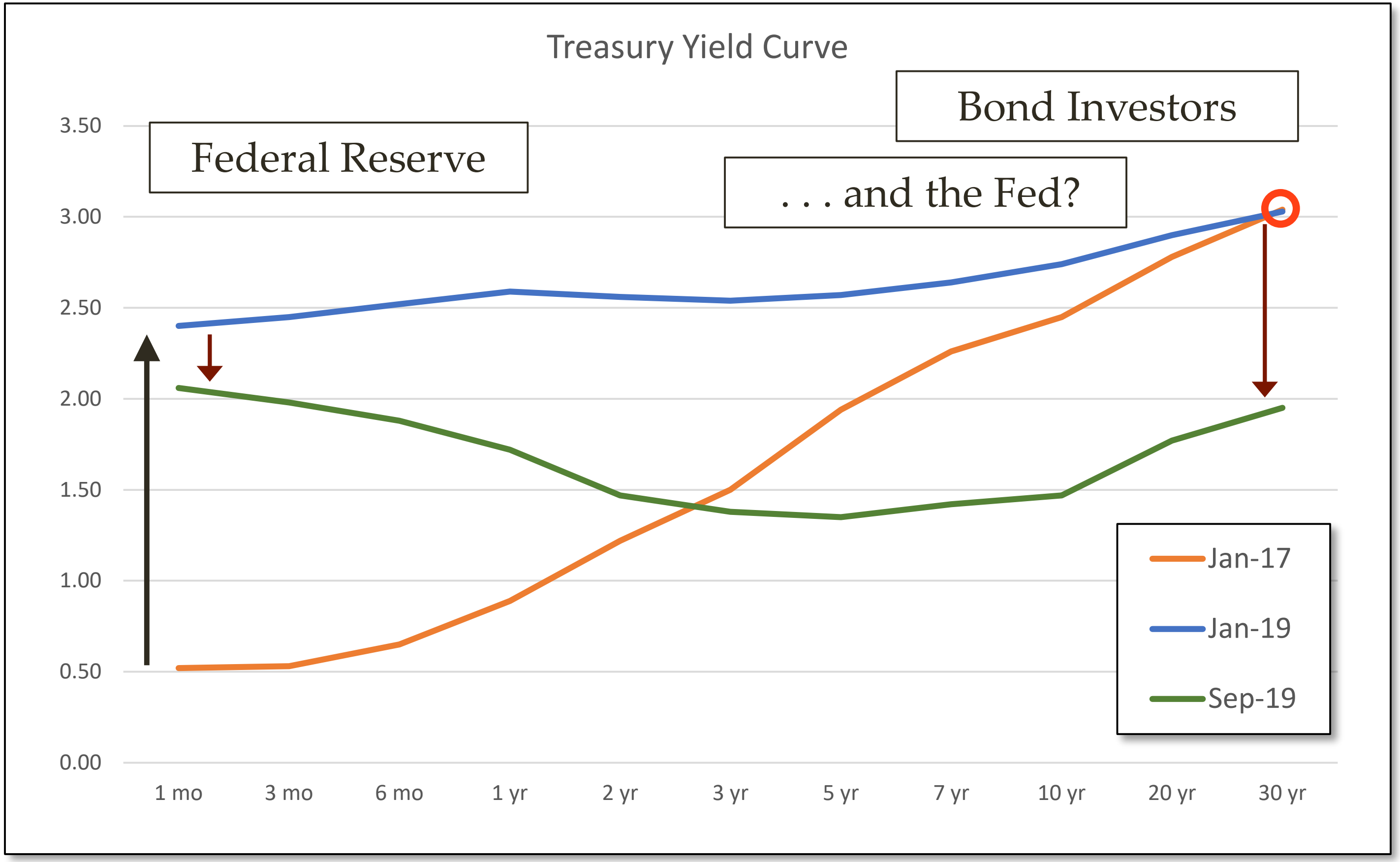
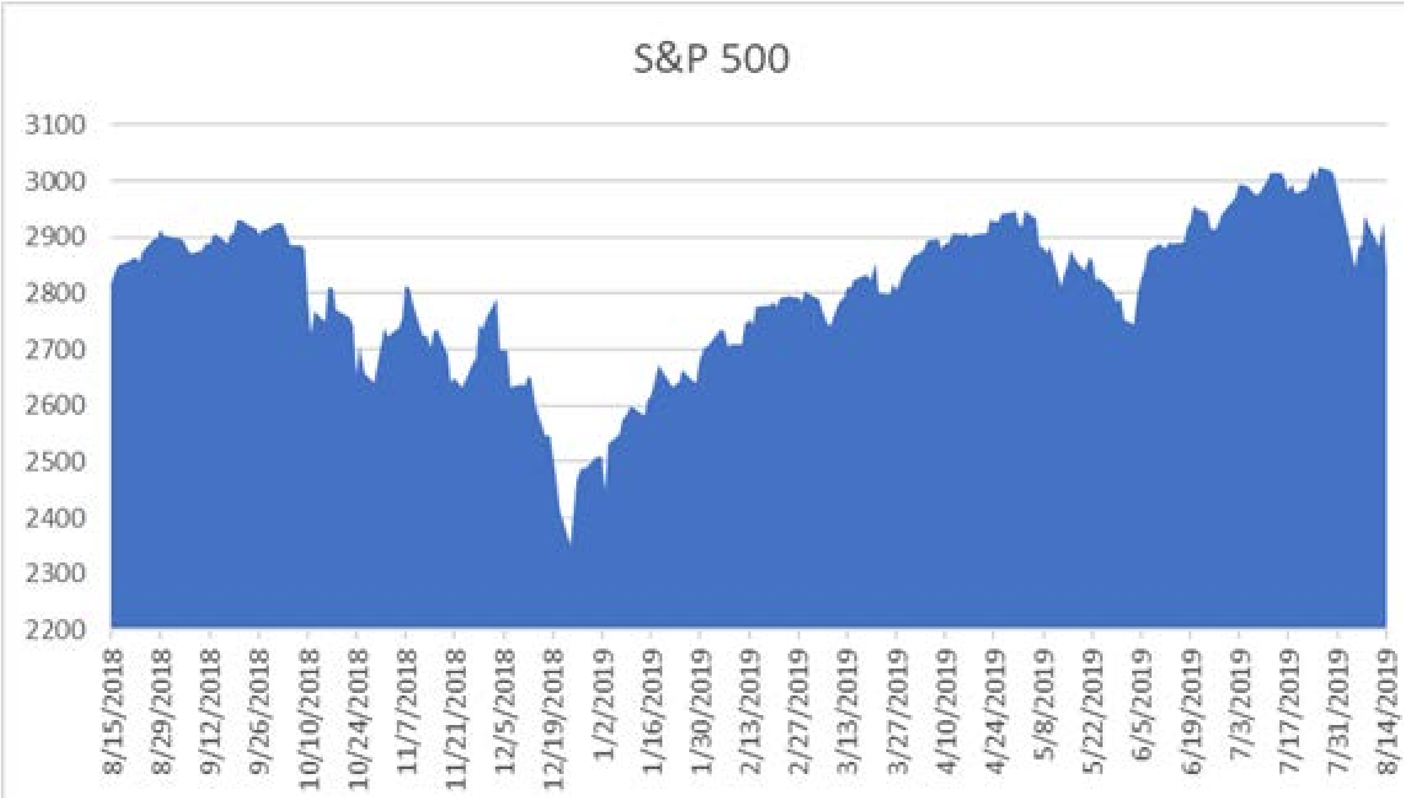


Inverted Yield Curve

- Why it may be less of a predictor than in the past:
- The Federal Reserve has been manipulating both ends of the yield curve for a decade, even if only passively on the long end now (unwinding QE).
- Expectations of bond investors. Are they expecting a slowdown/recession or simply low inflation (or both)?
- Further Fed action on the short end is likely.
  - *The current spread is -0.36, so it would take a relatively small reduction in short rates or small increase in long rates to "un-invert" the yield curve*

Other signals



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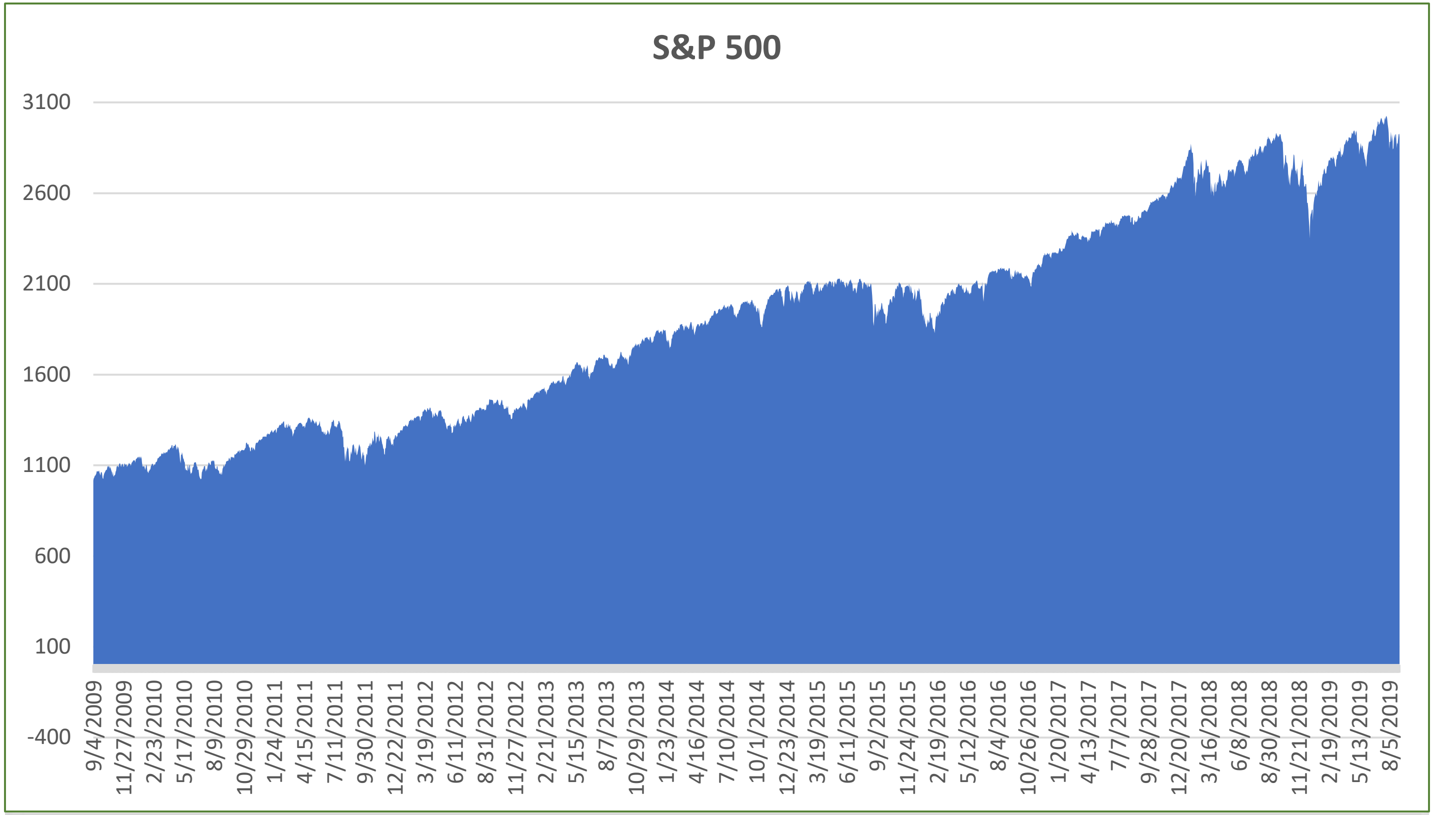


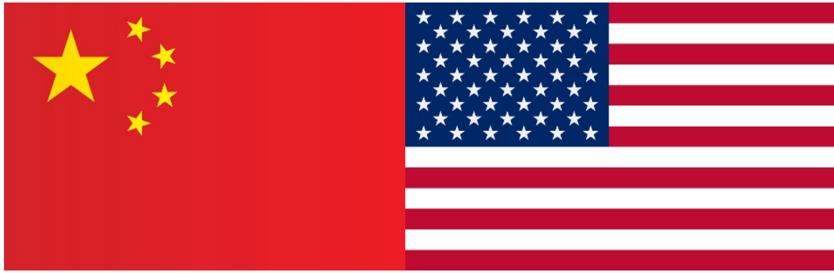
So much for economic indicators

They may be telling us something valuable, but we won't know what it is until that something has already happened.

Which doesn't mean we can't identify forces that will tend to push the economy in one direction or another . . .

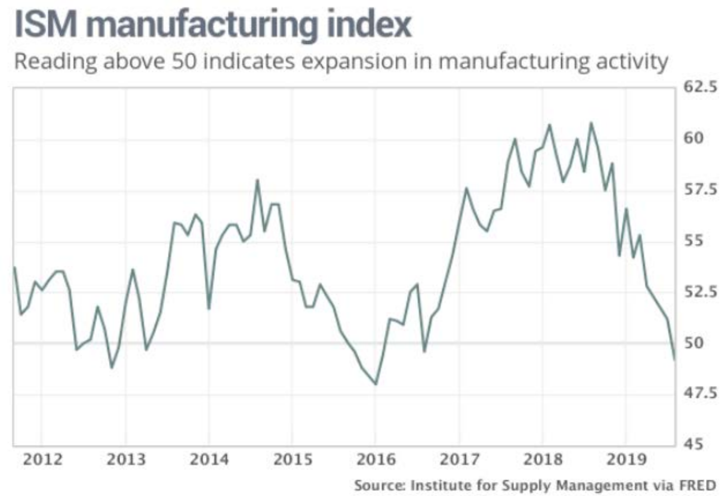
Which brings us to international trade

- Multi-lateral trade agreements vs. bi-lateral
- Do trade deficits matter?
- The case against China.
  - Expropriation of technology
  - Intellectual Property (IP) theft
  - Import restrictions
- The use of tariffs as a trade weapon.
  - Tariffs are not “free” money for the US government
  - Tariffs are a tax on businesses and consumers



Which brings us to international trade

- The average American's tax bill was $900 lower last year.
- The cost to the average American from new tariffs is $800 - $1,000 *(Federal Reserve, JPMorgan).*
- ISM Manufacturing Index falls below 50, down 10% since last summer.
- Consumer Confidence Index dipped slightly in August but is still strong.
- If bond investors are anticipating slower growth, the trade war is most likely a major culprit.

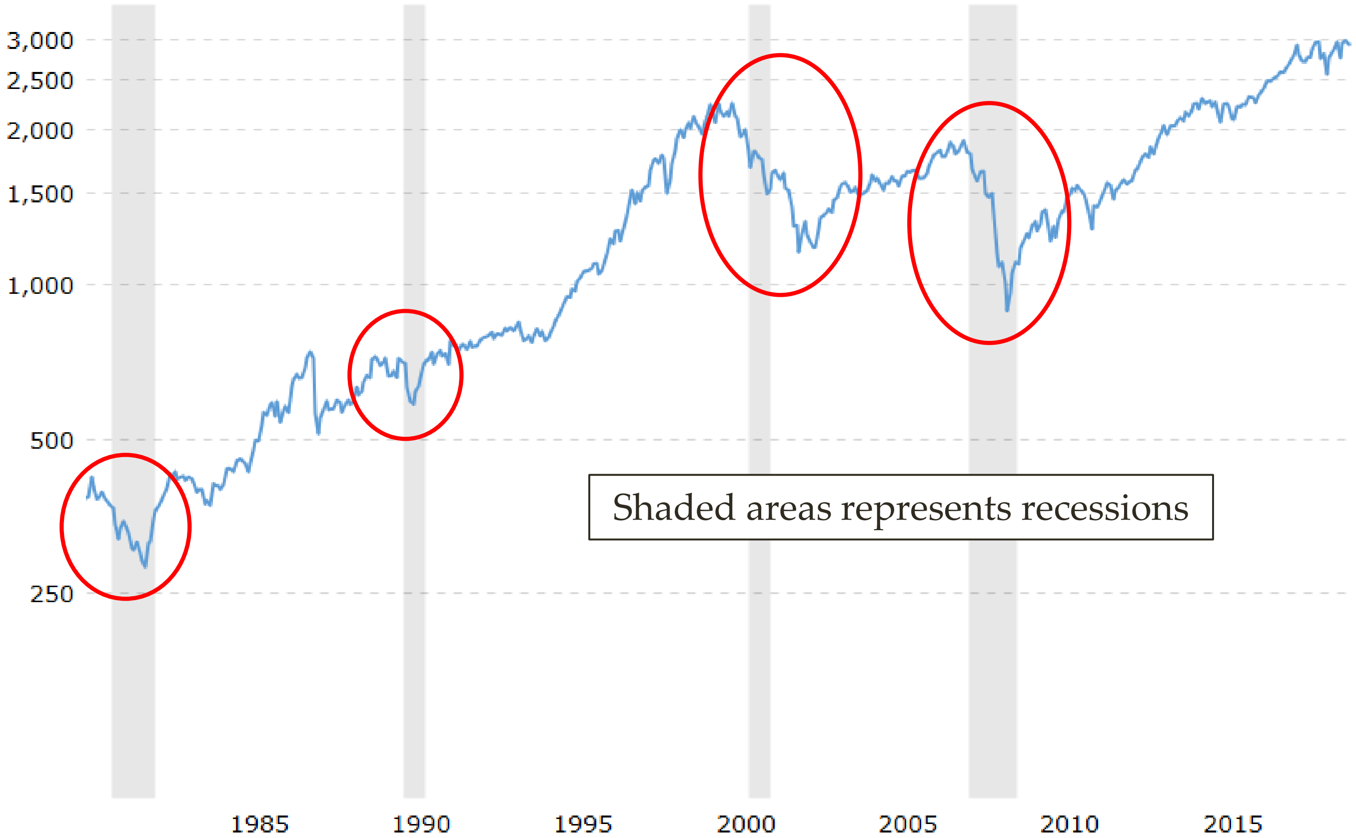


Which brings us to international trade

Trade wars are NOT easy to win.

Other Headwinds

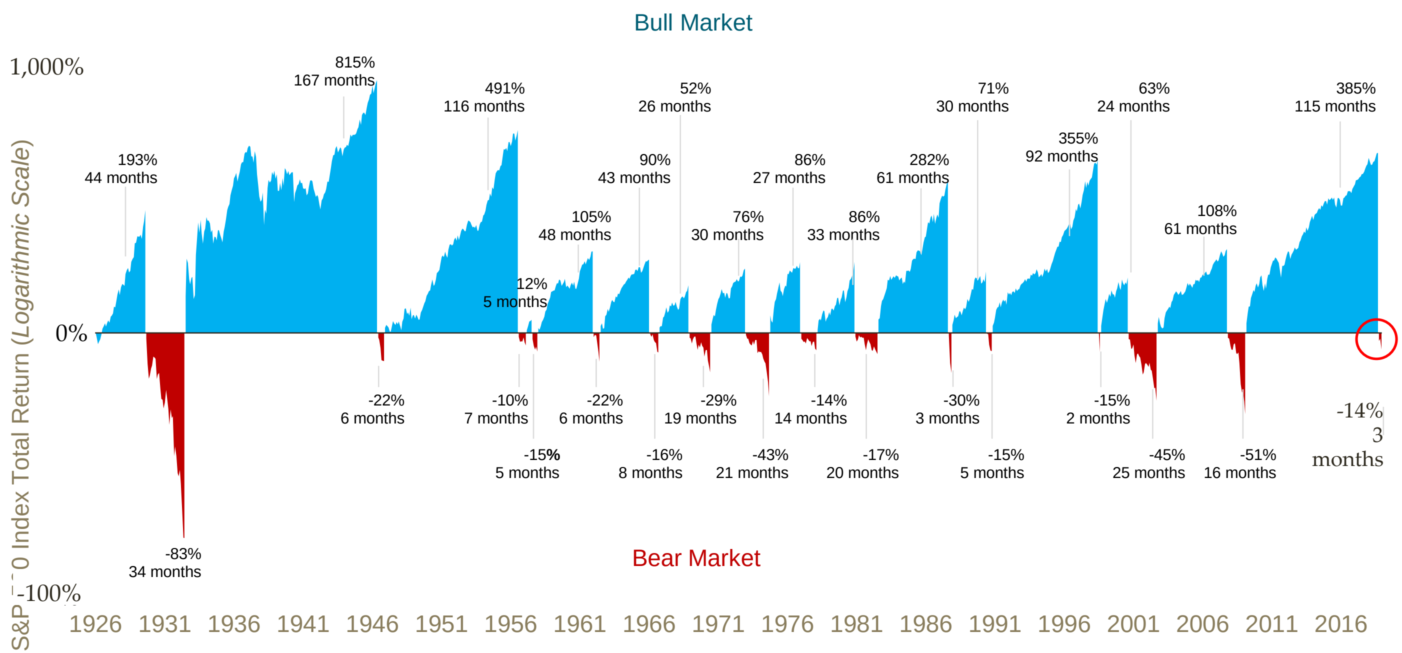
Recessions & the Stock Market



A History of Market Ups and Downs

S&P 500 Index total returns in USD, January 1926–December 2018

Using a 10% threshold for downturns



- Chart end date is 12/31/2018, the last trough to peak return of 385% represents the return through September 2018.
- Bear markets are defined as downturns of 10% of greater from new index highs. Bull markets are subsequent rises following the bear market trough through the next new market high. The chart shows bear markets and bull markets, the number of months they lasted and the associated cumulative performance for each market period. Results for different time periods could differ from the results shown.
- Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.
- Source: S&P data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved.

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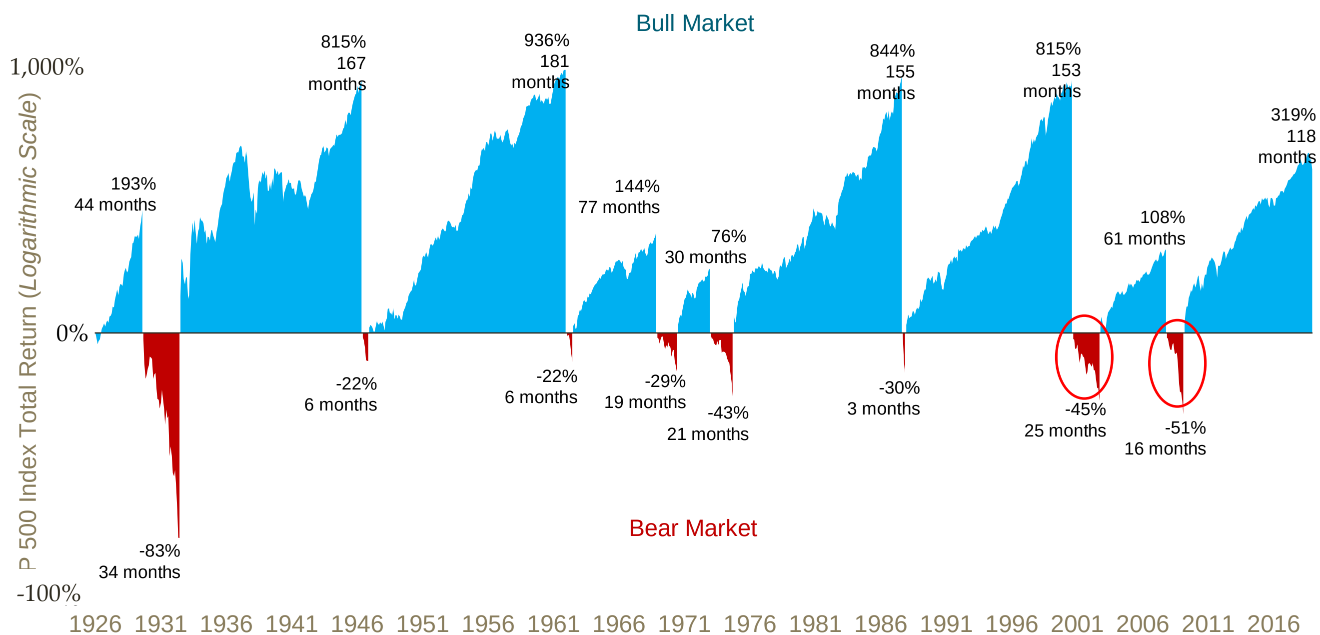
A History of Market Ups and Downs

S&P 500 Index total returns in USD, January 1926–December 2018

Using a 20% threshold for downturns



- Chart end date is 12/31/2018, the last trough to peak return of 319% represents the return through December 2018.
- Bear markets are defined as downturns of 20% of greater from new index highs. Bull markets are subsequent rises following the bear market trough through the next new market high. The chart shows bear markets and bull markets, the number of months they lasted and the associated cumulative performance for each market period. Results for different time periods could differ from the results shown.
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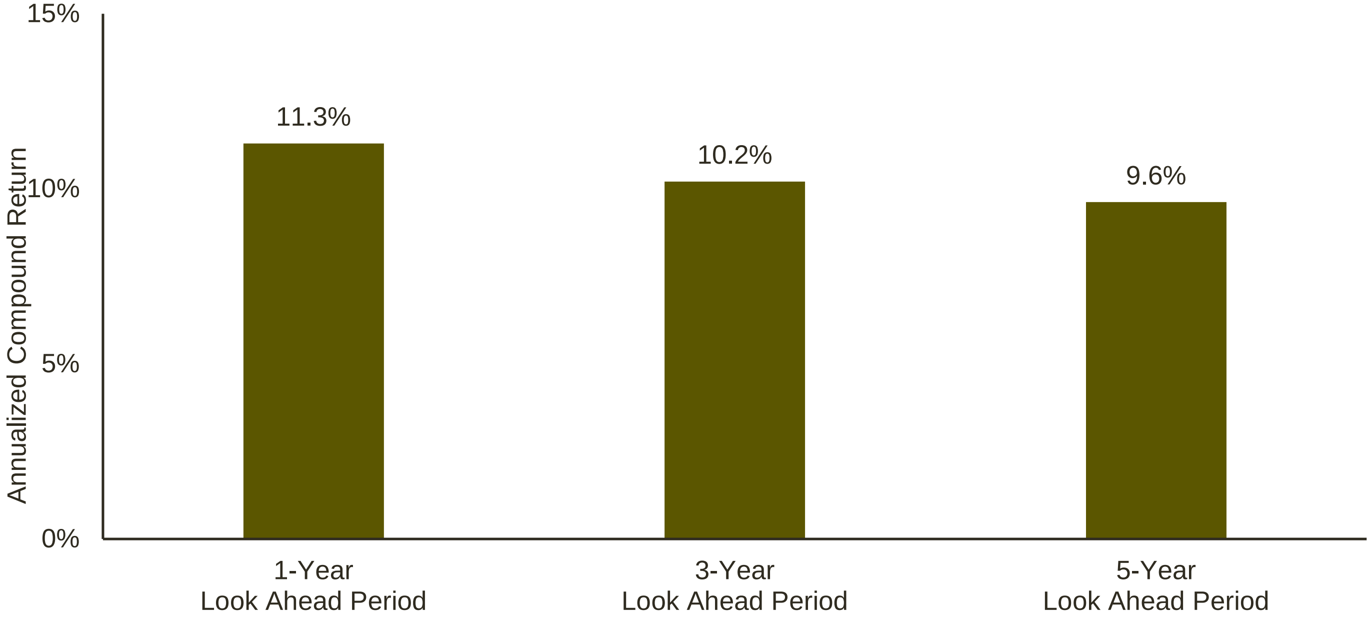
Average Annualized Returns after Market Decline of More than 10%

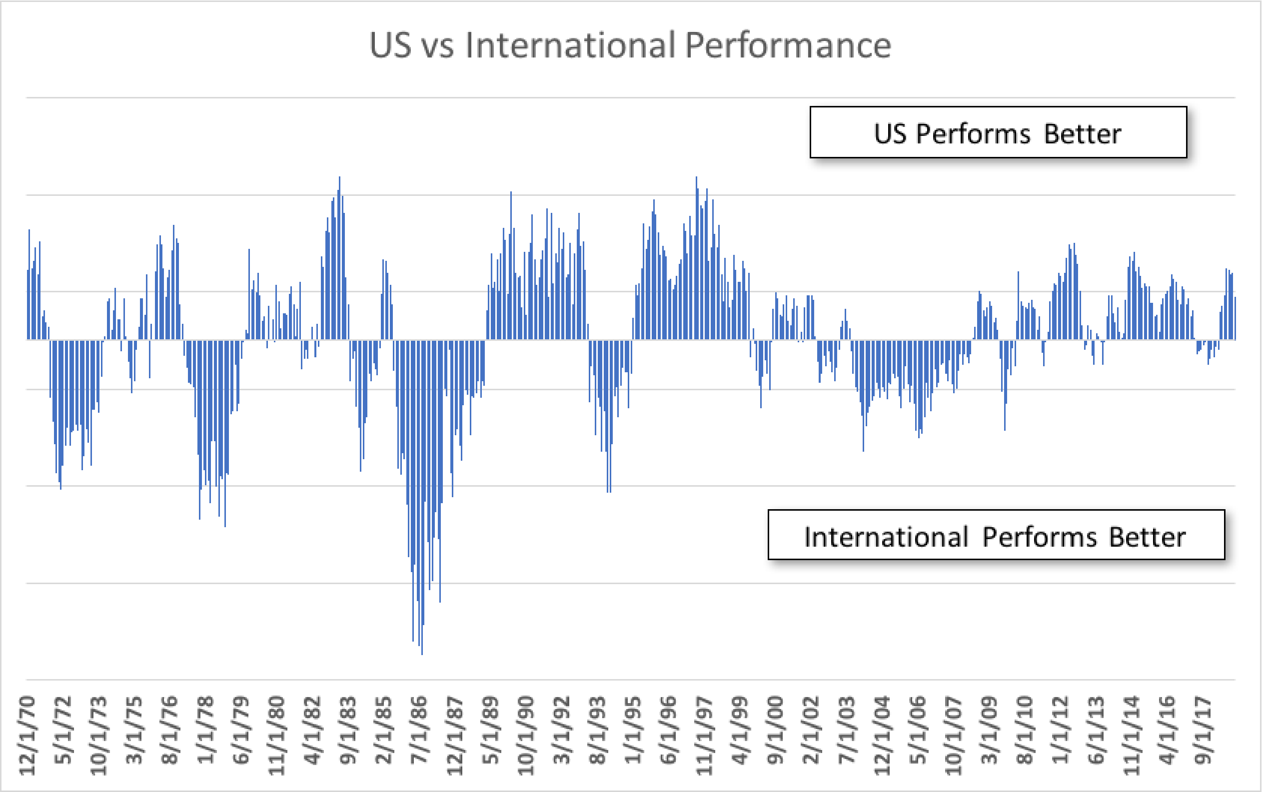
S&P 500, 1/1926–12/2018



- In US dollars.
- Past performance is no guarantee of future results. Declines are defined as months ending with the market below the previous market high by at least 10%. Annualized compound returns are computed for the relevant time periods after each decline observed and averaged across all declines for the cutoff. There were 1,115 observation months in the sample. January 1990–Present: S&P 500 Total Returns Index. S&P data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. January 1926-December 1989; S&P 500 Total Return Index, Stocks, Bonds, Bills and Inflation Yearbook™, Ibbotson Associates, Chicago. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. There is always a risk that an investor may lose money.

Global Landscape Going Forward

- Time for a shift in market leadership?



Recessions & Your Portfolio

- Diversification ensures that you avoid the worst.
- Diversification ensures that you survive to participate in the best.
- Diversification should build resilience.
  - Adequate cash reserves for emergencies and short-term needs
  - Adequate stable bond reserve to support longer-term spending
  - Stock investments spread across asset classes and within

Financial Planning for Recessions

- Things that should always be in place
  - Cash for emergencies
  - Cash for short-term needs
  - The right types and amounts of insurance
- Debt Planning
  - Do not earmark credit cards for emergencies
  - Draw down HELOCs if earmarked for specific projects
- Macro Strategies
  - Spend less rather than exiting markets
  - Understand your budget and where you can adjust

Focus on the Deep Regularities

- Human beings are fundamentally growth-seeking and resilient, as a consequence of which
- The U.S. and world economy are ultimately resilient and biased toward growth, thus
- The stock market, which represents ownership of the productive assets of the economy, is biased toward growth over the long run.
- Finally, the workings of the economy and markets are too complex and chaotic for short-term prediction.

And don’t forget to breathe . . .

Questions or Comments?

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