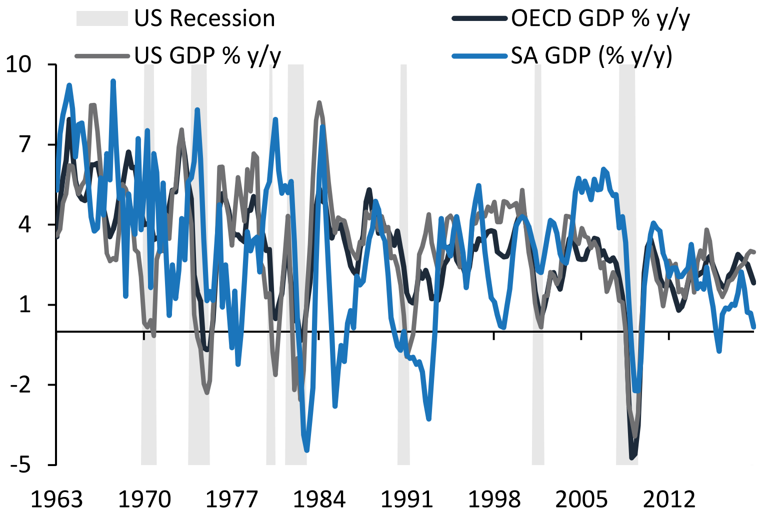
US recessions and asset prices: A quick take

By Carmen Nel

Fears of a US recession escalated during the fourth quarter of 2018 amid the slump in risk assets and tightening in financial conditions. Notwithstanding the Fed's dovish pivot in response to these concerns and attendant easing in financial conditions, various tools and models still assign a c.30% probability to a US recession in 12 months' time. Some of the experts continue to think there is a non-trivial risk that the US expansion – now 118 months old – will end in 2020.

Should we worry about a US recession? In short – yes. The adage "When the US sneezes, the world catches a cold" surely still applies given integrated global supply chains and sizeable cross-border capital flows. Should we worry about it now? This is more difficult to answer. Leading indicators, such as the slope of the yield curve, have good predictive power when it comes to a US recession, but the lead-time varies greatly. Hence, investors face a potential opportunity cost of positioning too early for a downturn. Alternatively, if the US has a soft landing, then the penalty for being long risk assets may not be as significant as feared.

Figure 1: US, OECD and SA real GDP growth



Note: OECD – Organisation for Economic Co-operation and Development, consists of 36 member countries, see http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm for more detail

Source: OECD, iress, Matrix Fund Managers

To get a sense of US recession dynamics, we reviewed the last seven events – periods for which we have reliable US and South African market price data. Based on this data set, a US recession lasts on average a year, while the expansionary phase tallies almost six years. The mean cost to real GDP is 1.5%, but the average decline in the S&P 500 price index is 33%.

Table 1: Summary of recent US recessions

	Date of peak	Date of trough	Duration (months)	Time since previous recession (months)	Severity	Primary cause(s)	Change in US GDP (%)	Change in OECD GDP (%)	Change in SA GDP (%)	S&P peak to trough (%)
1	Dec-69	Nov-70	11	106	Mild	Inflation; monetary tightening	-0.2	3.4	6.7	-33
2	Nov-73	Mar-75	16	36	Severe	Oil price shock; stock market crash; monetary tightening	-2.2	0.0	5.0	-46
3	Jan-80	Jul-80	6	58	Severe	Oil price shock; monetary tightening	-1.8	-0.5	4.0	-11
4	Jul-81	Nov-82	16	12	Severe	Monetary tightening	-1.4	0.4	-1.9	-24
5	Jul-90	Mar-91	8	92	Mild	Inflation; monetary tightening	-1.3	0.6	-0.8	-16
6	Mar-01	Nov-01	8	120	Mild	Dot-com bubble	0.4	0.3	1.5	-46
7	Dec-07	Jun-09	18	73	Severe	Sub-prime mortgages; house prices; banking crisis; credit crunch	-4.0	-4.5	-0.6	-53

Source: NBER, OECD, iress, Matrix Fund Managers

The detail reveals that the summary statistics mask differences in duration and extent. The episodes under review were caused by inflation leading to excessive monetary policy tightening or by financial imbalances, i.e. asset price bubbles. It seems that Janet Yellen was onto something when she remarked, “it’s a myth that expansions die of old age…” (16 December 2015). Recent history shows that they are killed off either by the Fed or by a bubble popping.

Based on the average returns in the lead up to the recession, we can make the following headline inferences:

- US equities’ performance tapers off during the 12 months leading up to the recession, peaking six to nine months before the recession starts.
- US bonds perform strongly in the three months up to the start of the recession.
- The US dollar rallies sharply in the three months up to the start of the recession.
- Emerging market currencies (the rand included) weaken in the lead up to a US recession, even using longer window periods, making EM FX the bellwether asset class for US (and global) growth deterioration.
- SA equities generally perform well, except in the last three months before the onset of the recession, when they underperform cash.

Table 2: Average returns around US recessions since 1965

Annualised returns (%)	S&P 500	UST 10-year	Dollar Index	EM FX Index	ZAR	SA equities	SA bonds	SA cash
3 years up to peak	8.2	2.4	-0.9	-8.2	-3.7	26.3	10.3	8.9
2 years up to peak	9.5	1.4	-0.6	-8.7	-2.6	33.7	10.8	8.7
12 months up to peak	-0.1	0.0	1.5	-11.9	-1.3	14.8	9.5	8.8
6 months up to peak	-0.4	1.9	3.2	-9.4	-4.8	14.7	10.7	8.8
3 months up to peak	3.5	12.1	8.4	-12.0	-4.3	2.9	9.1	8.1
During the recession	1.2	14.2	1.5	-10.7	-6.5	14.8	11.3	10.4

Note: S&P 500, US bonds, SA equities, SA bonds – total returns; EM FX and ZAR performance in dollars (positive = appreciation; negative = depreciation)
Source: Bloomberg, iress, Robert Shiller, BIS, Matrix Fund Managers

When we compare the recent asset price performance to our analysis of previous recessions, there are two opposing messages coming from markets. Equities point to an ongoing US expansion. This view has been buttressed by the 1Q19 US GDP release, which surprised sharply to the upside, and the “goldilocks” April labour report of very strong job gains, near-record low unemployment rate, and contained wage growth. Yet the US bond market and the US dollar – with the corollary of weak EM FX – are signalling that a slowdown is underway. The coincidence of equity and bond bull markets has occurred during only one of the previous recessions under review (1990/1991).

Table 3: Latest returns assuming April 2019 marked the peak in the US expansion

Annualised returns (%)	S&P 500	UST 10-year	Dollar Index	EM FX Index	ZAR	SA equities	SA bonds	SA cash
3 years up to peak	14.8	0.5	1.6	-2.3	-0.2	6.6	9.4	7.4
2 years up to peak	13.3	1.7	-0.8	-2.5	-3.3	7.6	8.9	7.3
12 months up to peak	13.4	6.5	6.1	-7.1	-12.9	3.9	4.5	7.3
6 months up to peak	20.3	13.6	0.7	2.6	6.7	29.0	19.8	7.3
3 months up to peak	43.5	6.7	8.2	-8.0	-26.4	43.6	6.6	7.2

Note: S&P 500, US bonds, SA equities, SA bonds – total returns; EM FX and ZAR performance in dollars (positive = appreciation; negative = depreciation)
Source: Bloomberg, iress, BIS, Matrix Fund Managers

The Fed’s patience amid contained inflation reduces the risk of excessive monetary policy tightening, for now. However, views differ on whether there are growing asset price bubbles, particularly when it comes to equity valuations and corporate credit spreads and leverage. Even so, the repair to household balance sheets in the US and the tighter regulations of the US banking sector should lessen the systemic threat from financial imbalances. A bigger concern for the pending downturn is that policy options are limited with the Fed pausing at a mere 2.50% and the US budget deficit already widening.

On balance, it seems that the US expansion has further to go with prospects for a mild recession rather than a hard landing. Yet we have to acknowledge that risks remain elevated given the tight US labour market and the ongoing US-Sino trade tensions. Escalation of tit-for-tat tariffs between the US and China (and potentially Europe) could weaken global growth, making non-US activity the possible source of the next US recession.

From an SA perspective, this view would support stronger risk appetite, with a preference for equities over bonds and cash. However, investors should be nimble given the short lead-time (three to six months) to switch to a defensive stance of overweight cash, short-duration in bonds and underweight equities.