MALVERN CAPITAL MANAGEMENT

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Why We're Not Going Into a Recession

It is not likely that the U.S. economy is headed for a recession any time soon. In the normal course of the business cycle there are peaks and troughs. We have seen sustained economic growth for the past 10 years and eventually there will be a slowdown. But such a trough, or recession, is not in the foreseeable future at least not according to the economic data we are reviewing.

There are certain data points which are considered leading, lagging or coincident indicators of a recession. We want to focus on leading indicators to get a sense of where we are going. Some of those leading indicators are as follows:

- **First**, nearly every recession we have had in recent memory has been preceded by a spike in oil prices. Following such a spike we fall into a recession. If anything, we have seen a collapse in oil prices in recent years. A spike in oil prices likely signals the consumer is directing more of their earnings toward gasoline and home heating oil and away from buying goods and services. The consumer has effectively been given additional stimulus in recent years because of the decline in oil prices.

- **Second**, we look to consumer confidence to see if consumers are tightening their belts in any way. At the present time, consumer confidence readings are high. Also, retail sales have been fairly decent recently. As long as consumers feel confident about the future, they will continue spending. If consumers continue to spend, a recession is less likely.

- **Third**, let's look at the employment numbers. The actual jobs report each month which reports the number of jobs created is more of a lagging indicator. The fact that the unemployment rate is at a 50-year low is also a lagging indicator. But inside the jobs report we want to focus more closely on hours worked. If employers are confident and productive, they will increase the hours worked for their employees. If things are slowing or they feel less confident, they reduce the hours worked. Right now, and over the past few years, the number of hours worked has been fairly consistent and positive for continued economic expansion.

- **Fourth**, are wages growing? We have seen a steady growth in wages over recent years. In the first half of this year, wages grew about 5.1%. If employers are finding it hard to hire workers, they will increase wages to help retain current employees and to induce new workers to join their businesses. That is what we are seeing.

- **Fifth**, prior to most recessions, the Fed Funds rate has been much higher than it is now. In the past, just prior to a recession, the Federal Reserve has been less accommodative than at present. True, the Fed has tightened significantly since 2015 until its recent cutting of rates. But we are still at historically low levels of interest rates.

- **Sixth**, the stock market is a leading indicator of the economy. The stock market generally declines months before a recession hits. Although we have seen a lot of volatility recently, mainly due to trade issues, the stock market is not far from all-time highs – highs which were reached recently.

- **Lastly**, we have to point to the yield curve as it has received a lot of attention in recent weeks. The media have made much noise about the current and brief inversions of the yield curve. An inverted yield curve has preceded each of the last five recessions. But the timing of such recessions is not so clear. As a predictive tool, it may be signaling a recession 12-months, 24-months or even longer into the future. Or perhaps this is a more spurious correlation. Nonetheless, there may be some validity here and it should be recognized as a signal favoring recession among all of those which favor no recession. But, could things be different this time? We have a lot of central bank activity going on here and around the world. In the U.S. there is "quantitative tightening" taking place as the Federal Reserve is gradually reducing its balance sheet. While at the same time, it is also replacing maturing bonds from prior "quantitative easing" programs. The Fed has also raised rates since 2015 (though it recently cut the Fed Funds rate). The raising of the Fed Funds rate affects the short-end of the yield curve. Quantitative tightening may affect the long-end of the curve. Plus, the 10-year U.S. Treasury Note is considered the safe haven around the world and foreign investors buy it as such. Such buying helps push the yield of the 10-year U.S. Treasury Note down. Many foreign countries offer negative yields on their government bonds making our positive yields more attractive. Perhaps these are reasons for yields on the short-end of the curve rising and the longer-end of the curve falling causing an inversion of the yield curve totally unrelated to what is going on in our economy. This is how we view the current environment.

If one looks at the positive data, it is hard to see an imminent recession. We can't ignore the fact that the yield curve has inverted but there just may be some reasons unrelated to our economy for such an inversion.

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