LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

August 28 2017

# RECESSION WATCH UPDATE

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## KEY TAKEAWAYS

We believe the odds of a recession in the next year remain below the historical average.

Leading economic indicators continue to signal a supportive backdrop for the economy.

We are seeing few of the excesses that tend to appear when recession risk is elevated.

**Market participants are always on watch for potential signs that the economy may be moving into a recession.** Almost all recessions are associated with large stock market declines, and 70% of the bear markets since the end of World War II have been associated with recessions. Given this relationship, the search for the catalyst of the next market downturn often focuses on recession threats. This is part of the reason LPL Research pays close attention to the business cycle when evaluating market prospects. Based on our analysis, we believe the likelihood of a recession in the next year remains low, but we are likely to see increased volatility as we move later into the cycle.

## ECONOMIC OVERVIEW

While we are likely solidly into the second half of the economic cycle, there are still some elements of the current cycle that are exhibiting early to mid-cycle behavior. While the Federal Reserve (Fed) has raised rates four times in the current cycle, the pace of increases has been slow to moderate and we do not yet see the Fed aggressively trying to rein in an overheated economy. By comparison, the Fed raised rates at 17 consecutive meetings between June 2004 and June 2006.

In addition, following the energy-driven economic slowdown of 2015–2016, the economy exhibited a pattern of rebounding profits and a strong move in stock prices more typical of early or mid-cycle behavior. These types of mid-cycle slowdowns and reaccelerations are common in longer expansions.

Finally, the election of President Trump and Republican majorities in the House and Senate raised expectations of fiscal stimulus via lower taxes and deregulation and drove a sharp increase in consumer and business confidence following the election. Legislative progress has been disappointing so far from a market perspective, and we've yet to see the strong economic data that often accompany increased confidence; however, confidence numbers have only retreated modestly.

Right now, economic growth expectations for the second half of the year are for a run rate of close to 2.5%, better than the expansion average of 2.2%. The U.S. economy is getting support from better global growth, continued expectations of some (possibly delayed) fiscal stimulus, and a weakening U.S. dollar, which ultimately makes our exports cheaper. With trend growth having slowed to 2–2.5%, it may feel like recession is a more regular threat, but the overall picture of U.S. economic growth remains fairly steady.



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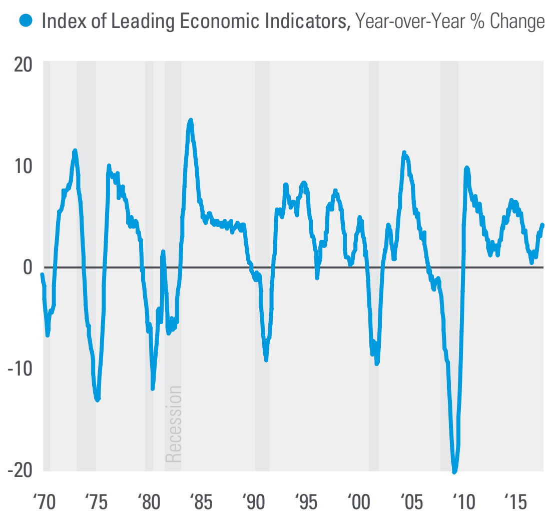
## EQUITY MARKETS AND ECONOMIC CYCLES

Since 1960, in the 6 months prior to the start of a recession, the average return of the S&P 500 Index has been -6.7%. During the first 6 months of a recession, the average return has been -14.8%; when the economy has still been in recession, the average return in months 7 through 12 has been -3.3%. However, markets almost always bottom during the recession, so in shorter recessions, markets would already be in their post-recession bounce during this period.

Because periods of unusual economic activity make recent data less reliable, knowing when the economy has entered a recession, or is in danger of entering one, can be difficult. The economy also doesn't progress in a straight line, and an expansion often sees periodic slowdowns, while recessions may see short-term pickups. It often takes some time to figure out whether these are head fakes or actual changes in trend. Historically, the National Bureau of Economic Research has waited between 6 and 21 months after an economic peak or trough to call the start or end of a recession. Therefore, we usually don't know whether we have officially entered or exited a recession until well after the fact. Despite these difficulties, it can be advantageous to investors to locate where the economy is in the business cycle.

**1 LEI SHOWS LOW RISK OF RECESSION**




Source: LPL Research 08/21/17

The Leading Economic Index is a monthly publication from the Conference Board that attempts to predict future movements in the economy based on a composite of 10 economic indicators whose changes tend to precede changes in the overall economy. Performance is historical and no guarantee of future results.

## LEADING INDICATORS

LPL Research follows a wide array of economic and market data to determine where we are in the business cycle, but we have a few favorites that we like for their combination of simplicity, a strong track record, and a sensible underlying narrative. One is the Conference Board's Leading Economic Index (LEI). The LEI is an aggregate of economic indicators that tend to lead overall economic activity, such as manufacturers' new orders, new building permits, and initial claims for unemployment. The Conference Board tracks, standardizes, and weighs the 10 components to form the LEI. It has been modified over the years with changes in data availability and improvements in our understanding of what drives economic cycles, but has also maintained general stability among the constituents and provides a reasonably consistent history dating back to 1960.

To start, we simply look at whether the LEI has gone up or down over the last year. While there is something intuitively meaningful about leading indicators rising or falling over a year, it is not a magical point that indicates a sudden transformation in the economy. Nevertheless, the change from rising to falling over the last year has provided a good signal of increased risk of a recession [Figure 1].

When the LEI has risen over the last year, the U.S. economy has been in recession at some point over the next 12 months only 7% of the time, compared to 22% of the time for all months. When the LEI has fallen over the last year, the U.S. economy has been in recession at some point over the next 12 months 71% of the time.

The lead time from signal to recession, based on how the LEI is currently constructed, has been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between 1 and 17 months with an average of 7 months, which means it has had some capacity to warn of the market declines that historically begin, on average, about 6 months ahead of a recession. Over its history, the crossover from rising to falling LEI year over year has captured seven of eight recessions (missing only in 1960) and has given two false signals, turning lower compared to its value one year earlier in 1967 and 1996 without an ensuing recession.

According to its most recent reading, the LEI rose 3.9% year over year in July, which is an average reading over its history, but still highly meaningful given the decreased likelihood of recession when the LEI is rising.

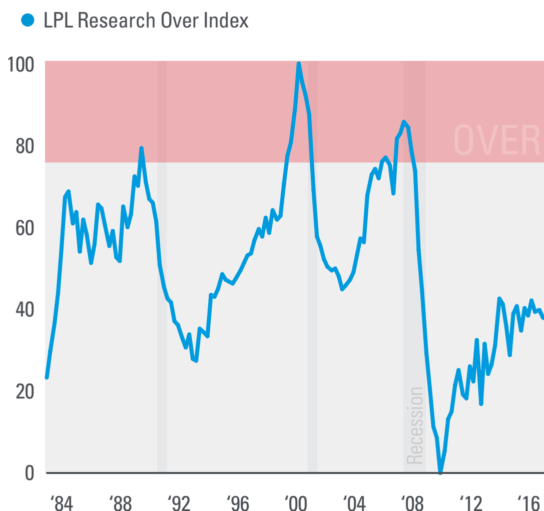
## EXCESSES STILL ABSENT

We often say that expansions (and similarly bull markets) don't die of old age. There's no reason an economy needs to take a breather just because it has been jogging forward for a long period of time. But human nature is often not satisfied with a slow advance.

When times are good, there is often a cycle of rising confidence that leads to overspending, which has to be financed by overborrowing. Early in a cycle, or even in the middle, the feedback loop between confidence, spending, and borrowing is often essential for a healthy economy. The danger arises when confidence leads borrowing and spending to shift into a gear that is not sustainable.

To capture the potential move from a healthy level of confidence, spending, and borrowing to one that makes the economy vulnerable to recession, LPL Research created the Over Index, which standardizes and aggregates 12 economic data series, 4 each for confidence, borrowing, and spending. Thus far, we have seen few signs that the economy has become overheated [Figure 2]. While confidence did rise post-election, we believe the overall dynamic remains healthy. In fact, the sub-indexes that represent all three are all below their historical average of 50, with confidence the highest of the three. (For more information, please see the August 14, 2017 *Weekly Economic Commentary, "Slow Evolution of Consumer Spending."*)

**2 FEW SIGNS OF OVERHEATING ECONOMY**




Source: LPL Research 08/21/17

The LPL Research Over Index measures trends in three broad economic drivers (spending, borrowing, and confidence), each with four diverse subcomponents. It normalizes and indexes each data series into an overall score for each of the three drivers, that, when aggregated, help to measure the likelihood that the economy may be approaching a cyclical peak. Performance is historical and no guarantee of future results.

## CONCLUSION

While we do not see warnings of an imminent recession right now, there's always the possibility that an unexpected shock, such as a government or central bank policy mistake or a major geopolitical event, could cause a recession. Although we do expect an increase in volatility in equity markets after an extraordinarily calm year so far, we see little indication of a recession in the next year. We do provide monthly updates of our reading of the LEI, the Over Index, and other cyclical indicators in our Recession Watch Dashboard, and will continue to provide timely reflections on the state of the U.S. and global economy. ■



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## IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

## DEFINITIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Leading Economic Index is a monthly publication from the Conference Board that attempts to predict future movements in the economy based on a composite of 10 economic indicators whose changes tend to precede changes in the overall economy.

The LPL Research Over Index measures trends in three broad economic drivers (spending, borrowing, and confidence), each with four diverse subcomponents. It normalizes and indexes each data series into an overall score for each of the three drivers, that, when aggregated, help to measure the likelihood that the economy may be approaching a cyclical peak. Performance is historical and no guarantee of future results.

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