Is a Recession Coming to Us?

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It has been almost ten years now since the United States first started recovering from the Great Recession. The theory of economic cycles commands a slowdown. Yet, the US economy keeps displaying an insolent health, closing 2018 at a 3% growth rate - well above most estimates of its longer-run trend. It contradicts the opinion that says the US economy should now have entered the downward part of the current cycle and is at the edge of the slowdown. So, let's first overview the current situation of major economies in the world. We will then discuss the major risk factors likely to trigger a Recession in the near future.

Overview of the current economic situation

The EU economy grew for the sixth consecutive year in 2018, at 2.1%, slightly lower than previous year 2017 (+2.4%), as it weakened in Q3 (+0.2% only) - the lowest quarterly growth rate since 2014 Q2, with Germany and Italy both experiencing in Q3 a contraction in their domestic economy (-0.2% and -0.1%, respectively)[1].

The moderation of momentum since mid-2018 and leading indicators both suggest that the EU economy hit its peak in 2017, and is now entering the downward path of the current economic cycle. However, OECD is confident that "the strength of Europe's domestic growth drivers should be sufficient to allow activity to continue growing and unemployment to continue falling". By "domestic growth drivers" , the OECD refers to strong wage growth (+2.5%), strong domestic investment as EU companies still enjoy favorable financing conditions, and expansionary fiscal measures in some Member States.

Labor market stays strong: unemployment rate was 8.1% in October 2018 (vs. 8.7% in October 2017) - close to its natural level. It is the lowest rate recorded within the Euro area since November 2008.

Inflation, after several years stuck on the floor, finally took off in 2017, and confirmed in 2018 at 1.8% - close to ECB's target, and sign of a healthy economy.

The US economy broke all records in 2018:

- Real GDP growth was 3.0%;
- Unemployment shrank further in 2018 at 3.7% - a 49-year low - and many other measures of labor market strength are at or near historic bests;
- Investment (as measured by gross fixed capital formation) rose 5% in 2018 as compared with 2017

Although the US economy looks unstoppable, a slowdown is inevitable in 2019, as the positive effects of the Tax Reform and Job Act that decreased corporate profits tax rate by 10% fades away and the FED

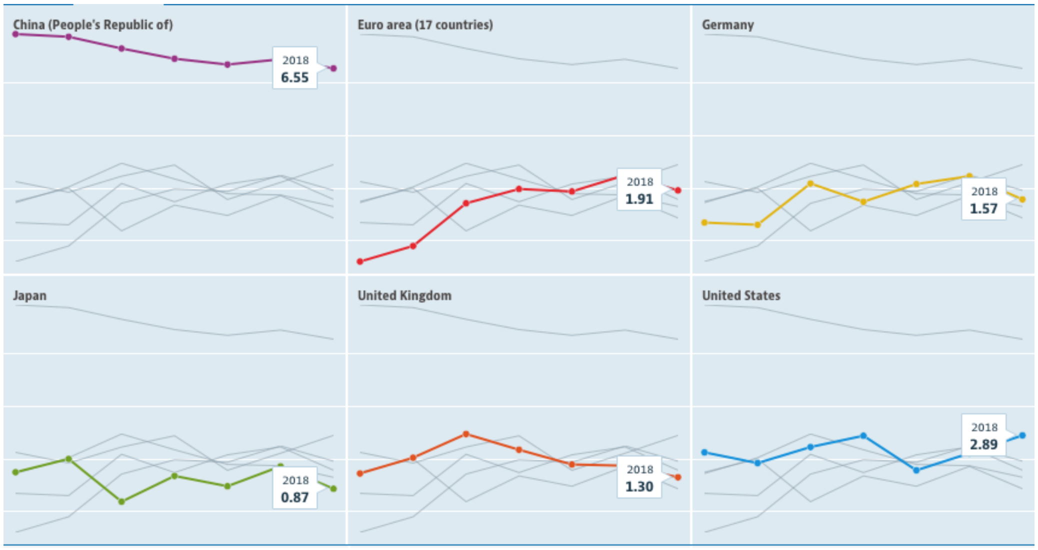
[1] Seasonally-adjusted GDP quarterly growth – Eurostat data

gradually normalizes its monetary policy (meaning it raises interest rates within the economy and lightens its Balance Sheet by selling assets bought during the QE period).

Inflation is right on FED's target (2%).

Global economy growth remained strong in 2018 (3.1%) – stable vs. 2017 (World Bank figures). However, it slightly peaked in the end of the year, as emerging market and developed economies (EMDEs) show first signs of slowdown: Japan economy contracted in the third quarter of 2018. China experienced weaker growth last quarter, as consumer spending remains weak and investment in housing construction slows down, and both the fiscal and monetary stimulus enacted by Beijing since the summer have failed to reverse flagging growth.

Figure 1 OECD major economies real GDP evolution from 2012 to 2018[2]



Source: OECD data; Note: the figures in the chart may differ slightly with the figures presented above because of different measurements methods across world trade institutions (Eurostat, World Bank and OECD).

So everywhere, the best of the current (global) economic cycle is behind us, and we are progressively heading towards a synchronized and global slowdown in the upcoming years.

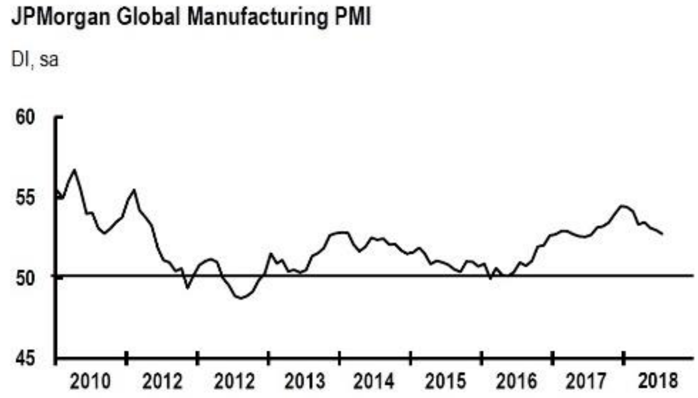
Leading indicators' insights

Let's go deeper now into our analysis and see what leading indicators foreshadow.

The JPMorgan PMI index (Figure 2)- computed by surveying purchasing managers of some of biggest manufacturers in the world - does indicate the Global manufacturing activities have started slowing down: at 52.1 in October, down from 52.2 in September, it fell to its lowest level in almost two years, as rates of growth in output and new orders weakened. However, the Global PMI index hides major heterogeneity across countries, with the US scoring a five-month high (59,3%) and Japan a four-month high (52.8%), while the euro area saw its PMI's rate of increases slowing to its lowest level since

October 2016 and the UK to a 27-month low. The China PMI remained close to the stagnation mark at 50.1% in October.

Figure 2 JPMorgan PMI Index[2]



The OECD Consumer Confidence Index3 (CCI) – that measures how optimistic or pessimistic consumers are with respect to the economy in the near future – remains above 100, which means overall consumers in OECD economies remain confident and still favors consumption over saving, which is positive for the economy. However, CCI has started to slump last July and hasn't stopped to do so since, meaning consumers feel less and less confident about their economic prospects.

The OECD Composite Leading Indicator4 (CLI), designed to provide early signals of turning points in business cycles, reached its lowest level since 2010 last October (below the 100 threshold) indicating OECD economies now enter the downward path of the cycle.

Markets' expectations and self-fulfilling prophecies

Some say there is no better way to predict tomorrow's changes in the economy than by looking at today's financial markets trend and movements, as they are thought to mirror investors' expectations about future economic environment.

One relevant indicator here is the VIX - that volatility (and, thus, risk) on financial markets. Significantly below 20% for most of the 2017 year, it crossed the 20% milestone on Mid-October, flirted with it until end-November and has remained above 20% since. (See Figure 3). This recent surge in the VIX index reflects investors' growing incertitude about economic perspectives.

Figure 3 VIX evolution from November 2nd, 2018 to December 31st, 2018

Source: Yahoo Finance

Finance theory suggests that stock prices are determined by expectations about future dividend streams, which in turn are related to the future state of the economy. We entered into a bear territory since the end of 2018: all the main asset classes lost 20% or more since their peak in 2017. It means, according to the above theory, investors expect lower dividends stream in the years to come as they buy on less growth in business activity. To be simple, markets bet on slowing economies.

Yield curve inversion and its potential impact on the US economy

The Yield Curve in the US is under particular scrutiny by the financial markets as historically its inversion means recession in the US economy 14 months afterwards (on average). It occurs when long-term rates on the 10-Year Treasury bond comes to step down and meet the short-term interest rates on the 1-Year or less Treasury bill. And it's happening right now! - see Figure 3. Since early December 2018, the spread between 10 Year T-Bond rate and 1 Year T-Bill rate is less than 0.10 and continues to shrink. On Friday 4th of January 2019, 10Y T-Bond rate is 2.65, while 1Y T-Bill rate is 2.56.

Figure 4 . 1-Year T-Bill rate (white curve) and 10-Year T-Bond rate (yellow curve) evolution since August 2018[6]

Source: Bloomberg

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It's interesting to note what it indicates about the markets/investors sentiment regarding future economic perspectives: they bet a reversal. A reversal of both the economic situation and, as a result, the monetary policy. They bet the FED will have no choice but to reverse its current rates hike in the near future, to support a slowing US economy that needs low interest rates. So, it does imply a recession of the US economy is on the horizon of 2020.

Another explanation, more "grounded" economically, is to say that when short-term rates exceed long-term rates there are strong incentives for banks and lenders not to fund the economy through long-term loans, but rather retain short-term liquidity under the form of 1 Year T-Bill, as long-term projects are less profitable relatively to the riskless asset the 1 Year T-Bill. So, less money available to fund long-term 'business' investments and households' consumption credits result in lower aggregate demand, causes activity to contract.

However, if the US Yield Curve inversion proved to be a reliable indicator of future US economic recession in the past, at best it is a strong correlation, certainly not a causality. In both 1966 and 1988, we saw yield curves inverse without the following economic contraction.

Normalization of Central Banks' policy

The normalization of the US monetary policy will play a major role in determining the current cycle's lifetime. Let's see why.

Historically, when the Fed raises interest rates too quickly and/or too sharply, not allowing business agents enough time to adjust, it is followed by a "hard landing" - meaning an economic slump. So, the pace at which the FED implement the rates hike, and its degree of predictability, will be decisive.

In the FED last meeting report, we can find an interesting sentence: "in determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective" -- meaning, as Alan Greenspan - former Fed chairman - once put it: "if I seem unduly clear to you, you must have misunderstood what I said." What we can conclude is that the Fed plans aren't frozen/set definitively; Powell will let economic forces define the pace and number of interest rate hikes. In particular, inflation will be the main decision variable: should inflation get nervous and accelerates unexpectedly beyond the 2% target, because of continuous labor shortages causing wages to rise sharply for instance, then the Fed would have no choice but to fasten its own rates hikes. In other words, an unexpected surge in inflation (faster and sharper than expected) would force the FED to accelerate its plans and implement several interest rate hikes in a few months time, not letting enough time to business agents to adjust. How is this a problem?

Figure 5 Economic projections of Federal Reserve Board members under their individual assessments of projected appropriate monetary policy, December 2018[7]

Percent

Variable	Median[1]					Central tendency[2]				
	2018	2019	2020	2021	Longer run	2018	2019	2020	2021	Longer run
Change in real GDP	3.0	2.3	2.0	1.8	1.9	3.0 – 3.1	2.3 – 2.5	1.8 – 2.0	1.5 – 2.0	1.8 – 2.0
September projection	3.1	2.5	2.0	1.8	1.8	3.0 – 3.2	2.4 – 2.7	1.8 – 2.1	1.6 – 2.0	1.8 – 2.0
Unemployment rate	3.7	3.5	3.6	3.8	4.4	3.7	3.5 – 3.7	3.5 – 3.8	3.6 – 3.9	4.2 – 4.5
September projection	3.7	3.5	3.5	3.7	4.5	3.7	3.4 – 3.6	3.4 – 3.8	3.5 – 4.0	4.3 – 4.6
PCE inflation	1.9	1.9	2.1	2.1	2.0	1.8 – 1.9	1.8 – 2.1	2.0 – 2.1	2.0 – 2.1	2.0
September projection	2.1	2.0	2.1	2.1	2.0	2.0 – 2.1	2.0 – 2.1	2.1 – 2.2	2.0 – 2.2	2.0
Core PCE inflation[4]	1.9	2.0	2.0	2.0		1.8 – 1.9	2.0 – 2.1	2.0 – 2.1	2.0 – 2.1	
September projection	2.0	2.1	2.1	2.1		1.9 – 2.0	2.0 – 2.1	2.1 – 2.2	2.0 – 2.2	
Memo: Projected appropriate policy path										
Federal funds rate	2.4	2.9	3.1	3.1	2.8	2.4	2.6 – 3.1	2.9 – 3.4	2.6 – 3.1	2.5 – 3.0
September projection	2.4	3.1	3.4	3.4	3.0	2.1 – 2.4	2.9 – 3.4	3.1 – 3.6	2.9 – 3.6	2.8 – 3.0

Source: Federal Reserve

Well, remember your Keynes lessons: the economic man behaves first and foremost according to its "animal spirit". So, the effect, in my opinion, is essentially psychological as business agents suddenly realize overnight that credits' interest rates are no longer negligible - time of free money/free borrowing with negative real rates is ended - and adopt more defensive behaviors. They will report present consumption and save more; it is what economists refer to as "intertemporal substitution"- they wait for good fortune to come back. Indeed, most of us don't read Fed meetings' reports every month and don't notice a 0.25 increase, but if within a few months (let's say half a year), interest surge from 2 to 3%, THEN it would start to matter and make a difference in peoples' minds. As a result, they would modify their borrowing and spending behaviors, but are likely to do so in an excessive (negative) way (as on the stock market, humans tend to overreact to bad news), triggering the classical mechanism: less consumption and business credits as well as less demand causing activity to curb.

So, the impact on the economy would depend upon whether the normalization takes a soft or hard landing. If the Fed manages to keep raising interest rates gradually in a predictive way, letting business agents time to adjust, then it should not do much harm - at worst it would cause credits to businesses and households to drop.

The financial system exposure to systemic risk

A decade has passed now since Lehman Brothers went bankrupt in September 2008, causing the whole financial system to collapse and the world to plunge amid the worst recession since the Great Depression (1930's). Is the financial system really more resilient now to systemic shocks than it was back in 2007-2008?

Jerome Powell believes so, saying, "after 10 years of concentrated efforts (…) the system is now much stronger, with greater capacity to function effectively in stressful times." According to him, the new regulatory framework implemented post-2008 in the US, consists of tighter capital and liquidity requirements, fiercer stress-tests and new powers granted to the Federal Committee to monitor systemic banks' exposure to junk assets and bad loans, and require they take immediate actions to improve the quality of their balance sheet or reduce their (financial) leverage.

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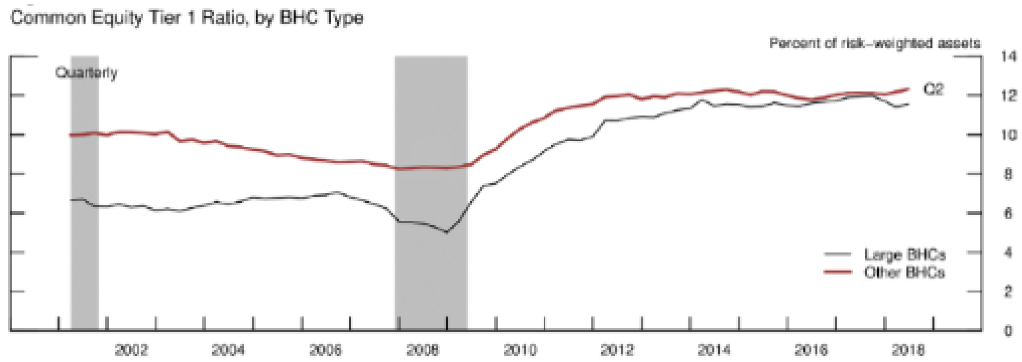
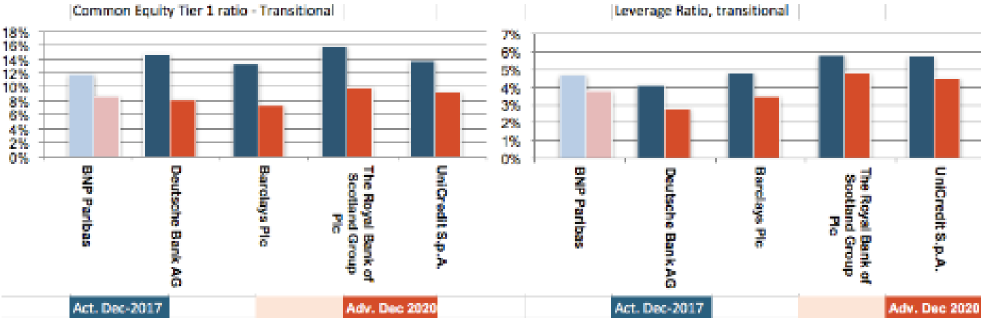
The conclusions of the Dodd-Frank Act Stress Test supports such a view: “The nation's largest bank holding companies are strongly capitalized and would be able to lend to households and businesses during a severe global recession.”

Figure 6 Common Equity Tier 1 Ratio evolution since 2000 for US bank holding companies with greater than $50 billion in total assets[8]



Source: Federal Reserve

Figure 7 Major EU banks’ 2018 stress tests results – simulation of CET1 ratio and Leverage ratio evolution at the beginning and at the end of the EBA-designed adverse scenario[9]



Source: European Banking Authority

Europe also had its “regulatory time”: MiFID II, Basel II... no fewer than five lots of rules have emerged from the regulators’ minds. Let’s do a rapid overview of the 2 most important: Basel II and Mifid II.

Basel II came after Basel I showed its limits in failing to prevent the 2008 financial crisis from occurring – notably by failing to regulate investment banks’ practices of “securitization”, which enables them to pack thousands of mortgages into one single security: the mortgage backed security (MBS), also known under another sweet name: “collateralized debt obligation” (CDO). As “The Big Short” movie luminously explains it, those little instruments are the monsters that let the US housing market crackdown poisoned the whole financial system. Less known though, securitization is also used by banks to bypass their capital requirements obligations, as once securitized, banks’ credits are no longer considered as “Assets”, thus shrinking their balance sheet credits commitments. The banks enjoy it to grant further credits without deteriorating their capital ratios.

Another note to be mentioned: under Basel III, capital and liquidity requirements have been strengthened. Notably, Banks are now required an additional “capital conservation buffer” equivalent to 2.5% of CC and a "discretionary counter-cyclical buffer” allowing national regulators to require up to an additional 2.5% of capital during periods of high credit growth.

MiFID2, the refreshed Markets in Financial Instruments Directive - which took effect on January 3rd, 2018 - is 1.4m paragraphs of rules whose main purpose is to make financial markets more transparent, fighting over-the-counter trading going on in the "shadow banking" system, which escapes all sorts of regulations as compared with organized markets such as NASDAQ. What is the main advancement? Banks now have the obligation to report their trades to the competent financial authorities and can be required, as a result, to reduce or even to limit their positions in certain types of financial instruments (commodity derivatives, for instance).

In 2016, the European Banking Authority (EBA) conducted stress-tests on 48 banks in 15 countries in the European Union aimed at assessing those banks' liquidity and solvency risk. It did so by simulating a significant deterioration of the economic and financial environment over a 3-year horizon (e.g. a decrease in real GDP of -1.2%, -2.2% and 0.7% as of 2018, 2019 and 2020 respectively, plus an aggregate credit loss of 358bn EUR). In conclusion, as a whole, the EU banking system successfully passed the test. Amid the adverse designed scenario, most EU banks have been able to maintain their minimum capital requirements and leverage ratios.

However, this all sounds too marvelous. We must be missing something. Indeed, beyond CBs' official communication, there is a figure (the Global Debt-to-World GDP) that provides us with a different picture of the situation. From 179 percent in 2007, it now culminates at 217 percent, pushed by both private and public indebtedness. So yes, financial institutions are much more prepared now than they were a decade ago to confront a systematic risk. But what about the risk itself? How has it evolved since 2008? It seems its nature changed. From the banks' balance sheet, it migrated further to States' sovereign debts and households' credit.

The topic of Eurozone sovereign debts has been overlooked for several years now since ECB, Member States, and IMF injected dozens of billion euros to unconditionally back Member States whose public debts were being attacked on the euro public bond market.

The implementation of the Quantitative Easing (QE) program in early 2015 by the ECB - which consists mainly in purchasing billions of Member States' public debt on the primary market to ensure they get cheap access to capital. This definitively deters the boldest and most daring investors like George Soros, who scrutinized the Bank of England.

However, as the QE program came to an end in December 2018 and some Member States' economies start showing signs of weakness, it is wise to discuss whether a new European debt crisis could happen again.

The question is worth discussing because investors once again defy some euro high-debt countries and the monetary weapon (QE) won't be available as it needs to reload. Indeed, unlike in 2011, when PIIGS (Portugal, Ireland, Italy, Greece and Spain) could still count on the ECB to back their asses, the ECB must now lighten its balance sheet which implies stopping the purchase of member states' public debt on the markets.

As we've seen previously, the EU economy is expected to slow down in a near-future. Lower growth means lower tax revenues for States. If public expenses remain unchanged (as a percentage of GDP), then less tax revenue means more borrowing. Combined with worrying public debt-to-GDP ratios for some member States and their seeming unwillingness to cope with the issue (see France and Italy 2019 budget forecast a public deficit of 3% or more) it may now be long before investors start defying again euro governments debt.

This is particularly worrying in the Italian case. Italian potential growth is close to 0 and the populist government shows no willingness to curb the budget deficit. Should the Italian economy - the third of Eurozone - undergo some troubles in the months or years to come, it may not be long before investors started demanding insane risk premium, causing Italy to default on its debt.

Hopefully, there exists some powerful solidarity mechanisms between the member states which makes this scenario unlikely to occur; notably: European Stability Mechanism (ESM), a safeguard designed to provide immediate access to financial assistance programs for member states in financial difficulty, with a maximum lending capacity of €500 billion funded by member states and the IMF

Global trade tensions

If the US were to impose 10 to 25 percent tariff on virtually everything the country imports from China, the impact on global trade would remain marginal. Indeed, the world trade is $18,000 billion per year while US annual imports of Chinese products is at best $500 billion dollars and Chinese imports of American products is about $ 100 billion. Combined, it represents no more than 3.5% of the world trade. If there were to be some really annoying consequences, it's more about the negative signal the US would send to the rest of the world: "We, Americans, are now officially isolationist", definitively signing the end of multilateralism-era and justifying everywhere else in the world the use of protectionism.

Conclusion

The 2 worst economic crises in recent capitalism history occurred after the financial system collapsed and, as a result, stopped to fulfill its role of funding the economy. The new regulatory framework implemented post-2008 in the US and EU makes me confident it won't happen again, as it does make the global financial system more robust or, at least, less vulnerable to systemic shocks. Global banks are well funded and high-risk practices are now regulated. Among the numerous more minor economic slumps through the twentieth century, a recurrent cause is a changing monetary environment, caused notably by an unexpected brutal changes in the CB's policy. If the Fed manages a soft landing then I am confident that beyond the classical credit crunch that result from higher borrowing costs, this won't cause the US economy to contract tremendously. We are left with the yield curve inversion. Relevant in the past to predict future recessions in the US, it can't be overlooked. My bet is emerged and advanced economies would continue to slowdown in 2019 and 2020, in nothing more than a natural move of economies regressing to their long-term growth trend. I do not believe in a global recession as systematic risks we've just assessed are, in my opinion, sufficiently controlled today thanks to policymakers learning from past mistakes. However, I don't discard any scenario of regional recessions, caused by the realization of idiosyncratic risks (Eurozone debt crisis and Italy for instance), but then again, my guess is they won't be synchronized and not caused by the same risk factors.

I further consider that the economic variations (both the up and down side) would prove less intense as we move forward. Economic cycles are losing momentum since the end of the 20th century as we converge towards what economists refer to as « secular stagnation »: a post-Industrial era of flat growth where the norm is 0.1 or 0.2 growth rate.

Sources:

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6: Bloomberg (USGG12M and USGG10Y).

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