WASMER SCHROEDER

Perspectives on Risk

A Storm is Coming

November 2019

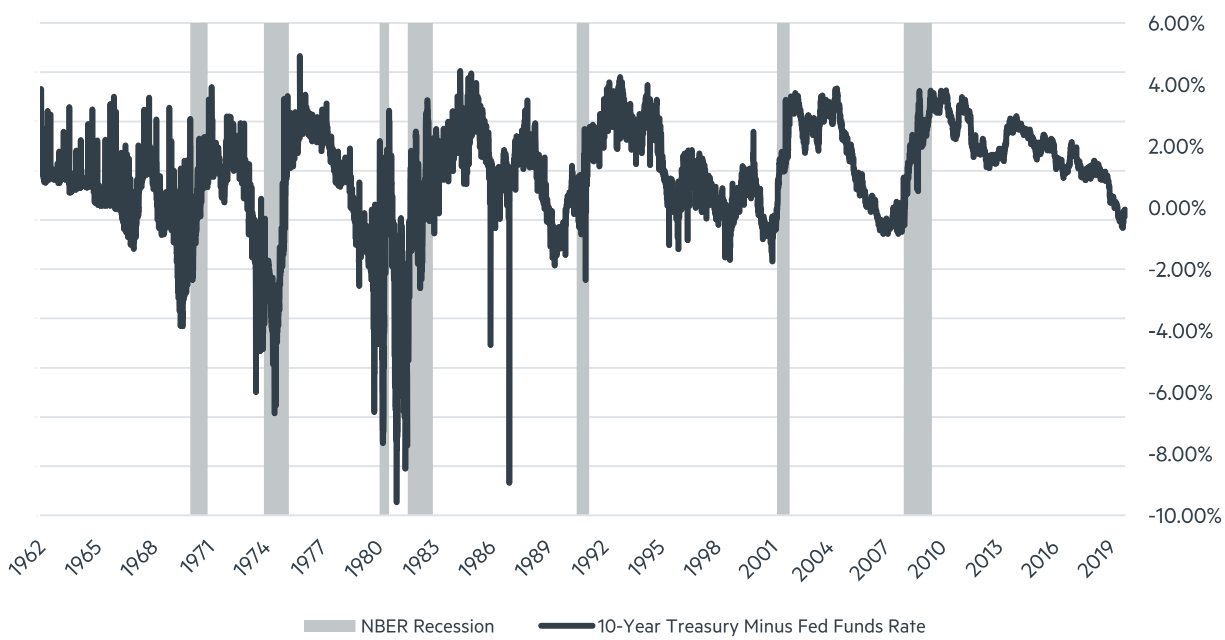
Introduction

The recent, albeit brief, inversion of the US Treasury yield curve may (or may not) be signaling a recession.

As the below chart indicates, recessions typically follow yield curve inversions with a lag of anywhere from 12-24 months. According to Credit Suisse, the average lag is about 22 months.[i] The implication we should expect here, assuming the average lag of 22 months is how things play out, is to see a recession start sometime in the Spring of 2021.

The only problem with this implication is that history isn't 100% reliable, but it is close. There are a few exceptions worth noting. For example, there have been two periods since 1953 when the yield curve inverted—1966 and 1979, following which the economy rebounded before eventually falling into a recessionary period. This era was marked by the winding down of the Vietnam conflict, Watergate, the oil embargo, the "bail-out" of New York City, and a bout of inflation. Turbulent times, to say the least.

US Yield Curve & Recessions



1/2/1962 – 10/17/2019; Source: Federal Reserve Bank of St. Louis

Then, in the late 1990s the curve flattened and nearly inverted around the time Long Term Capital collapsed, but the economy rebounded before succumbing to the dot.com/tech bubble crash—exacerbated by the US invasion of Kuwait and the complete shut-down of airports and the stock market following the September 11th terror attacks on the World Trade Center.

What About a Trigger?

It is often said that neither bull markets nor economic expansions "die of old age."

Everything eventually dies, usually as the result of aging. So, too, is the case with economic expansions—the older they become the more susceptible they are to outside forces that negatively impact their natural ability to survive.

That said, whether it be one event or the confluence of several, looking back over past recessions the argument has been made that a given event or set of circumstances served as a trigger, so to speak, that pushed an aging economic expansion into recession. Reasonable people can certainly debate the merits of this view, and it does have merit. Of course, it is always easier to spot the trigger event or events in hindsight—not so much in advance, despite our collective best efforts.

One thing is apparent and that is the fact that recessions are occurring farther apart. Take this most recent economic expansion for example. It came to life in the wake of the Great Recession of 2007-2009, which was the longest recession since the Great Depression of the 1930s, and the second most severe since then, measured by GDP decline—peak to trough and peak unemployment. (See below timeline).

This could mean that the economy is less vulnerable to modest outside influences/shocks than previously, which makes sense given changes in our economy since 2008, including enhancements to our regulatory framework, improved market transparency, growth in technology, the internet and information access, ease of global capital flows and reduced reliance on oil, to name a few.

Recession	Duration	Overview
July 1953–May 1954	10 months	Following the Korean War, the Fed tightened monetary and fiscal policy to prevent an increase in inflation. An increase in the discount rate and a decline in the real money base led to this recession. The economy declined by 3.2% and unemployment rose to 6.1%
August 1957–April 1958	8 months	As a result of the 1953-1954 recession, and growing concerns over the pace of recover, the Fed's actions in the years following 1954 led to another recession in 1957. Real GDP fell by 3% and unemployment rose to 7.5%
April 1960–February 1961	10 months	The Fed began tightening in the spring of 1959 in the face of rising inflation and gold outflows. Real GNP fell by less than 1% and the unemployment rate increased to 7%.
December 1969–November 1970	11 months	The three years following the 1960/1961 recession saw rapid growth and low inflation. In 1965, inflation began to rise and while the Fed tightened rates in an effort to stem rising inflation, it wasn't enough. The summer of 1969 saw Real GNP fall by less than half a percent, and unemployment increase to 5.9%, resulting in a relatively mild recession.
November 1973–March 1975	16 months	Noted as one of the worst post-war recessions, Real GNP declined by 4.7% and unemployment increased to 8.6%. CPI inflation increased to 10% by 1974. The 1973 oil crisis, a quadrupling of oil prices by OPEC, along with wage controls and a steep increase of the price of gold are to blame for this recession.
January 1980–July 1980	6 months	This short recession is the result of aggressive Fed actions to fight the high inflation seen in the 70's. Between October 1979 and April 1980, there was approximately a seven percentage point rise in the nominal funds rate, resulting in the largest increase over a six month period in the Fed's history. The recession ended in July 1980 followed by a very rapid recovery.
July 1981–November 1982	16 months	In the spring of 1981, the Fed raised the federal funds rate from 14.7% to 19.1% to fight double digit inflation. While the tightening succeeded in reducing the inflation rate from 10% to 4%, it didn't happen quickly. During this recession, Real GNP fell by 5% and unemployment increased to 10.8%.

Recession	Duration	Causes/Characteristics
July 1990–March 1991	8 months	In 1988 the FOMC wanted to reduce inflation from the 4.0%-4.5% range. As a result, Fed tightening led to the federal funds rate rising from 6.5% to almost 10% by May 1989. This mild recession began in 1990 and was aggravated by an increase in oil prices. Real GNP fell by 1.4% and unemployment peaked at 7.7% in 1992.
March 2001–November 2001	8 months	On the heels of the longest period of growth in US history, the Fed loosened monetary policy in 2000 due to fears of Y2K. However, the collapse of the speculative dot-com bubble, a fall in business outlays and investments, and the September 11th attacks, brought the decade of growth to an end. The FOMC didn't forecast a recession and was slow to respond, however, the recession was relatively short.
December 2007–June 2009	18 months	The "Great Recession" is known as the most serious event since the "Great Depression". The subprime mortgage crisis led to the collapse of the US housing bubble. The crisis led to the failure or collapse of many of the United States' largest financial institutions: Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, Citi Bank and AIG, as well as a crisis in the automobile industry. Both the crisis and recession were dealt with by vigorous policy responses. The severity of this recession reflected both a credit crunch and tight Fed policies. Real GDP declined by 4% and unemployment reached 10.2%.

Source: NBER

Watching for Signs

So, what should investors watch for in terms of the key factors contributing to the demise of this, the longest economic expansion since WWII?

A few come to mind, but the one most talked about—and the one that has contributed to recent stock and bond market moves, is the trade war with China. Some estimates now place China's GDP growth at under 6% - the lowest in nearly 30 years. Analysts have cited the risks associated with the tariff scuffle as a key reason for the lower growth pace.[ii]

Moreover, given the opaque nature of China's economic reporting and disclosures relative to the EU and US, it remains possible that China's economy could be slowing even more than these estimates reflect.

The table below is a dashboard created by Credit Suisse to track key predictive variables. The most consistent predictor—yield curve, briefly inverted in 2019 but has since reverted back to its prior slightly-positive slope following the three FOMC rate cuts. Was this a recession warning sign? Perhaps.

But the yield curve is not the only gauge that markets are watching. A close look at the Credit Suisse dashboard shows that housing and manufacturing are neutral indicators in their model, but recent reports in both sectors are worth watching closely.

Recession Dashboard

Start of Recession	Yield Curve	Inflation	Job Creation	Credit Perform	ISM Mfg.	Earnings Quality	Housing Market
Nov-73	↓	↓	↓	--	↓	↓	↓
Jan-80	↓	↓	↓	--	↓	↓	↓
Jul-81	↓	↑	↑	--	↓	↓	↓
Jul-90	↓	↓	↓	↓	↓	↓	↓
Mar-01	↓	↓	↓	↓	↓	↓	↔
Dec-07	↓	↓	↔	↓	↓	↓	↓
Present	↓	↑	↑	↑	↔	↑	↔

Key: ↓ **Recessionary** ↑ **Expansionary** ↔ **Neutral**

Source: Standard & Poor's, Federal Reserve, BLS, National Statistical Agencies, NBER, ISM, Census Bureau, Haver Analytics, Credit Suisse

Home price gains in the US have slowed since June to the slowest pace since 2012, and the ISM Manufacturing Index is now below 50 for the first time since August 2016. (iii)

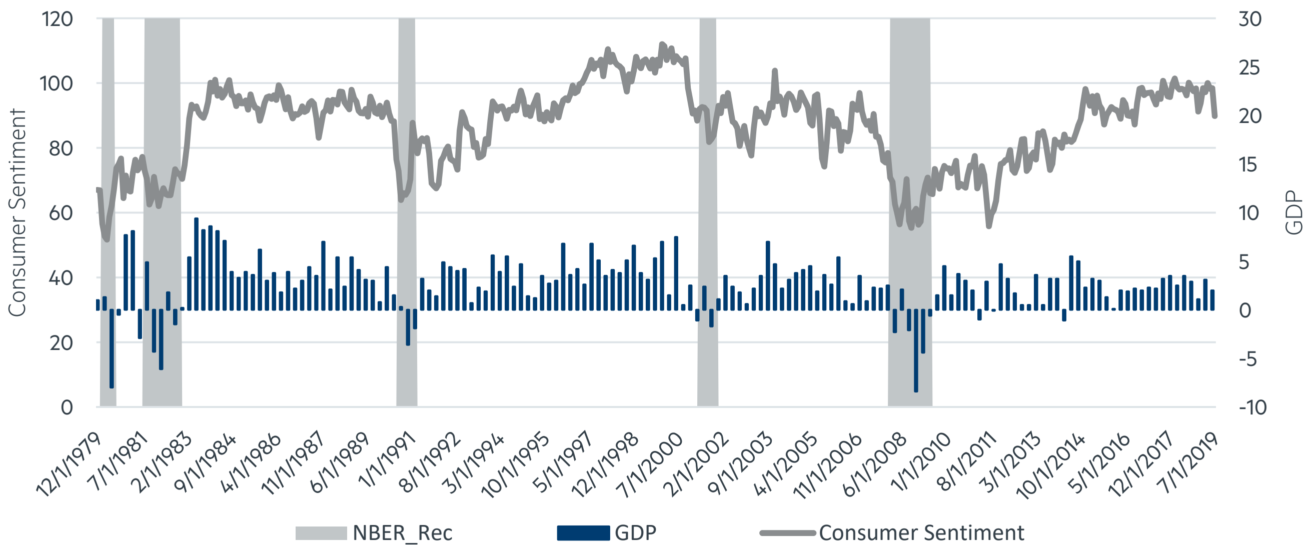
There are three other indicators away from the CS dashboard worth noting. The first is the Cass Freight Index, which has a high correlation to US GDP growth and has been a reliable early signal of global economic weakness. This metric is reflecting reduced global shipment activity and if recent trends persist, this would be another sign that recession is on the horizon. (iv)

The other two are US corporate profits, which are rising but the pace of growth is slowing this year according to FactSet, and new business formation, which is off 16% between 2007 and 2019. (v)

The Eye of the Storm: The Consumer

Finally, and perhaps most importantly, we need to keep an eye on consumer confidence because consumer spending is the largest component of GDP. The University of Michigan Consumer Confidence Index rose in November to 96.8 from 95.5 in October but remains slightly lower year-over-year and showing signs of fatigue of late. One big risk to consumer confidence is the 2020 election cycle, which is sure to feed the anxiety of some spenders.(vi)

University of Michigan Consumer Sentiment Index GDP and Recessions

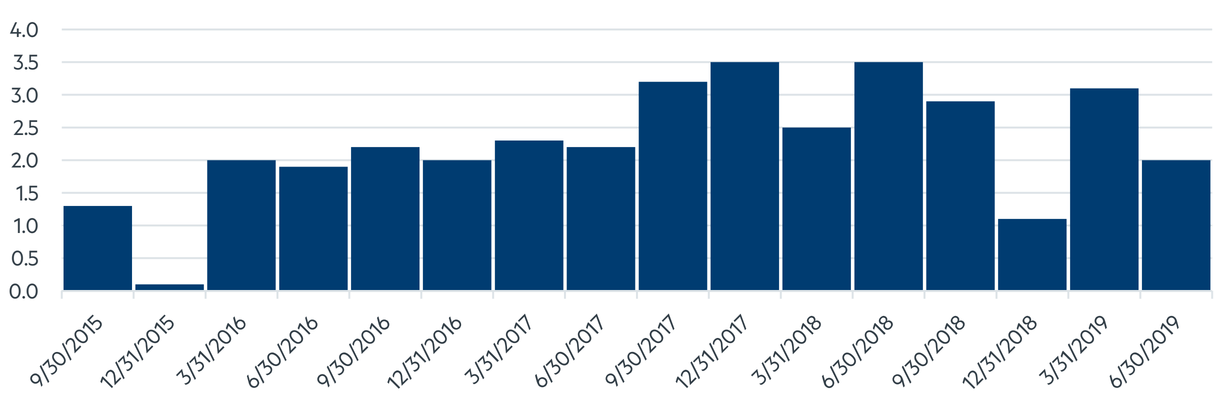


12/31/1979 – 07/31/2019; Source: Federal Reserve Bank of St. Louis

Indeed, a recent Gallup Poll revealed that nearly half of all Americans think a recession is at least fairly likely in the next year. (vii)

Still, based on the traditional standard definition of a recession as two consecutive quarters of negative GDP growth, the odds of 2020 being a recession year are at best a toss-up. The trend, it seems, is now more in line with a 2% growth pace versus the 3% or higher back in 2017 and 2018.

Real GDP: Percent change from preceding quarter



9/30/2015 – 6/30/2019; Source: US Bureau of Economic Analysis

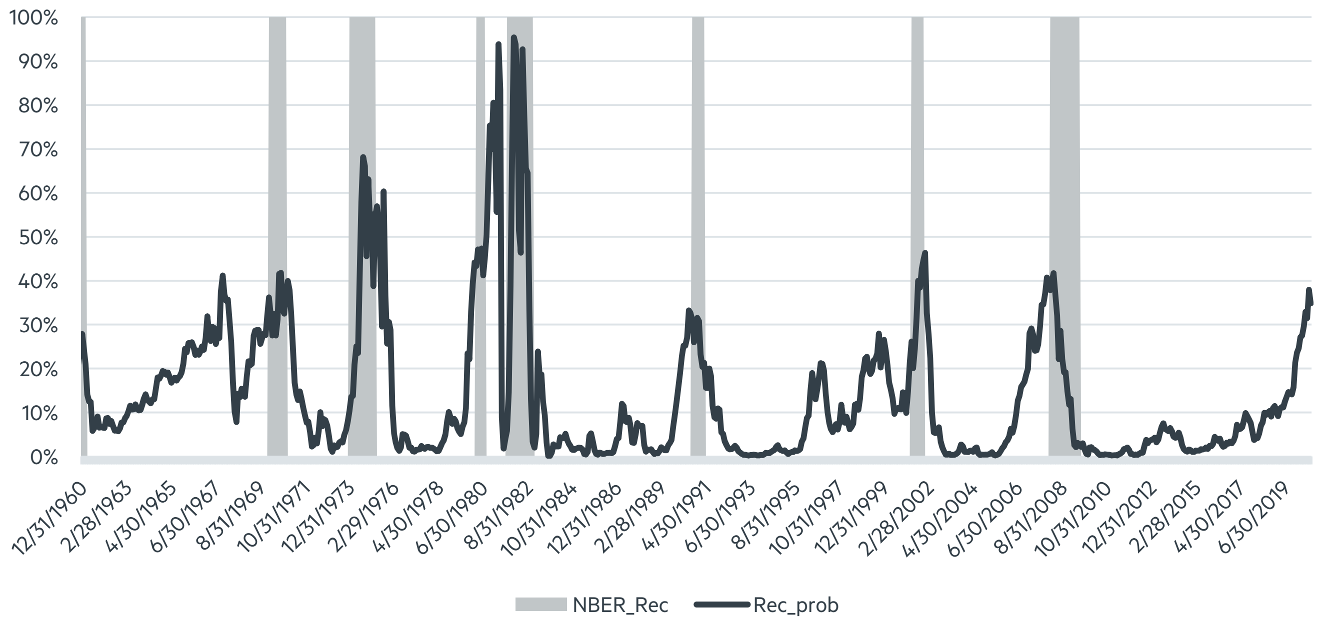
Many economic forecasters, including the Federal Reserve Bank of Cleveland, have been adjusting their recession probability outlooks upward this year, as the chart below illustrates. Speaking of the Fed—last year the FOMC was raising the Fed Funds rate, which hit 2.25% to 2.50% target range at their December 20, 2018 meeting, only to reverse course and cut the fed funds rate at three consecutive FOMC meetings in 2019.[viii] Clearly, the risk of a monetary policy error—in magnitude, timing or direction, is something the markets are keenly aware of and watching closely.

Bottom line: The US economy is currently strong and growing, but the risk of a recession is rising—if perhaps only modestly, and the best investment approach is to be prepared.

From a risk-reward perspective, each of our fixed income solutions is structured to reflect the liquidity, safety and income needs of our respective clients invested in those strategies. As with all risks, the risk of a recession and the potential credit, yield and liquidity effects on the bond market generally, and our client's portfolios specifically, is a top portfolio management priority at WS.

The team at WS welcomes any questions you may have about our fixed income solutions.

Probability of Recession Calculated from the Yield Curve



12/31/1960 – 09/30/2020; Source: Board of Governors of the Federal Reserve; National Bureau of Economic Research

Sources:

(i) https://www.cnbc.com/2019/08/20/a-recession-dashboard-from-credit-suisse-indicates-the-economy-is-nowhere-near-a-recession.html

(ii) https://www.bloomberg.com/news/articles/2019-10-18/china-economic-growth-unexpectedly-slows-to-6-in-third-quarter; https://www.bloomberg.com/news/articles/2019-09-03/u-s-manufacturing-contracts-for-first-time-in-three-years?srnd=premium

(iii) https://www.instituteforsupplymanagement.org/ismreport/mfgrob.cfm?SSO=1; https://fred.stlouisfed.org/series/CSUSHPINSA

(iv) https://www.cassinfo.com/hubfs/Freight%20Payment%20/Transportation%20Indexes/Cass%20Freight%20Index/Reports/Cass%20Freight%20Index%20Report%20-%20July%202019.pdf?hsCtaTracking=5fde9be4-1dd0-462f-8c5f-b100aca52fc1%7C0990f099-885d-442a-972a-aeb259c5a188

(v) https://apnews.com/e7179fc8b9dc4399818f2038b75ec423

(vi) https://www.cnbc.com/2019/11/22/us-consumer-sentiment-november-2019.html

(vii) https://news.gallup.com/poll/266960/economic-confidence-drops-lowest-level-shutdown.aspx

(viii) https://www.federalreserve.gov/monetarypolicy/openmarket.htm

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Chief Risk Officer

Michael Schroeder is the Chief Risk Officer of Wasmer Schroeder (WS). He is responsible for overseeing the firm's risk management process, which includes WS's enterprise and investment-related risk management strategy, policies, controls, and systems.

Michael was WS's Chief Investment Officer from 1991 to 2017. In that role, he oversaw the firm's investment process, which included the implementation and development of investment strategies, portfolio management, research, and trading.

Michael earned his BS in Business from the Carlson School of Management, University of Minnesota. He is a licensed CERTIFIED FINANCIAL PLANNER™.

About the Firm: More than 30 years ago, Wasmer Schroeder was founded on the principles of an unwavering commitment to service and a dedication to managing fixed income the right way. From its beginning, the firm has held steadfast in its spirit of collaboration—doing what's right for the advisors, investors, and institutions for whom we manage money. We do right by doing right by them—knowing their businesses, understanding their goals, and consistently finding solutions to meet their needs. As an active fixed income manager with a team of investment professionals across tax exempt and taxable strategies, we are dependable, collaborative, and insightful in our approach. Backed by research and emboldened by technology, our hands-on team is a true partner to the advisors, investors, and institutions who give us their trust.

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