CASTLE ROCK
WEALTH MANAGEMENT

Registered Investment Advisor Firm

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Recession Indicators

The economy is widely expected to continue to slow, and partial yield curve inversion has intensified concerns we're heading into a recession. Yet following the US economy involves checking in on hundreds of indicators – some of which can give conflicting signals. While I don't expect a recession anytime soon, over the years two indicators are particularly good at signaling a meaningful downshift in growth: initial jobless claims and consumer confidence.

It may seem surprising that we need timely indicators of a recession. After all, in the rearview mirror, recessions are obvious. However, in the moment it can be hard to distinguish a moderate economic slowdown from an actual recession, which is defined as a significant decline in economic activity. Economic data is released with a lag and can be conflicting.

The National Bureau of Economic Research (NBER) is the organization that decides the official start and end of recessions, but this typically happens with quite a lag. Since the 1970s, NBER has announced the start of a recession 6-21 months after it began, in some cases after the recession has ended.

Yet keeping tabs on the economy is perhaps more pressing now than at any time in the past 10 years, given the length of the current historic business cycle. Most forecasts expect the economy to slow throughout 2020, but a "soft landing", where growth gradually decelerates to match the pace of underlying potential growth, can be difficult to navigate. At present, the yield curve is inverted according to the often-watched 3 month – 10 year Treasury yield spread, which is considered a warning sign that a recession is likely within the next 4-6 quarters. Concerns about trade tensions and slowing worldwide growth have ratcheted up market jitters that a recession is looming.

Initial jobless claims

The data is very timely and released weekly. While this data series can be volatile in reaction to one-off events, like a hurricane or government shutdown, it's a powerful leading economic indicator of recession with few incidents of giving false-positive signal.

Initial claims for unemployment insurance typically bottoms 9 to 24 months before a recession begins. Often, the path from weaker business sentiment to the broader economy comes through a slowdown in hiring. A 20% increase in initial claims over an 8 – week period would be a clear warning sign that uncertainty is causing companies to increase layoffs.

At present, initial claims rest near multi-decade lows. In 2019 to date, claims have averaged 219,000, a level that reflects a tight labor market. Recently, the ISM (Institute for Supply Management) Manufacturing index dropped to a 33–month low, causing concern to spike about the health of the economy. But initial claims have remained at exceptionally low levels. Should claims rise to 275,000 over several months, I would become more pessimistic about the growth outlook.

Consumer confidence, present situation vs. expectations

The consumer is the single most important sector for the economy, making up 69% of GDP. Look at the spread of the two main components of the Conference Board's consumer confidence numbers: the difference between the Present Situation Index and the Expectations Index. This has a slightly better track record of timing the start of a recession than the headline index.

At present, this spread is near cycle highs. This is partly due to the tight labor market, which has propelled confidence and the present situation measure close to a 20-year high. Should the economy meaningfully falter, the difference between low growth and a contraction in growth is the consumer, and the deterioration in household sentiment is what causes spending to dry up quickly.

Although this spread has retreated modestly from its cycle high in January, it remains elevated. But should business confidence waver and hiring starts to slow, watch this measure to see whether households are entering bunker mode and radically cut back spending, which could push our economy into a recession.

It's critical to be mindful of the signals the bond market is sending about the economy. However, the yield curve inversion covers a wide variety of yield pairs, which right now shows a varied picture. While the 3M-10YR is inverted, the 2YR-10YR is not. The Fed fund futures curve is deeply inverted.

Consumer confidence reflects the outlook of Main Street an important guide to the underlying economy. Initial jobless claims is a timely indicator showing businesses' willingness to hire and retain workers, a critical forward signal of how business sentiment will feed into household spending habits.

History can serve as a useful guide for how these indicators act around turning points, but it is no guarantee. Yet while every expansion is unique, we haven't had a contraction in growth without a contraction in household spending, making the consumer a critical sector to track. Likewise, with a decline in business sentiment already apparent, it will be important to see whether this translates into more conservative hiring practices. I don't expect a recession in the near term, but any slowdown generates uncertainty and heightened volatility.

The watch continues. Remember the old adage: Bull markets don't die of old age, but external events.

If you need help with indicator or any other financial questions, contact me at (707) 648-2024.

FED Watch

The Federal Reserve lowered a quarter-point its key interest rate to 2.00-2.25% at their July meeting, their first cut in 11 years, and will continue cutting rates if needed to protect the US economy from trade conflicts and other threats. It issued a statement saying that because "uncertainties remain"; it would "act as appropriate to sustain the expansion".

The FED will end the process of reversing the quantitative easing by allowing assets to mature off their balance sheets, rather than re-investing them and plan to taper this process and plan to complete in August of this year.

Next meeting:
September 17th and 18th.

Castle Rock Wealth Management

Castle Rock Wealth Management is a Hybrid Advisory firm servicing the needs of clients across the United States.

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