ClearBridge Investments

Recession Indicators Update: Evolution of a Downturn

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Key Takeaways

- Even after initial signs of economic weakness, recessions can take time to develop. A review of the U.S. economy ahead of the Great Recession is instructive in showing how stresses can build up over several years.
- The ClearBridge Recession Risk Dashboard signal flashed yellow in October 2006 and red in August 2007, four months before the last recession officially began.
- Currently, eight of the 12 indicators in the dashboard remain green. After showing signs of strain over the last several months that resulted in several indicator changes, financial markets are now sending mixed signals. Business activity and consumer health, meanwhile, are displaying few signs of stress.

Following a sharp fourth-quarter drawdown, investors' appetite for risk has returned. Nowhere is this more evident than in credit spreads, which measure the difference or spread between the yields on corporate bonds and risk-free Treasury securities of similar maturities. The credit spreads indicator in the ClearBridge Recession Risk Dashboard tracks the spread between the Bloomberg Barclays U.S. Corporate High Yield Index and the 10-Year Treasury. After moving from green to yellow in the fourth quarter as credit markets began to price in the increasing likelihood of recession, high yield spreads have come in quite a bit as the outlook for equity markets and the economy have stabilized, meriting an upgrade to green at the end of February.

Judging recession risk by credit spreads alone, the U.S. economy would appear to be all clear right now. But it is this type of variability – what basketball fans might call a head fake – that makes it critical to judge the trajectory of the economy from a number of angles. This was our primary motivation in researching many indicators of economic performance and isolating 12 that we believe are most predictive of economic distress. As recessions tend to coincide with bear markets, we believe the dashboard can help guide investment decisions in periods of economic transition.

As we commemorate the 10-year anniversary of the bull market that started in March 2009 and an extended economic recovery, we think it's instructive to review the multi-year evolution of the ClearBridge Recession Risk Dashboard that led up to the Great Recession.

Exhibit 1: ClearBridge Recession Risk Dashboard

	February 2019	January 2019
Yield Curve	●	●
Credit Spreads	⬆	●
Money Supply	●	●
Wage Growth	●	●
Commodities	●	●
Housing Permits	⬆	⬆
Jobless Claims	⬆	⬆
Retail Sales	⬆	⬆
Job Sentiment	⬆	⬆
ISM New Orders	⬆	⬆
Profit Margins	⬆	⬆
Truck Shipments	⬆	⬆
Overall Signal	⬆	⬆

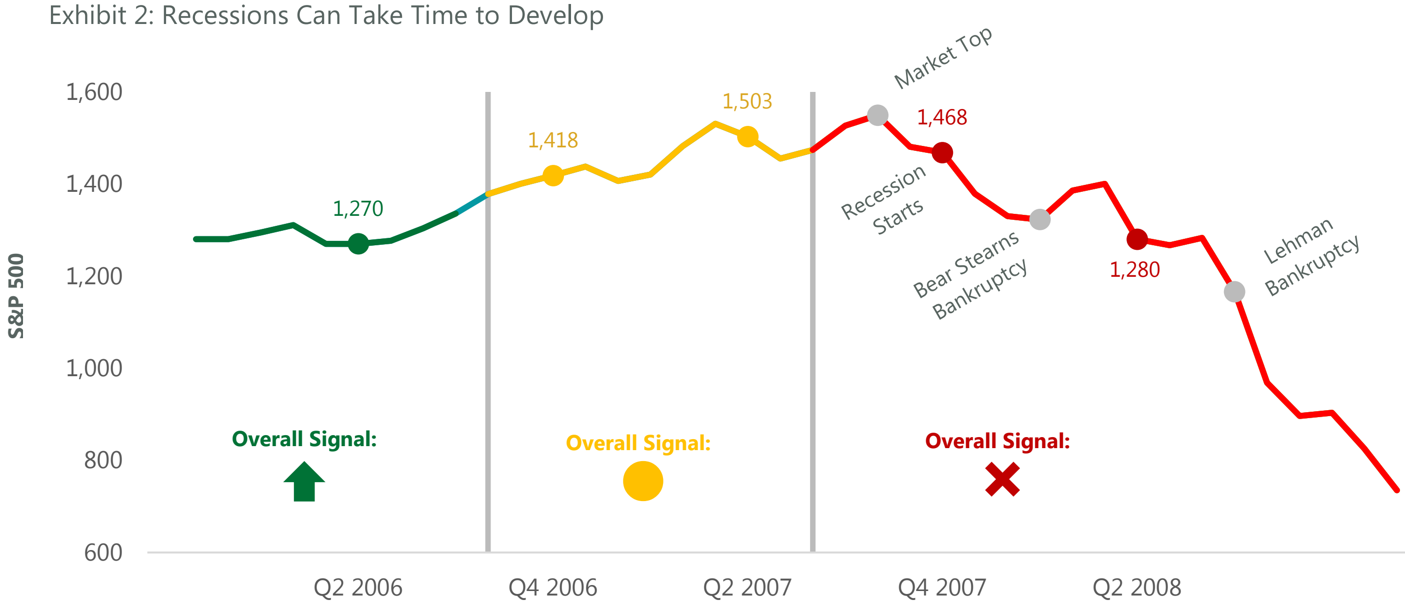
As of Feb. 28, 2019. Source: ClearBridge Investments.

At present, eight of the 12 ClearBridge Recession Risk Dashboard indicators we track remain green (with four yellow). Both of our inflation indicators have turned yellow over the last several months while two of the three measures of financial markets are also flashing caution. However, the portions of the dashboard that focus on the "real" economy remain healthy with consumer and business activity showing few signs of stress. As the economic cycle continues to mature, we would expect the dashboard to worsen, and importantly would be looking for a broadening of stressed signals beyond inflation and financial markets.

In some ways, this reminds us of 2006. We believe that studying the progression that led up to prior recessions can give investors a better appreciation of how a recession can develop. We continue to view near-term recession risks as low and believe that exiting equities based on one negative economic indicator is not a prudent move.

The Great Recession is America's most recent recession, and it is often considered the worst crisis since the Great Depression. As with all previous recessions, there were several warning signs. First was the inversion of the yield curve in December 2005. Then, in January 2006, fearing an asset bubble, Federal Reserve Chair Ben Bernanke raised interest rates. This worsened the situation. In April that year, Bernanke gave a speech to the House of Representatives, explaining that based on mortgage and job creation rates, the Fed expected markets to undergo a "gradual cooling rather than a sharp slowdown." In July 2006, the federal-funds rate increased to just over 5% and the yield curve, which had normalized after inverting the previous December, inverted again. In September 2006 the Dashboard's Yield Curve indicator changed from yellow to red.

Exhibit 2: Recessions Can Take Time to Develop



Financial	Yield Curve	●	✕	✕	✕	✕
	Credit Spreads	↑	↑	↑	✕	✕
	Money Supply	✕	✕	✕	✕	✕
Inflation	Wage Growth	✕	✕	✕	✕	✕
	Commodities	↑	↑	↑	✕	✕
Consumer	Housing Permits	●	✕	✕	✕	✕
	Jobless Claims	↑	↑	●	●	✕
	Retail Sales	↑	●	●	✕	✕
	Job Sentiment	↑	●	●	✕	✕
Business Activity	ISM New Orders	↑	●	●	✕	✕
	Profit Margins	●	●	●	✕	✕
	Truck Shipments	●	●	●	●	●

Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg.

Perhaps the most crucial catalyst was the housing market bubble; in the years leading up to the recession, hedge funds made investments in mortgage-backed securities, many of which had subprime ratings. As homeowners defaulted on their mortgages, large banks began collapsing, and with them the global economy that relied on them. In September 2006, the Dashboard's Housing Permits indicator turned from yellow to red, and Job Sentiment changed from green to yellow. That October, the ClearBridge Recession Risk Dashboard's overall signal changed from green to yellow (Exhibit 2), beginning a cautionary period. It's instructive to note that from a weaker period in mid-2006 when four indicators were yellow and two red, it took another six quarters for recession to start. Today's economic landscape is healthier, with the dashboard showing four yellow indicators but an overall green signal through February, suggesting the next recession will likely take time to develop. Such absence of near-term recession risk should give investors the confidence to stay invested in equities or return to the market.

About the Author

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- 13 years of investment industry experience
- Joined ClearBridge Investments in 2014
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