ClearBridge Investments

Recession Indicators Update: Green Shoots Begin to Emerge

June 3, 2020

Key Takeaways

- The economy appears close to a bottom with the ClearBridge Recession Risk Dashboard remaining red with two more indicators worsening during the month, consistent with the most severe contraction in modern U.S. history.
- As investors focus on recovery and the economy begins to reopen, we shift our attention to the ClearBridge Recovery Dashboard, which improved to a cautious yellow overall signal in May with upgrades to Credit Spreads and Initial Jobless Claims.
- While the economy may continue to catch up to market optimism, a reversal would not be unprecedented. The trajectory of the recovery out of the Global Financial Crisis may offer a guide to the uncertain nature of past recoveries.

Markets Buoyed By Early Signs Recovery Taking Hold

Many states began to ease stay-at-home guidelines in May as the spread of COVID-19 ebbed. Economic green shoots are emerging and stocks rallied 5% in response, largely in the last few days of the month. While the path forward is fraught with risk and potential downside surprises, the latest data paints an optimistic picture.

The U.S. economy has barely begun to catch up to the optimism embedded in equity markets, yet investor focus is firmly planted on the pace of the recovery. Although the official declaration of a recession is yet to come, we continue to believe the economy peaked in the first quarter. The worsening of two additional indicators on the ClearBridge Recession Risk Dashboard –Truck Shipments to red from green and Housing Permits to yellow from green – further cements this view.

Exhibit 1: ClearBridge Recession Risk Dashboard

		May 31, 2020	April 30, 2020	March 1, 2020
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	✕	⬆	⬆
	Overall Signal	✕	✕	●

⬆ Expansion ● Caution ✕ Recession

Source: ClearBridge Investments.

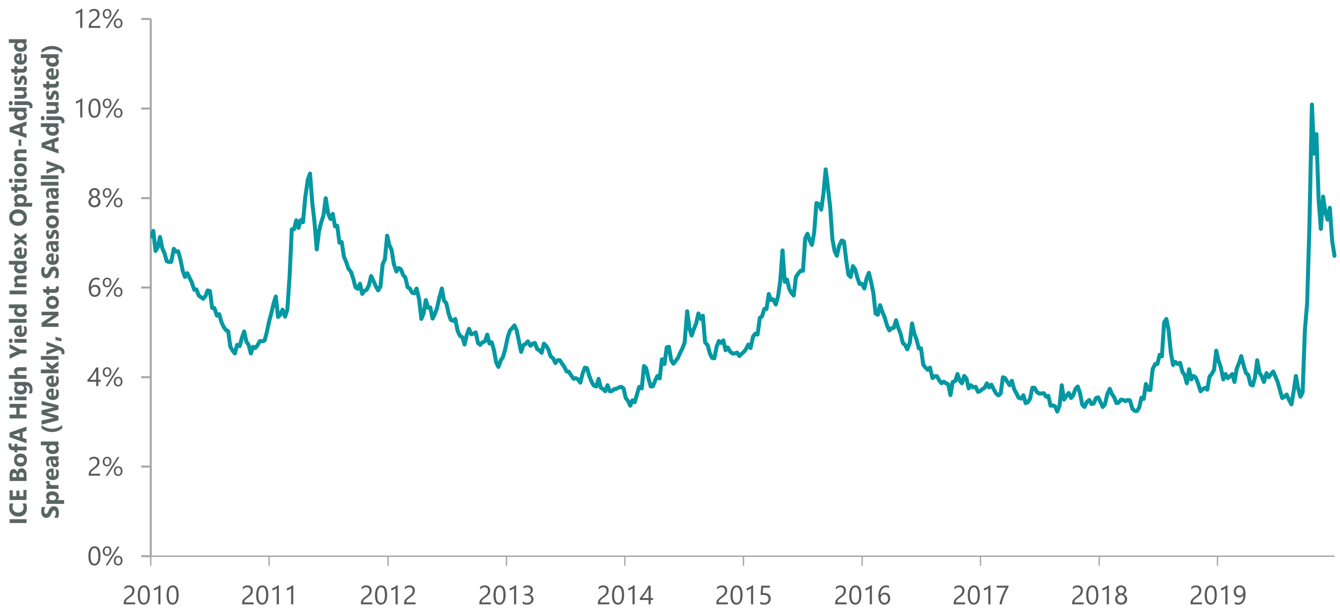
The dashboard's overall signal is now a deeper red than seen during the Global Financial Crisis (GFC). Given the shift in investor focus toward the recovery, this blog will serve -- for the time being -- as the final monthly update to the Recession Risk Dashboard. Once a durable recovery has formed and the economy is back on firmer footing, we will bring back the Recession Risk Dashboard to help investors in assessing the likelihood of future downturns.

Path of Recovery Coming into Focus

In the meantime, we turn our attention to the ClearBridge Recovery Dashboard, which showed improvement in May with three signal changes. Before delving into those, we wanted to make readers aware of a recent enhancement to the Recovery Dashboard. We are constantly evaluating new indicators and ways to interpret the data and have substituted Housing Starts for Building Permits. Our research suggests that Housing Starts have historically done a better job of identifying troughs in economic activity with less variability. While both signals have been red for the past several months, we believe Housing Starts will be more useful in highlighting the formation of a durable bottom going forward.

The first signal change is Credit Spreads, which have improved to yellow from red. The Federal Reserve has taken extraordinary measures in recent months to support credit markets, and their actions have kept credit flowing. For example, there has been nearly $850 billion of investment grade and high yield corporate bond issuance in the last three months, well above typical levels. Secondary markets have stabilized as well, with both high yield and investment grade spreads coming in from peak (distressed) levels. While spreads remain notably wider than pre-virus levels, almost half of the move has been retraced, enough to support a signal change (Exhibit 2).

Exhibit 2: High Yield Spreads Have Narrowed Off Recent Wides



As of May 29, 2020. Source: FRED, Federal Reserve Bank of St. Louis.

The second signal change to yellow from red is Initial Jobless Claims. Jobless Claims remain at historically high levels, with 2.1 million claims filed in the most recent data released – over three times the previous record of 695,000 back in 1982 but a dramatic improvement from the 6.9 million claims filed in late March. In fact, claims have fallen substantially every week for the past two months. Importantly, continuing claims, a measure of those who remain out of work, fell for the first time last week since the pandemic outbreak with around 4 million workers appearing to regain their jobs as portions of the economy reopened.

This progress boosted the overall signal of the ClearBridge Recovery Dashboard to yellow from red (Exhibit 3). Yellow does not suggest the coast is clear, but rather the conditions for a durable economic and market bottom are beginning to form. Confidence is the weakest portion of the dashboard with more strength emanating from financial markets and economic green shoots.

Exhibit 3: ClearBridge Recovery Dashboard

		May 31, 2020	April 30, 2020	March 31, 2020
Confidence	Consumer Confidence	↑	↑	✕
	Business Confidence (ISM)	✕	✕	✕
	Investor Sentiment	✕	✕	●
Economic	Housing Starts	✕	✕	✕
	Initial Jobless Claims	●	✕	✕
	Philly Fed	↑	↑	●
Financial	Credit Spreads	●	✕	✕
	Fed Policy	↑	↑	↑
	Financial Conditions	✕	✕	✕
	Overall Signal	●	✕	✕

↑ Expansion ● Improvement ✕ Recession

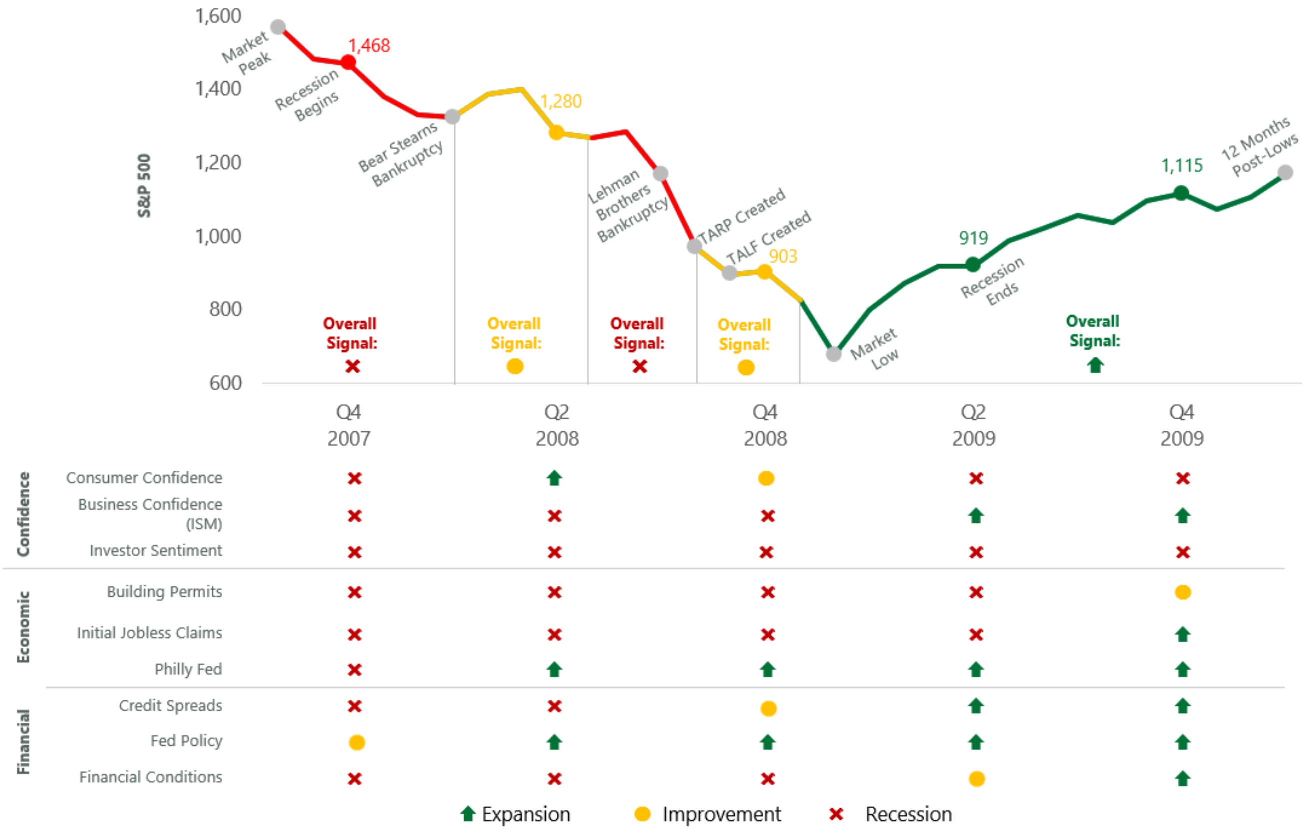
Source: ClearBridge Investments.

Historical Lookback: 2008's False Start

As of now, the overall signal is in fairly shallow yellow territory. While the economy may continue to catch up to market optimism, a reversal would not be unprecedented. For example, the overall signal on the Recovery Dashboard turned yellow in early 2008 when the economy was still in the early days of the recession. Following the collapse of Bear Stearns, a 51-day counter trend rally occurred against the backdrop of multiple indicator upgrades. The Fed lowered interest rates, which boosted the Fed Policy signal, while the Consumer Confidence and Philly Fed indicators both turned green. Credit Spreads, Financial Conditions and Investor Sentiment briefly turned yellow only to regress back to red.

As spring turned to summer in 2008, economic and financial market conditions deteriorated with the overall signal on the Recovery Dashboard returning to red in August, well before the worst carnage of the GFC played out. It would stay there for three months before turning yellow a second time at the end of November and green two months later (Exhibit 4). Equity markets did not bottom until early March and the recession did not end until June.

Exhibit 4: Recovery Lookback 2007-2010



Source: ClearBridge Investments.

Given the nature of the "sudden stop" in the economy caused by COVID-19, economic data is likely to continue to improve from historically low levels in the coming months. To illustrate this point, consensus expectations for second quarter GDP currently stand at -34.2%. This horrific print will likely be followed by a bounce off the low with one of the strongest quarters on record, with expectations for third quarter GDP currently at +15.0%. However, this does not signify a V-shaped recovery, but rather results from how GDP is measured. Unlike corporate results, which are stated in year-over-year terms, GDP is reported on a sequential-change basis with quarterly changes extrapolated into annual terms. If we convert GDP to like terms with financial results, the third quarter of 2020 is expected to be -6.8% below third quarter 2019 levels, following an expected -9.7% change in 2Q. While this ignores the impact of inflation, these economic prints are the most severe in modern U.S. history post World War II.

Activity Could Take Time to Pick Up as Economy Reopens

At present, data suggests the U.S. is not seeing a second wave of COVID-19 infections in states that have begun to ease stay-at-home restrictions. This is an encouraging sign, although it remains premature to make a definitive conclusion. Regardless, the pickup in economic activity has started to close the gap between the economy and financial markets, although not fully. This disconnect is likely to persist and we do not expect to know if the light at the end of the tunnel is an oncoming train for several months. In the interim, there are several events that could disappoint investors, including the size of the next stimulus package. Given the robust move in financial markets, policymakers may feel less pressure to "go big" in terms of stimulus, especially given the growth in the deficit. We believe this could be a mistake as there's a strong possibility that many recent layoffs are likely to become permanent. Many businesses will continue to need assistance in the socially-distanced economy, particularly if consumers continue to avoid activities that have high degrees of person-to-person interaction. Early data suggests consumer caution, and if lower activity levels persist for the next several months, even well-run businesses will come under pressure.

While many questions remain about the health of the economy and the path forward, animal spirits have been rekindled in the equity market. Over the last few weeks, investors have started to rotate into cyclical sectors and the equal-weight S&P 500 Index has outperformed the cap-weighted benchmark, a bullish sign of widening market breadth and less concentrated leadership. Although it remains too early to call this a trend, such undercurrents have typically been present at the beginning of past economic upturns as the market begins to sniff out an improving fundamental backdrop and a rising tide lifts all boats. Regardless of how the gap between financial markets and the economy closes, we believe investors will be well-served to continue to monitor the ClearBridge Recovery Dashboard for clues.

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