MAY 2016

Great-West Capital Management, LLC (GWCM) Research Note

Recession Fears Off the Rails

Why is talk of a recession front of mind?

While the new normal of the global economy seems to be one of persistent volatility and uncertainty, a robust U.S. consumer has so far weathered these events with remarkable resilience. An analysis of core domestic macroeconomic fundamentals leads us to the conclusion that fears of a U.S. recession occurring in the near term appear to be overstated. That being said, elevated negative sentiment that persists over an extended period of time can eventually lead to an erosion of fundamentals that in turn can become a self-fulfilling prophecy.

I.

Remember that feeling right before you reach the top of a new roller coaster? That lingering anxiety propelled by not knowing how scary the fall is going to be. Yet inevitably, after every ride you realize it wasn't that bad (or you were terrified and will never ride one again). It was the hype leading up to it, the commercial you saw, or all the people in line talking about how insane the ride will be that really freaked you out. This is not too far off from how markets started this year: lots of hype around what was happening to the markets and the economy, and plenty of pundits telling us a recession is imminent. Similar to the rollercoaster, we'll look back and realize the environment was not REALLY that bad, but emotions were certainly high!

The first six weeks of 2016 looked like that steep downward slope on a rollercoaster. Equity markets sold off across the globe and government bonds yields dropped. Some yields even went negative. These movements have been compounded by ongoing volatile sentiment and decreased market liquidity. The heavy contraction in the global commodities sector from 2014 continued to drag on inflation and growth prospects into the New Year. Despite these global developments, the Federal Open Market Committee, (FOMC of the Federal Reserve), believed the domestic economy had enough strength to warrant a December rate hike. Overall sentiment was optimistic to start the year but quickly turned in reaction to headline events rather than changes in trends or fundamentals.

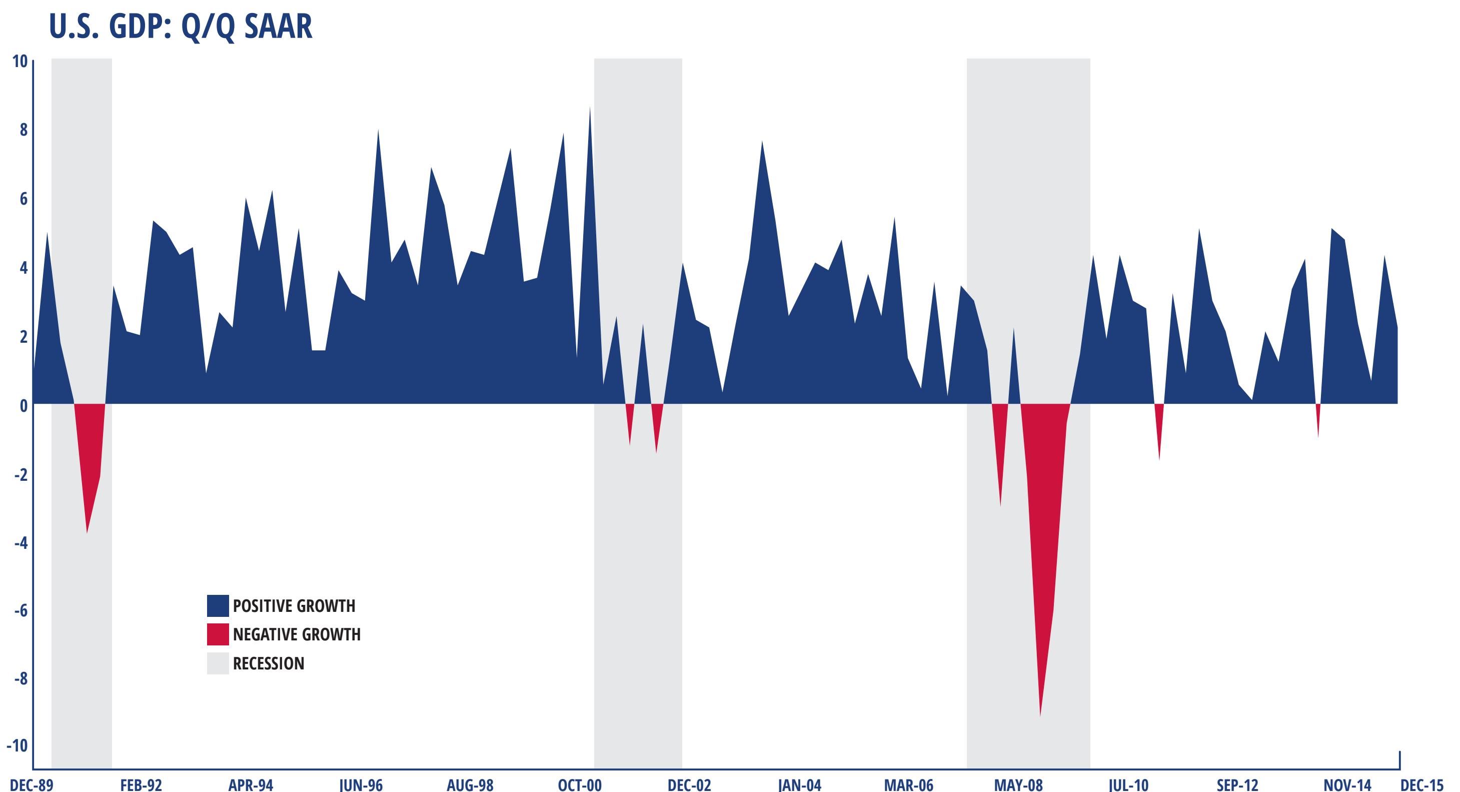
The troublesome component from an investor perspective was how quickly and sharply sentiment turned. To start the year, the ongoing debate surrounding the U.S. economy's overall health and growth expectations escalated and concerns increased with respect to the potential for an imminent recession. Economists and some investors were uneasy that the fragility in the global economy may indeed impact the

domestic economy more directly than initially expected. The primary drivers of these recession fears were the confluence of weakening global growth, a collapse in the energy and commodities complex, and disquiet around the decision by the U.S. Federal Reserve (the Fed) to raise rates in December. What has received the most attention has been the degree to which weakness being experienced abroad, especially in China and other emerging markets, could channel through to the domestic U.S. economy. Many of these recession concerns have merit, especially those that are structural (non-cyclical) in nature.

Equally compelling in our view is that most of the fundamental economic data suggest that the U.S. economy remains on healthy footing. We estimate real Gross Domestic Product (GDP) of approximately +2% for 2016, with the majority of that contribution coming from a healthy U.S. consumer. This constructive domestic outlook is supported by core macroeconomic fundamentals, especially within the labor and housing markets, two critical inputs into real GDP. Additionally, the recent recovery in the energy and manufacturing sectors that started in mid-February suggests that some of the most critical threats to the domestic economy appear to have subsided as the quarter progressed.

While weakness in the manufacturing sector has dominated headline news, keep in mind that consumers/services comprise roughly 70% of total domestic GDP. That portion of the economy has shown remarkable resilience to date. Therefore, the consumer is a primary focus of our attention and we believe we would need to see a consistent deterioration in consumer confidence and spending data to justify a meaningful upward revision to recession probabilities.

Not all recessions are created equal. The 2008 Financial Crisis left a lingering residue of risk aversion on market participant sentiment and behavior. Market events over the last several quarters have, in our view, created a far more alarmist environment than the fundamental data supports. Not all recessions are financial crises. The chart below highlights how significantly GDP fell during the 2008 Financial Crisis relative to previous recessions, and



Source: http://www.bloomberg.com

more importantly it illustrates how far away we are from that reality.

II.

Recessions in the textbook sense are defined by two consecutive quarters of negative real GDP growth. To put this in context, despite all the market volatility that transpired over 2015, revised Q4 GDP for the U.S. still sits at +1.4%. Therefore we would need to see negative GDP for the first two quarters of 2016 to be technically in recession.

Does that mean that all of the noted recessionary fears are unwarranted? In our view there are certainly elements of distress in the global economy that deserve careful attention and analysis. Credit cycles have typically been leading indicators as to the state of the business cycle, and corporate debt has been slowly rising over the course of last year. One sign of an ending business cycle is higher corporate default rates, and we are beginning to see increases there. In some sectors like energy, and metals and mining, companies levered up and issued debt when commodity prices were near record highs. At today's depressed prices, many of these companies will default on their debt. However, we believe this will be contained and not spread to other healthy parts of the economy.

Last year also marked a record year for mergers and acquisitions activity, indicating that organic growth opportunities appear to be more limited. While we are certainly getting long in the tooth from a prior cycle perspective, the domestic economy remains healthy and resilient and the record amount of Central Bank stimulus in the global economy gives us confidence that an imminent downturn in the near term is unlikely. Household deleveraging, increases in government spending, a recent reprieve in investor sentiment, fiscal consolidation, and a rebound in manufacturing are all growing tailwinds for the U.S. economy.

The National Bureau of Economic Research (NBER) offers a useful framework of indicators to evaluate whether the U.S. is in recession:

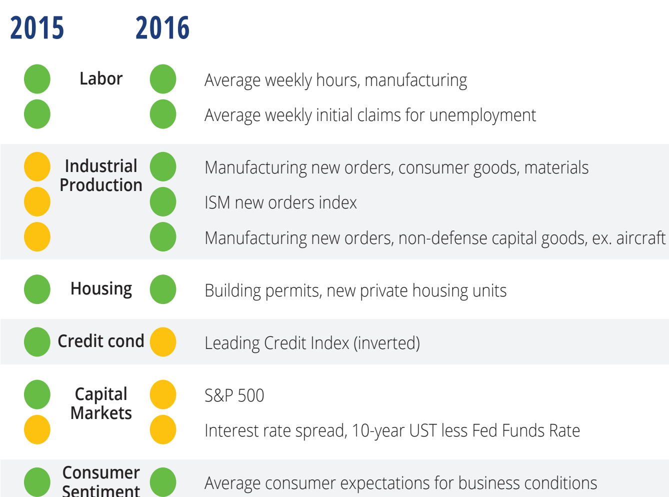
Deceleration: Business cycles tend to slow before they contract. *The 1Q16 growth outlook improved with 4Q15 revision, estimated at 1.4%.*

Diffusion: Weakness must be widespread across industries with less than 50% growing. *All four components that the NBER monitors – including industrial production – offering positive contributions.*

Depth: Coincident indicators need to contract by at least 1.5% from their cyclical peaks. *Non-farm Payrolls, real personal income gains, and inflation adjusted manufacturing and trade sales have continued to expand while industrial production (IP) is down 1% from cycle peak, which is an improvement from -1.9% in December 2015.*

Duration: The NBER looks for six-month contractions in the economy to be convinced episode was a recession. *Period of IP contraction now exceeds 12 months though the worst appears behind us – all other areas continue to expand.*

Now that we have established our view that a U.S. recession is not on the immediate horizon, we then look to economic data that can provide early insights.



Source: https://www.conference-board.org/

The Conference Board , which is a global, independent business membership and research association working in the public interest, has a list of Leading Economic Indicators that act as an effective barometer for assessing early warning signs of a potential recession.

The U.S. is not in recession and the majority of leading economic indicators suggest nothing is imminent. In fact, many concerns that emerged at the beginning of the year have since abated, especially in the manufacturing sector. We remain firmly supportive of the thesis that the U.S. consumer will be the driver of domestic GDP growth and will act as a sufficient buffer to offset weakness abroad. It will therefore be essential to monitor the foundation of overall consumer health to assess any early warning signs in deterioration of fundamentals.

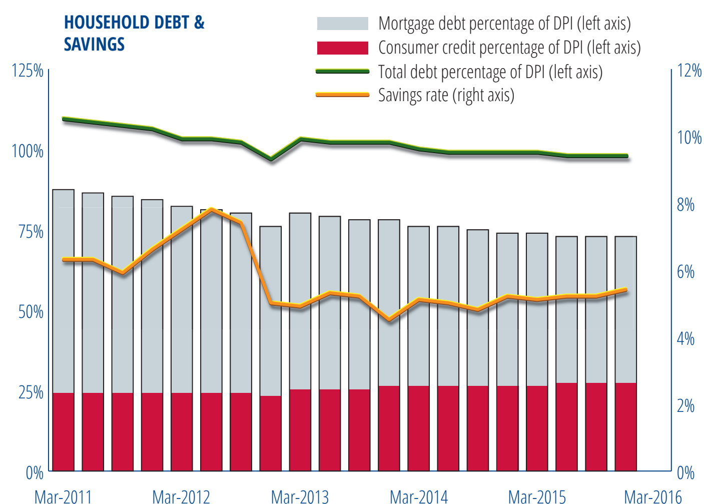
An evaluation of consumer fundamentals reveals that:

U.S. consumer balance sheets are in a strong position after having recovered much of their net worth lost during the 2008 Financial Crisis and subsequent recession in 2007. However, this period imposed lasting effects on consumer spending behavior that include a higher proclivity to save where they had once spent. Consumption is still high, and discretionary purchases like auto sales had a record year in 2015.

The US consumer is healthy, and overall credit conditions continue to improve. The housing market continues a slow, albeit steady recovery. Some core metrics that help us monitor the future state of consumer credit are unemployment and payment affordability. Deterioration in housing indicators and consumer durables have been historical alarm bells for recession and eight of the last ten recessions were preceded by declines in the housing sector. As of end Q1, 2016 fundamental consumer conditions are solid and the housing market continues on a steady recovery.

There are four key areas where we are actively monitoring the overall health of the consumer:

- **Labor Market:** Changes in jobless claims, payrolls and earnings give good indications to changes in consumer health.
  - Growth in Non-farm payrolls average 234K April year over year; jobless claims near cycle low; unemployment rate in sustained decline; labor participation increasing; labor market slack being absorbed; initial jobless claims at 42 year low
  - Average hourly earnings increasing 2.3% year over year, sluggish but significant
- **Confidence:** Future income expectations determine willingness to spend now.
  - Consumer confidence measures are below cycle peak but all at healthy and resilient levels (Conference Board Consumer Confidence Index, U of Michigan, BBG Consumer Comfort)
  - Financial expectations among income cohorts have begun to rebound
  - Resilience in confidence noteworthy given domestic and global developments
- **Consumer Spending & Saving:** Spending directly contributes to GDP and healthy leverage ratios indicate ability to withstand economic shocks.
  - Consumer household net worth fully recovered from the 2008 Financial Crisis and household balance sheets are supportive of future spending growth
  - Consumer spending continues to grow at a healthy pace averaging 3.1% in 2015 – fastest pace since ‘05 at 2.9% in Jan ‘16. Overall delinquencies across credit products remain historically low
- **Housing and Autos:** Housing and durable goods have historically been great indicators of overall consumer health
  - Steady 2015 housing market performance. Lingering constraints on credit availability dragging on new home formations & low rent affordability.
  - Auto sales had a record year in 2015 and credit lending standards are easing. February auto sales (SAAR) topped 17.5 million in Feb. There was little to no sign of delinquencies rising.



Source: http://www.bloomberg.com

III.

Now that we have laid the fundamental base case as to why current recession fears are, in our view, overblown, there are certainly risks to this core view. Many of these downside risks are interlinked and carry a central theme of volatility and uncertainty. The baseline of negative sentiment within markets accelerates any headline event to where it becomes a market mover in and of itself.

While not exhaustive, some key headwinds facing economies and capital markets are:

- Underwhelming market implied inflation expectations
- Illiquidity events: headline, regulatory and sentiment-driven
- Growing negative yields on government debt around the world
- Unusual capital market correlations and distortions
- Unbalanced market segments
- Rising influence of non-traditional political parties
- Well-managed segments of the economy are struggling
- Declining corporate profits, cash flow and organic growth opportunities

Given all the lingering volatility and uncertainty, there is a danger in focusing on indicators or economic data that are prone to headline risk events and distortions. Analyzing them in isolation is also a mistake. The global economic system is signaling deep systemic shifts where uncertainty is the only game in town. China's intention to transition from an investment to a consumer economy is but one example. The critical takeaway here is that the probability of sentiment triggering a real recession is higher than the recent past given that negative responses to the 2008 Financial Crisis have not fully subsided.

An overreliance on consumer spending to maintain its role as the sole driver of domestic growth also carries risk. There needs to be sufficient diversification within the consumer sector itself to provide adequate resiliency. Consumers from various demographics and wage groups all need to remain on solid footing.

The global economy is also in a period of below-trend real growth and underwhelming inflation. This is despite nearly a decade of expansive Central Bank efforts to stimulate their economies. Global capital expenditure relative to GDP is also on a structural declining trend. All of these signs point to an economy that is struggling to achieve trend growth and exhibits signs of stagnation. Structural headwinds, like an aging population and lower worker productivity from technological advances, will act as a growing drag on potential future growth.

Given that extraordinary Central Bank actions have not fully achieved their stated mandates and fiscal tools are in political gridlock, it comes as no surprise that investor sentiment has an asymmetrical bias towards the negative. Even after periods of calm market activity and positive economic data, any negative news or market event triggers widespread risk-off behavior. If the shock is large enough, this behavior can trigger systemic effects that become measurable and spread to other sectors. If the duration of the shock is lengthy enough, the erosion of confidence and sentiment in the end becomes fundamental data and therefore a self-fulfilling prophecy. Therefore, long lasting volatility and uncertainty certainly carries the risk of triggering a recession. We make the distinction that much of the current uncertainty and foreboding is one of lingering trauma from the 2008 Financial Crisis rather than of the current economic reality.

Although below historical trends, the U.S. is still realizing positive economic growth and remains in a stronger position than any other developed economy. Clear evidence of this is that the U.S. enjoys higher relative Treasury yields. The U.S. consumer, which is the lynchpin of our constructive view on the domestic economy, is in a very healthy position relative to previous business cycles. Furthermore, much of the consumer data continues to improve.

Additional headline events are certain to occur as we move further into 2016. The United Kingdom referendum on exiting the European Union is one potential example of how a singular, relatively isolated occurrence could lead to much more widespread negative impacts with downbeat sentiment being the accelerating force. This is reflective of a new era of volatility that shows no signs of abating, but markets still have to operate.

Navigating the markets during these periods can be challenging to say the least. As investment professionals, our primary role is to effectively serve the needs of our clients. It is our job to manage client's portfolios through these times of uncertainty and to remain focused on the economic reality.

Our approach to managing our client's portfolios is centered on disciplined bottom-up fundamental analysis while integrating a top-down macroeconomic perspective. We acknowledge and are cognizant of headline sentiment but do not remain fixated on it. We incorporate an active portfolio management approach that remains focused on the long-term investment perspective despite short-term economic ripples and sensational headlines. We strive to see through current business/credit cycles and identify and respond to critical risks. It is often during times of market stress and uncertainty where investment professionals can find the best opportunities to participate which in turn delivers added value to our clients.

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