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CAPITAL MANAGEMENT | INVESTMENT ADVISORS

MARKET INSIGHTS

From RiverPoint Capital Management

Assessing the Risks of a Recession

Benjamin Franklin coined the phrase, "In this world, nothing can be certain except death and taxes." We might modify this line of thinking with regard to the stock market for 2016 and recognize an additional given called volatility. Oil prices, the Fed and China continue to be in the headlines and are big contributors to the volatility and investor angst.

After significant study, however, we do not think these issues, that we have discussed with you for more than a year, will derail the economy or the markets. As the honorable Paul Samuelson said, "The stock market has called for nine of the last five recessions." We like to stay with the facts. Here is what we think about these three "wall of worry items" that continue to be front and center in the media:

1. **Oil Prices** – Prices continue to be under pressure given the current news flow. Recent hopes of an agreement between OPEC countries to reduce oil production has been shut down by Saudi Arabia. The Saudi petroleum minister, Ali al-Naimi, stated his country will continue to produce oil at full capacity. His comments confirmed that the purpose in doing so is to force the much less efficient producers to curb production or go out of business and that is how he sees supply and demand for oil coming back into balance. The market's reaction to declining oil prices continues to focus solely on the negatives – on concerns about banks' lending exposure to some of these smaller oil companies that will not make it and on the declining capital spending and hiring activity by the energy complex. We agree this is very tough for the oil patch, but banks have low exposure…in most cases 5 percent or less of their loans…and are well capitalized and well reserved for this. More important, declining gas prices are a huge "tax cut" to U.S. consumers to the tune of $115 billion in expense savings in 2015. This equates to roughly $1,000 per household. This is a big deal and net-net is a positive for the U.S. economy.

2. **The Fed and Global Central Bank Policy** – For the first time in over six years there is divergence in monetary policies being pursued by the world's major central banks. Japan has gone to the extremes of instituting a negative interest rate policy, whereby its central bank is no longer paying interest on deposits, but instead is actually charging Japanese banks to keep deposits on hand there. Their goal is to incent loan and investment activity and force excess reserves into the economy. Similarly, the European Central Bank (ECB) expressed their desire to increase monetary stimulus, as did China. All of this is in the face of the United States recently raising short term rates for the first time in a decade. With monetary policy seemingly moving in the opposite direction to these major foreign central banks, the fear is that the U.S. dollar will continue to strengthen in a significant way and put continued pressure on U.S. corporate earnings and exports. Our conclusion…given the volatility and threat of a global slowdown, we agree with the bond market on this, and find it highly improbable the Federal Reserve will aggressively move rates higher in the near term. It is likely to be very measured in its approach to increasing rates, thus curbing the strength of the dollar.

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3. **China** – Uncertainty around the current and future growth rate of China's economy also continues to be front and center. Leaders of the country will do everything in their power to avoid a hard landing (recession), and while it will be a long transition, we believe shifting to a consumer led economy is the right thing for the world's second largest economy. Even if you discount China's "true" GDP and retail sales growth rate from official numbers down to 5 percent and 10 percent respectively, these figures are more than double that seen in the rest of the world on these metrics and are far from describing a hard landing.

The most important thing we can do is not get caught up in the minutia and daily "breaking reports" from the media on these items, but instead focus on what really matters: Do these issues portend a recession in the United States?

Is the threat of a recession in the United States significant?

At present, we don't think so based on the data. The employment and spending picture in the United States remains on solid ground. The technical definition of a recession is two consecutive quarters of NEGATIVE GDP growth. Here in the United States, the first quarter of 2016 is pacing for 2.5 percent annualized GDP growth, and we think this will hold for calendar 2016 as well. The math is pretty straightforward to get there. The consumer (68 percent of the economy) is growing in the 2.5 - 3.5 percent range. The government (20 percent of the economy) is growing at 5 percent this year, and the remaining pieces of the economy, business investment and net exports (a net 12 percent of the economy), are netting out to zero contribution to growth this year...the end result or calculation is 2.0 - 2.5 percent growth overall. Recent data on wage growth in the United States has improved and January retail sales increased at a robust 5 percent rate if you exclude gasoline purchases that naturally fell in line with the attractively lower prices we pay at the pump. This just is not the type of data you see when approaching recession. One can use the "it's different this time" phrase, but that can be very costly for an investor.

This point regarding the value of linking market outlook and true underlying trends in the economy is very important because it makes a big difference on how you position portfolios. Specifically, short term corrections or "temporary/cyclical bear markets" are not uncommon. They generally are unassociated with recessions, last only a few months, are more mild in their percentage decline, and see significant recovery off the bottom in relatively short order. Think the 2011 variety, when the market fell almost 22 percent in over six months (as oil plummeted) but we went on to higher highs with very good returns in the ensuing three years. Deeper "secular bear markets," most often associated with recessions, are far longer, last more than a year or for years and are more painful in percentage decline as well as time to recover. Secular bear markets associated with recession do call for a more defensive strategy. Normal, shorter-lived cyclical pullbacks on the other hand, like what we believe we are experiencing today, require patience to hold high conviction positions and to selectively purchase securities that have gone on sale to enhance the portfolio.

Signals to watch for recession

Things look good on paper for 2016, but what are some indicators that growth would be slowing and the United States might be heading into a recession? We are following three items closely...

1. **The Yield Curve** - Historically, every recession has been preceded by an inverted yield curve. This means short term (2-year treasury) interest rates become higher than longer term (10-year treasury) interest rates. Currently, the 2-year treasury is yielding 0.73 percent and the 10-year treasury is yielding 1.7 percent. The spread has narrowed over the past few months, but we are still a ways off from inversion. Further flattening in a significant way would concern us.

2. **Employment** - Most employment metrics in the United States are very solid. We continue to pay close attention to one in particular...monthly payroll growth. The United States is consistently creating 150k-200k new jobs each month. Seeing this monthly number begin to trend poorly and fall below 100k monthly for more than just one monthly print would be a meaningful red flag.

3. **Service Sector Growth in the United States** - The service sector in the United States is the tail that wags the dog... it accounts for 88 percent of U.S. economic activity versus manufacturing, now at only 12 percent. The manufacturing sector in the United States has been challenged for some time, given weakness in energy related capital expenditures and declining exports in the midst of dollar strength. Should the service sector rollover and confirm the softness in manufacturing, this would cause us to become more cautious and change our tune. Specifically we are watching the manufacturing and the non-manufacturing Purchasing Managers Index (PMI) monthly survey data to tell us whether or not this is happening. During past U.S. recessions both have been negative; currently the service sector PMI is at growth/healthy levels, so this keeps us positive. We will stay tuned.

Bottom line, all three of the above indicators remain positive, pointing us toward steady, grind it out economic growth in the United States. That said we will continue to monitor the above indicators closely and take appropriate action if the data changes. Keep in mind, volatility will remain high as we work our way through the wall of worry list we highlighted at the beginning of the newsletter. As John Maynard Keynes said, "When the facts change, I change my view." We do the same and continue to remain constructive as the economic data, while mixed, still points toward growth. We will continue to look for opportunities to upgrade the quality of our client portfolios as we have done through recent trades. We remain mindful of client's specific goals and objectives from their portfolios, whether it is generating steady income, providing longer term growth or a blend of the two. Should you have questions about the market or your portfolio, please don't hesitate to contact your wealth advisory team.

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