



Will We See A Recession This Year?

SYNOPSIS

- It's been close to nine years since our economy recovered from the worst economic downturn since the Great Depression.
- Investors are becoming concerned that rising interest rates will lead our economy back into another recession.
- The economy will most certainly experience a recession in the future, but the real question is when the next one will arrive.

RISING RATES ARE HERE

This week, the Federal Reserve Bank (Fed) signaled their intention to raise their target interest rate when they meet in mid-March. If they do, which is by no means guaranteed, it will be the third interest rate hike over the last 15 months.

Our country has not experienced an extended rising interest rate environment for many years, and investors are concerned that higher interest rates will ultimately lead to another economic recession.

Their anxiety is certainly warranted. Recessions cause the stock market to get whacked, multi-year gains are erased in a matter of months, people lose jobs, and investor confidence takes far longer to recover than the economy.

Furthermore, history has shown that a sharp rise in interest rates has preceded each recession over the last half century, so the data supports their case (more on this below). However, the question is not *if* a recession will occur again but rather *when* one will happen because history has also shown that recessions don't happen immediately after rates begin to rise.

In fact, stocks have experienced tremendous gains in the early innings of rising interest rates, which often lasts

for several years. Therefore, the decision to sell stocks simply because rates are rising could risk leaving an investor out of attractive returns for quite some time.

A better approach is to get a ballpark idea of when the next recession could arrive, but before we dive into our analysis, we must first understand the Fed's role in our economy and how we got to where we are today.

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THE FED'S JOB

Think of a central bank as a bank for big banks. For example, Bank of America and J.P. Morgan are customers of the Federal Reserve in a similar way that we are customers to them.

We use banks to deposit paychecks and take out loans to buy houses and cars, and these large banks rely upon the Fed for similar needs. Big banks use central banks to hold excess cash and take out loans periodically to help support their business.

The Fed has a dual mandate that consists of (1) controlling inflation and (2) maximizing employment. The combination of these two should theoretically produce manageable growth, where consumers make more and spend more without inflation going haywire. Their primary tool to achieve such harmony is through adjusting our access to money.

Consider how most consumers buy expensive goods and assets. Rarely do we pay for homes, cars, and other big-ticket items in cash. Instead, we take out loans and then pay back these debts over time. Since big purchases are mostly done on credit, interest rates are



the life and blood of our economy.

Meaning, if a mortgage rate rises from 4% to 10%, house sales will probably get hit because fewer consumers can afford to pay a higher interest rate on a large loan balance. Control interest rate levels and you control how fast/slow an economy can grow (in theory).

The Fed's primary means of controlling interest rates is by the altering the deposit rate they pay banks and the interest rate on loans made to banks. If the Fed wants to slow down the economy to combat rising inflation, they increase both, which will (1) incent banks to earn a higher deposit rate, and (2) make loans to banks more expensive and subsequently less attractive.

More big bank cash will then be deposited at the Fed, which will decrease the supply of money available to bank customers for loans. The rise in the cost of a loan to a big bank will also be passed along to consumers, which slows down the economy.

NOTE: *This situation is no different than any other industry that can pass along price increases to its customers. If a gas station is forced to pay more for fuel due to rising oil prices, they will increase the price at the pump to maintain profitability. Banks effectively do the same.*

On the flip side, when the Fed wants to encourage economic growth, they will lower both the rate they pay big banks on deposits and loans made to them. Big banks will then withdraw money from the Fed and seek higher returns by loaning to their customers. The rise in the amount of money available for loans causes the price of a loan to fall. More attractive loan rates lead to more buying, which pushes economic growth higher.

QUE IN QE

During the depths of the financial crisis, the Fed moved interest rates down to zero to prevent our economy from falling into a depression. Per the reasoning above, the Fed believed that dropping interest rates to zero would encourage consumers and businesses to take out loans to buy goods and services, which would then translate to a rebound in economic growth.

In doing so, they embarked on an aggressive policy called Quantitative Easing (QE). This involved flooding banks with an overwhelming amount of cash. The problem is that there was not enough loan demand from consumers and businesses so this cash has sat idle for years.

In banking lingo, we refer to this as "excess reserves" because it is cash that banks want to lend out but exceeds the amount of demand available. This situation is identical to a farmer who produced too much corn one year. If the demand comes in at 1,000 bushels and he produced 3,000 bushels, then he has 2,000 bushels of "excess corn" that he cannot sell.

The Fed engulfed the banking system to the point where over \$2 trillion in excess reserves collectively remains today. However, where this differs from the farmer is that the banks are not in jeopardy of the cash going stale. A farmer who produces too much will watch those crops go bad, but cash in banks can last until it is loaned out or the Fed attracts it back.

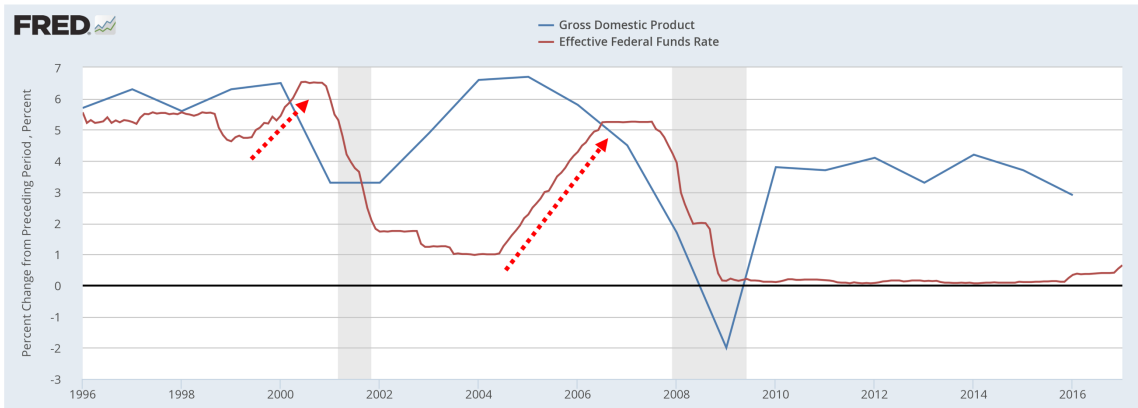
Simply put, the Fed controls economic growth by adjusting their target interest rate, and since the financial crisis was such a severe recession, they not only lowered interest rates to zero but also gave banks more cash than what consumers and businesses demanded to act as a buffer.

THE TIPPING POINT

Assessing the risk of a recession entails determining what level of interest rate will be high enough to put the brakes on the economy. The challenge is that economic cycles are always different, so there is no consistent level across each boom and bust.

However, a little bit of intuition can guide our analysis. If rising interest rates make borrowing more expensive, then there must be a point in each cycle where the *cost* to borrow exceeds the *benefit* of a loan.

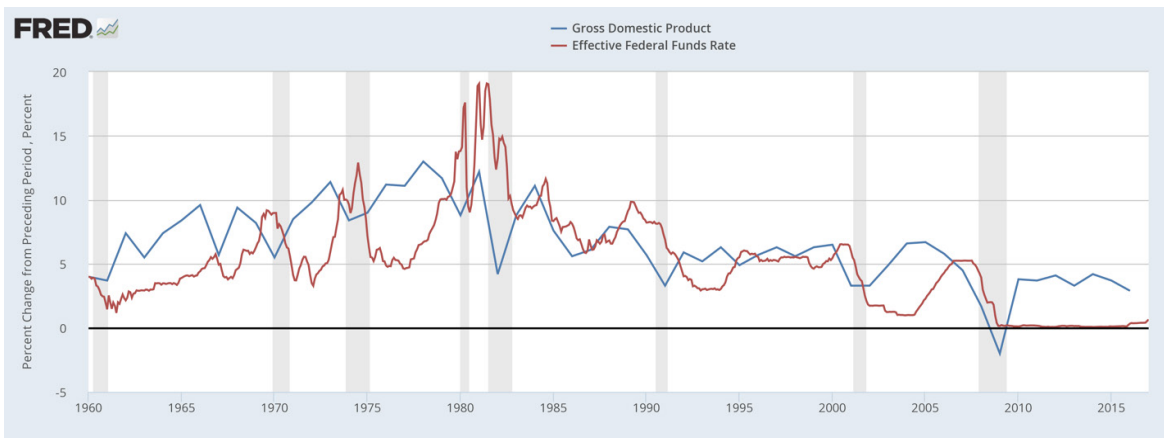
The chart below shows this effect by comparing the Fed's interest rate target to gross domestic product (GDP) growth over the last 20 years, capturing the last two recessions (dot-com bust and the financial crisis).



Source: Federal Reserve, Global Financial Private Capital analysis

The red dotted arrows indicate that a steep rise in interest rates (maroon line) preceded a fall in GDP growth (blue line) and drove the economy into a recession (grey shaded area). This is not a recent phenomenon either. Go back half a century, and the chart below shows that each recession happened after a sharp rise in interest rates.

For example, if an investor could purchase a rental property that generated a 5% return, but mortgage rates were 7%, then that property would lose money unless the investor paid in cash. The same applies to our economy, and since the overwhelming majority of purchases are done on credit, recessions happen once the cost to borrow money exceeds the benefit.



Source: Federal Reserve

This pattern makes sense because the cost to borrow money eventually became so high each time that it put the brakes on economic activity.

However, this does not answer the question of when high interest rates begin to cause problems. Closer observation indicates that the tipping point tends to be when the maroon line crosses the blue line (tip of the red-dotted arrow) or when the cost to borrow breaches the growth rate in the economy.

ADD IT ALL UP

We can now assess the risk of a recession in 2017 by determining when interest rates will rise high enough to cause real damage. For this to happen, the Fed would have to accomplish two rather difficult tasks:

1. **Dramatically Raise Rates:** GDP growth is right around 3.5%, and the Fed's target interest rate is currently 0.75%. This is a huge gap to close.
2. **Remove Excess Reserves:** That \$2 trillion in excess reserves needs to be taken out of the economy, which would be a herculean task to perform over the course of a year.

Let's dig a little deeper to get a sense of when the economy could reach the next tipping point. The Fed has signaled that they plan to raise interest rates three times this year. If each rate hike is 0.25%, which is consistent with the last two rate hikes, then their interest rate target will end the year at 1.50% ($0.75\% + 0.25\% + 0.25\% + 0.25\% = 1.50\%$).

If GDP growth remained constant, the gap would still be around 2.00% ($3.50\% - 1.50\% = 2.00\%$). That gap may not sound like much, but moving by 0.25% per quarter would take the Fed well into 2019 to get to a 3.50% interest rate target.

NOTE: *Given that the Fed signaled four rate hikes at the beginning of 2016, only to raise once at the very end of the year, it's tough to take Fed forecasts seriously anymore. Any fewer rate hikes by the Fed this year will only extend out the time until we reach the tipping point.*

Concurrently, the Fed would also need to remove a huge chunk of the excess reserves in the banking system. This process is very technical and beyond the scope of this discussion, but since it took the Fed years to inject all this money into the banking system, removing it will likely also take years.

IMPLICATIONS FOR INVESTORS

During an interview last year on CNBC, Warren Buffett told a reporter that interest rates "act on asset values like gravity acts on physical matter."¹

I know of no simpler way to sum up the power of the Fed. Since they control the level of interest rates, they can move our economy and asset prices at will. This is the precise reason why market pundits and traders spend so much time trying to predict the Fed's next move.

Although the Fed's decisions are confusing at times, their direction is crystal clear. They have absolutely no interest in slowing down our economy, and since

only the Fed can push us into a recession if desired, this significantly reduces the risk of a major downturn anytime soon.

It's also important to remember that the Fed is raising interest rates because the economy is growing, but there is a big difference between a growing economy and an overheating one.

In the former, stocks tend to do well because this growth trickles down into earnings for companies. This is usually the time when rates are rising but before the tipping point. In the latter, stocks begin to sell off as investors begin to see our economy reach the tipping point. Currently, we are nowhere close to such crossroads.

There are other ways we could fall into a recession, but it would require spending to stop dead in its tracks. Given unemployment is at historic lows, consumer confidence around all-time highs, business sentiment improving, and slowly rising wage growth, this seems highly unlikely.

The bottom line is that even after an 8-year bull market, the outlook for U.S. stocks still looks pretty good.

Sincerely,



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¹ <http://www.marketwatch.com/story/even-warren-buffett-is-confused-by-negative-interest-rates-2016-04-29>

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