THOUGHT FOR THE WEEK
IS A RECESSION LOOMING?

Global Financial Private Capital

SYNOPSIS

- It's been close to a decade since our economy recovered from the last recession
- Concerns over rising interest rates and equity market gains will drive the U.S. back into another recession
- Another recession is inevitable, so it is important to assess when it could happen again

RECESSION FEARS

The Federal Reserve (Fed) is raising interest rates. The S&P 500 was up over 20% in 2017 and feels like it has been hitting an all-time high every few weeks. It has been close to a decade since the last recession plagued investors, and recessions historically occur every 7 – 10 years. At some point, another recession is inevitable, and many investors are worried.

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. However, the question is not *if* a recession will occur again but rather *when* one will happen.

The Fed is inextricably linked to economic growth, so before we determine when one could happen, it's important to first understand why the Fed is so important to our economy and the reason why they do what they do.

RAISON D'ETRE

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 controlling inflation and 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.

> **"The question is not *if* a recession will occur again but rather *when* one will happen."**

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 incent banks to earn a higher deposit rate and 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.

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 consumer spending, which increases economic growth.

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.

GREAT POWER

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.

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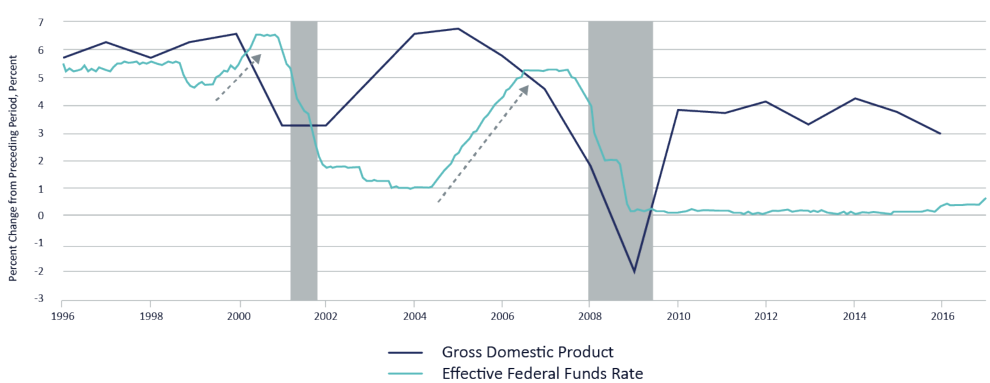

Source: Federal Reserve

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.

Chart 1 shows this effect by comparing the Fed's interest rate target or Effective Federal Funds Rate (EFFR) to gross domestic product (GDP) growth over the last 20 years, capturing the last two recessions (dot-com bust, 2000-2001 and the financial crisis, 2008-2009).

The grey dotted arrows indicate that a steep rise in interest rates (teal 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 chart 2 shows that each recession happened after a sharp rise in interest rates (EFFR).

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 of chart 1 indicates that the tipping point tends to be when the teal line crosses the blue line (tip of the grey-dotted arrow) or when the cost to borrow breaches the growth rate in the economy.

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. The same applies to our economy, and since the overwhelming majority of large purchases are done on credit, recessions happen once the cost to borrow money exceeds the benefit.

ADD IT ALL UP

We can now assess the risk of a recession in 2018 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 plus inflation is right around 3.5%, and the Fed's target interest rate is currently 1.5%. In finance, this is a big gap to close.

2. **Remove Excess Reserves**: That almost $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 recent rate hikes, then their interest rate target will end the year at 2.25% (1.50% + 0.25% + 0.25% + 0.25% = 2.25%).

If GDP growth remained constant, the gap would still be

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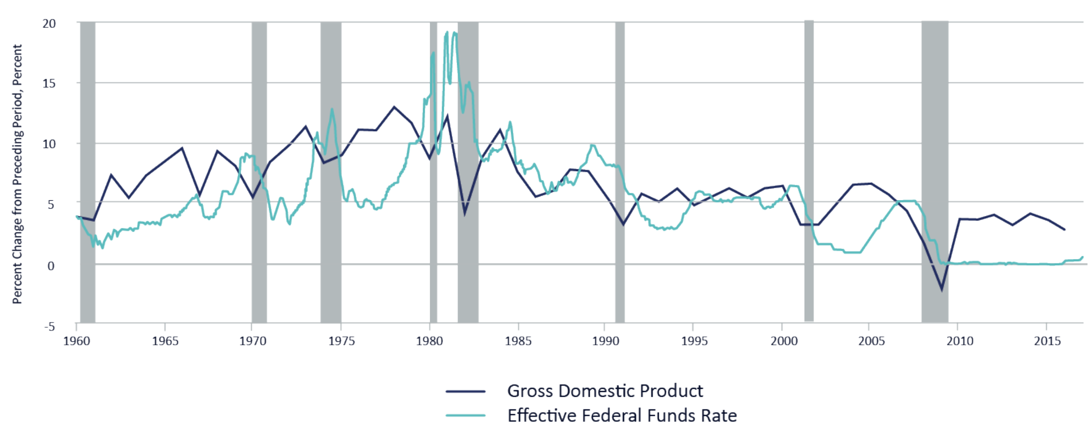

Source: Federal Reserve

around 1.25% (3.50% - 2.25% = 1.25%). That gap may not sound big, but moving by 0.25% per quarter would take the Fed well into 2019 to get to a 3.50% interest rate target.

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 in 2016 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 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 are showing no interest in slowing down our economy. 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 worry that the cost to borrow has gotten too high. Currently, we are nowhere close to such crossroads.

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

THE BOTTOM LINE is that even after a 9-year bull market, the outlook for U.S. stocks still looks pretty good.

SINCERELY,

Mike Sorrentino | CFA
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1 http://www.marketwatch.com/story/even-warren-buffett-is-confused-by-negative-interest-rates-2016-04-29

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The effective federal funds rate (EFFR) is calculated as a volume-weighted median of overnight federal funds transactions reported in the FR 2420 Report of Selected Money Market Rates.

The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.