GUGGENHEIM

Macroeconomic and Investment Research

Forecasting the Next Recession

Will Rate Cuts Be Enough?

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Recession Outlook Summary

- Historical evidence on the Federal Reserve's skill in using rate cuts to avoid recession is mixed. This time around, numerous headwinds combined with limited policy space globally mean it is a close call as to whether the Fed has cut early enough to help extend the expansion.
- The odds of a recession both in the near and medium term rose in the second quarter. This trend continued in the third quarter, according to our preliminary estimate, with our Recession Probability Model showing a 58 percent chance of the economy being in a recession by mid-2020, and a 77 percent chance of a recession beginning in the next 24 months (see page 10).
- History shows that once our recession forecast model reaches current levels, only aggressive policy action can delay recession, but not avoid it.
- We expect the Trump administration will continue to use easier monetary policy as a green light for more aggressive trade policy. Fed Chair Jerome Powell explicitly cited trade policy as a rationale for cutting rates, which risks the development of a feedback loop between Fed rate cuts and trade war escalation.
- If core inflation heads back up toward 2 percent, some Fed officials may more forcefully resist further rate cuts, complicating an already difficult messaging exercise.
- Incoming data support our longstanding baseline of a recession beginning by mid-2020, per our Recession Dashboard (see page 11). Given that credit spreads are still relatively tight on a historical basis, we continue to believe it is prudent to remain up in quality as we await better opportunities to deploy capital in riskier credit sectors in the coming downturn.

Forecasting the Next Recession: Will Rate Cuts Be Enough?

According to our Recession Probability Model, the chances of a recession starting during our forecast horizon rose in the second quarter. This trend continued in the third quarter, according to our preliminary estimate, with the model showing a 58 percent chance of the economy being in a recession by mid-2020, and a 77 percent chance of a recession beginning in the next 24 months. Key drivers of higher recession risk in the model include a tighter labor market, an inverted yield curve, and a slowdown in leading indicators.

In addition to the statistical warning that our Recession Probability Model is sending, our Recession Dashboard continues to show that the economy is exhibiting characteristics consistent with a recession beginning in the first half of 2020.

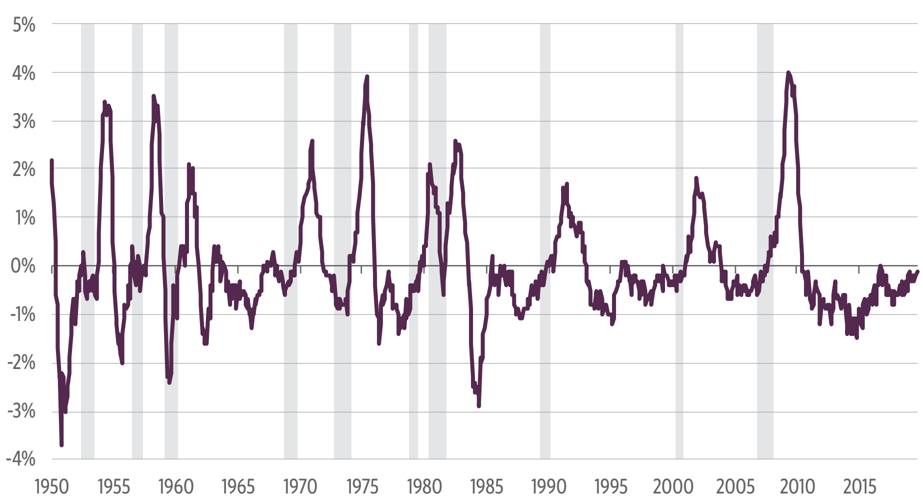
The Dashboard shows typical late-cycle trends playing out. While the unemployment rate remains below full employment, momentum in the labor market has slowed, consistent with late-cycle behavior prior to past recessions. This slowing is a natural consequence of a tight labor market, as it becomes increasingly difficult to keep lowering unemployment as the pool of the unemployed shrinks and those remaining on the sidelines are less employable. Other indicators also suggest that the labor market is nearing an inflection point, including a slowing in our Dashboard's measure of aggregate hours growth to a nine-year low. Newly revised data on corporate profits, which showed both a lower level of profits and a steeper rate of decline, also suggests less scope for above-trend payroll growth.

Several other Dashboard components also continue to show cause for concern. The three-month/10-year Treasury yield curve has now been inverted for 17 weeks, which we believe remains a valid recession signal, despite the refrain from many observers that this time is different. Meanwhile, indicators of economic activity

The labor market is losing momentum, a trend consistent with historical late-cycle dynamics.

The Pace of Decline in Unemployment Slows as Recessions Draw Nearer

One-Year Change in the Unemployment Rate



Source: Guggenheim Investments, Haver Analytics. Data as of 8.31.2019. Shaded areas represent recession.

have cooled, as seen by retail sales activity also softening from last year's strong pace. Additionally, yearly growth in the forward-looking Leading Economic Index has slowed by 5 percentage points since last September, led by moderating gains in sentiment and pressure on the globally sensitive manufacturing sector, which signals subdued growth prospects for the U.S. economy.

Rate Cuts and Recessions

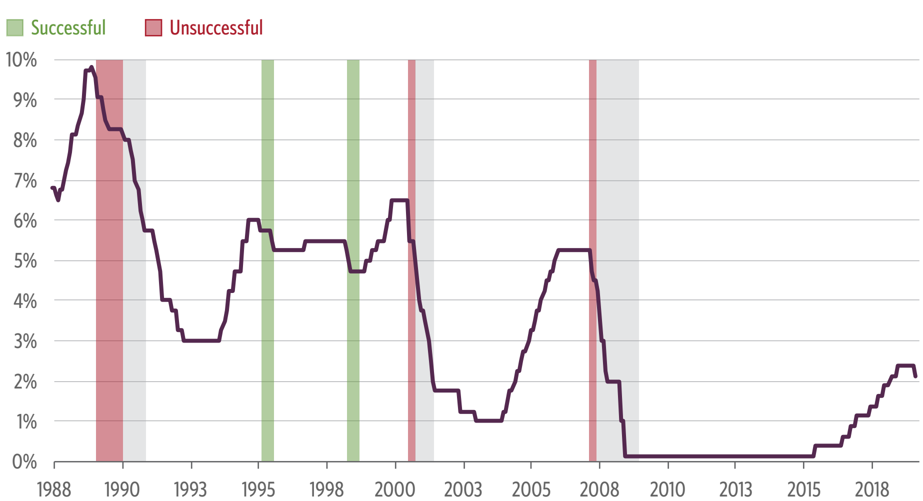
The final component of our Dashboard is the stance of monetary policy, as measured by the difference between the real fed funds rate and the natural rate of interest. This measure showed policy nudging into restrictive territory in February, where it remained through the first half of the year. Of course, this measure excludes the policy tightening that occurred through the Fed balance sheet runoff, hawkish forward guidance, and communication missteps. With the Fed cutting rates in July and the market pricing for further rate cuts, many are wondering whether these "insurance cuts" will be enough to avoid a recession.

The historical evidence is mixed on this issue. While there have been two notable periods in the 1990s where rate cuts helped avoid—or at least delay—a recession, we also know that the Fed was cutting rates in advance of the last three recessions.

We can identify several factors that enabled rate cuts to be successful in staving off recession in prior cycles. For one, cuts need to come before the economy has weakened to the point that layoffs have begun to rise and confidence has started to turn down. As the following charts show, it is a close call as to whether the Fed has cut early enough to help extend the expansion.

In order for rate cuts to stimulate the economy and avoid a downturn, they need to work through one of two channels: spurring credit growth or easing financial conditions.

Historical Evidence for "Successful" Fed Cuts Is Mixed
Fed Funds Target Rate

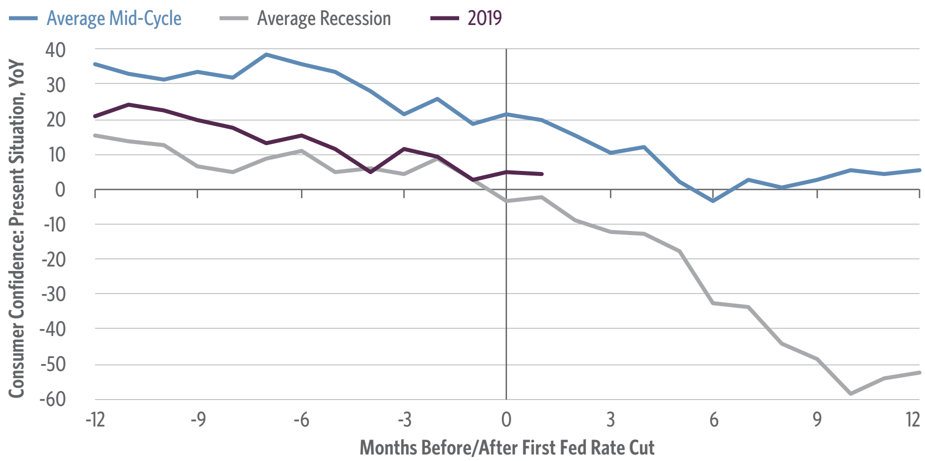


Source: Guggenheim Investments, Haver Analytics. Data as of 8.31.2019. Gray shaded areas represent recession.

The Fed does not have a consistent track record of using rate cuts to stave off recessions. While it was successful in the 1990s, cutting rates did not have the same impact in other late-cycle scenarios.

Consumers have responded positively in instances where the Fed was successful in using rate cuts as an anti-recessionary tool, adding weight to its effectiveness.

Successful Fed Cuts Help Support Consumer Confidence

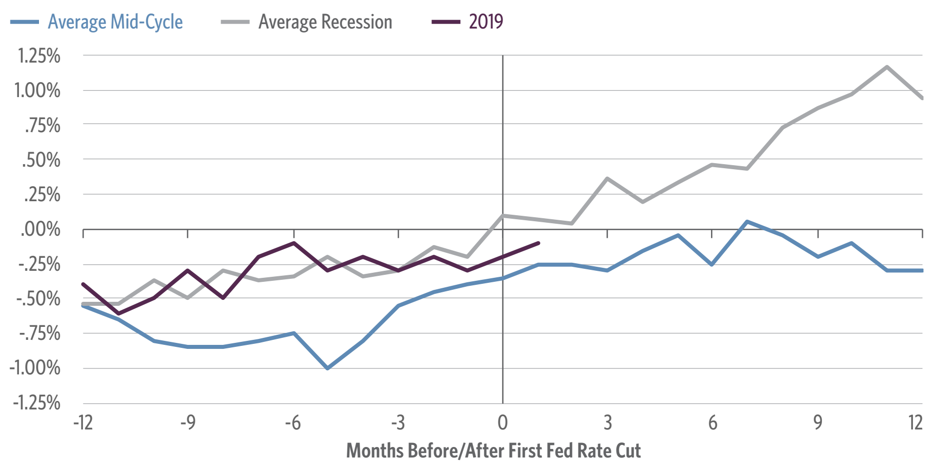


Source: Guggenheim Investments, Haver Analytics. Data as of 8.31.2019. Mid-cycle episodes correspond to 1995 and 1998 rate cuts. Recession episodes correspond to 1989, 2001, and 2007 rate cuts.

Successful rate cuts avoid a rise in layoffs, helping to counter an economic slowdown.

Successful Fed Cuts Bolster the Labor Market

Unemployment Rate, YoY Change

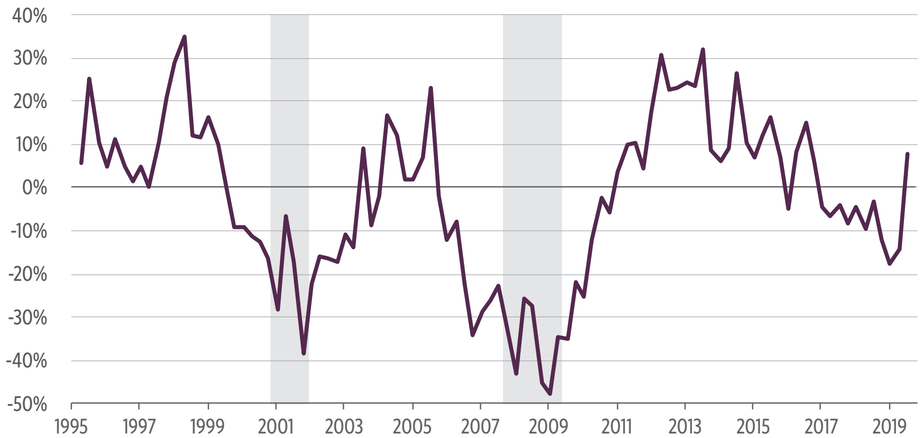


Source: Guggenheim Investments, Haver Analytics. Data as of 8.31.2019. Mid-cycle episodes correspond to 1995 and 1998 rate cuts. Recession episodes correspond to 1989, 2001, and 2007 rate cuts.

We are skeptical about the ability for rate cuts to stimulate credit growth in this cycle. After all, years of rock bottom rates only led to modest credit growth over the course of this expansion, and the rate-sensitive sectors of the economy are now a smaller share of gross domestic product (GDP) than they were in the past. In this cycle, the cost of capital does not seem to be the major constraint to borrowing and investment, so a modest reduction in rates is unlikely to meaningfully alter credit growth dynamics. In fact, with corporate America already overleveraged, further growth in indebtedness will only serve to exacerbate the severity of the eventual downturn. That being said, recent data from the Senior Loan Officer Survey showed

Sustained Pickup in Loan Demand Could Help Extend the Expansion

Net Share of Senior Loan Officers Reporting Stronger Demand



Source: Guggenheim Investments, Haver Analytics, Bloomberg. Data as of 6.30.2019 for loan demand. Shaded areas represent recession. Note: Demand is bank asset-weighted. C&I loans to large and small firms are given equal weights due to lack of detail in bank loan exposures in the Fed's H.8 data on bank assets.

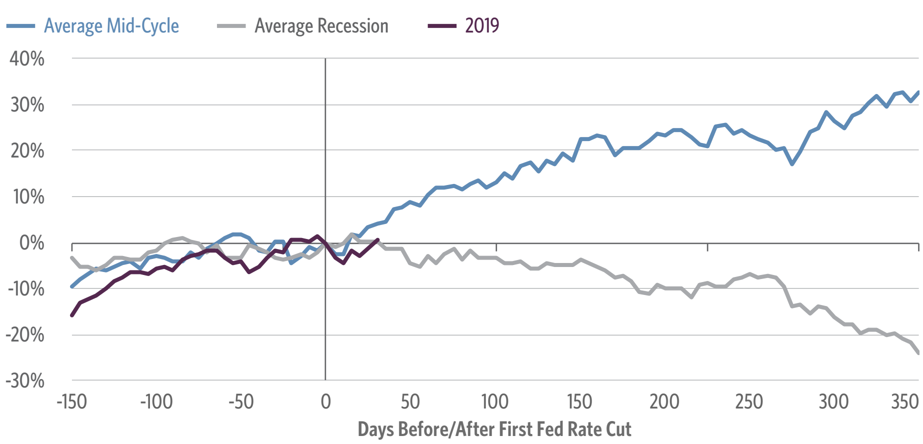
Loan demand rose in the second quarter of 2019, particularly for residential and consumer loans. It will be important to see if lowering rates sustains this trend, because it would boost the odds that the Fed's policy easing is successful.

loan demand rising during the second quarter, particularly for residential and consumer loans. Whether lower rates can offset high housing prices and economic uncertainty will be an important question for determining the efficacy of rate cuts.

A more likely channel for rate cuts to work through would be a substantial easing in financial conditions, which Fed Chair Powell acknowledged in his July press conference. Watching the reaction of financial markets in the aftermath of Fed cuts will be key in determining how effective those cuts are, and whether a recession can be pushed back. The main channel for easing financial conditions would likely have to be a stock market rally, as longer-term rates are already pricing in

Stocks Are a Key Signal for Successful Fed Pivot

S&P 500 Level Relative to Day of First Fed Rate Cut



Source: Guggenheim Investments, Bloomberg. Data as of 9.11.2019.

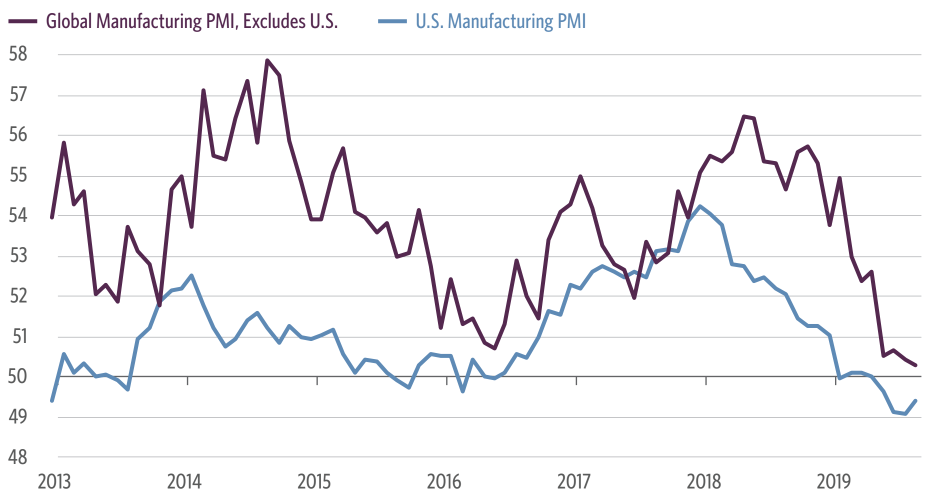
Stock market response will be a key indicator of the success of the Fed's move to cut rates.

aggressive easing and credit spreads are already near historical tights. This sets up one of two scenarios: either stocks fail to rally in the wake of rate cuts and the economy continues to lose steam and tips over into recession, or we see a liquidity-induced market rally that supports economic growth temporarily, only for the stretched market valuations to cause a more severe downturn when the rally falters and a recession eventually arrives.

Easier financial conditions could also come in the form of a weaker dollar. However, economic growth around the world continues to slow, especially in manufacturing and trade-sensitive industries and countries. Not only does sluggish growth abroad negatively impact demand for U.S. exports, but it is also prompting monetary easing by central banks around the world. These factors have more than offset the effect of easier Fed policy on the dollar recently, resulting in a 3.4 percent appreciation of the trade-weighted dollar since the Fed's dovish pivot in January 2019.

Fed policy easing is typically accompanied by a weakening of the dollar. However, global economic weakness is likely to offset downward pressure on the dollar and undercut that tailwind to economic activity.

Weakening Global Growth Limits Scope for Dollar Depreciation



Source: Guggenheim Investments, Haver Analytics, Markit, JPMorgan. Data as of 8.31.2019. Purchasing managers indexes (PMI) are GDP-weighted. A PMI reading above 50 represents an expansion over the prior month, below 50 represents a contraction, and 50 represents no change.

Of course, this analysis assumes that the Fed will meet market expectations by cutting several times. While July's cut was largely baked in before the meeting, each subsequent cut will be increasingly difficult given still-healthy U.S. data, a message Powell tried to drive home in his press conference and several Fed presidents have since reinforced. And while core personal consumption expenditure (PCE) inflation remained subdued on a year-over-year basis in the latest reading, the Fed's forecasts assume the slowdown early in 2019 was largely transitory, a view supported by the rise in the three-month annualized rate of change to 2.2 percent in July. If core inflation heads back up toward 2 percent year over year, some Fed officials might more forcefully resist further rate cuts, disappointing market expectations while failing to deliver any economically meaningful policy change.

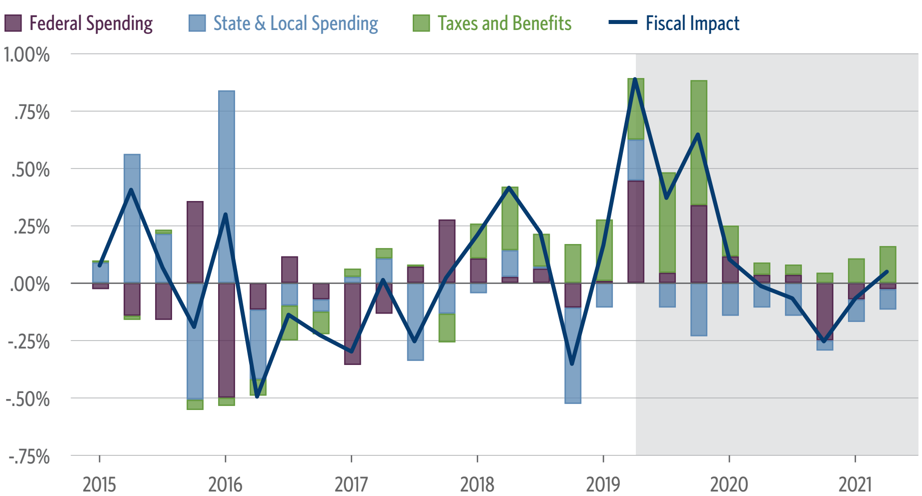
In order to avoid a downturn, however, Chair Powell may be forced to overrule the dissenters and overdeliver on rate cuts. Whichever approach the Fed chooses, messaging around future rate cuts will continue to be a challenge, as demonstrated in the July Federal Open Market Committee (FOMC) press conference and by growing divergence among FOMC participants, as the meeting's minutes highlighted. Mishandled communication that leads to a post-cut tightening in financial conditions risks wasting rate cut ammunition at a time when the Fed is constrained in how much easing it can deliver to prop up the economy. Limited policy space in the United States and abroad is a key factor that we think could make the coming downturn more severe and/or make the ensuing recovery more tepid.

Fiscal Policy to the Rescue?

In addition to a Fed cut, the U.S. economy also recently received a reprieve in the form of a two-year budget deal. Not only did the deal help avert another debt ceiling showdown, but it also eliminated the automatic spending cuts that would have taken place in the absence of a deal. These would have cut federal discretionary spending by about 10 percent, resulting in a fiscal drag of about 20 basis points in 2020.

Even With the Budget Deal, Fiscal Stimulus Is Set to Fade

Contribution of Fiscal Policy to U.S. Real GDP Growth



Source: Guggenheim Investments, Hutchins Center. Actual data as of 6.30.2019.

The 2018–2019 boost to fiscal spending and tax cuts will fade in 2020, offsetting any tailwind from lawmakers' two-year budget deal.

The budget deal is good news for the economy (we are setting aside longer-term fiscal sustainability issues for the time being), and on the margin reduces the odds of a downturn beginning next year. However, investors should not get too excited about this budget deal, as the 2018–2019 boost from federal spending and tax cuts will still fade next year. Meanwhile, we expect to see a drag from state and local government spending following a construction binge this year.

More Hawkish Trade Policy on the Horizon

Markets received welcome news on the monetary and fiscal policy front in July, but that news was quickly overwhelmed by developments on the trade policy front, which is likely no accident.

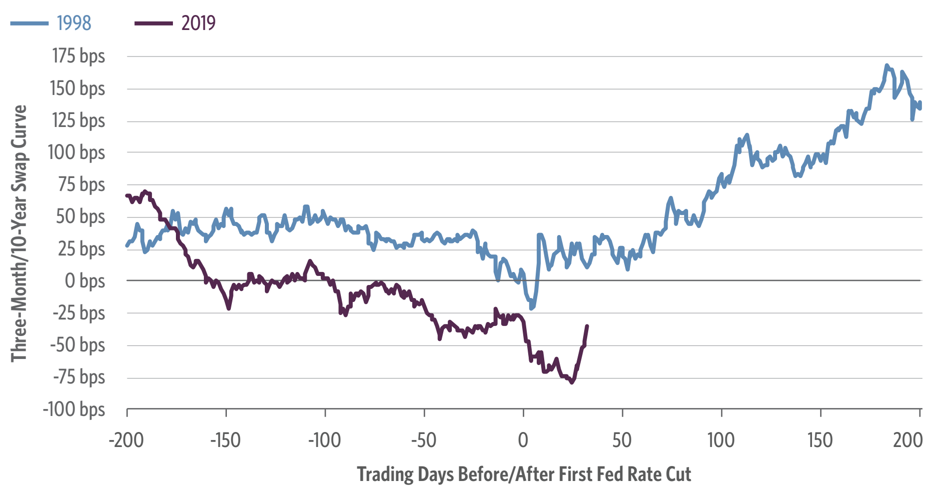
One negative side effect of Fed cuts and the budget deal is that it has emboldened the Trump administration to be more aggressive on trade policy. The fact that President Donald Trump announced the new round of 10 percent tariffs on remaining imports from China just a day after the Fed cut rates would support this view. The president has accused other countries of using monetary policy as a trade weapon, so he could view easier monetary and fiscal policy at home as a green light to pursue tougher trade policy. That being said, the Trump administration is sensitive to market dynamics, and feedback from the market could temper the administration's hawkish impulses on tariffs. Moreover, bearish positioning leaves risk assets primed for a rally in the event of positive trade developments.

The Fed has explicitly cited trade policy as a main rationale for cutting rates, which risks the development of a feedback loop between Fed rate cuts and trade war escalation. We have already seen how the latest tariff announcement caused market volatility, resulting in a jump in market-implied expectations of further rate cuts in September and beyond.

U.S. and Chinese negotiators appear in no rush to make a deal, as China may be trying to wait out the clock until after the 2020 election, while the U.S. side does not appear to be budging on its core demands. Meanwhile, the clock is ticking on a decision by the Trump administration on whether to impose tariffs on auto imports, which would put the European Union in the crosshairs. Tariffs on auto imports could prove to be even more disruptive than China tariffs. A decision by

Investors should keep a close eye on the shape of the yield curve. If the curve stays inverted the market is signaling its skepticism that Fed policy will keep the economy from falling into recession.

An Increasingly Inverted Yield Curve Suggests the Fed's 2019 Pivot May Be Too Little, Too Late



Source: Guggenheim Investments, Bloomberg. Data as of 9.13.2019. Note: 10-year interest rate swap rate minus three-month Libor.

the Trump administration on whether to impose tariffs on European auto imports is due in November, just after the Oct. 31 deadline for the United Kingdom to cut a deal with the European Union or face a hard Brexit.

The key question for our recession call will be how the competing forces of easier monetary policy and more aggressive trade policy intersect in terms of their relative magnitude and timing. In theory, one would expect rate cuts to be more powerful than tariffs. But given how quickly and forcefully financial markets, business sentiment, and consumer confidence have reacted to trade news, monetary policy easing could turn out to be too little and too late to offset the negative trade shock.

The market has so far confirmed this view, with long-term yields falling since the July rate cut and the three-month/10-year interest rate swap curve becoming more deeply inverted. This bull flattening conveys skepticism that the Fed can pull off a successful "mid-cycle adjustment" a la 1998, which saw the yield curve bear steepen even as the Fed underdelivered on rate cuts relative to market expectations. An important distinction is that in 1998 the policymaker was able to resolve the situation with Long-Term Capital Management and take that risk off the table, while today the Fed lacks the ability to control policy.

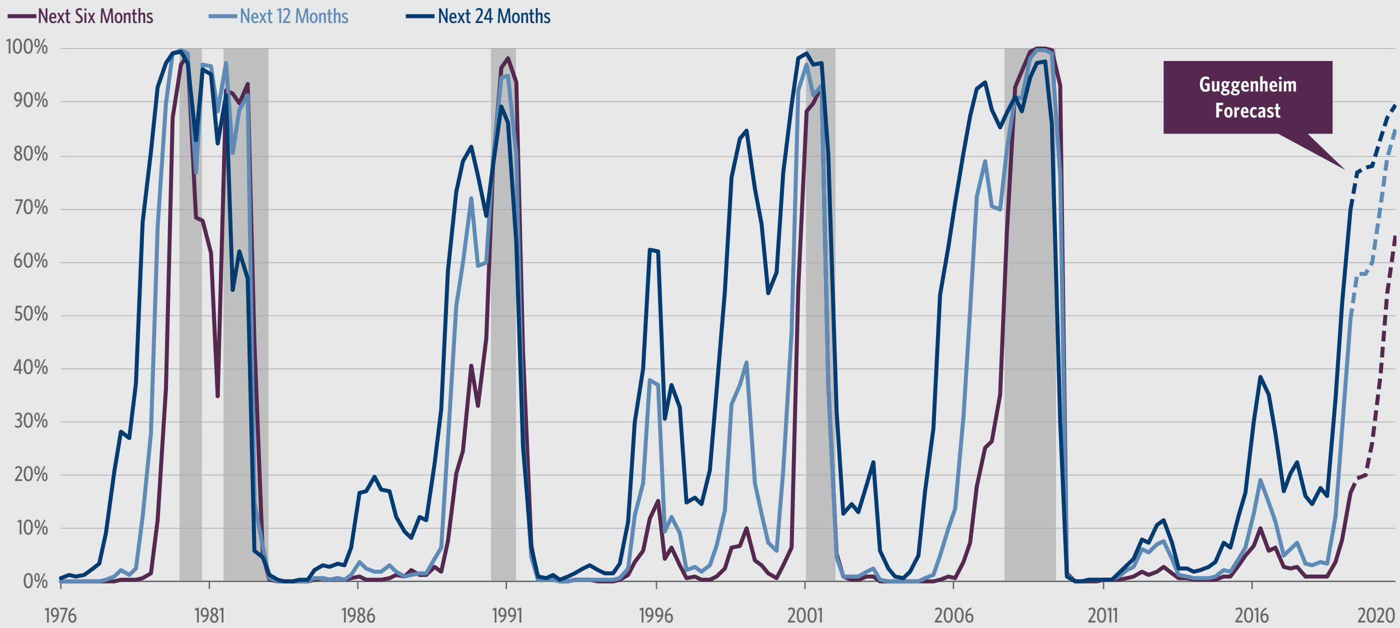
In sum, incoming data, market price action, and policy developments seem to confirm our longstanding baseline of a recession beginning in the first half of 2020. History shows that once our recession model probability reaches current levels, only aggressive policy action can delay recession, though it cannot avoid it. The speed and magnitude of rate cuts will be pivotal, as will trade policy developments. Given that credit spreads are still relatively tight on a historical basis, we believe it is prudent to remain up in quality as we await better opportunities to deploy capital in riskier credit sectors in the coming downturn.

Guggenheim Investments' Recession Probability Model

Our view that the next recession will begin as early as the first half of 2020 remains intact in the latest update of our Recession Dashboard and Recession Probability Model. Recession probability rose across all horizons in the second quarter of 2019, most notably in the 24-month timeframe, and our preliminary estimate shows probabilities rising further in the third quarter. The Dashboard on the next page shows a loss of downward momentum in the unemployment rate, an inverted yield curve, and slowing economic activity, which together support our recession baseline.

Recession Probability Model

Recession Risk Is Rising



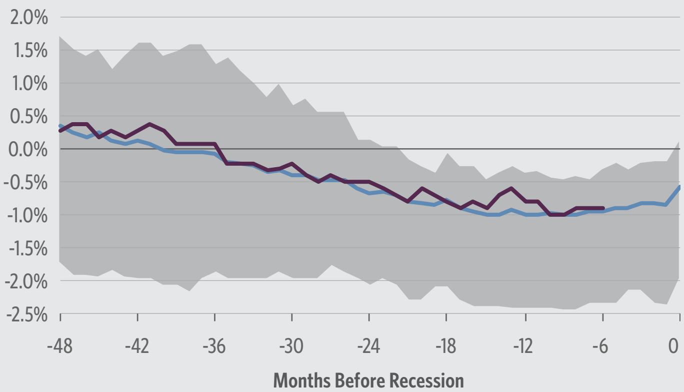
Hypothetical Illustration. The Recession Probability Model is a new model with no prior history of forecasting recessions. Actual results may vary significantly from the results shown. Source: Guggenheim Investments, Haver Analytics, Bloomberg. Data as of 6.30.2019. Shaded areas represent recession.

Guggenheim Investments' Recession Dashboard

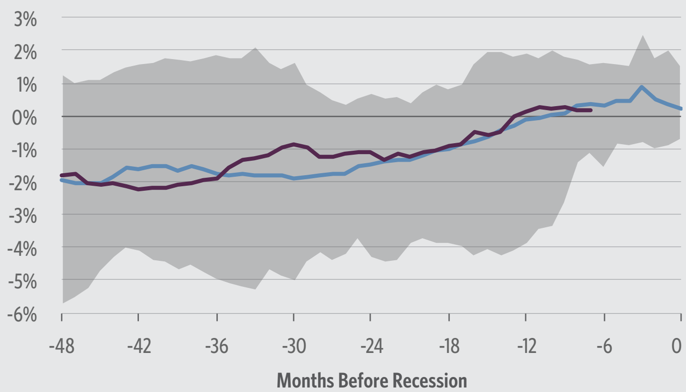
The six indicators in our Recession Dashboard have exhibited consistent cyclical behavior that can be tracked relatively well in real time. We compare these indicators during the last five cycles that are similar in length to the current one, overlaying the current cycle. Taken together, they suggest that the expansion may be just six months away from ending.

Current Cycle — Average of Prior Cycles — Range of Prior Cycles

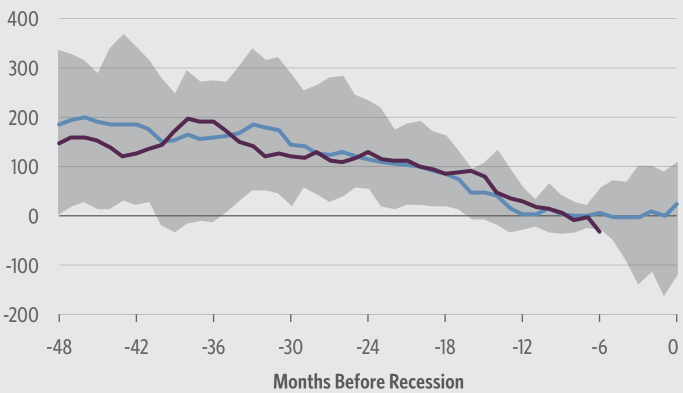
Unemployment Gap (Unemployment Rate–Natural Rate of Unemployment)



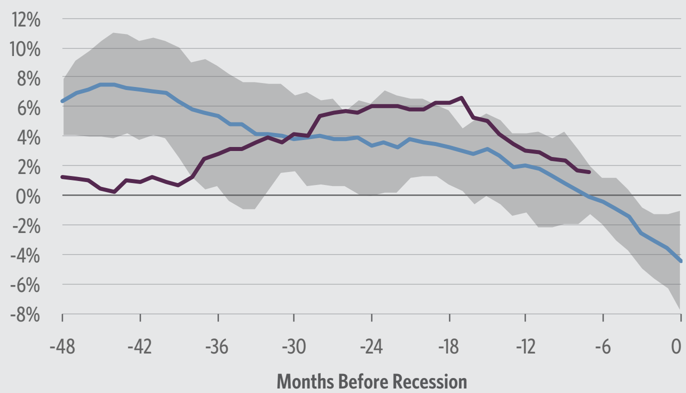
Real Fed Funds Rate–Natural Rate of Interest (r*)



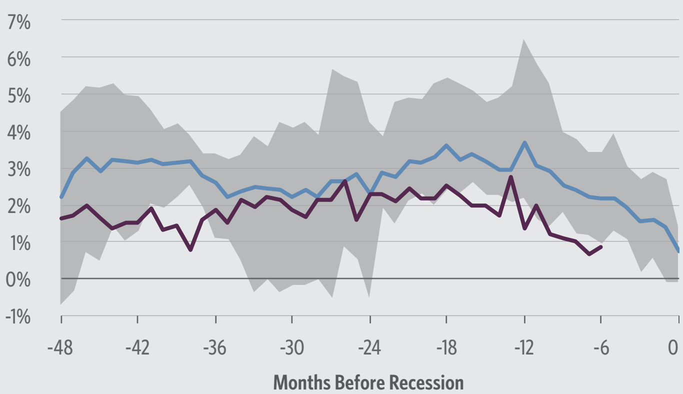
Three-Month/10-Year Treasury Yield Curve (Basis Points)



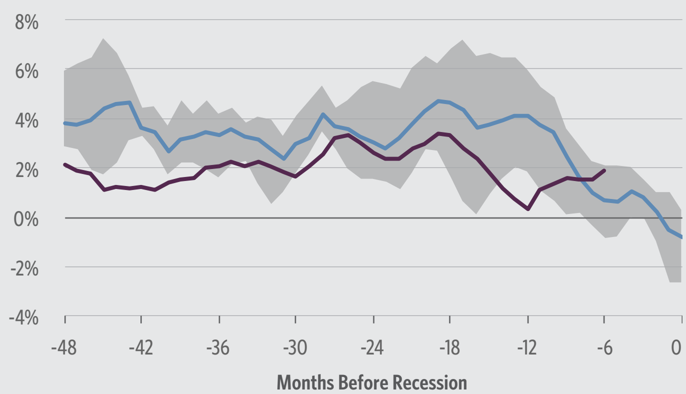
Leading Economic Index, YoY % Change



Aggregate Weekly Hours Worked, YoY % Change



Real Retail Sales, YoY % Change



Source all charts: Haver Analytics, Bloomberg, Guggenheim Investments. Data as of 8.31.2019 for unemployment, the yield curve, aggregate hours, and retail sales. 7.31.2019 for LEI and real fed funds. Includes cycles ending in 1970, 1980, 1990, 2001, and 2007. Past performance does not guarantee future results.

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One basis point is equal to 0.01 percent.

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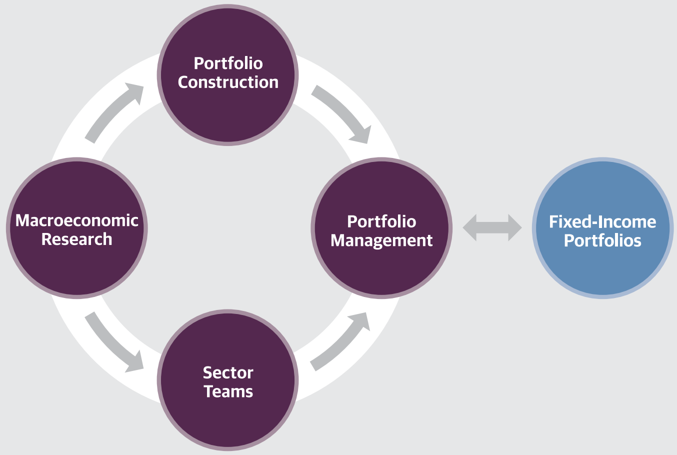

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Guggenheim Partners

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