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Global CIO Outlook
The Great Recession Scare of 2016

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Markets are in a funk over the risks to the global economy—and there are many—but I believe future market historians will refer to the current period as "The Great Recession Scare of 2016." At this point, market dynamics are playing out the way our macro research predicted over one year ago—that collapsing oil prices would lead to an increase in defaults in energy credits sometime in the first or second quarter of 2016, and that there would be a sympathetic widening in other high-yield sectors outside of energy. Our research tells us that beyond this spike in energy defaults **fundamental conditions are copacetic**, yet the markets and policymakers are reacting as if recession or full-blown financial crisis were at the gates, if not already upon us.

For example, the decline in breadth, as exhibited by one of my most reliable indicators, the New York Stock Exchange Advance/Decline line, continues to make new cyclical lows, signaling that equity prices have further to fall. Our analysis indicates that the S&P 500 could drop to a range of 1,600 to 1,650 and the Nasdaq to 3,800 before we find a bottom. A fitting analogy for the recent rollercoaster in equities may be the sharp series of rallies we experienced in 2007 and 2008 before the market ultimately capitulated. At the same time, investors should remember that such a market decline does not necessarily portend a recession. For those of us who remember, after the market crash of October 1987 the next U.S. recession was still two years away, creating a great buying opportunity. I could say the same for the periods following similar market declines in 1994 and 1998.

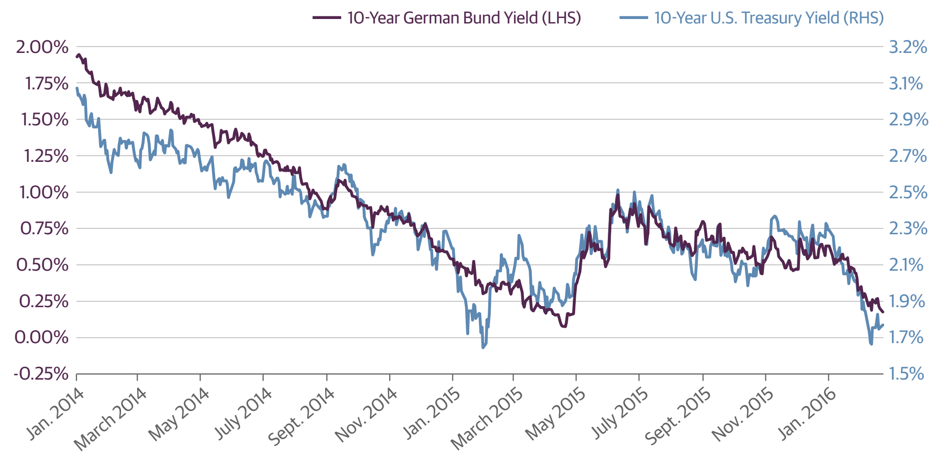
Central banks around the world, reacting to the same recessionary fears, are likely to cause long rates to sink materially lower than where we are today. I see the 10-year Treasury note falling to 1 percent, perhaps even lower, before year-end. According to technical analysis, the current target bottom for the 10-year Treasury note is 28 basis points! That may seem like voodoo, but technical analysis provided key insight to our macroeconomic team a year ago when **we called for oil to hit $25 per barrel** back when it was trading at $60.

A barrel of oil at $25 or 10-year Treasurys yielding less than 50 basis points may seem like crazy numbers, but so do the negative interest rates that we are already seeing in Europe and Japan. As low as rates are today, I expect further declines in short-term and long-term rates, both in Europe and Japan, and that ultimately the Bank of Japan and the European Central Bank will take their respective overnight rates to as low as -100 basis points. Such an event would likely cause Germany's 10-year bund to trade at around -50 basis points. When you consider that the current spread relationship between bunds and Treasurys is about 150 basis points, you can easily see why the U.S. 10-year note at 1 percent is not that farfetched. Given that U.S. Treasurys have traded at yields lower than bunds, it is not hard to imagine that the 10-year note could yield less than 1 percent if the bund were to reach -50 basis points.

Since the beginning of 2014, 10-year Treasurys have moved closely in line with 10-year bund yields, sending U.S. rates lower even with tighter Federal Reserve policy on the horizon. With economic growth in the euro zone showing little signs of acceleration, the European Central Bank could soon cut rates deeper into negative territory. This would drive 10-year bund yields well below 0 percent, and based on recent history this would in turn pull down Treasury yields meaningfully lower from today's levels.

Treasury Yields Have Followed Bund Yields Lower as ECB Has Eased

10-Year German Bund Yield and 10-Year U.S. Treasury Yield



Source: Bloomberg, Guggenheim Investments. Data as of 2.22.2016.

Recession watchers were offered another dose of fear this week. Thanks to recent stock market weakness, the index of leading economic indicators (LEI) registered a negative print for the second month in a row. Recessions typically do not occur in the United States without the LEI declining for three consecutive months, and now we have two in a row. Nervous market participants are already discussing the importance of the next reading of the LEI. Even if such a three-peat were to occur, I must caution that a recession is by no means inevitable. As I am fond of pointing out, the leading economic indicators have predicted something like 11 of the last seven recessions. The decline of the leading economic indicators for three consecutive months has generally been a condition for a recession, but not necessarily a confirmation of one.

There are a few good reasons why the LEI, and the markets, will be wrong about the likelihood of an impending recession. GDPNow, the Federal Reserve Bank of Atlanta's real-time estimation of U.S. gross domestic product based on current data, is currently predicting 2.6 percent growth for the first quarter, which is above current consensus of 2.2 percent. The employment numbers clearly show the U.S. economy is growing, with solid gains in manufacturing employment, increases in hourly earnings and hours worked, and an uptick in participation. In addition, the consumer continues to show a strength that is spilling over into the manufacturing base. Based on our purely dispassionate analysis of economic fundamentals, the reality is we are not currently in a recession, nor are we likely to face one this year. The U.S. economy has plenty of steam and should continue its expansion for another two, maybe even three, years.

While choppy markets like these require a strong stomach, **do not be frightened**—they historically hold the most value. I have great confidence that continued deterioration of market conditions over the next three to six months will prove an excellent opportunity to allocate to risk positions too heavily discounted by unwarranted, looming fears of recession or financial crisis.

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