ADVISOR PERSPECTIVES
Helping advisors enable clients to achieve their financial goals

How to Position for the Coming Recession

October 16, 2019
by Robert Huebscher

Brian Smedley is Head of Macroeconomic and Investment Research at Guggenheim Partners. He manages a team of nine macroeconomists and investment strategists with global macro coverage responsibility, and oversees Guggenheim's sovereign credit research. Brian writes commentaries on a variety of wide-ranging topics, which have been ranked among the advisory industry's most-read and most-shared articles.

I spoke with Brian on October 2.

Bob: As head of macro research, how does your team influence portfolio allocations at Guggenheim?

Brian: My team consists of a mix of economists and strategists. We have responsibility for global economics, policy analysis, and investment strategy across all global markets. Our job is to build a roadmap that can guide our investment decisions. Macro research performs a unique function at Guggenheim in the sense that it's a cornerstone of our investment process. That's not necessarily true for other asset managers. We work closely with our global CIO, Scott Minerd, to develop our house views. We meet with Scott every Monday morning and present our analysis on a wide range of topics. We debate as a group where we think the economy and the markets are, and where we think things are going.

To the extent that the conclusions we arrive at are different than what markets are pricing in, it often results in interesting investment opportunities. From there, our house views get implemented across all our portfolios, factoring in the different objectives and constraints of each strategy. We work with our portfolio construction group to ensure that our house views are represented appropriately in each mandate. We also work to support our portfolio management teams and the sector trading desks with ad hoc analysis and forecasts as needed.

Bob: In your recent commentary, you said that the U.S. economy is on track to fall into recession by mid-2020. What do you base that call on?

Brian: Let me take a step back and provide context on this process. Two years ago, we undertook an effort in our macro research group to develop a suite of tools that could help us forecast the timing of the next recession. Part of that process involved trying to understand why economic forecasters have such a hard time forecasting downturns. There are a few primary causes. First, economic data is lagged and there is the problem of driving while looking in the rearview mirror.

Second, economic indicators are subject to substantial revisions. Our analysis finds that those revisions tend to be pro-cyclical, meaning that when the economy is strengthening, the revised data tends to look better than the initially reported numbers did. When the economy is weakening, as it is now, data tend to get revised downward, which is exactly what we've seen in recent months with GDP, corporate profits, and payrolls.

The third factor is personal and institutional biases. Many people have a personal or professional incentive that causes them to hope for, or at least publicly forecast, that a recession won't happen.


Brian Smedley

With these shortcomings in mind, we developed some tools to guide us as we get into the later stages of the business cycle. There are two key outputs from that process. The first is our recession probability model, which we first started publishing two years ago. That model currently indicates that the odds of a recession starting by the middle of 2020 are above 50% and that probability has been rising over the last several quarters.

The second tool is our recession dashboard. It walks through a narrative of how the data look when you're in the final years of an expansion. To begin, we're seeing an unemployment rate that is very low: That's very typical of the final stages of that expansion. We're also seeing a loss of momentum in the pace of improvement in the labor market. The Fed has tightened policy, because as the labor market gets tight, the Fed raises rates. Eventually they push too hard and have to back off and cut rates. So far these indicators are lining up with the historical pattern.

It's hard to know whether the Fed has gone too far with its tightening cycle. That's why we look at the shape of the yield curve.

> **"It's hard to know whether the Fed has gone too far with its tightening cycle. That's why we look at the shape of the yield curve."**

We focus on the three-month to 10-year curve. The yield curve flattened and inverted along the timeline we expected. We published a report about a year ago saying "this time is not different," and investors shouldn't discount the inversion.

Finally we see weakness in other indicators of future economic performance. The leading economic index, which is a collection of leading indicators, has been softening throughout the past year. We've seen a slowdown in job gains and an outsized slowdown in weekly hours worked. Before employers start to lay off employees, especially when the labor market is tight, they begin to cut back hours. The slowdown in aggregate hours worked over the past year is a leading indicator. Within the next six months we should see a pickup in layoffs.

The final indicator on the dashboard is real retail sales, which have picked up in recent months. But we think it is about to soften.

To sum it up, the data we track, which have a reliable track record of predicting a recession, are pointing to a start date of approximately six months from now.

Bob: What role does the Fed play? Will they be able to stave off a recession by cutting interest rates?

Brian: Year-to-date we have seen a barbell in market performance, with the safest and riskiest assets among the top performers. Safe havens like long-dated Treasury and Agency debt and precious metals have done very well. Equities and the energy commodities have also done well year to date after the recovery from the fourth quarter of 2018, thanks in large part to the Fed.

While the Fed's pivot has supported growth relative to where it would have been if it kept tightening, the Fed isn't easing in a vacuum. The Fed is contending against the usual late-cycle headwinds, which I just laid out, and they're up against a trade war involving the world's two largest economies. They're also up against fading fiscal stimulus and rising policy uncertainty as the 2020 election approaches.

The committee is acutely divided. The leadership—Powell, Clarida, and Williams—have been leading the charge in favor of rate cuts. They will probably push through another rate cut in late October when the Fed meets next. But much of the committee thinks the economy is in fine shape and they're resisting further easing until we see clearer signs of a downturn developing.

The problem with that approach is that monetary policy works with long and variable lags, to quote Milton Friedman. If the Fed waits until the job market and economic activity are clearly turning down, it will be too late to avoid a recession. That's where understanding the pro-cyclicality of revisions is important. If we are turning down, the data, with the benefit of hindsight, are going to look worse than they do today. The Fed should try to get ahead of that. But Powell has his hands full trying to manage a divided committee.

Bob: How does the ratcheting up of trade tariffs factor into your recession forecast?

Brian: That's the other major policy development shaping our outlook. The escalation of a trade war undermines global growth and makes it more likely that we will enter into a recession.

The trade tensions affect U.S. growth along four broad channels.

First, the tariffs lead to tighter U.S. financial conditions. That means lower stock prices, a stronger dollar, and wider credit spreads than would otherwise be the case. This is partially offset by lower interest rates, but the net effect is a tightening of financial conditions that weighs on growth.

The second is some combination of higher inflation, which hurts consumer spending, and corporate profit declines, insofar as businesses aren't able to pass on higher input costs to their consumers. Both of those are negative for growth.

The third channel is that the tariffs increase uncertainty. We know that creating uncertainty has been the hallmark of this president's approach to negotiating deals. The increased uncertainty unfortunately hurts business investment and consumer spending.

A fourth is that tariffs may reduce the trade deficit, although this is debatable. But even assuming that tariffs help growth on the margin through a narrower bilateral trade deficit, this is more than offset by the damage that they do to global growth and global supply chains. What we're seeing in the data is that the manufacturing sector is bearing the brunt of the damage from the trade war, especially in countries like China and Germany that are the most geared toward manufacturing.

Interestingly, the recent services PMI data for Europe and the United States suggest that the much larger services sector may be starting to tip over as well. The trade war is coming at a time when the economy is already exhibiting a wide range of late-cycle symptoms.

It's never a good time to have a trade war, but it would be hard to pick a worse time in the business cycle than where we sit today.

Bob: Let's come back to what you said about the inverted curve. You look at the three-month to 10-year spread. A lot of people are discounting the signal from the yield curve, because they believe it's been distorted by QE. Can we trust the yield curve this time around?

Brian: We've also seen the same tendency to dismiss the message of the inverted yield curve leading up to past recessions. Part of this reflects personal and institutional biases. We don't want a recession to happen for various reasons, and so we come up with reasons why this time is different. We've looked at this issue very carefully. Part of this builds on my past experience working as a U.S. rates strategist covering the Treasury and swap markets, as well as my work at the Fed.

When people talk about these distortions, they mostly look at a narrow component of the demand side of the Treasury market, namely official demand from the Fed or other central banks. But it's important to consider what's happening on the supply side, specifically the amount of duration risk issued in the Treasury market. It's very different for the market to absorb a billion dollars of 30-year bonds than for a billion of three-month bills. The supply of duration risk in the Treasury market has increased dramatically since the financial crisis, even after we net out the bonds that the Fed bought during QE.

This happened as a result of two factors. The Treasury department issued a massive amount of debt on a cumulative basis to fund the deficit and it has also lengthened the average maturity of the outstanding debt stock by focusing its issuance at the long end of the curve.

The Fed's QE purchases weren't enough to outweigh this wave of duration supply. The net effect has been to cause the Treasury curve to be steeper than it has been in the past. We can see evidence of this when we compare the shape of the Treasury curve to the shape of the swap curve. The three-month to 10-year Treasury curve is widely followed as a recession indicator. It is about 30 basis points steeper, or less inverted, than the swap curve. As a result, the Treasury curve inversion was late to the party. The three-month to 10-year swap curve inverted on January 3 of this year, while the Treasury curve didn't invert until March.

Not only should we not discount the inversion of the Treasury curve, we should recognize that the start of the recession might be a little closer than the Treasury curve is telling us based on the historical lead time of the first curve inversion.

Bob: When the recession does happen, how severe will it be, both for the economy and for markets?

Brian: We tackled this question last year. We approached it by developing a quantitative model that looks at several factors that have a bearing on the severity of a recession. That quantitative work suggests that the next recession will be of average severity, or maybe even a little less severe than average. We define severity by the length and the depth of the downturn in GDP and the trough-to-peak increase in the unemployment rate. That is relatively good news after what we lived through in the last downturn.

There is a caveat, however, which is the downside risk to that baseline is that we have limited policy space. There's less room for the Fed to cut rates. There's also very little room for the European Central Bank (ECB), the Bank of Japan, or the Bank of England to cut rates. The People's Bank of China (PBOC) and the Chinese have had a massive build up in debt over the last decade. There's limited room for them to act aggressively through credit stimulus.

For markets, we believe the recession could be more severe than average. We developed a bear market severity model that envisions a 40% to 50% peak-to-trough decline in stocks, which would be almost as severe as the 2000–2001 and 2008 bear markets.

That model factors in two variables. The first is market valuations. The higher the valuation (using the Shiller CAPE ratio) before the recession relative to its long-term average, the deeper the equity bear market tends to be. We are not at an all-time high level of valuation, but we are meaningfully higher than the historical average. The second factor is the severity of the recession.

The 2001 bear market is an interesting case study, because we had a recession that was much milder than average, but the declines in equities and corporate credit were much greater than average. That was due to stretched equity market valuations and an overhang of corporate debt, which is similar to the situation we have today.

Bob: Does next year's presidential election have any bearing on your outlook? In particular, how will markets react if Elizabeth Warren emerges as the likely Democratic nominee?

Brian: The main issue between now and Election Day is the increase in policy uncertainty. Generally we expect uncertainty to weigh on consumer spending, business investment, and markets by tightening financial conditions. Policy uncertainty is a function of the difference in policy preferences between somebody like Elizabeth Warren and the incumbent president. Of course, there's a lot of daylight between President Trump's agenda and that of Senator Warren.

Many Democrat candidates have promised to undo some of the signature economic policies of the Trump administration, namely the tax cuts and his deregulatory agenda. As a result, the risks to confidence are skewed to the downside. We also find that economic confidence among Republicans is much higher than among Democrats. If Trump goes down the path toward impeachment and it doesn't work out well for him, or if he looks increasingly weak heading into the 2020 election, we could see consumer confidence fall, particularly among Republicans. That would support our baseline that the economy is headed for a recession.

Gallup recently conducted a poll on economic confidence, and it found a remarkable divide between Republicans and Democrats. Republicans told the Gallup pollsters that they thought the odds of a recession in the next year was just 21%, compared to 50% for Independents, and 74% for Democrats. If Warren gains ground against her Democrat rivals or the president and in head-to-head polls against Trump, that stands to undermine Republican consumer confidence. That could turn out to be a problem for the economy.

Warren does have momentum. The news about Bernie Sanders' heart attack could play into that. Also, the Ukraine situation involves both President Trump and former Vice President Biden. Those are the key people that stand in the way of her becoming president. It's a little early to say what the effects of that story will be on those two gentlemen, but Warren stands out as likely to benefit on the margin from that development.

Bob: In the last downturn, the housing bubble and mortgage debt were key problems. Are there any sectoral imbalances that concern you today, and if so, how is that reflected in your portfolio positioning?

Brian: The household sector has made a lot of progress in deleveraging. But there are concerns, especially at the lower end of wealth distribution, where debt has grown meaningfully. But where we're more focused on imbalances is in the corporate sector, which has taken advantage of record-low borrowing costs to add leverage. That leverage has been used to pursue M&A targets and to use debt to finance share buybacks and dividends, or to optimize the capital structure in light of falling interest rates. We see risk from imbalances most acutely in the concentration of BBB-rated debt within the investment-grade bond market.

> **"About half of investment-grade corporate bonds are comprised of BBB-rated issuers. That's a lot higher than it's been historically."**

About half of investment-grade corporate bonds are comprised of BBB-rated issuers. That's a lot higher than it's been historically. Those issuers are on the cusp between high yield and investment grade. If there's unexpected weakness in earnings, that could cause them to tip into the high-yield category if they're downgraded. A lot of those BBB capital structures belong to very large companies that have long-maturity debt, which is pretty easily digested by the investment-grade bond market. But there's less appetite for that in the high-yield space.

This is another area where we've tried to add value from a macro research standpoint in our investment processes. We took a look at "fallen angel" risks among the investment-grade issuers in the U.S. corporate index. We started with Moody's ratings criteria, which differ for each industry. We applied those criteria to the issuers in the corporate benchmark. We found that a surprisingly large number of U.S. investment-grade corporate bond issuers have either leverage multiples or interest coverage metrics that are consistent with a high-yield rating.

We then asked ourselves, "What's going on here?" The answer is that the rating agencies generally don't forecast recessions even though we think it's more likely than not to happen within the next year or so. Number two, the agencies are giving those issuers time to de-lever. That works fine as long as the economy is growing and earnings are trending higher, which makes it easier to grow into an over-levered capital structure. The opposite happens if the recession occurs and earnings turn down; instead of leverage falling, it increases.

That's where the rubber hits the road. If our view of the world plays out, the rating agencies will have some catch up to do. We could have a cascade of fallen angels, where BBB-rated companies get downgraded to high yield. That has macro consequences. This story could filter through a strong consumer through the job market. If companies start de-levering, laying off workers, or cutting back expenses, then that's going to spill over into the consumer.

How are we implementing this in our portfolios? Across our strategies, we've reduced our exposure to corporate credit. In our multi-asset portfolios, like our total-return fund (GIBIX), which is a core-plus strategy, we've reduced the allocation to corporate credit overall. Within that, we've reduced our allocation to lower rated segments of the corporate bond market. We are very selective around BBB issuers where we see a risk of downgrade. We've also looked for industries and sectors that are less vulnerable to a turn in the business cycle. For those issuers, ratings and fundamentals are more resilient.

Bob: Looking outside the U.S., central banks overseas are wading deeper into negative interest rate territory. Of course, during the last downturn Fed policymakers were strongly opposed to negative rates. You worked on the Open Markets Desk at the New York Fed at the time, so I'm curious to know whether you think the U.S. could also see negative rates at some point.

Brian: The Fed is reluctant to employ negative rates. We looked at this issue when I was at the New York Fed during the financial crisis. There was virtually no appetite to go down that path. Having analyzed the more recent experience of Japan and especially some European countries, however, makes it a little easier for the Fed to think about this. But before the Fed ever seriously contemplated employing negative rates, the first thing it would do would be to take the fed funds target rate back to zero. It would then use aggressive forward guidance—communicating to the market that policy rates would likely stay at the lower bound for a prolonged period of time. The Fed would be even quicker and more aggressive with that type of guidance than it was in the last downturn.

The Fed would announce a large-scale QE program that would certainly involve Treasury securities, but it would probably also involve Agency mortgages, just to gain more capacity. If our view of the vulnerabilities of the corporate credit market turns out to be accurate, then buying mortgages, which are like the cousins of investment grade corporate bonds, would be a way to limit the potential for spread widening.

Beyond QE and forward guidance, the Fed would probably also employ some version of yield curve control, as we've seen in Japan for the last few years. It's unclear how far out the curve they would be willing to venture. But this is not too far removed from using forward guidance and QE.

If after all that, inflation and inflation expectations are still too low, which would be the key drivers of a decision to look at negative rates, the Fed would come around to embracing negative interest rates. But that would be a last resort.

Before the Fed could implement negative interest rates, there's some technical work to be done. Currently the Fed targets the fed funds rate, and that is a very wonky market. The vast majority of the lending of cash in the fed funds market is done by the 11 Federal Home Loan banks. They have the opportunity to keep cash uninvested in their non-interest-bearing deposit accounts at the Fed. If the Fed ever lowered interest rates to the negative territory, those banks, instead of lending the cash at a negative rate to a bank, would just leave their cash in their account at Fed. That matters because you could see a dramatic reduction in overnight trading volumes in the Fed funds market. That would leave us with a Fed benchmark that looks just as broken as Libor, which policymakers are now working to replace.

The solution is that instead of Fed funds, the Fed could target the overnight Treasury repo rate, which it could push into negative territory. Those are examples of some of the things the Fed would have to look at before it uses negative rates.

Bob: Given your outlook, what asset allocation recommendations would you have for financial advisors?

Brian: This is a difficult time for advisors and for their clients. We're at this Twilight Zone juncture where everything has rallied year to date. Risk assets are near their cycle highs, while the bond market is pricing in some meaningful probability that we will enter an economic downturn.

We have a high degree of conviction that we're entering a period that will be rough for risk assets. You can look at it two ways—which assets will do well in this environment and which will suffer. Our work suggests that highly cyclical sectors such as equities, commodities aside from precious metals, emerging markets, and high-yield bonds are the most sensitive to the business cycle. The returns over the next couple of years for those asset classes will likely be deeply negative.

On the positive side, we favor high-quality fixed income. Look to extend duration, own fixed-over floating-rate debt, favor high quality over current income. That combination will serve as a ballast in client portfolios.

We also get questions about precious metals. Gold and silver will do well as safe havens. They tend to trade reasonably similar to long-term Treasury bonds.

The bottom line is this is a time to be conservative. This is a time to think about safeguarding gains. Investors who have been in the market through this cycle have enjoyed nice gains in risk assets. We recommend that advisors rotate into the safe havens to the extent that they think they can.

Bob: If we were to talk a year from now—and I hope we have the opportunity to do so—what do you expect the yield on the 10-year Treasury to be? What will the S&P 500 return over that period?

Brian: We'll be at a new all-time low on 10-year yields—most likely below 1%. That would be on the order of 75–100 basis-point rally from where we are today. The S&P will likely be in a technical bear market, meaning probably down at least 20% from its recent peak.

Bob: If there is one thing you'd like our readers to take away when it comes to how Guggenheim sees the macro landscape and how that translates into its investment approach, what would that be?

Brian: I've sketched out a fairly unattractive outlook for a lot of investors. Of course, my focus is on macro research. We also do thorough security selection from a bottom-up standpoint. Our focus is on preserving investor capital and safeguarding what our investors have worked so hard to accumulate.

This is a time to focus on preservation of capital and reducing risk. That's the way we're managing our portfolios.

But we're certainly not perma-bears. We're known for having a deep expertise in the corporate and structured credit markets. Our strategies have performed well through this bull market in risk assets. We will be nimble. If the world plays out the way we're expecting over the next couple of years, we will be well positioned to take advantage of opportunities to add exposure to assets that will benefit from the upcoming economic recovery.

Disclaimer

AP-SM-RPT4 #40416