Guggenheim: Prepare for Recession in 2020

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by Robert Huebscher

Brian Smedley is Senior Managing Director and Head of Macroeconomic and Investment Research at Guggenheim Partners.

Brian joined Guggenheim in 2015 from Bank of America Merrill Lynch, where he was Director and Head of U.S. Short Rates Research. Prior to joining BAML in 2010, he spent nearly five years at the Federal Reserve Bank of New York. There he served as a senior trader in the Markets Group during the financial crisis and previously as a senior economic analyst in the Emerging Markets and International Affairs group.

Brian graduated summa cum laude with a B.S. in finance and economics from Utah State University and an MA in international development studies from the Elliot School of International Affairs at George Washington University.

I interviewed Brian last week.

Please discuss your role at Guggenheim and how you support the investment decisions that get made throughout the firm.

I head the Macroeconomic and Investment Research team at Guggenheim Investments. In that role I lead a team of macroeconomists and investment strategists. We work closely with our global chief investment officer, Scott Minerd, to provide the rest of the investment team with the outlook on the U.S. and global business cycle, market forecasts, and policy views that determine our positioning at a high level across portfolios.

In your recent commentary, you said that the U.S. economy is about two years away from the next recession. How severe will that recession be and what was your analysis behind the two-year timeframe?

Last year we developed a framework that brings together several indicators to give us an early warning sign as a recession is approaching. We started by studying the common characteristics of pre-recessionary periods historically. The narrative begins with an economy that is growing above its potential for a sustained period. We see evidence of that in the fact that the unemployment rate is declining. As it declines below full employment, the Fed grows concerned about an unsustainably tight labor market and what that may portend for rising inflation. The Fed raises interest rates and tightens monetary policy. As it does, we tend to see evidence that monetary policy is getting tighter in the flattening of the Treasury yield curve. We focus on the three-month/10-year Treasury curve.

That set of circumstances describes the current U.S. economy pretty well. It’s only in the last few quarters of the expansion that we see economic growth decelerating. Near the end of the expansion we see a decline in the leading economic index, a sharp slowdown in payroll growth and an increase in the unemployment rate. As the labor market begins to weaken we see a falloff in real consumer spending. At this stage, the indicators that we track that have the best leading properties this far out suggest that the economy is likely to run into a recession in the first half of 2020. We’ll be looking for a growth slowdown as we move through 2019 to confirm this view.

As to the severity of the recession, the quantitative work we've done around factors that cause more severe recessions suggests that the next downturn in the U.S. could be about average. This is good news. However, we're more concerned with some of the qualitative factors that could pose more of a downside risk and are difficult to model. Specifically, we're concerned about the lack of policy space, both in the U.S. and abroad. U.S. interest rates will have less room to fall than they have had historically. The Fed is likely to go back to the zero-lower bound and it’s likely to reengage with both aggressive forward guidance and quantitative easing.

Meanwhile, we're finishing this expansion with the largest peacetime non-recessionary budget deficit that we've ever seen, so there's also less space than average for a fiscal policy response to cushion the next downturn. The problem is even more acute outside the U.S. We see the markets likely forcing belt-tightening measures in southern Europe. As sovereign spreads there widen in the next recession, governments in Spain, Italy, Portugal and Greece are going to need to tighten fiscal policy in response to market pressure. We have serious concerns about whether the political dynamics in those countries will allow for both markets and voters to be appeased in a deteriorating economic environment.

From the ECB’s standpoint, it has limited scope to ease monetary policy to cushion the downturn. Japan also has limited scope for monetary policy action, even as fiscal policy tightening is in the pipeline for 2019. The Chinese economy is likely to be choking on defaults after what's really been a decade of epic credit expansion across all sectors of its economy. That, plus the fact that China’s balance of payments position has weakened over the past decade, means the authorities won’t be able to juice the economy through aggressive stimulus like they did during the Global Financial Crisis.

Summing it all up, we take some comfort in the quantitative measures that tend to historically give a good leading indicator of recession severity, but we do have some concerns about potential downside risks due to limited policy space.

How do you expect the fixed income and equity markets to perform this late in the business cycle? How have they performed historically during similar periods?

At this stage of the cycle we expect Treasury yields to continue to rise and for the yield curve to continue to flatten. The rise in yields is driven primarily by the fact that the market is not pricing in the full extent of the Fed rate-hiking cycle. We anticipate the Fed will hike rates again in December 2018 and then four times next year before it’s done. That is more than both the Fed and the markets are currently expecting.

That suggests that rates will rise, but the increase in yields will be led by the front end of the curve. We expect that Treasury yields across the curve will probably end the cycle near 3.5%. We see three-month LIBOR leading the way, and ending the cycle above 3.75%. The yield curve will flatten and eventually invert once the Fed hiking cycle is complete. We expect that credit spreads will move sideways for the next several months. But starting in the first half of next year, based on historical experience, we would expect credit spreads to begin to widen, with the lowest-rated segments of the credit market experiencing the most pronounced widening leading up to and during the recession.

On the equity side, we are coming into what should be a favorable seasonal period for the stock market. History indicates that returns are pretty strong during the November through April period. We also have the additional tailwind of mid-term elections, which historically tend to be a bullish catalyst for stocks, regardless of the outcome. And after the pull back that we've had recently, the equity market is a little bit cheaper relative to still-rising corporate earnings. So the short-term outlook is reasonably positive. But that will be the rally to sell. Sometime around the second quarter of next year, we would expect to turn much more defensive on stocks. We anticipate a substantial bear market will begin next year, with the outlook beyond mid-2019 looking much darker.

We already talked a bit about recession severity. But we've mapped our work on recessions to the severity of drawdowns that we've seen in the stock market. We found that recession severity does a pretty good job of identifying the depth of the downturn in the stock market. But the model fit improves substantially when we add another factor: the valuation of the market before the recession. Because current valuations are toward the upper end of the historical range, our models indicate that we should expect a 40% to 50% pull back from the peak in the S&P 500 during the next bear market.

What is the risk that the Fed will bring on a recession sooner through its interest rate hikes?

A hawkish Fed is already embedded in our base-case scenario. It would take a much faster pace of rate increases to bring about an earlier end to the expansion. That's a risk we have to bear in mind, given that the economic data has been so strong and that the Fed has acknowledged that it will need eventually to move policy into restrictive territory.

In addition, starting in January, the Fed will host a press conference at the conclusion of every FOMC meeting, so in theory there will be more “live” meetings at which they could hike. But absent a hiking pace that accelerates with hikes occurring at every meeting starting in early 2019, we don't see significant risk that the cycle would end earlier than our baseline due to an aggressive Fed.

Do you expect an escalation in the trade war and how does this factor into your recession forecasting?

We certainly do expect the trade war to escalate, specifically between the U.S. and China. In fact, we've seen the emergence of a multi-front trade war. It's a geo-strategic, military and economic issue. In the last several years, we've seen public opinion around U.S. trade with China take a turn down. Voters across the major political parties have a very negative view, with large majorities viewing trade with China as being unfair to the U.S. Policymakers have reinforced this view with their increasingly hawkish rhetoric on China. Given where public opinion seems to be, we expect that political leaders, whether it be the current president or the Democrats, are going to continue to escalate the trade war with China. Tariffs will boost U.S. inflation, eating into disposable income and forcing the Fed to continue hiking even as business investment spending cools off amid a big increase in supply chain uncertainty.

One of the drivers of the strong equity market performance, at least over the last several years, has been corporations that have bought back their own stock. Do you expect that activity to continue, particularly as the Fed continues to tighten its monetary policy?

We don't see any reason for the buyback tailwind to fade, at least for the next few quarters. But once we get into the latter part of 2019 and 2020, we expect the buyback wave to peter out. Historically, when we analyze corporate share buybacks and M & A activity, there's a very strong cyclicality. Given our expectation that the business cycle is nearing its conclusion and that credit spreads will widen as we move through 2019, we expect that corporate buyback activity will taper off and that that tailwind to the stock market will disappear.

What do you make of the volatility in the equity market in the last two weeks?

It's symptomatic of the world we're living in where the Fed is removing accommodation, so “good news is bad news.” With the backdrop of a Fed that's moving in the direction of a restrictive policy stance, the key catalyst for the recent stock selloff was very strong economic data, which pushed up interest rates.

It wasn't only the increase in interest rates that caused concern in the stock market. It was also the rapidity of that move, which caused implied interest-rate volatility to move sharply higher in advance of the move higher in equity volatility. You could think of it as a tug of war between the stock market and the bond market. This is a condition that investors have to get used to seeing for the next several quarters. After that a genuine risk-off environment will emerge where we begin to price in an economic downturn.

What signs do you look for in the credit market that would indicate that a recession is imminent?

It begins with a widening of credit spreads, which will be evidence that credit investors are becoming more selective and more risk averse as earnings growth slows. Once the recession hits and corporate earnings decline, we’ll see a very significant wave of ratings downgrades and ultimately corporate defaults.

Much has been written about the recessionary implications of an inverted yield curve, should that happen. What guidance do you offer on this topic?

There is an ongoing debate about whether an inversion of the yield curve is a symptom or a cause of economic downturn. Our view is that it is primarily symptomatic of an economy that is running too hot. As monetary policy moves into restrictive territory to cool down the economy, a flatter term structure of interest rates reflects a view that rates are at their cyclical peak and more likely to move lower in the future as growth decelerates. A flat yield curve is an indication that monetary policy has moved to a restrictive stance.

There are some causal elements, however, that affect asset allocation decisions. For example, foreign investors, such as Japanese life insurance companies or European pension funds, have been sizeable buyers of U.S. corporate debt. They've looked for opportunities to earn better yield than they can find in their local market. They tend to hedge their U.S. exposure in the FX forward market. As the U.S. yield curve flattens, those hedging costs rise to the point where it becomes unattractive to invest in long-term U.S. fixed income instruments with a currency hedge. This has the effect of reducing or eliminating an important source of funding for U.S. businesses.

Another example would be a multisector U.S. fixed income portfolio that is considering the tradeoff between investing in short-term credit instruments such as commercial paper versus longer-term corporate bonds. When the yield curve is flat, it's easy for portfolio managers to avoid taking a lot of spread duration risk, which is what you get with a long-maturity corporate bond. Instead, they can generate a pretty decent yield on the portfolio by keeping their credit exposure more limited and rolling a shorter-dated position in commercial paper. They can meet their duration targets by buying long-term Treasuries or agency debt, which have much less downside risk than long-term corporates. This probably contributes to the widening in credit spreads that typically occurs once the yield curve flattens.

Are you worried about the degree of leverage across corporate America?

Yes, corporate borrowers in the US have added a great deal of leverage in this cycle. We see that in the investment-grade market where currently 50% of the corporate index is comprised of corporate bonds rated BBB, the lowest investment-grade rating. This is a startlingly high percentage. When we look at the fundamental characteristics of those BBB-rated issuers, we find that many of them have leverage and debt-service metrics that are more consistent with below-investment-grade ratings.

A major concern we have is that, as the business cycle turns and spreads widen, you're likely to see a wave of downgrades that bring a substantial share of those corporate issuers into the below-investment grade market, where the investor base is considerably smaller. We call formerly IG-rated issuers “fallen angels.” A sizeable fallen-angel wave could overwhelm the high-yield market in the next several years, potentially doubling its size.

The downward rating migration will cascade through the credit markets and contribute to substantial tightening of financing conditions for corporate America.

Of course, a big theme in the investing world has been the growth of passive strategies. We've seen this in the fixed income space, where index-based ETFs and mutual funds have grown quite a bit in the last decade. The growth of passive investing in some ways has enabled the rise of this large share of BBB-corporate borrowers. As long as they're in the index, these index funds have to buy them.

We also fear that when the tide turns and we have a wave of fallen angels, you'll have a large number of passive funds that are turned into forced sellers. They'll be forced to liquidate downgraded positions into an illiquid market, which is a recipe for a sharp widening in credit spreads. That's an important issue that we've been watching, and one that has motivated us to upgrade the credit quality of our portfolios well in advance of when we expect the recession to begin.

The service sector in the U.S. economy has grown over the last several decades, while its manufacturing footprint as shrunk. There is less investment in brick-and-mortar capital spending, which historically has been interest-rate sensitive. As a result, some argue that the U.S. economy is less vulnerable to higher interest rates. What is your view of this thesis?

There's no doubt that the business cycle has generally become more stable as the industrial share of the U.S. economy has fallen. In recent decades we've seen longer expansions and less cyclical volatility, with the Great Recession being the notable exception. That reflects the changing structure of the economy and the rising share of services output.

The flip side of this is that as the business cycle has become more stable, consumers and businesses have taken advantage of the opportunity to add leverage to their balance sheets. So while we don't have as volatile or as short a business cycle as we've had in the past, we do have a lot more debt to service. From that standpoint, the U.S. economy is arguably as sensitive as it’s ever been to a rise in interest rates.

How should advisors allocate assets, at least between the fixed income and equity markets? Are there any asset classes that look particularly attractive now?

This is a difficult point in the cycle for investors because although economic growth is strong, we are nearing an inflection point where monetary policy becomes a headwind for the economy. We view this stage of the bull market as an opportunity to book gains in equities and to de-risk ahead of the next bear market.

In fixed income, we are moving up in credit quality. We prefer more highly-rated and less-cyclical corporate issuers and structured credit investments. But given how tight credit spreads are for high-quality corporates, we have also increased our allocation to agency debt, whether it be debentures or agency MBS or CMBS, which offer an agency guarantee and a bit of a spread over Treasury yields.

This is a time to be conservative by shortening durations, moving up in credit quality and reducing equity exposure. This is not a time to be swinging for the fences. If our recession forecast plays out as we expect, the next bear market will offer some great opportunities for long-term investors that are willing to endure some short-term volatility.

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