Trend Macro™

Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

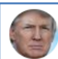
So About That Recession

Monday, April 15, 2019
Donald Luskin

Everything causing a recession has stopped causing it. 10-year yields finally realize that.

It took a couple weeks, but as we expected, the 10-year Treasury yield is finally above where it was at the March FOMC when the Fed lowered the "dot plots" and intensified the recession scare in the bond market (see "On the March FOMC" March 20, 2019). To be sure, we were wrong before we were right. But we're happy we doubled-down (see "The Curve Inverts, and a 'Growth Hawk' for the Fed" March 25, 2019) and then tripled-down (see "On the March Jobs Report" April 5, 2019) on our call for higher yields. *And except for the 6-month/3-year spread, inverted yield curves have now all un-inverted.* So what about that recession?

- *In client conversations, when we ask at the beginning what subjects are most top-of-mind, the near-universal response is something like: "So is this finally a recession?"*
- The easiest interpretation of the March FOMC is that the Fed thinks so. Why else express so much caution, and jerk the "dot plots" down from two more hikes (as expected in December, when so much market turbulence was already in evidence) to not even one?
- There are other interpretations. Why not believe that the FOMC has been cowed by President Donald J. Trump's calls for lower rates and more asset purchases (see, first and among many, "Did Powell Just Cut a Deal?" December 23, 2018) – in which case any policy move in the direction of dovishness would require some bearish macroeconomic rationale to avoid any impression of political influence.
- *But clients, taking it at face value, worry that the Fed's caution sends a confidence-destroying signal, perhaps indicating that "the Fed knows something we don't know." But no single client believes that himself.* Every client knows that the Fed's economic forecasting record is terrible, and that when it comes to macro, there's nothing it could know that everyone else doesn't know. *But it seems they're all afraid that everyone else believes it.* So since the March FOMC it's been John Maynard Keynes' famous "beauty contest," in which the judges aren't picking the prettiest girl, but rather the one that they think all the other judges will pick regardless of the facts.



> **Donald J. Trump**
> @realDonaldTrump
>
> If the Fed had done its job properly, which it has not, the Stock Market would have been up 5000 to 10,000 additional points, and GDP would have been well over 4% instead of 3%...with almost no inflation. Quantitative tightening was a killer, should have done the exact opposite!

What are the facts?

Update to strategic view

US BONDS, US STOCKS, US MACRO: As expected, the 10-year yield has backed up to above its level at the March FOMC, indicating that the recession scare is over. Stocks had a 20%-plus bull market in Q1 2019, indicating the same thing. Stocks and bonds were out of whack at year end, with stocks predicting recession when bonds did not – then in March, bonds were predicting it when stocks were not. Now neither is, with long-term yields having backed up more than 20 bp and most yield curves un-inverting. The fundamentals that set up recession risk in Q4 2018 – the oil price and inflation expectations collapse, the credit spread and real yield blow-out, the risk that China was walking into a disorderly slowdown by not negotiating with Trump, and a rogue Fed chair with a balance sheet on "automatic pilot" – are all fixed. Absent some notion of an irreversible "tipping point" or "stall speed," this recession scare should serve as a mid-cycle refresh like the 2015-16 scare did. Both stocks and bond yields should work higher.

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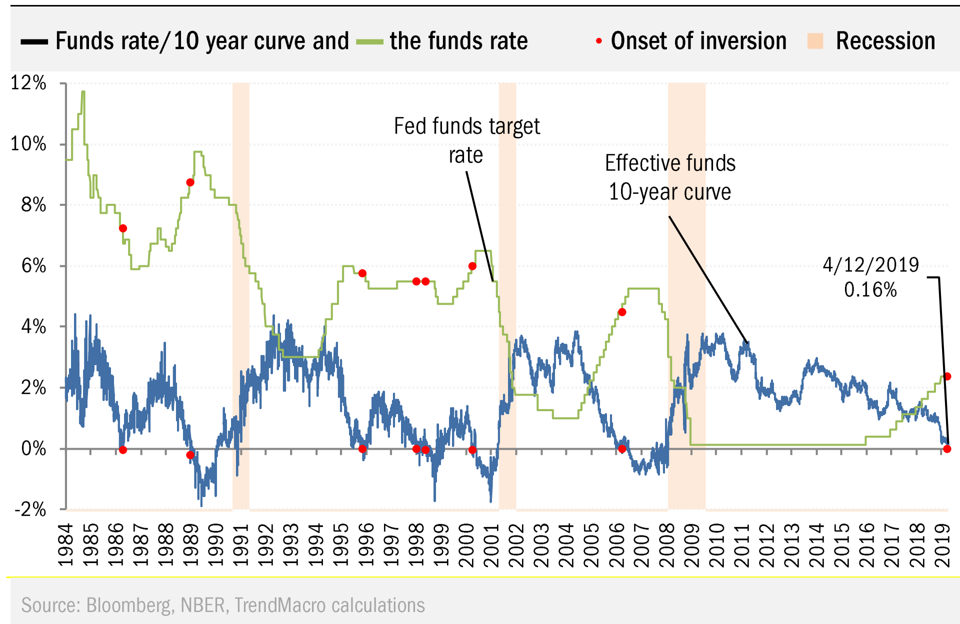
- We had a yield curve inversion for a couple weeks. But again, except for the 6-month/3-year spread, inverted yield curves have now all un-inverted.
- We've seen that in prior business cycles. It's actually fairly typical. The funds rate/10-year curve especially seems to invert early, and then un-invert with many years still to go in the cycle expansion, provided the Fed doesn't raise rates immediately following the inversion (please see the chart below, and "Video: What Jay Powell should be telling you about the inverted yield curve" April 1, 2019).



Source: Bloomberg, NBER, TrendMacro calculations

- ***Indeed, this highlights an obvious yet seemingly forgotten aspect of the Fed's apparently alarming pessimism – historically, when the Fed reacts dovishly, it can forestall the very future that it is pessimistic about.*** Problems only occur when it *ignores* pessimistic signals and acts hawkishly, as it was doing in Q4-2018. In that sense, any sense of alarm from the Fed should be seen as a good thing – which is why we expected the 10-year yield to back up in the first place, responding to a more growth-friendly and inflation-friendly Fed (again, see "On the March FOMC").
- *If you believe, as we do, that many recessions in the past were entirely avoidable, and were simply the result of Fed tightening errors, then what is possibly the predominant cause of recessions has been taken off the table for now.*
- *And other than the yield curve and the 10-year yield, what credible authority was predicting recession anyway?*
- *There was one very credible one. Our favorite recession indicator is year-ahead bottoms-up consensus S&P 500 forward earnings.* They peaked, for the moment at least, last October 25. That caused us to go on precautionary recession-watch, which allowed us to be prepared for much of the nastiness in Q4-2018 (see "Recession Risk at Last?" November 20, 2018), including a full-fledged 20%-plus bear market in US equities.

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

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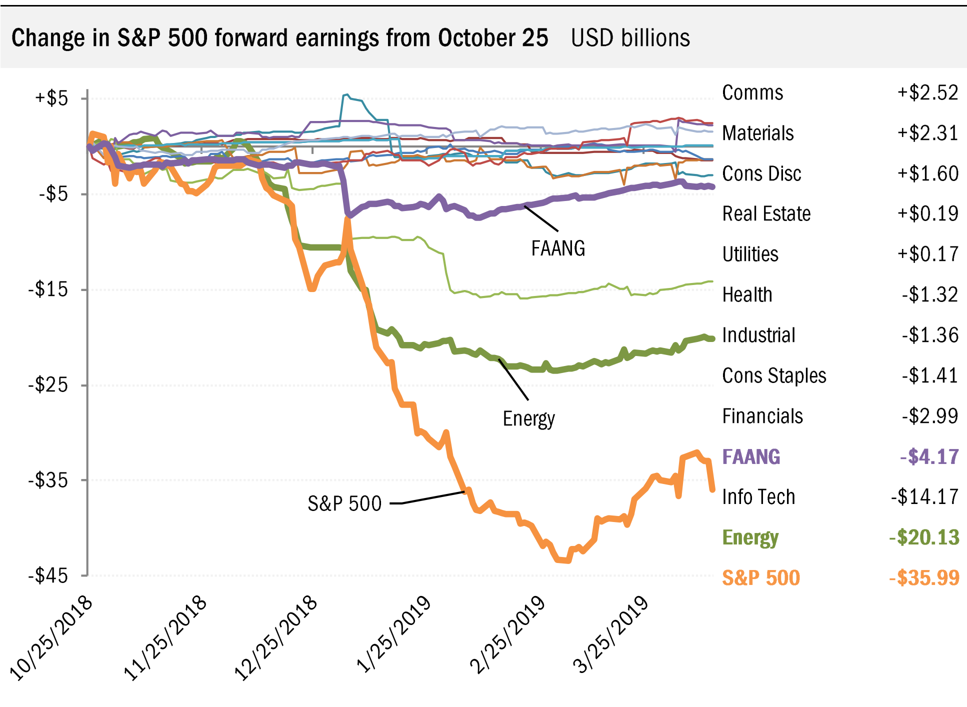
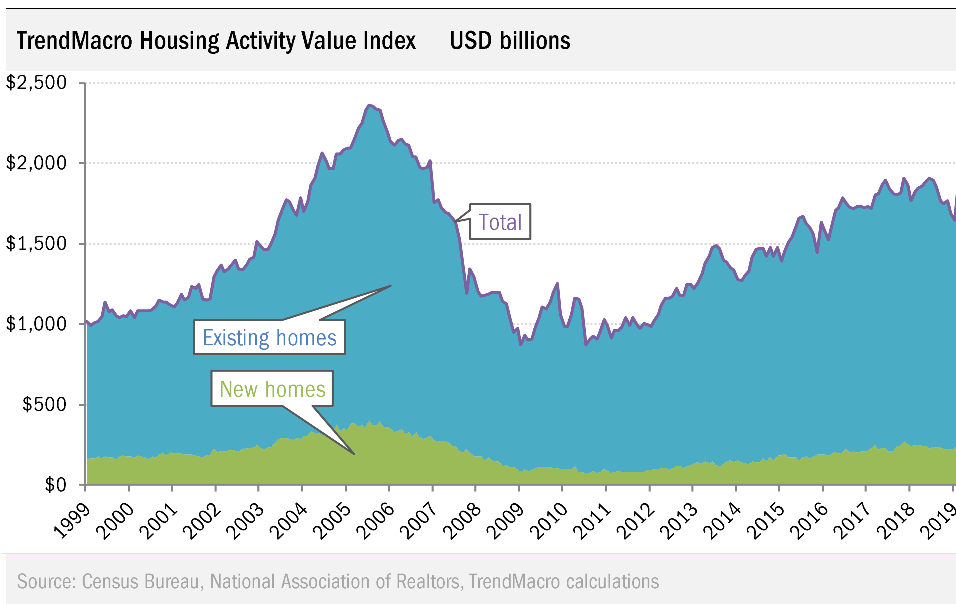
- *Stocks bottomed the morning after Christmas, when forward earnings were off-peak by just 1.0%.*
- It would seem to us that stocks, by Christmas, were looking hard at a lot of stuff going wrong all at once – not just the then-little softening in forward earnings, but a potential Constitutional crisis pitting a president of the United States against his own Federal Reserve chair, a chair so demonstrably incompetent that he must be fired, yet apparently under law he could not be; a collapse in oil prices driving a commensurate collapse in inflation expectations and a blow-out in real yields and credit spreads; and at the same time, a prideful China that appeared to prefer walking the plank into disorderly recession rather than negotiate a trade deal with the US (see "Our Knife at China's Throat" October 8, 2018), and then just when Trump and Chinese president Xi Jinping sat down for dinner to talk about it (but no actual negotiations had yet begun), it all seemed to get knocked off the rails by the arrest of Huawei's CFO in Canada (see "On the Margin: Well, We Said 'Brace Yourself'" December 5, 2018).
- *Everything about all of that has gotten far better.*
- Fed chair Powell has halted his plans for "further" "gradual" rate hikes, taken the balance sheet off "automatic pilot" and become "patient," exactly as we predicted very much in real time (again, see "Did Powell Just Cut a Deal?" December 23, 2018).
- S&P 500 forward earnings seem to have bottomed in early March, off as much as 2.9% at the worst. They are still off 2.3%, but at the moment they are pushing higher (please see the chart below).
- Oil prices have recovered most of the way to their early October highs, and inflation expectations and credit spreads have almost completely healed as a result. We don't think oil has any higher to



Source: Bloomberg, TrendMacro calculations

go from here (see “Why Aren’t Oil Prices Higher?” February 12, 2019). But the present recovery pulls it safely back from the kind of brink it experienced in late 2015 and early 2016 when its collapse threated to trigger the first-ever recession caused by low oil prices (see “The Recession Caused by Low Oil Prices” January 8, 2016).

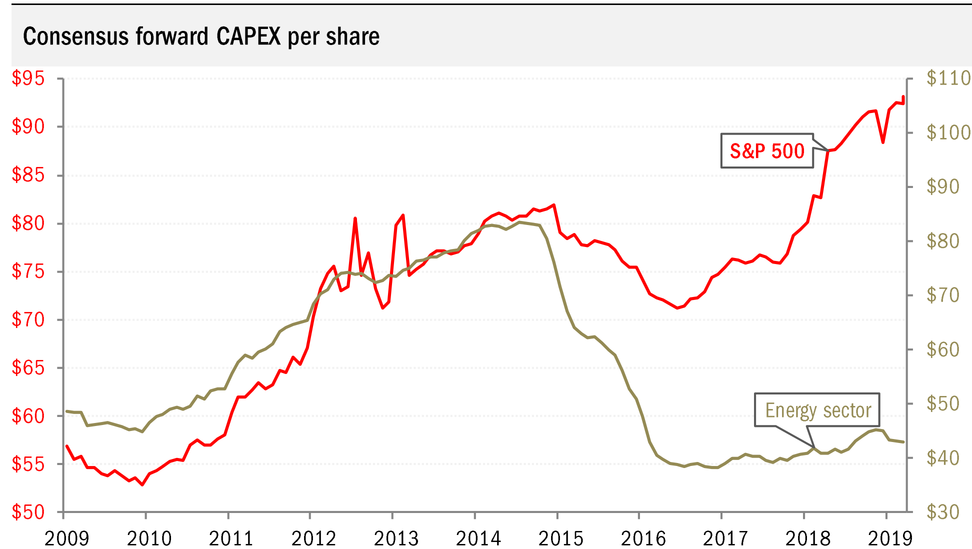
- Trade negotiations between the US and China are ongoing, and we believe that China has already conceded so much that Trump could take yes for an answer any time he wishes. Indeed, Xi continues to foolishly reveal weakness by repeatedly calling for a deal “as soon as possible,” according to state-controlled media reports. Naturally, Trump is now deliberately dragging things out, trying to get more and more (see, among many, “Fail in Hanoi, Win in Beijing” March 4, 2019).
- The most recent emanations from the negotiations are Treasury Secretary Steven Mnuchin’s statements Friday that the US would be willing to be subject to reciprocal enforcement mechanisms under a potential deal. If such a thing helps the Chinese to save face, then so be it – but the reality is that the burden of compliance in any imaginable deal will be almost entirely on China. They simply have no demands of the US that aren’t just the maintenance of the *status quo*, such as continued US recognition of the “one-China policy” and the US continuing to welcome Chinese students in US universities.
- *What about the universe of standard business cycle indicators?* Let’s look at our favorites, most of which are featured monthly in “Data Insights: A Few of Our Favorite Things”.
- Housing – which we believe is an engine of domestic growth out of all proportion to its small size as a share of GDP – had a very difficult time in the second half of 2018 as mortgage interest rates rose. In Q1-2019 it has come roaring back as rates have retreated (please see the chart below).
- Household debt service and financial obligation ratios remain near historic lows, indicating no financial fragility among consumers.



Source: Census Bureau, National Association of Realtors, TrendMacro calculations

- New orders for non-defense capital goods (ex-aircraft) have ticked up in 2019 after a retrenchment in Q4-2018. Forward CAPEX per share for the S&P 500, though, after a catastrophic drop in December, has strongly recovered and moved to new highs, and very little of it can be explained away by energy sector (please see the chart below).

Consensus forward CAPEX per share

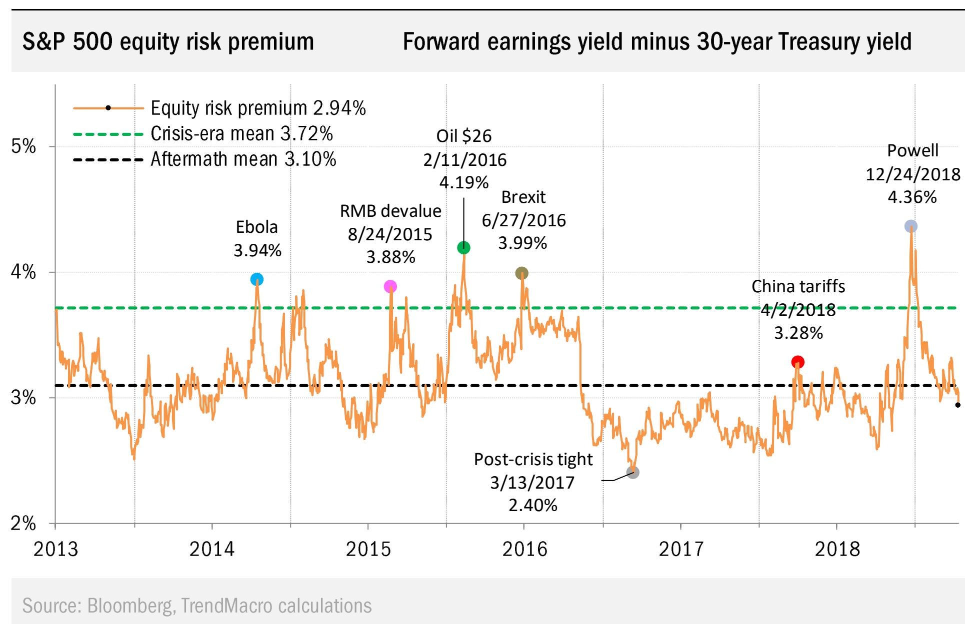


Source: Bloomberg, TrendMacro calculations

- Inventory-to-sales ratios, as last reported, are not attractive. But the most recent data is for January, so we are going to wait and see.
- New claims for unemployment benefits, after a little scare early in Q1-2018, have fallen all the way back to historic lows not seen since the 1960s, all the more remarkable considering the vastly larger size of the work force today (see "On the March Jobs Report" April 5, 2019). And even with the unemployment rate also at historic lows, our analysis of the demographics of the labor force – set against the still-low participation rate, indicates that 1.7 million prime-age workers could still come out of the shadow economy. We are a long way from running out of workers in this expansion (see "Data Insights: Jobs" April 5, 2019).
- As for Q1-2019 gross domestic product, the consensus forecast is 1.6% and the Atlanta Fed's "GDPNow" estimate is 2.3%. While well off the 4.2% and 3.4% pace of Q2 and Q3, respectively, 2.3% would be the best Q1 in four years, and even 1.6% would be no worse than the average Q1 since the end of the Great Recession.
- By the way, we have consciously left Europe's troubles out of our narrative today. We think its economic difficulties are blown up disproportionately for political purposes, in order to deliberately stoke panic about Brexit. In real terms, we simply don't see how a little slowing in Europe's already sclerotic growth makes any meaningful difference to any other economies in the world.
- *With all these very positive developments, it's no wonder that, since the Christmas bottom, US stocks have had a full-fledged 20%-plus bull market. Emerging markets stocks have done even better, as we predicted they would as soon as China finally came to the*

negotiating table (see “Did China Just Run Up the White Flag in the Trade War?” July 10, 2018).

- *The big mystery is why stocks and bonds seem to be telling us such different stories about the business cycle.*
- *Or are they? As we shall see, stocks were predicting recession in December (and we think they were wrong); bonds were predicting recession in late March (and we think they were wrong, too).*
- *Stocks and bonds were just wrong at different times. Now we think that neither market is especially strident in its respective recession warning.*
- The US equity risk premium (ERP) – which looks at the relationship of the forward earnings yield of equities and the 30-year Treasury yield – is now very close to its mean level since the end of the Global Financial Crisis (please see the chart below).



S&P 500 equity risk premium — Forward earnings yield minus 30-year Treasury yield

Source: Bloomberg, TrendMacro calculations

- *In this framework, equities and bonds were severely out of whack in late December*, when the S&P 500 was at a post-crisis wide on Christmas Eve in the depths of the Powell panic. We had said the day before that Powell’s having cut a deal with Trump would “trigger a substantial risk-on rally” (again, see, “Did Powell Just Cut a Deal?” December 23, 2018). Days later we said “stocks are on sale,” despite an atmosphere of seemingly catastrophic loss of confidence on all fronts (see “2019 Outlook: Confidence Rots from the Head Down” December 31, 2018).
- *Starting then*, stocks were virtually predestined to outperform bonds, which they very much have. *It’s not so clear starting now*, especially with the 10-year Treasury having already backed up 23 bp in just two weeks from the late-March bottom (again, see “The Curve Inverts, and a ‘Growth Hawk’ for the Fed”).
- *Accepting the ERP as an indicator that stocks and bonds are actually in approximate equilibrium now, it’s time to stop asking what these markets are telling us about recession – they may be telling us nothing at all! – and instead get down to the business of*

predicting the macro fundamentals that will really determine the economic future. They will also determine the stock and bond markets, not the other way around.

- That's the approach we've taken here today. What caused the turbulent recession threat in Q4-2019? The oil price collapse. *Fixed*. The collapse in inflation expectations. *Fixed*. Back-up in real yields and mortgage rates. *Fixed*. The break-out in credit spreads. *Fixed*. China pridefully walking off the cliff while refusing to negotiate. *Fixed*. A rogue Fed chair with a balance sheet on "automatic pilot." *Fixed* (in the sense of spay and neuter). And we haven't mentioned this earlier – but hey, why not? – a finding of no collusion by Special Counsel Robert Mueller, which no matter how you feel about Trump, removes a very chaotic potential from the political landscape that, at the worst, might have spilled over into economic chaos. *Fixed*.
- *You'd have to posit some notion of an irreversible "tipping point" or "stall speed" to think, with all these causal factors fixed, that recession is inevitable.*
- *The risk factors in play are all weirdly similar to those of the recession scare of Q4 2015 and Q1 2016 – China slowdown, oil price collapse, credit spread blow-out, tone-deaf Fed. The whole thing.* We were more pessimistic going into that episode (see "Is This the Oil Shock Tipping Point?" August 20, 2015) than we were going into the present one, but we called the February 2016 bottom perfectly (see "Have We Suffered Enough?" February 26, 2016) – and we've said ever since that the experience was an "undocumented recession" that served as a mid-cycle refresh, setting the stage for the global risk-on rally that began right after the Brexit referendum in the summer of 2016. *If the present scare plays out the same way – which in this case would require a resolution to the US/China trade war – we would be looking at another leg up in the business cycle expansion.*
- *The key statistic we really want to see to truly sound the all-clear signal is a continued turnaround in forward earnings.* It is potentially beginning. So far the forward earnings recovery is strongest in the "canary in the mineshaft sectors" – US small cap, and emerging markets.
- *While at least in ERP terms there is equilibrium between stocks and bonds, we expect as fundamental conditions improve, the risk premium will narrow as the joint product of rising stock prices (and recovering earnings) and rising bond yields. The ERP is still wide by historic standards, even if about average by recent post-crisis standards. Risk aversion still runs high – it just feels normal at this point because we've gotten used to it over the last decade. It's not.*

Bottom line

As expected, the 10-year yield has backed up to above its level at the March FOMC, indicating that the recession scare is over. Stocks had a 20%-plus bull market in Q1 2019, indicating the same thing. Stocks and bonds were out of whack at year end, with stocks predicting recession when bonds did not – then in March, bonds were predicting it when stocks

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