ClearBridge Investments

Recession Indicators Update: Money Supply

September 5, 2018

Key Takeaways

- The ClearBridge Recession Risk Dashboard experienced two changes in August, but the likelihood of a recession in the next 12 months remains below average as 11 of the 12 indicators continue to flash green.
- Money supply growth in the economy has been slowing, causing the Money Supply indicator to move from green to yellow, reflecting an economy less able to withstand liquidity shocks.
- Corporate profit margins, meanwhile, are growing steadily, causing the Profit Margins indicator to move from yellow to green as revenue growth, tax reform, and firming oil prices take hold.

Dashboard Sees Two Signal Changes

The ClearBridge Recession Risk Dashboard experienced its first indicator changes of 2018 this past month: the Money Supply indicator changed from green to yellow while the Profit Margins indicator changed from yellow to green. Money supply growth has been slowing for several months against the backdrop of tighter Fed policy and increased short-term debt issuance. Simultaneously, profit margins have been expanding on the back of improving revenue growth, muted gains to unit labor costs, and of course lower taxes. Importantly, these changes do not alter our outlook for the U.S. economy over the coming year, with the overall Recession Risk Dashboard continuing to signal expansion.

Exhibit 1: ClearBridge Recession Risk Dashboard

		September 2018	August 2018
Financial	Yield Curve	↑	↑
	Credit Spreads	↑	↑
	Money Supply	●	↑
Inflation	Wage Growth	↑	↑
	Commodities	↑	↑
Consumer	Housing Permits	↑	↑
	Jobless Claims	↑	↑
	Retail Sales	↑	↑
	Job Sentiment	↑	↑
Business Activity	ISM New Orders	↑	↑
	Profit Margins	↑	●
	Truck Shipments	↑	↑

↑ Expansion ● Caution ✕ Recession

Source: ClearBridge Investments.

Money Supply Growth Slowing

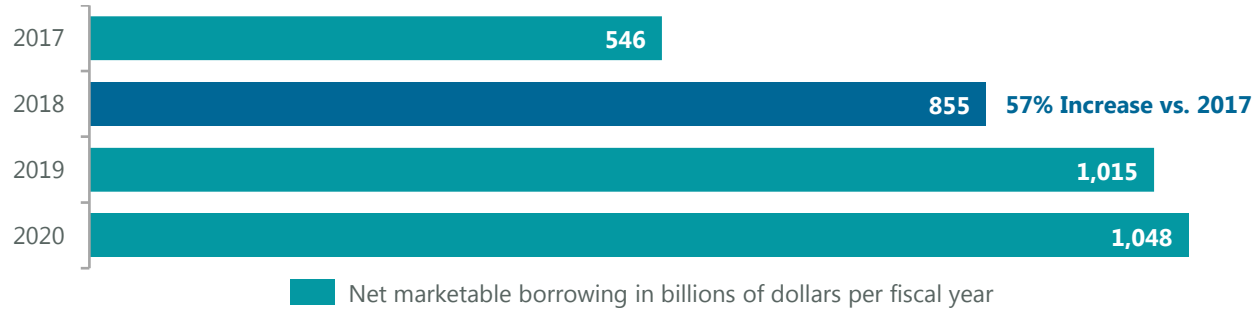
Money supply is one of the indicators used to evaluate financial stress within the dashboard. As overall liquidity declines, the financial system and economy are less able to weather stresses or shocks, elevating the risk of a recession and/or market crash. Importantly, many financial stress indicators such as money supply tend to roll over ahead of market peaks and recessions, making them particularly useful to investors.

ClearBridge's research has found that the most liquid definition of money supply — a subset commonly referred to as M1 — has proven particularly useful in anticipating economic downturns. M1 consists of physical money (paper currency & coins) as well as checking accounts, demand deposits, and negotiable order of withdrawal (NOW) accounts. In plain English, M1 is the most liquid portion of the money supply while "higher M" versions of money supply such as M2 or M3 count increasingly less liquid assets. For example, M2 includes everything counted in M1, as well as savings deposits, money market securities, money market mutual funds, and other time deposits. Because these "higher M" forms of money supply include less liquid assets (by definition), they give investors less insight into how available liquidity is within the financial system.

M1 money supply tends to reflect monetary policy, with a tighter Fed typically slowing money supply growth and looser policy providing a boost. Fed actions to concurrently raise short-term rates while reducing the size of the balance sheet has resulted in less cash moving through the financial system than the recent past. The increase in short-term rates slows money supply growth because M1 tends to be sensitive to interest rates. As rates rise, the opportunity cost of holding money in non-interest-bearing accounts rises, attracting cash off the sidelines in search of higher yield. This consideration has been an afterthought for much of the current recovery due to the zero-interest rate policy (ZIRP) pursued by central banks globally. Additionally, the shrinking of the Fed balance sheet reduces liquidity in the system, with businesses and consumers stepping in to purchase debt the Fed formerly held and giving up some of their cash holdings in the process.

Fiscal policy has also put a damper on M1 due to the increased debt issuance from the most recent Federal budget as well as tax reform. When the Treasury issues more debt (both to fund the larger budget and tax reform), this has the impact of reducing the amount of cash circulating in the financial system in a manner similar to the unwind of the Fed balance sheet, with investors converting existing cash holdings into Treasury securities.

Exhibit 2: Treasury Borrowing Set to Surge



Source: Treasury, primary dealer estimates. Data as of June 30, 2018.

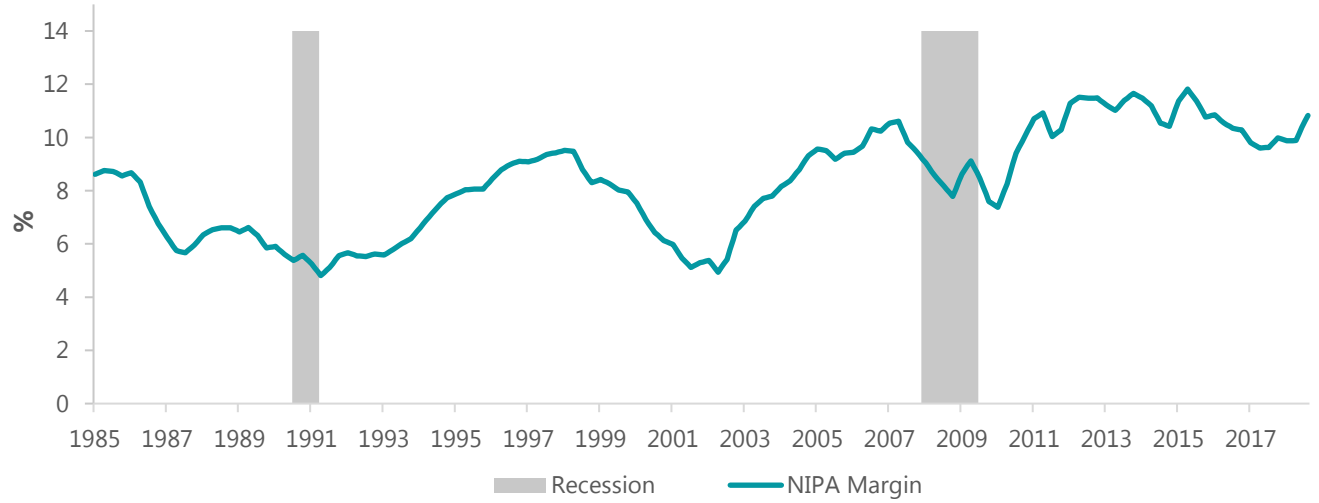
Ultimately, slowing money supply growth should weigh on spending and in turn overall economic activity. M1 is typically correlated with spending expectations. When consumers and businesses expect to increase spending, they tend to build up liquid assets in anticipation, which boosts M1. Conversely, when spending expectations are declining, the private sector tends to move liquid assets towards higher interest alternatives, lowering M1. As a result, money supply growth has provided ample lead time ahead of past recessions, turning to red approximately 2½ years prior to past recessions on average. While money supply is one of the longer leading indicators within the ClearBridge Recession Risk Dashboard, it is also somewhat less consistent than other indicators, resulting in a relatively smaller weight to the overall signal.

Corporate Profit Margins Expanding

While the benefits from tax reform to profit margins are well understood by many investors, there are several additional dynamics that are positively impacting profit margins, helping to push the signal from yellow to green. We evaluate National Income and Product Account (NIPA) profits, which is a more comprehensive sample of corporations than the S&P 500 Index. The NIPA data includes small and mid-sized businesses, whose conditions tend to be more reflective of the U.S. economy. For additional background information on this indicator, please see our July 2017 post, Recession Indicators: Is Recent Trend in Profit Margins a Game Changer?

When oil prices fell from over $100 in late 2014 to a low of $26 in February 2016, the energy sector specifically and U.S. economy more broadly felt the pain. Energy company margins collapsed, dragging down margins for the S&P 500 (and NIPA) as a whole. With the oil market in a much healthier place today in the $60-70 per barrel range, energy margins have begun to re-normalize, and in turn our indicator is no longer flashing a warning sign.

Exhibit 3: NIPA Profit Margins (ex-Financials)



Source: U.S. Bureau of Economic Analysis via Bloomberg. Data as of August 31, 2018.

As we look ahead, we see potential drivers of further margin upside. First, revenue growth has accelerated in 2018, providing additional operational leverage (fixed costs can be spread out over additional sales) resulting in improved margins. Second, unit labor cost — a measure of employee compensation relative to inflation-adjusted output — has remained subdued in the first half of 2018, meaning companies are receiving value for the raises they have given out in the form of better productivity. Both should combine to push corporate profit margins even higher in the back half of 2018 and into next year. And of course, the benefits from lower corporate tax rates will also improve margins, although these benefits are more one-time in nature.

With one indicator improving from yellow to green, and one deteriorating from green to yellow, the overall ClearBridge Recession Risk Dashboard continues to show 11 green indicators and one yellow. The overall signal remains solidly expansionary (green), as the benefits from tax reform continue to circulate through the economy.

About the Author

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- 12 years of investment industry experience
- Joined ClearBridge Investments in 2014
- BS in Finance from Rutgers University

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