ClearBridge Investments

Recession Indicators Update: Delving Deeper into Yellow Signals

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Key Takeaways

- The economy continues to show increasing signs of stress despite the continued upward march in stocks; the ClearBridge Recession Risk Dashboard remains yellow.
- In the period following the Dashboard's four historical non-recessionary yellow signals, the Dashboard turned back to green three times and worsened to red once.
- Dashboard yellow signals have typically seen positive stock market environments in the months immediately following the initial signal change.

A Tempest or a Teapot?

Meteorologists get a bad rap, but their forecast error has been diminishing in recent years. In fact, their forecasts have improved to the point that they might even put to shame the "all-knowing" stock market, which by comparison doesn't have such a great track record of predicting an impending slowdown in the economy.

At the start of past recessions, the market had already fallen -10% from its peak, on average. Because of this dynamic, selloffs of -10% or more are often interpreted as the market signaling an increased possibility of an impending recession. If the market was right even as often as meteorologists are, this signal would be very valuable indeed, because a recession drawdown usually worsens as the recession goes on. From peak to trough during a recession-linked bear market, equities have historically fallen by -36%, on average. Anyone would want to be prepared for such a storm.

By this -10% measure, the market has "called" 28 recessions dating back to 1965, while only seven have actually occurred — a track record that makes even the weatherman look good. In fact, in the last 10 years alone (since the end of the global financial crisis), the market has experienced six corrections of at least 10%, roughly one every two years.

Dashboard Signals Caution, but Not the Cycle's End

The unreliability of the equity market alone as a recessionary indicator is why we believe tools like the ClearBridge Recession Risk Dashboard can be useful in helping investors gauge the likelihood of a recession. In fact, the health of the Dashboard at the end of 2018 was the primary reason we remained bullish at the time, despite the market selloff in the fourth quarter. Ultimately this proved to be the correct call, with the market bouncing back to new all-time highs less than six months after its December 24 low (and no recession occurring in the first half of 2019).

More recently, the economy has begun to show increasing signs of stress, highlighted in our mid-year Long View commentary. Despite the continued upward march in stocks, the Dashboard turned yellow at the mid-year mark. However, there are no changes to the Dashboard this month.

Exhibit 1: ClearBridge Recession Risk Dashboard

	July 2019	June 2019
Yield Curve	✖	✖
Credit Spreads	⬆	⬆
Money Supply	●	●
Wage Growth	●	●
Commodities	✖	✖
Housing Permits	⬆	⬆
Jobless Claims	⬆	⬆
Retail Sales	⬆	⬆
Job Sentiment	●	●
ISM New Orders	●	●
Profit Margins	⬆	⬆
Truck Shipments	⬆	⬆
Overall Signal	●	●

Source: ClearBridge Investments.

There is no such thing as a crystal ball, however, and the ClearBridge Recession Risk Dashboard has called for caution in several instances historically where a recession did not ensue. In fact, the Dashboard has signaled yellow (caution) 11 times. Of these 11 yellow signals, seven came before recessions and four did not. In the period following the four non-recessionary yellow signals, the Dashboard turned back to green three times (1995, 1998, and 2015–16) and worsened to red once, in the mid-1960s. The red signal tends to paint a much more ominous picture for future conditions of the U.S. economy, correctly identifying a recession in seven out of eight instances. The overall hit rate for a red signal is much higher than its yellow counterpart.

This dynamic is in part why yellow is classified as only caution; conditions typically have worsened following historical yellow signals, but there typically remains a chance that the economy improves and avoids a recession. One of the biggest drivers of this improvement historically has come from an early recognition of rising risks that led the Fed to shift toward more accommodative policy. The Fed cut rates by 75 basis points (bps) in both 1995–96 and 1998, and in 2015–16 ultimately hiked only once against a market that was expecting four hikes coming into the year, a net "loosening" of policy by the equivalent of three cuts (or 75 bps). In each instance, the Fed over-delivered compared to what market participants were pricing in at the time. If a recession is ultimately avoided, the rate cut just implemented (along with the possibility of additional easing prior to year-end indicated by the futures market) is likely to be part of the narrative why.

Whether the current yellow signal migrates back to green or worsens further to red remains to be seen. However, if history is a guide, the data will accelerate or deteriorate within the next quarter or two, giving us a better idea of the end destination. Regardless of the outcome, the market will likely move higher in the near term, as yellow signals have typically seen positive stock market environments in the months immediately following the initial signal change.

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