ClearBridge Investments

Recession Indicators Update: Lessons from 1998–2002

May 7, 2019

Key Takeaways

- There are many parallels between today and late 1998: a 19% correction and quick recovery and a brief inversion of the yield curve. The 1998 pullback proved to be a great buying opportunity as the economy and markets marched higher into the new decade.
- One major catalyst for the early 2000s recession was the bursting of the speculative dot-com bubble, which occurred after the rapid growth of the Internet and its early commercialization. Today lacks the market overvaluation and cyclical excesses of 2001.
- The ClearBridge Recession Risk Dashboard's overall signal changed to yellow in May 2000 and red in August, seven months before the start of the recession. Today the Dashboard's overall signal remains green.

Conditions in Place for Further Upside This Cycle

Equities hit all-time highs once again in April, with stocks making up all their lost ground from the 19.8% drawdown in late 2018. The large magnitude of this non-recessionary correction and its swift rebound reminds us in many ways of the market hiccups during the summer of 1998. That year, stresses from the Asian Financial Crisis found their way to U.S. shores, and the S&P 500 Index fell 19.3% from July 17 to August 31. The market turmoil led to the near blowup of hedge fund manager Long Term Capital Management (LTCM) in September, which was only avoided when the Fed stepped in to facilitate a $3.6 billion backstop from 14 banks and brokerage firms. With the economy and financial markets on wobbly footing, the yield curve briefly inverted in September 1998. The Fed responded by reversing course from its previous policy and cutting interest rates by 50 basis points (0.5%). Ultimately, the economic and market volatility subsided and the market marched higher in the years to come. In fact, the S&P 500 was back to a new all-time high by November 1998, just two months after LTCM was saved.

There are other parallels between the current environment and that of 1998. In both the market sold off sharply, the yield curve briefly inverted, and the market recovered strongly, making new all-time highs and avoiding a recession. Also, as in 1998, we are now in the midst of an elongated economic cycle, and technology stocks are the market leaders. However, considering the 1998–2002 period, there are several key differences between today and then, namely the lack of market overvaluation and cyclical excesses today that in the late 1990s led to the dot-com recession. This should bode well for the prospect of further market and economic upside this cycle.

ClearBridge Recession Risk Dashboard: No Change at Present

Continued market and economic growth are consistent with the ClearBridge Recession Risk Dashboard, which is currently showing an overall green signal. There have been no individual indicator changes from last month's release: eight signals are green, three are yellow and one is red. Economic data, broadly speaking, came in above expectations in March, with U.S. GDP growing at an annualized 3.2%. While volatile inventories and trade boosted this figure, the strong report should help continue to allay investor concern from the recent market volatility.

Exhibit 1: Overall Dashboard Signal Remains Green

		April 2019	March 2019	Fourth Quarter 2018
Financial	Yellow 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	↑	↑	↑
	Overall Signal	↑	↑	↑

↑ Expansion ● Caution ✗ Recession

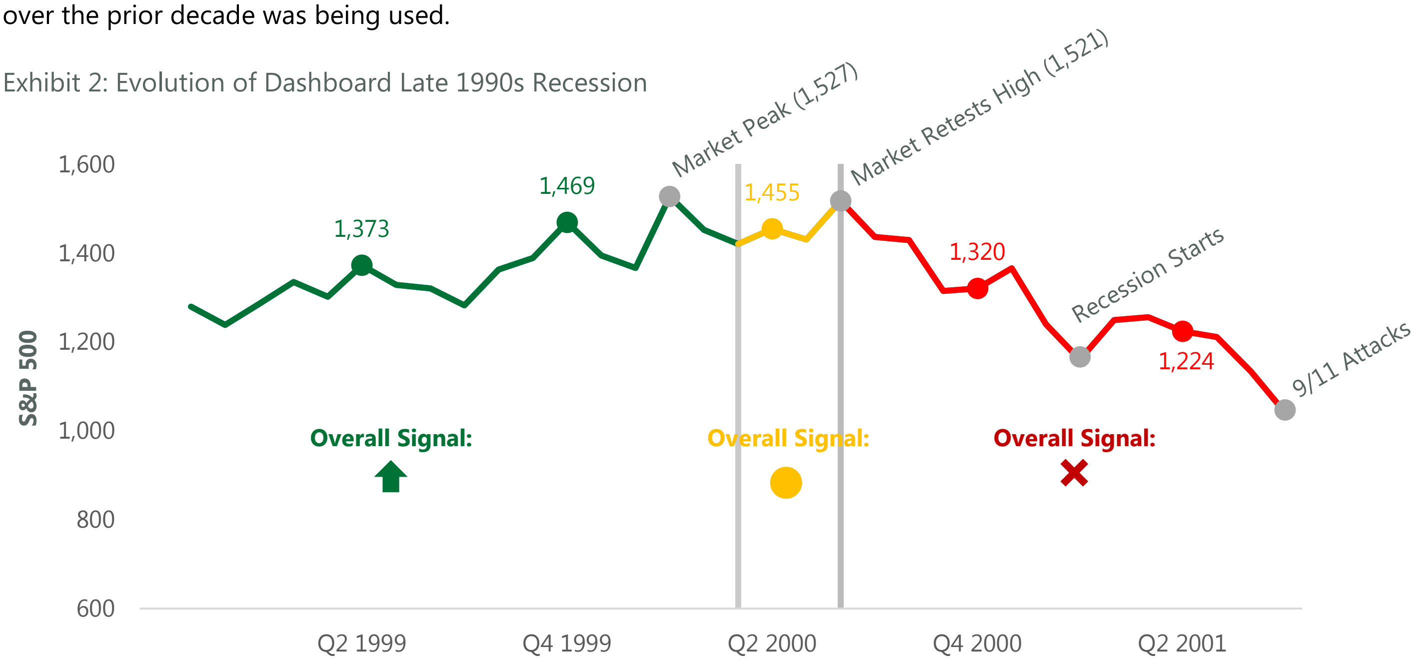
As of April 30, 2019. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg.

With the Dashboard continuing to signal expansion at this time, we believe an examination of its signals during the late 1990s and early 2000s period can be illustrative for investors looking to evaluate similarities — and differences — between then and now.

A Closer Look at the Early 2000s Recession

Similar to several recessions, the collapse of a technology bubble led to the recession in the early 2000s. Like many bubbles, the early stages of the dot-com bubble were somewhat well-grounded. In the mid/late 1990s, the Internet grew rapidly and began to be commercialized to a much greater degree. Some of the early companies involved went public, leading many others to try to follow in their wake. Capital flowed in as investors chased the early successes, and they lost sight of fundamentals. Similarly, business managers became overconfident and overspent. For example, thousands of miles of fiber optic cable were laid in anticipation of ever-expanding Internet traffic. However, as the most speculative internet companies went belly-up, these overly optimistic expectations eventually came back to earth. Cracks began to emerge in the economy too, with key economic indicators such as Wage Growth flashing an early warning sign on the Dashboard in June 1999. Ultimately, the economy entered a recession in March 2001. By 2003, some estimated that just 3% of the fiber optic cable laid over the prior decade was being used.

Exhibit 2: Evolution of Dashboard Late 1990s Recession



	Q2 1999	Q4 1999	Q2 2000	Q4 2000	Q2 2001
Yield Curve	×	×	×	×	×
Credit Spreads	↑	↑	●	×	×
Money Supply	↑	●	×	×	×
Wage Growth	×	×	×	×	×
Commodities	↑	↑	●	×	×
Housing Permits	↑	↑	↑	●	●
Jobless Claims	↑	↑	↑	×	×
Retail Sales	↑	↑	↑	●	×
Job Sentiment	●	●	●	●	×
ISM New Orders	↑	↑	●	×	×
Profit Margins	×	●	×	×	×
Truck Shipments	↑	↑	×	×	×

As of April 30, 2019. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg.

1997–1999

In the late 1990s, the Internet revolutionized the world. Many early e-commerce companies went public in these years, such as Amazon.com (then an online bookseller) in March 1997 and eBay in September 1998. With investors excited to participate in these "new economy" companies, many saw substantial gains following their initial public offerings (IPOs). Over time, investors began to chase these hot offerings and focused more on the upside than on the fundamentals of the companies themselves. For example, online grocer Webvan went public in November 1999, having been founded only three years earlier and not yet having turned a profit. Webvan raised nearly $400 million in venture capital to fund a rapid expansion, and at the time of its IPO was expected to lose $65 million in the coming year. Regardless, shares rose 65% on their first day of trading, valuing the company at $7.9 billion.

Fueled by the rapid growth in the technology sector, the broader economy was humming along at rates we would be envious of today; 4.4% GDP growth in 1997, 4.5% in 1998, and 4.8% in 1999. Wary of letting the economy run too hot (which could lead to inflation), the Fed raised interest rates by 25 basis points in June 1999. It continued with another rate increase in August. As the Fed tried to cool the economy, the Money Supply indicator on the Dashboard picked this up, turning yellow in the third quarter of 1999.

2000

The Fed continued to raise rates in 2000, but the economy continued to soar. GDP grew by an astounding 7.5% in the second quarter of 2000, a rate that has not been matched in the nearly 20 years since. Against this backdrop, the technology bubble continued to inflate, with the NASDAQ and S&P 500 reaching their pre-recession peak levels in March 2000. After years of successful returns investing in "new economy" companies, investors became even less discerning and valuations even more stretched. However, the quality of these businesses was becoming increasingly worse, the underlying business models more questionable, and the fundamentals even more challenged.

Many point to Pets.com — an online seller of pet supplies — as the poster child of speculative technology investment and perhaps the high-water mark of the bubble. Pets.com was not profitable and didn't have much of a path to becoming so; it offered free shipping on every sale, guaranteeing itself a loss given the high shipping costs associated with heavy bags of pet food. The company did not see as much of a post-IPO bounce, trading up a mere 27% on the day it went public in March 2000. Pets.com had been founded just two years earlier, had a float at the previous Macy's Thanksgiving Day parade and an ad during the 2000 Super Bowl. It would not even survive to see its third birthday, liquidating in November 2000.

In April 2000, the yield curve (whose signal was already red following the 1998 inversion) inverted briefly for a second time (and once again shallowly), before inverting a third and final time in July. The July inversion was deeper and much more prolonged. It also came against a backdrop of a rising dollar, higher oil prices (which saw a nearly 300% rise from November 1998 to November 2000) and collapsing ISM Manufacturing PMI. On the Dashboard, ISM New Orders, Money Supply and Truck Shipments signals all declined in June 2000: ISM New Orders to yellow, and Money Supply and Truck Shipments to red.

While the market peaked in March 2000, it traded largely sideways for the next six months or so and nearly made a new high in late August. It was during this time the overall signal for the Dashboard changed, turning yellow in May 2000 and red in August 2000.

2001

After the economy (and the stock market) started to cool in the second half of 2000, conditions continued to deteriorate into 2001. The recession officially started in March, seven months after the Dashboard's red signal. The terrorist attacks of September 11 weighed on the nation, forcing financial markets to close briefly and worsening the economic malaise. The Dow Jones Industrial Average suffered its largest one-day point loss in history during this period, after having previously weathered the storm of the technology (and NASDAQ) collapse. While the weakest technology companies such as Pets.com had already ceased operations, many more went bankrupt in 2001, such as the previously mentioned online grocer Webvan.

2002

By 2002 green shoots started to emerge and the economy began to find its footing (the recession ended in very late 2001). Some of the more sustainable technology companies such as Amazon.com and eBay would ultimately survive. In some cases, while companies didn't make it, their ideas did; Webvan was later folded into Amazon.com, which is now more than just an online bookseller and online grocer. The S&P 500 bottomed in October 2002, 49.2% below its peak roughly 2.5 years earlier.

Telling Similarities and Differences

The late 1990s and early 2000s period is instructive for investors for both its similarities with and differences from today's market. Both featured brief and intense selloffs followed by brief yield curve inversions, after which the market rose to new highs. In the case of 1998, the market continued to climb to new highs for another two years. A major difference, however, is that what ultimately brought the market down in 2000 — a trend of overvaluation, speculation and an economy running too hot — is largely absent from the market and economy today. This is consistent with the overall signal in the ClearBridge Recession Risk Dashboard today, which continues to show green, indicating this cycle has further room to run.

About the Author

Jeffrey Schulze, CFA
Director, Investment Strategist
- 14 years of investment industry experience
- Joined ClearBridge Investments in 2014
- BS in Finance from Rutgers University