ClearBridge Investments

Recession Indicators Update: Cautious as Activity Rebounds

February 6, 2020

Key Takeaways

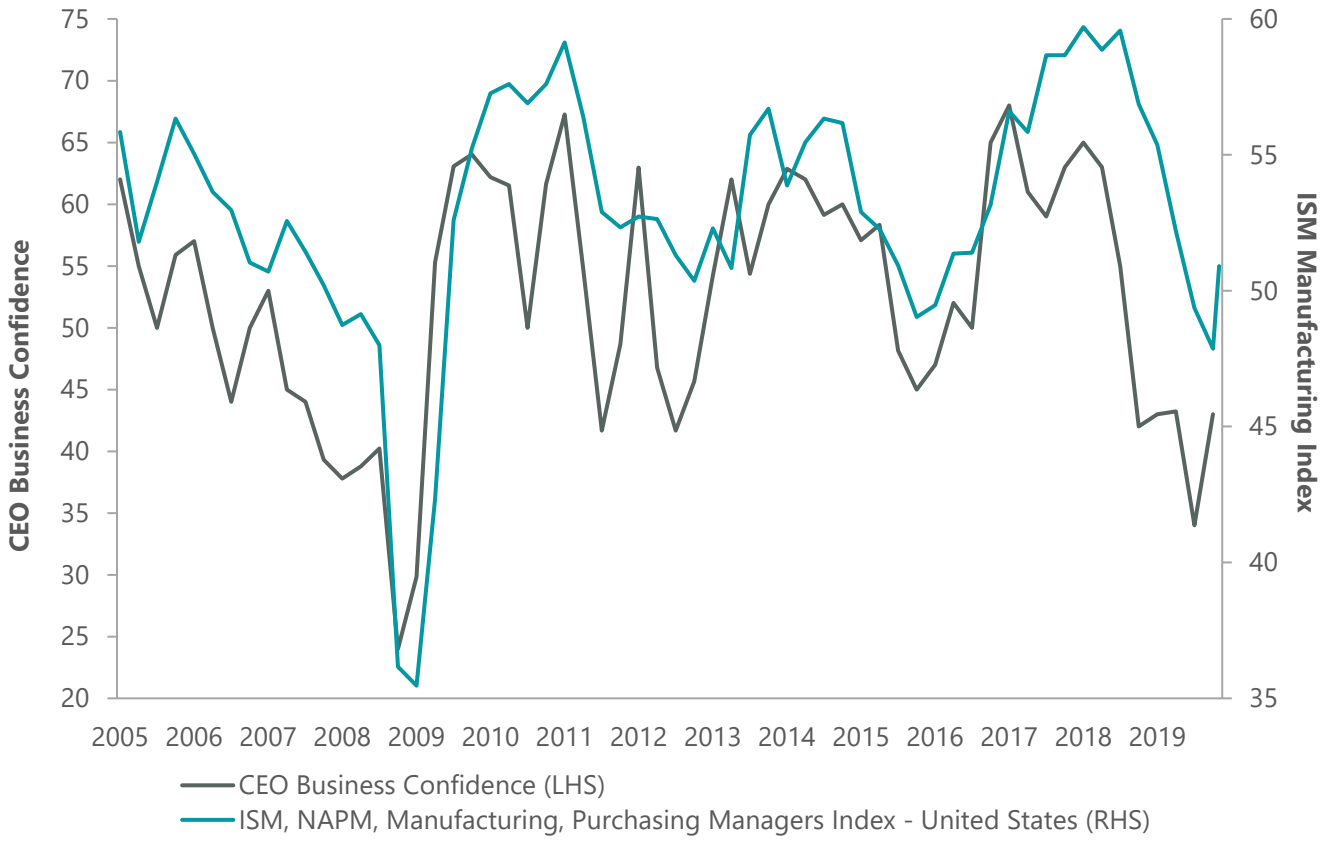
- The ISM New Orders indicator on the ClearBridge Recession Risk Dashboard turned to yellow from red as new U.S. manufacturing data showed improvement.
- The recent reinversion of the yield curve continues to signal economic caution, which rhymes with the current overall yellow dashboard reading.
- With business activity slightly improved, inflation-related indicators remain the most negative indicator grouping, although as the 1980–82 recessions show, the inflation regime matters less in identifying a recession than the overall health of the economy.

U.S. Manufacturing Back in Expansion Mode

The U.S. manufacturing sector returned to expansion territory in January after five months in contraction, according to the latest reading of the Institute for Supply Management (ISM) Purchasing Managers Index (Exhibit 1). The boost in business confidence is perhaps not surprising given recent monetary easing, indications of troughing global growth, and the signing of a provisional U.S.-China trade deal. Of particular relevance to us was the rise in new orders, from 47.6 to 52, which was enough to change the ClearBridge Recession Risk Dashboard's ISM New Orders signal from red, where it had been since September 2019, to yellow.

The signal change is an incremental positive for the dashboard, although two indicators remain red — Yield Curve and Wage Growth. As concerns over the coronavirus and its effect on both Chinese demand and international supply chains drove money away from riskier assets and into bonds in January, Treasury yields retreated and the 10-year/3-month yield curve briefly reinverted. Historically, the yield curve has been one of the best indicators in identifying a recession and it suggests that the U.S. economy is not in the clear yet. At the same time, as we highlighted recently, wage pressures continue to rise, particularly for lower earners, keeping the Wage Growth indicator red. Overall, the Dashboard continues to read yellow, signaling caution.

Exhibit 1: Caution Still Needed as Manufacturing Rebounds



Data as of Jan. 31, 2020. Source: ISM, The Conference Board.

Broadly speaking, the inflation indicators — Wage Growth and Commodities — are the most negative indicator grouping (Exhibit 2). It is worthwhile examining the role of inflation in recessions, and the back-to-back or double dip recessions in 1980–82 come to mind in this regard. Inflation played a major role in the 1980-82 recessions, largely through the way it drove a radical change in monetary policy.

Exhibit 2: ClearBridge Recession Risk Dashboard

	Current	Fourth Quarter 2019	Third Quarter 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	●	●	●

↑ Expansion ● Caution ✕ Recession

As of Jan. 31, 2020. Source: ClearBridge Investments.

The early 1980s recessions were triggered by an extreme adjustment in monetary policy, which ultimately ended a nearly two-decade battle with inflation. Lasting from 1965 to 1982, the Great Inflation is arguably the most defining U.S. macroeconomic period of the second half of the twentieth century. The period also gave birth to a new economic term: stagflation, or slow economic growth occurring simultaneously with high rates of inflation.

U.S. inflation entered this period at 1% in 1964, ultimately peaking near 15%. This acceleration was not the result of a single incident but rather a confluence of events that created a perfect environment for higher inflation. The high inflationary period of the 1970s was caused by several events:

- Higher deficit spending, as the U.S. aimed to increase the social welfare system and fight the Vietnam War.
- Inappropriately loose monetary policy pursued by the Fed to finance the massive budget deficits
- Higher deficit spending leading foreign investors to question the ability of the U.S. to maintain the gold standard, which led to a run on the U.S. dollar and the official closing of the gold window in 1971. The buildup of selling pressures and uncertainty created by a new global monetary fiat system caused higher inflation through dollar weakness.
- Demographics, as baby boomers entered the workforce and bought houses, cars and appliances, created an unprecedented level of demand and drove prices higher.
- Price and wage controls introduced by the Nixon administration over three phases in 1971 and 1974, which temporarily slowed the rise in prices but exacerbated shortages and eventually led to much higher prices when the controls were removed
- Multiple oil crises, notably the 1973–74 Arab oil embargo and the 1979 Iranian revolution, which spiked oil

prices 400% and 300%, respectively, and crippled U.S. consumers, who spent close to 8% of their disposable income on energy in the 1970s (as opposed to 2.5% today)

The era of rising inflation would change when Fed Chairman Paul Volcker announced a radical change in monetary policy in 1979. The message was simple: the Fed would now attempt to beat inflation by controlling the supply of money rather than the price of money (interest rates). If the Fed only determined how much money was available to the financial system, markets would set the price of money. This is a key reason why money supply is a financial indicator in the ClearBridge Recession Risk Dashboard.

As a result, the markets pushed rates up substantially with the prime rate nearly doubling by Election Day 1980, peaking at 21.5%. Initially, Volcker didn't fully commit to defeating inflation at any economic cost and the Fed showed signs of relenting as the economy descended into the 1980 recession. As inflation showed renewed signs of accelerating in response to a less hawkish Fed, the Fed tightened substantially, causing a deeper second recession in 1982. As the recovery took hold, it was clear that Volcker had finally broke the back of inflation.

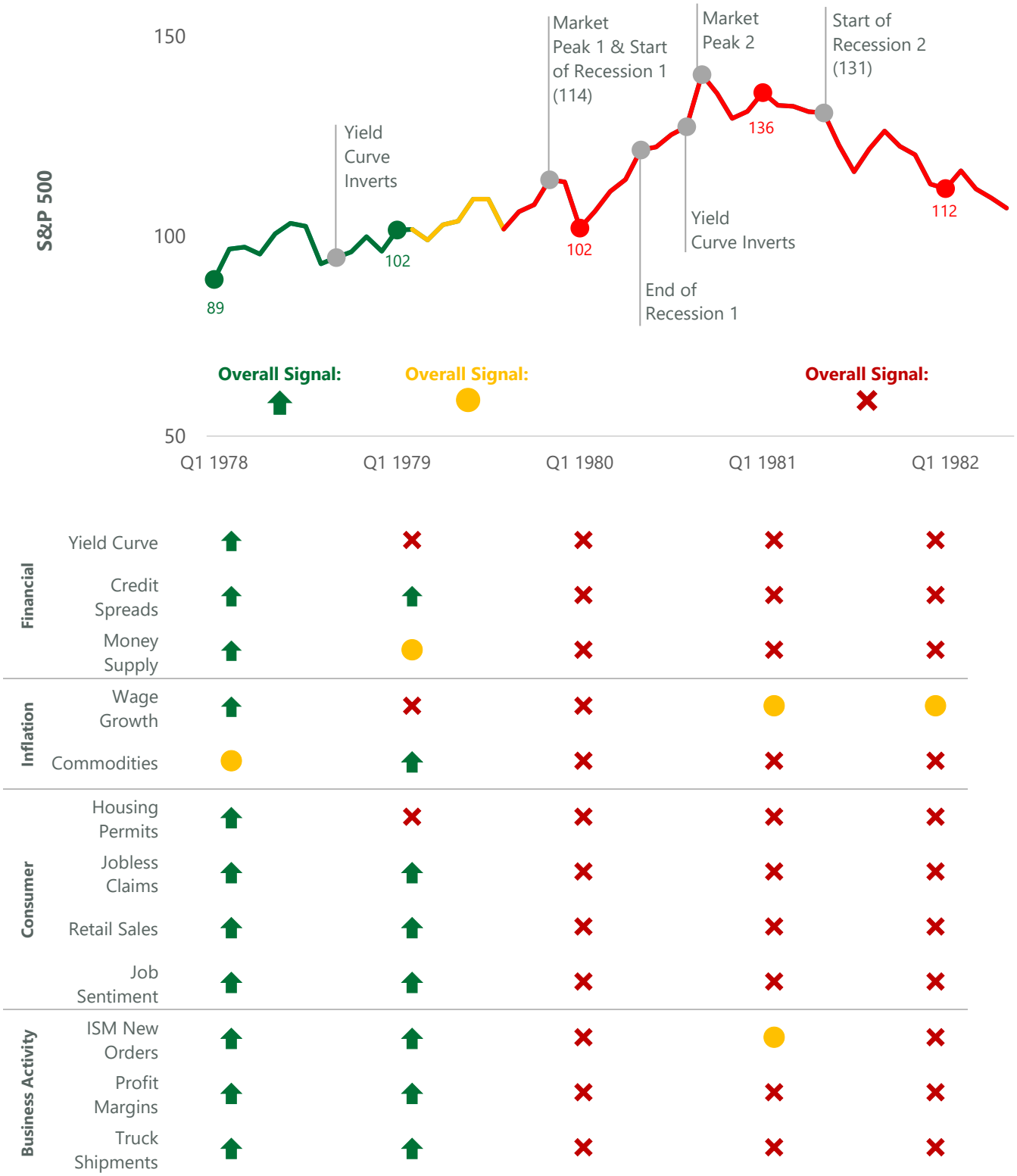
It's important to realize that high inflation isn't always a necessary cause of recessions. The ClearBridge Recession Risk Dashboard has identified recessions in disinflationary environments like 1990–91, 2001–03 and 2007–09. As we see, the inflation regime does not matter in identifying a recession, but rather the health of the economy as economic growth slows down. Let's take a deeper look into the recessions of the early 1980s and how the dashboard evolved.

How the Dashboard Evolved in 1980–82

Although the ClearBridge Recession Risk Dashboard shows yellow as early as May 1979, the first major signal of the recession in 1980 was the yield curve inversion in November 1978. That quarter, the Dashboard's Yield Curve indicator signal jumped from green to red. Soon after, Chrysler, one of America's largest car manufacturers, was bailed out of financial difficulty for $1.5 billion. Not surprisingly, ISM New Orders, the signal that tracks business orders as a leading indicator, showed yellow in the second quarter of 1979. By the third quarter of 1979, Jobless Claims and Truck Shipments had turned from yellow to red, and in the fourth quarter Credit Spreads, Retail Sales and Profit Margins would follow.

Driven by deteriorating signals across financial, inflation, consumer and business activity indicator groupings, the overall dashboard signal turned red in November, two months prior to the official start of the recession in January 1980, and would stay red throughout both recessions. Overall, the market lost 17.1% during this first recession. As of the dashboard showing red, the market lost 7.5%.

Exhibit 3: U.S. Recession Dashboard 1978-1982



Source: ClearBridge Investments.

The next recession, which began in July 1981, had signals as early as the recovery from the previous recession. With inflation still high after the first recession ended in July 1980, the Fed raised rates beginning in August and through the end of the year. In November Ronald Reagan defeated incumbent Jimmy Carter and the S&P 500 hit a peak at 140.5. But the rate hikes would prove to be too much too fast. On the dashboard, the Yield Curve indicator returned green in the second quarter of 1980 but was red two quarters later as the yield curve inverted.

Other signals showed signs of temporary relief. ISM New Orders reverted to green in the third quarter of 1980 but slipped to yellow again the following quarter and stayed yellow until the second recession began in the third quarter of 1981. Wage Growth likewise improved during the 12 months between the two recessions, turning from red to green as the first recession ended and then to yellow at the end of 1980, only to return to red in the second quarter of 1981.

The two recessions in the early 1980s ended in November 1982, after the S&P 500 hit its second-recession trough of 102.4 in August 1982. At the end, interest rates were back down to around 10%, allowing economic growth to return. In the second recession, the S&P 500 lost a total of 27.1%.

A number of economic variables, then, were responsible for the 1980–82 recessions. Of note, the ClearBridge Recession Risk Dashboard's early indicators then were Yield Curve and Wage Growth — the two indicators red at present. Yet today the consumer indicators are all green and encouraging, whereas by the end of 1979 all were either yellow or red. Also, the confluence of factors leading to extreme inflation in the 1970s are absent today. A strong consumer, improving manufacturing and mostly benign inflation suggest more support for the current economic expansion.

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