ClearBridge Investments

Recession Indicators Update: Policy Responses Critical

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Key Takeaways

- The S&P 500 Index has sold off 29.5% from its peak in February, representing the quickest peak to bear in history.
- The Federal Reserve has led the charge with a comprehensive monetary stimulus package to ensure the smooth functioning of financial markets. However, substantial fiscal stimulus is still needed to combat the demand destruction resulting from COVID-19 shutdowns.
- At this time, the ClearBridge Recession Risk Dashboard remains yellow, although Credit Spreads has turned red. We believe the overall signal will turn red in coming months and currently estimate the odds of a recession at 75%.

An Unprecedented Time

The events of the last several weeks have been unprecedented. Financial market volatility is at record highs and interest rates at record lows amidst the growing spread of a global pandemic. Given the global reach of COVID-19, at times it feels like there is nowhere to hide out that is safe, either personally or within financial markets. Equities are down 29.5% from their peak in just 26 days (18 trading sessions), a much more rapid decline than seen during the last two recessions or during the two large selloffs of the current cycle (Exhibit 1). In fact, this decline was the fastest bear market (20% decline from peak) on record in just 22 days.

Exhibit 1: Speed of Stock Selloff

*Mid-Cycle Slowdowns are 2011-2 Euro Crisis and 4Q18 U.S. Selloff.
Source: Standard & Poor's and Bloomberg.

Monetary Policy Leads the Initial Charge

With financial markets acting as vigilantes, policymakers have been spurred into action with central banks leading the initial charge. On Sunday evening, the Fed introduced a number of measures primarily aimed at ensuring liquidity so that financial markets can continue to function in an orderly manner. Short-term rates were cut to zero, a $700 billion quantitative easing (QE) program was introduced, the rates for dollar swap lines among major central banks was reduced and the period for which banks can borrow at the Fed's discount window was lengthened at reduced rates. Although many of these moves were expected to occur in the coming months, the surprise was that they all happened at once. The saying "Go Big or Go Home" comes to mind with this monetary reaction. This statement is usually a choice between the two options. However, in this case, the Fed has gone big because many of us are staying home. While some are worried that the Fed is now out of ammunition, there are several steps the central bank could take to further ease financial conditions if needed, including bringing back crisis era emergency lending facilities like backstopping commercial paper or upsizing the scope and scale of the QE program.

The Fed's actions alone will not solve this problem. The current crisis began as an exogenous or supply shock. Academic theory suggests fiscal policy is better suited to cure that type of ill, whereas monetary policy can be more effective to stimulate demand. While that might be debatable as rates approach zero, given the experience of Europe and Japan over the last several years, few question the need for fiscal stimulus at the current juncture. Congress has already passed an initial COVID-19 bill that provided $8.3 billion in funding largely for vaccine research and is currently working on a second bill aimed at providing free testing, expanded sick and quarantine leave, food assistance and several other programs. This bill is expected to pass in the coming days and comes on top of nearly $50 billion in funding available under the Stafford Act after President Trump's declaration of a national emergency last Friday.

Despite the widespread actions being undertaken to limit the spread of COVID-19, the aforementioned steps are likely not enough to avoid a recession. Large portions of the economy such as travel, restaurants and retail are seeing substantial declines in activity if not outright shutdowns. OpenTable, a platform for making restaurant reservations, has begun publishing daily comparison data that shows total annual declines in traffic of 36% last

Friday night and 42% last Saturday night across the U.S. Major cities such as New York, Boston and San Francisco saw greater than 50% declines (Exhibit 2).

Exhibit 2: OpenTable Restaurant Bookings Plummet

	2/18	2/19	2/20	2/21	2/22	2/23	2/24	2/25	2/26	2/27	2/28	2/29	3/1	3/2	3/3	3/4	3/5	3/6	3/7	3/8	3/9	3/10	3/11	3/12	3/13	3/14	3/15	3/16
Phoenix	-4%	0%	11%	-1%	0%	1%	7%	3%	-2%	-2%	7%	-5%	-11%	-13%	-21%	-8%	-8%	-7%	-6%	-8%	-18%	-13%	-28%	-21%	-28%	-27%	-45%	-66%
Los Angeles	7%	6%	9%	1%	8%	29%	12%	15%	5%	0%	8%	13%	-3%	-1%	4%	7%	-5%	1%	-2%	-15%	-27%	-23%	-26%	-38%	-48%	-47%	-57%	-82%
San Francisco	-15%	-11%	-4%	-8%	-9%	-9%	9%	16%	12%	5%	-8%	-10%	-18%	-22%	-24%	-24%	-22%	-18%	-18%	-26%	-41%	-43%	-43%	-51%	-53%	-58%	-72%	-80%
Denver	-1%	-12%	-9%	14%	2%	-3%	-10%	-12%	-2%	-2%	1%	27%	38%	3%	-9%	-3%	-10%	-9%	-6%	2%	-20%	-19%	-4%	-17%	-46%	-46%	-50%	-56%
Miami	0%	-8%	-5%	1%	5%	-7%	17%	1%	-9%	0%	0%	4%	-18%	-13%	-15%	-6%	-2%	-11%	-2%	10%	-9%	-15%	-18%	-22%	-27%	-30%	-36%	-46%
Atlanta	6%	9%	-5%	-5%	-3%	-7%	-6%	1%	-3%	-4%	7%	1%	8%	-17%	-21%	-11%	-9%	-2%	1%	13%	1%	-14%	-14%	-26%	-35%	-34%	-44%	-78%
Chicago	-7%	-3%	-5%	-4%	7%	11%	-6%	-16%	-15%	-8%	-8%	-3%	1%	-21%	-16%	-10%	-11%	-8%	4%	13%	-25%	-23%	-27%	-31%	-37%	-49%	-53%	-75%
Boston	5%	15%	-3%	-12%	-2%	14%	5%	3%	1%	12%	1%	22%	1%	1%	-10%	-4%	11%	7%	-1%	10%	-14%	-29%	-30%	-47%	-56%	-64%	-70%	-81%
Minneapolis	-14%	27%	-33%	-15%	12%	33%	18%	27%	12%	29%	39%	11%	14%	-19%	-3%	6%	-13%	-6%	61%	23%	-19%	-14%	-17%	-28%	-22%	-35%	-33%	-76%
New York	1%	11%	3%	0%	3%	13%	7%	1%	1%	-2%	1%	-2%	-2%	-6%	-12%	-12%	-9%	-15%	-10%	-4%	-18%	-30%	-36%	-52%	-61%	-64%	-69%	-77%
Portland	1%	-4%	7%	11%	6%	22%	14%	-7%	17%	4%	-4%	4%	9%	5%	-3%	-1%	3%	0%	-3%	5%	-16%	-7%	-20%	-32%	-41%	-39%	-54%	-61%
Philadelphia	10%	55%	11%	1%	2%	6%	-2%	-2%	10%	13%	11%	7%	21%	13%	4%	6%	8%	-7%	1%	3%	-7%	-14%	-16%	-39%	-40%	-48%	-54%	-85%
Dallas	6%	-4%	1%	3%	-3%	-2%	-2%	14%	1%	-7%	6%	10%	11%	1%	-6%	-8%	0%	3%	-1%	-2%	-15%	-10%	-12%	-25%	-35%	-35%	-42%	-61%
Houston	-2%	-8%	-3%	3%	1%	-10%	4%	7%	9%	1%	-6%	-6%	2%	2%	-8%	-8%	7%	6%	10%	7%	-14%	-17%	-8%	-24%	-33%	-34%	-40%	-61%
Seattle	8%	11%	6%	1%	1%	12%	1%	0%	3%	5%	7%	0%	-18%	-29%	-31%	-31%	-36%	-34%	-35%	-25%	-47%	-49%	-54%	-58%	-63%	-63%	-62%	-83%
Washington	-5%	57%	9%	0%	9%	16%	13%	9%	9%	2%	4%	2%	6%	0%	-8%	8%	-4%	-5%	1%	0%	-9%	-18%	-22%	-38%	-44%	-44%	-55%	-76%

Source: OpenTable.

The Monetary-Fiscal Handoff

With this "sudden-stop" in activity, what began as a supply shock can quickly morph into a demand one, as workers go unpaid or are laid off. While many businesses are admirably trying to find ways to blunt the impacts to their workers, if revenues decline precipitously and things like rent, interest on debt and other costs continue to be owed, there comes a point where they cannot continue to pay their employees. This has the potential to worsen the economic impact of COVID-19, as once the risk from the virus recedes, those businesses that run out of cash will not be able to reopen and their workers will not be able to resume life as it left off before the virus. Additionally, it's unclear whether consumers will go back to their normal routines that involve travel and mass gathering events until a vaccine is developed as there will likely be continued pockets of infection post shutdown. As a result, the magnitude of the economic recovery will be less than the decline, although there certainly will be an initial bounce-back.

Given this dynamic, calls for a third stimulus bill are widespread and well-understood by Congress. Whatever policymakers can do to keep businesses "in business" through the COVID-19 shutdowns will be welcome. Steps may include directing banks to pause collecting interest on loans (forbearance), mechanisms to provide cash to businesses (bailouts), or even directly sending cash to every American. Given the pervasiveness, magnitude, and potential duration of social distancing, substantial stimulus is likely needed to combat the coming economic shock. If half of the economy shuts down for two months, that equates to an 8.3% reduction in GDP. Of course, there would be a bounce-back as some activity is deferred and not lost, but that still equates to a nearly $2 trillion reduction in aggregate output, a figure that is close to 40% of the entire proposed 2020 Federal budget. Regardless of what is legislated, the key will be providing programs that help keep consumers and businesses solvent through this difficult period. This will allow for the country to emerge on the other side of the current crisis on firmer footing with a more broad-based recovery.

Recession Risk Rising, Dashboard Remains Yellow For Now

Against this backdrop, the probability of a recession has risen to 75% over the next 12 months, in our view. We believe the most likely chance for a recession to be avoided would come from either an overly strong policy response (i.e. fiscal stimulus), a near-term peaking of the infection rate or a quirk of the calendar. In the latter scenario, the economy would contract aggressively but due to the timing of these events, there are not two consecutive quarters of negative real GDP growth. However, the NBER (National Bureau of Economic Research) has said previously that a sufficiently deep economic contraction that lasted even only a few months, like the 1982 recession, could meet their definition of a recession.

Despite these increased chances of a recession, the ClearBridge Recession Risk Dashboard remains at an overall yellow signal at this time (Exhibit 3). As noted in our previous post, most economic models including the dashboard are not designed and should not be able to anticipate a previously unknown global pandemic, unfortunately. This proved accurate during the last true supply shock-induced recession, the oil embargo and 1973-75 recession, as the red signal lagged the beginning of the recession. The rapid rise in crude oil prices (supply shock) was too much for consumers to bear (demand shock) as the average American spent over three times more of their income at the pump compared to today. For those looking for other historical parallels in modern history, 9/11 comes to mind, although those tragic events occurred after the economy had already entered a recession. Other global pandemics have occurred under dramatically different circumstances, such as the Spanish Flu over 100 years ago, which makes drawing comparisons rather challenging and of limited utility.

While financial markets have responded in rapid fashion to the spread of COVID-19, economic data reflecting its impact is only beginning to trickle in. Our assessment of the economy, while driven by the dashboard, incorporates many tools as well as our own judgement and experience (as well as that of our colleagues at ClearBridge). Much of the data showing the true economic impact will not be available for at least a month or two, given widespread social distancing is only beginning now. Because of this, many indicators on the dashboard do not yet reflect what is currently happening. One indicator that has changed is Credit Spreads, which has turned red as investors re-price the risk of downgrades and defaults given the economic disruptions the country is facing.

Exhibit 3: ClearBridge Recession Risk Dashboard

		March 2020	February 2020	January 2020
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	⬆	⬆	⬆
	Overall Signal	●	●	●

⬆ Expansion ● Caution ✕ Recession

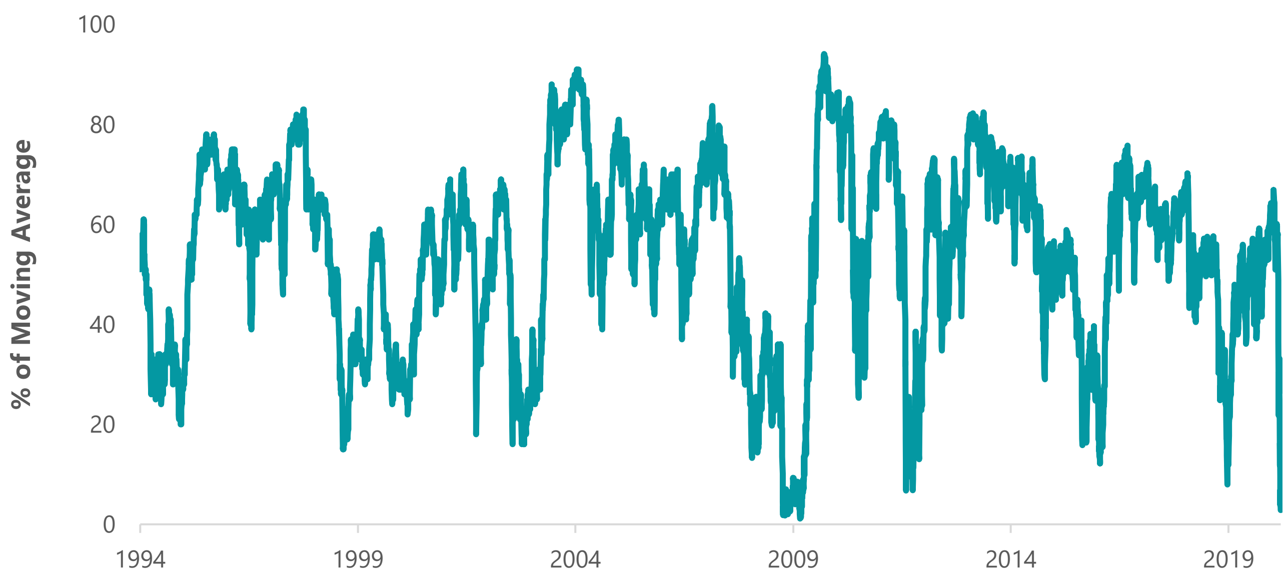
Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg.

We continue to believe that the dashboard will be useful as the initial supply shock morphs into a demand one. We expect the dashboard to turn red in the coming months and monitoring its evolution will allow us to track what is going on. We would expect Jobless Claims to begin to rise in the coming weeks as layoffs begin. Job Sentiment is likely to worsen as hiring freezes take effect, and ISM New Orders are likely to tumble back into red.

Beyond that, we will be focusing on Retail Sales, Truck Shipments and Housing Permits. The former is likely to see mixed results with some businesses (online retail) benefitting and others (restaurants/bars) seeing substantial declines. The overall decline in economic activity should reduce the volume of freight moving around the country. Housing permits will be an important barometer of how much demand destruction occurs, as low interest rates should support housing, but virus fears could keep buyers at bay. The degree to which layoffs and falling optimism potentially overwhelm this could be telling over the intermediate term.

The market has come a long way in a short period of time. Market action will likely remain choppy in the coming weeks and months until we get visibility on the scope of the fiscal stimulus plan and/or the virus shows clear signs of peaking. However, we may be approaching levels that have historically signaled major market bottoms. In fact, the percentage of NYSE stocks closing above their 200-day moving average is below 5% and just above the all-time low seen in the depths of the global financial crisis (Exhibit 4). As we have written previously, it's darkest before the dawn.

Exhibit 4: –Percentage of NYSE Closing Above 200 Day Moving Average



Source: NYSE and Bloomberg.

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