ClearBridge Investments

The Long View

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Key Takeaways

- The overall signal for the ClearBridge Recession Risk Dashboard turned yellow this month, with two indicators (ISM Manufacturing New Orders and Job Sentiment) turning yellow following the shift in Commodities to red last month.
- A yellow signal indicates caution but not the end of the cycle as the dashboard has seen several "false positives" historically, including one in a year (1995) that appears to have several important parallels to the current environment.
- While evidence is mounting that we could be in the final stages of the current bull market, we expect equities to grind higher through increased volatility.

Soft Patch or Slowdown Leading to Recession?

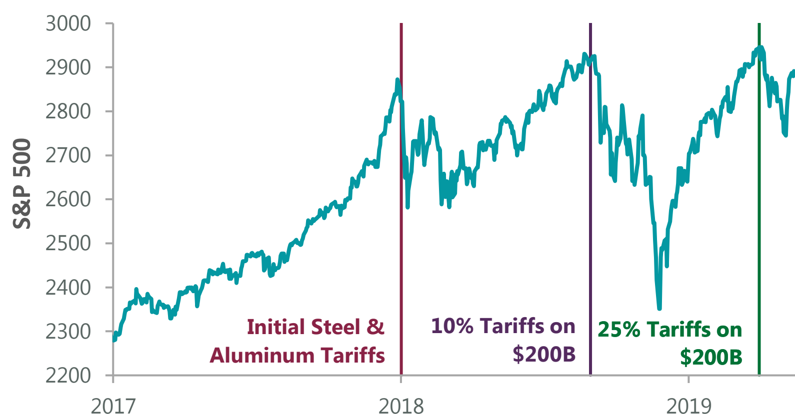
The U.S. economy hit its 121st consecutive month of economic growth last week, surpassing the previous record from the 1990s. On the surface, there appear to be several positives for equity investors at present, including a renewed détente on the trade front, a more dovish shift for the Fed and a strong first half for stocks, with the S&P 500 up 17%. This backdrop isn't too far off from what we anticipated in our year-ahead outlook in January, though we believe that as the market begins to more narrowly focus only on the positives, a more acute awareness of risk is warranted by investors. A look beneath the surface shows several signs of deterioration that justify greater caution.

Reasons to Be Optimistic or Concerned?

Several of the perceived positives that have driven equities to all-time highs may be less supportive going forward. First, the trade détente appears to be similar to the "agreement" that emerged from the G-20 summit in Argentina last November. In the weeks after that meeting between Trump and Xi, different interpretations led to a breakdown and ultimately the next escalation in the trade saga. Despite the headlines and positive market reaction, the "agreement" from the G-20 meeting in Japan several weeks ago does not appear to have resulted in any progress on the thorny issue of enacting new Chinese laws against intellectual property theft and forced technology transfer, a non-negotiable from notable trade hawks in the administration. If an agreement can't be forged in the coming months and trade tensions re-escalate, it could push equities lower like previous episodes when stocks sold

off swiftly from all-time highs due to trade war fears. In our view, the recent trade "truce" could be a "sell the news" type of event due to the lack of substance and tangible progress (Exhibit 1).

Exhibit 1: Trade Escalations Have Come at Market Highs



Tariffs on $200B of Chinese Goods. Source: FactSet.

The second perceived positive for stocks that could warrant a more cautious stance is the expected easing of Fed policy. The markets are currently pricing in at least two interest rate cuts this year and futures markets imply slightly better than even chances of a third before year-end. Put differently, the bond market is signaling (via the inverted yield curve) that the central bank has overtightened. Historically, Fed cuts are bearish for equities and the economy. Ten of the last 13 interest-rate hike cycles have ended with a recession because the Fed acted too late and lower rates couldn't prevent the economy from rolling over. Importantly, the current yield curve inversion has not persisted for a long time and is relatively shallow, meaning there is still a chance the Fed can reverse course and manage a "soft landing" à la 1995 or 1998.

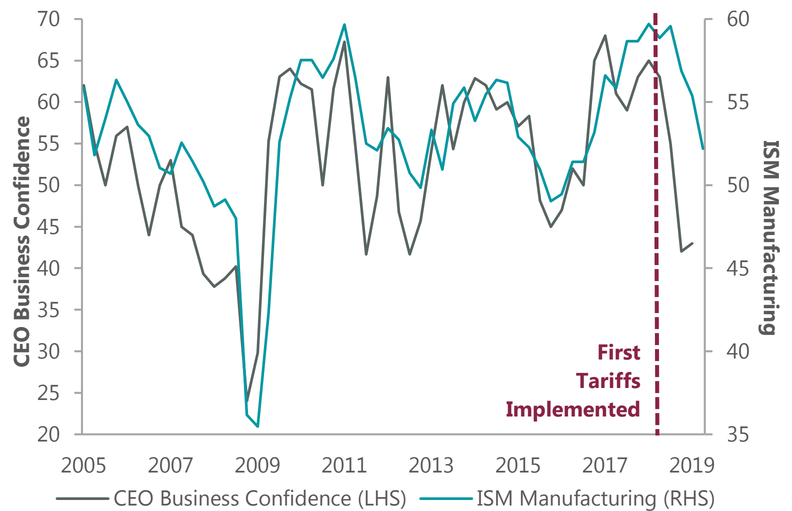
The third and final positive that, upon closer inspection, shows potential cracks emerging is the S&P 500's strong start to the year. At 17%, the first half of 2019 was the strongest since 1997. However, equity market internals indicate that caution may be warranted. Market leadership has been mixed, with defensive leadership and cyclicals lagging by a wide margin. Further, value has lagged growth and small caps have trailed large caps. Both of these are signs of a less healthy market backdrop and give us less confidence for a sustained move higher.

Recession Risk Dashboard Turns Yellow

The ClearBridge Recession Risk Dashboard is also picking up on movement beneath the surface that could warrant caution with two indicators turning yellow in the last month: ISM Manufacturing New Orders and Job Sentiment. These changes follow the turn in

Commodities to red last month. We believe all three of these changes are largely a consequence of the escalation of trade tensions, which is leading to a tremendous amount of uncertainty. Business confidence peaked at the time trade tensions first rose and has continued to trend lower, with the New Orders component of the ISM Manufacturing survey touching the breakeven 50.0 level in the most recent print. On the consumer side, while the labor market remains strong with a record 1.6 million more job openings than unemployed individuals, last month saw the fifth-largest leap in respondents to the Conference Board survey stating, "jobs are hard to get." Notably, each of the four larger spikes occurred in the middle of a recession (Exhibit 2).

Exhibit 2: Trade War Fears Have Weighed on Business Confidence



Data as of June 28, 2019. Source: The Conference Board, ISM, FactSet.

While these newly changed indicators are "soft" survey data, several "hard" data points on the dashboard have begun to deteriorate, including Truck Shipments, Housing Permits and Retail Sales. While initial stresses late last year largely came from signals related to the financial markets, we are now starting to see stresses emerge in the "real" economy, specifically within business activity and consumer health. As a result of the aforementioned changes, the overall signal for the ClearBridge Recession Risk Dashboard has now turned yellow (Exhibit 3).

Exhibit 3: ClearBridge Recession Risk Dashboard

		June 2019	First Quarter 2019
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	●	⬆

Source: ClearBridge Investments.

Importantly, a yellow signal does not mean that the market or economic cycle is over just yet. The dashboard has turned yellow before both recessions and market tops more or less equally. As a result, we believe equities will continue to move higher in the coming months. Looking back to the last cycle, the dashboard turned yellow in October 2006, almost a year before the market peak and five quarters before the onset of the recession. This dynamic isn't atypical, as the market tends to move to new highs even as risks rise late in the economic cycle.

It is also important to note that the ClearBridge Recession Risk Dashboard has displayed three cautionary yellow signals in the past that never worsened to red: in 1995, 1998, and 2015. Although the U.S. economy avoided a recession in each of these instances, economic activity slowed substantially before quickly reversing course. We continue to monitor the dashboard and economic conditions broadly for signs both of a further slowdown and a reacceleration. Should the dashboard continue to erode and turn red, we would become much more cautious given the stronger track record from the red signal. In fact, there has been only one "false positive" red signal all the way back in 1966, an environment which saw GDP growth slow to just +0.2%.

Risks and Opportunities as the Cycle Matures

The yellow signal is consistent with an economic cycle entering its later stages. As we move into this phase, there are several

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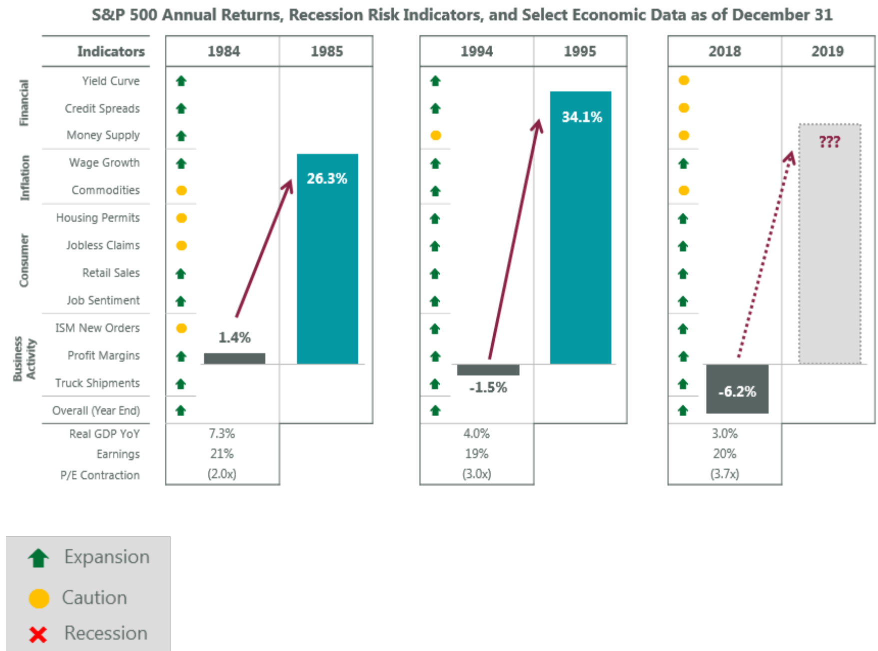
headwinds and tailwinds that could cause it to take on a longer or shorter duration. On the negative side, it isn't just the U.S. economy on shakier footing. Two-thirds of the constituents in the Global Manufacturing Purchasing Managers Index (PMI) have a reading below 50, with the aggregate measure standing at 49.4. By these measures, the current soft patch is already "worse" than the 2015–16 slowdown, when the proportion of countries with PMIs below 50 reached a high of 50% and the low in the aggregate Global Manufacturing PMI was 50.0. However, past recessions did see figures that were worse than current readings. In our view, global economic malaise is emanating largely from China, where efforts to deleverage the shadow banking system and rebalance the economy have rippled throughout the global economy, given China's role as the global marginal source of demand. While Chinese authorities have implemented over 80 individual stimulus actions to counteract slowing growth, weak data persist across broad swaths of its economy, including in the consumer, export, manufacturing and investment sectors. Stimulus actions have been specifically targeted as part of a "rifle" approach, as opposed to the broader "shotgun" approach implemented in 2008 and 2015–16. Because of this shift, we do not currently see China as a near-term driver of a global rebound, barring a modification in policy approach.

However, there are several reasons for equity investors to remain optimistic. At the start of the year, we identified two potential historical parallels to the current environment: 1984-85 and 1994-95. Six months later, we believe 1995 (which saw a slowdown and not a recession) may be the more appropriate of the two, for several reasons. First, in 1995 the ClearBridge Recession Risk Dashboard turned yellow (from almost entirely green at year-end 1994) after ISM New Orders, Commodities and the Yield Curve all worsened to yellow or red. Second, the Fed moved to cut rates twice in the second half of 1995 (25 bps in July and December), propelling the markets to a 13.1% second-half return after the 18.7% first-half rally. Third, P/E multiples rose 2.7x in the first half of 1995, similar to the 2.3x increase so far this year. While this story from 1995 sounds familiar, there are two important differences: market leadership in 1995 was far less defensive, and 10-year Treasury yields rose rather than declined, as we have seen so far this year (Exhibit 4).

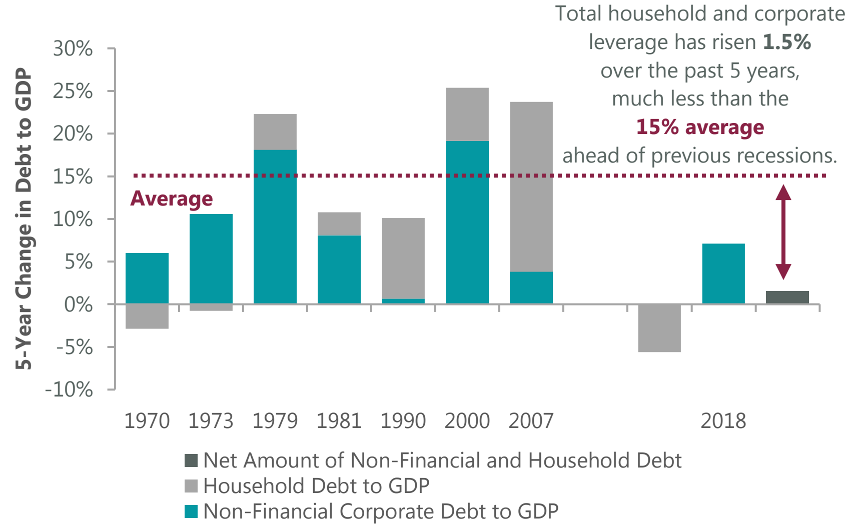
Exhibit 4: Two Important Historical Analogues



Data as of Dec. 31, 2018, most recent as of June 30, 2019. Returns and economic data source: FactSet. Dashboard: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg.

Another potential tailwind for the economy is the lack of excesses so far this cycle. Historically, recessions result from policy mistakes, supply shocks (such as the oil embargo in 1973), or the overextension of debt. While trade could be a supply shock, tariffs implemented to date have been manageable. As a result, many are focused on the overextension of debt, fretting that the substantial increase in corporate leverage will be the catalyst for the next downturn. However, the household accumulation of debt has actually been shrinking, meaning that net leverage as a percentage of GDP is up just 1.5% over the past five years. This is a very different backdrop compared to the past seven recessions, when net leverage was up 15% on average in the five years heading into the downturn. This is a strong indicator that debt in the system is not overextended, and if a recession does emerge despite this, it is likely to be much shallower (economically speaking) than the last one (Exhibit 5).

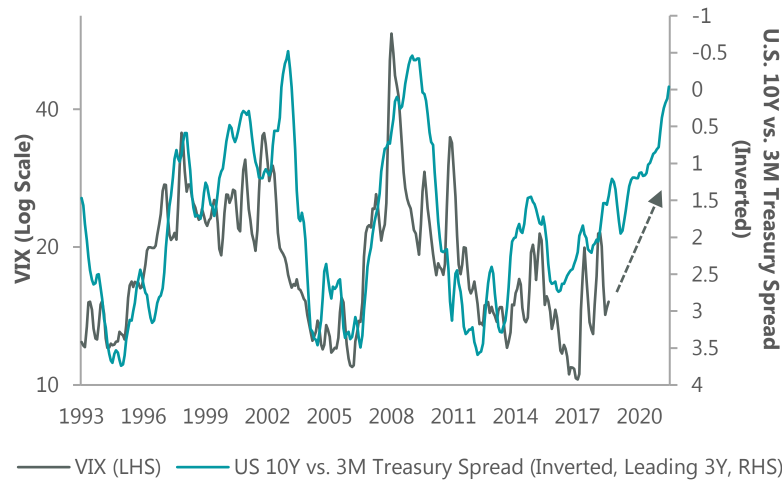
Exhibit 5: Leverage Does Not Look Recessionary



Source: J.P. Morgan, IMF. Note: 5-Year Change in Household Debt to GDP & Non-Financial Corporate Debt to GDP.

Putting this all together, the U.S. economy is at a crossroads: soft patch versus recession on the horizon. Regardless of the outcome, history suggests that volatility is likely to pick up in the coming months. Volatility tends to grind higher as the economic cycle matures, and historically the CBOE Volatility Index or VIX has followed the yield curve in the opposite direction with a 3-year lag. With the curve having flattened, the VIX should continue to move higher in the next few years if this pattern holds (Exhibit 6).

Exhibit 6: Volatility Usually Follows the Yield Curve

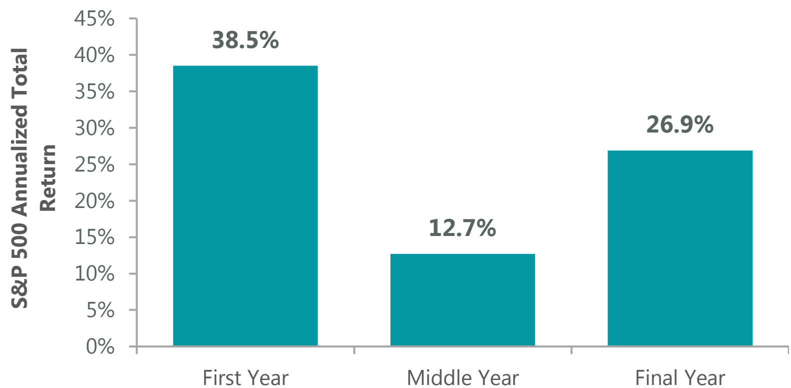


Data as of June 30, 2019. Source: CBOE, U.S. Treasury.

Against this backdrop, we do believe that equity markets will grind higher from current levels, choppiness notwithstanding. In fact, we would not be surprised to see another pullback - similar to the one

experienced last quarter - before year-end. Long-term investors should take the opportunity to review their holdings and asset allocations and upgrade into higher-quality opportunities. Shorter term, this will likely prove a detriment to relative returns, because the final stage of bull markets tends to be quite strong. At the end of a bull market, participants become more and more euphoric, leading to a final blow off top and outsized equity returns. As a result, returns are 26.9% on average in the final year of a bull market since 1975. Whether we are currently in the midst of that final year remains to be seen; however, we do believe the chances of the current bull market coming to an end have increased (Exhibit 7).

Exhibit 7: Final Stages of a Bull Market Tend to Be Strong



Bull markets shown are the gains between bear markets defined as declines of 20% or more, 1975 to present, current bull market excluded. Source: FactSet, Yardeni Research.

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