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The R Words: Recession & Re-election

For too many, it surely feels like we are still in the old one. Others say we are in the midst of a brand new one. Ben Bernanke has just prescribed his most potent medicine yet to avoid one while Congress seems deadlocked enough to push us to the brink of one. All the while, those watching this bull market can be forgiven for wondering if there is even the slightest chance of one.

The word recession provokes a nasty reaction for good reason – jobs are lost, families struggle, and investors lose their collective shirts. Today we are thirty nine months from the official end of the last recession yet we are mired in a tepid recovery. Another recession at a time when the unemployment rate is already too high and government has little ability and/or will to stimulate would be particularly devastating. We would like to weigh in on the chances of recession and, should it occur, the likely impact on investors.

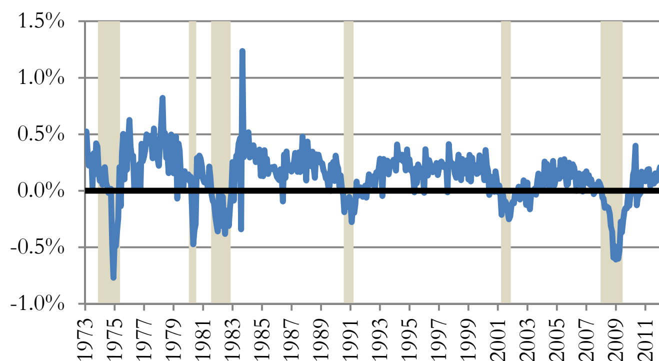
Smart People Disagree

There is a compelling argument that the US economy will continue on its anemic expansionary path. Another recession caused by high interest rates or inventory adjustment is unlikely. The Fed's September 13th announcement that interest rates will be effectively zero through mid-2015 eliminates the first concern. Housing starts and auto sales are already at low levels (and have been since 2008); they are unlikely culprits this time. On the 13th, Ben Bernanke also announced the Fed's intention to purchase $40 billion of mortgage backed securities per month for an indefinite period of time, a policy designed to lend further support to housing. And despite all the economic problems we observe overseas, the US Dept of Commerce reports that the value of US exports is 2.8% higher year over year through July.

Critics have their own data. The Institute for Supply Management's manufacturing and new orders indices have indicated contraction for three months in a row. The Economic Cycle Research Institute (ECRI), a group with a sterling record on recession prediction, announced late last year they expect the economy to start shrinking this year. And Congress has the power to make recession a near certainty by allowing the following to occur at the end of this year: expiration of all the Bush tax cuts, the payroll tax cut, and unemployment insurance, and the beginning of the spending cuts agreed to during last year's budget negotiation. This fiscal cliff is estimated to cost 4.0% of GDP per Goldman Sachs Asset Management.

In order to get a sense of which camp will prove to be correct, it is instructive to look at the data. Some of the most well-known economic data points, however, are not good indicators of the future path of the economy. Take the payroll report. Each month the Bureau of Labor Statistics (BLS) reports by how much non-farm payrolls increased or decreased versus the prior month. Figure 1 plots the change as a percentage of the prior month's total payroll. Time periods when the economy was in recession are shaded in gray.

Figure 1: Headline News is Co-incident News
Payroll growth (% Δ month over month); recessions shaded
Sources: BLS, Nat'l Bureau of Economic Research (NBER)



There are a few key takeaways from this graph. It's clear that payroll growth is negative in recessions, but almost never immediately beforehand, and sometimes during expansions. Payroll growth is usually decreasing immediately before the economy enters recession, but the same can be said of expansionary periods (1987, 1995, 2003, etc). Despite the fact that the monthly payroll number often colors our views on the economy, on its own it does not offer a lot of value when forecasting future economic performance.

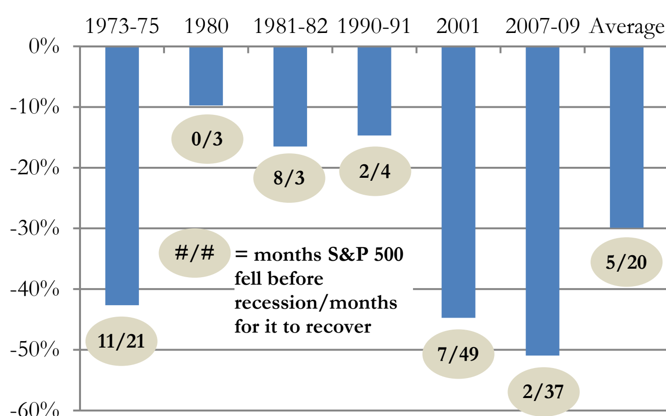
In economic jargon, payrolls are a co-incident indicator: they move at the same time as the overall economy. The useful indicators to look at lead the economy. The Conference Board combines ten variables from manufacturing to financial market to consumer expectations data to arrive at a leading economic indicator. Despite growing by 0.3% over the past six months, the indicator has been down in three of those months and helped along by strength in the financial market components (as opposed to manufacturing or consumers).

The ECRI publishes their own weekly leading index which they use in conjunction with other variables to forecast the business cycle. The index has recently turned up, but the group stands by their call that the economy is in a recession based on their evaluation of an ensemble of data points. In our view, the resolve of the unemployment-fighters at the Fed and the pent-up demand in the cyclical sectors gives the US a better than even chance of avoiding recession.

The Market Pays Attention

In the post-war era, the economy expands for six months for every month of contraction. The long-run performance of stocks is logically more dependent on the economic performance of the expansion years. However, recessions tend to cause disproportionate losses in portfolios. Figure 2 details the extent of the damage. The blue lines plot the amount of loss experienced by an S&P 500 investor from the pre-recession peak of the index to its lowest point afterwards (sometimes this occurred during the recession, sometimes afterwards). The average loss experienced in the last six recessions has been 30% with the last two standing out as particularly nasty.

Figure 2: Recession Damage
S&P 500 (total return index) losses measured from pre-recession peak to lowest point thereafter
Sources: Morningstar, NBER



Further, the chart shows two other important data points in the tan ovals. The first number is the headstart the S&P 500 had on the overall economy on turning negative. On average the index starts to dip five months prior to the official start of a recession. Current knowledge of a recession is of reduced value because chances are your portfolio has already started to slip. The second number indicates the months required to regain the market peak after bottoming out. Not surprisingly, there is a connection between the depth of the plunge and the time required to resurface. If you consider all the recessions together, a $100 investment at a market peak would have dipped to $70 and required about twenty months to return to $100. Because recessions are difficult to predict, highly destructive, and involve long recoveries, diversifying a portfolio with investments that can mitigate this kind of damage is a huge benefit to investors. □

Presidential Futures

Most people turn to polls to get a read on the upcoming presidential election, but investors may be surprised to know there are futures markets for the presidential race. The business school at the University of Iowa runs an electronic exchange on which participants can trade contracts linked to the outcome of elections. The Iowa Electronics Market (IEM), as the exchange is known, has been in existence since 1988.

As of September 20th, the price for a contract that pays $1 if Pres. Obama wins the White House ($0 otherwise) is $0.74, meaning that traders are pricing in a 74% chance of victory for the Democrats. The contract for Gov. Romney is priced at $0.27 (or a 27% chance of victory). The gap between the two candidates was as small as 5% in June, but Pres. Obama has since opened up a significant lead.

The IEM also has a market for the race to control Congress. The two highest probability outcomes are a Republican House/ Democratic Senate (36%) or Republican full control of Congress (31%). Historical prices indicate that the latter had been the most likely outcome all the way back to July 2011 and has only recently dipped into second place.

Let's entertain the idea for a moment that the IEM markets are correct. The result is that we have divided government; a Democratic White House and either a fully Republican Congress or one in which the Republicans have the filibuster option in the Senate will need to cooperate in order to get things done. Chief among these things is the fiscal cliff issue. Divided government may in fact be the best catalyst to solve the problem as neither side will want to be blamed for plunging the country back into recession.

What does a deal look like? The Congressional Budget Office (CBO) has an alternative fiscal scenario that likely comes close to what divided government would agree on. They assume tax cuts (except for the payroll tax cut) are extended and spending cuts mandated by the Budget Control Act are circumvented. The CBO estimates the combined effect of these changes would reduce the cliff by 2.5% of GDP.

Markets are likely most concerned with the fate of the capital gains tax rate. Under this scenario, there would not be pressure on equity markets as the wave of low basis stock for sale would be stayed. Defense cuts would not be a worry either. However, should brinkmanship return, we would be on the lookout for end of year volatility.□

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