An End Has a Start: Keeping an Eye on Recession Indicators

By LIZ ANN SONDERS | OCTOBER 08, 2018

Key Points

- Second-longest expansion likely to make it to longest; but we're starting to see a few markings that peak growth is drawing nigh.
- LEI, yield curve and yield curve-based recession models not yet flashing red.
- But consumers' confidence—in general and about the labor market—suggest caution is warranted.

There is much to cheer about the U.S. economy; so perhaps it's heresy to bring up the topic of recession. Although I believe the runway between now and the next recession is reasonably long; it perhaps looks a bit like the runway at LaGuardia—long enough to land the plane, but fraught with potholes and construction obstacles.

As seen below, the current recovery/expansion is now the second-longest in history; but also the shallowest. I think we will get to the record-breaking point in about nine months, but it's still appropriate to highlight the signs to look for to get a sense of when the next recession will descend.

2nd Longest Expansion

Source: Charles Schwab, Bureau of Economic Analysis, FactSet, as of June 30, 2018.

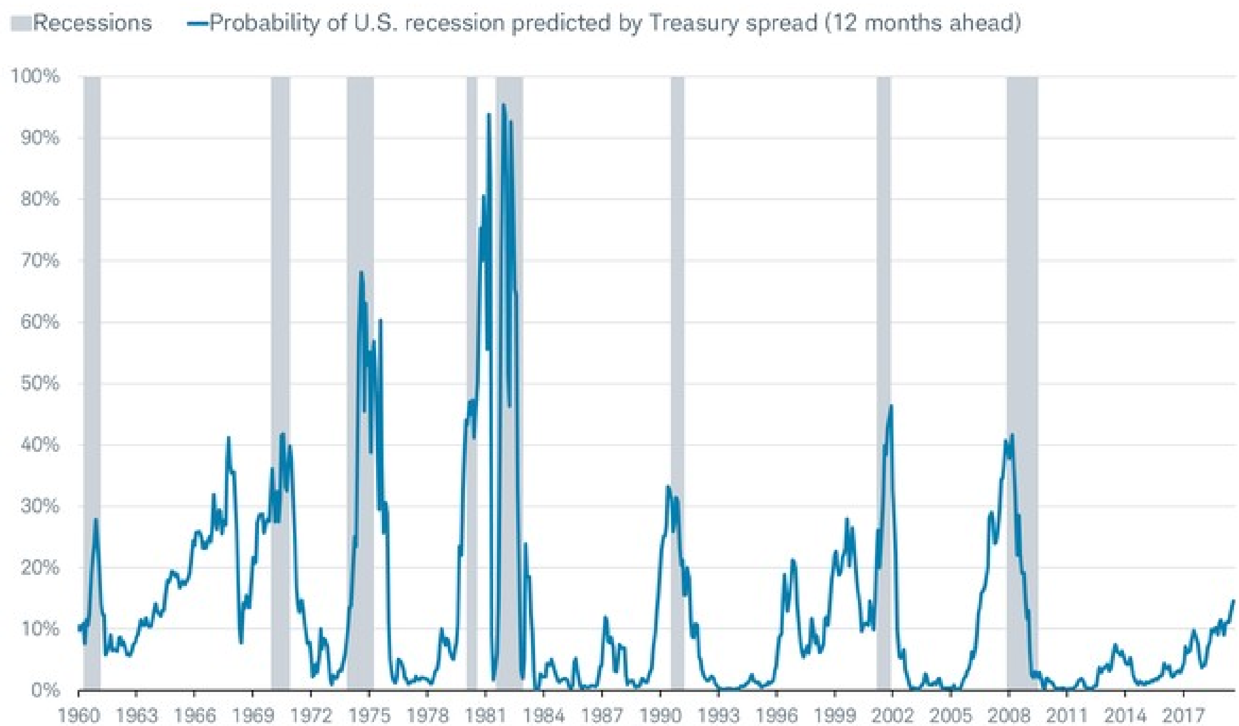
The Treasury yield curve is known as one of the most consistent recession indicators. The curve shown below represents the spread between the 10-year Treasury note yield and the 3-month Treasury bill yield. Not only has the curve steepened a bit recently, due to the back-up of longer yields; it's not yet close to inverting, which tends to precede recessions.

Yield Curve Not Yet Flashing Red

Source: Charles Schwab, FactSet, Federal Reserve, as of October 4, 2018.

The Federal Reserve Bank of New York keeps a recession probability model, using the aforementioned version of the yield curve. You can see below that it's been steadily rising and is approaching 15%. Obviously that's a low probability, but at its highest reading since 2008.

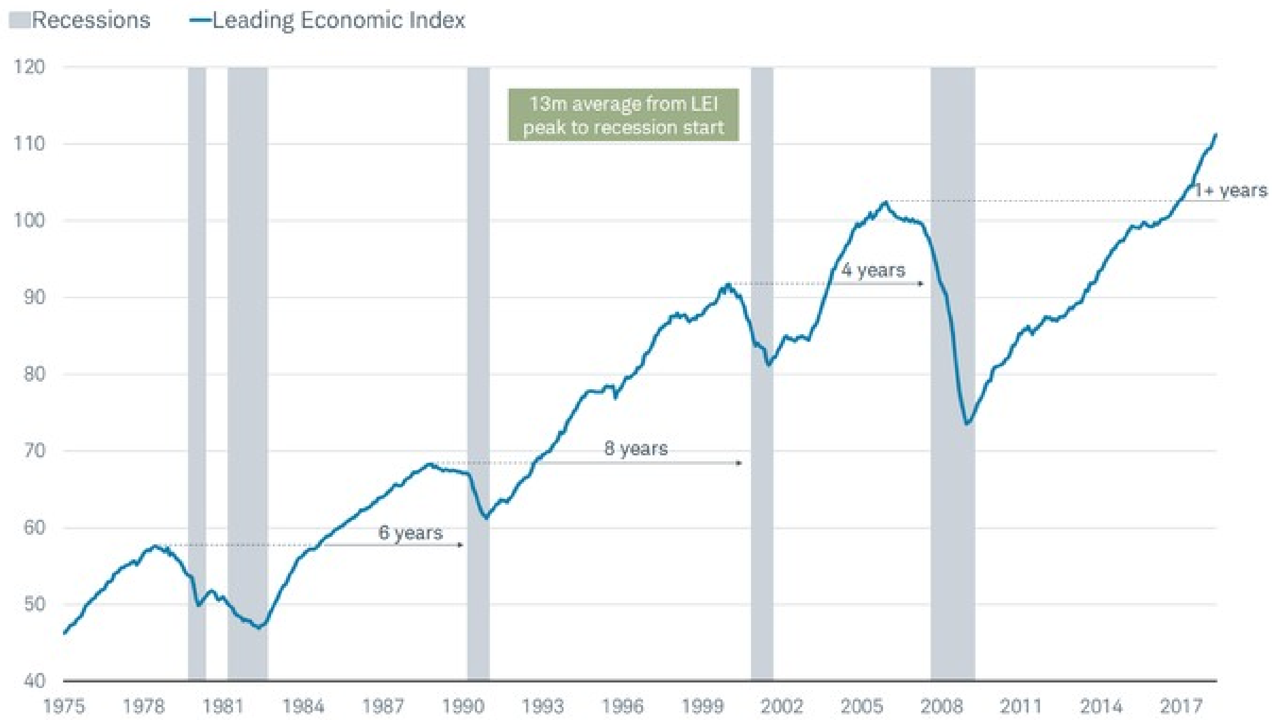
Recession Probability Up, But Still Low



Source: Charles Schwab, Federal Reserve Bank of New York, as of September 30, 2018. Model uses difference between 10-year and 3-month Treasury rates to calculate probability of a recession 12 months ahead.

Most readers likely know I also focus a lot on the leading economic index (LEI) put out by The Conference Board on a monthly basis. The index is a combination of ten sub-indicators, all of which tend to lead the overall economy. I call it the “heads up” indicator given it’s never failed to roll over in advance of a recession starting (see chart below).

Leading Indicators Not Yet Flashing Red



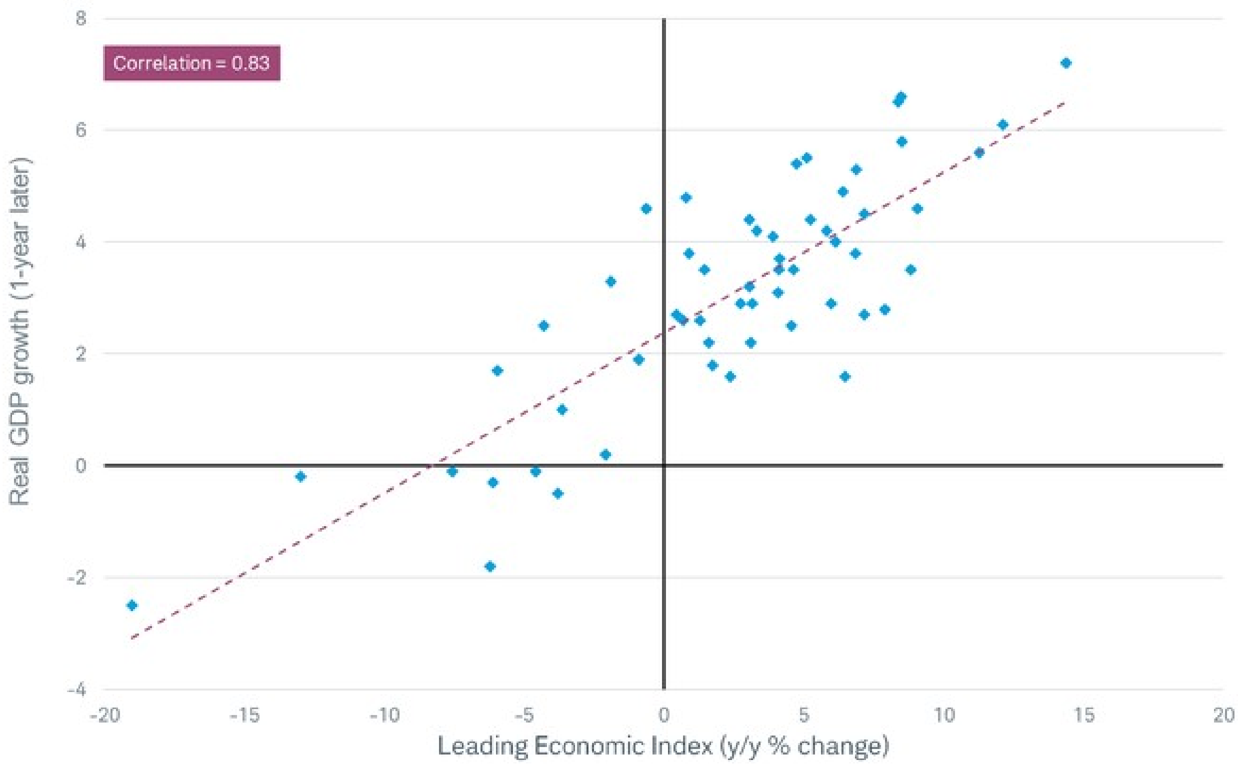
Source: Charles Schwab, FactSet, The Conference Board, as of August 31, 2018.

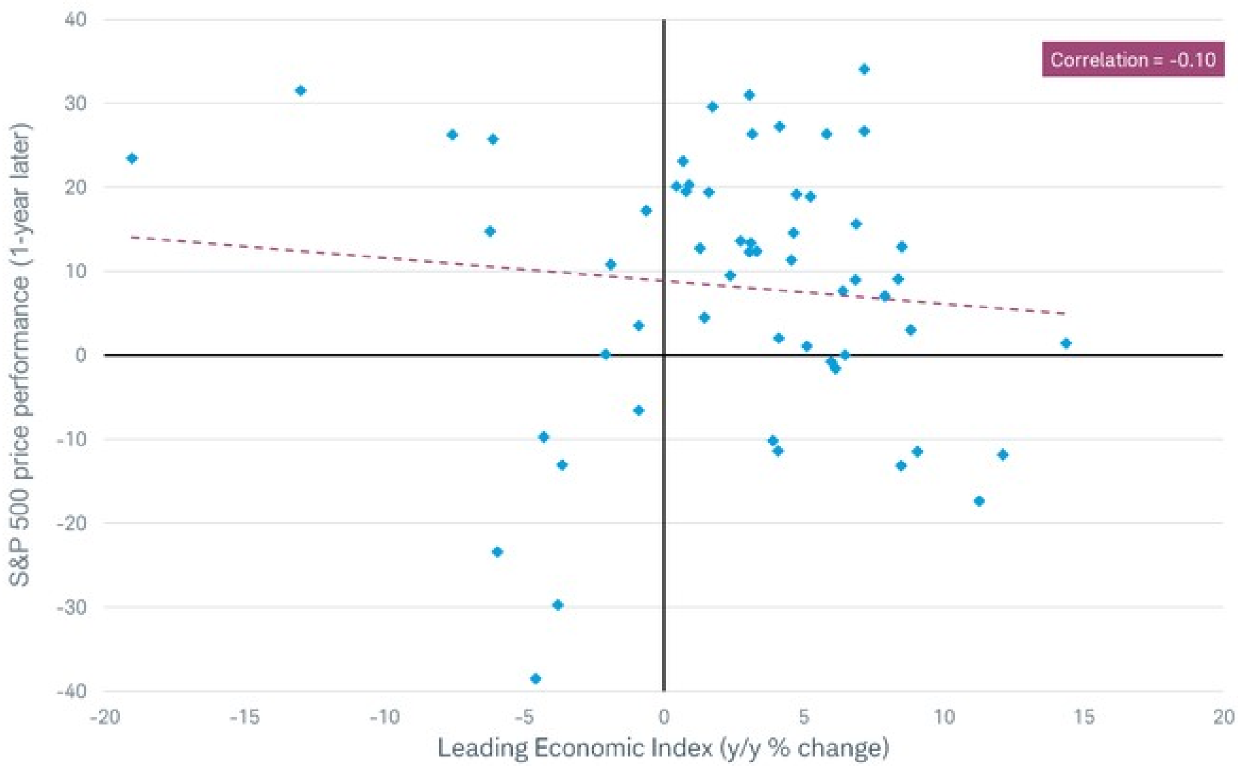
The dotted lines on the chart above show what I call "round trips"—the part of the LEI cycle going from its pre-recession peak to the post-recession point at which the index took out that prior high. The portion of that move from the LEI's trough to the prior peak can be considered the "recovery." From that point forward (solid lines) the economy goes from recovery to expansion. The number of years labeled on those lines represents the time span between when the LEI took out its prior high and the next recession. As you can see, historically that ranged from two to eight years.

As it relates to the current cycle, the LEI took out its prior high in March of 2017, having taken the longest stretch ever to get there. But since then, the LEI has been mostly straight up. So far, only two of its sub-indicators have rolled over and are sending warning signals—the average workweek and building permits. But I will be keeping a close eye on this indicator in the months to come.

As an aside, I'm often asked about the LEI and whether it is a good predictor of stock market performance—given that the S&P 500 is one of the 10 sub-indicators in the index. The answer may be surprising to some readers. As you can see in the correlation charts below, the LEI has done a terrific job "forecasting" economic growth over the subsequent year; but there has been no relationship between movements in the LEI and subsequent stock market performance (in fact, it's actually a slight negative correlation).

LEI Forecasts GDP, But Not Stock Market





Source: Charles Schwab, Bloomberg, Bureau of Economic Analysis, FactSet. 1960-2017.

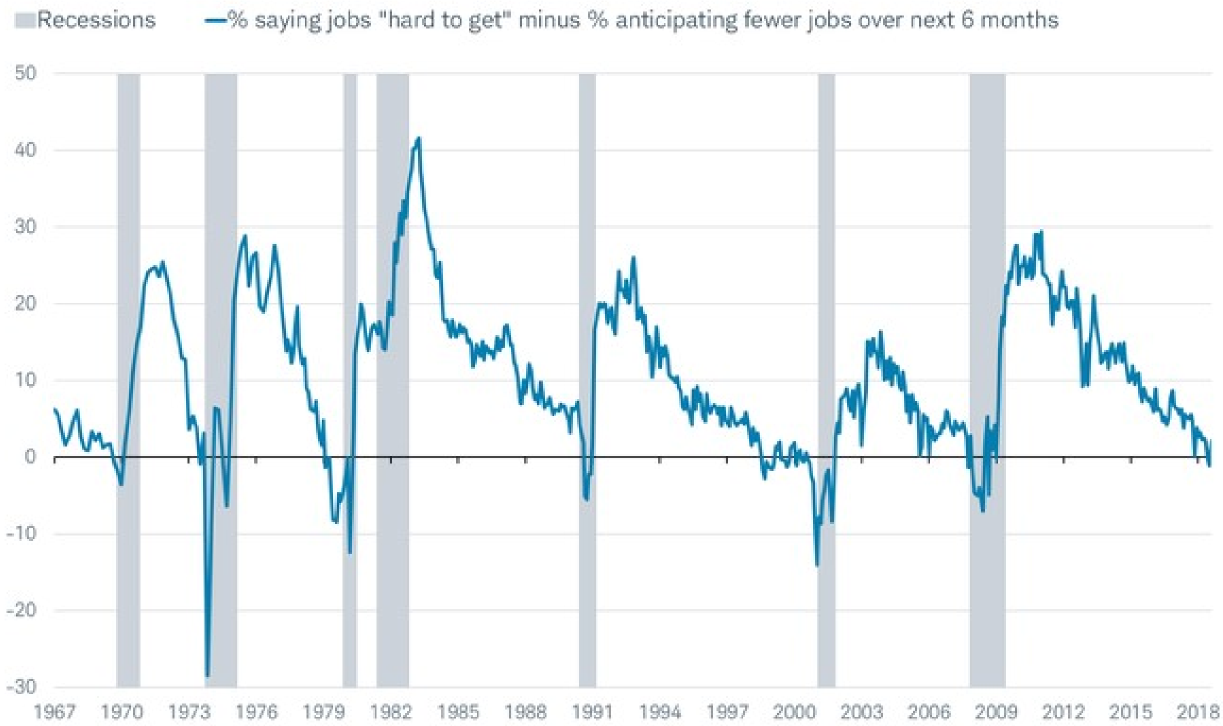
Let’s look at some other economic indicators and what they say about rising recession risk. In addition to the LEI, The Conference Board also publishes its Consumer Confidence Index. A lot of attention swirled around the most recent release given its spike to a historically-high 138. Of course, we don’t know whether that will mark the peak, or whether we have more room to run on the upside. Nonetheless, you can see that peaks in consumer confidence have been warning signs of recessions unfolding; and the latest reading has only been surpassed twice—in 2000 and in the late-1960s.

Consumer Confidence Spiking Higher

Source: Charles Schwab, FactSet, The Conference Board, as of September 30, 2018.

The Conference Board also surveys about labor market conditions, and calculates the percentage of respondents who say jobs are “hard to get” and the percentage anticipating fewer jobs over the next six months. The chart below is calculated by subtracting the latter from the former—falling and low readings mean consumers are highly confident in the health of the labor market. This, too, has been a consistent indicator of pending risk. But the caveat again is that we don’t know whether we’ve yet hit bottom in that indicator.

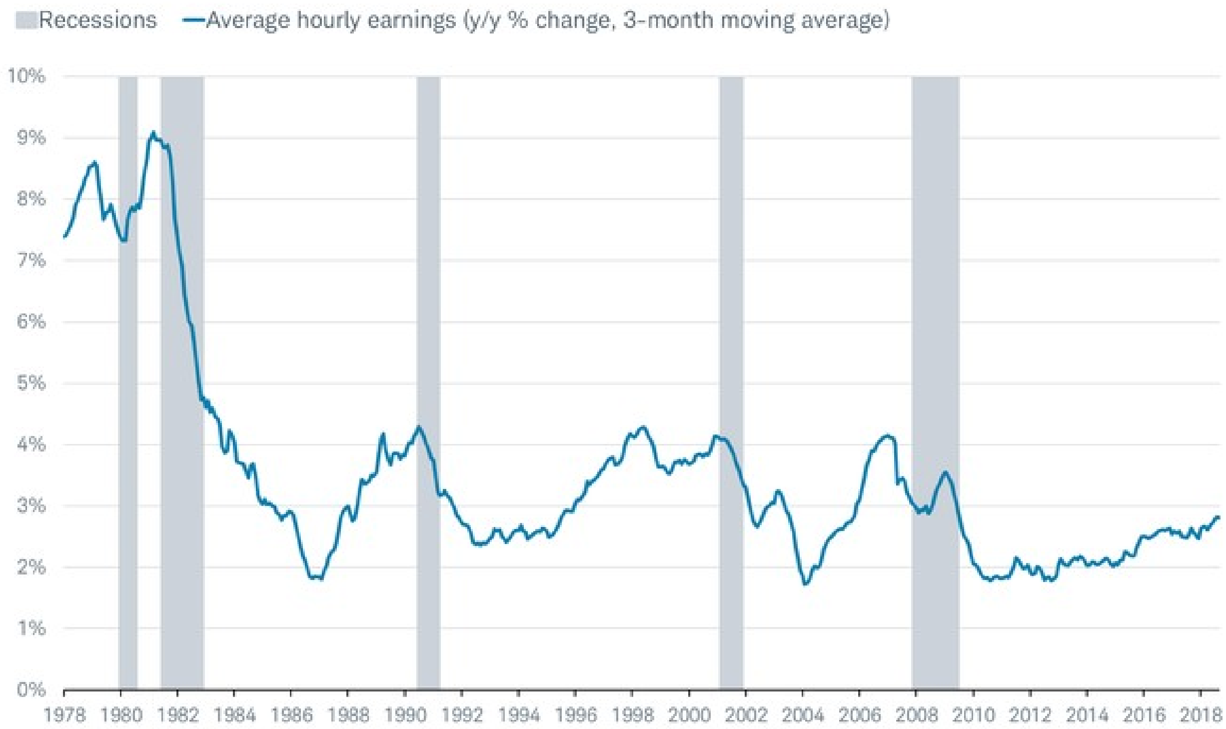
Consumers Highly Confident in Labor Market



Source: Charles Schwab, FactSet, The Conference Board, as of September 30, 2018.

Speaking of the labor market, keen attention lately has been on rising wage pressures; especially as it relates to prospective Fed policy. The chart below shows a three-month moving average of average hourly earnings (AHE). This is one area where it's clear there remains some length in the runway based on historical trends, given that the past three recessions came following moves up to the 4% level.

Wage Pressures Slowly Rising

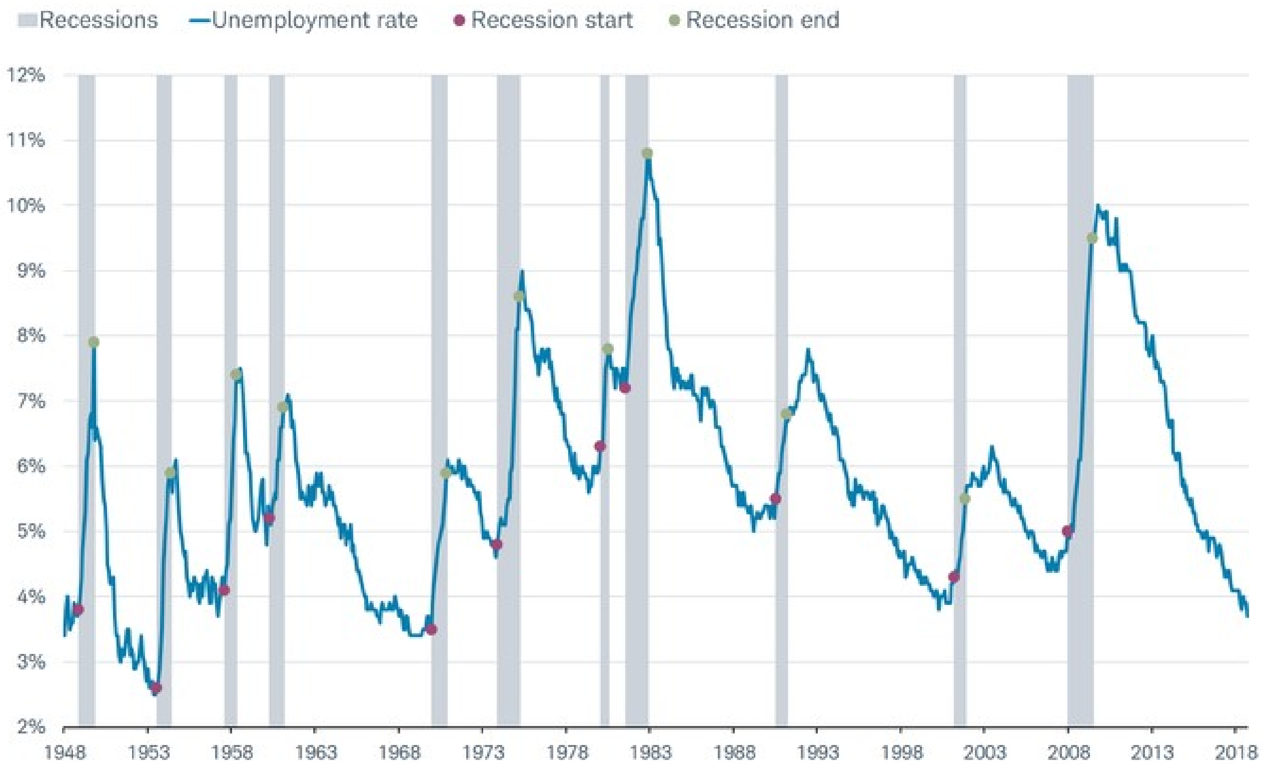


Source: Charles Schwab, Department of Labor, FactSet, as of September 30, 2018.

Arguably among the most common of labor market indicators is the unemployment rate—which dipped further to 3.7% in the September payroll report (a 48-year low). On the surface, there's much to cheer about with so few people unemployed; but the rub is that the unemployment rate is one of the most lagging of economic indicators.

As you can see in the chart below, peaks in the unemployment rate have typically occurred as the economy is entering recoveries; while troughs have been warning signs of pending recessions. Also highlighting the lagging nature of the unemployment rate are the red and green dots on the chart, which clearly show that the unemployment rate has always been near its low point when recessions began and near its high point when recessions end. In fact, the unemployment rate had often continued to rise after a recession had ended.

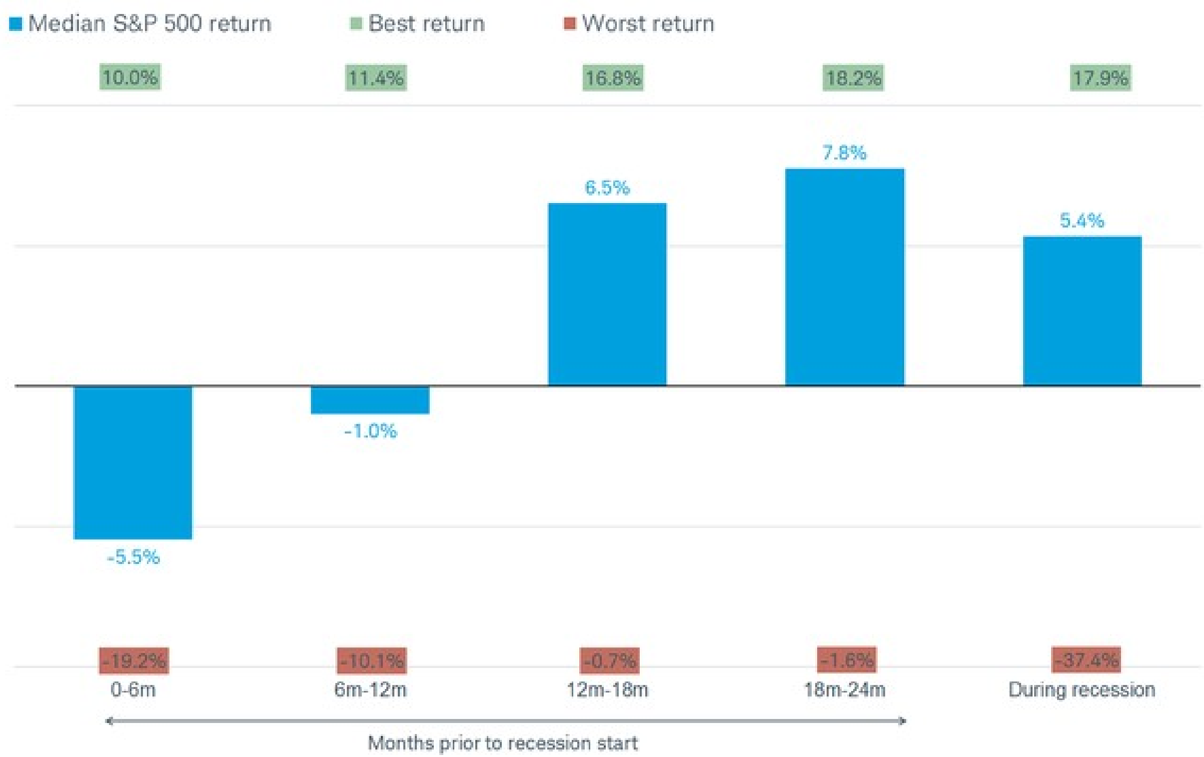
Unemployment Rate Plumbing Historic Lows



Source: Charles Schwab, Department of Labor, FactSet, as of September 30, 2018.

I will end on a couple of more positive notes. The stock market, as a leading indicator, tends to display its greatest weakness in the months immediately prior to the start of recessions, as you can see in the chart below. It's not a perfect indicator, but it's usually the case that the stock market gives some warning that the economic landscape is changing. It's been a rough October so far for the stock market, so this bears watching; but a few days doesn't a trend make.

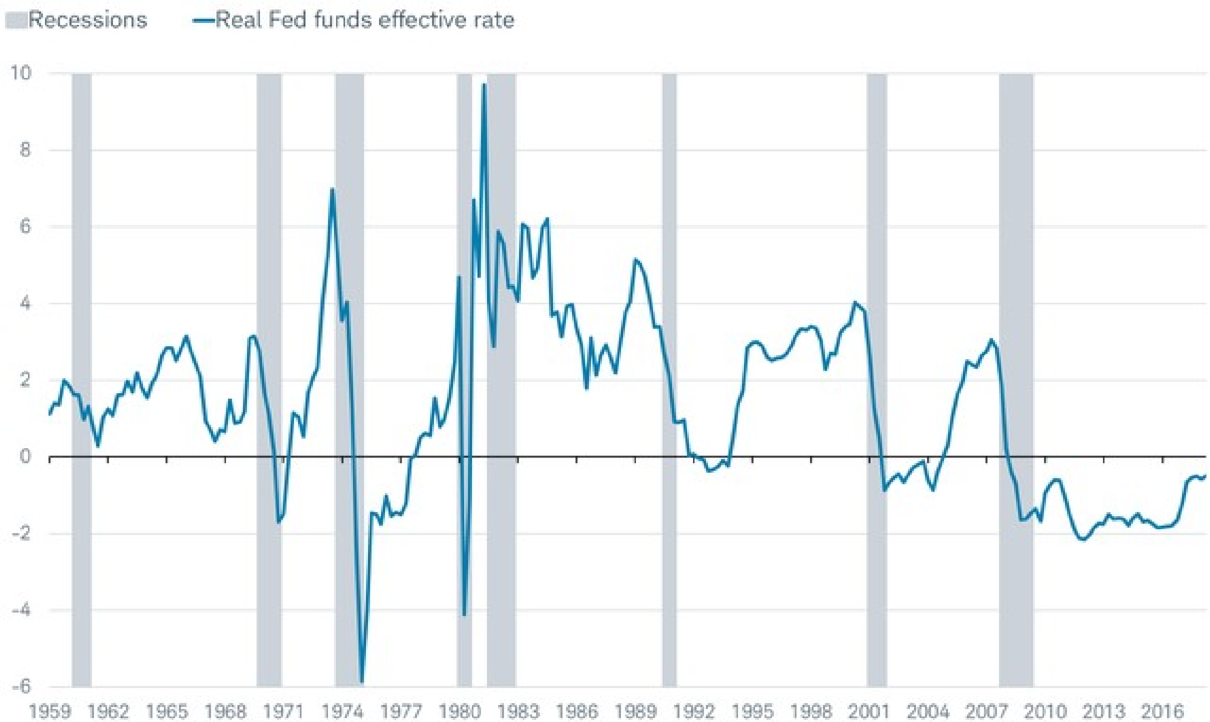
Stocks Suffered Most Immediately Before Recessions



Source: Charles Schwab, Bloomberg. 1945-2009.

Finally, I addressed the yield curve and other implications for Fed policy; but it's worth reminding investors that recessions have generally come after the Fed has finished hiking rates in a cycle—not while they're in the process of raising rates.

Recessions Came After Fed Was Finished



Source: Charles Schwab, Bloomberg, as of June 30, 2018. Real Fed funds effective rate measured by Fed Funds effective rate minus y/y % change in core CPI.

In sum, there is plenty to cheer about the U.S. economy, the growth rate of which should make it another nine months—at which point it would become the longest expansion in modern history (which in and of itself doesn't represent a risk). As the old adage says, expansions do not die of old age … they are murdered by the Fed. Financial conditions remain fairly loose, but liquidity is draining alongside monetary policy tightening; so it's time to keep an eye on the recession shot clock.

Next steps

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