GOLDEN OAK
WEALTH MANAGEMENT

Markets Fall BEFORE Recessions are Declared

That there is a "next" recession somewhere in the future is always a true statement. Recessions are part of the economic cycle and as long as we imperfect human beings make up the economy, recessions will always occur. There are myriad reasons for this and studying past business cycles does help understand the "why" of a recession. However, rather than delving into an economics tutorial I believe it more important for investors to pay attention to what happens before a recession is formally announced.

The National Bureau of Economic Research (NBER) is the governmental body charged with officially declaring when recessions begin and when they end. Importantly, their task is not to tell us when a recession is actually *beginning* (present tense) – it is to tell us when it *began* (past tense). Noting that the definition of a recession requires 2 Quarters of negative GDP growth, it makes perfect sense that the NBER cannot tell us that the economy is in recession for at least 2 Quarters after the recession actually began. This is vitally important. *The last recession was declared to have begun in December of 2007 but the NBER didn't declare this until 9-months after December 2007*. In other words, the US economy had been in recession for 9 months before the NBER declared that there was a recession. In fact, on average, the NBER has declared the beginning month of the past 4 recessions a whopping 228 days after that beginning month had past.

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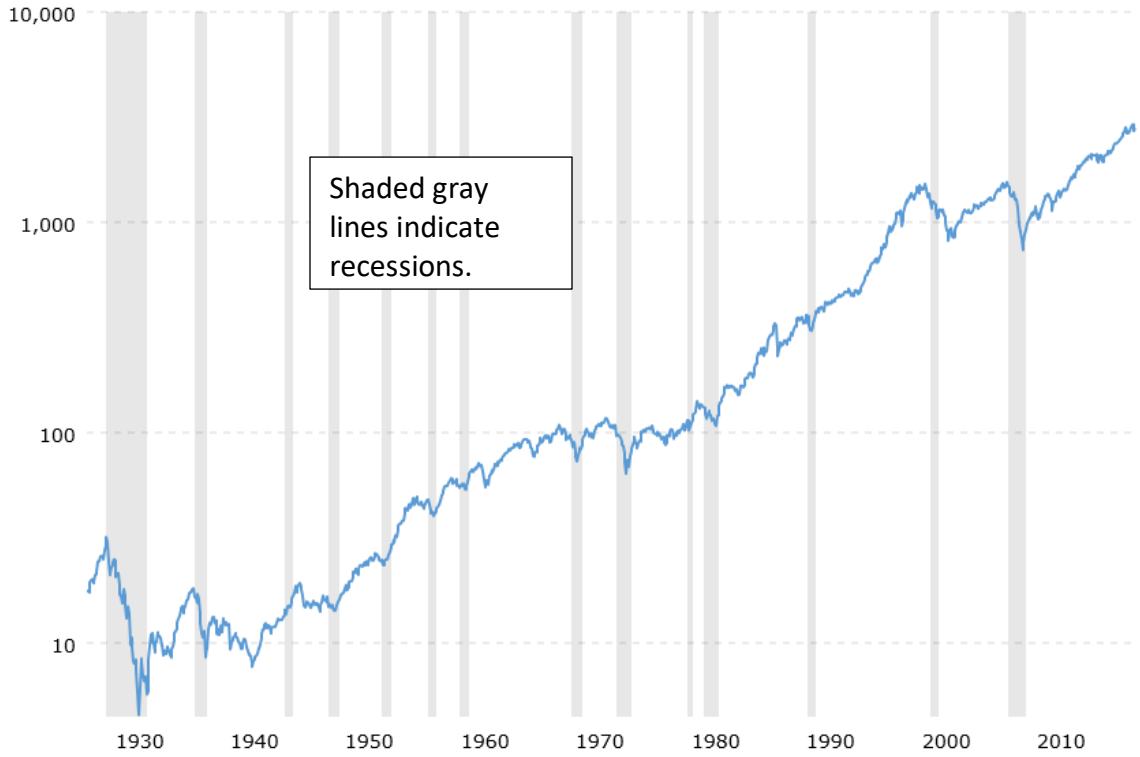
Why is this so important to investors? *Because stock markets lose more money in the period <u>before</u> a recession is formally declared to have begun than they do <u>after</u> the declaration*. Consider this chart of the S&P500 performance set against shaded areas of recessions from MacroTrends.net;



The picture rightly shows large drops during the recessions. However, those recession dates were not formally announced until well after much of the drops had already occurred. The Nasdaq, for example had already lost 43% of its value before the NBER declared that December 2007 had been the beginning of the recession. So waiting for an official *<u>declaration</u>* of recession is useless in terms of portfolio adjustments. The only way to avoid the significant losses that occur during a recession is to make those adjustments around the *<u>actual beginning</u>* of a recession.

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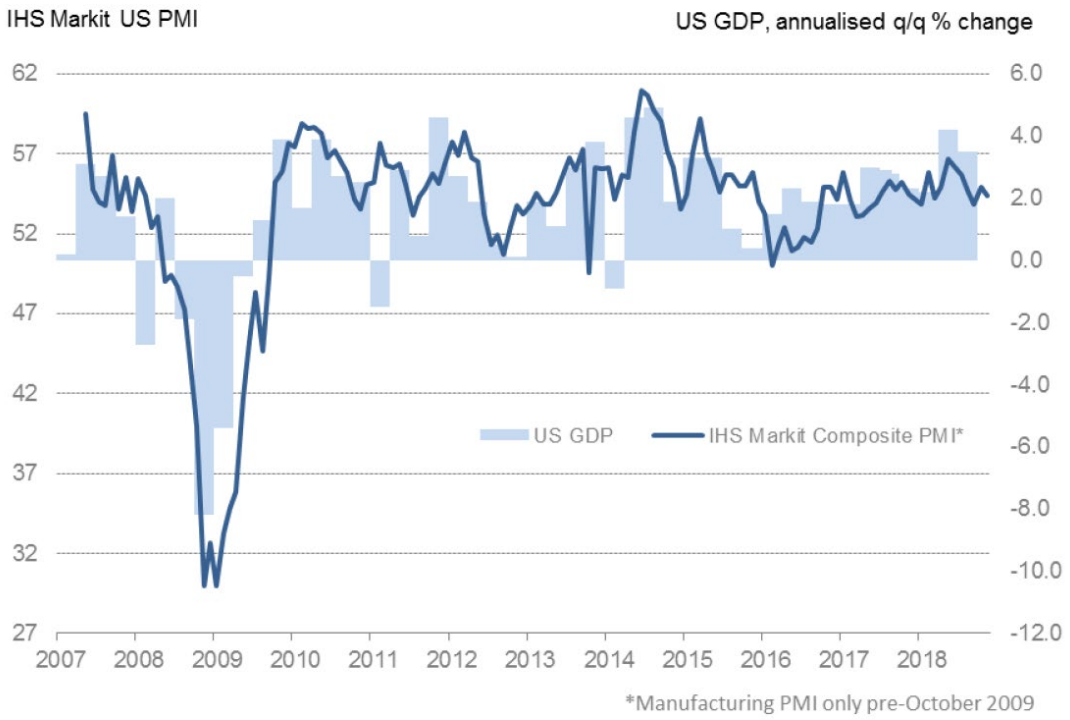
But are we close to what could be the actual beginning of a recession now? As I've mentioned in past letters I watch the monthly PMI readings (fundamental economic activity data) and the yield-curve (relation of shorter-

term to longer-term interest rates) closely to try to discern how far away a recession may be. It is far from an exact science, but given the cyclical nature of economies it does provide some signposts in the fog. Let's take a look at these data points and see what they indicate.

The fundamental readings provided by IHS Market continue to be quite strong.



Sources: IHS Markit, U.S. Bureau of Economic Analysis.

As a refresher, the higher the reading above 50, the faster the economy is growing; the lower the reading below 50, the faster the economy is shrinking. November's numbers come in at 54.4 overall, down a fraction from October's 54.9. The Service Sector is at 54.4 (54.8 in October) while the Manufacturing

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Sector is at 54.5 (55.2 in October). The bottom line is that these are good numbers and continue a stability in positive economic activity that began in 2016 versus the fits-and-starts economic activity readings we had from 2009-2016. If we look under the hood we do see some potential warning signs that may indicate slower growth ahead. In particular, hiring growth is slowing as business outlook, while still positive, has waned of late; and goods exports are coming under pressure mainly due to tariff concerns. These warning signs deserve watching, but current readings do not indicate a negative GDP reading and thus, a US recession does not appear to be around the corner soon.

The same fundamental readings from other major economies are not as solid. The Eurozone readings are at a 4-year low and the under-the-hood readings point to continued slowing. Germany actually posted a barely negative GDP reading while France in on the verge of seeing their manufacturing activity fall below the no-growth 50 line. The UK is in a slowing mode but still positive. Japan also posted a slightly negative GDP reading for the 3rd Quarter. China's manufacturing is also on the verge of contraction but did barely maintain a plus-50 reading at 50.2.

In a Global Economy, the slowdowns across the Ponds do have negative effects on the US economy. Not that we all experience synchronized recessions mind you, but weakness does flow back & forth between economies so it is important to factor that into where drags on the US economy may come from.

The Yield-Curve picture is changing rapidly. Remember that in normal conditions the longer the term of a loan, the higher the interest rate will be. When someone charges you more for a shorter-term loan than a longer-term loan it indicates that they think that while you may be fine over time to pay back a longer-term loan, they are not so confident in your near term prospects. The same hold true for an economy overall – while lenders may be confident that the US economy will be just fine over the long haul, they may price in a higher yield for money lent over a shorter-time if fears of a near-term slowdown are growing. When a shorter-term loan costs more than a longer-term loan we have a yield-curve inversion.

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This is an important data point to keep an eye on because yield-curve inversions of the 2-year Treasury relative to the 10-year Treasury have preceded each of the past 7 recessions (yield on the 2-year was higher than yield on the 10-year). Generally the recession has followed about 1-year after the inversion. Also of import is that while every recession has been preceded by an inversion, not every inversion has been followed by a recession – there have been 2 inversions that were not followed by recessions.

So, where is the yield-curve presently? The 2-year & 10-year have not inverted, but they are getting close enough to cause discomfort. We have seen some inversions on the shorter end of the yield curve. On 12/3/18 the 3-year Treasury yielded more than the 5-year Treasury. On 12/4/18 the 2-year yielded more than the 3-year. More importantly, the 2-year closed trading on 12/4/18 yielding more than the 5-year. In other words, inversions are making their way out to medium-term Treasuries. The next logical step is the inversion of the 2-year & 10-year, though it is not a foregone conclusion that this must happen. Not every shorter-term inversion has led to a longer-term inversion.

But let's assume that the 2-year & 10-year do invert. What then? Looking at history as a guide provides the following chart;

Inversion Occurs	Lag-months	Recession Starts	S&P500 Return during Lag
Aug. 1978	17	Jan. 1980	22.90%
Sept. 1980	10	Jul. 1981	11.50%
Dec. 1988	19	Jul. 1990	37.60%
Feb. 2000	13	Mar. 2001	-15.60%
Dec. 2005	24	Dec. 2007	22.20%

So the lag-time between inversion and recession has ranged from 10-months to a full 2-years and the stock market, aside from the Tech-Crash recession, did very well during the lag-time between inversion and recession, averaging over double-digit annual gains or better. Does this mean an investor should stay Bullishly positioned when the yield-curve inverts, at least for a while?

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Well, unfortunately, looking at the same history does not really answer that question. If we adjust the chart to look at the start of each market decline rather than the start of the recession we get this;

Inversion Occurs	Lag-months	Decline Starts	S&P500 Return during Decline
Aug. 1978	19	Feb. 1980	-17.10%
Sept. 1980	3	Nov. 1980	-27.10%
Dec. 1988	20	Jul. 1990	-19.90%
Feb. 2000	2	Mar. 2000	-49.10%
Dec. 2005	23	Oct. 2007	-56.80%

So in 2 of the 5 cases, the market decline began only 2 or 3 months after inversion while in 3 of the 5 cases the decline didn't begin for 19+ months after inversion. There is simply no way to conclude anything from this data in terms of how long an investor should remain Bullishly positioned after an inversion. Getting too conservative could mean watching nice gains pass you by for nearly 2 years; while remaining too aggressive could cost you losses you don't have time to recover from if you are at or near retirement. As an investor ask yourself which is more detrimental to your financial future. The answer will vary on your particular circumstances, but you should really spend some time thinking it through.

Couple Shorter Observations

Another bit of historical data to throw in the mix is the reality that a stock market can experience double-digit sell-offs, and even Bear markets, without a recession. The 1960's were particularly notorious for this. However, generally, larger sell-offs that were not accompanied by a recession tended to recover far more quickly than those sell-offs that did occur attendant to a recession; there was more of "V-shaped" decline & recovery.

Another piece of data I watch is the size of cash positions held by the mutual fund managers who have shown the best ability to "lose less" in bad times. To summarize why I watch this, here is my explanation from my Investment Philosophy piece available at GoldenOakWM.com;

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We are also not saying that good managers saw the extent of the trouble brewing in 2000 or 2007 – most of them readily admit they did not. Rather, they were focusing on trying to find bargains. They were not trying to "time the market", they simply refused to buy things if they were not on sale. If there were fewer bargains they were content to not chase prices higher. It just so happens, not surprisingly, that if few bargains exist in the market, trouble is probably brewing. But that trouble is precisely what produces lower prices – and the good managers, because they were willing to forgo gains in an expensive market, had plenty of cash to go bargain hunting when the lower prices arrived.

Currently some of these managers' cash positions stand at nearly 30%, which signals their belief that bargains are hard to come by in today's market. They are doing some buying, but it is highly selective.

So What Does it all Mean?

Let me be brutally honest here – anything can happen. There is a reason economics is dubbed "the dismal science". Physics allows NASA to know exactly where a probe will be millions of miles away 10 years in advance because the laws of mass & gravity do not change. Economics has as its subject the most changeable and unpredictable thing known to man – himself. There is no way to predict with certainty what the markets or economy will do, and anyone who tells you different is a charlatan. There are however, signposts in the fog that we can look to in order to make educated guesses. Right now those signposts are even harder to read due to the static & noise of the motley crew of 24/7 TV talking heads incessantly filling airtime with hype and hyperbole rather than thoughtful & reasoned analysis.

My best educated guess at this point is that a recession is at least a year away and that markets will recover before it hits.

Does any of this mean that you need to rush and change your investments? No.

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If you are a long-term investor with no near-term need of the money invested and are positioned according to your time horizon & risk tolerance you may need to do absolutely nothing or perform a few minor adjustments.

An aggressive, more active investor may want to shift down a step on the risk curve and focus more on the Value side of the stock market.

If you are in or near retirement you may want to consider having a segmentation analysis done to see if breaking out your investments across multiple time-segmented & risk-tolerance segments makes sense - such a move can take the fear & bite out of large market swings.

For those in strategic allocations such as a 70/30 or 60/40 portfolio, a notch down one level may be appropriate.

Regardless your situation, please never hesitate to give me a call with any questions, concerns, or just to talk things through.

Thank You for Reading & Please Feel Free to Share,

Tom Ellis

P.S. I will be sending out two new reports soon; First, on the Probability Deception which takes on one of the financial industry's holy grails ; Second, on why the next recession could be worse than the "moderate" one expected by most economists.

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