US recession risk rising - market is not pricing this in

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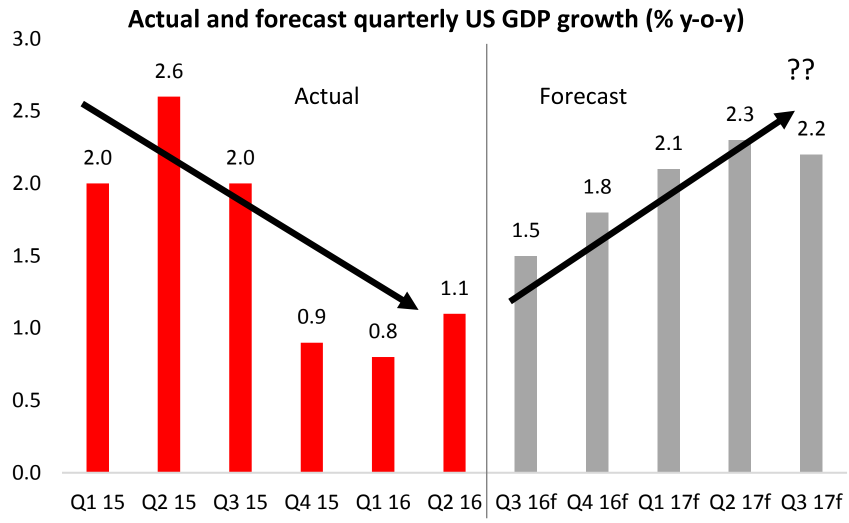
- **Economic growth in the US has been sequentially slower in recent quarters, averaging below 1% for the first half of 2016. US equities, still close to record levels are pricing in continued loose monetary policy, but not a recession. This is where the danger lies**
- **With interest rates close to zero, the choices for the Fed are to hike and risk pushing the economy into recession only to later be able to cut, or to leave rates at current levels but risk having no room for cutting when the recession does eventually arrive. Neither outcomes are positive for equities**

Intuitively many people believe that in the long-run, the relationship between economic growth and equity returns should be positive. However, most academic studies actually show the relationship to be negative, i.e. faster growing economies typically generate weaker equity returns than economies which grow more slowly. Maybe this is not so surprising as slowing economies tend to have low or falling interest rates which support equity markets. This has especially been the case post 2008-09 (in addition lots of unconventional policy). But the inverse relationship between economic growth and equity returns only works up until a point. If the economy slows so much that it goes into recession, equity returns tumble.

The reason to highlight this now is because US economic growth could in the coming year or two, turn negative. Close to record highs, US equities are clearly just pricing in a slowdown (and continued easy policy/more stimulus) but not a recession. Investors are (for the moment) happy to see weak economic data as it further delays the Federal Reserve's ability to hike interest rates. To put it another way; it is human nature to focus on the shark closest to the boat, as this presents the most immediate danger (in this case rate increases). By doing so, however, one fails to spot the danger further out (potential recession).



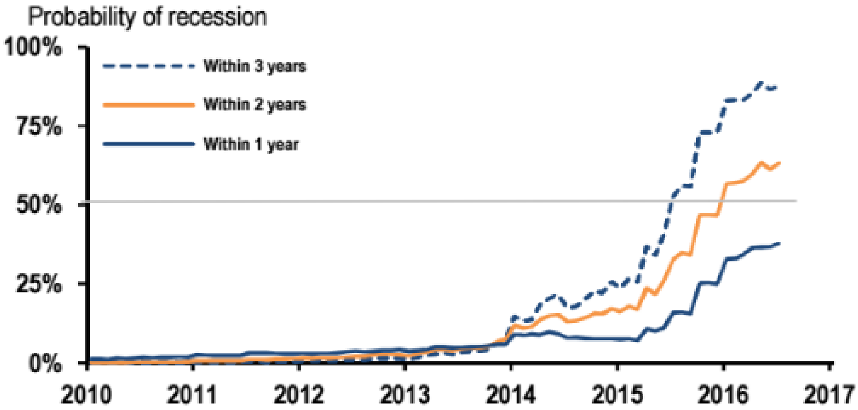
Source: Bloomberg

The above chart shows actual and forecast GDP growth for the US economy. Actual growth (red bars) has clearly been slowing; the average growth rate of the past 6, 4, and 2 quarters is 1.6%, 1.2% and 0.95% respectively. The likelihood therefore that the consensus is correct in the forecasts for growth over the coming 5 quarters (the grey bars), which average 2%, is quite low in our view.

For investors this should matter because what is most important for equity markets is not what does happen, but what happens relative to what is expected. The same can be said of the unrealistic double-digit earnings growth expectations which the consensus is currently forecasting for US equities over the next 12 months (this will be very difficult to achieve unless top-line growth accelerates substantially).

The reality is that economies move in cycles and it has already been over 7 years since the trough of the last US recession. If history is any guide, we are should be much closer to the next US recession than to the previous one. Not all market commentators share the "optimistic" outlook for US growth depicted in the above chart. A regression model from JP Morgan (see chart below taken from the FT) shows a rapidly increasing chance of a recession in the US, up to 37% probability in the next 12 months, >60% in the next 2 years and >80% in the next 3 years. This, we believe, is a fairer reflection of the macro risks in the world's largest economy, in fact, these probabilities may even have risen further in the wake of the recent sharp declines in the ISM manufacturing and non-manufacturing indices.

Figure 15: Probability of US recession from regression model



Source: NBER, BLS, CBO, BEA, J.P. Morgan

In the Investment Strategy team we have also been more worried about outlook for the US economy than most market participants. Not only because growth has been slowing but also because of the now quite limited policy tools available to the Fed to cushion the slowing economy. Although the recovery in economic growth post-financial crisis has been lacklustre, the recovery phase (post-recession) should ordinarily be characterized by a return to policy "normality" (higher interest rates), rather than only by a return to economic growth. For reference, all post-1970 US recessions have been cushioned by a (minimum of) 5 percentage point cuts in benchmark interest rates.

Interest rates have hardly risen, meaning that policy ammunition has not been replenished post the 2008-09 recession, which is why the Fed now finds itself in such a difficult position. If interest rates were already at 3% or 4% we would likely be talking about interest rate cuts given the weak environment. It is only because interest rates are close to rock bottom that rate hikes are being considered. The choices for the Fed are to hike and risk pushing the economy into recession only to later be able to cut, or to leave rates at current levels but risk having no room for cutting when the recession does eventually arrive. Neither outcomes are positive for equities.

Conclusion:

It is impossible to predict the precise moment that investors will stop celebrating economic disappointment and start fearing a recession instead. History shows that equities typically sell off sharply only when the threat of recession appears imminent. Therefore it may not happen in 2016, but with the probability of a US recession on the rise and already too high to ignore (37% chance in next 12 months according to JP Morgan), still close to record high US equity markets are pricing in very little risk, when it fact there is a lot of risk around (not least US November elections). As a result we maintain our equity underweight stance and see better opportunities in US Treasuries, gold and hard currency EM bonds.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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