# Growth Conditions Update

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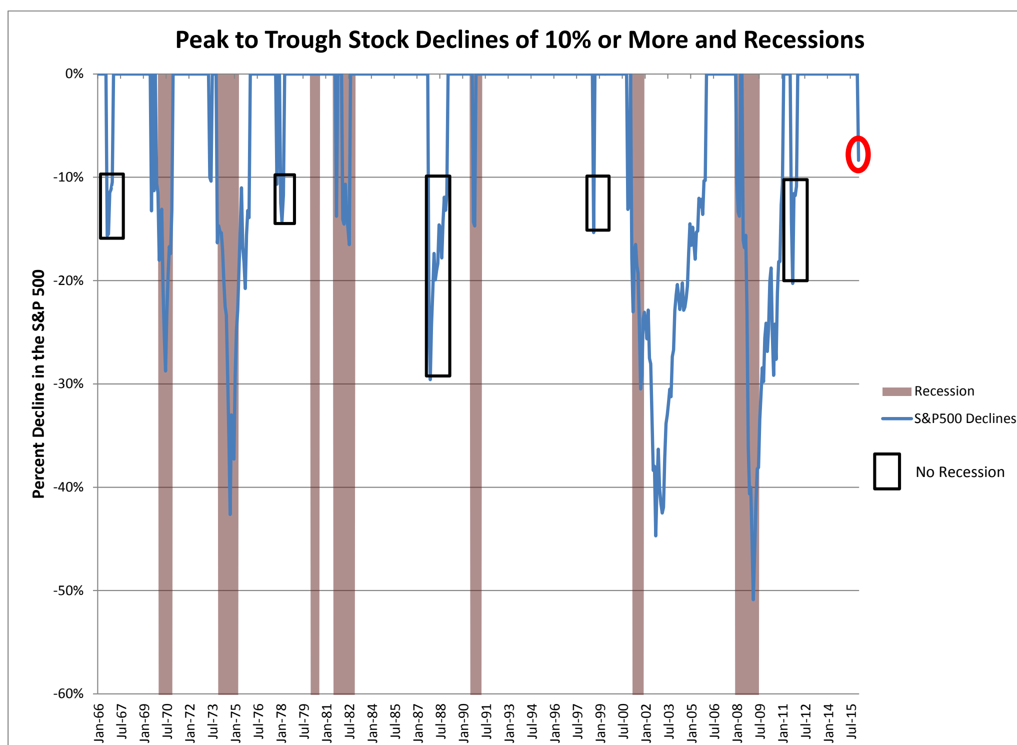
## "Wall Street indexes predicted nine of the past five recessions"

Paul Samuelson was one of the most influential economists of the later 20th century and the first American to win the Nobel Prize in economics. He also wrote a Newsweek column. The quote above is from his column on September 19, 1966. Here is the quote in context:

> *"To prove that Wall Street is an early omen of movements still to come in GNP, commentators quote economic studies alleging that market downturns predicted four of the last five recessions. That is an understatement. Wall Street indexes predicted nine out of the last five recessions! And its mistakes were beauties." –"Science and Stocks," Newsweek, September 1966*

Here is what the data looks like since that widely quoted article was published:

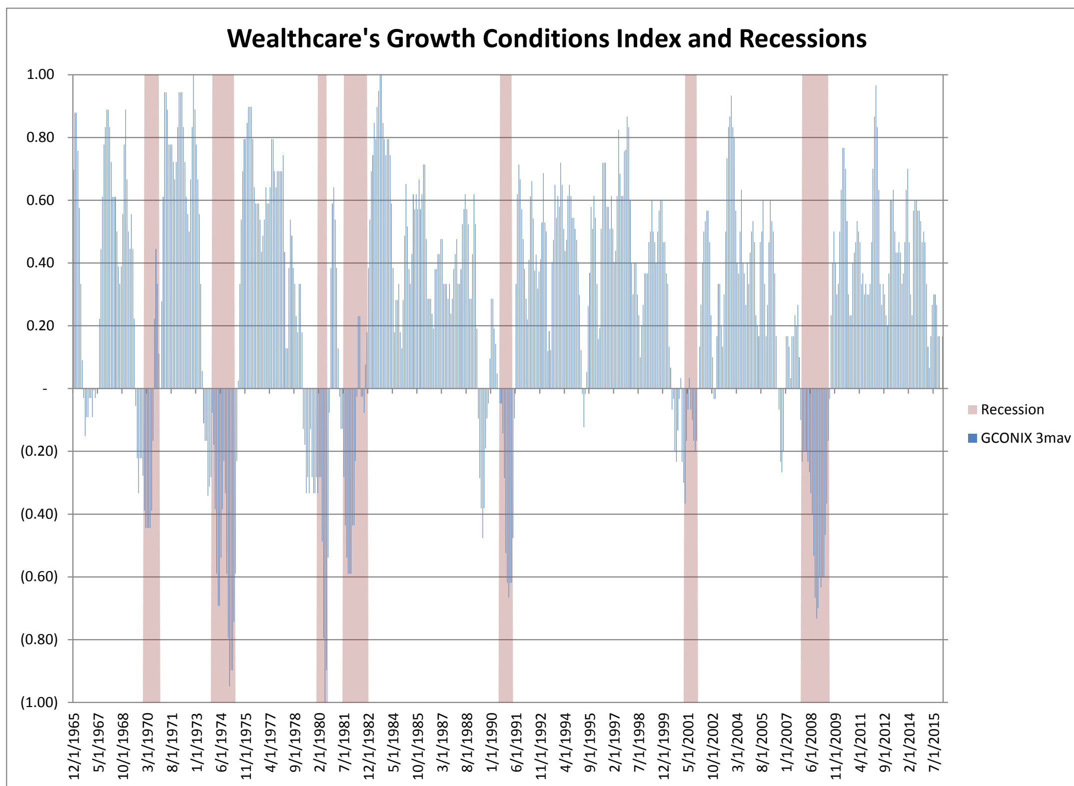



Since 1966, there were eleven times where stocks lost 10% or more using monthly data and including dividends. Of the eleven times, six closely preceded and/or coincided with a recession. The stock market "failed to predict" the 1979-80 recession, by a narrow margin. Stocks returned a minus 9.7% in March of 1980. Close enough, but it doesn't make the chart. If we add Samuelson's data to our own, stocks have predicted twenty of the past eleven recessions. So it seems, ***when the stock market has declined by more than 10%, about half the time a recession has followed.***

The most recent decline, circled in red above, did exceed 10% intra-month, but month-to-date, we are down by less after the rally over the past week. We also had a similar occurrence in August of last year. So far, no recession.

## GCONIX "predicted" nine of the past seven recessions

***GCONIX, the acronym for Wealthcare's Growth Conditions Index, has preceded and/or coincided with every U.S. recession since 1965. There were no misses, but two "false predictions" did occur*** where GCONIX fell to minus 20% or less and a recession did not closely follow. As a reminder, minus 0.2 on the Index means that 12 of the 20 GCONIX component indicators are falling and 8 are rising. For more background on GCONIX, see my September 11, 2015 article *Assessing Growth Conditions.*




***The current reading for GCONIX is a positive 17%, which is not recession territory***. The single-month reading for December was just 10% and January, with 14 of 20 indicators reported, is tilting negative. So, GCONIX is not calling for recession, but the trend in the recent data is not favorable either.

***A look at the components of GCONIX shows a decline in all real economy gauges*** – business activity, consumer/worker, and real estate. The business activity gauge has turned negative, meaning on-balance the economic indicators we track are declining for this gauge. Only government policy measures – real changes in monetary base, money supply and fiscal borrowing – improved over the fourth quarter of last year.

| | Weight | Sep-15 | Dec-15 | Change |
|---|---|---|---|---|
| Business Activity | 35% | 14% | -14% | -29% |
| Consumer/Worker | 30% | 44% | 33% | -11% |
| Real Estate | 20% | 50% | 33% | -17% |
| Policy Measures | 15% | -11% | 33% | 44% |
| GCONIX | 100% | 27% | 17% | -10% |

So, despite the rate hike in December, policy is still supportive of economic growth, but growth has been slowing.

## Policymakers Shake Confidence around the Globe

***Neither economic activity nor observed inflation suggested a need for a rate hike on December 16th. The goal of the rate hike was to begin the process of monetary policy normalization.*** The Fed had been holding the Fed Funds rate near zero for about a decade. Fed Chair Janet Yellen was quoted at the time saying "The first thing that Americans should realize is the Fed's decision today reflects our confidence in the U.S. economy." At the same time, policymakers projected a Fed Funds rate of 1.4% by the end of 2016, implying four quarter-point rate hikes over the course of 2016.

At the time of the rate hike, we wrote, "If they (the Fed) do not get the inflation increases they are expecting/targeting and the economy falters at all, then expect them to lag the forecasted rate increases." Well… it took only a month for markets to put a dent in the Fed's rate hike plans, with leading macro-oriented investment managers – Jeffrey Gundlach of DoubleLine Capital, the new bond mutual fund "king", and Ray Dalio CEO/CIO of Bridgewater Associates, the $154 billion hedge fund firm – openly calling out the Fed to not raise rates further anytime soon. To wit, Dalio is on record saying the next Fed move may indeed be more quantitative easing. Old worries have come back to the fore – deflation rather than inflation, China dragging the world into a global recession, and concerns over the debt burdens and defaults, particularly in China, oil exporting countries and oil-related industries.

***Is the rocky start to 2016 about the economic consequences of a 0.25% rate hike from a month ago? Hardly. Fed policy is still very accommodative:*** The Fed has not reduced their whopping $4.5 trillion balance sheet as bonds mature…they are reinvesting. $4.5 trillion is one-fourth the size of the U.S. economy. Before the 2008/09 financial crisis, the Fed balance sheet stood at about 20% of its current size. Short rates in the 0.25% to 0.50% range are well below both current and potential nominal growth in the economy. Short rates are also below the core personal consumption expenditures inflation rate, the Fed's preferred measure, which is currently running at about 1.3% year-over-year.

***Given that Fed policy remains growth friendly, and weakness in oil and China are not new, what has changed to cause all this market turmoil? In one word, <u>confidence.</u>*** There has been a litany of policymaker-induced doubts over the past year or so, and the cumulative effect appears to be taking hold in the market psyche. Let's take a look at the big ones:

1. ***The Fed:*** The Fed wanted the recent rate hike to symbolize putting the financial crisis mentality behind us, but it has become ***a sign that the Fed may not continue to bail out markets for misallocating capital as it has done since 2008… and there is plenty of misallocated capital*** tied to low interest rates and high oil prices.

2. ***The ECB:*** Markets thought Mario Drahgi, President of the European Central Bank, learned the lesson of the Fed's financial crisis rescue strategy – take short rates to zero and buy a lot of bonds – only to be disappointed by Mr. Draghi with ***a smaller than expected stimulus last month***. Now, he is all over the press saying he is prepared to launch additional monetary stimulus in March to address the low-growth, low-inflation environment. There is a reason for the saying, "actions speak louder than words."

3. ***China:*** Once vaunted as the growth engine of the world and the poster child for a successfully centrally-managed economy, ***Chinese leaders have mismanaged their attempted liberalization of their financial markets and their effort to transition the economy from production and export led growth to consumption and services.*** They surprised markets last year with a currency devaluation to shore up exports. They have failed in attempts to stabilize their equity markets through interventions and circuit breakers, which led their chief securities regulator to tender his resignation. The latest economic growth number at 6.9% was below expectations and with total debt in China estimated by McKinsey at $28 trillion, which is more than the U.S., there is little scope to borrow and spend their way to growth. Concerns now focus on managing the debt burden down and avoiding a rash of defaults.

4. ***Saudi Arabia:*** In late 2014, Saudi Arabia led OPEC down a new course of pumping more oil in the face of falling prices in an effort to drive out higher cost producers and assert more control over supply. However, they underestimated the resilience of shale oil producers and **oil prices have fallen by more and for longer than anyone expected. Shale oil technology has fundamentally altered the dynamics of the oil industry.** While the Saudis remain the low-cost producers, and higher-cost producers will eventually be forced out, the financial stress on the Saudis, as well as other OPEC countries, is significant. They have come to rely on oil revenues for government finances and the fiscal breakeven oil price is much higher than the cost of production. According to the *Wall Street*

*Journal*, “Many oil producers need $80 a barrel to balance their national budgets.  Yet industry experts at RBN Energy foresee vast swaths of American shale profitable at just north of $40 a barrel. And it can come online extremely quickly.”  This implies a couple of things:

- When the oil price does start to recover, it will likely be a muted slow moving price rise
- Business models, debt issued and government finances based on an assumption of $80+ per barrel will be under pressure for quite some time.  This is where the misallocated capital is.

The drop in oil price is ultimately stimulative to world economic growth.  However, the extremity of the price drop will create bumps in terms of some companies failing or doing a forced restructuring.   The process of allowing companies to fail is ultimately healthy, and a stronger domestic oil industry will emerge from the rubble.  However, government finances that are under the pressure from low oil prices have a social cost that may lead to more political instability in oil-dependent countries.  In addition to oil price-induced financial stress, debt incurred by developing countries on the presumption of continued low interest rates will test the Fed’s ability and resolve to walk away from being a backstop for misallocated capital… its plan to keep its balance sheet at $4.5 trillion suggests it is not ready to walk away, and it is just a short step to increase it.

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We can’t control the evolution of market confidence and psychology.  We can only observe it, pay attention to the fundamentals, and manage risk in our goals-based portfolios and financial plans as prudently and effectively as we know how. Rest assured that we will continue to do so on your behalf using our patented goals-driven process.

*Data sources include Bloomberg, MPI Stylus and Wealthcare.*
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