



SPECIAL COMMENTARY
Investment Advisory Group

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Recession Watch: Risks Remain Low

- With the current US business cycle extended from a historical perspective, some investors are concerned about heightened recession risks.
- Our SunTrust Leading Indicator Composite (SLIC), however, places near-term recession risks at only 20%, which is still relatively low by historical standards.
- While there are risks we are monitoring, such as the flatter yield curve and tighter monetary policy, the weight of the evidence suggests the expansion has further to go and is set to challenge the longest in history.

Is a Recession Imminent?

With the US business cycle approaching its ninth year of expansion—the second longest in history—some investors are asking when the next recession will occur. Chief among those concerns is the flattening yield curve (the spread between long- and short-term US Treasury yields), which is currently at its narrowest level since December 2007. Likewise, tighter monetary policy has also coincided with recessions in the past.

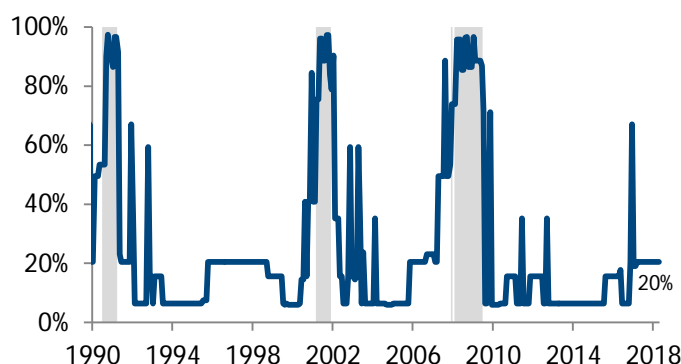
Before we address these concerns, we acknowledge that predicting turning points in the economic cycle is extremely difficult. Thus, we monitor economic and market factors that have *historically* been associated with downturns in the economy.

We developed a proprietary tool—the SunTrust Leading Indicator Composite (SLIC). It is used to track the likelihood of a recession over the next several quarters based on various economic and market factors, including leading economic indicators, employment trends, interest rates and crude oil prices.

The indicator is useful in identifying turning points in the cycle. For instance, prior to the last three recessions, a 50% probability of recession was triggered, on average, five months prior to the actual start of the recession. By the time the recession began, our work showed an

average 70% probability of recession. Currently, the SLIC indicator shows a 20% likelihood of a recession near term, still relatively low by historical standards.

SLIC Recession Risk Indicator
(Probability of Recession)



Source: SunTrust IAG, BCA, Haver

Current Economic Conditions

One of the key factors that we monitor, the Conference Board's Index of Leading Economic Indicators—which gauges a range of manufacturing activity, labor trends and consumer expectations—is at its best level in a decade. It has historically peaked an average of 17 months ahead of the past three recessions.



Additionally, US payroll trends, another key factor, still remain firm. The unemployment rate is at a cycle low, weekly jobless claims hover near a 45-year low, and wages are rising. Retail sales, moreover, are improving, while housing and manufacturing activity also remain stable. These trends will likely continue in the coming quarters.

Fiscal stimulus, additional government spending, and a pickup in capital investment should help lift 2018 US growth above 3%, which would exceed the fastest pace of this recovery. Thus, the current expansion is not currently showing any signs of easing.

Things SLIC Flagged That Are Worth Watching

However, the chance of recession has increased from where we were nearly two years ago, entirely driven by the actions of the Federal Reserve (Fed), which has been raising the federal funds target rate. Historically, Fed rate hikes typically coincide with recessions, the onset of which occurred about a year or so *after* the end of the tightening cycle.

The Fed has raised rates seven times in the past two-and-a-half years for a combined total of 1.75%. That is the slowest and shallowest Fed tightening cycle in the past 30 years, especially compared to 17 straight increases from 2004 to 2006 totaling 4.25%. The Fed will maintain its gradual pace of normalization, expecting two additional quarter-point rate hikes in 2018 and perhaps three in 2019. Thus, this tightening cycle does not appear to have an end any time soon.

Another issue of wide concern is the flattening yield curve, which is the yield spread between 10-year and 3-month US Treasuries. Under normal conditions, the curve is upward sloping. When the 3-month Treasury yield is higher than 10-year yield, this is known as an inverted yield curve.

Historically an inverted yield curve has coincided with past recessions, occurring roughly 13 months on average *before* the start of the recession. The yield curve is currently flat, a condition that can persist for years. It has been flat for the past two years and was also relatively flat during the strong economic environment from 1995 to 2000. This is worth monitoring but, at this time, does not imply an imminent recession.

Given the dynamism of the US economy, however, and the realization that *new* factors can come into play leading up to the next recession, we also regularly complement SLIC with short-term trend analyses of other areas of the economy and markets that could foretell changes in some of our key indicators, such as credit, housing, market based-signals and financial conditions.

We also acknowledge that tariffs do represent a risk to global growth. However, a reciprocal response from China to the US move last Friday of a 25% tariff on \$50 billion worth of Chinese goods, along with any tariffs on steel and aluminum products, would still only be a 0.1% hit to US real GDP—in other words, the impact on the US economy would be fairly small.

Bottom Line

Despite being the second longest recovery in history, the weight of the evidence suggests the expansion has further to go and is set to challenge the longest in history.

Furthermore, with US recession risks low, we maintain a portfolio risk posture slightly above neutral, with a bias toward equity. We expect business activity to continue on its growth pace and improve over the next couple of quarters as the effects of stimulus kick in. While geopolitical risks, Fed policy and upcoming elections are likely to sway markets in the near term, the fundamentals of the economy continue to remain solid.



Appendix: Causes of Past Recessions

Recessions have generally been triggered by one or more causes. Usually there is some sort of imbalance or asset bubble, such as the housing bubble of the Great Recession, the Savings & Loan Crisis in the 1990s, and the dot com craze in the early 2000s, which starved the rest of the economy in favor of all-things-dot-com. Another cause is an external shock, such as a war (i.e., Korean War, Gulf War I) or policy missteps as was the case with wage and price controls during the early 1970s, and dramatically increased tariffs in 1930.

Often those imbalances instigate a stock market sell-off, though we would argue that bear markets are a symptom of the imbalances rather than a cause of recessions.

Most recessions are exacerbated by the actions taken trying to correct imbalances, such as inflation or asset bubbles. The most common example is increasing interest rates, which has fomented the myth that the Fed *causes* recessions by raising interest rates. We disagree.

Although the Fed controls overnight rates, interest rates are controlled by markets. Alas, the Fed merely reacts to market circumstances, which feeds another myth that the Fed is always behind the curve (e.g., raising rates too slowly). Indeed, the Fed can get the timing wrong, but cannot be both reactionary and causative.

Lastly, with respect to the question of length, expansions do not die of old age.



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