# TURNER INVESTMENTS COMMENTARY

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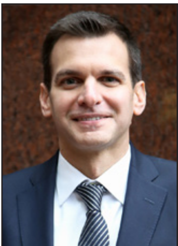

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## RECESSIONS AND BEAR MARKETS: ASSESSING THE ODDS

*Fear makes the wolf bigger than he is.*

*- German proverb*

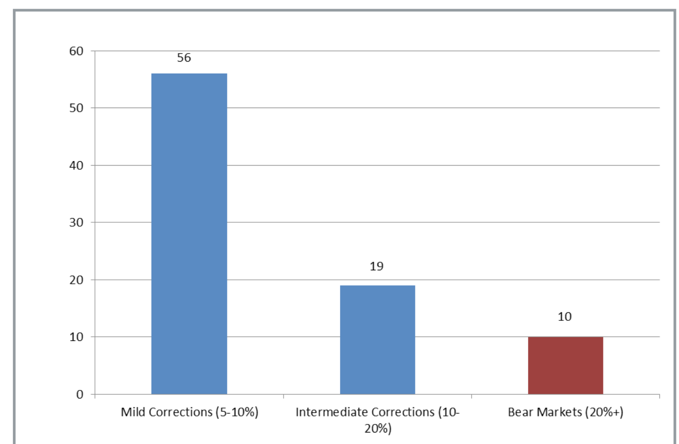
### CORRECTIONS ARE NORMAL

One of the questions we're most frequently asked is "Will the market pull back this year?" We expect it likely will, though we also expect it to quickly resume its uptrend. The follow-up question is almost always "Is a bear market coming soon?" This, we believe, is highly unlikely.

It's important for our clients to remember two things: 1) by market pullback or correction we're referring to *equity* market weakness. And we have *not* built an equity-only portfolio for our clients — we have built a balanced, globally diversified portfolio with multiple asset classes. So our client portfolios, in all likelihood, will decline much, much less if equity markets were to correct; And 2) equity market corrections are a normal and necessary part of overall bull-market cycles. They occur frequently and very seldom lead to full-fledged bear markets. For example, in the US since 1945 there have been 75 mild (an equity market drop of 5–10%) to intermediate (10–20%) corrections, but only 10 bear markets (20%+ declines). In other words, there's only about a 12% chance that any given correction will lead to a bear market, or put another way, an 88% chance that the bull-market cycle will simply continue its uptrend after a pause.

**Number of S&P 500 Corrections and Bear Markets Since 1945:**

**Corrections Very Seldom Lead to Bear Markets**




Source: RBC

## RECESSIONS AND BEAR MARKETS

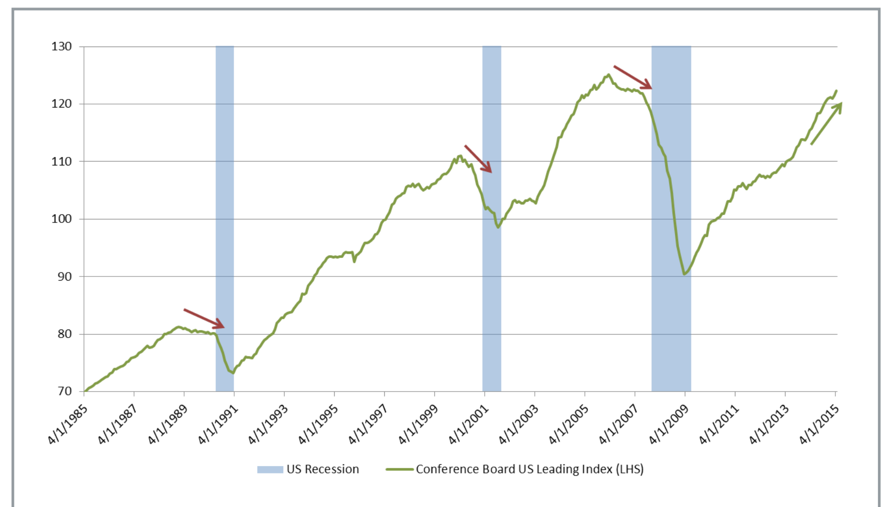
Corrections are virtually impossible to react to. The duration, peak to trough, of a mild correction, for example, is only one month on average. Bear markets, however, average 18 months in duration and because they are so devastating—the average decline for S&P 500 bear markets since 1945 is 35%—it's important to determine what causes one. Almost always it's a recession or at least the prospect of a recession (let's call it a "looming recession"). Like bear markets, recessions are rare. In the US, which, of course, sets the economic table for the entire world and certainly for Canada, there have been only 12 recessions in the past 70 years. US recessions are determined by the National Bureau of Economic Research (NBER) and it actually guards against revealing the specific criteria used to determine one, defining it simply as "a significant decline in economic activity". (Note that the standard definition of a recession—two consecutive quarters of decline in real GDP—actually doesn't apply to NBER's definition.) Therefore economists examine many aspects of the economy in order to attempt to accurately predict recessions. These include labour market conditions, industrial production, retail sales, trade data, corporate profits, consumer sentiment and equity markets to name but a few.

At Turner Investments, we focus on four main data points and find that each is highly predictive of upcoming recessions: US leading economic indicators, the US unemployment rate, the US Treasury yield curve (specifically an inverted yield curve, which we'll explain below) and simple GDP growth trends. Naturally, if these indicators were showing significant softness, it would allow us time to reposition portfolios and potentially reduce some of the damaging fallout. However, none of these indicators are signalling a recession and, in fact, they are all suggesting further economic expansion.

### *US Leading Indicators*

This is perhaps the most holistic approach to predicting an economic downturn as the Conference Board US Leading Indicators Index combines 10 different economic variables ranging from building permits to manufacturing levels. While the latest Index data (March) was slightly soft, there has not been the prolonged downtrend, or "rolling over", of this index that typically occurs prior to a recession (see chart).

**A Downturn in Leading Indicators Occurs Prior to a Recession:**
**Current Leading Indicators are Signalling No Danger**



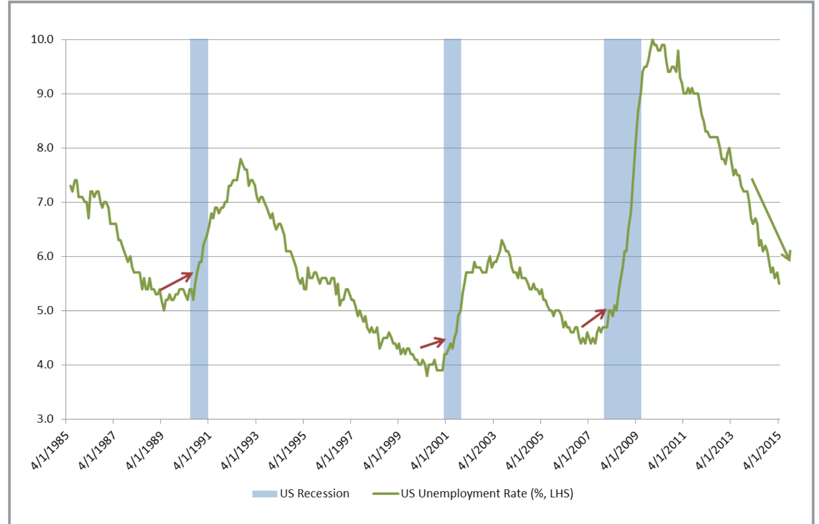

Source: Bloomberg, Raymond James Ltd.

## *Unemployment Rate*

There is also almost always a move higher, or at least a moderation, in the US unemployment rate prior to a recession. This occurred before each of the last three recessions, for example (see chart). Currently, there has been no change in the US unemployment-rate trend as the rate has moved steadily lower from 10% at the heart of the credit crisis to only 5.4% in April 2015. US Non-Farm Payrolls, another key labour market statistic, which not only set the tone for the current US economy but are also predictive of future economic growth, have been exceptionally strong. Non-Farm Payrolls have been above 200,000 for 14 of the past 15 months. Compare this to 2009 when they were negative every month for the entire year. The bottom line is that the US labour market remains very healthy.

**A Moderation or Steady Uptick in the Unemployment Rate Occurs Prior to a Recession:**

**The Current Unemployment Rate is Signalling No Danger**




Source: Bloomberg, Raymond James Ltd.

## *An Inverted Yield Curve*

An inverted yield curve occurs when yields on short-term bonds are higher than yields on long-term bonds. This occurs rarely as investors normally expect a lower return when their money is tied up for a shorter time period and a higher return if it's tied up for longer. However, all this can change when it's perceived central banks will begin lowering interest rates to support a weak economy. When this perception occurs, demand can get disproportionately weaker for short-term bonds (moving their yields higher) and stronger for long-term bonds (moving their yields lower). Simply put, if investors anticipate a weaker economy, they don't want to hold short-term bonds that they're soon going to have to roll into new bonds with lower yields.

**An Inverted Yield Curve Precedes Recessions:**
**The Current US 10-year/2-year Yield Spread is Signalling No Danger**

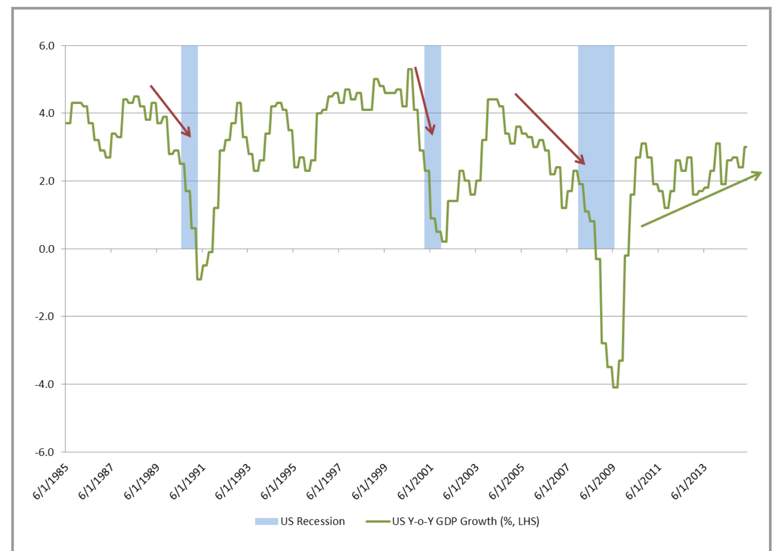
Source: Bloomberg, Raymond James Ltd.

A yield curve inversion usually takes place about 12–18 months before the start of a recession and an inverted yield curve has correctly predicted seven out of the past seven US recessions. Economists often look simply at the spread between the US 10-year Treasury yield and the US 2-year Treasury yield as a proxy for the yield curve. Again, the chart above indicates that this spread has moved into negative territory (an inversion) prior to each of the past three recessions. Currently, the spread is firmly positive indicating no recession danger.

## *GDP Growth*

The final factor, and admittedly the least precise "early warning" indicator, is simply GDP growth. However, GDP growth must still be examined because, after all, it is the best general measure of a region's economic health. Steadily falling GDP growth rates, or a particularly sharp and sudden decline, can often indicate a looming recession and should be a clear danger sign for investors. Declines in GDP growth rates act as a kind of final warning of a potential market downturn. Once again, no recession danger is currently indicated as annual y-o-y US GDP growth sits at 3%. Growth is slower now than the historical norms of other expansionary periods but still solid. It has also been in a steady uptrend for several years.

**GDP Growth not the Most Reliable Recession Indicator, But it too is Signalling Little Danger**

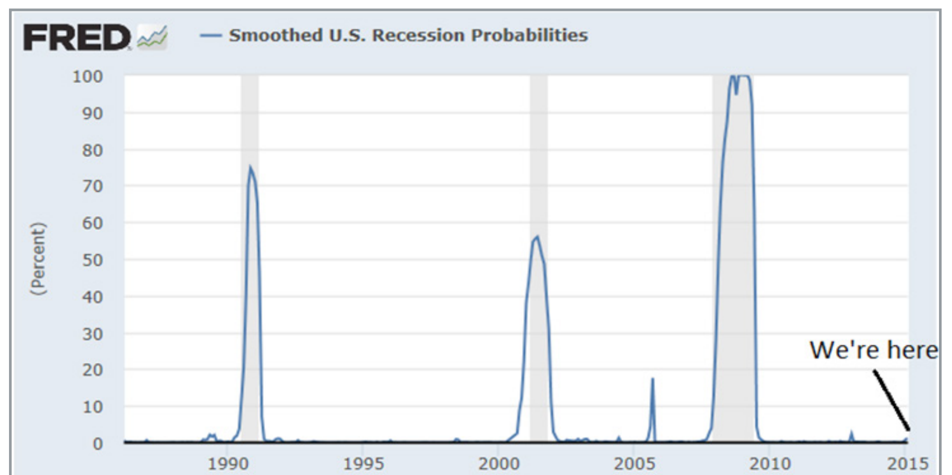



Source: Bloomberg, Raymond James Ltd.

## *Right Said FRED (Federal Reserve Economic Data)*

Though it's not specifically one of our four key economic data points, it's worth mentioning the recession indicators presented by the Federal Reserve Bank of St. Louis, one of the satellite institutions of the larger US Federal Reserve. The Federal Reserve Bank of St. Louis' indicators also forecast an extremely low likelihood of recession. As the chart to the right indicates, only when the probability rises above 20% are the prospects of

**US Federal Reserve Data Indicating Little Recession Danger**




Source: Federal Reserve Bank of St. Louis, Raymond James Ltd.

an economic contraction concerning. Further, often this indicator rises to the high teens then quickly retreats with no recession occurring. Right now the probability indicator sits at only 1.2%.

## *Keep Calm and Carry On*

So if a US recession is highly unlikely in the coming year (at this point occurring only, in our view, as a result of an unforeseen external event such as a geopolitical crisis), we therefore view a US bear market as unlikely as well. We could see an equity market correction, but would view this as simply a normal part of an ongoing bull-market cycle. Equity markets cannot ascend in an uninterrupted straight line and there will inevitably be pullbacks—these are healthy and help protect against bubble formations, which can cause even worse and more sudden declines further down the road. So, will there be market weakness at some point this year? Likely, but keep it in perspective, don't assume the worst and be confident that your portfolio has been designed to control much of the ensuing volatility. Fear is normal, but the data doesn't currently justify it. For now, the wolf you think you see is actually just a pup.

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