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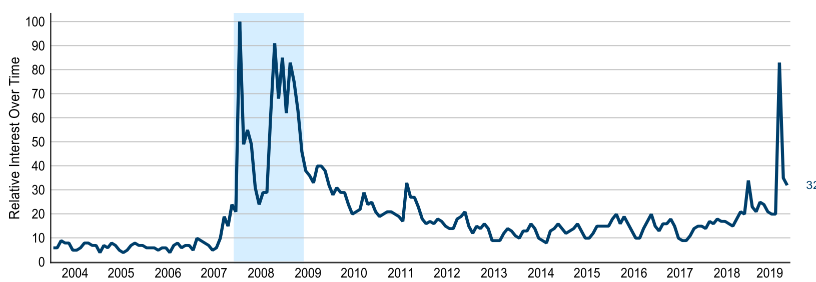
RECESSION INDICATORS COME IN MANY FLAVORS

With the Federal Reserve having put three interest rate cuts on the books this year, indications are for a hard pause.

As the current recovery enters its tenth year, it is natural to ask how long it can continue. The prospect of a U.S. recession has been on the mind of investors for most of this year, peaking this summer, as indicated by a Google trend search on the word “recession”. The spike in August was largely driven by an inversion in the U.S. Treasury bond yield curve, considered by some as a leading indicator of economic recession. It is important to keep in mind, however, that the yield curve is one of several indicators, and a somewhat simplified measure in many ways.

Exhibit 1: Google trends: search term “recession”



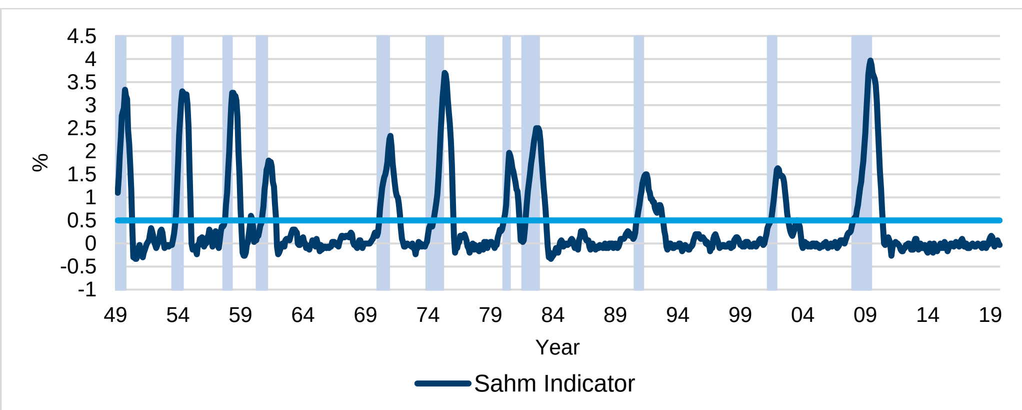
Source: Macrobond and Columbia Threadneedle Investments

The yield curve inversion in August, coupled with the slowdown in economic growth during the third quarter, raised concerns in the financial markets and long-term yields reached an all-time low. Fears of recession were amplified in September, as the Institute of Supply Management’s purchasing managers’ index—a key gauge of U.S. manufacturing activity—fell sharply, and there was pronounced weakness in capital expenditure. There was no doubt that the U.S. economy was slowing down. But was it going into recession?

A large part of the recent discourse on recession has been driven by the shape and behavior of the yield curve. An inverted yield curve, which first appeared earlier this year in some segments of the bond market, is viewed as a harbinger of recession. (Please refer to, *Yield Curve Inverts – Is Recession Around the Corner?*) On a small number of prior occasions, factors other than recessions had a hand in creating yield curve inversions. (Remember that a curve inversion means that shorter dated maturities have a higher yield than the longer-dated maturity and can occur in various maturity pairings.) In our view, the recent inversions were the result of global economic stress originating in Europe and China and the subsequent demand for safe-haven assets such as government bonds. To put it another way: the yield curve inversions were not a reflection of economic conditions within the U.S. Indeed, growth has been in the range 2.0–2.5% so far this year.

Given the propensity for this type of false positive recession signal, what can investors look to? In our own work, we prefer broader gauges to evaluate recession risk, including measures of manufacturing activity, industrial production, consumer health, labor market, housing, monetary measures, and financial indicators. These are part of the range of indicators that flash warning signs prior to the National Bureau of Economic Research's (NBER) official determination of a recession. While we have our own preferences, others look to the widening of credit spreads in bond markets to see whether the cost of capital is rising to levels that could stifle growth. Some follow labor market indicators such as that advocated by Claudia Sahm *("Direct Stimulus Payments to Individuals", Claudia Sahm, Board of Governors of the Federal Reserve System*) as the most important measure. Her indicator measures the rise in the unemployment rate relative to its prior 12-month low.

Exhibit 2: Sahm real-time unemployment rate recession indicator

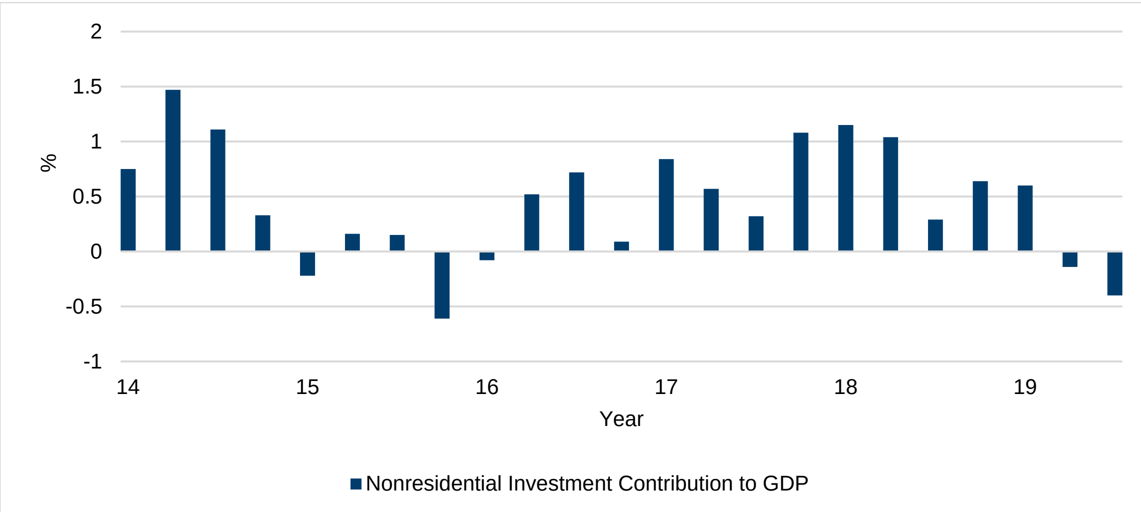


Source: St. Louis Federal Reserve, NBER, Columbia Threadneedle Investments

A 0.50% or more change in the three-month moving average of the unemployment rate versus the low is an indicator of recession—and would be a trigger for fiscal policy stimulus. As seen in the chart above, this indicator has not only correctly signaled a recession, but has also never called a recession incorrectly since 1970. In contrast, NBER often identifies a recession nearly a year after it's underway. This indicator is currently not moving meaningfully toward the 0.50% point.

Besides the yield curve-based models, such as the NY Fed's recession probability estimate, or labor market data, such as the Sahm Indicator, indicators that focus on broad-based economic data currently suggest lower odds of a recession. The Columbia Threadneedle recession probability estimate, which takes into account a number of inputs, suggests lower odds of a recession than that indicated by the yield curve only. There are pockets of concern driven by weakness in the manufacturing sector, which has translated into weakness in capital expenditure (capex). This has been a drag on U.S. economic growth for the past six months.

Exhibit 4: Nonresidential investment contribution to GDP



Source: Bureau of Economic Analysis, Columbia Threadneedle Investments

The inversion in the yield curve captured the bond market's uncertainty about global economic growth and the changes to U.S. trade policy. Some of this weakness also showed up in lowered capital spending in the past two quarters of U.S. growth data. However, broader measures of the economy and the markets suggest that odds of a recession in the next 12 months are elevated—near 20%—but are not as high as suggested by the simplistic yield-curve-based models.

For asset managers, timing the precise onset of a recession is difficult, and perhaps meaningless. Leading indicators will show a slowing economy well in advance of the "official" recession start date. However, there are ways to mitigate portfolio risk using probabilistic methods to determine if recession risks are rising, indicating a need to shift portfolio composition.

Past performance does not guarantee future results.

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