Environment Update

Environment ripe for volatility

The main takeaway from our meetings with institutional and individual investors in the UK last week was the level of bewilderment as to how the US markets have been able to decouple from the political drama in Washington. The president’s approval rating remains historically low, yet the equity markets, confidence, and manufacturing sentiment are at a cycle high. This solid confidence remains despite the almost certain Fed rate hike later this month, near inversion of the yield curve, and coming mid-term elections. There is no doubt these potentially disruptive influences could cause increased volatility in the weeks ahead given the move to new highs and drop in volatility, but the data and history show that any pullback – no matter how nasty – should prove temporary.

It isn’t magic. The one market fact that has again been proven true in the current cycle is that recessions do not magically show up. They are created by deterioration in credit that causes consumer and business confidence to significantly worsen, which leads to negative economic activity, and ultimately a sustained drop in earnings. Again proving “it is NOT different this time,” during the past nine years, we have seen a European debt crisis (2011-12), an Emerging Economy commodity collapse (2014-15), a “Brexit” vote and Trump victory (2016), and yet no sign of an outright recession in the US. Throughout all these disruptive events, credit stress as measured by the Chicago Fed NFCI sub-indices shows there has been no period of credit stress broad enough to shut down economic activity (Figure 1). It is hard to have a credit-crisis-driven recession absent real signs of credit stress.

The environment lets us know when sustainable problems are approaching. While many try to figure out the elusive “level” of interest rates that would cause a shutdown of credit, we believe it is more important to identify the “conditions,” or indicators, that offer a guide to when it might be approaching.

• Inversion of the yield curve. As we have highlighted over recent years, the best indicator for an ultimate recession over the past seven cycles is an inversion of the YC. If you look at periods of relatively benign inflation (1960s, 1980s, 1990s, 2000s), the median lead time to recession is 31 months (Figure 2). Many have suggested the YC may not work as a recession indicator due to the impact of Quantitative Easing; but, in a research paper the San Francisco Fed found it should be no different this cycle. The paper is well worth the read.

• Fed sr. loan officer survey. Each quarter, the Fed asks the banks whether they are “tightening” or “easing” their lending standards. In the most recent survey, the Fed found that despite one of the longest economic expansions in history, banks actually eased their lending standards to both small and large businesses (Figure 3). According to the Fed, “almost all domestic banks that reportedly eased standards or terms on C&I loans over the past three months cited increased competition from other lenders as a reason for easing. In addition, significant fractions of banks mentioned a more favorable or less uncertain economic outlook, increased tolerance for risk, and increased liquidity in the secondary market for these loans as important reasons for easing.”
• **Small Business confidence.** The NFIB Small Business Optimism Index (NFIB), which is likely the broadest measure of sentiment among small business owners, recently made a new cycle and record high (Figure 4). This clearly is a result of the expectations of a more business-friendly environment following the Republican sweep in the 2016 election. We found the cycle peak in the NFIB leads recession by a median 41 months.

• **Manufacturing optimism.** The ISM Manufacturing Survey (ISM) has measured sentiment at the manufacturing level since 1950, and in the most recent release hit a cycle high (Figure 5). We found a cycle peak in the ISM leads recession by 31.5 months.

**Summary – Approaching a possible “pop-up” thunderstorm.** In our September Picture Book, we noted that a positive fundamental backdrop can be interrupted with the temporary periods of volatility. We expect increased likelihood of one of those periods as we approach 1) increased trade war rhetoric with Canada and China, 2) the likely September 26 FOMC rate hike, and 3) the heightened political drama of the US mid-term elections. The market has made a move to record highs and volatility as measured by the CBOE Volatility Index (VIX) is again dropping toward the cycle lows, and that opens the door for news-driven pullbacks. That said, we believe the weight of the fundamental evidence suggests buying any weakness until there is an identifiable recession in sight, which appears to still be at least two years away.
Figure 1: It is hard to have a credit crisis without a huge pickup in credit stress

![Graph showing National Financial Conditions Index (NFCI) Subindexes with emphasis on recessions and credit stress]

Every recession has been preceded by Risk, Credit and Leverage indices over zero.

Source: www.nber.org / Canaccord Genuity

Figure 2: The Yield Curve suggests recession is 20 months away from initial inversion

![Graph showing US Treasury 10-year - 2 year Yield Spread Monthly chart with emphasis on yield curve inversion and recession]

Source: Bloomberg / Canaccord Genuity

17 September 2018
Figure 3: Fed’s Sr. Loan Officer Survey shows C&I lending standards still easing

Source: www.nrd.com / Canaccord Genuity

Figure 4: NFIB Small Business Confidence peak leads recession by 41 months

Source: www.nfd.com / Canaccord Genuity

Figure 5: ISM Manufacturing Survey peak leads recession by 31 months

Source: www.nrd.com / Canaccord Genuity
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Date and time of first dissemination: September 17, 2018, 05:32 ET
Date and time of production: September 17, 2018, 05:32 ET

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**Global Stock Ratings (as of 09/17/18)**

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*Total includes stocks that are Under Review

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