Daily Note

THE 20/20 RECESSION

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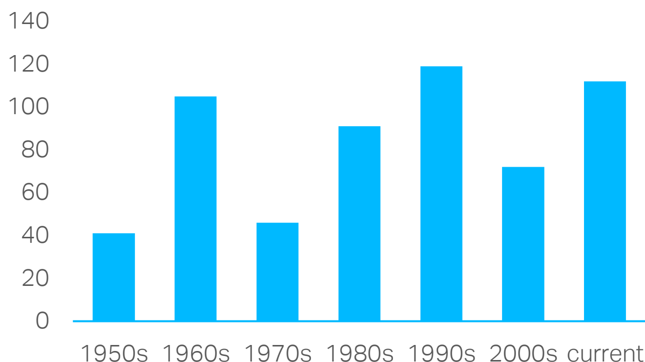
- **Most of the sellside is talking about a global recession in 2020**
- **Usually they blame the Fed, which apparently can't see the 'obvious'**
- **Trade wars are a threat but the long expansion could continue**

There are three rules to sellside macro (none of which is "don't talk about sellside macro"): 1) The 40% rule. If you want to make a big non-consensus splash but are worried the thing you're predicting won't happen, give it a 40% probability. 40% is big enough to grab people's attention but still provides a built-in escape clause. 2) The 0.3% rule. If something unexpected happens in the world (hurricanes, rising yields or a spike in oil) and somebody asks what impact it will have on the economy, say it will cut GDP by 0.3%pts. Some of our competitors crunch huge econometric models that always come up with this exact answer. 3) The t+18 rules. If you like forecasting recessions, you can always say the next one is 18 months away. If the boom continues, people will forget (you can always push your forecast back) but if the economy suddenly deteriorates, you'll be a hero (of sorts). Clearly I'm joking about these rules, but I have found it surprising how many people in the industry are predicting a 2020 recession. I guess it gives them plenty of time to change their minds, or be proved 'right' earlier than they expected.

'The 2020 recession' (formerly known as 'the 2019 recession' and once 'the 2016 recession') isn't totally implausible. By then, the US expansion would have lasted longer than any other in modern history, not that age is an important feature. Financial markets are already looking choppier and risks are mounting. But the downturn I keep reading about in rival publications – not that you should ever read rival publications – always blames Jerome Powell and his colleagues at the Federal Reserve for not being particularly smart, unable to see something that is blindingly obvious to every sellside macro guru. Bascially it seems everyone is forecasting a Fed policy error. Officials will focus on backward looking inflation data and because the lags from monetary

US economic expansions

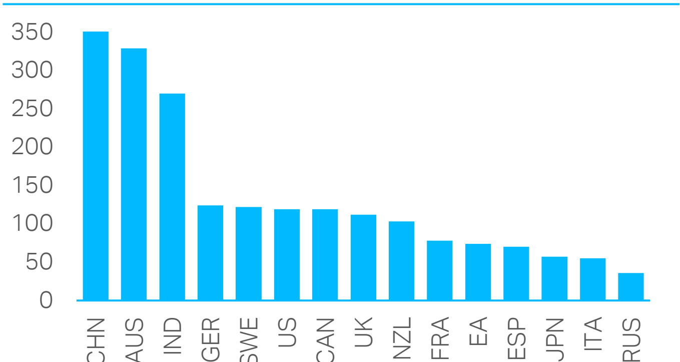
duration in months



Source: NBER, TS Lombard

Length of the current expansion

duration in months



Source: ECRI, TS Lombard,

tightening are notriously long and variable, they will just keep raising interest rates until the economy suddenly cracks. Even an inverted curve won't discourage the central bank because officials are sure to think up lots of clever technical reasons why the yield signal is "distorted". After all, in the battle of the curves, the Federal Reserve surely puts more weight on the fictitious Phillips variety rather than on the bond market's (proven) ability to predict interest-rate swings .

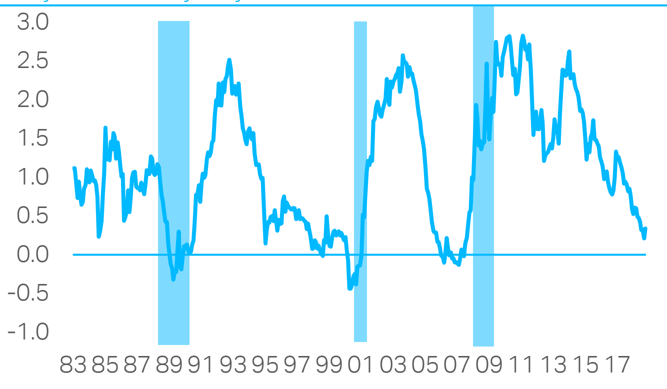
To be fair to the Recession TwentyTwentiers, this is a mistake Fed officials have made lots of times in the past. They always overtighten and they always ignore an inverted yield curve. But it would surely be monumentally silly to make this same mistake again, particularly when the whole industry is saying this is exactly what they are going to do. Plus it would be an amazing act of self-belief to hike through an inversion, displaying a confidence that isn't justified on the basis of the Fed's post-2009 forecasting record. To continue to put so much faith in the Phillips curve, after ~~years~~ decades of misleading signals, would really be an impressive feat. And that's before we even get into the issue of r* models being totally useless in practical terms. (By the way, Mr Laubach and Mr Williams, creators of everyone's favourite r* model have just totally revised their estimates, re-writing recent macro history). Isn't it more likely the FOMC will only raise interest rates as far as the market allows them, trying to avoid inversion at all costs? Put another way, perhaps the US bond market is now setting monetary policy, not officials at the Federal Reserve.

So if the Fed avoids the error the whole industry expects them to make, can we still forecast a 2020 recession? The global expansion has lasted a long time, sure, but mainly because it has also been so weak and unsatisfactory by historical standards. It took ten years for the US economy to hit full employment ("mid-cycle"), while many other nations are yet to achieve this goal. If growth remains lacklustre, why should inflation suddenly take off? All we can really do is look for late cycle markers, which are traditionally i) accelerating inflation; 2) a squeeze on corporate profits; 3) tight monetary policy; and 4) macroeconomic 'imbalances', such as asset-bubbles, overinvestment, excessive borrowing and insufficient saving. While some of these indicators provide food-for-thought (e.g. US corporate debt), none of them is compellingly bearish. By all means, watch for new imbalances, but don't assume a recession is imminent.

The factor most likely to cause a recession within the next two years is the one thing most economists are assuming away – international trade wars. As our strategy team points out, financial markets are not particularly good at discounting political risk. If tensions escalate and markets hit a sudden tipping point, the world economy would suffer. And probably the odds of such an outcome are above 30%, with a likely impact larger than 0.3%pts off GDP (wink, wink).

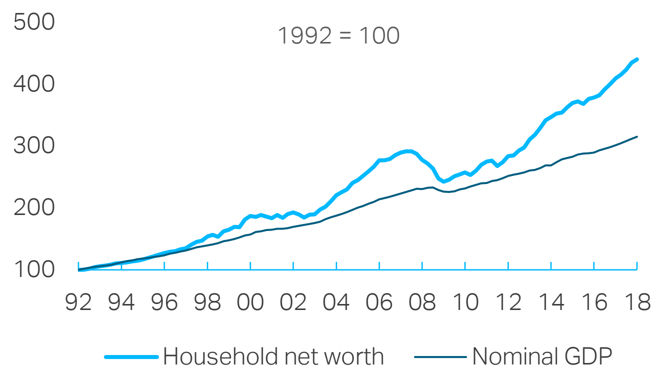
Flattening yield curve

10 year minus 2 year yield



Source: Bloomberg

US asset price risk



Source: Federal Reserve, TS Lombard