Ready for Recession: It's Inevitable, But is it Imminent?

Recession fears are gripping financial markets, but not every type of investor feels the exact same way about the risks at hand. Andy Kochar, AGF's head of credit, and Mike Archibald, an associate portfolio manager of equities, give their perspectives on the current economic climate and what's at stake for their respective asset classes.

Questions and answers that follow have been edited for clarity and length.

By Andy Kochar and Mike Archibald

A global recession may be inevitable but is it imminent?

Andy Kochar (AK): It's extremely difficult if not impossible to call a recession. Instead one must look at various parts of the market for signals for better direction. As it stands today, there are parts of the bond market such as the [U.S. Treasury] yield curve, which recently inverted, that does give the sense that we are very much in the later stages of an extremely prolonged cycle, if not at the end of it. For the record, this is the longest economic expansion since 1851. Having said that, there are certain developments that we are witnessing at the moment that may be sowing the seeds of prosperity some in the second half of 2020.

Mike Archibald (MA): To my eye, the bond market is pricing in a much greater likelihood of recession than the stock market, which is giving off more off more of a mixed signal at the moment. While some of the underlying trends are concerning, others are more encouraging.

AK: Bond investors, broadly speaking, consider capital preservation as a key focus prior to any upside opportunities given the asymmetric matrix of risk/return opportunities. That is also true for corporate credit. Capital preservation and risk management is especially key this late in the cycle.

MA: Everything we do these days absolutely takes in to account the downside potential of the market because we're ten years into this economic cycle and the likelihood of it lasting another three to five is fairly low. It doesn't make sense to take on an excessive amount of market risk at this point unless you are going to tactically trade, which is difficult to do and not advisable for most investors.

What are some of the mixed signals that you are watching closely these days?

MA: Leading indicators like housing and semiconductor stocks are acting very well, as if the economy is not ready to roll over. But others that have a lot of economic sensitivity, like autos have lagged—they have been a poor performer. And then there's the equity market's preference for bond-like proxies associated with the very high-quality, defensive parts of the market – utilities, REIT's and consumer staples – these sectors have all performed extremely well this year. In the past, this type of positioning has happened in anticipation of weaker times ahead.

AK: Financial tightening almost inevitably results in economic tightening. If you look at the U.S. bond market, and in particular the U.S. Treasury market, the dramatic fall in yields over the past year is clearly a signal of economic weakness that one should have expected after the financial shock of the four quarter in 2018. But you have to remember this is not a domestic market but a global one and much like the U.S. dollar, valuation says a lot about the global economy, many parts of which are already in recession. As a bond investor, one of the big questions is whether that pain is going to come back home where things have been softening for nine, ten months already.

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MA: Jobless claims and the overall unemployment rate are still fairly benign, but if they start to rise, it could put more stress on the consumer and lead to less spending. You don't see that yet, though, and consumer confidence is holding in. Credit quality is pretty solid too and none of the recent bank loan officer surveys indicate any significant pullback in lending to small and medium sized business.

AK: The signals for the credit market, which leads the equity markets down, are quite healthy. A big reason for that is the stimulus being added by the U.S. Federal Reserve, which has really calmed the nervousness that emerged late last year. That has resulted in record low yields and default rates, but things can turn quickly. There are some parts of the credit market they are dislocated but that is more due to sector specific challenges rather than a broad market technical.

MA: A few other indicators that I pay attention to include the price of copper. It doesn't have a perfect hit rate on calling economic expansion and contraction but does have a reasonable one and copper has continued to fall all year. It needs to hold here and start to trend higher in order to signal improving demand and better times ahead.

AK: Something that has the potential to keep me up at night is the health of the overnight funding markets. The health of these markets is crucial and recently there has been some deterioration. The cause is self-inflicted and could develop into something ugly. We think the U.S. Federal Reserve fixes its problem, but we continue to watch that closely.

3.25%

1.43%

The 10-year U.S. Treasury yield has fallen as much as **185 basis points** during the past year.

Source: Bloomberg LP as of October 1, 2019

MA: One other important gauge is the slump in manufacturing data. Purchaser Manager Indices (PMIs) now show contraction in around 75% of the global economies around the world. In North America, manufacturing makes up quite a bit less of the economy than in the other parts of the world but it has a good correlation to prior recessions which makes it a growing concern.

AK: The slowdown in manufacturing has been with us for several months. PMI scores in most major economies peaked last year. It's been a process that continues. You need to go through it. It's nothing new. Last year, they were at record highs. Look at them now. We have to have a forward-looking view.

How much is a recession already baked into asset prices?

AK: Sometimes we get too bogged down in discussing recession. As investors, what matters more is the market cycle. And because market cycles lead the economy, some markets around the world are already suffering. Take Europe as an example.

MA: In aggregate, economic data is unlikely to get materially worse and is likely to bottom sometime in the next three to six months unless there is an exogenous shock. That doesn't mean the repricing of stocks and bonds won't be significant in the near term. Equities could easily suffer a large correction from here.

What role do central bankers play at this stage in the cycle?

AK: If we look at a classic business cycle, interest rate cuts have tended to be a key ingredient in the economic recoveries of the past, in part, because it leads to steeper yield curves which help stimulate lending. The fact that the U.S. Federal Reserve and other central bankers are now providing more stimulus is positive and should bring about a healthier economy and financial markets. My only worry is that they move too slowly as they usually do.

MA: That should result in changes to the underlying makeup of the markets. The things that have gone down and been hated such as cyclicals like the banks usually outperform in an [easing] environment and we're seeing the potential green shoots of that trade setting up. Cyclicals have stopped going down and they are cheap, but better economic data is required for them to rebound and take market leadership from the defensive parts of the market. When growth is back in the economy, people will say, "I don't need to be as defensively positioned with all of these yield proxies," and shift to resources, banks and industrials.

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AK: Overall, stocks will do better than bonds, credit will do better than rates, but not as well as stocks. And because cyclicals will rally, that should benefit high yield credit, which also happens to be resource-heavy part of the corporate bond market, much like the Canadian stock market.

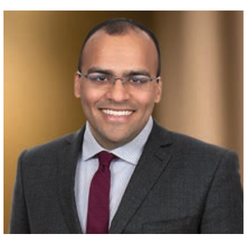
MA: It will take some time for the transition to happen. It can take up to six months and has historically required a correcting market. But if the S&P 500 corrects 10% or 12%, and the cyclicals correct much less than the overall market, than that is a good signal that preferences have changed and those are the trades that you want to be in on. This would be good for countries like Canada, South Korea and Germany that are more economically sensitive, but you don't want to be early. As PMIs are coming down, cyclicals can fall dramatically. You want to wait until you see PMIs bottom and tick up. Investors still need to exercise some patience here.

AK: Another thing that will happen with rate cuts, is a weaker dollar which is generally good for the rest of the world, especially those countries that are externally funded through the U.S. dollar. The global markets, which have troughed, start to perform better as a result and may lead the way. A stronger U.S. dollar sucks liquidity out of the financial system as U.S. dollar funding for overseas investors becomes more expensive across the yield curve. A weaker U.S. dollar will have the opposite effect.

If a global recession is inevitable, could it be less painful to investors than previous economic contractions?

MA: In my opinion, it should be significantly less painful than the last one. You have much better household balance sheets and the consumer, which drives the biggest economy in the world, is in better shape than it was during the previous recession. They have more savings and are in an improved position to withstand unemployment and a slowdown in wage growth.

AK: Bear markets associated with recession tend to be more painful than those not associated with it but when recessions are associated with asset bubbles that burst like in 2007/08 and the tech wreck before that, they are even more painful. This time around, there doesn't appear to be anything systemic that could cause a full blown crisis. The public corporate debt market has been deleveraging for the past couple of years and while there's a lot of money being lent out in the private debt market, we don't see major excesses that could spread to other parts of the financial markets in the near to medium term.



Andy Kochar, CFA

Portfolio Manager and Head of Credit

Andy Kochar is a principal member of AGF's Fixed Income Team and serves as the firm's head of global credit. Using a cross-asset framework, Andy is responsible for the research and allocation of credit risk across all of AGF's fixed income portfolios.

He previously served as Associate Portfolio Manager for AGF's credit-oriented portfolios from 2013 to 2018. Prior to that, for more than five years, Andy served as Investment Analyst, Credit Research at Acuity Investment Management, which was subsequently acquired by AGF in 2011.

Andy earned a B.A. in Economics (Cum Laude) from York University. He is a CFA® charterholder and member of CFA Society Toronto.

Mike Archibald, CFA, CMT, CAIA

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Mike focuses on research, analysis and selection of North American equities. His investment process is a bottom-up stock selection methodology using a blended approach of quantitative, fundamental and technical inputs.

Most recently, Mike was a Portfolio Manager with Aurion Capital Management Inc. where he was responsible for research, security selection and portfolio management of equity investments for pension plan clients. Prior to that, he was with Computerized Portfolio Management Services (CPMS), an equity research firm providing fundamental and quantitative investment data to institutional and retail money managers.

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