StraightTalk
PROVIDED BY STRAIGHTLINE FINANCIAL OF RAYMOND JAMES VOLUME 5 OCTOBER 2019

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The Dreaded R Word

The incessant media drumbeat of the looming (and presumably horrific) recession has only temporarily been replaced by breathless coverage of the coming Presidential impeachment process. At some point that circus will conclude, and the media will pivot once more to the drumbeat of a coming recession. Experts from firms I have never heard of will assure readers and viewers that "the signals" they are seeing portend an economic slowdown, and a concomitant decline in the U.S. stock market. What is my answer on this matter? Don't believe all of the recession hysteria.

Before digging in to the question of when a recession is actually likely, it may first be helpful to review what normal recessions are, and what they are not. Given that the last two recessions have been an order of magnitude larger than a normal "garden variety" recession, everyone's memory could probably use a refresher. According to the National Bureau of Economic Research, a recession is simply defined as a "significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP." The NBER is the official designator of recessions in our economy, as well as declaring when they begin and end.

However, the mainstream media always beats them to the punch. Having as their guide the less technical, but more widely used definition of two consecutive quarters of economic decline – the media will not even wait for that second down quarter to end before ginning up the alert system. Red and orange banners will crawl across television screens with headlines stating that if the quarter finishes as expected, then we will have *already been* in a recession. (Never mind that if growth turns back up by quarter-end, they will just pivot their alert banners to the next emergency.)

When we will have our next recession is unclear, but why we will have one remains very clear. Recessions are a necessary part of the business cycle, and are critical for future growth. Without periods where businesses correct bad habits, or respond to changing markets, or correct hires that no longer make sense, there can't be future progress. Think of it as recessions being the cure for the mistakes made when we all get carried away – they cure the excesses that build up in the course of the business cycle. Whether it is irrational exuberance in the sky-high dot com era in the late 1990s, or three decades of increasingly lax lending standards leading to a mid-2000s mortgage mania – when the excesses occur, a correction is needed. If the excesses are large enough, you get a bubble popping, which mates the economic decline with a significant stock market decline. The dot com bubble and subprime mortgage crisis both had meaningful market selloffs well before the evidence of a recession appeared in the data. Because of these two most recent experiences, many investors are assuming that the next recession and the market reaction to it will be similar to those. And that's where a little historic fact finding can be helpful.

Using the data going back to World War II, the average length of the twelve recessions over that period was 11 months, and the average decline was actually not a decline! According to Bloomberg Research, the average S&P 500 return during all of the recessions since 1945 was 5.6%. It was the periods *before* the recession started that held the declines – that average was -8.1%.

This is important for two reasons. First, we all just witnessed a 20% market drop in the fourth quarter of last year without any decline in the economy. We also saw a 20% market drop in 2011 because of the European debt crisis, without an accompanying recession. (Do you even remember when Greece's looming bankruptcy threatened to end life as we know it?) Also, in 2016, we experienced the worst start to a year ever, when in the first six weeks the market fell 15% from its all-time highs on fears about China and the Federal Reserve. No recession there either. Nor was there one when the market dropped 6% on the Brexit vote in the summer of 2016, or when the market fell almost 7% in May of this year. My point is, that by now we are all used to ignoring routine price drops for the media's reason du jour.

And if we are, why should a temporary drop in prices prior to a recession be any different?

The second reason the data is important has to do with what has historically come after those recessions ended. If the typical pattern is a stock market that declines in advance of a recession, and rises somewhat during it, what does the data show about the one and three year periods *after* the recession ends? Well, that my friends, is the rest of the story. And it is not likely to be included in the scary news headlines when the next recession appears. Bloomberg's research shows that the average gain in the market one year after a recession is 15.3%, and the average three year gain is 40.1%. So, if the average decline prior to a recession is less than several of the recent corrections we have experienced, and the average gain during the following three years adds double digit returns, why would we bother paying attention to any news about a recession?

The answer, of course, is that the long term is made up of lots of short term periods, and those can sometimes be difficult to navigate. I would submit that it is actually harder today than at any time in history, given the myriad of news sources available, and the echo chamber environment we live in today. No matter how stiff your resolve, when the same negative news story is drummed into your subconscious all day long – it can be difficult to tune out. Which is why I have General George Patton's famous quote on my website, "Courage is fear holding on a minute longer." The rest of that quote, which is lesser known, but more applicable to investors today is, "If you give in to your fears, you are on the path to defeat." Selling out when things look scary, to get back in at some vague point in the future "when things look better" has never worked anywhere it has ever been tried. Which is exactly why we don't do that. Knowing that typically markets dip before a recession, recover half of that dip during it, and gain meaningfully in the one to three years afterward should give us all the courage to hold on a minute longer.

However, knowing that we will have a recession at some point in the future, and the predictions of, and reporting on that recession will be next to non-stop, let's at least discuss why it is unlikely in the next year or so. There are too many individual statistics to list, but most of them can be broken down into two groups; broad economic statistics, and specific industry statistics that often get lumped together and called Leading Economic Indicators, or LEI. Things like cargo container shipments, various manufacturing indexes, maritime port activity, and interstate trucking indexes are some of the better known, specific inputs that go into that group. LEI is currently at an all-time high, and while in each of the prior recessions it turned down before the economy did, there has be no softening of those numbers yet.

The grouping of broader, easier to find numbers also look robust. According to the U.S. Bureau of Labor Statistics, we have the lowest general unemployment rate since the 1960s, and the lowest unemployment rate in history for women, blacks, Hispanics, and those without a high school diploma. We also have historically low inflation, and the lowest interest rates in most investor's lifetimes.

Wages are also growing – despite media assertions that corporations are not paying workers, the Labor Department reports wage growth for workers as high as it has been at any time in the last twenty years, and recently revised 2017 and 2018 pay data upward. There are 7.35 million open jobs in America – the highest number in our nation's history. More statistically relevant – *there are more job openings than unemployed people to fill them* – a condition which has persisted for nineteen straight months. Unemployment could spike by an additional 1.3 million people tomorrow, and there would still be more open jobs than unemployed workers.

In addition to a strong labor market and still rising leading economic indicators, consumer confidence is just off an 18 year high. In a never ending effort to deflate that confidence, news headlines often focus on our country's record debt of $22.5 trillion. However, the debt service, or "minimum payment" on that debt is less than 2% of our GDP each year. In your own household budgets, paying less than 2% of your income in interest payments probably does not rise to the level of a crisis. At some point in the future the interest on the debt will become an issue, just as at some point in the future we will have a recession. If I had to guess, the debt issue will become a problem a couple of decades from now, while the timing on the next recession is much sooner, likely sometime in 2021. But whenever it comes, we will remember the facts around markets and recessions and weather the storm. And…there is still upside to this market before we get there, so stay buckled in your seats.

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