Weekly Market Podcast – Transcript

February 29, 2016

Hello. This is David Kelly. I'm Chief Strategist here at J.P. Morgan Funds. Today is February 29, 2016.

In finance, almost as much as in politics, the most passionate and least reflective voices receive the most attention. A slump in Chinese stocks and the Chinese currency at the start of the year triggered a global stock market selloff. This, together with lower oil prices and some pretty weak numbers on global manufacturing, prompted many loud voices to say that the U.S. is either already in recession or is falling into one with near certainty. These dire predictions, in turn, have frightened many investors who remember the pain of seeing the stock market fall in half in the last two recessions.

However, in this emotionally charged atmosphere, there are four key aspects of the current economic and financial environment that investors need to appreciate:

- First, there is simply no evidence that the U.S. economy is in recession and little evidence that it is going to enter one over the next few quarters.
- Second, the real risk of recession is cumulative; while the danger of recession in the next few quarters is low, the risk of recession over the next few years is high.
- Third, the last two recessions were extraordinary from a stock market perspective as, in each case, the stock market saw the worst bear market since the depression. There is no reason to believe that the next recession would have an equally dramatic stock market impact.
- Fourth, even if the risk of an imminent recession was very high, relative valuations of stocks and bonds are completely different from their normal pre-recession configuration, making it very difficult to argue for an underweight to traditional risk assets today.

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On the first issue, data last week should have calmed fears of an imminent recession. Most importantly, numbers on consumer spending for January suggest that consumption is rising at a 3%+ pace in the current quarter. Data on existing home sales and durable goods suggest that both housing and investment spending will contribute to growth in the current quarter, while low unemployment claims point to a still strong labor market.

There are, of course, areas of weakness, including a worsening trade deficit, inventory growth that looks too high and some further signs of manufacturing weakness. Overall, however, the numbers suggest growth of close to 2% in the current quarter following 1% growth last quarter.

Numbers due out this week should provide further confirmation of steady growth, with payroll job gains for February of close to 200,000, a further edging down in the unemployment rate (although perhaps staying at 4.9%, rounded to one decimal) and an edging up in wage growth. Data on pending home sales on Monday and light vehicle sales on Tuesday should also be reassuring.

While global PMI numbers should be more sobering (judging from flash numbers released last week) and investors will be nervously watching oil prices and signals on the Chinese economy, it should be remembered than no modern U.S. recession has been triggered by a collapse in exports. The reality is that U.S. exports represent just 12% of our GDP and weakness in exports should not, on its own, send the economy into a tailspin.

However, while there is no sign of an immediate recession, it is certainly worth considering when one might occur and what the potential for a recession implies for investment strategy.

The right way to think about recession risk is as a cumulative probability – the result of rolling the dice many times. On any one roll, the probability of getting a 12 or a 2 is low. However, if you keep rolling, the probability of eventually getting a 12 or a 2 is high.

There have been just three recessions in the U.S. in the last 33 years. 33 years is 132 quarters so a recession starting in any one quarter has been a rare event – it has happened just 2.3% of the time.

A crude Monte Carlo simulation model using the observed distribution of real GDP changes over the past 30 years (and allowing for serial correlation), suggests that the probability of two or more consecutive negative GDP quarters, starting in any given quarter, is only about 3%.

We believe the probability of a recession starting in one of the quarters of 2016 or 2017 is higher than that, due primarily to the age of the expansion (which has eroded some pent-up demand), and the slower pace of growth (which makes it easier to tip into negative territory). Nevertheless, it is likely still the case that the true probability of a recession starting in any one quarter is no more than 5% or 6%.

However, the cumulative probability of recession is a different matter. If we assume a 6% probability of a recession starting in any one quarter, then, as a rough calculation, the risk of recession starting in 2016 is over 20%, the risk of recession starting by the end of 2017 is close to 50% and the risk of recession starting in the next three years is above 60%.

Finally, valuations are always important. Historically, as an expansion ages, both P/E ratios and real interest rates rise, reflecting investor exuberance and an attempt by the Fed to ward off overheating.

This makes financial advice relatively straightforward when anticipating a recession: get out of expensive stocks and into cheap bonds. Today, the story is much more complicated as stocks look close to average valuations but Treasuries look expensive.

To make this more concrete, there have been eight U.S. recessions since 1960. On average, the stock market peaked 7 months before the recession started and troughed 3 months before the recession ended.

On average, at the pre-recession stock market peak, the yield on 10-year Treasuries was 1.7% above the earnings yield on stocks (deriving earnings yields from Shiller P/E ratios). In other words, stocks were relatively expensive compared to bonds.

On average, at the mid-recession stock market trough, the yield on 10-year Treasuries was 1.7% below the earnings yield on stocks (meaning stocks were cheap relative to bonds).

However, today, the yield on 10-year Treasuries is actually 2.3% *below* the earnings yield on stocks. While we don't believe a recession is likely to start in the next few quarters, if it does, it is worth noting that stocks today are cheaper relative to Treasuries than they have been on average at mid-recession stock market troughs.

Moreover, this anomaly is present across a number of areas of financial markets – the most expensive stocks appear to be value stocks while the most expensive corporate bonds appear to be those of high quality. Typical risk assets, such as commodities and emerging market equities, look cheap by historical standards.

This is why, although investors are right to be more cautious on the economy than a few years ago, it is still hard to recommend a risk-off approach in a world where risky assets are priced cheaply relative to more traditionally conservative investments.

Well that's it for this week. Please tune in again next week and if you have any questions in the meantime, please reach out to your J.P. Morgan Representative.

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