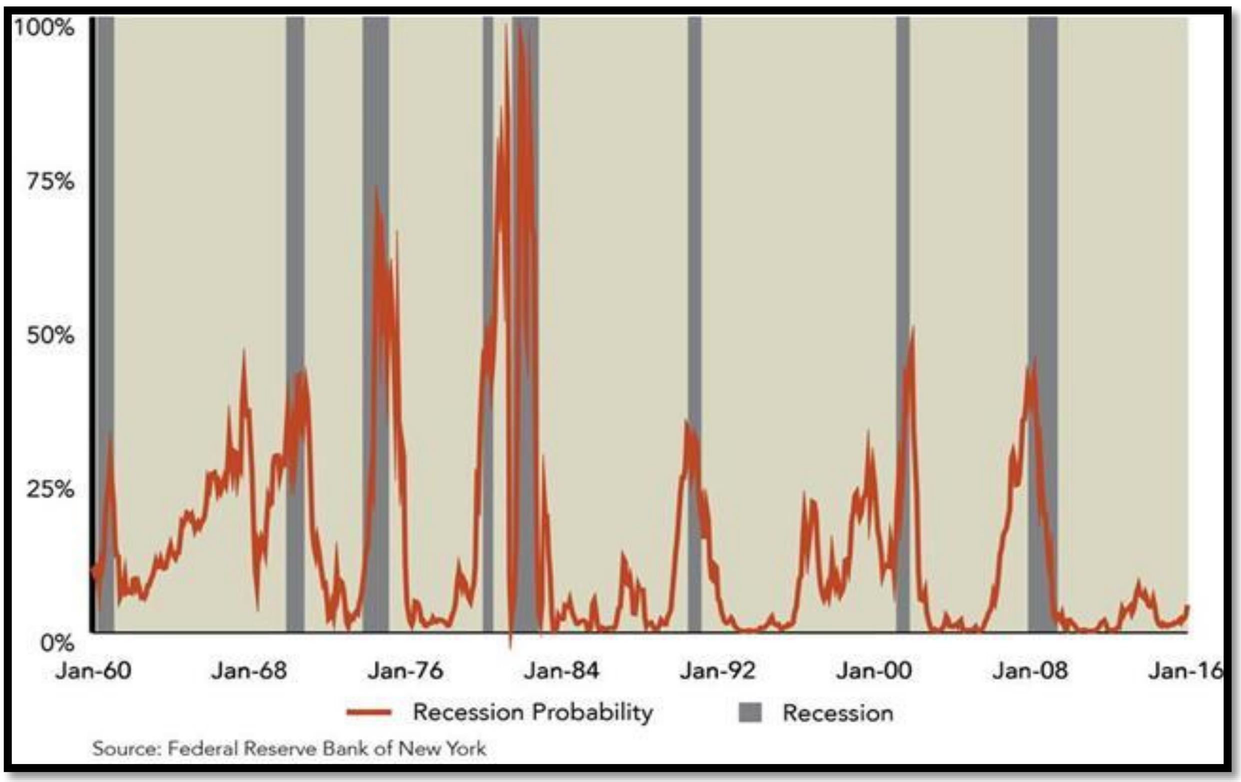
Is the U.S. on the Brink of a Recession?

February 5, 2016

Dear Friends,

January was one of the worst starts for global equities in modern-day history. The steep sell-off followed a year of mediocre returns amid slowing global growth. The prolonged deep drop in oil prices rattled investor confidence, leading many to shed risk-assets in a broad flight-to-quality. As a result, credit spreads have widened to pre-2008 levels. These narratives are leading many investors to question whether the U.S. may be heading towards a recession.

Probability of a U.S. Recession



The chart evaluates the latter narrative by exploring the probability of a U.S. recession using the historical Treasury yield curve as a gauge to predict future economic movement. The orange line represents the difference, or spread, between 3-month and 10-year U.S. Treasury yields. The grey columns identify past U.S. recessions, as published by the Federal Reserve Bank of New York. As the spread between short and long Treasury yields narrows, the probability of a U.S. recession grows.

The model above has served as an excellent predictor of future U.S. recessions. Marquette Associates analyzed the January data and determined the probability of a U.S. recession occurring within the next 12-months to be 4.6%.

This result sheds a positive light on the upcoming year, but should an investor rely exclusively on the chart above when positioning a portfolio for the next 12-months? Certainly not. There are many indicators pointing toward a slowing economy. This period reminds us a great deal of 2011, when the U.S. economy faced several headwinds, but remained fundamentally sound and recovered. Lower oil prices are a positive stimulus to nearly 80% of the U.S. economy. But such a steep decline clearly has inflicted a high cost on U.S. exploration and production companies. Combined with the sell-off of most other commodities, these deflationary forces are a major headwind for corporate revenue and profits.

For thoughtful investors with sound long-term asset allocations, this is not a time for wholesale changes. We suggest investors concentrate less on the short-term, and take advantage of the current market environment to rebalance portfolios to long-term targets. Stay the course.

Anecdotally, I am leaving a meeting of 106 middle market companies almost evenly divided between manufacturing, distribution and service companies. Almost universally, all of these companies are financially sound, growing and having a reasonably good start to the year. Executives in these companies are discussing the current state of the global economy with a mix of concern for what they read in the press and optimism for their own businesses. There is clearly strength in “main street” American business amid the perception of higher risk in the global economy.

To paraphrase the President of a South Carolina based industrial pipe valves and fittings company, “I’m just glad we don’t sell into the oil patch. Our commercial construction business is doing just fine.” This seemed to sum up the consensus of the room; if you were not involved in the oil and gas industry, you were probably doing “just fine.”

We invite you to contact any of us at Independence Asset Management with questions or to discuss your concerns and observations.

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