The Gathering Storm: The Coming Recession

- Credit, liquidity, and fiscal signals suggest a high probability of materially weaker economic momentum later this year.

- But cycles do not typically just die of old age and this one is unlikely to be an exception.

- Activity signals are already coming under significant pressure, and with equity markets rebounding once more, monetary policy is the most likely candidate for a recession trigger as the Fed pushes too hard on the brakes.

- We monitor a set of key signals on our ClearENGINE to dynamically set our conviction to recession timing. With the current economic cycle long in the tooth, and with the balance of these signals already flashing red, we initiate with a High Conviction rating.

- We recommend a theme implementation basket long of US Treasuries and Inflation Linked Bonds (TIPS) and short of DM/EM equities and IG/HY credit.

**CONVICTION: HIGH**
(40%-60% probability this theme will impact market returns over the next 12 months).

**KEY RECESSION SIGNPOSTS**
These are the key signals we follow on ClearENGINE to dynamically set our recession conviction levels. These are colour coded:

- Neutral View
- No Recession
- Recession Soon

**COMPOSITE SIGNALS**
- Short Term Global Activity Matrix
- Short Term Global Monetary Policy Matrix
- Medium Term Economic Cycle Matrix
- Activity/US/Momentum
- Cycle Exhaustion/World/Aggregate
- Lead Indicator/US/Momentum
- Tactical Monetary Conditions/DM/Level

**ACTIVITY SIGNALS**
- Labour/US/Momentum
- Business Conditions/US/Aggregate
- Alexandria ESI/World/Level
- Trade Pulse/World/Momentum
- Nowcasting/US/Level

**MONETARY SIGNALS**
- Excess Liquidity/DM/Level
- Strategic Policy Impulse/DM/Level
- Money Impulse Strategic/US/Level
- Strategic Expectations Impulse/DM/Level

**CREDIT SIGNALS**
- Credit Conditions/US/Aggregate
- Credit Bust Risk/US/Aggregate
- CrossBorder TLI/World/Level

**POLICY SIGNALS**
- Fiscal Thrust/US/Aggregate
- Policy Uncertainty/US/Level
A recession is overdue

Based on precedent, recession appears imminent. We take a liberty in Figure 1 with the standard textbook definition to define a recession as any 2 quarters of negative US real GDP growth over a rolling 4 quarter period. Based on this, there have been 9 such “recessions” since 1969, and the average period in-between them has been 5 ½ years with the longest at just over 10 years. The current economic upswing is now 8 years young, so it’s clear, at least from a purely statistical perspective, that the probability of a recession over the next 12-24 months is extremely high.

Of course, economic cycles don’t die of old age alone, and there needs to be a trigger. Whilst event risks and “unknown unknowns” certainly play their part, we believe they become more likely when the macro environment is fragile, and so we monitor a range of medium and short-term signals designed to give us an investing edge.

Structural trends are turning bearish

Whilst our Cycle Exhaustion Signal (Figure 2) does not yet signal excessive caution, a number of key ClearENGINE signals are flashing warning signs. The US Fiscal Thrust Signal (Figure 3), which identifies the likely impact on the cycle of public sector fiscal impulses, has collapsed in recent months, whilst the Policy Uncertainty Signal (Figure 4), derived from the Baker, Bloom and Davis databases and which tracks the likely impact of policy-related economic uncertainty on the cycle and prospective market returns, is now at an all-time low.
Long-term credit trends are weakening dramatically. Our highly rated CrossBorder Capital Total Liquidity Signal (Figure 5), which aggregates and normalises all sources of public and private credit creation and normally operates with a cycle lead time of 6-9 months, is signalling that growth will slow materially in H2 2019.

At the same time, higher frequency credit signals are also deteriorating. Our Credit Conditions Signal (Figure 6) has recently fallen into negative territory, driven lower by a material tightening in lending standards for both medium and small size firms.

Whilst a medium-term negative credit impulse now appears a certainty, short-term triggers are key to timing. Our Credit Bust Signal (Figure 7) aggregates credit vulnerability metrics with financial condition inputs. Although we have seen credit delinquencies increasing significantly over the last few months, the recent rebound in equities and fall in interest rates has softened the blow and caused this signal to bounce back into positive territory. Having said this, we think the weak underlying credit market environment now makes the economy highly vulnerable to either a return to higher yields or another bout of weakness in stocks.

Monetary policy likely to be a decisive factor

We expect monetary policy to be a critical factor in the timing of the next recession. Policy makers remain keen to tighten but are playing cat and mouse with skittish financial markets. Nevertheless, our Excess Liquidity Signal (Figure 8), which measures both the level and the momentum of monetary conditions, has now become restrictive.
But a broader set of monetary policy signals are not yet providing a consistently negative message. The trend is clear, but there is some way to go before we are at the monetary tipping point. For example, the Strategic Monetary Policy Impulse Signal (Figure 9) for Developed Markets, which tracks the 12 month change in ClearMacro’s definition of a “neutral rate”, is not yet in negative territory.

The Yield Curve Signal (Figure 10) measures the likely impact of the slope of the yield curve and is clearly contractionary, but precedent suggests that the lag time can be 6-18 months before there is a substantive cycle impact.

Money growth will be key to connecting these credit and policy signals - Figure 11 highlights ClearEngine’s Strategic Money Impulse Signal for the US, which evaluates the degree of policy liquidity impulse by measuring the medium term (12m) rate of change in M1 as a % of GDP. Higher scores reflect stronger money growth and lower scores reflect weaker money growth. We will be monitoring our money signals intently in order to decide when to raise our Recession Conviction Rating from High to Very High.

As highlighted, the recent fall in yields has provided a support for the near-term cycle outlook. Our DM Strategic Monetary Policy Expectations Signal (Figure 12) measures the 12m net change in the slope of the 2-year govt yield curve relative to official policy rates (an approximation of the forward monetary policy stance). A return to negative territory in this signal will increase recession risks.
Activity signals are a clear negative

Our composite US ClearMacro Activity Signal (Figure 13), which measures current aggregate economic activity by equal-weighting 6 stand-alone ClearMacro signals - Business Conditions, Consumer, Credit Conditions, Housing, Labour Market, and Lead Indicators - is making new lows. All component signals are deep in negative territory, with the most powerful, and historically most predictive, being the Lead Indicator Signal (Figure 14).

Whilst clearly concerning, our higher frequency activity signals are more optimistic. With the recent stimulus in China, our World Trade Pulse Signal has bounced (Figure 15), and 2 of our other key activity signals for the US, the Nowcasting Signal (Figure 16), and the Alexandria Economic Sentiment Signal also remain positive. Any renewed weakness in these higher frequency signals will likely cause us to raise the Conviction Rating to Very High.

Implementation

To select an appropriate implementation basket, we reviewed the estimated return and risk characteristics of candidates using both theoretical assumptions and an empirical observation of the performance in previous recessionary periods.

First, for each “recession”, we define the “in-sample” observation period as the period from the end of the quarter prior to the first period of negative quarterly real GDP growth and then continuing for 15 consecutive months.
In Figure 17, we calculate for each “short” candidate, the % fall from the high water mark to the lowest observed price (Avg Performance, which becomes our target return). The Worst Case Estimate represents our qualitative evaluation of how much the asset could move against us over a 12 month period if the theme view does not play out (how much we could lose...). The Skew is then the target return divided by this potential loss. Finally, we normalise for risk in the Skew/Risk ratio, and this becomes our key metric for identifying the attractiveness of each basket candidate.

Next, in Figure 18, we repeat the exercise for all “long” candidates, with the difference being that we evaluate how much they appreciated in price during previous recessions, and how much they could fall in price, if the theme view is wrong.

Finally, candidates are selected and sized qualitatively based on the ranking of their skew/risk ratios.

Bottom line: The recession theme basket (Figure 19) has a heavy weighting on the short side to credit - principally US IG and US HY credit. In addition, this is complemented with shorts in DM and EM equities. On the long side, there is a bias to US inflation-linked govt bonds, complemented by US Treasuries. The long/short basket has a return target (Figure 20) of +35%, and a maximum estimated downside of 19%. There is a small negative carry of around 1% and an estimated volatility of 5%.
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A single, modular environment linking forward-looking, global, multi-asset investment insights to YOUR portfolio. Enhancing your global macro screening capabilities and powering your investment decisions across short, medium and long-term investment horizons.

This is ClearENGINE™, our ‘Next Generation’ Investment Framework.

**KEY TEAM:** ClearMacro brings together experienced investors, data experts, and technologists.

- **Mike Simcock,** CEO/CIO, was a Managing Director at the GIC, Singapore's Sovereign Wealth Fund.
- **Grainne Dooley,** Deputy CIO, has over 20 years experience in fixed income markets, most recently running an active bond mandate for Pioneer Investments. Prior to that, she spent 6 years in derivative strategy and sales at UBS in London. She chairs the Investment Committee for Trinity College Dublin’s Endowment Fund.
- **Seng Cheang,** CTO. Seng has had over a decade of experience programming for RBS and AQI Capital. He has a PhD in Applied Mathematics/Mathematical Physics from Imperial College, a PhD in Physics and Applied Physics from Nanyang Technological University, and an MSc in Applied Mathematics/Mathematical Physics.
- **Arturo Rodriguez,** Head of Systematic Investment Solutions. Arturo has innovated technologies used by some of the largest financial firms in the world, developing systematic investment programs and complex risk management frameworks.
- **Guanhua (Ian) Luo,** Head of Data. Ian has spent almost a decade developing Quantitative Analytics and has been at the forefront of exploring capabilities within Data Science. Currently Head of ClearMacro's Quant Team, he holds an MSc in Mathematics from London School of Economics.
- **Mogens Rye,** Global Head of Sales, has spent the last 25 years working closely with the buy-side to create and deliver solutions for senior investment decision makers.

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