Recession in 2020?

Over the last few weeks, there has been a precipitous change in the mood of capital markets, both domestic and international. Six months ago, the yield curve was inverting, manufacturing activity was declining, and the dollar was strengthening. Since early October, the macro-economic environment has changed significantly:

- the yield curve is no longer inverted
- the dollar has weakened against all major currencies
- the copper-gold price ratio, a strong indicator for the manufacturing industry, is up
- cyclical stocks are again gaining favor

The upswing in mood is not just restricted to the United States as sentiment has improved globally. Investors seem to embrace riskier assets in Europe too as banking stocks are doing relatively better than consumer staples stocks. Please see Chart 1 below to see this shift in markets since the beginning of October.

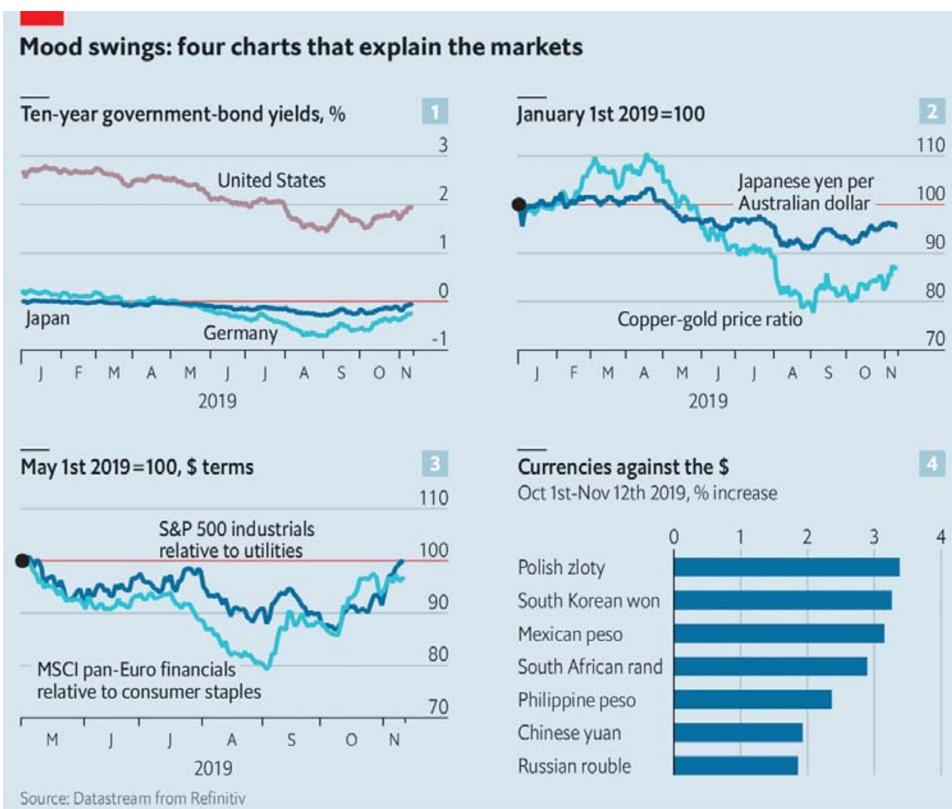

Chart 1: Source - *The Economist*

The questions are: Can this buoyancy last? Have all the fears of a recession in 2020 diminished? In our opinion, the short answer is no but given the proactive response of the Federal Reserve and other major banks, the global economy may just muddle through in 2020 and escape recession. Let's examine this forecast.

Chart 2: Source - Federal Reserve Bank of St. Louis

An inverted yield curve between the 3-month and 10-year treasury segments that lasts for more than three months tends to be followed by a recession with a lag of 6 to 13 months. Chart 2 above shows that when the yield curve inverts as denoted by the solid blue line, a recession (denoted by shaded grey area), and technically defined as two consecutive quarters of GDP contraction, tends to follow. In the recent past, the yield curve inverted around April-May 2019 and many assumed, based on past data, that a recession was likely to ensue over the next twelve months. What many experts missed is that unlike previous occurrences, the Federal Reserve was extremely proactive and expanded its balance-sheet as seen from Chart 3, soon after the yield curve inversion.

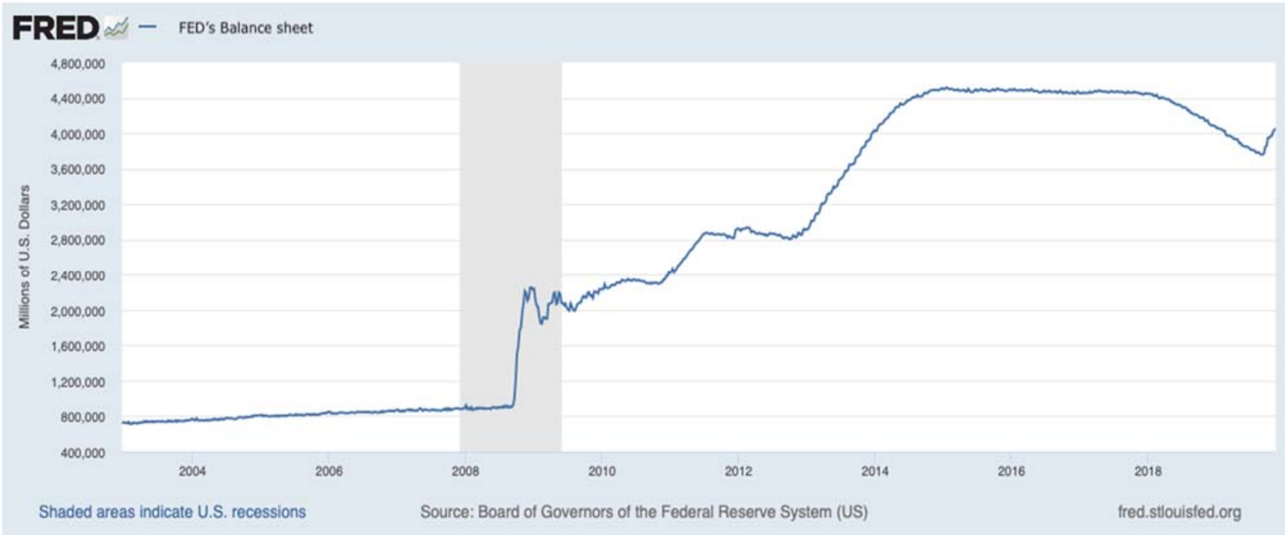

Chart 3: Source - Federal Reserve Bank of St. Louis

The Federal Reserve lowered rates three times in a span of fewer than 90 days, each time by 25 basis points. The current Fed Funds rate range is 1.50%-1.75% which is much lower than the high of 2.25%-2.50% in late July 2019. Also, what went unnoticed is that the Federal Reserve started buying bonds after a gap of almost four years. The Fed has been contracting its balance sheet since 2015 but in the last couple of weeks, the central bank has expanded its balance sheet by around $300 billion (as seen in Chart 3).

Elsewhere, the European Central Bank announced the resumption of its own quantitative easing program, which was initially suspended in January 2019. The ECB followed other major central banks globally (Australia, New Zealand, South Africa, etc.) and reduced its base rate to -0.5% to stimulate lending to the private sector.

In summary, with unemployment and inflation low, and an aggressive Fed, we believe that the U.S. economy will likely avoid a recession and if it happens, it might be a shallow one. We at Lynx continue to like relatively cheaper valuations in the international equity markets. Also, any trade agreement with China, while positive for the United States, will immensely help Germany (and Europe) as they are a major exporter to China. We will continue to monitor leading indicators and keep a keen watch on the economy.

Thank you,

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