Recession Obsession

By Michael Eisenband

The dreaded "R word" has entered business conversations more frequently since a fierce selloff began in financial markets in late 2018. Surely a selloff of such ferocity must be indicative of investors' sentiment that our economy is nearing a downturn, claim the skeptics. Nonsense, claim the bulls, who counter that most measures of economic vitality and corporate health remain strong and intact—which is absolutely true, but arguably irrelevant with respect to whether we will be in recession within a year or so. Recessions rarely preannounce their arrival, so economists and investors expend considerable effort to predict their timing—with mostly inconsistent results.

A recession is a period of broad economic contraction, typically lasting about 8-11 months. The U.S. economy has experienced 11 recessions in the 73 years since the end of WWII, or roughly one every 6.5 years. However, recessions have occurred less frequently in our working lifetimes, with just three since 1990. The nine-year economic expansion from 1992-2000 during the Clinton years was the longest period of uninterrupted economic growth on record until the current cycle, which began in mid-2009 and is approaching one decade. Our current expansion is atypical not only in its length, but in its weakness; GDP growth has been erratic and sub-par throughout this recovery. Historically speaking, the U.S. economy is long overdue for a recession, but that fact itself is an insufficient argument to claim that one is coming.

Recessions are a vexing phenomenon for economists because they are inevitable events that remain highly unpredictable. If recessions were more easily predicted then they would become self-fulfilling events. Businesses anticipating a recession would cut back on purchase orders and staffing in advance of a downturn. These actions obviously would all but ensure that a recession occurs if enough key decision makers believe it will. In other words, the anticipation of a recession would hasten its arrival. Instead, most businesses react to conditions on the ground. They respond when product demand slows. For all the advances in predictive analytics, businesses are still largely reactive in terms of planning ahead. It's hard to imagine a business forecast and budget that plans around an expected recession in year T+1 if current conditions are benign. Consequently, when recessions begin they are often unanticipated and nearly undetectable in their early phase except in retrospect. For instance, who was predicting a recession in early 2008, when in fact one was already underway eight months before the collapse of Lehman Brothers? Very few were.

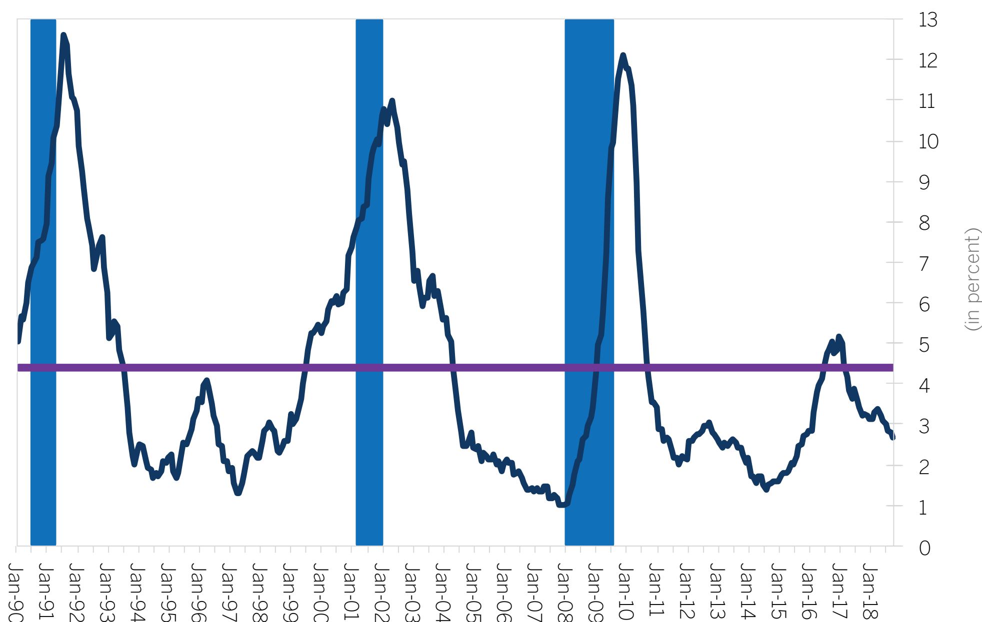
Because recessions tend to creep up unexpectedly, investors look to market indicators that historically have signaled a business downturn. An inverted yield curve is the most well-known and reliable indicator of recession, but its track record hasn't been infallible. It has yet to signal a recession, with the yield curve flattening considerably in the short-to mid-maturity range but not yet inverting with respect to the yield differential between 2-year and 10-year Treasuries, the maturities most often referenced by economists when discussing yield inversion as a harbinger of recession.

Where economists focus on recession to define a period of negative growth (i.e., contraction), the comparable event horizon for restructuring professionals is the default cycle—informally defined as a time period culminating in a speculative-grade debt default rate exceeding 10%. A default cycle encapsulates periods of recession. This is intuitively understood: credit availability and borrowing terms become more restrictive when the economy begins to weaken, causing corporate debt defaults to escalate. Default cycles almost always begin before the onset of recession and endure past its conclusion. This is a useful characteristic because it informs us that deteriorating corporate credit market conditions are a reliable early indicator of impending recessions. However, the last three default cycles since 1989 don't all tell the same story. During the default cycles of 1990-1992 and 2000-2002, default rates were already climbing for months prior to their associated recessions (Exhibit 1). This is typical. However, the default cycle associated with the Great Recession was different. The default rate was barely 1.0% at the end of 2007 and still was trending lower entering 2008, at the onset of the recession. Debt defaults didn't move appreciably higher until later that year when global credit markets began to seize up. In that instance, the default rate failed to signal an imminent recession.

So what will it be the next time around? There is general agreement that the 2008-2009 cycle and the events surrounding it was an outlier. Should the next recession conform to a conventional template, we would expect to see the default rate (and distressed debt levels) moving higher before engaging any serious discussion of a downturn. We aren't there. The U.S. spec-grade default rate currently stands at 2.6% and continues to grind lower, with the rating agencies expecting it to drift towards 2.0% by mid-2019. Distressed debt levels finally turned higher in November after having hit a four-year low just prior to that. These trends need to reverse before recession talk gets more traction. Given all the market tumult in recent months, it has become a parlor game to guess when the next recession will hit. Credit markets are telling us that such speculation remains premature. Until then, all we can do is be vigilant.

EXHIBIT 1

U.S. Spec-Grade Corporate Default Rate



Note: Shaded areas represent recession. Horizontal line is long-term average default rate.

Source: S&P Ratings Direct

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