Investors - Stop Obsessing About a Recession

Your Real Risk is Longer Term

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Why This Matters?

Concerns of imminent large scale recession in the US are misguided. According to our models, a recession in the next 12 months is unlikely. Rather, our models point to a continuation of low long-term trend growth, driven by low growth in total factor productivity (TFP) and the labor force. Stagnant low growth also implies a prolonged period of low equity returns and real bond yields, relative to history. In this context, investors should focus on their long-term portfolio decisions.

Who Should Read This Paper?

The issues in this paper are important for managing the long-term risk of public and private assets, and should be of interest to the risk and investment strategists, and asset allocators.

Introduction

Recently, there has been no shortage of commentators willing to supply free advice to the world's central bankers. For the most part, that advice has focused on the appropriate monetary policy to proactively combat a recession.

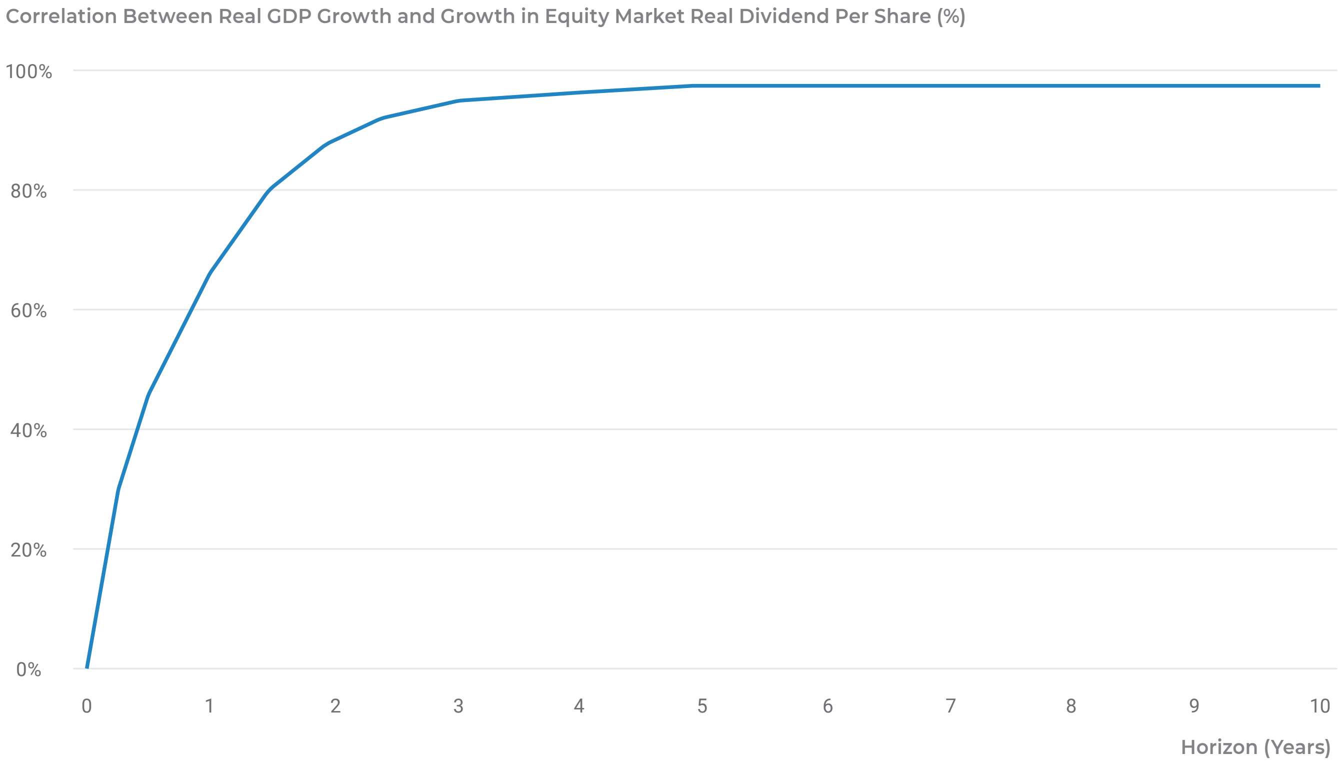
In our view, the hysteria surrounding an imminent, large scale global recession is misguided, and especially in the US. Yes, workers and budget directors should legitimately worry about short-term declines in growth (as employment, wage and revenue are directly tied to real economic activity). However, investors and their agents should only worry if it influences the drivers of long-term growth. Our models suggest that the long-term picture is quite sobering. Here's why.

It is well known that investors primary concern should be whether their portfolios properly balance risk and return. In this context, it is entirely appropriate that investors should worry about the linkage between real economic activity and asset returns. The real issue though, is whether, and how, changes in real economic activity are translated into changes in future asset returns, and especially equity returns.

Equity Cash-Flows Are Sensitive to Real Economic Growth

Changes in real economic activity have their effects on equity pricing through their impact on cash flow (dividends) growth and interest rates. It is easily documented that over long horizons cash flow risk and equity risk are synonymous, over short horizons less so. Similarly, it can be documented that changes in real economic growth have a small effect on cash flow growth over short horizons. Over longer horizons, though, real economic growth is the key driver of cash flow growth. These points are illustrated in Exhibit 1. Thus, we can conclude that for equity cash flow growth, short-term fluctuations in real growth are almost irrelevant, but long-term growth is critical.

Exhibit 1 - Cash-Flows (Dividends) Are Sensitive to Real Economic Growth



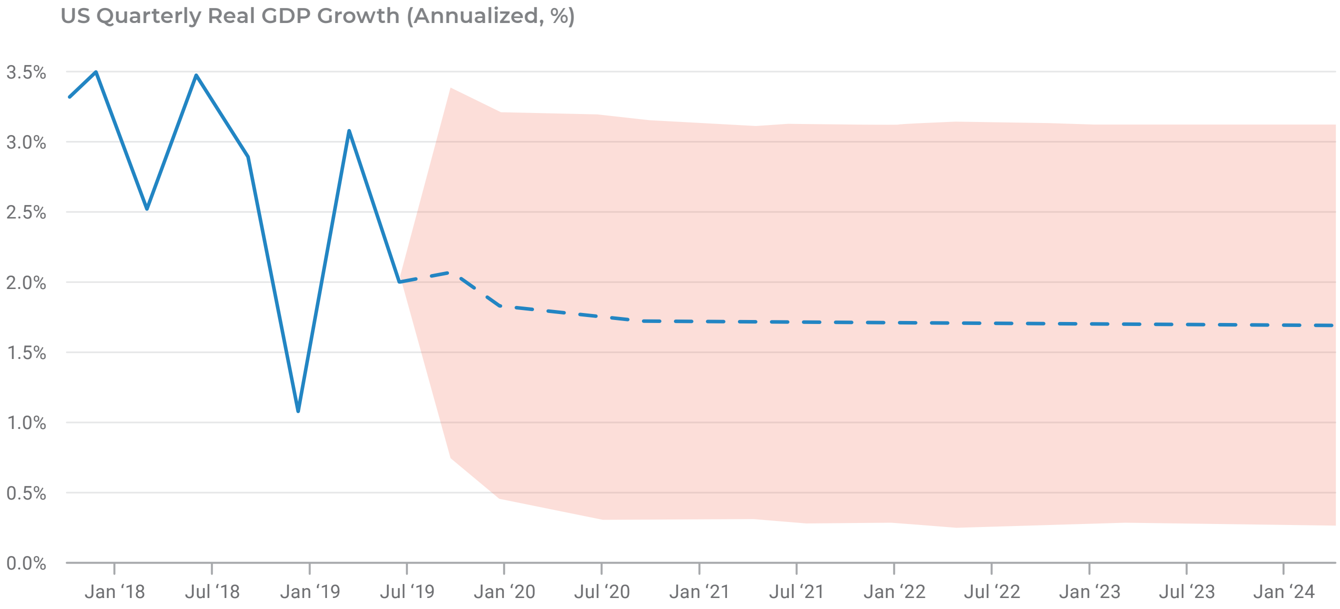
SOURCE: NAVEGA STRATEGIES LLC RESEARCH

Imminent Recession Is Unlikely

Our recent note argued that the yield curve inversion is not reflecting recession fears. Instead, we argued that bond market pricing is reflecting a view that in the US, long-term real growth is likely to continue to be well below its historical average. We further showed that the bond market's view is consistent with our macro forecasting model. According to both our model and the bond market, real growth is projected to average around 1.7% over the next five years. And, our model suggests that a recession in the US is unlikely, at least over the next 12 months. This point is illustrated in Exhibit 2.

The main reason that our model (or any other data-driven model) suggests that a recession is unlikely is because recessions are rare- there have been 11 recessions (as determined by the NBER) since 1949. The average length of each recession has been 11 months,

Exhibit 2 - Low Recession Risk According to Navega Model Baseline Scenario



SOURCE: NAVEGA STRATEGIES LLC RESEARCH

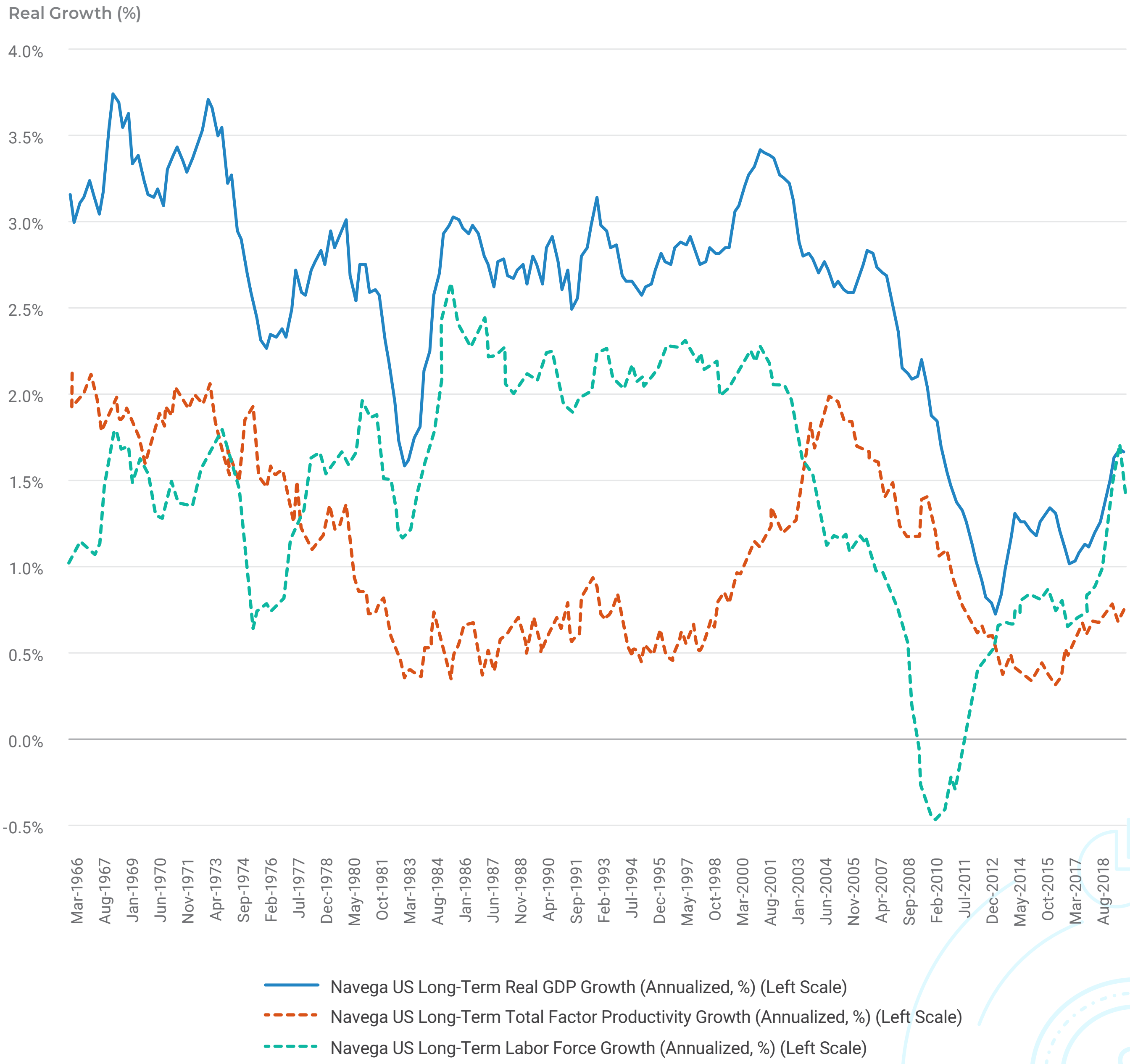
versus an average expansion length of 58 months. And, on average, real growth declined by 2.3% during these recessions. In fact, what stands out about the recession of 2008-9 is its magnitude- from peak to trough, real output declined by about 5.9%!

The Big Risk Is a Prolonged Period of Low Real Econonomic Growth

The reason that the bond market and our model indicate a prolonged period of low real growth in the US is because the drivers of long-term real growth themselves are below their long-term trends. Long-term real growth is driven by the growth in labor (as measured by hours worked) and the growth in total factor productivity. Indeed, a prior for long-term real growth can be easily derived from these two factors.

Exhibit 3 shows the Navega prior for US long-term growth and the two main constituents. As the exhibit makes clear, growth in TFP and hours worked remain below their long-term trends.

Exhibit 3 - Low Long-Term Real Growth, Driven by Low Growth in TFP and the Labor Force

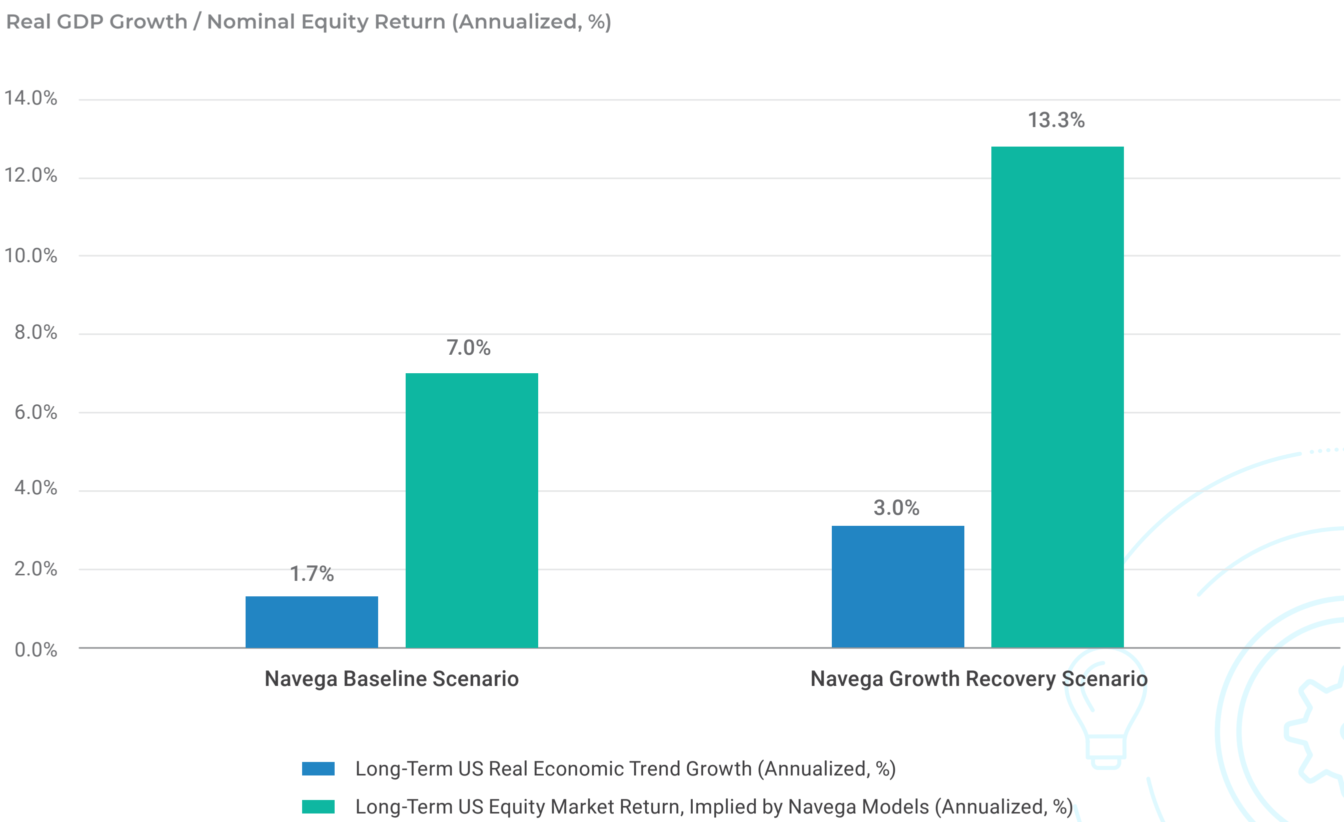


SOURCE: NAVEGA STRATEGIES LLC RESEARCH

Low Trend Growth Is Low Long-Term Equity Return

The big reason all of this matters is because a prolonged period of low real growth is likely to lead to a prolonged period of low (relative to history) real equity returns. While low real growth translates into low real bond yields, it also translates into lower cash flow growth. *Lower long-term equity returns arise*, because over long horizons, the reduction in cash flow growth dwarfs the effect of lower interest rates. This point is illustrated in Exhibit 4. The exhibit shows model-derived nominal equity returns conditioned on our model's baseline scenario and a higher growth scenario. As is evident from the exhibit, long-term growth matters.

Exhibit 4 - Low Real Trend Growth Can Mean Low Long-Term Equity Returns



SOURCE: NAVEGA STRATEGIES LLC RESEARCH

So where does all of this leave investors? Our advice would be the following: first, pay close attention to the drivers of long-term real growth. Second, understand the effects of long-term growth on your portfolio. Third, maintain a disciplined approach to portfolio construction and rebalancing (especially true for asset allocators). Finally, please don't obsess about a recession.

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