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Insight

Global Equity Perspective

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Markets, recessions, and telltale signs

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- **We expect a U.S. recession to arrive later this year.**
- **Timing differences between the economic cycle and the ebbing and flowing of stock prices can be useful to know.**

We look for a U.S. recession to get started sometime in the second half of this year. Our Recession Scorecard update adds some detail.

U.S. recessions have always been associated with bear markets for U.S. equities. But American economic downturns have always reverberated beyond the U.S., ushering in challenging periods for stocks in Canada, Europe, the UK, and Japan, as well as in most of the developing world.

Following are some historical observations that might be useful references for investors looking to navigate through the coming 12 to 18 months.

Equity views

Region	Current
Global	=
United States	=
Canada	=
Continental Europe	–
United Kingdom	–
Asia (ex Japan)	=
Japan	+

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

It's not over until it's over ... the economic expansion that is

The economy goes on growing right up to the point where it rolls over into recession. Today, it is still in that pre-recession growth phase. Q1 2023 data has so far fared somewhat better than most expected going into the quarter. As we see it, credit conditions are not yet restrictive enough nor the all-important consumer weakened enough to make the start of recession imminent.

Along with GDP, Q1 earnings are likely to have held their own vis-à-vis Q4 2022 results. Nor can some further improvement be ruled out for Q2—one of the reasons why major stock indexes have been able to remain above their October lows despite the banking turmoil.

Now S&P 500 earnings estimates for 2023, after falling steeply from $251 per share in May last year to $218 per share recently, look to have pulled

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All values in U.S. dollars and priced as of market close, March 31, 2023 unless otherwise stated.
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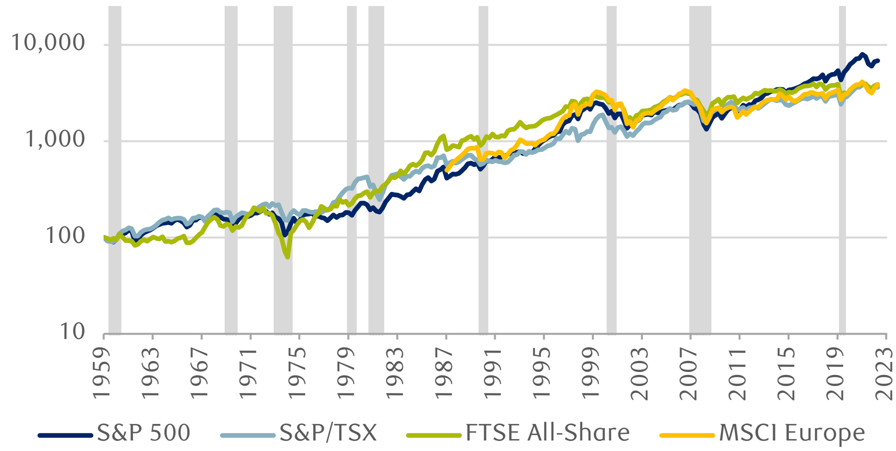
U.S. recessions and global equity bear markets go hand in hand



Source - Standard & Poor's, Toronto Stock Exchange, FactSet; quarterly data through 3/31/23, shown on a logarithmic scale, indexed to December 1959 = 100; shaded areas indicate U.S. recessions.

out of that drop and have stabilised around current levels. We believe the index, already up some 18% from October, may be able to post further advances for some weeks or months as long as the economy remains able to gain some ground.

But it will be over later this year

The two most reliable leading indicators of U.S. recession—the inversion of the yield curve and the year-over-year downturn in the Conference Board's Leading Economic Index—gave negative signals in July and September of last year, respectively. Both have "perfect" track records of signalling a U.S. economic downturn is on the way well in advance of the recession getting started.

Their respective histories would point to mid-2023 as the most likely start date for the coming U.S. recession. A bit earlier or somewhat later is always possible, but as far as these two series are concerned, the U.S. economy is now about to enter "the zone" where a recession could be expected to get underway.

Waiting for two more shoes to drop

Two other recession indicators we follow normally flip to negative just before or just as a recession starts. The first of these is the unemployment rate. Usually, it declines rapidly during an economic expansion, then plateaus at a low level over several quarters before reversing course and trending decisively higher. In this case, it has meandered at or near current levels for 12 months. It would only take a move up to 4.0% from the latest reading of 3.6% and January's cycle low of 3.4% to turn the series trend higher and start the countdown clock for recession in earnest.

The second indicator that typically crosses its "red line" just as a recession is getting underway is the federal funds rate moving higher than the six-month annualised run rate of nominal GDP growth. (Nominal GDP is GDP that is not adjusted for inflation, and distinct from the most often cited real GDP, which takes out the effect of price increases.) As of Q4, the run rate of nominal GDP growth had subsided to 7.2% (down from a cycle high of 12.8% in Q2 2021), still well above today's fed funds rate of 5%. We expect nominal GDP will

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slow further and by Q3 of this year will have fallen below the fed funds rate, meeting that pre-condition of all previous recessions of the past 70 years.

Fed cutting won't save the day

But the sooner the rate cutting happens, the shorter and shallower the recession will likely be. The Fed and most other central banks, mindful of the late '70s experience, are leery of cutting too soon. However, the banking turmoil now has them reconsidering the wisdom of any further increases. We think a pause may be seen within the next couple of months. (The Bank of Canada has already gone there.)

But rate cutting, in our view, probably awaits a year-over-year inflation rate of close to 3% (it was down to 5% in February) with a clear indication of lower inflation readings on the way. We expect inflation could reach those encouraging levels by late summer. More often than not, the Fed began cutting before most past recessions started. Notable exceptions were the downturns of 1973–75, 1980, and 1981–82—all ultra-high inflation periods—when Fed rate cutting started only after the recession was already underway.

Nobody rings a bell

In the U.S., the job of officially determining the start and end of recessions (and expansions) goes to the National Bureau of Economic Research, a private, nonprofit, nonpartisan organisation. Its objective is accuracy, not speed. On average, it has made the call about a year after the event. So there can be a long stretch where debate continues to rage about whether the U.S. economy is or is not in recession without "a referee" making the call.

And the same goes for recoveries from recession. The global financial crisis and the accompanying recession ended in Q2 2009, but it was 2012 before most consumers and many businesses came around to accepting that.

While one waits for the referee's call, the yield curve has proven to be a useful timing tool. One of the yield curve's great strengths as a leading indicator, in our view, is that it works equally well in both directions. Inversion happens on average about 11 months before the recession starts, while normalisation (i.e., short-term interest rates fall back below long-term rates) occurs about 11 months before the economy pulls out of recession.

The stock market peaks before the recession starts …

The market has set its bull market high on average about seven months before the recession begins. If the peak of the S&P 500 almost 15 months ago in early January 2022 marked the beginning of the bear market associated with the coming recession, then the time gap between the start date of the market downturn and that of the recession will be the longest on record. Even more so if the recession doesn't get underway until Q3.

The rally from the October lows is still intact despite the Russia-Ukraine war, banking turmoil, as well as Fed and other central bank tightening. Breadth among the large-cap stocks has been stronger than the S&P 500 Index and is already close to setting a new all-time high—often a sign the index is going to follow suit. However, small caps have lagged badly both in index performance and breadth, usually an indication that the overall market advance has limited room and time to run.

… and the market typically turns higher before the recession ends

Such upward moves have usually emerged four to six months **before** the recession concludes. However,

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the market has never bottomed before the associated recession even began.

Bottom line

We expect a U.S. recession will get underway later this year, ushering in another period of challenging stock market performance with knock-on negative implications for economies and stock markets in other developed countries. We recommend a global balanced portfolio be Market Weight to equities for now with a focus on quality, resilient balance sheets, sustainable dividends, and business models that are not intensely sensitive to the economic cycle. More aggressive defensive positioning may be called for in coming months.

That said, we believe bear markets can provide once-in-a-decade buying opportunities. The yield curve, when it normalises, should give some idea of when the recession will end. Stock indexes would typically embark on a new bull market upleg some months/ quarters prior to that.

Research resources

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As of March 31, 2023

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Rating	Count	Percent	Count	Percent
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