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Recession Incoming?

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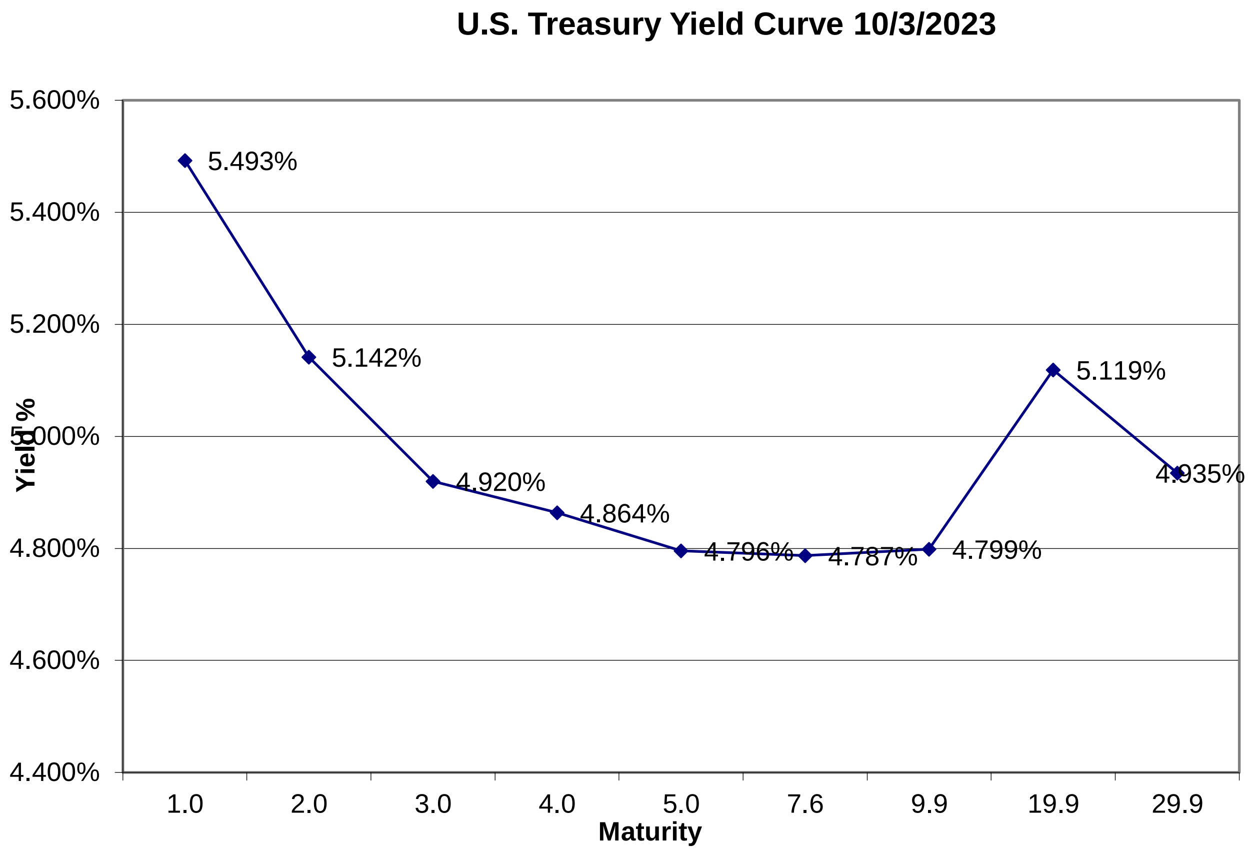
Economists are not particularly good at predicting recessions. In June 2022, Fortune magazine reported that more than two-thirds of economists expected a recession in 2023. Six months later in December 2022, Bloomberg reported that economists placed a 70% chance for a recession in 2023.

The US reported GDP growth of 2.2% and 2.1% for the first and second quarter, respectively. In early September of this year, the average forecast of Blue Chip economists for GDP growth is close to 3.0% for the third calendar quarter that just ended. However, there are some reasons why we could have a US recession.

The global economy is slowing down. According to TradingEconomics.com and EuroStat, the Euro Area GDP had quarterly real growth of 0.1% in both the first and second calendar quarters. The "Euro Area" consists of 19 countries that use the euro as their currency. Germany, Netherlands, and Italy are currently in recession. China reported positive GDP growth of 0.8% during the second quarter but it has an ongoing crisis in real estate and construction. While there are some exceptions, most countries in the world are growing at a slower pace than they were during the last two years.

Inverted yield curves are infrequent and occur when short-term interest rates are higher than long-term rates. Usually, they are the result of aggressive Federal Reserve policy and happen after several increases in the target rate for Fed funds. Because higher interest rates suppress business and consumer spending, an inverted yield curve is usually followed by a recession. During a recession, the Federal Reserve eases policy and the yield curve normalizes and returns to a positive slope with short-term rates lower than long-term rates. According to Bloomberg, from 1968 to 2019, there were seven times when the spread between the 10-year US Treasury bond and the 3-month US T-bill turned negative. In each case, the inverted Treasury yield curve was followed by a recession in the US.

The current yield curve for US Treasury securities is shown below. The risk of default rises as maturities extend further out, but that is not reflected in the current yield curve. Perhaps that is one reason why the long end of the yield curve has been rising lately as more signs of an imminent recession appear.



Dr. Ron Paul, MD, was one of the very few fiscal conservatives in the US Congress. He recently wrote:

> Federal spending is so out of control that it only took three months for the federal debt to increase by one trillion dollars to over 33 trillion dollars. In contrast, it took almost 200 years for the federal debt to reach one trillion dollars. So, the federal government racked up more debt in the last three months than it did from the ratification of the US Constitution until Ronald Reagan's first term! There will be even more shocking increases in the future since, according to some experts, federal debt is increasing by approximately 14 billion dollars a day.
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> Those tempted to blame the increase on President Biden, the Democratic Congress, or the COVID-related spending spree, should consider the debt increased by around a trillion dollars a year in 2017 and 2018 — years when Republicans controlled the White House and both houses of Congress.

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While not much attention is paid to the growing federal debt and maturities that will be refinanced at higher rates, the math is problematic. Trey Reik is a market strategist at Bristol Gold Group and cites the latest Bloomberg estimate of the annualized federal interest cost that hit a new high of $960 billion as of August 2023. He writes, "$7.6 trillion of Treasury debt (31% of the publicly held total) matures during the next 12 months and will need to be refinanced at higher interest rates." He continues, "It would be fair to assume the blended interest rate paid by Treasury on this total ($33 trillion outstanding) will be approaching 4% by next year, implying an annualized interest tab of $1.3 trillion."

While the cost of financing the federal debt is rising, federal tax receipts have declined about 8.6% during the last three quarters from Q3-2022 to Q2-2023. Trey Reik points out that since 1969, every decline in quarterly tax receipts has been immediately followed by a recession. It makes sense. When wages and business income decline, consumers and businesses will reduce their spending. So, the two most reliable leading indicators of a recession (inverted yield curve and lower federal tax receipts) are now in agreement and indicating a recession will be coming in the near future. That scenario is not reflected in the current price level of US stocks, while foreign stocks are priced at more reasonable valuation levels.

Portfolios are currently positioned conservatively with a low allocation to equities, investment-grade fixed income (bonds, CDs, T-bills), and precious metals (to hedge against US currency risk and inflation).

If you have any questions or comments, please contact me.

Sincerely,
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