Does Financial Market Turmoil portend a U.S. Recession?

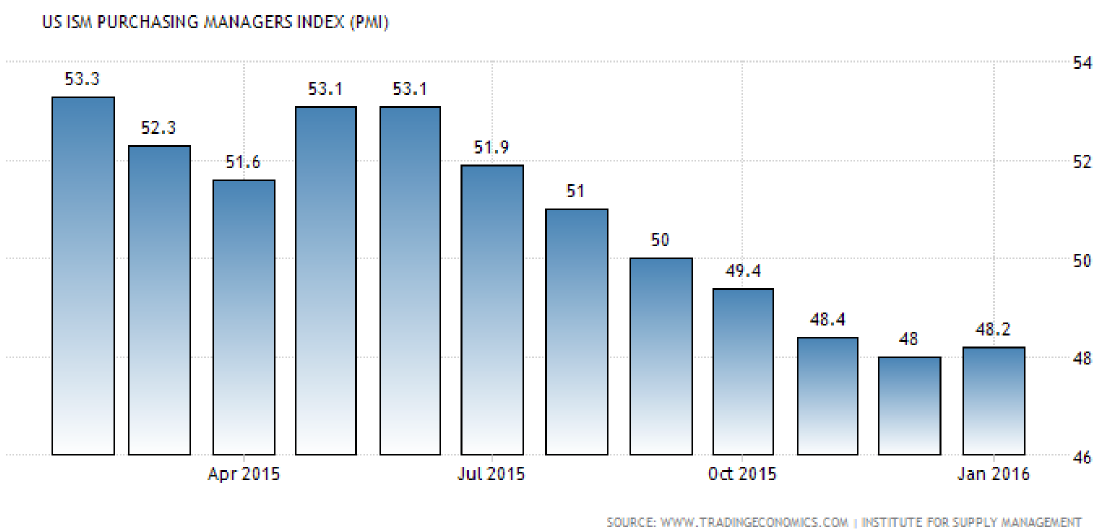
Equity markets are in the midst of a correction (2130.82 on 5/21/15) with the S&P 500 down 13% from the May 2015 highs. Credit conditions continue to deteriorate with spreads wider than they have been at any point since 2012. Commodity prices have collapsed, with oil (93.01 on 6/30/14) down 70% since mid 2014. Given all the turmoil in the financial markets, concerns about the economic environment have risen substantially as investors wonder if the United States is headed for a recession.

When weighing the likelihood of a recession investors should remember that weakness in financial markets does not, necessarily, lead to contractions in the economy. Historically, markets have been much more volatile than economies, which brings to mind the punchline of a classic joke: "the stock market has predicted nine of the last five recessions. "

In the last 20 years, the 1987 stock market crash, 1994 bond market selloff, 1998 Asian currency collapse, 2002 credit crunch and 2011 European debt crisis are all examples of financial markets pricing in significant recession risk which never materialized.

By most measures, the U.S. economic environment remains relatively healthy. Employment trends are strong with nonfarm payrolls continuing to rise and unemployment falling to under 5%. The housing market is healthy and other measures like auto sales and tax receipts also point toward continued economic growth.

At the same time, it is important to realize that conditions have deteriorated in some areas and that the possibility of a recession is on the rise. Commodity and industrial related sectors of the domestic economy are under significant pressure as illustrated by the ISM Purchasing Managers index (a reading below 50 percent indicates that the manufacturing economy is generally declining.)



Source: http://www.tradingeconomics.com/united-states/business-confidence

Much of this weakness can be attributed to the economic slowdown in China. Although, exports to China are less than 1% of U.S. GDP, it is the world's 2nd largest economy and slower growth impacts industrial and manufacturing activity across the globe. In addition, the collapse of commodity prices has negatively impacted numerous industries, prompted significant weakness in the credit markets and heightened concerns about possible exposure throughout the financial system.

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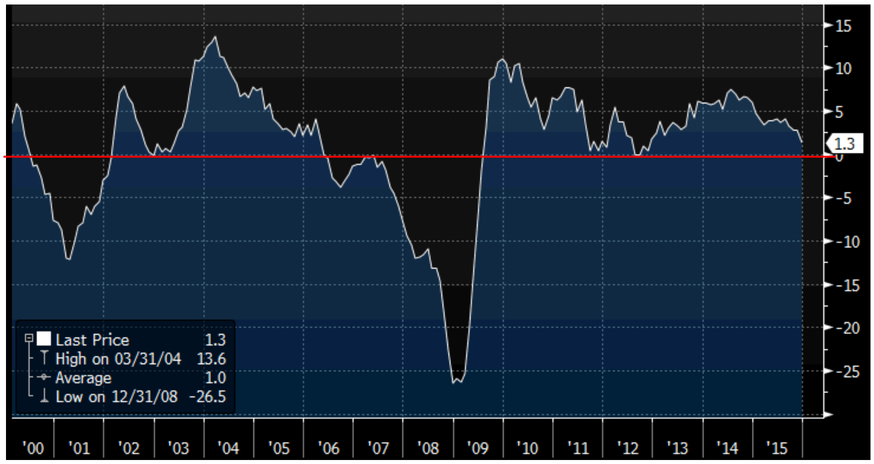
Two measures used to evaluate the economic environment are leading economic indicators (LEI) and the slope of the yield curve. Although they are headed in the wrong direction, neither of these measures currently indicate that a recession is likely.

As the graph below shows, in the last two recessions the LEI moved into negative territory. Importantly, at this juncture, they remain in positive territory.



Source: Bloomberg

Going forward, we will continue to monitor trends in employment and housing to see if weakness in the manufacturing sector spreads to other areas of the economy. Although the possibility of a U.S. recession cannot be ruled out, we believe it is more likely than not that the trend of slow, but positive, economic growth continues.

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