How The Next Recession Could Be Worse Than The Financial Crisis

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Long/Short Investments

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Summary

How can the next recession be worse? Monetary policy will become less effective over time, as I detail below.

Deflationary forces in the global economy represent a headwind to higher growth and inflation, challenging central banks' ability to raise interest rates that much more before needing to cut again.

It's therefore likely that each subsequent recession will require going all the way down to zero percent interest rates, plus additional quantitative easing.

As the spreads between overnight rates and sovereign bond yields continue to contract, this will challenge how effective monetary easing is going forward.

If secular forces cause monetary easing to become less effective over time, this will challenge central bankers in what they can do to stimulate their economies back to growth.

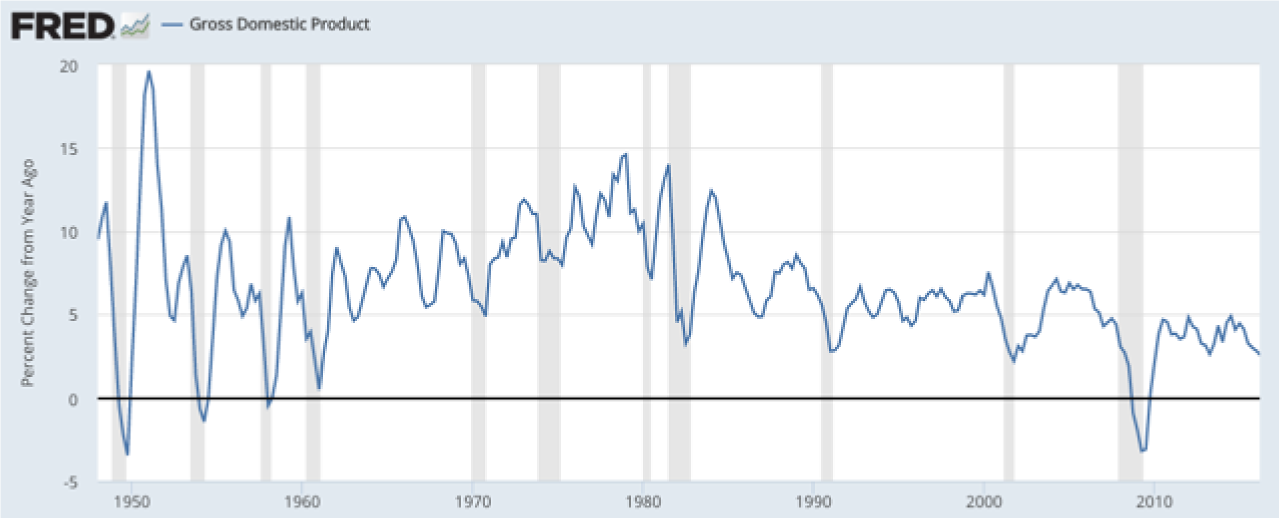
Central argument: Long-term deflationary forces are pushing down long-run growth, inflation, and interest rates. This challenges how high central banks can raise rates in the future and how effective monetary policy can be over time when it comes to combating down-cycles. This also brings down the long-run returns of asset prices.

Overview

The financial crisis was a once- or twice-per-century type event characterized by a meltdown in subprime mortgages and excessive risk-taking by certain banks that exacerbated the financial effects on a global scale. The US Federal Reserve began lowering interest rates in August 2007 as a consequence of the first shreds of evidence of a subprime meltdown with BNP Paribas' infamous "absence of liquidity" press release. It had the benefit of a large cushion when dropping rates from 5.25% to zero.

Since zero interest rate policy wasn't sufficient enough to drop credit spreads further, the Fed resorted to quantitative easing, or government bond purchases to bid down their yields and consequently create demand for riskier assets. This helped effectively lower interest rates further. Lowering nominal interest rates to 0.00% simply wasn't enough when nominal growth fell as low as -3.2% when measured on a traditional year-over-year scale.

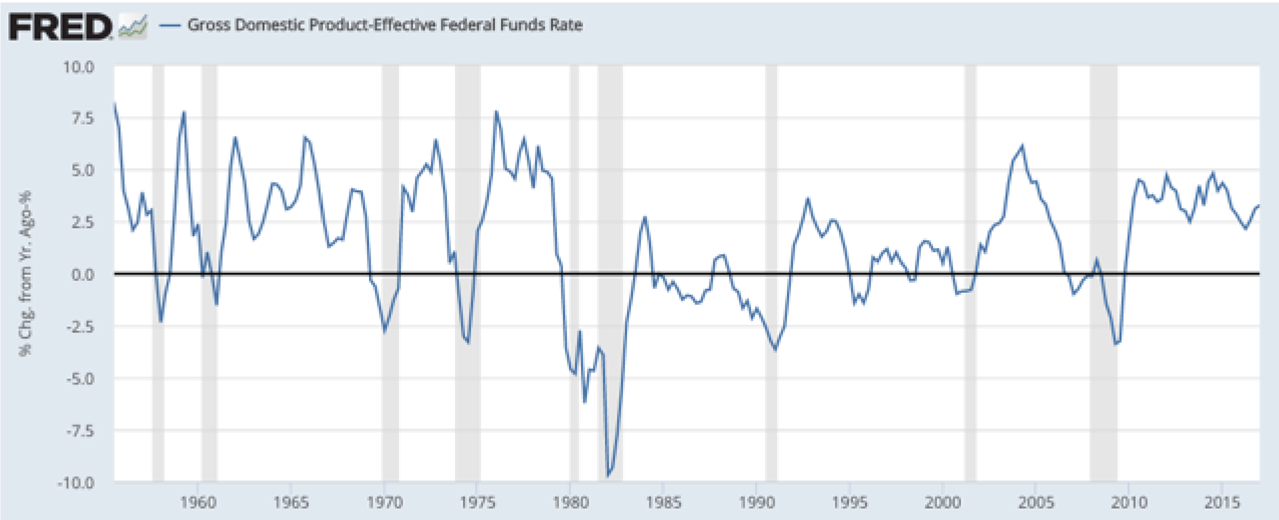
As the chart below demonstrates, it is rare that nominal growth ever falls below zero in the US economy (approximately one-quarter of the overall world economy). However, when it does, extreme measures such as quantitative easing may be needed when it's not possible to lower nominal interest rate below the nominal growth rate.



(*Source: St. Louis Federal Reserve*)

In order to help facilitate a deleveraging, the nominal interest rate needs to be lower than the nominal growth rate. If this does not occur, then it sets up an environment where debt compounds at a rate faster than the economy can grow, which obviously isn't the goal.

We can see over history that the nominal interest rate normally remains below the nominal growth rate. (The chart below takes nominal growth minus the effective federal funds rate).



(*Source: St. Louis Federal Reserve*)

During recessions, nominal growth generally hits a low of about 2.5% under the nominal interest rate. (1980-1982 were exceptional circumstances due to excess inflation.) Rates are then lowered and eventually growth accelerates back into positive territory.

The chart above nonetheless doesn't accurately reflect the current monetary regime which keeps rates lowered as a consequence of unwound stimulus. The Fed maintains around [$4.5 trillion in assets] on its balance sheet, predominantly comprised of Treasury bonds (NYSEARCA:IEF) (NYSEARCA:TLT) and "no-risk" mortgage-backed securities.

As part of the monetary loosening regimen during the crisis, when Treasury bonds provided weak yields, this pushed investors into corporate bonds, raising their prices and lowering yields. This dropped credit costs and made debt payments easier to service to help the economy at large better deal with the effects of the crisis.

However, now 8-9 years after this crisis, the Fed has managed to raise rates to a lower-bound of just 0.75%. It has still not yet begun to unwind its balance sheet, which would most likely begin next year and run-off around $1.5-$2.0 trillion worth of assets. My expectation is that the Fed will get up to somewhere in the 2.00%-3.00% range in the overnight rate before it will begin cutting.

The Case of Europe and Japan

Europe and Japan are in a situation in which nominal rates are still flat at zero (or slightly negative in the case of the latter) with large amounts of sovereign debt, corporate bonds, and some equity instruments under ownership of the central bank. Due to central bank demand, returns on sovereign bonds in the most creditworthy countries are essentially zero.

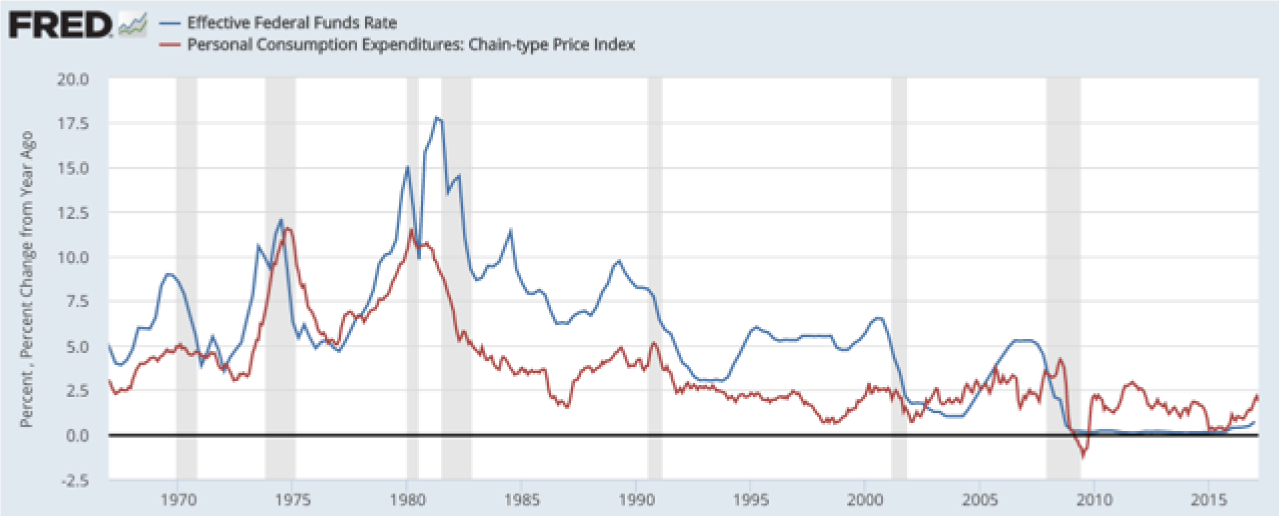
In Europe, 10-year bonds are yielding less than 1% in Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Ireland, Lithuania, Netherlands, Slovenia, Sweden, and Switzerland. In Japan, its 10-year yield is pegged to a 0.00%-0.10% rate and its 40-year issuance is yielding just 1.00%.

With 0% interest rates and near-0% spreads, this means the future stimulatory impact of monetary policy will become less effective than it has been in the past. Currently, we're in a relatively good part of the cycle. We are eight years from the previous recession, but the length of any given expansion itself has practically little bearing on how close we are to the next down-cycle.

But in 1-3 (or more) years' time, when the next recession hits and we haven't tangibly moved rates above the 0% lower-bound this will limit what impact easing can have in facilitating growth conditions moving forward.

Deflation

If we look at where rates and inflation have been since just after 1980, we can see that each cyclical high and low point has become progressively lower.



(*Source: St. Louis Federal Reserve*)

So there is an unmistakable deflationary force that has been putting pressure on growth, inflation, and interest rates over the past 35+ years. I won't go into these forces in too much detail, but it largely revolves around a few main factors:

1. High levels of debt at the government, corporate, and household levels. This limits future spending power as higher proportions of government, corporate, and household budgets must therefore be dedicated to paying this debt off.

2. Productive resources, such as oil, have been underutilized.

On top of that, technological improvements in extraction processes have lowered exploration and production expenses and thereby lowered the breakeven price of oil per barrel. This incentivizes further production and leads to more supply on the market. Demand in the market for oil will continue to increase as world population grows, but for now the supply side is overwhelming demand and keeping prices down.

3. There is industrial overcapacity in India and China, where 37% of the world's population resides.

4. China for years has had downward pressure on its balance of payments (or, loosely defined, money that goes in and out of the country). This has caused the yuan to depreciate against the US dollar (and other major currencies) since the beginning of 2014.

With China as the world's second-largest economy, this is influential in that a depreciation in its currency causes a relative appreciation in other currencies. This is deflationary given stronger currencies have greater purchasing power, which is inherently deflationary.

5. Aging demographics is an issue in developed economies. The average age in the US is nearly 40. The average age in the European Union is already 43. In Japan it's approaching 50. This is a headwind to growth and inflation (and therefore interest rates), given people tend to consume less as they age. And more importantly, it leads to higher dependency ratios - i.e., a lower fraction of the population working and a higher fraction on social security.

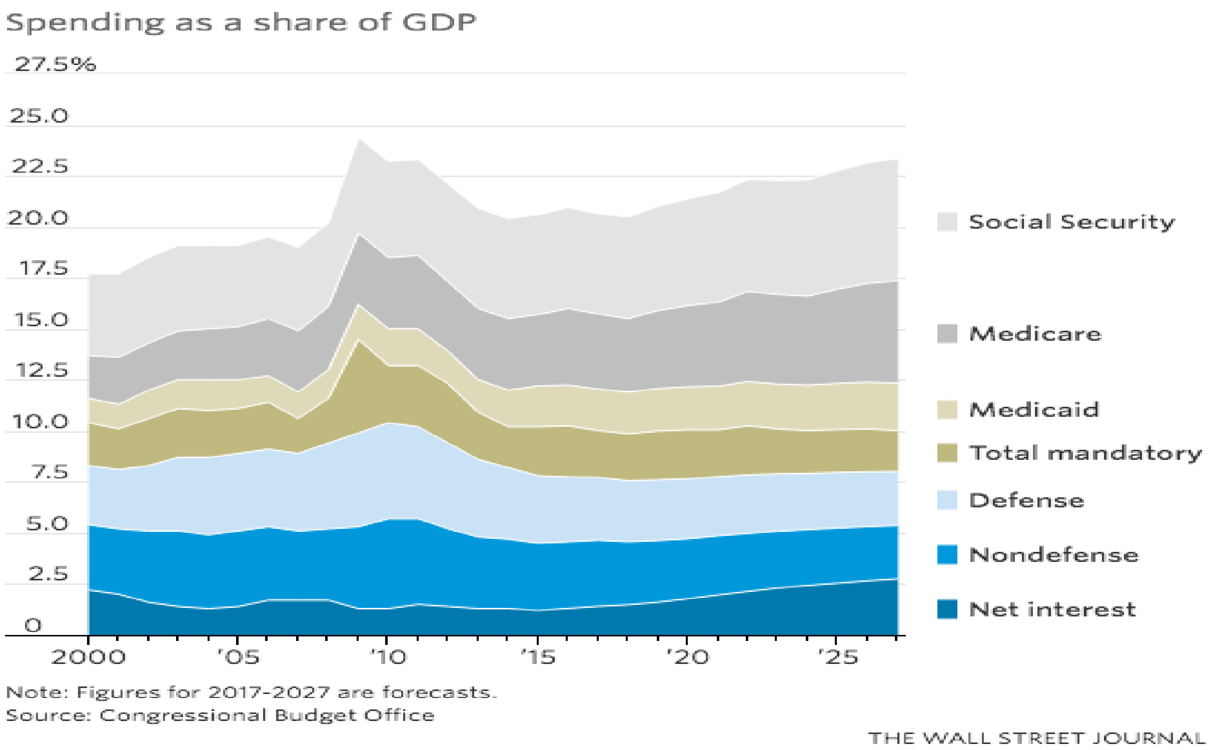
6. Within the US specifically, inflation expectations have been waning since late January after having had increased since June 2016 (with an additional jolt after the November 2016 US elections). Real estate and automobile sales collectively make up about half of US CPI inflation, and both are facing headwinds, as discussed further in this article.

The Current Situation

Tax cuts and deregulation can help spur growth and inflation. But without sufficient budget cuts and revenue uptake to decrease deficits, US debt totals will continue to rise. As the supply of debt increases, holding all else constant, this will tend to lower their prices, leading to higher yields. This helps support the argument for higher rates and monetary tightening as a whole.

However, as debt totals rise, and rates increase along with it, it becomes more difficult to service these payments and interest on debt will take up a greater fraction of the federal budget. Only about 6.6% of the US budget is currently dedicated toward net interest on US debt (about $261 billion per year), but this is subject to increase at least in absolute terms.

As a fraction of GDP, net interest payments on debt are raising and set to rise further, though at a slower pace than Social Security and Medicare. The graph below is from a recent Wall Street Journal article.



At a national debt of $19.9 trillion, each 25-bp increase in nominal interest rates, assuming a parallel shift in the yield curve, increases annual interest payments on debt by $50 billion. This inherently leaves less room for the government to support other economic initiatives.

All these factors point to the idea that the Fed and other central banks are fighting a secular disinflationary force that will materially impact their desire to raise rates - even in relatively good times as we are now.

More Extreme Measures Ahead?

With the way things stand currently, this means for all future subsequent recessions it's very likely we'll be brushing down against the 0.00% lower-bound interest rate. And this will provide little stimulatory impact if rates are already fairly low to begin with.

This likely means more extreme monetary policy measures going forward. The Fed has not dipped into corporate debt as part of a quantitative easing regime as they've done in Japan and Europe. The Fed is actually prohibited from buying up certain assets as it stands, though if the situation is dire enough these rules are very much subject to change. The Fed could also adopt other easing measures, such as helicopter money, wherein the Fed bypasses the banking system and financial markets altogether.

In the event of the next US recession, if dropping nominal rates down to zero is not sufficient (i.e., nominal interest rate needs to be below the nominal growth rate), and buying up Treasury bonds is not enough - either by effectively running out of bonds to buy or yields for certain maturities turn negative - the Fed will likely need to venture out over the risk spectrum to corporate debt.

A Challenge to the Global Economy More Broadly

We're running into a situation where spreads are contracting to the point wherein it challenges the basic nature upon which our economic system is built. When you invest your money, you're basically chasing a spread. If there was no future return on your money to be had - that is, no spread - there would be no point in investing in the first place.

Everything in capitalistic economies is fundamentally based on spreads between borrowers and lenders and these transactions help transmit economic activity. Based on the deflationary forces we've seen progressing over the past few decades, this dynamic is becoming decreasingly effective.

Impacts on Asset Prices

This disinflationary trend that we've seen has been the central factor behind the bond bull market that is still ongoing and influential in the favorable risk-adjusted returns of bonds relative to stocks (NYSEARCA:SPY) over this period. Bonds tend to thrive when growth and inflation run under consensus expectations.

Many believed that Donald Trump's election would cause a bond bear market because of his pro-business policies. But one administration's policies cannot very easily overturn several embedded structural factors impacting the global economy. While bonds went through somewhat of a modest decline following the election and are now in consolidation mode, I think in the long-run bonds are still likely to outperform stocks on a risk-adjusted basis given they thrive in these lower growth, lower inflation environments.

We will get periods where growth and inflation run higher than expectations, but I expect these cycles will be shorter and within the longer-term trend of a downshift in both.

Stocks will continue to achieve higher returns relative to bonds over the long-run given by nature they are inherently leveraged investments (i.e., most companies have debt). But over longer periods of time I expect that they will return worse on a risk-adjusted basis. If we were ever to enter into a high growth, high inflation period - as initially anticipated after the November elections - the environment would shift more favorably to stocks and away from bonds.

But I again expect these to be of shorter duration and contrary to what we're likely to observe over a multi-decade horizon.

Conclusion

The next recession may be more mild than the last. But what's concerning is that going into the 2008 financial crisis we were in a moderate-interest rate, pre-QE environment. Now we're in a low-rate, ongoing/unwound QE environment.

What central banks have been doing has been and still is beneficial for asset prices. The US stock market is up 16% in the past year. Japan's is up 22%. Europe has gained 16%. With recession risks low for now, there is nothing immediately foreseeable that could reverse these gains, though forward returns have been pushed lower as a consequence.

However, should the Fed need to begin cutting interest rates from the 2.00%-3.00% range in response to the next down-cycle, lowering rates down to zero will have less impact than it did previously. This means more QE and more aggressive QE to get the same stimulation to the economy as before, all in response to this ongoing deflationary trend.

So what is concerning is not whatever the magnitude of the next recession happens to be, but rather whether central banks will have the ability and tools at their disposal to engineer the economy as they once did.

Japan is the most prominent example of the economic tribulations that come about when the spread between lending and borrowing rates closes almost fully. With regard to this predicament, Europe is behind Japan, and the US is behind Europe.

However, the US in several decades could see the same type of stagnant situation as Japan, with ~0% 10-year yields and demographic and other global headwinds being a drag on growth and improvements in overall living standards. For investors, these means lower returns on assets over what could be broadly described as the longer-term future.