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10 SIGNS THAT A RECESSION IS NOT UPON US

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Since 1926, over 91 years, the U.S. stock market has returned 20% or greater 33 times (36%) and lost more than 20% only six times (7%). When markets are so clearly favorable, fear of the few big down years is irrational – yet powerful.

We have not had a pronounced sell-off, a 15% correction in the Standard & Poor's 500, for almost four years. Optimism is evident in the sentiment surveys, which is normally a good time to start looking for the exits. But instead of pausing and waiting for calmer heads to prevail, many investors tend to give into fear and sell at the worst possible times, even exiting the markets.

Bad decisions result from panic: by not remaining consistently invested, over the last 30 years of annualized returns, every single major asset class had a better return than the average investor, who garnered a mere 2.5% return, annualized. That did not even keep up with inflation.

To harness the markets' power over the long term, investors must learn to distinguish between noise and signals. "Panic attacks," sudden market dips, are often just noise. Yet determining when we are going into a recession is a signal, because that's when markets crash.

A market crash is defined as a decline of 20% or more on the Standard & Poor's 500 Index that lasts longer than 12 months. There have been three market crashes over the past 36 years, plus one near crash. Each coincided with the past four recessions.

We believe the likelihood of a recession over the next 12 months is around 20%.

ClearBridge has found 11 data points that historically foreshadowed a looming recession:

- Average Hourly Earnings
- Institute for Supply Management's Purchasing Managers Index (M-PMI) New Orders
- Consumer Price Index Energy/Oil Prices
- 10-Year U.S. Treasury and 3-Month T-Bill Spread
- Consumer Non-Mortgage Delinquency Rate
- Corporate Profits (Financial and Non-financial) as percentage of Gross Domestic Product
- High Yield Spread
- Housing Permits
- U.S. Dollar Strength
- Temporary Worker Trend
- Four-Week Average of Initial Unemployment Claims

Only one data point is flashing a warning sign: corporate profits.

Corporate profit margins last peaked in 2014. Historically, they have peaked ahead of recessions. Narrowing corporate profit margins can lead to less capital investment and hiring, ultimately resulting in higher unemployment, lower consumer spending and decelerating economic growth. Corporate revenue growth has been solid this year, which we believe will be sustained. Corporate margins also should remain flat, at a minimum, despite possibly higher labor costs.

The other signs are all positive.

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Proxied by average hourly earnings, labor costs have picked up. An increase in hourly earnings can be a great recession predictor: on average, when earnings hit growth of 4% or more, a recession ensued two years later. We are well below that level.

Housing permits are firmly in an uptrend we expect to go higher.

Oil price spikes precede virtually all recessions. Oil has been volatile, dropping from over US$100 a barrel in 2014. Even though oil is up from 2016 lows, it is not at levels that signal danger.

Employment numbers only tell us where we've been, not where we're going, so temporary worker trend is a better metric than unemployment: it heads down before recessions begin, and heads up before exiting. The temporary worker trend continues to grind higher.

M-PMI registered a healthy 58.8% in August – over 50% is expansionary, signifying earnings should continue to gather steam.

Bond rates have pulled back, but the 10-year Treasury is likely to go higher.

The U.S. dollar will continue to weaken or be possibly range-bound over the next year; it lost 18% of its value, on average, after the first rate hike during the last three rate hike cycles. Dollar weakness is generally good for the global economy and for U.S. equities.

Is another recession ahead? Maybe, but the signs are against it.

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