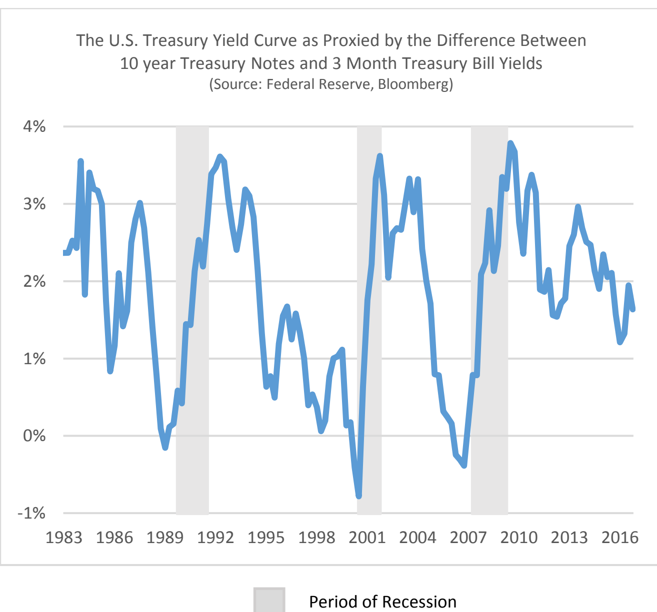
# Economic & Investment Perspectives

**Are recession odds higher than forecasted?**

The U.S. business cycle is now well into its 95th month of expansion. To say that we are increasingly nervous is to understate the obvious. We are actively monitoring a broad set of economic and financial leading indicators for signals and turning points that will likely signal a disruption of the current economic environment. The key, of course, is timing. Not all of these factors are created equal – some are predictive of the degree of disruption, while others provide insight into timing.

**Chart One**




Over the years, researchers at the Federal Reserve, academia and elsewhere (including ourselves) have shown a keen interest in the predictive powers of the U.S. Treasury yield curve (the difference between long and short-term interest rates). The theory states that as markets begin to anticipate weak economic performance over the coming year or two, that short-term interest rate assumptions for the future should begin to drop, and that today's long-term interest rates serve as the best proxy for the aggregate assumptions of those short-term interest rates. Therefore, the spread between the present yields of long and short-term interest rates should provide us with strong guidance regarding market assumptions of future economic activity. Historically speaking, when long-term interest rates have dropped below short-term interest rates (i.e. an "inverted" yield curve), an economic contraction has followed within a relatively short window. This phenomenon has been especially evident during the last three cycles. However, we are currently a long way away from a flat or inverted yield curve. As seen in Chart One (left), the difference between the 10-year Treasury Note and the 3-month Treasury Bill is currently 1.63%. In fact, three different models which use this spread (and are used by the Federal Reserve Banks) place the odds of an economic contraction at between 0.68% (St. Louis Fed) and 9.8% (Cleveland Fed) over the coming twelve months.

However, the influence of the exceptional policies of the Federal Reserve employed in the aftermath of the great recession of '07-'09 has led many (including us) to question and attempt to quantify the degree of that influence, and to adjust the yield curve accordingly. In fact, we believe the influence of such policies is impacting both ends of the yield curve. Treasury Note yields are being impacted and artificially kept low by the Fed's asset purchasing activities, while the excessively cautionary stance of the Fed as it pertains to overall economic activity has kept short-term interest rates artificially low as well.

With respect to long-term interest rates (as proxied by 10-year Treasuries), our outlook for potential/trend nominal economic activity and normal cyclical volatilities indicates a fair-value range of 2.25%-3.25%. The mid-point of this range, or 2.75% is very close to what we believe interest rates would be in a "normal" environment absent any Federal Reserve purchases, or roughly 0.35% higher than the present level of 2.4%.

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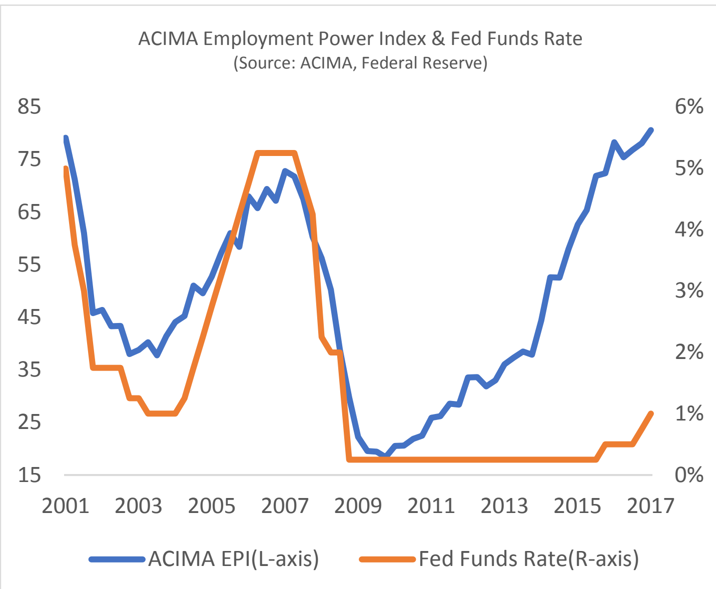
### Chart Two




With respect to short-term interest rates, we have long believed that the Federal Reserve is being overly cautious and sensitive to short-term economic and financial market fluctuations, and is under-estimating the potential negative consequences of delaying monetary policy normalization (the raising of interest rates). We believe this delay is especially obvious when looking at labor market conditions. While the employment gap (the difference between the actual unemployment rate and the full employment level) is an excellent indicator of slack and wage growth potential, we have complimented it with our own internally developed Employment Power Index (EPI), which looks at slack from the demand side. One way of interpreting our EPI is: what potential does the existing demand for labor have in filling the ranks of the unemployed if we control for factors such as location and necessary skills?

As seen in Chart Two, the EPI today is higher than the cyclical peaks of both 2000 and 2007, indicating significant potential for wage growth and subsequent corporate profit margin squeeze and ultimately another earnings recession. Equally important is the level of the Fed Funds Rate at similar points in time during prior cycles (above 5%). Having pointed that out, as proponents of the "New Normal" theory of slower growth in the U.S., we do believe that the neutral level of short-term interest rates should be much lower than previous cycles (probably no higher than 3%). However, given the signals from labor markets, we believe that they should be higher than their present 1%. During the prior cycle, the Fed began raising interest rates when the EPI rose above 45, which it did in the current cycle during Q1 2014. The beginning of the last tightening cycle also corresponded to labor slack of 1% as defined by the employment gap. During this cycle, that 1% gap occurred in Q4 2014. However, the Federal Reserve did not embark on a tightening cycle until Q4 2015. So, at least from a labor market perspective, we believe the Federal Reserve is behind the curve by about 18 months and at least 1.25% and much closer to the end of the tightening cycle.

So, if by our estimates short-term interest rates are 1.25% lower than they should be, and long-term interest rates are 0.35% lower than they should be, the current yield curve is too steep by 0.9%. Controlling for everything else, this scenario provides us with recession probabilities for the coming twelve months that are far higher than what is currently assumed.

As always, stay tuned:

Ardavan Mobasheri
Chief Investment Officer
May 11, 2017

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