Preliminary Report

Unpacking the Next Recession

By Samuel Culper, Forward Observer

One of the more important trends I'm observing is the increase in major, mainstream news outlets publishing articles about the next financial crisis or the next recession. I usually flip between CNBC and Bloomberg TV during the business day to catch the interviews with top bankers, investors, and other financial figures who are usually quite candid about what they're seeing. When they start talking about a financial crisis or recession, it's time to listen. So let's unpack all this and examine some of their expectations.

In January 2018, the founder and co-investment officer of Bridgewater, the world's most successful hedge fund, told a CNBC panel that he expects the next recession to occur in late 2020. My ears perked up as I watched the live coverage. A few months earlier, I had just finished reading his book, *Principles*, which spelled out the life and investment strategies that have made him and his firm so successful. Indeed, that's why I was watching that particular interview in the first place, but my jaw dropped when I heard what he said.

"[W]hat I'm concerned about is what would the next downturn be like? I'm not worried about an immediate downturn. But I would say if we were to look two years forward, okay, probably right before the next presidential election, there is a good chance that you will have a downturn and if you have a downturn for that segment, I'm worried about how we will be with each other in that element of cohesiveness. I mean, basically the formula for having problems, social with political problems, is have a difference between, a lot of difference between rich and poor people..."

"I think it's a very difficult thing to get monetary policy precise. That's why we have recessions because you never can get it exactly right. I think it's particularly difficult to get it right now because of the fact that interest rates are so low... because the duration of bonds and debt has lengthened, it just takes a little change in interest rates to have a bear market."

In another notable interview, Dalio said, "There's a squeeze that will be emerging, but generally speaking we're in, I would say, the seventh inning of the [business] cycle... We're in the later stage, maybe we have two more years, I would say, in the cycle. Something like that... This [coming debt crisis] looks more like the 1935-40 period."

That "1935-40 period" is the tail end of the Great Depression. We know that despite the economic optimism of today, the underlying fundamentals (growing national debt, trillion dollar deficits, etc.) are not beneficial to the country in the long term. We've lived with the Jim Rogerses and Peter Schiffs and Marc Fabers and Jim Rickardses, who for years have been predicting financial catastrophe. Well, they may eventually be right.

But to hear Ray Dalio say it seemed to have opened the flood gates of crisis warnings because since Davos, I've noticed more and more.

- According to a *Wall Street Journal* poll conducted in May 2018, some fifty-nine percent of economists believe that U.S. economic growth will end sometime in the year 2020, signaling the start of the next recession.[1]
- CNBC published an article in April on the results of a JP Morgan survey that found 75 percent of its high net worth investors foresee a recession, possibly as soon as 2019.[2]
- A Bloomberg model published last week shows that the next recession is more likely to occur in 12-24 months, which matches other expectations that a recession will occur around 2020.[3]
- Former Federal Reserve chairman Ben Bernanke warned that the U.S. economy faces a “Wile E. Coyote” moment. The Trump tax stimulus “is going to hit the economy in a big way this year and next year, and then in 2020 Wile E. Coyote is going to go off the cliff.” [4]
- A Bank of America / Merrill Lynch Global Fund Manager Survey, nearly 35 percent of respondents expect the next U.S. recession to begin in the second half of 2019. Nearly 30 percent of them believe it will hit in the first half of 2020, and about 17 percent of them believe it will arrive in the second half of 2020 or beyond.[5]

These are just four out of dozens of such stories about a coming financial crisis or recession.

Recessions, by definition, are two or more straight quarters of negative economic growth, so you can compare today's four percent growth with a negative growth rate, now

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[1] https://www.wsj.com/articles/economists-think-the-next-u-s-recession-could-begin-in-2020-1525961127
[2] https://www.cnbc.com/video/2018/04/19/75-percent-of-the-ultra-rich-forecast-a-us-recession-in-the-next-two-years-survey-finds.html
[3] https://www.bloomberg.com/news/articles/2018-10-05/the-next-u-s-recession-is-moving-further-away
[4] https://www.bloomberg.com/news/articles/2018-06-07/bernanke-says-u-s-economy-faces-wile-e-coyote-moment-in-2020
[5] https://www.cnbc.com/2018/09/18/fear-about-global-growth-is-the-worst-since-2011-sending-investors-to-cash.html

potentially two years away, and see just how much of swing will have to occur. Potential causes of a recession could be a financial crisis, a sustained spike in oil prices or, more likely, the Fed raising interest rates. When borrowing money becomes more expensive, businesses take out smaller and fewer loans. The economy is made of economic transactions, so when economic transactions begin to fall -- which is what happens when business spending slows down -- economic growth begins to wane. This is what Austrian economists call the "boom-bust cycle". During periods of low interest rates, businesses borrow more, spend more, and hire more, which causes an economic boom. This is exactly why the Federal Reserve cuts rates during a recession -- to spur economic growth. During periods of increasing interest rates, business spending slows down, which slows down the economy. When Ray Dalio says that we're in the "seventh inning of the cycle," this is what he's referring to -- the seventh inning out of nine innings. We're at the end of the business cycle, marked by a recession, and then the cycle begins again.

But what makes the next recession so concerning is similar to why 2008's recession was so bad: debt. Lots and lots of debt that carries significant risk of not being paid back. Here are some of our reported indicators from the past six months that lead me to believe the next recession will rival 2008's. (It could be even worse.)

- The national debt currently sits at 21.6 trillion dollars.
- According to research from investment firm Piper Jaffray, the upcoming recession could double the Trump administration's $1 trillion budget deficits by 2021. The Congressional Budget Office is projecting the U.S. to run $1 trillion deficits for each of the next four years, and possibly longer. One alternative projection has the U.S. with $2 trillion deficits by 2028.
- Post-recession corporate bonds have exploded, and no where is that more apparent than in BBB-rated bonds. BBB-rated bonds are still technically "investment grade" but are riskier than superior quality bonds. BB- and B-rated bonds, on the other hand, are straight up "junk" and are sitting at or near highs since the 2008 recession.
- U.S. consumer debt has now surpassed $4 trillion and accounts for about 25% of total disposable personal income. Consumer debt has doubled since 2004.
- Personal loan balances have more than doubled since 2014 and are now the highest since at least 2005.
- In the past 10 years, student loan debt has more than doubled from $627 billion (2008) to $1.5 trillion (2018). Student loans now account for 45 percent of the "assets" on the books for the federal government.
- Moody's Investors Service recently published two charts showing weak economic performance in credit cards and auto loans. The increasing percentage of 30-day delinquencies in both sectors should be a warning of defaults during the next recession.
- Citing a Federal Reserve survey showing that "40 percent of Americans wouldn't be able to pay their bills if faced with a $400 emergency," Clinton-era labor secretary Robert Reich wrote in an op-ed that the problem with the U.S. economy is that it's increasingly top heavy. Because the U.S. economy depends on consumer spending to expand, and working- and middle-class incomes are not

keeping pace with the growing economy, he writes that we're nearing another crash.

- *Elliot Wave International*: “We think the major economies are on the cusp of this turning into the worst recession we have seen in 10 years… Should the [US] economy start to shrink, and our analysis suggests that it will, the high nominal levels of debt will instantly become a very big issue.”
- Some at the Fed reportedly want to regulate banking capital, specifically requiring large banks to increase the amount of cash on hand in the event of an financial downturn. Banks historically have a very high ratio of money that’s loaned out versus cash on hand (i.e., they’re highly leveraged), and so a few large loan defaults could mean that a bank goes underwater. Are some Fed officials proposing this change out of an abundance of caution or because they’re beginning to actively prepare for the next downturn?

This is a developing issue that we're monitoring each day. We'll continue to post our financial and economic briefs in the daily Early Warning report, as well as a summary in the National Intelligence Bulletin. – S.C.