LPL RESEARCH
WEEKLY MARKET COMMENTARY

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RECESSION WATCH

Ryan Detrick, *Senior Market Strategist, LPL Financial*
Jeffrey Buchbinder, *Equity Strategist, LPL Financial*

Why would we write a report about recession with the S&P 500 at record highs? Consider it a check-up. Just because you feel good doesn't mean you skip your annual physical at the doctor. We check in on some of our favorite leading indicators to see if any cracks are forming in the economic expansion and its accompanying bull market.

NO SIGN OF IMMEDIATE RECESSION OR BEAR MARKET

With stocks setting more new record highs last week, why are we concerned about watching for recession? While our outlook is still optimistic, we don't want to be complacent. We expect steady growth in the U.S. economy and corporate profits in 2020. We are encouraged by recent progress on trade and evidence of stabilizing growth in international economies, and we expect further gains for stocks are possible.

However, as shown in our Five Forecasters chart [Figure 1], some indicators suggest the bull market might be running out of steam, while others suggest we may have quite a bit more room to run. Overall, we see near-term recession risk as low, but we'll continue to monitor data for any late-cycle or recessionary signals.

1 FIVE FORECASTERS POINT TO LOW RISK OF NEAR-TERM RECESSION

		Late Cycle Warning?		
		No	On Watch	Yes
There is no magic formula for predicting recessions and bear markets—every cycle is different. But we believe the Five Forecasters cover a variety of perspectives and help capture a more complete view of the economic and market environment. They are meant to be considered collectively, not individually.	Treasury Yield Curve		X	
	Leading Economic Indicators		X	
	Market Breadth	X		
	Purchasing Managers' Sentiment		X	
	Market Valuation	X		

Source: LPL Research 10/31/19

LEADING ECONOMIC INDEX

While coincident economic data helps capture current economic health, leading indicators can help better forecast the near-term economic trajectory. The Conference Board's Leading Economic Index (LEI) is calculated from 10 individual leading data sets, including weekly jobless claims, manufacturers' new orders, building permits, and stock prices. The LEI is one of our favorite economic indicators because of its predictive power: The Index has turned negative year over year an average of 14 months before every recession since the 1970s.

The LEI rose 0.4% year over year in September, its 118th straight increase. We believe the LEI is signaling continued economic growth, but we're monitoring the index more closely given that September's reading was its slowest pace of year-over-year growth since June 2016. The index has largely remained flat this year, suggesting that the smaller annual gains reflected 2018 strength, not renewed weakness. We expect this indicator to benefit from easier year-over-year comparisons in the coming months, with possible support from additional progress on trade agreements, stock market gains, and the yield curve.

YIELD CURVE

Yield curve inversion has preceded each of the nine recessions going back to 1955, so it's understandable that this signal has spooked some investors this year. In March, the 10-year U.S. Treasury yield closed below the 3-month yield for the first time since 2007. The spread between the 2-year and 10-year yield followed suit in August.

Thankfully, three Federal Reserve rate cuts and an improved economic outlook have helped lead the yield curve back to positive territory. The 3-month and 10-year yield spread reached a 10-month high of near 0.4% last week before pulling back some, while the 2-year and 10-year yield spread hovered around 0.25% most of last week.

Still, the yield curve is historically flat, and prior to past recessions, parts of it flickered between positive and inverted territory several times. Because of this, we're not ready to give the all-clear signal for the yield curve. We'd like to see more sustained steepening, led by a rise in long-term yields.

ISM MANUFACTURING INDEX

Recent weakness is U.S. manufacturing activity is concerning despite the manufacturing sector's relatively small role in the overall economy (manufacturing is about 12% of gross domestic product). Manufacturing is a bellwether for profits and the economy, and bouts of weakness matter for corporate profits, capital investment, and corporate America's productivity.

Historically, a peak in the Institute for Supply Management's (ISM) manufacturing purchasing managers' index (PMI) typically has been followed by a recession about three years later. The U.S. manufacturing PMI hit a new cycle high in August 2018 and has been gradually falling since then. In August 2019, the manufacturing PMI fell below its key 50 level and has remained in contractionary territory (below 50) since then: The latest reading was modestly contractionary at 48.3. The yield curve re-steepening suggests this may just be a shallow downturn, and consumer spending remains quite healthy, but corporate profit growth has stalled and trade remains a risk.

VALUATIONS

It's logical to think stocks may be expensive after a 360% gain in the S&P 500 Index 10 years into the longest bull market ever. While stocks are certainly more expensive relative to earnings than they were when this bull market began, we consider stocks fairly valued in this environment, especially considering low levels of interest rates and modest inflation.

BREADTH

Market breadth measures how many stocks are participating in gains or losses of broader indexes. One of the easiest ways to measure this is via advance/decline (A/D) lines. An A/D line is a ratio of how many stocks go up versus down each day. If gains have been caused by increases in many stocks, then there were plenty of buyers and the upward trend may continue, if everything else is equal. On the other hand, if an upward move in an index was driven by relatively few stocks, it can be a warning sign of cracks in the bull's armor.

We like to look at the price of the NYSE Composite Index along with the NYSE Common Stock Only A/D line to identify negative divergences from the A/D line. Not only did the A/D line hit a new all-time high in October, but the A/D line has been leading prices higher, suggesting more and more stocks are participating in the market's advance, evidence of a healthy bull market.

OVER INDEX

Many past economic expansions and bull markets have ended with an overheating economy. Borrowing, confidence, and spending typically have been catalysts for growth. However, when these components have risen to excessive levels, they have tended to lead to runaway inflation and unsustainable growth. Because of this, we watch for signs of excess using the Over Index, which tracks trends in borrowing, spending, and consumer and business confidence.

The Over Index held steady in our latest update, and all three drivers remained well short of the excessive levels we've seen in prior recessions. In fact, evidence of over-borrowing actually diminished amid a slowdown in commercial loan growth, likely related to trade tensions.

We remain optimistic that the U.S. economy will deliver continued steady, albeit possibly slower, growth in 2020, potentially bolstered by progress on a U.S.-China trade agreement. Leading economic indicators show changes that we are watching carefully, but we continue to believe our next recession will not appear until at least late 2020 or early 2021.

You can view the "Five Forecasters" along with the complete LPL Research Recession Watch Dashboard on the client-approved LPL Financial Research House of Charts.

WEEKLY MARKET PERFORMANCE REPORT

Please see our new *Weekly Market Performance* report with insights on major asset classes.

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