3 Likely Triggers Of The Next Recession

Recently I was watching my kids break in our family pool for the first time this year. All four of them stood motionlessly, side by side, staring at the clear blue water with their toes just over the edge of the coping. Knowing that the water is still cold from the winter months the anticipation and trepidation of the "cold shock" kept all four of them glued to the edge. "Who is going first?" I asked. The oldest began to lean over. Knees bent, hands on his knees to maintain stability and an intense concentration to prepare himself for the plunge. It was just at that moment that my younger son screamed "Kowabunga" and shoved him in.

That is where we are in today's economy. The conjecture about the next recession has raged ever since the end of the last one. Will it be in 2012 or 2013 or, if you believe the many mainstream economists' estimates, never? Historically speaking recessions have occurred on average of about every 6-8 years regardless of monetary or fiscal policies, the strength of the economy or global peace - they occurred nonetheless.
There is really no argument whether there will be a recession in our future — the only question is the timing and cause of it. The latter point is the most important. Recessions do not just happen — they need a push. In 2011 the economy was just a breath away from a recession due to the dual impact of the Japanese earthquake and tsunami and the European debt crisis. Had it not been for the combined efforts of the Fed through "Operation Twist" and the Long Term Refinancing Operations via the ECB, a drop in oil prices and a plunge in utility costs due to the warmest winter in 65 years, it is entirely likely that that we may have already been discussing a "recession." The ECRI launched a debate that was literally heard around the world with their recessionary call in 2011. The weight of evidence as shown by our composite economic output indicator index shows that the ECRI call was most likely correct. However, the restart of manufacturing, primarily automotive, after the crisis in Japan combined with an effective $90 billion tax credit due to lower oil and utility costs, turned the previously slowing growth rate of the economy around over the last couple of quarters. Sustainability is becoming the question now as weather patterns return to a more normal cycle and the effects of the lower energy costs began to dissipate.

In a more normal post recessionary recovery the third year should be closer to a 6-8% economic growth rate versus 2%. While 2% growth is much better than zero — the current sub-par pace of growth leaves the economy standing on the edge of the pool with very little stability to offset any unexpected "push" into the cold waters of recession. The problem is identifying what that "push" could likely be.

Export Shock

With the Eurozone slipping into recession, combined with the economic contraction in China, the most likely event will be an export related slowdown for the U.S. The recent plunge in durable goods, factory orders, and many of the regional manufacturing reports point to early signs of a slowdown. The Eurozone accounts for about 20% of U.S. exports and profits and any slowing of consumption due their economic ills will wash ashore in the U.S.
The chart shows the year-over-year deterioration in exports relative to GDP. The slowdown in exports would shave a significant chunk off the calculation of GDP by itself, however, it is the ancillary effects that would push the already weak economy into recession. As exports slow the profit margins of U.S. corporations are reduced and they react by ceasing hiring, cutting back temporary labor and increase productivity to suppress wages and maintain

profits. Those actions, and outlook, by corporations are reflected not only by the stock market but also by declining consumer confidence. The pullback in consumption causes corporations to get more defensive. This virtual spiral further slows economic growth pushing the economy into recession.

Liquidity Crisis

Secondly, a resurgence of the Eurozone crisis that leads to a "liquidity shock" would likely stall the economy. While the ECB has currently committed funds to provide liquidity to the Eurozone the problem of a single large potential default issue from either Italy or Spain, or even a combination of events through the entire region, could quickly create a liquidity crisis. We have written in the past the European Financial Stability Fund (EFSF) and the subsequent European Stability Mechanism (ESM) was not large enough to adequately deal with the European financial crisis. While current actions by the ECB through the Long Term Refinancing Operations (LTRO's) have temporarily calmed financial markets around the world — however, it is a temporary solution that will ultimately fade.
The ECB has already stated that they have done enough in this regard and are unlikely to provide further liquidity in the future. This is a potential problem given the difficulty in trying to get European leaders, particularly Germany and France, to cooperate quickly and efficiently. The delays, arguments and political gamesmanship in the future may well lead to an inability to act quickly enough to avoid another financial crisis.

"Black Swan" Event

When considering the many possibilities that could occur from the information that we have readily available we must not discount the possibility of an event that is completely off the radar. It is these seemingly random events that occur without warning such as the Japanese earthquake in 2011, the "Asian Contagion", Long Term Capital Management or 9/11 that can push the economy off the ledge and into the cold waters of recession.

It is interesting that these "once in a hundred years" events occur with such regularity and yet these are the very things that are dismissed in current analysis. Current growth expectations for the economy are stronger growth by the end of 2012 and increasing economic growth rates in 2013 and beyond. These assumptions are based upon expectations of a continued organic economic recovery even though the recent post recessionary recovery cycle, driven by trillions of dollars of varied stimulus and financial support programs, has been anything but. Each financial injection to support the economy has had a diminishing rate of return and each time these programs have ended the economy has quickly begun to weaken back towards recession. This is not an economy that can grow without massive fiscal support so assuming growth projections well into the future may be a bit shortsighted.

The "Fiscal Cliff"

The impending "fiscal cliff" coming at the end of 2012 where a plethora of tax cuts, credits and incentives, many left over from the Bush era and extended by the Obama administration, will collectively expire. This is no small matter. The simultaneous expirations of these tax benefits will create approximately a 2% hit to GDP which, given the associated fallout across the economy, will be more than sufficient to create a recession.

However, I do not expect that this will happen even though it has lately been a topic of great debate. Regardless of winner of the next Presidential election the economic impact of the "fiscal cliff" is well known. Therefore, it is extremely likely, since no one in Washington wants to take the responsibility of taking away the "government cheese" that another round of extensions for most of the tax benefits will be approved.
The simple fact is that the U.S. is now caught in the "trap" of the debt cycle where cuts in deficit spending, budget reductions, increases in taxes or interest rates cannot be accomplished because the economy is simply too weak to offset the negative impacts. However, at the same time the increase to the debt burden continues to deteriorate the economic prosperity of the U.S. This is the problem that the Eurozone faces today. It is impossible to implement "austerity programs" when the economy is already on the brink of recession. Austerity, as a measure, must be done when economies are growing strongly with a high employment level which offsets the cuts to government spending and support. Today that is not the case either in the Eurozone or the U.S.

A Recession Is Coming

With these ideas in mind it is easy to understand that a recession is coming - recessions are part of the overall economic cycle and despite wishes, hopes and prayers, they will occur with a surprising level of regularity. During economic boom times they are spaced further apart due to stronger economic growth. During debt deleveraging cycles, such as we are experiencing now, they occur much more frequently.
Furthermore, recessions are not a bad thing - they are simply the pause that refreshes the economy. As the economy, or the stock market, grows it creates excesses. These excesses must be reset from time to time through a contraction, or recessionary, phase. What is important to understand is the impact that recessions have on your life and your finances.
The recessions in 2001-2002 and 2007-2008 were important to prepare for, and we warned in our writings well in advance of their occurrence - just as we are now. The problem for most individuals is that they did nothing to prepare of the event until it was far too late. Preparation such as taking an umbrella with you when you suspect that it will rain can save you from negative consequences. Understanding that a recession will occur and preparing accordingly will save you as well.

The push will come. In what form - I really have very little clue. What I am confident of is that no one will be yelling "Kowabunga" just prior to the shove.

Written by Lance Roberts on Wednesday, May 2, 2012