> ***"Treasury Secretary Steven Mnuchin on Sunday downplayed the likelihood of an economic recession as the economy takes a beating from the coronavirus outbreak.***
>
> *When asked on ABC's 'This Week' if the US was now in an economic recession as some have suggested, Munchin said, '**I don't think so.'** " - **CNN***

However, it wasn't just Mnuchin making such a claim, but Larry Kudlow as well:

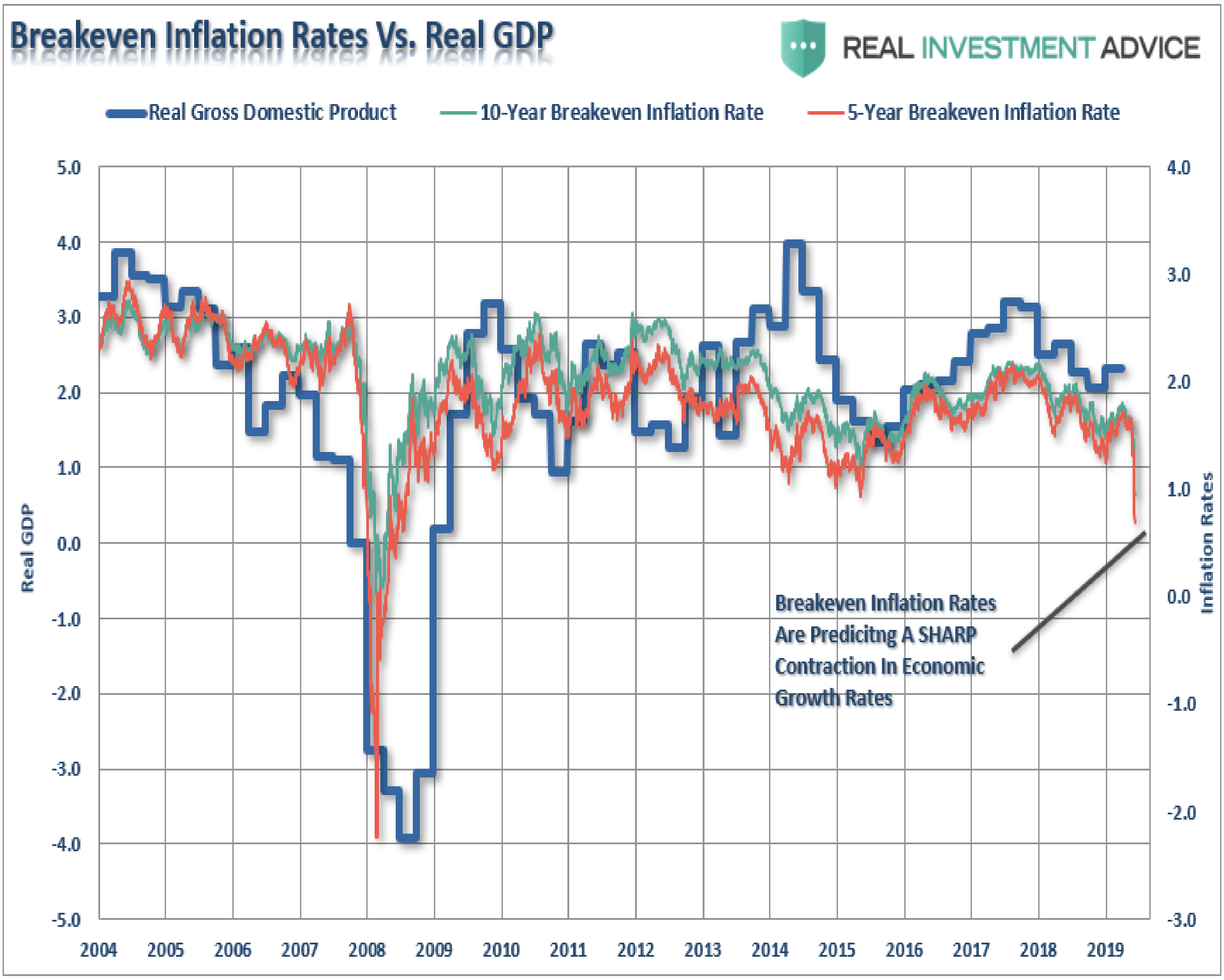
> ***?I just think, in general, I would be very careful to put too much emphasis on what bond rates are doing, what interest rates are doing.** Or even in the short, short run, the stock market. **I think you have a lot of mood swings here and I don?t think it reflects the fundamentals."** - Larry Kudlow via **CNBC***

I understand they have to pander to the administration, but this is a stretch to say the least.

**Let's dig into some facts to determine our real risks.**

Even before COVID-19 had infected the planet, economic data, and inflationary pressures were already weakening. This already suggested the decade long economic expansion was *"running lean."*

However, the sharp decline in both 5- and 10-year *?breakeven inflation rates,?* are suggesting economic growth over the next couple of quarters will drop markedly. **The last time there was such a sharp drop in inflation expectations at the beginning of the *?financial crisis.?***




Since then, the markets have been rocked as concerns over the spread of the?*COVID-19?* virus. The U.S. has shut down sporting events, travel, consumer activities, restaurants, bars, stores, and a host of other economically sensitive inputs. This is on top of the collapse in oil prices, which impacts a very important economic sector of the economy. *(The O&G sector either directly or indirectly creates millions of jobs, has some of the highest wages, and is responsible for about 1/4th of all capital expenditures.)*

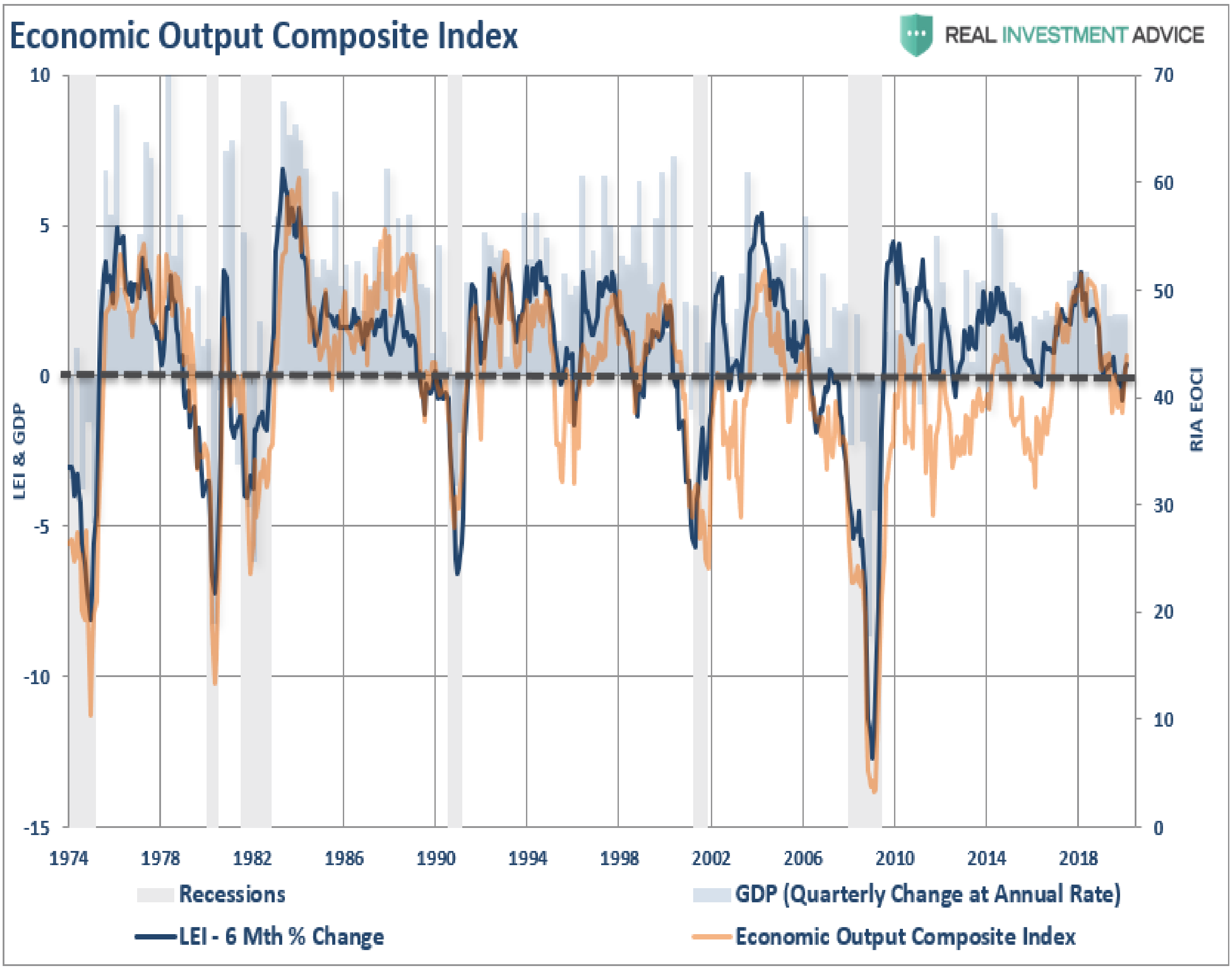
However, this is just in the United States. This is a *"global issue,"* and the supply chains of the world are tightly interconnected. ***As we discussed previously:***

> *?Given that U.S. exporters have already been under pressure from the impact of the ?trade war,? the current* ***outbreak could lead to further deterioration of exports to and from China, South Korea, and Japan.*** *This is not inconsequential as exports make up about 40% of corporate profits in the U.S.?*



Our **Economic Output Composite Indicator (EOCI)** was already at levels which warned of weak economic growth. Furthermore, as shown below, even the *Leading Economic Indicators (LEI)* were already suggesting something was amiss long before the virus became *"a thing."*

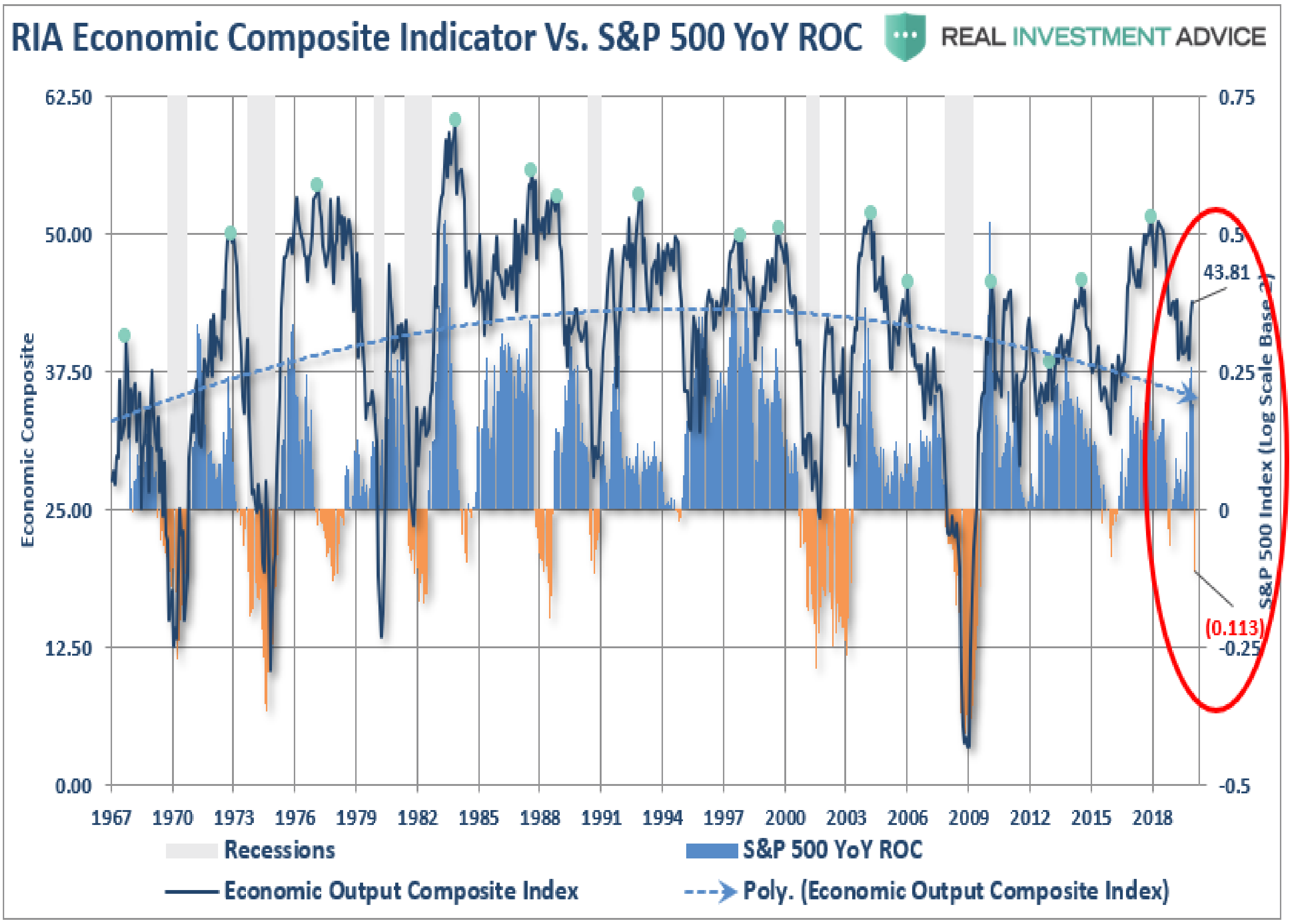
***Data as of February 2020.***




> (*The EOCI is comprised of the Fed Regional Surveys, CFNAI, Chicago PMI, NFIB, LEI, and ISM Composites. The indicator is a broad measure of hard and soft data of the U.S. economy)?*

One reason we are confident the economic data will worsen near term is the correlation between the index and the annual rate of change of the S&P 500 index.

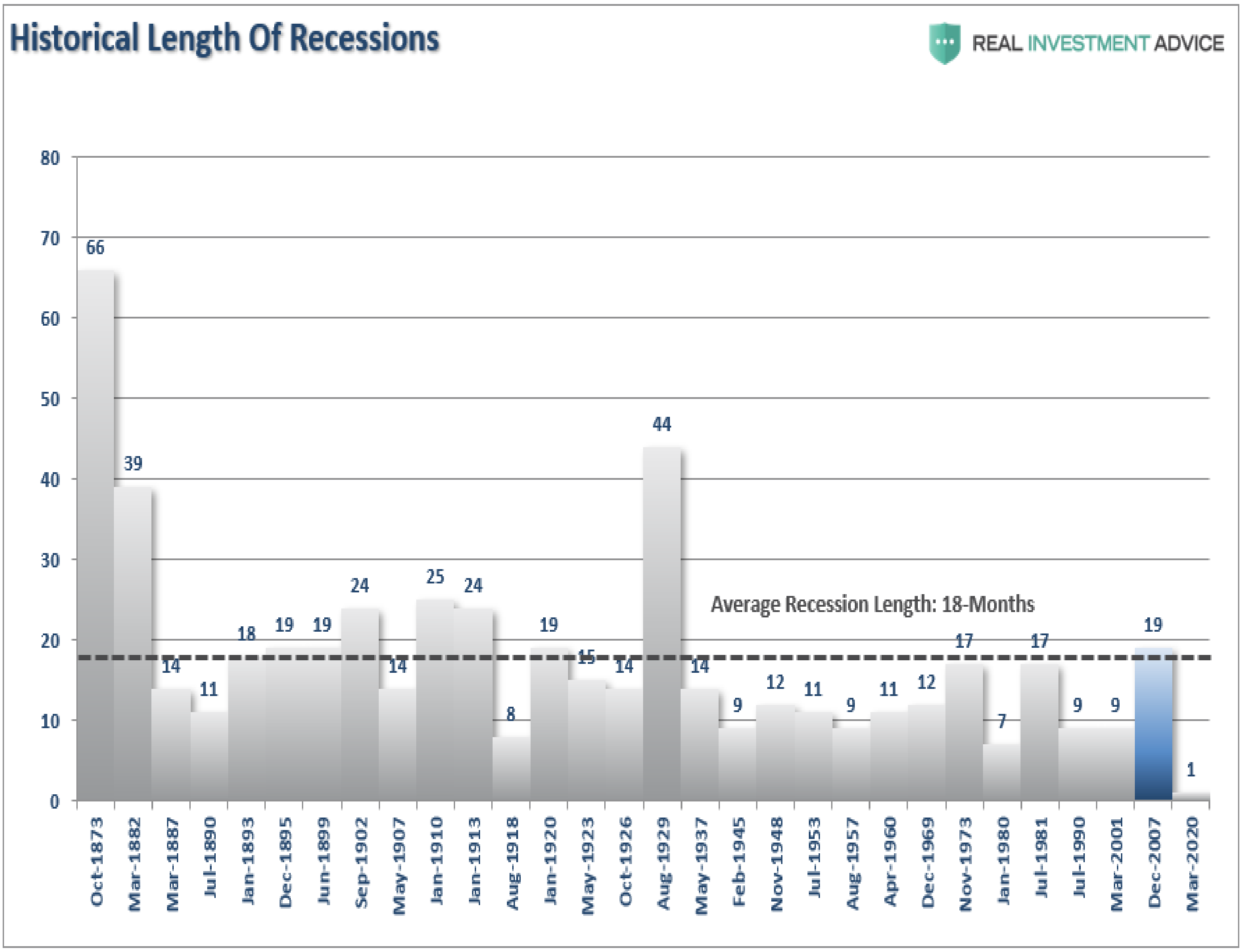
The financial markets lead the economy by about 6-months as markets begin to *?price in?* changes to earnings due to the outlook for economic strength. **The recent plunge in the S&P 500 has deviated from the current EOCI index reading suggesting the index will decline towards recessionary levels over the next two months.**




## The Question Isn't If...

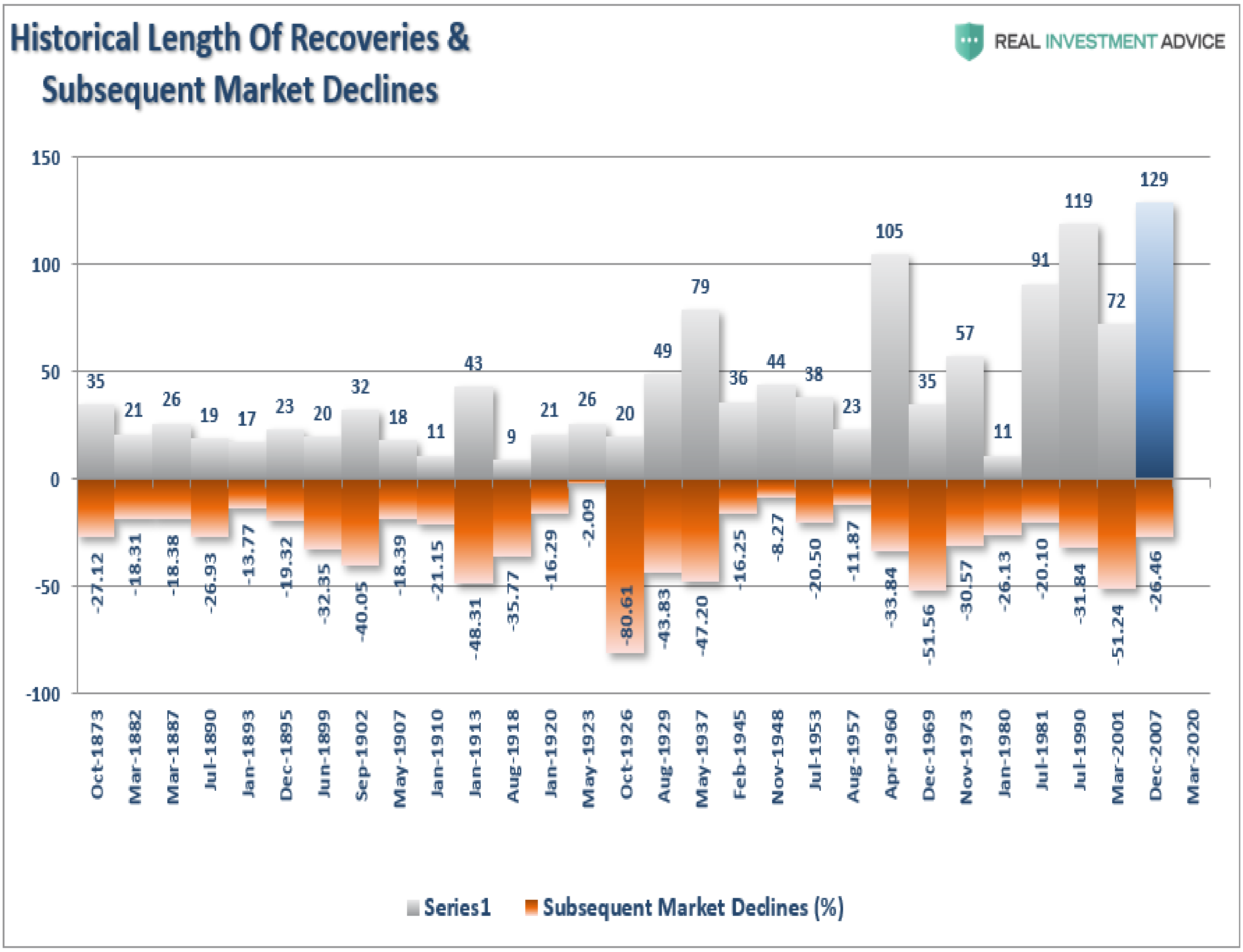
The U.S. economy, along with the bulk of the globe, **is already in *"recession."***

Let's start with a bit of historical context. Since the 1800's, the average length of an economic recession has been 18-months. Some of that length is skewed by a more agricultural-based economy at the beginning, with more modern recessions having been shorter. *(We are assuming that March 2020 was the start of a new recession at one-month.)*




While the average recession has been somewhat shorter in recent decades, the recessions of 1973, 1991, and 2007 have pushed those long-term averages. The chart below also shows the subsequent decline in asset prices during subsequent recessions.

**Given, declines of these magnitudes only occur during recessionary periods, the recent near 30% decline is likely good confirmation a recession has begun.** *(However, at just one-month, it may be overly optimistic to assume it is over with already. )*






## Yields Are Screaming: "Recession"

Interest rates are also a very good confirmation of recessionary periods as well.

Since 2013, I have disagreed the mainstream analysis *(including Jeff Gundlach and Bill Gross*) that the *"bond bull market"* was dead. The reality has been substantially different as rates have continued to trend lower, and recently approached ***our long-term target of ZERO***.

> *"There is an assumption that because interest rates are low, the bond bull market has come to its inevitable conclusion. The problem with this assumption is three-fold:*
>
> 1. ***All interest rates are relative.*** *With more than $10-Trillion in debt globally sporting negative interest rates, the assumption that rates in the U.S. are about to spike higher is likely wrong.*
> 2. ***The coming budget deficit balloon.*** *Given the lack of fiscal policy controls in Washington, and promises of continued largesse in the future, the budget deficit is*

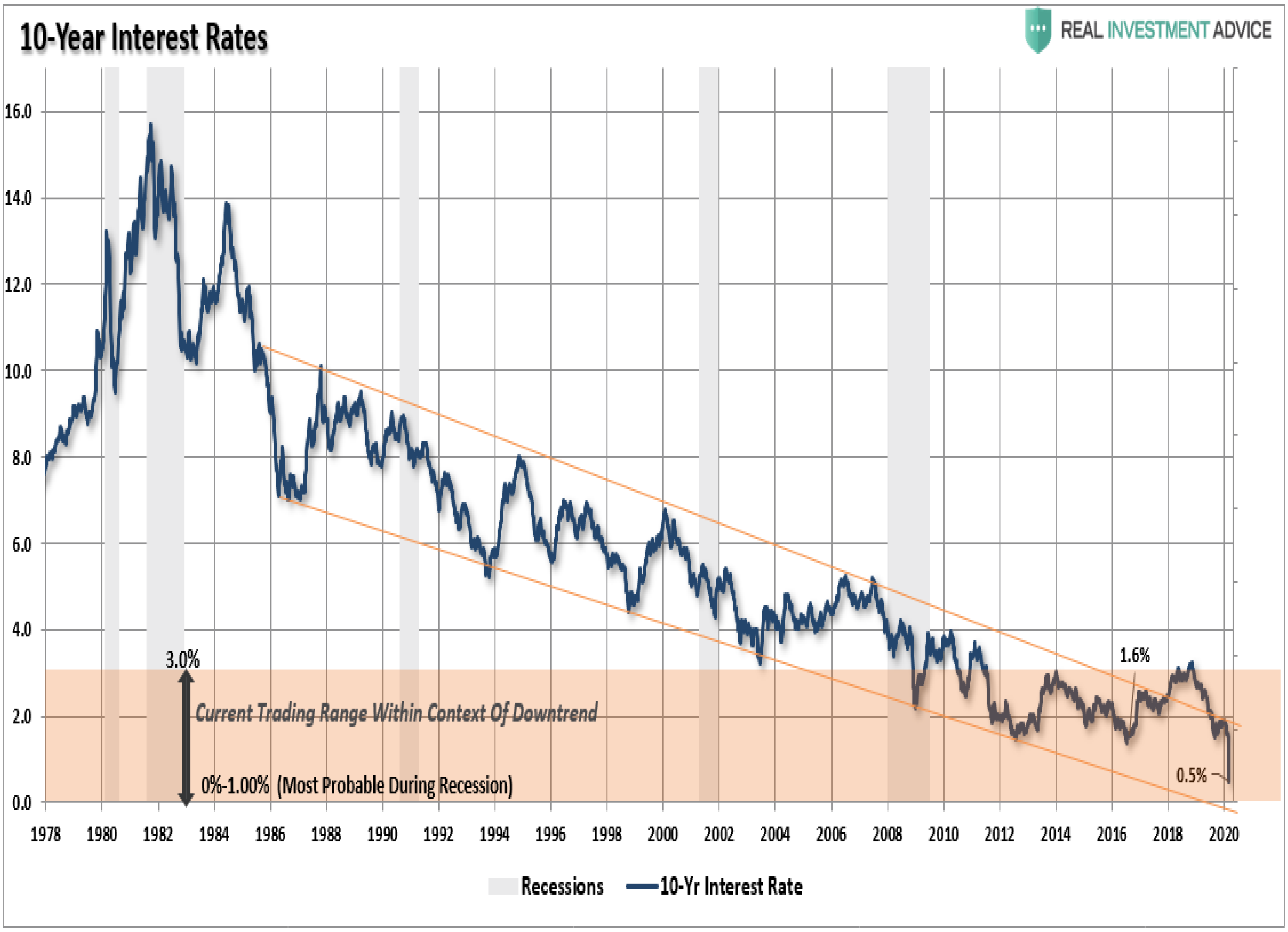
*set to swell back to $1 Trillion or more in the coming years.*

3. ***Central Banks will continue to be a buyer of bonds** to maintain the current status quo, but will become more aggressive buyers during the next recession. **The next QE program by the Fed to offset the next economic recession will likely be $2-4 Trillion,** which will push the 10-year yield towards zero.? - **August 30, 2016***

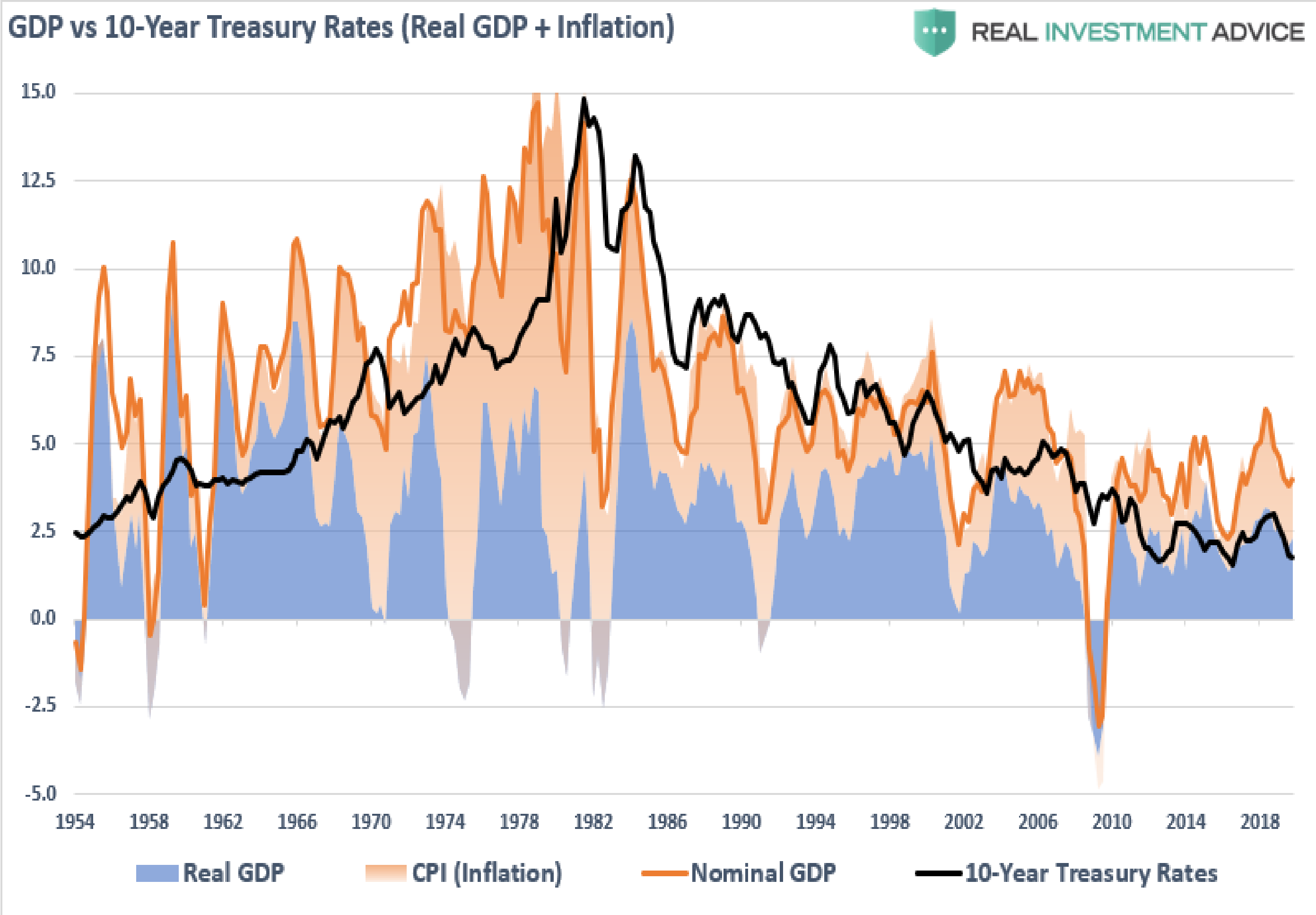
**So, where are we nearly 4-years later?**

- *23% of global debt is now supporting negative interest rates.*
- *The U.S. deficit has well surpassed $1 Trillion on its way to $2 Trillion.*
- *Central Banks continue to be a primary buyer of bonds as the Fed's balance sheet has swelled back to its previous peak and the Fed recently dropped rates to zero and started a $700 billion QE program.*

Here is the relevant chart I posted in 2016. At that time rates were hitting lows of 1.6%, which was unthinkable at the time. **And, where are rates, today? Approaching zero.**




As shown above, over the last sixty years, the yield on the 10 year has approximated real GDP plus inflation *(shown in the chart below)*. Given this historical fact, we can do some basic math to determine what yields are currently predicting for the U.S. economy currently.

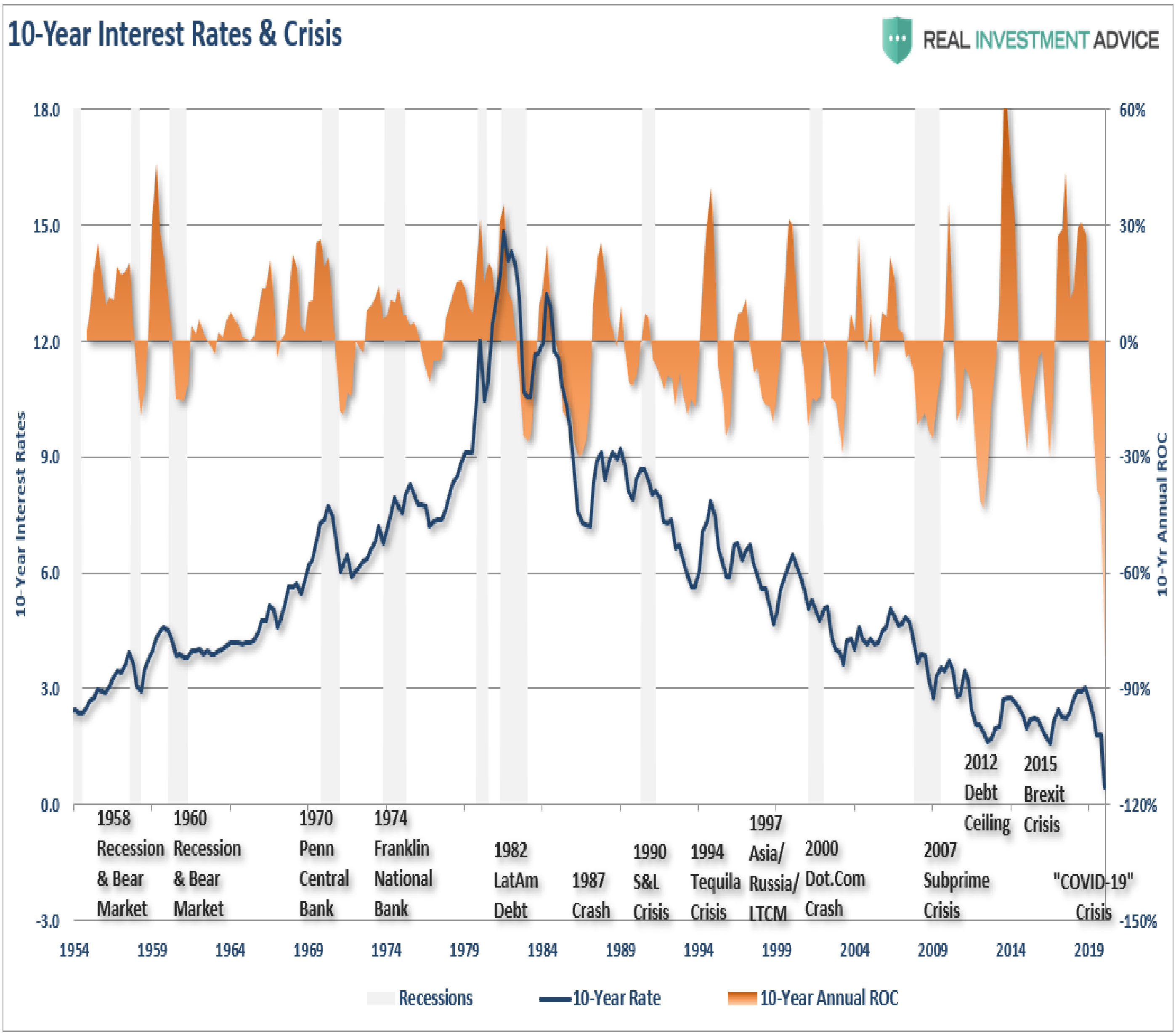



Via Doug Kass:

> *"Given ZIRP and QE policies around the globe which has pulled an extraordinary amount of sovereign debt into negative territory coupled with secular headwinds to energy prices, I have assumed that the 10 year yield will fall from 1.0x nominal GDP and average about 0.8x nominal GDP.*
>
> *According to my pal Peter Boockvar, the 10 year inflation breakeven (in the tips market) stands at 1.41% this morning:*
>
> *So, let's solve for what the market expects Real GDP to be (over the next 1-2 years) with this formula:*
>
> ***10 Year Yield (0.744% Actual) = 0.8x (Real GDP + 1.41% Actual (inflation))***
>
> ***The implied U.S. Real GDP of this equation is now negative -- at -0.48%. (This compares to the consensus 2020 Real GDP growth forecast of between +1.75% to +2.00%)*** *It also implies that nominal GDP (Real GDP plus Inflation) will be only about +0.93% - substantially below consensus expectations of slightly above 3%."*

It's markedly worse now as the collapse in oil prices has sent breakeven rates below 1%.

[*As we noted in "On The Cusp Of A Bear Market,"*](#) the collapse in interest rates, as well as the annual rate of change in rates, is screaming that something *?has broken,?* economically speaking.

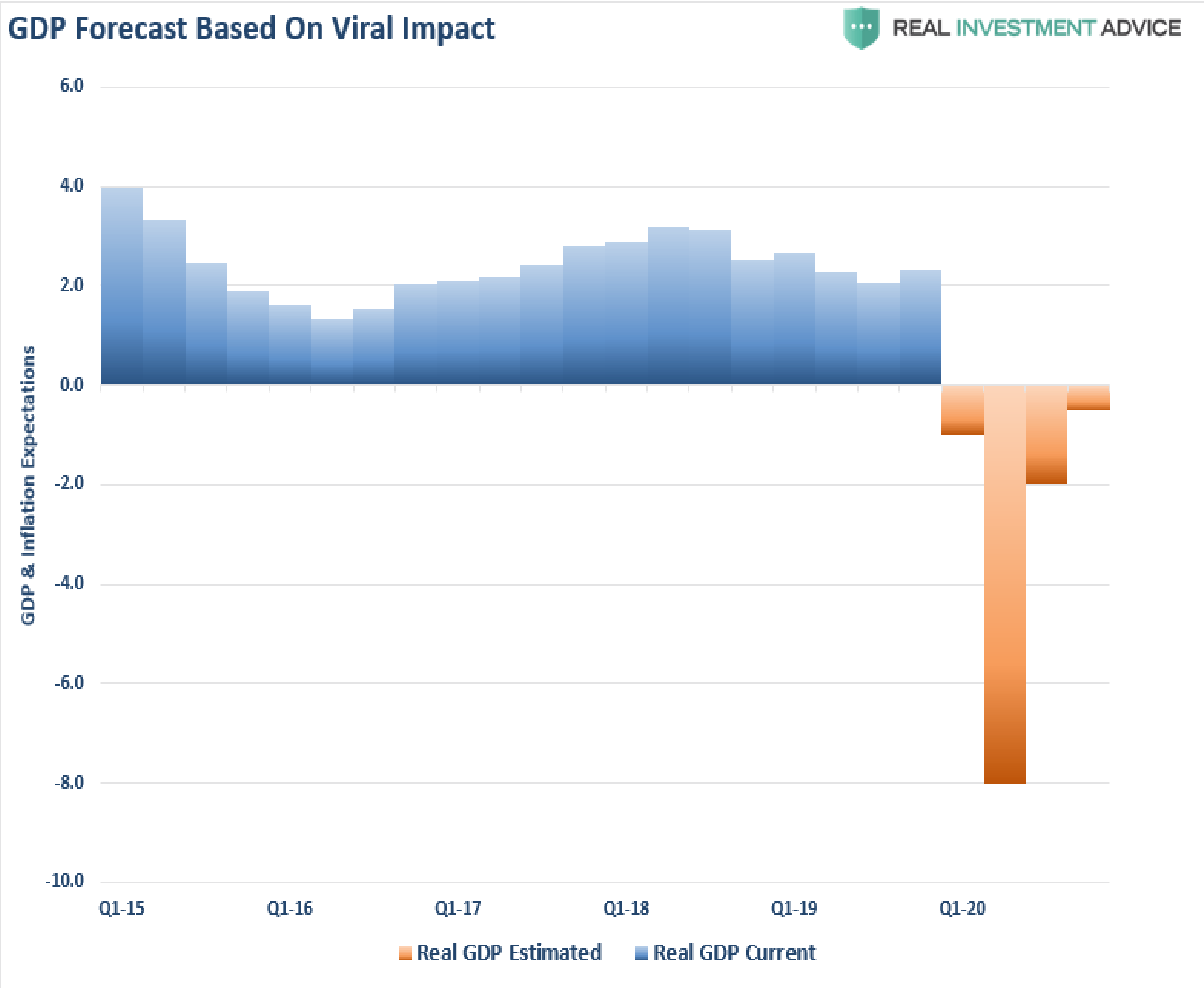



Mnuchin's suggestion the economy will likely avoid *"recession,"* is a bit ludicrous. The data suggests an entirely different outcome. However, David Rosenberg recently put some numbers on the impact to the economy from the "economic shutdown" from the virus. [***To wit:***](#)

> *"The pandemic is a clear ?black swan? event. There will be a whole range of knock-on effects.* ***Fully 40 million American workers, or one-third of the private-sector labor force, are directly affected ? retail, entertainment, events, sports, theme parks, conferences, travel, tourism, restaurants and, of course, energy.***
>
> ***This doesn?t include all the multiplier effects on other industries. It would not surprise me at all if real GDP in Q2 contracts at something close to an 8% annual rate (matching what happened in the fourth quarter of 2008, which was a financial event alone).***
>
> ***The hit to GDP can be expected to be anywhere from $400 billion to $600 billion for the year.*** *But the market was in trouble even before COVID-19 began to spread,*

*with valuations and complacency at cycle highs.?*

Given the average recession is 18-months, and given the severity of the economic impact, even this 12-month forecast is likely overly optimistic. However, we are still missing a LOT of data, which will come to light over the next several months.




The recession will be quite severe.



As David concludes:

> *"A 35% slump in global financial stocks and a similar plunge in U.S. small-cap equities cannot be wrong on this forecast.* ***And the massive volume of leverage complicates the outlook that much more."***

I know you shouldn't point and laugh, but you almost have to when Mnuchin and Kudlow have the audacity to suggest this is a temporary negative shock. **This a collision of multiple shocks**

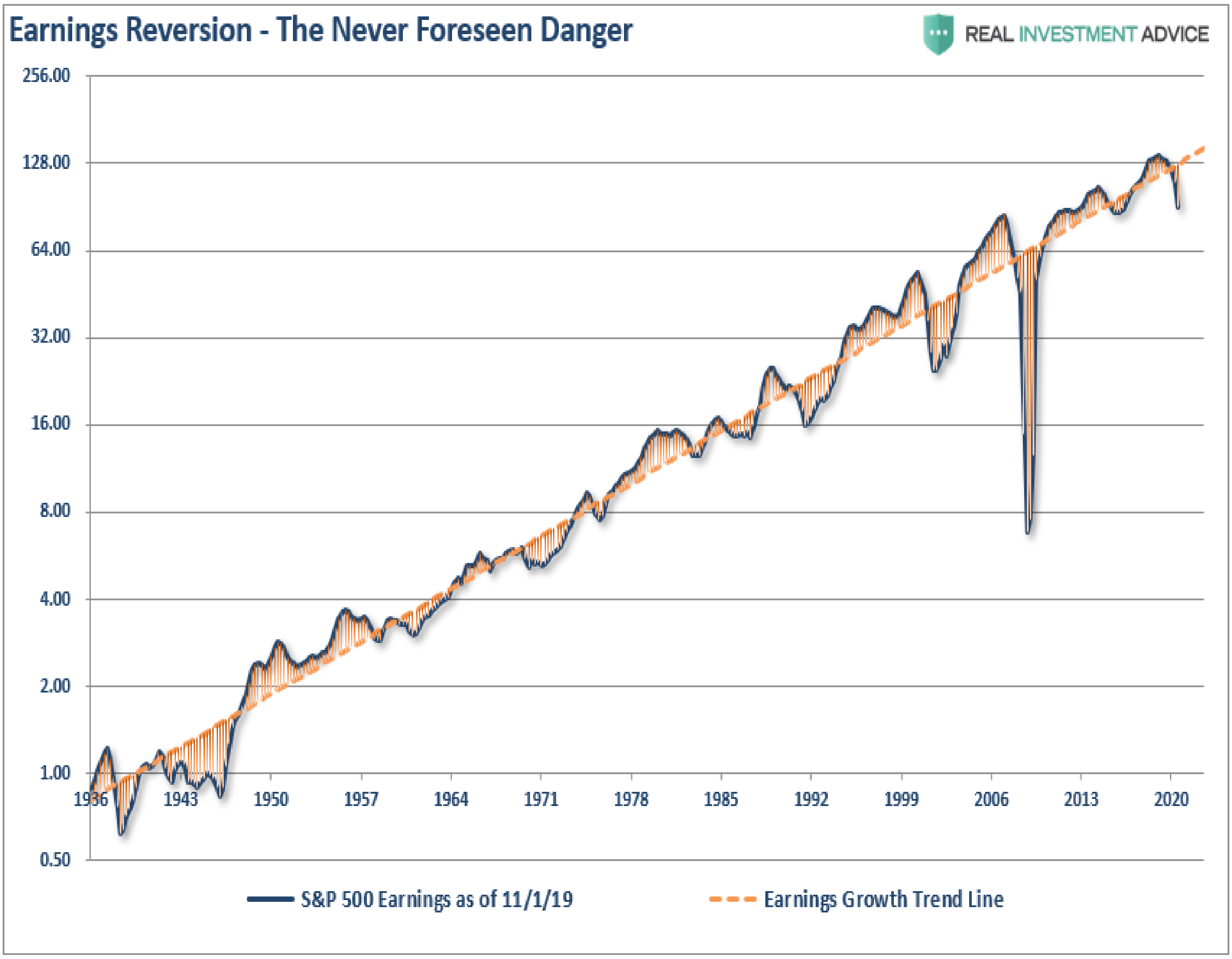
**impacting an overly leveraged, overly valued, and overly bullish market simultaneously.**

- *Coronvirus impact*
- *Supply chain shutdowns*
- *Economy wide "closures"*
- *Consumer confidence collapse.*
- *Employment shock*
- *Debt crisis*

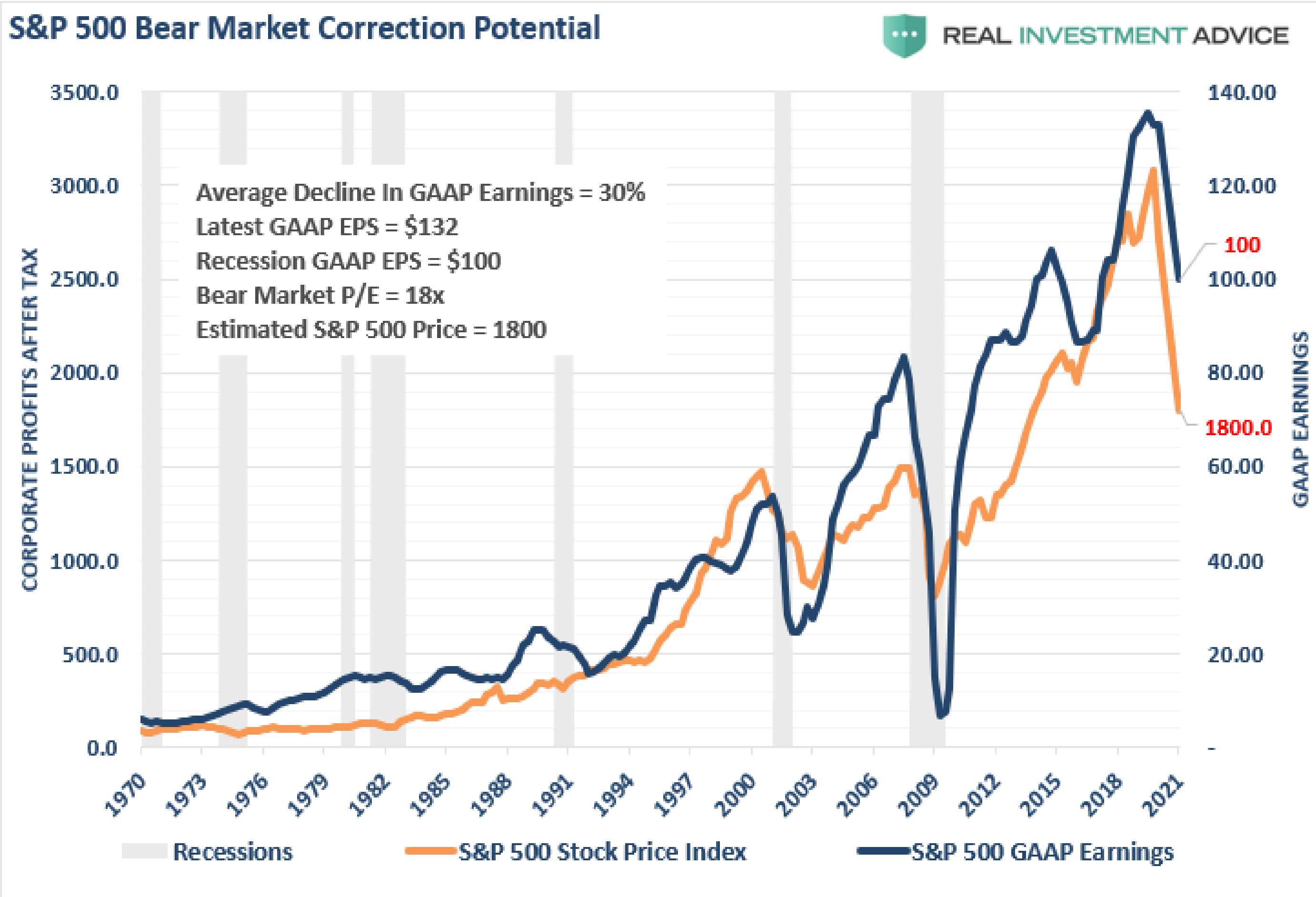
The problem for the Federal Reserve is this is NOT a *"financial crisis,"* or a simple *"business cycle"* recession, that monetary policy can fix. **Governments have opted for to *"contain the virus*" by shutting down the economy.** Giving households $1000 checks sounds great, but not if you can't spend them. Maybe they will opt to pay down debt, but that doesn't spur economic activity, or improve earnings, in the near term.

Of course, since stocks price in future earnings growth, and since we have a feel for the impact of the recession coming, ***we can guesstimate the impact to earnings.***

> *"**Profit margins are probably the most mean-reverting series in finance, and if profit margins do not mean-revert, then something has gone badly wrong with capitalism.** If high profits do not attract competition, there is something wrong with the system, and it is not functioning properly.? ? Jeremy Grantham*
>
> *The impending recession, and consumption freeze, is going to start the mean-reversion process in both corporate profits and earnings. In the following series of charts, I have projected the potential reversion.*
>
> *The reversion in GAAP earnings is pretty calculable as swings from peaks to troughs have run on a fairly consistent trend. (The last drop off is the estimate to for a recession)*




*"Using that historical context, we can project a recession will reduce earnings to roughly $100/share.* ***The resulting decline asset prices to revert valuations to a level of 18x (still high) trailing earnings would suggest a level of $1800 for the S&P 500 index."***




***"If our, and Mr. Rosenberg?s, estimates are correct of a 5-8% recessionary drag in the second quarter of 2020, then an average reduction in earnings of 30% is most likely overly optimistic.***

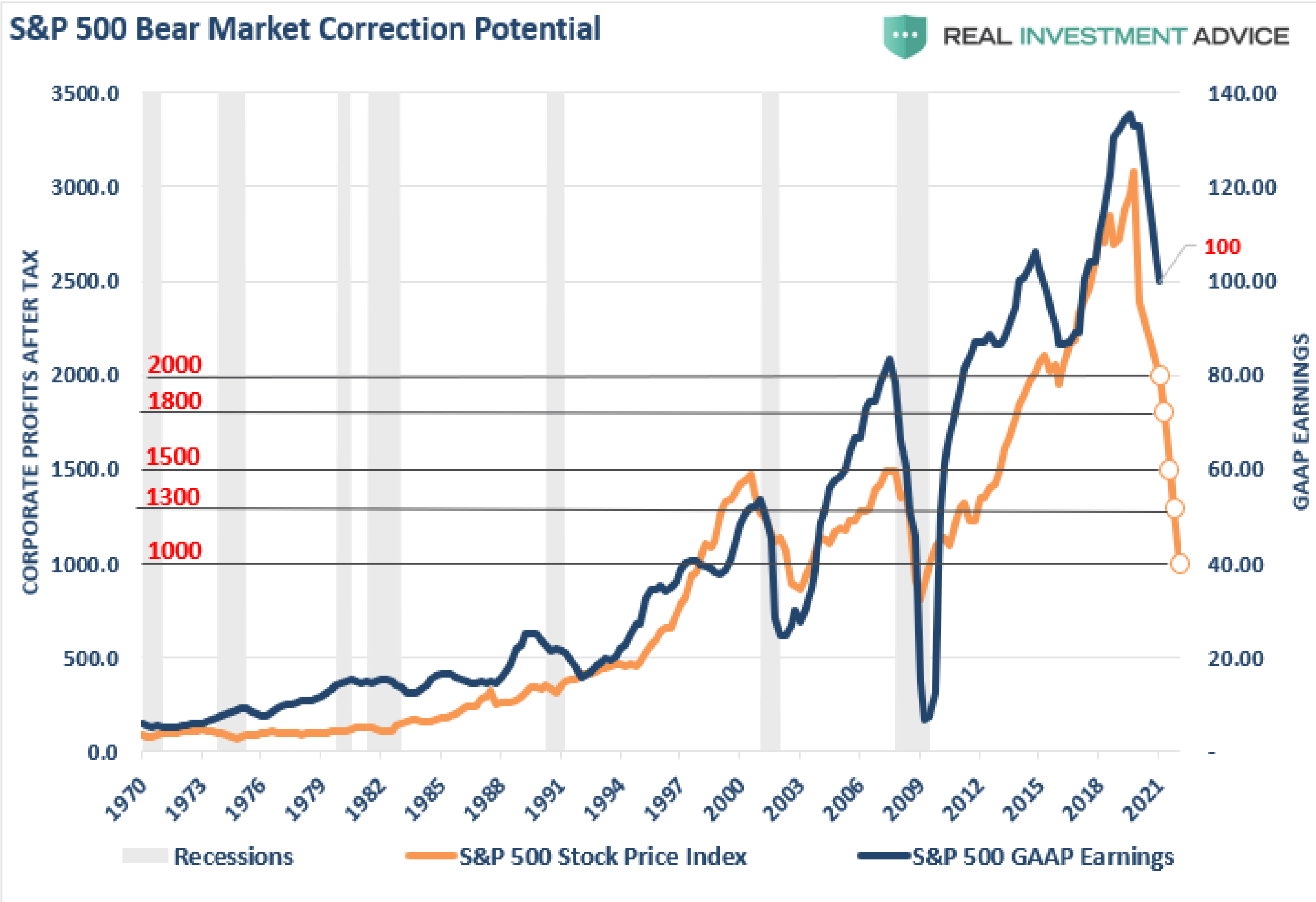
*However, here is the math:*

- *Current Earnings = 132.90*
- *30% Reduction = $100 (rounding down for easier math)*

*At various P/E multiples, we can predict where ?fair value? for the market is based on historical assumptions:*

- ***20x earnings:*** *Historically high but markets have traded at high valuations for the last decade.*
- ***18x earnings:*** *Still historically high.*
- ***15x earnings:*** *Long-Term Average*
- ***13x earnings:*** *Undervalued*
- ***10x earnings:*** *Extremely undervalued but aligned with secular bear market bottoms.*

*You can pick your own level where you think P/E?s will account for the global recession but the chart below prices it into the market."*




**Unfortunately, both Larry Kudlow, Steve Mnuchin, and the Fed, are still misdiagnosing what ails the economy, and monetary policy is unlikely to change the outcome in the U.S.** Furthermore, the lack of economic growth, resulting in lower earnings growth, will eventually lead to a ***full repricing of assets.***

**Yes, we are in a recession, it has just started, and we have quite a ways to go before it is over.**

Fade rallies, and reduce risk accordingly.