LANTERN
CAPITAL

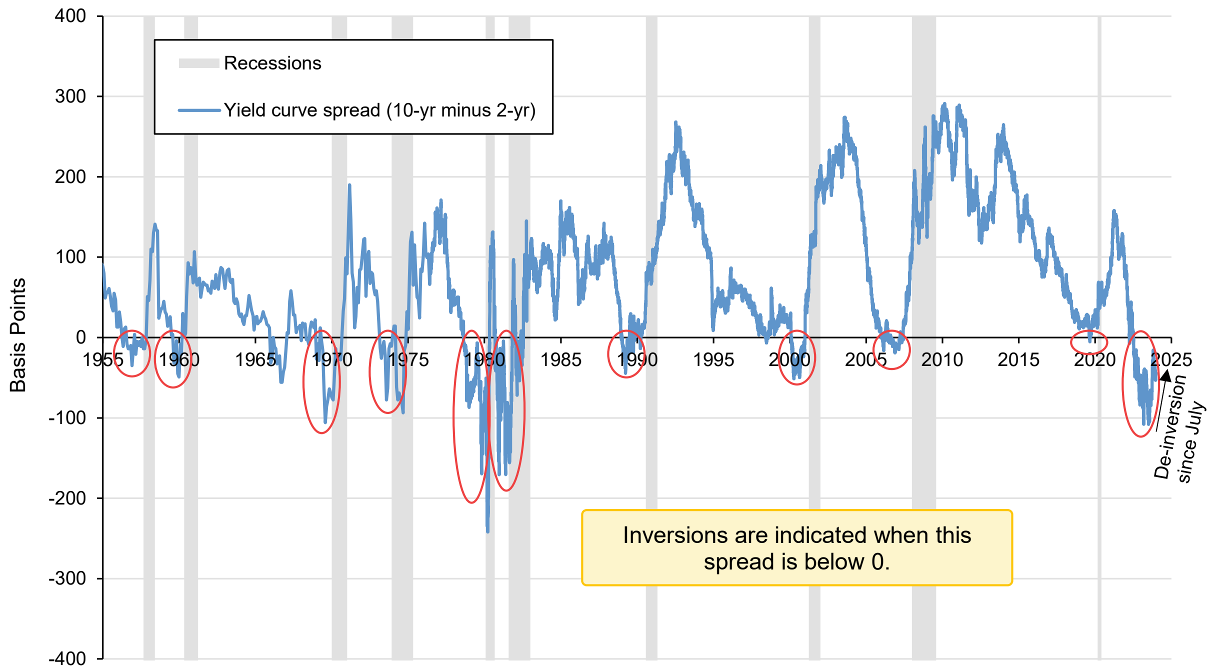
Heed the Ghost of Recessions Past

Eric Hickman, 12/22/2023

Many have seized upon the idea that because a downturn hasn't happened yet, inflation has fallen, and the stock market has risen strongly, a recession has been avoided. Yet, the most reliable indicators of recessions continue to suggest one is coming soon and the sequence of events over the last two years is what typically happens before recessions.

The two best long-term indicators of recession; inversion of the Treasury yield curve (the 10-year Treasury yield falling below the 2-year yield) and a material drop in the Conference Board's Leading Economic Index (LEI) have signaled for a while that a recession is coming. They've been forgotten or dismissed because a downturn hasn't shown up yet, but they are too regular to ignore and the timing of their signals is not out of place with the past.

An inverted yield curve is the gold standard of recession indicators and present now. The logic is that when long-term yields are below short-term yields, the bond market's consensus thinks future growth and inflation will be less than it is now and recessionary. They've been right. Every recession since 1958 has been preceded by an inversion (see chart below.) The yield curve inverted two times without a recession in 1966 and 1998, but magnitude matters too. When the yield curve has inverted 60 basis points or more (it got to 108 in this cycle), a recession followed each time.



The timing also fits within the past. It has been 21 months since the yield curve first inverted. The average time from an inversion to recession is 15 months but the curve inverted 24 months before the Great Recession, 20 months before the Early 1990's Recession, and 24 months before the Recession of 1969-1970. It has evolved as well, de-inverting since July, a further indication of recession proximity.

The Leading Economic Index, comprised of 10 economic indicators, has now fallen 12.6% from its peak and even 7.5% from before the pandemic. Every time this index has fallen 5% or more from its peak, a recession came with it. It fell no more than 2% from peaks in the only soft landings since WWII; 1967, 1986, and 1995.

24 months have passed since the peak in the LEI which makes it the longest drop without a recession since the inception of the index, but it was nearly as long before the Great Financial Crisis at 21 months and pandemic stimulus has likely delayed a recession this time. Also, the LEI has steadily deteriorated, falling for 20 straight months, making it impossible to ignore.

The sequence of events in this cycle has been remarkably similar to periods before past recessions too. Over the last two years, we've passed by a peak in the Leading Economic Index (12/21), a steep Fed Funds raising cycle (beginning 03/22), an inverted yield curve (beginning 04/22), the ISM Manufacturing survey falling below 50 (11/22), the yield curve beginning to de-invert (7/23), Industrial Production falling year-over-year (8/23), the unemployment rate spiking higher (8-10/23), a classic dramatic Treasury sell-off (10/23), and most recently, a Fed pivot

(12/23.) While the process has taken longer than I expected, these are all hallmarks of past cycles leading to recessions and incremental reminders that “this time isn’t different.”

It is tempting to think the danger of a recession has passed because it hasn't happened yet and good cheer abounds from the recent rise in the stock market, but history suggests one should be expected. As the ghost of Christmas past told Scrooge who wanted to stay warm in his bed to avoid facing his past, “take heed!”