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Will the Federal Reserve Cause the Next Recession?

Global Markets and Regions

	2nd QTR	2017 YTD
US	3.87%	9.50%
Developed Europe	7.50%	15.90%
Asia	6.20%	16.90%
Emerging Markets	5.20%	18.60%

US Markets

	2nd QTR	2017 YTD
Dow 30	3.60%	9.30%
Large Cap Cos.	3.53%	9.13%
Mid. Cap Cos.	1.80%	5.80%
Small Cap Cos.	1.43%	2.17%
Bonds	1.62%	2.68%

The Federal Reserve raised the Federal Funds rate to 1.25% this month. This is the fourth Fed Funds increase in the last two years and the Federal Reserve has signaled they intend to continue to increase the rates into the future. The increases will be determined by the data generated by the economy.

They have also announced they intend to begin to unwind the bond purchases of Quantitative Easing. The tightening has begun. The unprecedented monetary stimulus of the last eight years is being withdrawn. Of the thirteen post WWII Fed Funds tightening cycles, ten have ended in recessions.

The National Bureau of Economic Research (NBER) defines a recession as a significant decline in activity across the economy, lasting longer than a few months. It is visible in industrial production, employment, real income, and wholesale-retail trade. The technical indicator of a recession is two consecutive quarters of negative economic growth as measured by the country's Gross Domestic Product (GDP), although the NBER does not necessarily need to see this occur to call a recession. They are generally caused by a loss of business and consumer confidence, which precede a downward spiral of business sales and earnings.

The last recession was 2008-2009. It was also accompanied by a global financial crisis of epic proportions, the worst since the Great Depression. While the Great Recession was a nasty one, it paled in comparison to the Great Depression but was still the deepest recession in the post-WWII era. The stock market decline that accompanied the Great Recession was particularly severe. What is interesting to note is that historically not all recessions have been accompanied by severe stock market declines. Market volatility may have increased, but in several recessions stock prices actually advanced during the official recession. For instance, between January 1980 and November 1982 there were two official recessions in close succession. It may have been a bumpy ride, but the S&P 500 advanced 23%. How the stock market responds depends on the causes and nature of the recession.

Higher interest rates are probably the most significant cause of recessions. They reduce liquidity and limit the amount of money available for spending and investment. So why is the Fed doing this? They see the beginnings of inflation, which higher interest rates are designed to slow. While general prices don't reflect much inflation, an unemployment rate of 4.3% is seen as an early indication of wage inflation. They see asset bubbles forming and the economic damage they can cause when they deflate. Remember the Sub-Prime mortgage crisis? They also acknowledge that the monetary policy post-Great Recession has left them few tools to fight the next recession. So they want to get to a position where they will be able to counter the effects of the next recession.

The leading indicators are flashing economic disappointment ahead. Growth has been slowing for several months. There have been indications that fiscal policy could step up and take over from the Fed. Tax cuts, infrastructure spending and rolling back business unfriendly regulations have been identified by analysts as changes that could keep the economy rolling along. These are changes our political system is supposed to deliver. We'll see if they are up to the task. The Economist editorialized; "a central bank hell bent on keeping inflation low and stable risks cutting short a boom with room to run". For most of this cycle the economy and markets have been supported by unprecedented monetary stimulus that appears to be well on its way to being withdrawn. Hopefully it's not being withdrawn too soon.