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Bracing for the Next U.S. Recession

By LAWRENCE C. STRAUSS

There's a widely held view that the U.S. economy will continue to generate decent growth, even if there's an occasional step backward. David A. Levy, chairman of the Jerome Levy Forecasting Center in Mount Kisco, N.Y., isn't so sure. Skeptical about the underlying strength of the U.S. economy, Levy says investors should brace for a recession in the near term. He worries that shaky profit growth in the U.S., slowing economic growth in China, and weak fundamentals in Europe all could squeeze the U.S.*Barron's* readers will recognize the Levy name: His late father, Jay Levy, frequently offered us his insights. The younger Levy, 58, has some strong views of his own.

Barron's: *We read that you think Treasury bonds are a Buy, contrary to the popular view. Most people think yields are ready to rise, possibly to 4% from 2.6% now, as the economy picks up some steam. You doubt that?*

Levy: This economy, with its debt structure, could not support a 4%-plus Treasury yield. We still have way too much vulnerability in the housing market, to name one sector. There is way more leverage in the business sector as a whole than people who focus on large corporations realize. In fact, the overall nonfinancial business sector debt-to-output ratio is higher than it was at the beginning of the 2008 recession. So this is not an economy that would tolerate high rates without a lot of things breaking down. And even before that, we see very serious problems in emerging markets and elsewhere if yields move to that level.

And all that makes Treasuries looks pretty good?

We are still in a disinflationary and balance-sheet adjusting phase in the U.S. and globally, and that is going to bring, at some point, another recession. It could be sooner rather than later, and when that happens, we'll probably get a little bit of deflation. At some point, we'll see the 10-year Treasury yielding well under 1%, much as we have seen in Japan.


Brad Trent for Barron's

"This is not an economy that would tolerate high rates without a lot of things breaking down." —David A. Levy

So, you just don't believe the economy is improving?

The economy is improving cyclically. And there are areas where corrections have been made, and there certainly are some good trends in parts of the economy. But the big picture is that we still have way too much debt relative to income. The total value of assets in our economy is still unusually high and very hard to justify with this slow growth. People talk about the low interest rates, but the very low nominal growth has to be factored in, as well.

What's your take on corporate profit growth?

It is very hard to make the case for profits to do better than maintain the rough plateau they've been on for the past couple of years. We'll see what they look like, but there is a lot of downside risk, much of it coming from overseas.

Do you think profit estimates are too rosy?

The most optimistic case we could make for the economy is that we would get a little bit of firming in profits toward the end of the year, if a lot of things go right, although that is still going to be short of what Wall Street is looking for. We've seen this quarter after quarter; people are looking for profits to resume some sort of normal rise, but it is very difficult for that to happen. We are looking for domestic profits to be flat year over year. Profits in a private economy are basically reflecting increases in wealth, which largely come from two drivers: fixed investment creating more fixed assets or from inflating values of the existing assets. You can also get it from accumulating claims against other countries through a trade surplus, which we are not doing. Right now, the rest of the world is weak, so even though the U.S. is improving its trade deficit on a secular basis, I don't anticipate much, if any, improvement this year, which means that U.S. trade performance will not boost second-half corporate profits. Meanwhile, we have a tiring fixed-investment trend, especially in capital expenditures, which means diminishing contributions to profits growth.

Long-term Treasury yields are up about a percentage point since May. What impact is that having on the economy?

Traditionally, a 100-basis-point move in the 10-year Treasury will be reflected fairly quickly in a cessation of any rise in home sales.

Even if that increase is coming off such a low base that we have today?

You can argue even more so, because the percentage increase in a mortgage-loan payment is even greater when you are talking about very low interest rates going from, say, 3% to 4%, rather than 8% to 9%. If you look at the improvement in housing, which has been significant over the past year or so, mortgage originations really haven't picked up. It has been the improvement in cash sales, which reflect other sorts of financing, whether it is individuals or hedge funds or whoever is buying houses. This is not a market where the first-time buyers are now coming in and more households are being formed.

It sounds like you definitely see a recession on the horizon.

Whether we have a recession will depend on political decisions made in Washington, Europe, and China. We don't know what the government deficit is going to look like in the U.S. next year. If we have a significant further deficit reduction -- but we may well not -- that would definitely increase the recession risk. It would be hard for the economy to absorb a sizable deficit reduction two years in a row. In Europe, while there are a few green shoots people get excited about, they aren't likely to grow into anything. And China is undergoing a much more difficult adjustment than is widely recognized, as it faces slowing growth. China is in danger of falling below a stall speed where things start to unravel more than the government is prepared to deal with. Any one of those regions getting significantly weaker could trigger a global recession under these circumstances. So there is certainly a case for the U.S. to have another plodding-along year in 2014. But I just don't see a whole lot of upside.

But won't the Federal Reserve, which has made a strong commitment to propping up the U.S. economy, be able to avert a recession?

I totally agree that they are committed, and the Fed does sense a lot of vulnerabilities in the U.S. economy. But at this point, the Fed is relatively powerless when using monetary policy. When you actually look at how monetary policy gets into the individual profit sources, quantitative easing ends up looking a lot less important. Markets react dramatically on a short-term basis to any statements about what the Fed says it might do with tapering or quantitative easing. But, ultimately, yields will react to where the economy is going and where financial stability is going. The drop in yields to a low in 2012 reflected fears about instability in Europe. Whenever we've seen signs that our economy is a little bit firmer, regardless of what the Fed is saying at the moment, we've seen yields move up.

So we ask again, a recession?

I'm not a good political handicapper, but you have to give very serious consideration to both the recession case and to the moderate sluggish growth case continuing next year. And you have got to be prepared for both of those scenarios.

Is inflation, which has been quite benign, going to rear its head in the near future?

We've had very little discussion of inflation, except to the extent that [Federal Reserve Chairman Ben] Bernanke has brought it up. With inflation low, the Fed feels it has room to be accommodative. It is notable that we have continued to even see some disinflation in pay rates during this expansion, and labor costs are the No. 1 driver of sustained inflation. This shows how little inflation pressure and how much deflationary potential there is if we were to go into a recession. In that case we actually could see not only some goods and services prices drop but possibly even wage gains drop to zero or even slightly negative, if it got bad enough. I don't think we are going to go anywhere near the 1930s, don't get me wrong. But investors need to think about that deflation risk, though it's not an immediate concern in 2013.

What are the investment implications of the U.S. having another recession relatively soon?

There are several principles. No. 1 is that for the long- term patient investor who can ride out a little volatility, there are significant capital gains in Treasury positions and, obviously, protection from a lot of risk. We are also bullish about the U.S. dollar because we believe the U.S. is stronger than the rest of the world and that there are going to be bumps along the way. We are in this Goldilocks range of sluggish growth but not enough growth to really send bond yields up too much -- although we are a little nervous about where they have gone recently. There's been a lot of pressure on people sitting on the sidelines to come back into the stock market, helping to push equity prices higher. But we don't really trust the U.S. equity market, per se. Still, we feel it is a lot sounder than the European and emerging markets, broadly speaking. So we are actually doing a long/short play, which so far this year has worked out very well for us. We are long the U.S. stock market but short European and emerging-market indexes.

What happens to the U.S. economy over the long term?

After we go through our next recession, we are likely to get a lot more of the excesses out of our system. And it will be a much more appropriate time to start looking for long-term growth. Of course, we'll have another cyclical low at some point from which we can look for a recovery. Profits are not low in terms of profit margins, but they've been a little disappointing in terms of how they are trending, such as when measured against previous years' profits. But in this economy, because of the balance-sheet problems across the private sector and the slow growth, businesses will not react to a given profit margin with as much investment as they would have during previous periods.

To boil it all down, what are the key factors about the U.S. economy that are being overlooked?

There is a broad perception that we have deleveraged. For example, people look at the household sector and they point to a very misleading measure, the financial-obligations ratio, and say, "Gee, it is way down near the lows." But the lows were back around 1980. And the ratio does not reveal a huge skewing, notably that the income growth has been at the very high end. People at the high end tend to use very little debt relative to their incomes, and the debt has accumulated in recent decades at the lower end. So you still have a very serious debt problem for a lot of households. You also don't have much inclination to use credit. An exception is auto loans, which is one place where they really are helping consumer demand, as well as student loans, which are now becoming more popular since home-equity loans are no longer an option the way they used to be.

How far does that debt need to come down?

It is going to take time. We have brought our debt ratios down, but it has been less progress than a lot of people think. The household sector has come down from a peak of about 128% debt to income down to 104% now. We would like to see it down back around 80%, to really feel we are in good shape.

Thanks, David.