Don't Fear the Re-cession

Douglas Porter, CFA, Chief Economist • douglas.porter@bmo.com • 416-359-4887

No, I'm not saying a recession can't happen in North America over the next 18 months. And, no, this isn't meant to downplay the real damage an economic downturn can cause. It's meant more as a reminder that we shouldn't leap to attention every time a growling bear mouths the R word—"we" as in analysts, investors, the media. A classic example is what just unfolded in the past few months. **It's amazing how, after reaching a fevered pitch around the turn of the year, recession chatter suddenly faded fast as we entered 2019, following neatly in line with the rapid rally in equities.** After cresting in the final weeks of December, Google searches for the word "recession" have all but receded back to near-normal levels.

The economic data and financial markets have largely played along with the fading concerns. While there is little debate that global growth is cooling, it's a long way from an outright downturn. Instead, we look for global GDP to simmer down to 3.3% this year from an above-potential pace of 3.6% last year. More specifically in the U.S., the consensus on 2019 GDP growth has slipped only modestly since last Fall, from 2.7% to 2.4% now (we have shaved our call to 2.3%). This week's round of data, while far from stellar, also helped put recession fears further to bed, with a small rebound in core retail sales in January, decent durable orders, and some further recovery in sentiment for both small business and consumers. Meantime, equities churned out yet another solid weekly advance after their first semi-serious setback in almost three months last week. By Friday, the S&P 500 had punched up to its highest level since early October.

This lengthy preamble is aimed at softening the blow before noting **a couple key warning flares that markets sent into the air this week.** First, while equities may be sending the all-clear signal, the bond market most certainly is not. For example, the benchmark 10-year Treasury yield continues to run in precisely the opposite direction of stocks, dropping below 2.6% at one point Friday and thereby testing its lowest level in more than a year. This persistent drop in yields is despite a steady back-up in oil prices, which is actually nudging up inflation expectations. Real yields are driving the bus—for the 10-year area, they have dropped below 0.7%, the lowest in more than a year and hardly a vote of confidence in the growth outlook.

The **second warning** signal comes from Canada's very own bond market. **For the first time in more than a decade, we have a full-on yield curve inversion—the 10-year GoC yield now sits at 1.73%, breaking below the Bank of Canada's overnight rate of 1.75%.** While Canada's yield curve has sent many false positive signals over the decades, most of those were in the bad old days of the 1980s and 1990s, when the BoC was occasionally forced to crank rates higher to defend the currency. That is clearly not the case here. Meanwhile, the 5-year bond yield has absolutely plummeted: Since peaking last Fall at nearly 2.5%, it has plunged almost 90 bps to barely 1.6% today. As well, 30-year yields are testing the 2% threshold, and are now at a whopping and record 100 bp spread versus like-dated U.S. yields. The market is now pricing in almost a 50% chance of a BoC rate cut at some point in 2019—again, not exactly a vote of confidence in the economic outlook.

Despite these obvious warning signals, we would revert to the initial contention that **the underlying backdrop just doesn't point to such dire circumstances.** Always remember that recessions are actually quite rare events, and **it takes a lot to tip an economy into a full-scale downturn.** While many are pointing out that the U.S. expansion is about to become the longest ever at 10 years this summer, there is nothing set in stone about the length of the cycle. Australia is working on a record 27 years without a recession. Even Canada went 16 years between official downturns at one point (between 1992 and 2008). One completely random Canadian example: If someone (ahem) had started their career on Bay Street in, oh, let's say 1984, they would have only seen just two Canadian recessions in almost 35 years. And, someone starting in 1994—25 years ago!— would have seen only one full-blown recession. The point is that it is entirely possible that this expansion could live for many more years yet.

Having said all that, and hopefully not having given this cycle the kiss of death, **growth clearly struggled around the turn of the year, especially in Canada.** We suspect that GDP will do well to stay out of the red in Q1 amid the deep oil production cuts and harsh winter weather. Accordingly, the consensus call on Canadian 2019 GDP growth has dropped 0.6 ppts since late last year to just 1.4% now (we are at 1.3%). However, the combination of firming sentiment, stronger oil prices, lessening oil curtailments, and perhaps even some mild fiscal stimulus from next week's Federal Budget all suggest that growth will improve modestly in the spring and summer.

Perhaps the **most notable aspect of the renewed retreat in bond yields is that it is occurring against a backdrop of a steady comeback in oil prices.** Even with a small pullback on Friday, WTI knocked down yet another weekly gain. At more than $58, prices are close to a four-month high and have managed 30% gains from the lows hit around the turn of the year. No surprise, gasoline prices are now being pulled along for the ride, and U.S. pump prices are now back to about flat versus year-ago levels. That's a different world from the double-digit declines seen in the opening weeks of the year, declines that helped chop U.S. headline CPI inflation to 1.5% in February. Meantime, ex-energy inflation has been holding just above 2%, and that pace will soon reassert itself in the headline measure if oil prices remain firm. The main message is that the recent run of mild inflation readings looks set to disappear soon.