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Why Recession Forecasting Matters

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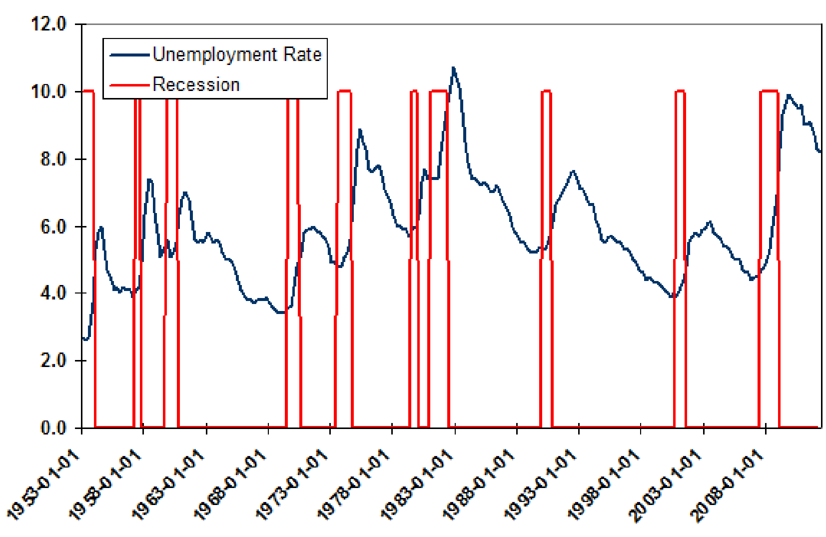
Fears over recession are persistent in the news and particularly on Wall Street. Rarely does a day go by without someone declaring a new recession on the horizon or discussing the various reasons why a recession is a potential risk. But why do policy makers, investors, the media and the general public obsess over recessions?

A recession, according to the NBER, "is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."

From the perspective of policy makers it's clear why there is a recession obsession. The unemployment rate, without fail, rises



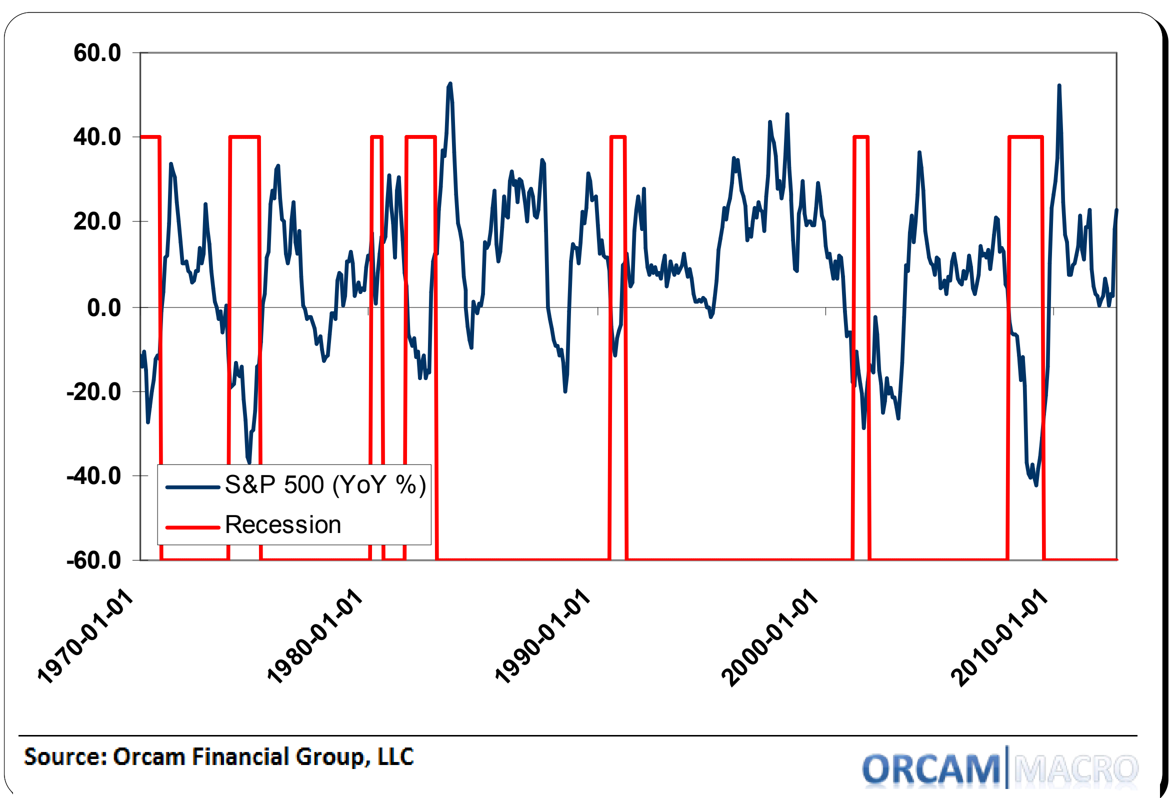
Source: Orcam Financial Group, LLC , BLS

"Ask five economists and you'll get five different answers - six if one went to Harvard.
- Fiedler

during a recession. Clearly, one of the worst things that can occur in an economy is job losses as this is consistent with an environment where output is going unsold and capitalists are reducing costs through their workforce as a result. It's nearly impossible to operate in this world without a source of income so when unemployment is high policy makers are at substantial risk of seeing themselves in the ranks of the unemployed.

But the destruction of a recession goes well beyond the labor market. In the last 40 years there have been just three year over year periods where total household net worth declined. All three periods occurred inside a recession. The recent decline in household net worth was the greatest in the post-war era with households losing a staggering 19% of their total net worth (using quarterly figures).

The real damage is done on a more micro scale and is a much more "in your face" type of loss in net worth. This is the real-time loss we see in equity accounts such as 401Ks, brokerage accounts and corporate net worth declines. In the last 42 years there have been just 4 technical bear market declines of 20% year over year (on a monthly basis). All 4 occurred inside of a recession. This explains Wall Street's recession obsession. A 20% decline in the equity markets requires a 26% appreciation in price just to get back to break-even. Since equities account for a substantial amount of household net worth this decline can be devastating and has far reaching ramifications. With the equity market



(Year over year % decline in S&P 500 – monthly basis) averaging an annual return of about 6.7% per year, this can mean years worth of losses in net worth. At Orcam, we believe there are few things more valuable than time so this loss is more real than just a pure monetary sense.

This data explains not only Wall Street's persistent recession obsession, but also why economic contraction is so broadly worried about throughout all of society. Economic contraction has a devastating and far reaching impact on society. Of course, this works both ways. Persistent fears over recession will keep investors out of the market during its best years. The ability to properly forecast recession can mean the difference between years in net worth lost or gained. Economists claim to have predicted 10 of the last 9 recessions. Ie, forecasting is remarkably important, but easier said than done.