The "Muddle Through" Continues

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Recent economic data doesn't change the overall outlook much. We're essentially still in a "muddle through" environment in which the US economy is likely to continue growing, but will remain sluggish. Our Q2 GDP estimate is tracking at about 1.8% versus consensus estimates of 1.9%. That's an okay environment for stocks even if it will feel like a moderately weak macro environment.

This view of "no recession", but meager growth is confirmed by recent manufacturing data which has turned very sluggish. The real-time PMI composite is tracking at a ISM level right around the 49 level which implies minor contraction. The latest official PMI reading of 51.9 is likely a bit on the high side given the recent manufacturing weakness. Although this is slightly contractionary it's nothing to get overly worried about at present.

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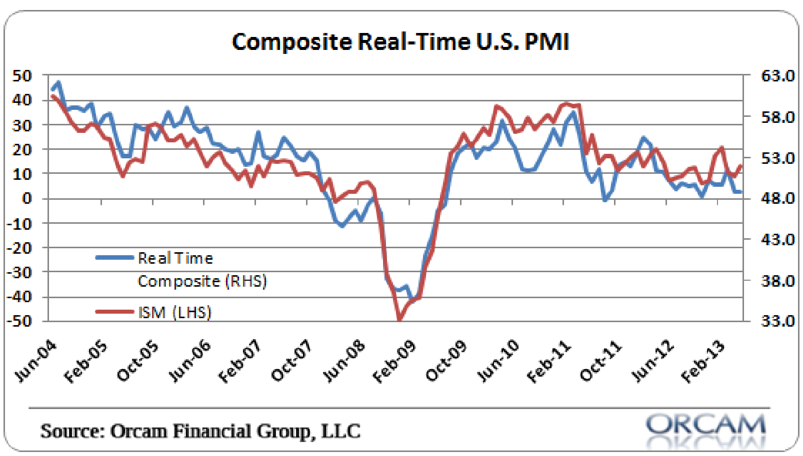

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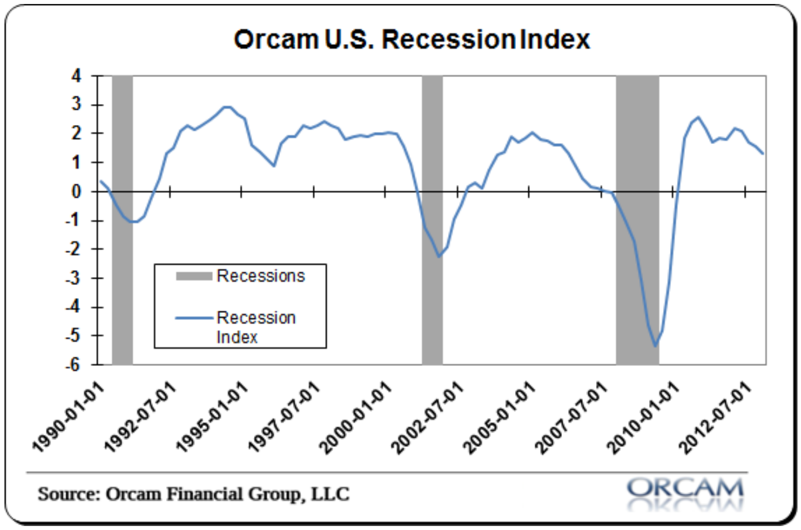
Of course, the more important index in our work is the Orcam Recession Index which has tracked the recovery quite nicely. The latest reading is still consistent with an expanding US economy even though the trend is clearly negative. This index has tended to lead recessions by several quarters so the current readings are consistent with our overall modestly positive outlook for continued economic growth.



The Importance of the Recession Watch

I've highlighted several reasons in previous notes why we should be concerned about recessions. The most important reason is that the most destructive market declines always occur within recession. All four 30%+ S&P 500 year over year declines in the last 50 years have occurred inside of recession.

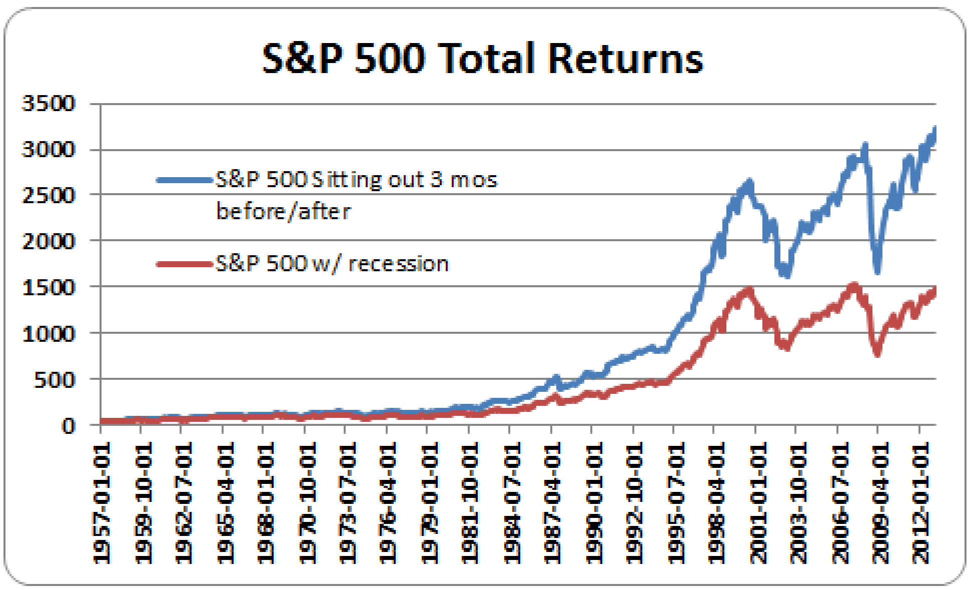
Although a bear market decline is technically a 20% decline it's the bigger declines that can become so devastating. If we look at the figure on the following page you can see the unfortunate math behind market declines. While a 20% decline requires a 25% price increase to break-even a 30% decline requires a staggering 42.9% increase to break-even.

The numbers obviously get worse as we decline further, but the point is that a 10-20% decline is not nearly as devastating as the compounding effect that occurs in the 30%+ range. So the ability to be able to manage the risks around a potential 30%+ decline are paramount. And given the knowledge that 30%+ declines always occur inside of a recession...well, you do the math.

Initial Account Balance	% Loss	Balance after loss	Return required to break-even
$100	-10%	$90	11.10%
$100	-20%	$80	25%
$100	-30%	$70	42.90%
$100	-40%	$60	66.70%
$100	-50%	$50	100%
$100	-60%	$40	150.00%
$100	-70%	$30	233.00%
$100	-80%	$20	400.00%
$100	-90%	$10	900.00%

Source: Orcam Financial Group, LLC

It's also interesting to note the performance of the S&P 500 if one were able to sidestep such devastating moves. The chart to the right shows the S&P 500's performance with recession (the red) and the performance of the index if you moved to cash in the 3 months before and after a recession officially started (using NBER official recessions). As you can see the market performs substantially better in the scenario where you sidestepped just the beginning period of a recession.



Given that data, it's not surprising to note that the market is ALWAYS negative in the 3 month period before and after a recession begins. But it would be foolish to remain perpetually bearish as many have throughout the last 5 years. After all, the US economy is only in recession 15% of the time since 1957. That means the economy is actually expanding 85% of the time. Clearly, the market doesn't always go up, but the economy (and the markets) tend to have a growth bias. Fighting that trend is likely to be a poor wager in the long-run, but that doesn't mean we can't manage the risks along the way. For now, the risk of recession and an extremely devastating market decline appear relatively low.

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