Stock Market Risk Should Not Be Equated With Recession Risk

By James Hickman Follow | 08/27/15 - 01:25 PM EDT
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NEW YORK (TheStreet) -- A significant upward revision to U.S. second-quarter GDP growth to 3.7% from 2.3% (economists expected 3.3%) was mostly driven (59% of entire revision) by a change in all-important private domestic investment (see table below).

It strains credulity to believe that private-sector capital allocators became meaningfully and sustainably more optimistic about reinvestment opportunities in the second quarter.

In the 14 quarters since the first one of 2012, private domestic spending in the current quarter ranked 7th highest, as measured by contribution to the total change in GDP (fixed investment ranked 8th best).

The latest U.S. GDP revisions provide a timely segue into whether a significant market decline hinges on the next U.S. recession as asserted frequently in recent days by strategists and market watchers.

U.S. Second-Quarter GDP Growth Revision

	2015				Current Quarter	
	I	II	Revised	Change	Rank	Observations
Percent change at annual rate:						
Gross domestic product	0.6	2.30	3.70	1.40	4.00	14.00
Percentage points at annual rates:						
Personal consumption expenditures	1.19	1.99	2.11	0.12	5.00	14.00
Goods	0.25	1.04	1.19	0.15		
Durable goods	0.14	0.53	0.59	0.06		
Nondurable goods	0.1	0.52	0.60	0.08		
Services	0.94	0.95	0.93	-0.02		
Gross private domestic investment	1.39	0.06	0.88	0.82	7.00	14.00
Fixed investment	0.52	0.14	0.66	0.52	8.00	14.00
Nonresidential	0.2	-0.07	0.41	0.48		
Structures	-0.22	-0.04	0.09	0.13		
Equipment	0.14	-0.25	-0.02	0.23		
Intellectual property products	0.29	0.22	0.34	0.12		
Residential	0.32	0.21	0.25	0.04		
Change in private inventories	0.87	-0.08	0.22	0.30	7.00	14.00
Net exports of goods and services	-1.92	0.13	0.23	0.10	5.00	14.00
Exports	-0.81	0.67	0.65	-0.02		
Goods	-1.1	0.57	0.55	-0.02		
Services	0.3	0.10	0.10	0.00		
Imports	-1.12	-0.54	-0.42	0.12		
Goods	-0.93	-0.47	-0.34	0.13		
Services	-0.18	-0.07	-0.09	-0.02		
Government consumption expenditures	-0.01	0.14	0.47	0.33	2.00	14.00
Federal	0.08	-0.08	0.00	0.08		
National defense	0.04	-0.06	0.01	0.07		
Nondefense	0.03	-0.01	-0.01	0.00		
State and local	-0.09	0.21	0.46	0.25		

Source: US Department of Commerce.

The magnitude and direction of interest rates is the key driver of U.S. stock market trends, and a 20% or more correction has not occurred in the post-World War II era when the U.S. 10-year yield was less than 3.9%. In contrast, of the nine distinct episodes of at least a 20% drop in the **S&P 500** from peak since 1950, three occurred in the absence of a recession (see table below).

History of 20% Stock Market Drawdowns and Coincident Economic Factors

Max Draw Reaches >=20%	Trough	Recession within + or - 12 Months of -20%	10-Year Yield (TTM)	Yield Trend	Last Recession to -20% Draw
5/28/62	6/26/62	Y	3.9%	Flat	NA
8/29/66	10/7/66	N	4.8%	Up	68 months
1/29/70	5/26/70	Y	6.8%	Up	NA
11/27/73	10/3/74	Y	6.8%	Up	NA
5/31/77	2/28/78	N	7.5%	Down	27 months
2/22/82	8/12/82	Y	14.2%	Up	NA
10/19/87	12/4/87	N	8.0%	Up	61 months
3/12/01	10/9/02	Y	5.7%	Down	NA
7/7/08	3/9/09	Y	4.1%	Down	NA
?	?	?	2.2%	Up	75 months + ?

Source: Federal Reserve, BLS and Yahoo Finance.

September will be the 75th month since the end of the last recession. This recovery may be the worst of the post-World War II era in terms of average growth, but it is the fourth longest streak without a recession in that period. How much longer can it last in the face of sluggish and decelerating global growth, continued capital spending weakness among corporations, poor demographics, a chronic labor supply overhang and a domestic fiscal picture that remains frightening despite smaller recent deficit growth caused by forced discretionary spending cuts under the sequester?

One need not look beyond the unprecedented experiment of quantitative easing and zero-bound interest rate policies to explain, at least in part, the protracted avoidance of recession. We are not predicting a U.S. recession any time soon, but we are certainly not seeing blue skies in perpetuity.

The **Federal Reserve** will be raising rates sooner rather than later, but the enduring deflationary headwinds historically created by financial panics will prevent the U.S. 10-year bond yield from seeing 4% before 2017, and *that* is the reason a 30% correction is less likely in the near-term than the S&P 500 threatening its highs once again.

But history suggests returns from current stock market levels over the next 10 years are likely to be significantly below long-term averages and at least a 30% drawdown is probable.

Investors hanging around to capture the top are bearing too much risk for too little reward, especially given uncertainties around how uncharted territory of quantitative easing and zero-bound interest rate policies might alter the protection observed from low interest rates historically.

This article is commentary by an independent contributor. At the time of publication, the author held no positions in the stocks mentioned.