Economic Commentary

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Highlights:

- Signs of recession?
- Closely linked to U.S. recessions
- Conditions for recession not yet present
- Shock event or policy error possible recession trigger

Recession concerns have risen in 2019 with more media commentary on the subject and forecasters assigning a higher probability of a recession occurring in the next 24 months. Primary reasons cited are the slowing global economy, trade tariffs and the threat of more tariffs, an inverted yield curve, and length of the current economic expansion. This note examines the prospects for a recession playing out in Canada and the likely conditions causing a recession.

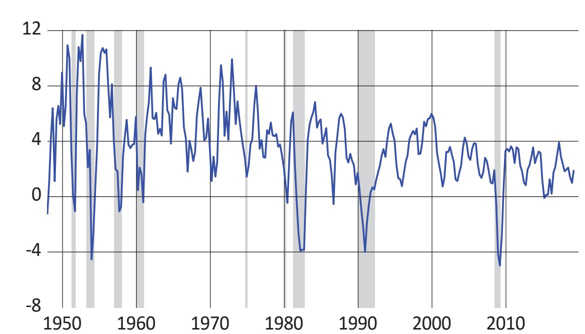
First, when is a recession a recession? The oft-used two consecutive quarters of contracting, or negative growth, in real Gross Domestic Product (GDP) rule of thumb is not used by the official arbiters of business cycles[1]. These experts use a range of economic indicators, including GDP, to consider the depth and breadth of the decline in economic activity, which must be significant and not transitory. A 3Ps rule of thumb is useful here, namely, a recession is a pronounced, persistent, and pervasive decline in aggregate economic activity. Recessions can last for a few months or more than a year.

Canada's economy last fell into a recession in October 2008 until May 2009, according to the C.D. Howe Business Cycle Council, during the Great Financial Crisis (GFC) that engulfed the economies of the U.S., Europe, Japan, and others. The oil price collapse in 2014-15 resulted in two consecutive quarterly contractions in real GDP in Canada, but the Business Cycle Council did not classify it as a recession primarily because it was not pervasive, or widely-based[2].

[1] In Canada, the C.D. Howe Institute Business Cycle Council is an arbiter of business cycle dates. In the U.S., the National Bureau of Economic Research Business Cycle Dating Committee performs the same function.

[2] https://www.cdhowe.org/cpc-communique/business-cycle-council-communique-december-2018.

Canada Real GDP and Recessions

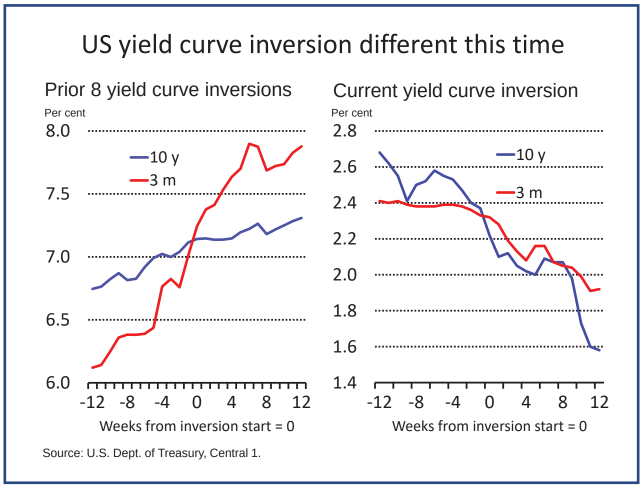


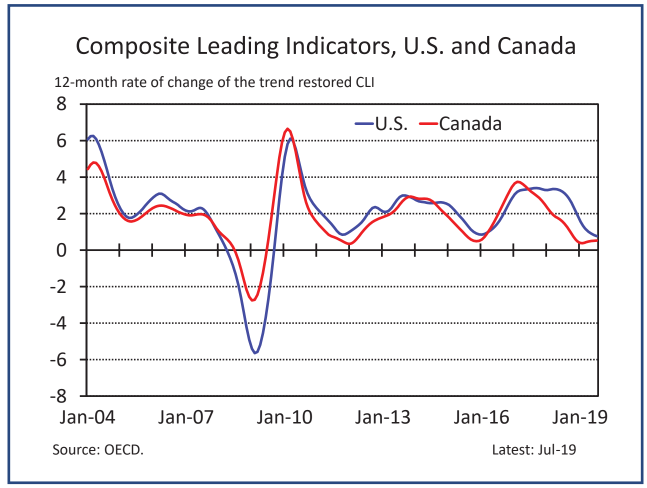
Source: Statistics Canada, CD Howe Institute. Shaded areas are recessions.

The expansion phase in Canada's current business cycle is 10 years and four months ending in September 2019 and the U.S. expansion phase is one month less in duration. This is not the longest expansion in the post-war era in Canada, though it is in the U.S. That distinction goes to the expansion phase in Canada that began in May 1992 and ended in September 2008, lasting 16 years and five months. The average duration of an expansion phase in Canada in the post-war era is five years and eight months, excluding the current phase. Recessions have become less frequent and expansion phases much longer over time.

It is understandable to view long expansion phases as 'overdue for a recession', but the reality is more complex. Being long-in-the-tooth does not cause a recession. Recessions are usually the result of substantial imbalances, typically investment and consumption aided by easy credit, developing in an economy, which requires tighter monetary conditions. Shock events, such as the oil supply disruptions in the 1970s, or policy errors can also result in recessions.

Canada's small economy is dragged into recession through its export and financial channels when the global economy, usually led by the U.S. is in recession. Since 1953, Canada has not been in a recession without the U.S. also in recession. The U.S. economy is a bellwether for Canada's economy with 70 per cent of its exports destined there along with substantial business and financial linkages. To assess whether Canada is at risk of a recession requires an examination of U.S. recession risks.





Current U.S. recession risks centre around deteriorating external economic conditions and U.S. trade policy, mainly the trade war with China. A monthly survey of economic forecasters put the average recession probability at 34 per cent in October 2019, compared to 18 per cent one year earlier, and nearly one-half of respondents expect a recession in 2020 and almost 30 per cent expect a recession in 2021[3].

The global economic growth slowdown and heightened uncertainty around trade policy caused the interest rate yield curve to invert[4], i.e., long rates are below short rates, which historically tends to be a reliable predictor of a recession. Long rates declined because growth and inflation prospects worsened. Short rates, controlled by the central bank, followed on a lagged basis. In the lead-up to U.S. recessions in the post-war era, the yield curve inverted due to short rates rising faster than long rates because the central bank was tightening monetary conditions to cool inflation. The current inversion is the exact opposite and could be a false positive.

The lead time between inversion of the yield curve and the business cycle peak is ten months on average, with five months the shortest and 16 months the longest since the 1960s in the U.S. The current yield curve inversion began on March 22, 2019 then reversed slightly before inverting on a consistent basis through to mid-October 2019. The news of a likely Phase 1 trade deal with China lifted market sentiment and the long end of the yield curve which is no longer inverted.

Canada's yield curve tends to closely follow the U.S., and since mid-2017, has been nearly identical in trend and level. However, the most recent rotation in the U.S. yield curve out of inversion has not occurred in Canada, though its curve is less inverted than two months ago.

Leading economic indexes, designed to predict the future direction of the economy in the coming months, are signaling a growth slowdown, not a recession in the U.S. The lead time between the onset of a U.S. recession and a peak in the leading indicator varies from nine months to 22 months with an average of 14 months. One problem is to identify when a peak has occurred, which is not known until after the fact. However, the available leading indicators[5] are currently expanding at a slower pace, no peak has yet occurred, which puts a recession off until mid-2020, at the earliest, barring a shock event.

Canada's leading economic indicators[6] are rising at a slower pace as of the latest month. Not surprisingly, the U.S. leading indicator is one component making up the Canadian leading index due to the close interconnections between the two economies.

The main recession concern is another trade policy error. Should the U.S. administration impose a tariff on auto imports, it would depress market sentiment and global growth. A collapse in trade talks with China would have a similar impact, and if in combination with auto tariffs, growth would slow considerably, probably knocking a full percentage point off global growth with the EU, Japan, South Korea, and others looking at recession.

Credit booms often precede recessions. In the U.S. there is concern about high corporate debt levels, and in Canada, high household debt levels. However, high

3 Wall Street Journal Economic Forecasting Survey, October 2019.

4 Based on the spread between the 10-year government bond yield and the three-month treasury bill rate.

5 Produced by the Conference Board, OECD, Federal Reserve Bank of Philadelphia, Economic Cycle Research Institute

6 Produced by the Conference Board of Canada, Macdonald-Laurier Institute, OECD.

debt levels alone do not cause a recession. A trigger event is needed to cause a liquidity crunch, or higher unemployment, resulting in income loss, rising debt arrears and defaults, and a credit freeze. In the lead up to the GFC, high debt levels resulted from poor lending practices, lax or no regulatory supervision, and fragile funding. This set the conditions for a trigger event, the Lehman bankruptcy, to cause the GFC and recession in the U.S. Canada did not have a financial crisis but fell into recession because of its close linkages with the U.S.

While trade policy and uncertainty are hindering growth, monetary and fiscal policies are being used to counter slowing growth and possible recession. Easier monetary conditions have played out in many countries, more recently including the U.S., and fiscal policy is likely to become more utilized in some countries. An inflection point in growth rates is possible in 2020 under these conditions. Growth would stabilize at a lower rate and improve as economic actors adjust to more stimulative conditions and new opportunities present themselves.

When is the next recession? Based on economic and financial indicators, not in the next 6 months can be stated with a high degree of confidence, and not in the next 12 months with a lower, but still high degree of confidence. The further out one looks, the probability of a recession rises, however, this is a statistical risk assessment result only.

What matters is, are the conditions for a recession present? Those conditions could be significant economic imbalances, a surge in poor credit quality, high and rising inflation, a shortage or disruption in a critical supply, a currency crisis, or a serious policy error such as an expansion of tariffs and trade balkanization. Noneconomic factors could also cause a recession and a geopolitical shock event is at the top of this list.

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