INVESTOR ALERT

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Unanticipated Recessions

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Since our inception in 2000 we've forecasted, in real time, the two U.S. recessions that have occurred (2001, 2007-09); just as important, our models haven't falsely forecasted any recessions that *didn't* occur.[1]

The same can't be said for the performance of professional economists, especially before the last U.S. recession (see "The Problem in a Nutshell," page 3). The two recessions we've forecasted since 2000 weren't mild or inconsequential: the first included a plunge of 49% in the S&P 500 from its peak (in March 2000) to its trough (in October 2002); the second recession, even worse, included an S&P 500 plunge of 57% from peak (October 2007) to trough (March 2009) and a 4% drop in real GDP. In both cases, equities began dropping *well before the recessions began* (and also before being "officially" declared by the NBER).[2]

Our forecasting success benefits enormously from our proprietary model, which incorporates (among other crucial factors) the remarkable fact that inverted Treasury yield curves have reliably forecasted all seven U.S. recessions over the past half-century and haven't falsely signaled any recessions that didn't occur subsequently (see the evidence in Table One, page 2).

The U.S. Treasury yield curve has been inverted since May, yet most economists now deny that there might be another U.S. recession in 2020 or 2021.

We all realize that White House economists aren't well known for being very objective, at least not while working for politicians in Washington; but even those who have conceded, in the past, the power of inverted yield curves to forecast recessions, are willing to evade today's ominous signal.

Take Larry Kudlow, for example, President's Trump's economic advisor. Kudlow joined with other conventional economists in failing utterly to predict the Great Recession of 2007-09, despite the prior yield curve inversion. Now he makes this claim:

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[1] On anticipating the recession of 2001, see "Why Greenspan Trashes the Markets," *The Capitalist Advisor*, February 22, 2000; "How Long Can This Keep Going On?" *Investor Alert*, February 4, 2000; and "The Anti-Wealth Effect," *The Capitalist Advisor*, April 17, 2000. On anticipating the recession of 2007-2009, see "The Recession of 2007," *Investor Alert*, December 7, 2006; "Outlook 2007," January 17, 2007; "Signs of Economic Weakness," *Investor Alert*, February 15, 2007; "Inverted Yield Curves as Bull Market Killers – and Bear Market Predictors," *Investment Focus,* February 7, 2007; "Will the End of the Yield-Curve's Inversion Be Bullish for U.S. Stocks?" *Investment Focus*, June 15, 2007; and "The Fed Downgrades Growth – Just Like the Last Recession," *Investor Alert*, July 20, 2007.

[2] The National Bureau of Economic Research (NBER) provides, ex-poste, official starting and ending dates for U.S. recessions; its job is to date recessions accurately, even if in a tardy manner, not to forecast them, yet many professionals look to the NBER for guidance in analyzing recessions. They're reluctant to declare that a recession has begun until the NBER declares so, by which time it's too late. For NBER dating since 1857, see http://www.nber.org/cycles.html.

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> Looking at the data, both the coincident and forward -looking indicators, I believe there is no recession in sight. We could be in a turning point zone back to 3% (GDP) growth due to the household [employment] numbers. I'm a congenital optimist. I can't help myself. I love America. I know Trump has instituted supply-side incentives and free-market policies that will make America even greater.[3]

This isn't analysis or forecasting; it's *cheerleading*. Is it not possible to reasonably forecast a U.S. recession and still, dare we say, love America? Yes, it is. One might even love America enough to despise policies that ignorant leaders and incompetent political hacks deploy to stunt her prosperity or put her into recession—like Mr. Trump's punitive tariffs and profligate spending, neither of which Kudlow has bothered to oppose or critique.

Are "congenital optimists" objective in their analysis or accurate in their predictions? Not if there's evidence of trouble ahead. The alternative isn't to be an inveterate pessimist and perma-bear who's wrong 95% of the time (*e.g.,* Gary Shilling and Nouriel Roubini). The approach to take isn't optimism or pessimism but *realism*—a focus on reality, history, causality, and *consequently*, the possibility of some genuine, reliable *predictability*.

Professionals who study and opine on markets and future developments—whether economists, investment strategists, or central bankers—have had poor forecasting records, especially regarding recessions.[4] Presumably, equity holders who've believed the "optimists" and other perpetually bullish forecasters have suffered periodically from severe portfolio declines—and may do so again (soon).

Why are professionals so bad at forecasting recessions? Well, they're not so able at forecasting *generally*, let alone *particularly*. But economic contractions pose a special problem: they're rarer than expansions, thus outside the norm of experience. Professionals prefer to expect what's normal, not abnormal; on that, they're mostly right, since the normal is, in fact, what *normally* happens. It's a good way to build and tout a decent track record based on absolutely no proven or superior foresight!

Many market professionals who pose as seers prefer not to stick out from the crowd and look bad; thus many of them simply *trend extrapolate*, or project whatever's been the average historical performance of the variable under

Table One

Lags from Yield Curve Inversions to the Beginning of Reecssions

U.S., 1969 - 2019

Beginning of		Lag in terms of	
YC Inversion	**Recession**	**Days**	**Months**
6/18/69	**1969.12**	166	5.5
6/1/73	**1973.11**	153	5.1
11/1/78	**1980.01**	426	14.2
10/27/80	**1981.07**	247	8.2
5/24/89	**1990.07**	403	13.4
7/7/00	**2001.03**	237	7.9
7/17/06	**2007.12**	502	16.7
5/22/19			
	averages (pre-1985)	**248**	**8.3**
	averages: ALL YEARS	**305**	**10.2**
	averages (post-1985)	**381**	**12.7**

consideration. If they forecast wrongly, they'll be in company with everyone else who uses a similar approach; they won't be singled out for special blame. This explains why most market professionals are inept at anticipating trend reversals, turning points, and inflections, precisely those cases when predictive accuracy may matter most.

As for *economists*, their poor forecasting record may be further attributable to various specious theories about the way economies actually work (*e.g.*, Keynesian, monetarist, and other demand-side theories) and/or faulty data inputs to econometric models (*e.g.,* backward-looking accounting data that are revised years after the fact).

As for investment *strategists*, note that many are employed by "sell-side" firms and as such they tend to be biased towards bullishness; those who work instead on the "buy side" may be more skeptical, thus more balanced, but they're still heavily influenced by sell-side prognosticators, and besides, they aren't really paid to go public with their forecasts.

As for *central bankers*, they're the worst forecasters of all, even while touting their alleged expertise and huge stable of Ph.D. economists; for political reasons alone they don't ever forecast a recession, as it might imply either

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[3] Larry Kudlow, interviewed by anchor Stuart Varney on Fox Business Network, October 4, 2019. Kudlow also said he expected no recession in the coming years because the jobless rate is low and housing starts are strong. Every economist knows that these are not leading indicators, that if anything they tend to look best just before recessions.

[4] See Amelia Thomson-DeVeaux," Economists are Bad at Predicting Recessions," *FiveThirtyEight*, August 21, 2019 (https://fivethirtyeight.com/features/economists-are-bad-at-predicting-recessions/).

that they may have *caused* it (indeed, if they inverted the yield curve) or are taking no active steps to *prevent* it.

The next U.S. recession won't be forecasted by economists, least of all by a "consensus" of them. A consensus is but a herd of sheep in wolves' clothing; it can be as bad as wolves, leaving you exposed to harm. Forward-looking market prices, like those embodied in the yield curve, will more likely do the job right—yet again.

The Problem in a Nutshell

(emphasis added)

"Economists are immensely influential. More frequently than the practitioners of perhaps any other academic discipline, they are called on for their learned judgments on public policy. Yet on a public policy question that is central to their field, economists have often been dead wrong. ***Economists, as a group, have been so bad at forecasting the ups and downs of the business cycle that it's a wonder they continue trying to forecast at all.*** According to a 2011 study by Simon Potter of the Federal Reserve Bank of New York, most private economists and the staff of the Federal Reserve failed to foresee the Great Recession—the greatest economic downturn since the 1930s. We now know that it started in December 2007 and ended in June 2009. Almost nobody saw it coming. Presumably, if we'd had some early warning, it might have been possible to take action to forestall the disaster—or at least prepare for it. Governments, corporations, families, universities, pension funds—just about everybody—was blindsided. That's the nasty side of forecasting failure. There is a lighter side, too. Economists often discern phantom recessions—downturns that never materialize in the real world."

—— Jeff Sommer, "Scoping Out a Phantom Recession,"
***New York Times*, May 24, 2015**

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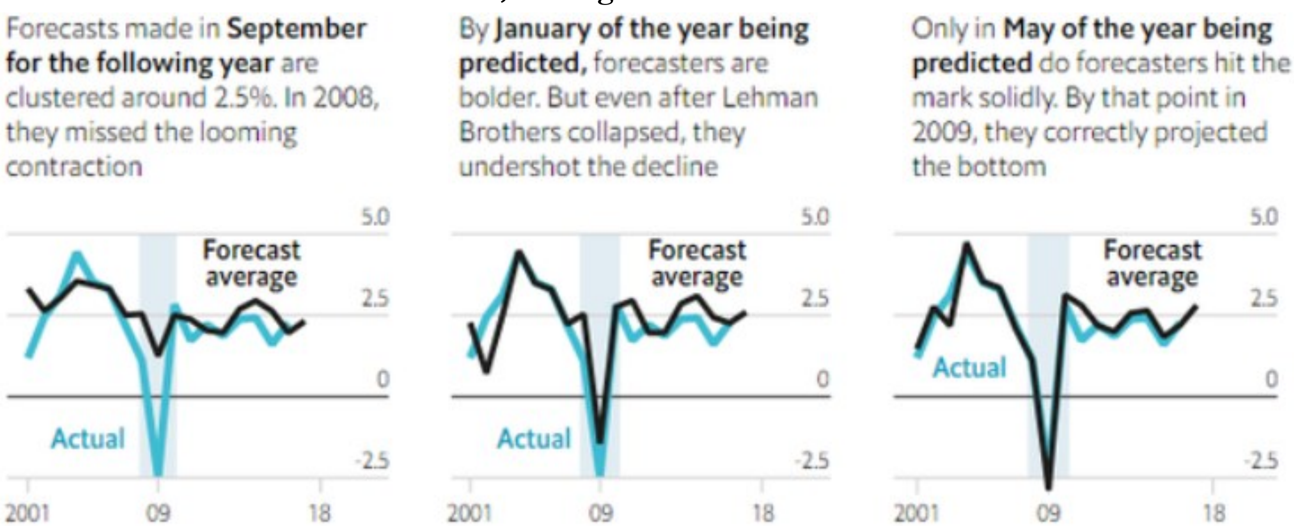
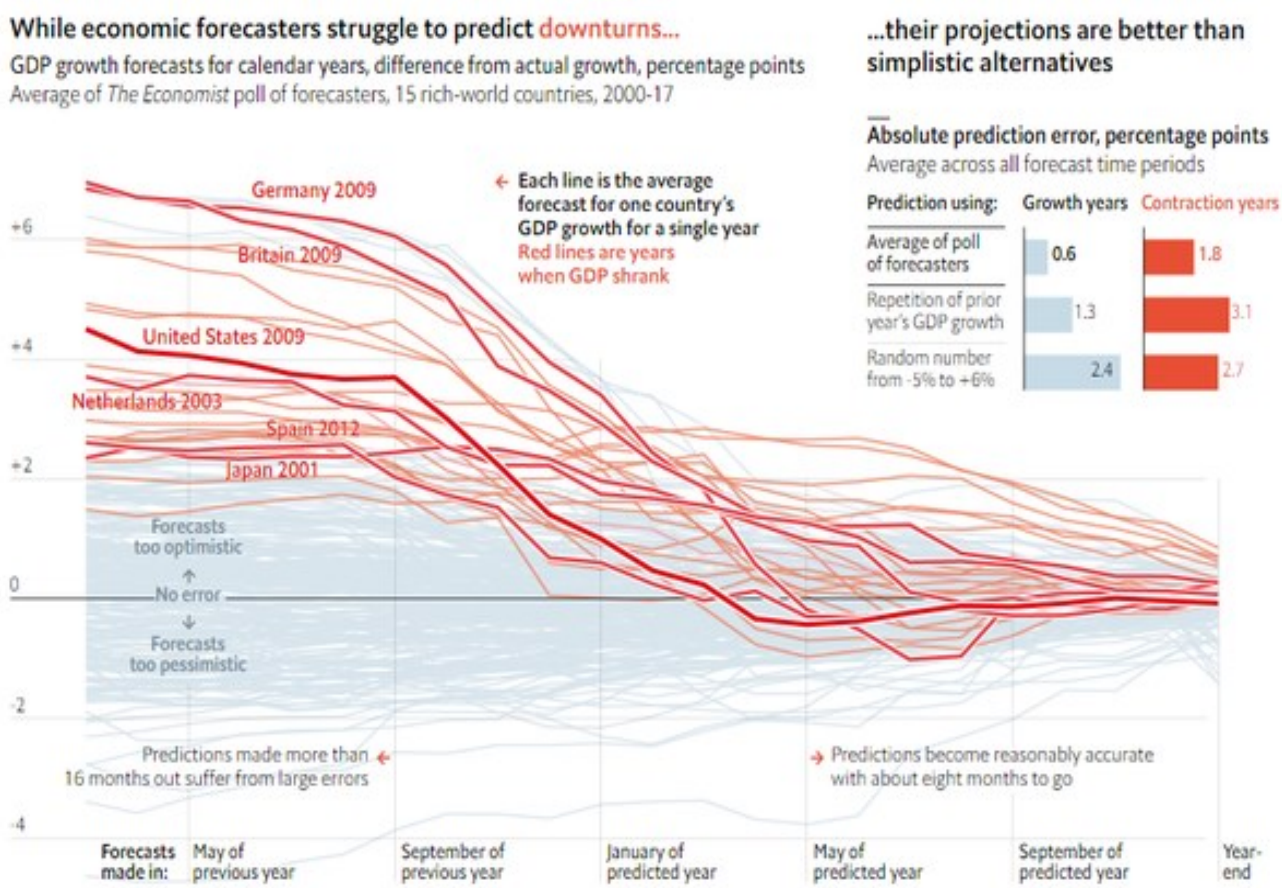
Warning: Economists Are *Not* Leading Indicators

Source: Peter Sainsbury, "Why Economists Can't Predict," *The Internationalist's Journal*, January 5, 2019.
https://medium.com/the-internationalists-journal/why-economists-cant-predict-9692e63a022

Forecasts of U.S. Economists Before, During and After the "Great Recession"





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How to Forecast a Yield-Curve Inversion

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JANUARY 30, 2019

In the Federal Reserve's long (104-year) history, it has never forecasted a recession, although it's bone-headed policies have caused many of them. It's remarkable, really, and a bit puzzling (to some). *Nineteen U.S. recessions* have occurred on the Fed's watch, seven over the past fifty years alone, when it has had full policy discretion—having jettisoned the gold standard in 1971—and thus a material influence on the business cycle. Although the early Fed rarely publicized its economic outlook, it's done so routinely in recent decades. *Still, no recession forecasts*. Today's Fed employs hundreds of Ph.D. economists. *Still, no recession forecasts*. The Fed is either inherently stupid, unwilling to be definitive, or reluctant politically to predict a bad thing which it can prevent. Regardless, why should anyone view the Fed as credible?[1]

> **"Economic expansions don't die of natural causes. They're murdered by identifiable, anti-market policies, and no component of a nation's policy mix matters more for future fluctuations in business activity than monetary policy. . . Just as the U.S. achieves its current record [expansion], the Fed has adopted a policy [yield-curve inversion] that, in time, could halt it."**
>
> — "How Long Can This Keep Going On?" *Investor Alert*, IFI, February 4, 2000, p. 2. Note: the subsequent U.S. recession began in March 2001 and lasted through November 2001.

Reliably misguided. There is, however, one thing the Fed can always be trusted to do, because it does the thing so dogmatically and regularly: it combats prosperity (a low jobless rate) by raising short-term rates, inverting the Treasury yield curve, and triggering recession. Each of the seven U.S. recessions since 1968 has been preceded by a curve inversion (with an average lead time of eleven months) and no inversion has occurred that falsely signaled recession.[2] That's a perfect forecasting record.

You might think responsible, fact-focused Fed officials and staff economists would take notice of the empirics. You'd think they'd be impressed by the beautiful and efficient forecasting power of a single signal. They are, on occasion, but usually dismiss the link between the curve and the cycle as anomalous and unlikely to recur.[3] "It's different this time," they're wont to cry as they invert the curve and turn the screws. It's crazy, especially given how the Fed has been *responsible* for each yield-curve inversion, whether by *actively causing it* (by hiking rates and bringing the bill yield above the bond yield) or *passively allowing it* (by refusing to cut the short-term yield even as the long-term yield drops below it).

Inverted curve as recession forecaster. As for lead times, Table One (page 2) illustrates how the U.S. yield

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[1] See "What the Fed Knows (and Ignores) About the Yield Curve," *The Capitalist Advisor*, December 31, 2017 and "Should Investors Trust Forecasts of Fed Policy Made by Fed Policymakers? Connecting the Dots in FOMC Projections," *The Capitalist Advisor*, April 28, 2014.

[2] See "The Treasury Yield Curve: Seven Inversions for Seven Recessions," *Investment Focus*, May 7, 2014 and "Ahead of the Curve: Using the Term Structure of Interest Rates for Investment Outperformance," *Investment Focus*, May 14, 2014.

[3] See Richard G. Anderson, "Yield Curve Inversions and Cyclical Peaks," *Economic Synopsis*, Federal Reserve Bank of St. Louis, 2006 (https://files.stlouisfed.org/files/htdocs/publications/es/06/ES0610.pdf). He admits that "all [U.S.] business cycle peaks since 1960 have been preceded by a flattening or inversion of the Treasury yield curve" but insists that "the relationship between yield curve inversions (negative slope) and subsequent economic downturns is tenuous," while "the variability of inversion episodes suggests caution when interpreting changes in the yield curve as leading indicators of business cycle peaks." Non-committal complexification is typical of Fed research on the yield curve.

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Richard M. Salsman, Ph.D., CFA®

Richard Salsman is founder, president and chief market strategist. Prior to IFI he was senior economist at H.C. Wainwright Economics, Inc. (1993-1999) and from 1981 to 1992 a banker and capital markets specialist at the Bank of New York and Citibank. Mr. Salsman has authored numerous articles and is an expert in market history, economics, forecasting, and investment strategy. His work has appeared in *The Wall Street Journal*, *Investor's Business Daily*, *Barron's*, *Forbes*, *National Post* (Canada) and *The Economist*. In addition, he has authored three books—*Gold and Liberty* (1995), *Breaking the Banks: Central Banking Problems and Free Banking Solutions* (1990), *The Political Economy of Public Debt: Three Centuries of Theory and Evidence* (2017) —plus many chapters in edited books. Salsman speaks regularly at conferences, investment gatherings and universities. He earned his B.A. in Law and Economics from Bowdoin College (1981), his M.B.A. in Economics from the Stern School of Business at NYU (1988), and his Ph.D. from Duke University in Political Economy (2012). In 1993 he earned the designation of Chartered Financial Analyst (CFA) from the Association for Investment Management and Research.

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