When Will The Recession Start: Deutsche Bank's Disturbing Answer

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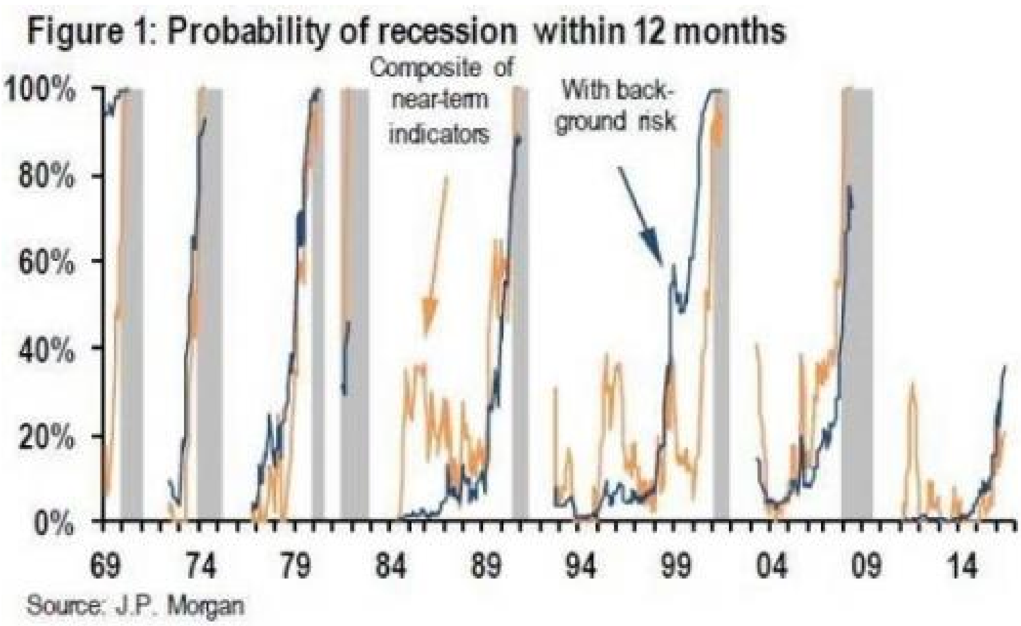
Just yesterday, when looking at the latest sudden drop in the US employment, JPM warned that as a result of the dramatic downshifting in the US economy, the bank's recession indicator had just hit a new cycle high of 36%.



This is what JPM said: "**This morning's employment report also raised the recession probabilities,** although for counterintuitive reasons. We do not include the payrolls number in the recession model because it is subject to larger revisions than other labor market data. But the unemployment rate enters the model in two ways. As a near-term indicator, we watch for increases in the unemployment rate that occur near the beginning of recessions. **So this morning's move down in the unemployment rate lowered the recession probability in our near-term model. But we also find the level of the unemployment rate to be one of the most useful indicators ofmedium-term recession risk.** So the move down in unemployment raises the model's view of the risk of economic overheating in the medium run and raises the "background risk" of recession."

So we have unemployment. However, a far bigger risk to the US economy is a topic we have flagged since last fall: peak, and now sliding, profits.

Because as DB's Dominic Konstam notes something every high school econ student knows, companies cutting headcount in rising numbers, while beneficial for profits at least in the short run, has negative impacts for long-run aggregate demand, to wit:

> *If aggregate demand is steady, then slower employment growth could well stabilize or improve productivity. However, the rub as always is that workers are also consumers, so as fewer jobs are created (or jobs are cut), then aggregate demand tends to decline.*

As such, declining profits and a slowing work force (as the exodus from the labor force returns) is the worst possible feedback loop for an economy; it is the one that the US finds itself in now, ironically just as the Fed hopes to telegraph the all clear by continuing to hike rates and in doing so confirming just how misplaced the Fed's optimism has been all along.

So while the BLS was finally forced to admit the truth about the US labor market yesterday, here is a reminder from DB's most unexpected "bear", Joe Lavorna, that **"profit margins have likely peaked"**:

> *The broadest measure of operating profits is pre-tax corporate profits with inventory valuation (IVA) and capital consumption adjustments (CCAdj). As the first chart below indicates, this series shows substantial compression of corporate margins.*
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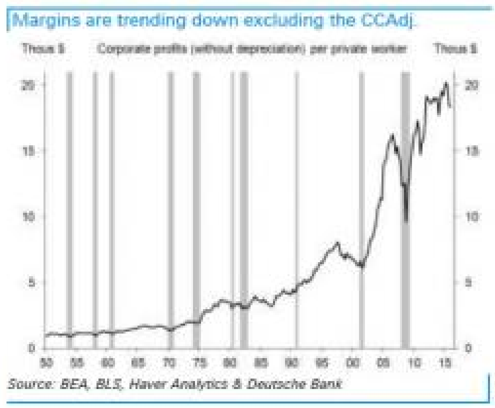
> 
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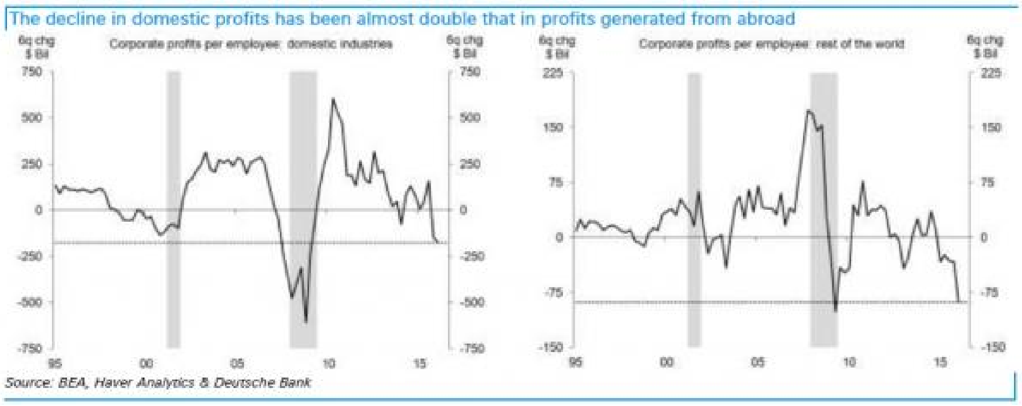
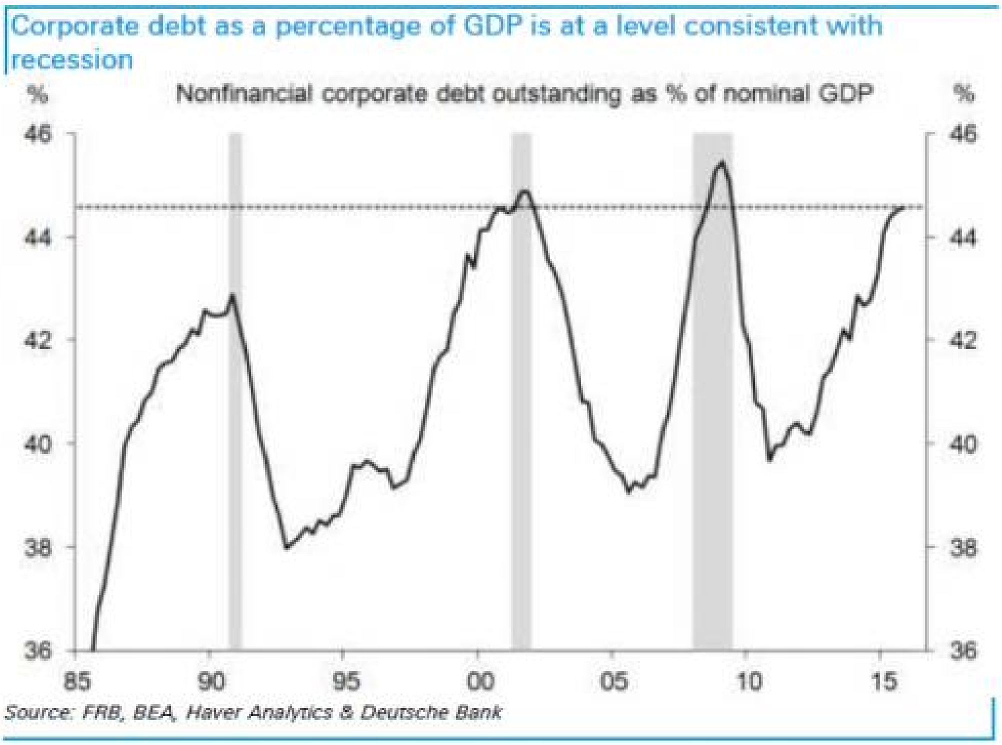
> *As illustrated in the above charts, profits per worker have generally trended higher over time. This is a function of productivity gains and inflation. Notice that our ratio is measured in nominal dollars. In the current business cycle, margins peaked at $18,403 per worker in Q3 2014. This compares to a current ratio of $15,615 per worker as of Q1 2016. Margins have fallen because corporate profit growth has declined while private sector job growth over the intervening period has been very steady, running at around a 2.3% annualized rate.*
>
> *Within corporate profits, the majority of the decline has been in domestic rather than overseas profits.* ***This means that recent margin compression has had less to do with the strengthening dollar, and perhaps more to do with weak domestic demand.*** *From Q3 2014, when profit margins peaked, to Q1 2016, domestic profits have declined by a little over -$175 billion. As we can see in the charts below, this is nearly double the -$88 billion decline in profits from outside the US. Not surprisingly, the decline in profit growth has occurred alongside a deceleration in domestic demand. In fact, the year-over-year growth rate of real final sales to private domestic purchasers, our favorite indicator of underlying demand, peaked at 3.6% in Q4 2014 and has since slowed to 2.6% as of last quarter.*



If it were only jobs and profits, maybe the Fed would have some degree of control, even if it is reflexive. Normally tightening happens after companies start competing for scarce labor resources, generating cost inflation at which point the Fed raises rates to ease inflation pressures and un-compress cost pressures; only this time the Fed is putting the cart in front of the horse and is hoping that by tightening it will somehow prompt wage inflation which has been the biggest variable missing from the US economy. By way of reference, the last time the unemployment rate was 4.7% in November 2007, average hourly earnings were growing 3.1% Y/Y without a raise in the minimum wage; now wages are rising at 2.5% mostly thanks to the boost for the lowest-paid workers.

However, what is very different this time, is that companies have taken on debt in the current business cycle. **Make that lots of debt.** As DB calculates, nonfinancial corporate debt has increased by $2 trillion from its trough in Q4 2010 through Q4 2015. And here things get interesting because as shown in the chart below, **the ratio of nonfinancial corporate debt to nominal GDP is at its highest level since Q2 2009,** when the economy was still in recession and nominal output was substantially depressed. As LaVorgna puts it, "**this is one reason why the Fed needs to be very cautious with respect to the pace of policy normalization**."



While unnecessary, the following observation is mostly for the benefit of the Fed which continues to shock analysts with its level of cluelessness:

> *An over-tightening of credit conditions would be problematic for a highly-levered corporate sector, especially if final demand were to remain weak.* ***If capital costs were rising in an environment of declining margins, employers would at minimum slow the pace of hiring, and perhaps even cut labor outright. This may already be occurring, given the broad-based weakness of the May employment report****.*

Which brings us to the question at hand: **when will the next recession strike** (if it hasn't done so already because according to most manufacturing indicators including factory orders, core capital goods orders, CapEx spending both macro and micro, manufacturing PMI and manufacturing employment, the US manufacturing sector has already been contracting for over a year).

Here is DB's answer:

> ***Profit margins always peak in advance of recession.*** *Indeed, there has not been one business cycle in the post-WWII era where this has not been the case. The reason margins are a leading indicator is simple:When corporate profitability declines, a pullback in spending and hiring eventually ensues. Normally, margins compress because of cost pressures— namely the labor share of income rises relative to the corporate share of income. Put another way, when companies compete for scarce labor resources, worker pay is bid up. In turn, inflation pressures often surface. This typically induces a monetary policy response—****the Fed begins raising interest rates to dampen inflation****.*

As a reminder, profit margins peaked in Q3 2014. With that in mind, the historical data reveals that the average and median lead times between the peak in margins and the onset of recession **are nine and eight quarters**, respectively, which as DB concludees **"would imply that the economy could enter recession as soon as the second half of this year."**

Profit margins peak on average about two years before the onset of recession, but the lead times vary substantially across business cycles

Business cycle	Peak in margins	Distance to recession (quarters)
1949 to 1953	Q4 1950	11
1954 to 1957	Q4 1955	8
1958 to 1960	Q2 1959	5
1961 to 1969	Q1 1966	16
1970 to 1973	Q1 1973	4
1975 to 1980	Q4 1978	6
1983 to 1990	Q4 1988	8
1991 to 2001	Q3 1997	15
2002 to 2007	Q3 2006	6
2009 to present	Q3 2014	?
Average>		9
Median>		8

Source: BEA, NBER, Haver Analytics & Deutsche Bank

Oops.

To be sure, Deutsche Bank tries to mitigate its disturbing conclusion somewhat - after all the last thing Germany's most "troubled" bank wants is to infurate the Fed even more:

> *"as we can see in the table on the following page, the time period between the peak in profit margins and the beginning of recession varies substantially across business cycles. Margins can sometimes peak well in advance of the onset of recession, as they did in the 1960s and 1990s business cycles. In the former period, the peak in margins occurred 16 quarters before recession. In the latter episode, the peak occurred 15 quarters ahead of the economy's entering recession. Conceivably, such a scenario could unfold now."*

But... there is always a but...

> ***"However, the current business cycle is already the fourth longest in the post- WWII period, and the corporate debt-to-GDP ratio suggests that imbalances are building***.*"*

So, Janet, about that July (or September, or December) rate hike.