



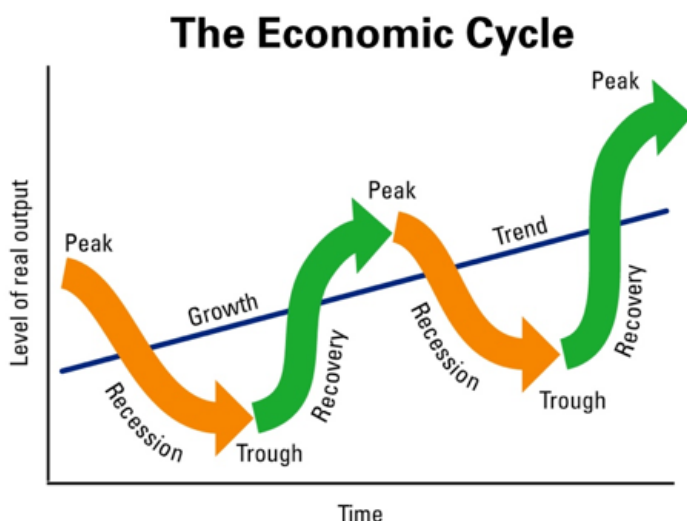
The Seven-Year Itch

SYNOPSIS

- Economies cycle from expansion to contraction, and each cycle is different in both scale and timing.
- Since it's been over seven years since the end of the last recession, many investors believe that it is now time for the U.S. economy to start slowing down.
- The financial crisis was not an average recession, so investors should not expect to see an average recovery.

ABOUT TIME FOR A RECESSION

The picture below depicts the economic cycle from boom to bust, and most developed economies follow this pattern where short-term cyclical growth causes growth to speed up and slow down, while the long-term growth trend (the black line) typically rises over time.



A recovery (green arrow) is an extended period of growth that can last anywhere from a few years to

well over a decade, and a recession (orange arrow) is a much shorter time period of economic weakness.

Control interest rate levels and you control how fast/slow an economy can grow.

The bad news regarding recessions is that the stock market gets whacked, multi-year gains can be erased in a matter of months, people lose jobs, and investor confidence can take far longer to recover than the economy.

The good news is that they don't happen all that often. The National Bureau of Economic Research (NBER) collects data on recessions, and since the end of World War II:

- On average, recessions have occurred once every 66 months.
- There have been 14 official recessions.
- The economy has been in a recession 14% of the time.
- The average recession has lasted just around 11 months.

NOTE: Go back to 1926, and recessions become more frequent and last longer. Meaning, as our economy has grown, it's become much stronger and able to rebound from these downturns (black line in the chart).

It's now been around seven years since the Great Recession of 2008 ended, and investors are once again being bombarded by market pundits on why we are "due" for another recession. Their



logic goes something like this: It's been roughly seven years since the last recession, and since we typically see a recession every six or seven years, that means we are due for one.

I refer to this as the “seven-year itch” of the investment world, and we are knee deep in it at the moment. The problem with this rationale is that economies and financial markets do not run on calendars.

Instead, they react to changes as events occur over time, so it's not as easy as circling a day, month, or even a year in a calendar to determine when the next recession will hit our economy.

Hence, let's analyze where we are right now in this cycle, determine what will drive our economy into the next recession, and then use history as a guide to get a sense of what we can expect and when it could arrive.

THE “WHO” & THE “WHY”

Based current economic trends, we are slowly moving through an expansion phase. My estimate puts us in the middle innings, and we will remain here until the Fed chooses to change its policy towards interest rates.

The Fed has a dual mandate that consists of (1) controlling inflation and (2) maximizing employment. The combination of these two should theoretically produce manageable growth, where consumers make more and spend more without inflation going haywire.

Hence, the Fed is constantly trying to find the right balance of the two, and tweaking interest rates is their primary tool to achieve their goal.

Think about how most consumers buy expensive goods and assets. Rarely do we pay for homes, cars, educations, and other big ticket items in

cash. Instead, we take out loans and then pay back these debts over time. Since these purchases are mostly made on credit, interest rates drive the *potential* for economic growth.

Meaning, if the mortgage rate rises from 4% to 10%, house sales will probably get hit because far fewer consumers can afford to pay a higher interest rate on a large loan balance. Control interest rate levels and you control how fast/slow an economy can grow.

The Fed aims for a “Goldilocks” level of 2.0% inflation because this level allows for enough inflation to keep wages rising but not enough to cause damage. Currently, inflation is coming in around 1.7% this year, which is lower than their desired target, so they have little incentive to raise interest rates any faster than their current glacial pace.

NOTE: *The Fed will start getting nervous in the 2.5% - 3.0% range. Once inflation approaches this level, the Fed will tighten the screws to prevent long-term risk to our economy.*

Simply put, the most important concept to remember about the economic cycle of the U.S. is that the Fed is the dominant force in determining whether our economy is growing or shrinking, and they are currently doing everything within their power to keep us in an expansion phase.

THE “WHEN”

Back in December, the Fed raised rates for the first time since 2006. The timing of the first rate during this expansion phase is worth observing.

Ed Hyman heads the economic research team at Evercore, which is one of the most prestigious research firms in the world, and he has been rated the #1 economist on Wall Street for the past 35 years by the *Institutional Investor* poll of investors.

His research shows that (1) the Fed typically begins raising rates two to three years after the recovery begins, and (2) recessions usually happen around five years later (there's that seven-year number again).

It's important to understand that Mr. Hyman's findings are based on an "average" recession. I think it is safe to say that the financial crisis was no average recession. The drawdown experienced back then was way deeper and persisted for a lot longer than any other recession dating back to the Great Depression.

Because this most recent recession was so severe, the Fed waited over six years to start raising interest rates instead of the historical average of 2-3 years. Therefore, this notion that we are due for a recession simply because it's been seven years cannot hold water for the sole reason that the Fed just started raising rates a few months ago.

The question still remains of when we should expect a recession. To start, I believe that a conservative baseline is five years, given the conclusions from Mr. Hyman's research. But remember that there was nothing average about the last recession.

The current recovery period has been incredibly slow relative to average recoveries, and since there are little to no signs that inflation is about to accelerate, I see little reason to expect the Fed to move any faster than they are at the moment. In fact, their recent guidance to investors has indicated their desire to keep it slow and steady for the time being.

Hence, it's hard to envision the Fed driving us into a recession for a minimum of five years with the realistic possibility that it could extend out past six or more years from today.

IMPLICATIONS FOR INVESTORS

At some point down the road, wages will begin to rise once consumers can confidently walk into their boss's office and demand a raise. These wage hikes will give consumers more purchasing power, which will cause the demand for goods to rise. Inflation will soon follow.

The Fed will be watching the entire time and adjusting interest rates along the way. Eventually, they will cause our economy to peak. High interest rates will kill the demand for loans, which will hurt sales and result in falling stock prices.

Mark my words, this will happen, and when it does, it will be time to exit the stock market. But we are not there yet. The absolute last outcome the Fed wants at the moment is to slow our economy down by even a fraction of a percent.

The bottom line is that economic cycles are never the same, and although historical averages are interesting and worth observing, be sure to take them with a grain of salt.

Sincerely,



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