What do 1987, 1998, 2005 and 2015 have in common?

Dr Robert Gay | Fenwick Advisers | 19 September 2015

In all of 1987, 1998, 2005 and 2015:
- The US economy was close to full employment.
- Inflation was tame (relative to the norm at the time).
- Commodity prices were low or recently had fallen.
- Emerging markets were under financial strain.
- Volatility roiled financial markets.
- The US dollar was strong or had been strong in the recent past.
- US monetary policy was excessively generous in part because of market volatility and the perception that global growth was slowing.

What did 1988, 1999 and 2006 have in common?
- They all proved to be the strongest year for global growth during their respective expansions.
- Resurgence in growth pushed the US economy beyond full employment (i.e., the output gap turned negative).
- The Fed fell behind the curve and was forced to tighten monetary policy abruptly; inflation rose and the Fed overshot.
- Credit quality deteriorated and banks began to tighten lending standards.

What did 1990, 2000 and 2007 have in common?
- The seeds of the coming recession had been sown.
- The global economy and financial markets topped out.
- The US dollar weakened.

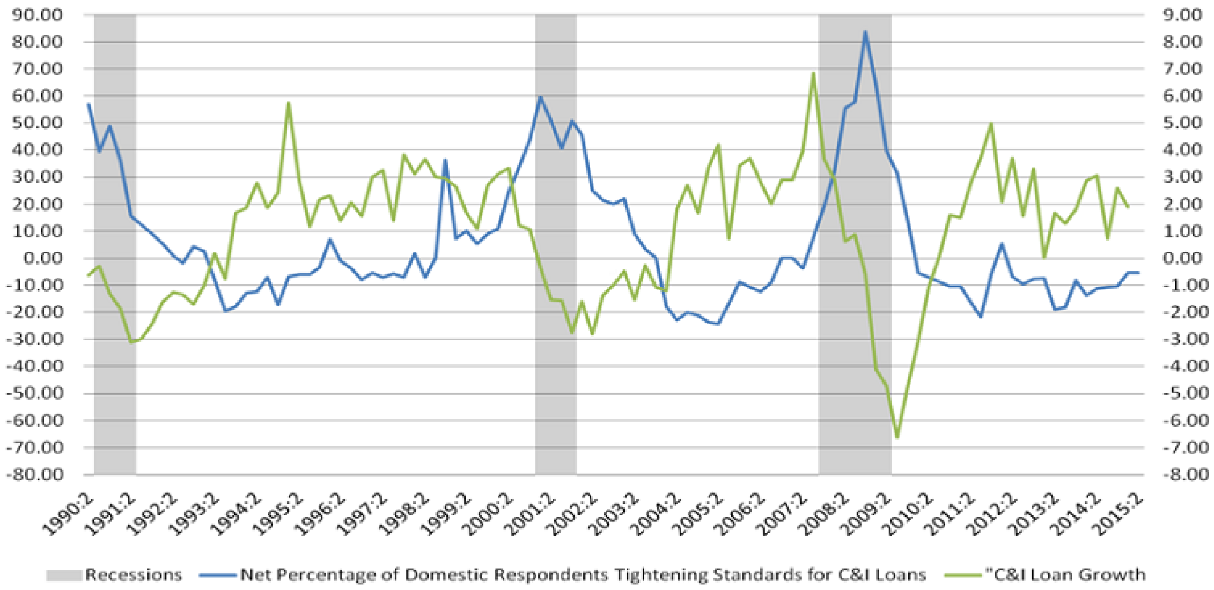
What do you think is my view of 2016?
- Economic growth picks up.
- Credit expands rapidly on the back of low rates.
- Banks tighten lending standards.
- Low inflation causes the Fed to procrastinate.
- EM currencies and the yen recover.

And 2017?
- Recession!
- Equities sell off and credit spreads blow out.

From here, there are two charts to monitor.

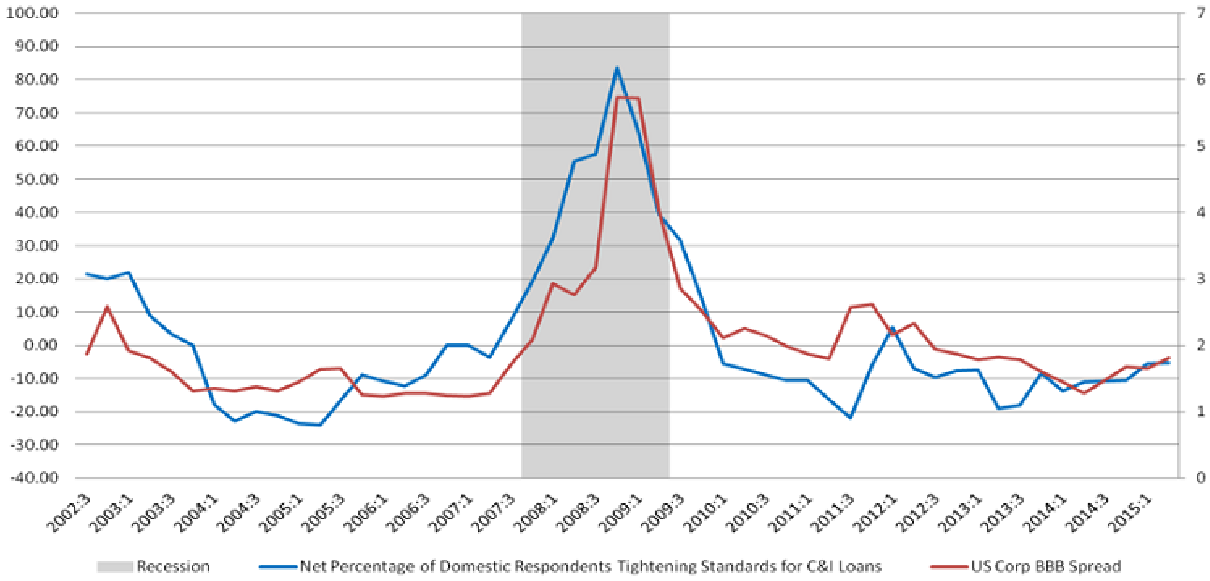
Figure 1 depicts the end-cycle surge in lending as businesses take advantage of low, or even negative real interest rates. Mergers also ramp up the private sector demand for credit. Banks soon find the quality of their loan books is deteriorating and belatedly tighten lending standards.

Figure 1: Credit booms and bank lending standards



A tightening in bank lending standards also is the only decent lead indicator of US recessions. Note in Figure 2, banks start to tighten standards well in advance of when financial markets recognise the deterioration in credit quality and credit spreads widen for riskier issuers, foreshadowing the coming recession.

Figure 2: Bank lending standards as a lead indicator of recessions



Dr Robert Gay is managing partner of Fenwick Advisers, a financial consultancy serving global investment banks, hedge funds, and other fund managers and financial institutions including fixed income manager, Stratton Street Capital. Prior to forming Fenwick Advisers, Dr Gay served as international economist and global strategist Morgan Stanley, Bankers Trust and Commerzbank AG. He spent eight years as Senior Economist with the Board of Governors of the Federal Reserve System in Washington, DC, primarily during the chairmanship of Paul Volcker.