ECONOMIC VIEWPOINT

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017
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In This Time of Uncertainty, Careful Not to Confuse Economic Slowdown with Recession

Fears about economic growth have intensified in recent months. After a buoyant 2017 worldwide, the stars fell out of alignment in 2018, particularly in the second half of the year. Clouds have also gathered on the horizon for 2019. The word "recession" even reappeared in some economic commentary. Is this truly something we are in for?

It is always difficult to predict with a high degree of certainty whether or not the economy will contract. We must be cautious in interpreting a slowdown in economic growth. A slowdown does not necessarily lead to a recession, where economic activity retreats and the unemployment rate rises significantly. The difference is important. As things currently stand, it is still likely for the economy to catch its breath without too much trouble.

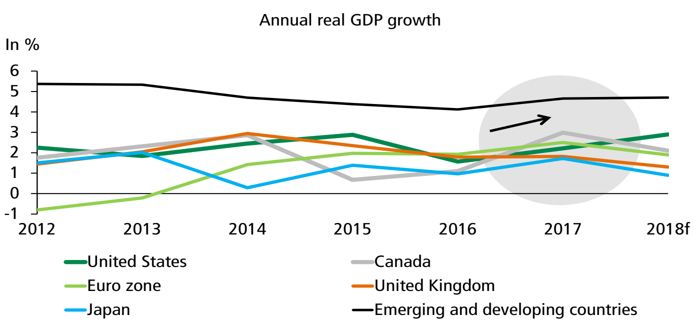
There Was Quite a Difference between 2017 and 2018

On the economic front, 2017 was an excellent year. It was particularly marked by an acceleration in growth in virtually every part of the world (graph 1). However, the picture looked very different in 2018. The United States was one of the few places where economic growth was still accelerating. The deep tax cuts ordered by the Trump administration were the main contributor to this favourable climate. Growth declined in most other advanced countries and stabilized, on average, in emerging and developing nations. An improvement in India and in some other countries offset the downturns observed elsewhere, like in China.

The reversal was even more pronounced in the financial markets. Greater volatility moved in and ultimately sent the markets plunging in 2018 (graph 2). For some stock indexes, the psychological threshold of 20% losses was even achieved, suggesting the arrival of a bear market, that is, an extended period of stock market underperformance. Emerging countries were more affected by the declines.

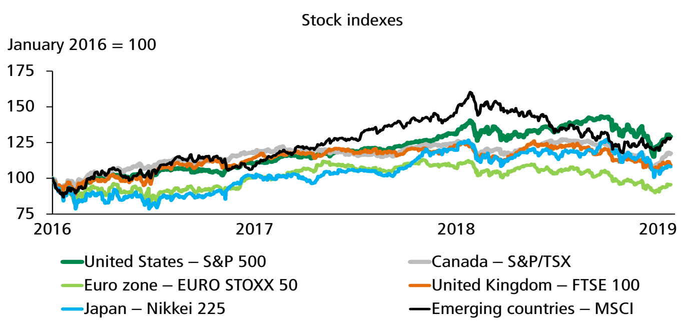
A change of course was also noted in bond yields. They started off maintaining their momentum from 2017, but soon began to level off and then fall by the end of the year for a number

GRAPH 1
Economic growth was synchronized in 2017, but did not last into 2018



f: Desjardins forecasts
Sources: Datastream and Desjardins, Economic Studies

GRAPH 2
After a great 2017, the stock markets lost ground in 2018



Sources: Datastream and Desjardins, Economic Studies

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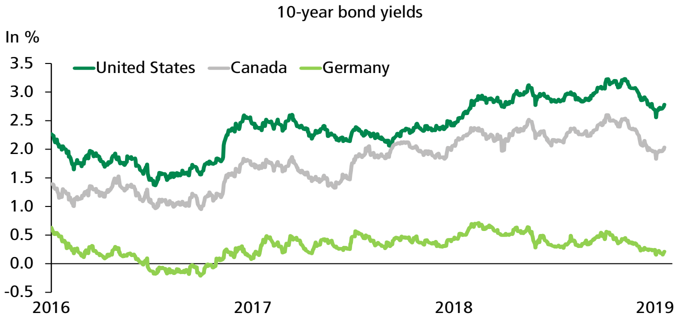
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

of terms (graph 3). In Canada and the euro zone, 10-year bond yields ended the year lower than they began. A slight annual gain was maintained in the United States, helped by continued monetary tightening, which brought a total of four key interest rate hikes in 2018—one more than in 2017. The yield curve flattened considerably in the United States.

GRAPH 3
The ascent in bond yields was also dampened

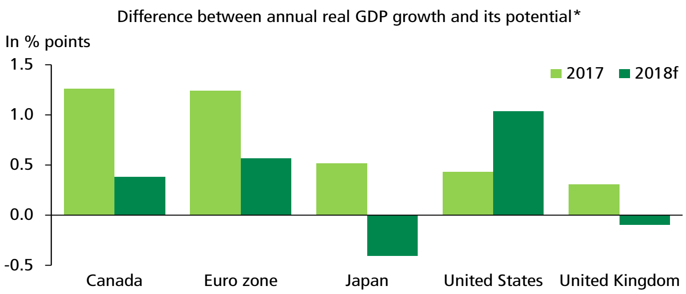


Sources: Datastream and Desjardins, Economic Studies

A Return Closer to Economic Growth Potential

Despite the slowdown in 2018, it is interesting to note that economic growth in a number of countries remained above its long-term potential (graph 4). That was notably the case in Canada and the average of euro zone countries.

GRAPH 4
Economic growth remained above potential in many countries in 2018



f: Desjardins forecasts; * Deviation from potential real GDP growth estimated by the Organisation for Economic Co-operation and Development (OECD).
Sources: OECD, Datastream and Desjardins, Economic Studies

Potential growth is linked to structural rather than situational factors. It is a kind of limit that cannot be continually exceeded over a long period. It is estimated based on the change in the number of available workers and productivity. The capital available, the number of hours worked and workers' education level are other factors affecting potential economic growth.

According to the estimates of the Organisation for Economic Co-operation and Development (OECD), potential growth in the United States is about 2.00%, compared with approximately 1.75% in Canada and between 1.00% and 1.50% in Japan, the euro zone and the United Kingdom.

Potential growth has already been higher, but has decreased as a result of demographic changes, bringing in a lower influx of new workers. Productivity gains also slumped in some countries. That said, there is really no cause for concern while growth hovers around its potential. Among other things, the unemployment rate should not increase as long as economic growth does not fall below its potential.

What Does It Take for a Recession to Occur?

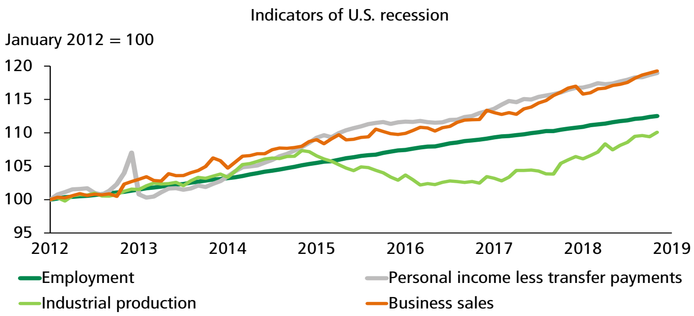
The commonly used definition of recession is when real GDP declines for at least two quarters in a row. We therefore have to look for more than a slowdown in economic growth; we have to look for a contraction.

However, there is a big difference between a recession that lasts just two quarters and one that is four or five quarters of GDP declines, or even more. When GDP falls for just two quarters and the accumulated contraction is limited, this is often referred to as a technical recession. In a technical recession, the unemployment rate generally does not rise very much. The effect on the labour market is more evident when a recession drags on and results in a considerable cumulative contraction. The 2008–2009 recession lasted six quarters in the United States, where real GDP shrank by a total of 4%. This period was called the "Great Recession." In the worst of situations, we talk about an economic depression. That is when GDP contracts more than 10% over a period of at least eight quarters.

Depending on the country, real GDP is not the only variable used to identify reversals in the economic cycle. In the United States, the National Bureau of Economic Research (NBER) usually uses four variables to determine economic cycle highs and lows more accurately. These variables are employment, industrial production, business sales and personal income less transfer payments.

At present, the four variables used by the NBER show no reversal in the economic cycle (graph 5 on page 3). To confirm the start of a recession, a widespread, sufficiently persistent weakness in these variables must be observed. In 2015–2016, industrial production contracted, but the other variables were not as gloomy and so a recession was not declared. Employment continued to rise at a good pace, personal income less transfer payments sat stagnant for a number of months but did not decrease, and business sales growth only slowed. A similar scenario could re-emerge in the coming quarters, and this would not be enough for a recession to be officially declared. This would nonetheless be characteristic of a weaker economy.

GRAPH 5
NBER U.S. recession indicators all remain strong

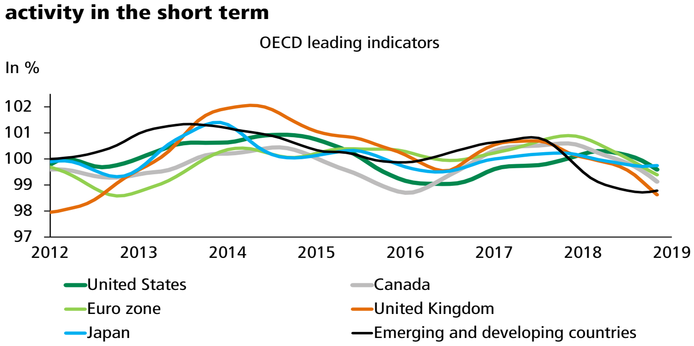


NBER: National Bureau of Economic Research
Sources: NBER and Desjardins, Economic Studies

The Horizon Has Clouded Over

The stock market and bond yield slump observed at the end of 2018 may be viewed as a loss of investor confidence in an economy that is slowing and may slow even further. Some express a foreboding regarding these market movements, but it is also important to look at indicators that are more directly representative of economic activity to get a better read on what the coming months hold in store. The variables used by the NBER are useful for keeping track of the economic cycle, but not for anticipating what is coming. Leading indicators, such as those calculated by the OECD, may help in that respect. For the time being, these indicators show few signs of improvement in growth over the next few months (graph 6). At best, we might see the situation stabilize in emerging countries. For the United States, the euro zone and a number of other economies, the situation might still deteriorate.

GRAPH 6
OECD leading indicators do not suggest an upturn in economic activity in the short term



OECD: Organisation for Economic Co-operation and Development
Sources: OECD and Desjardins, Economic Studies

A number of potential obstacles could worsen the economic situation. A rise in U.S. protectionism marked 2018. The United States imposed a number of new customs tariffs, bringing retaliation from the countries on the receiving end. Other tariffs could be added in 2019, risking further penalizing the global economy.

The growing political uncertainty is another major risk. This makes the economic climate less conducive to investments. Households may become more hesitant to make large purchases. The effect could also be felt by governments, which may have a more difficult time implementing reforms or carrying out projects with potential benefits for the economy. Political uncertainty appears to be running particularly high in Europe with the United Kingdom's future in the European Union still unclear, but also in light of the yellow vest crisis in France, the fragile coalition between the League and the Five Star Movement in Italy, and the rise in the popularity of the far right in Germany. The United States is not one to be left out, with another possible partial government shutdown in mid-February.

Market volatility could itself become a risk for the economy by further undermining consumer and business confidence. The volatility in the price of natural resources, including oil, could also cause some trouble. Black gold prices seesawed in 2018, sometimes worrying those forced to pay more for gas and other times unnerving investors seeing corporate profitability in this sector dwindle. Oil price swings also have a great deal of influence on short-term inflation. However, a spike in crude prices could quickly raise total inflation and unsettle the markets as to the reaction of central banks.

A rebound in the main stock market indexes has nonetheless been noted since the beginning of the year. The more cautious tone adopted by some central banks, including the Federal Reserve (Fed), has helped reassure investors. By slowing the pace of its monetary tightening, the Fed should leave more breathing room for an economy that seems to need to catch its breath. The repercussions of a more cautious Fed are also being felt internationally, particularly in emerging countries where changes in interest rates and capital flows are very much affected by U.S. monetary policy.

Another aspect that reassured investors early in the year was the easing of trade tensions between the United States and China. Ongoing negotiations could lead to a reduction in protectionist measures. However, a happy ending is still far from being guaranteed, and animosity could quickly return.

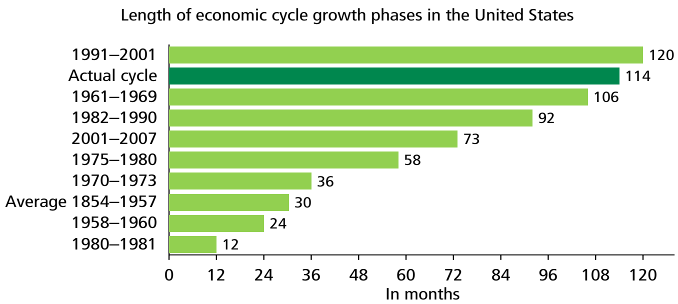
And, What about the Age of the Cycle?

Time is likely starting to take a toll on the economic cycle. It has been close to ten years since the last U.S. recession ended. If growth continues until June, the 1991–2001 record for the longest cycle will be tied (graph 7 on page 4).

However, the current cycle differed from previous ones in that the recovery took longer to take root, among other things. When the economy began to grow again in the summer of 2009, it took two years for it to return to just the pre-recession GDP level.

GRAPH 7

In the United States, the economic cycle is starting to age and could soon be the longest ever recorded



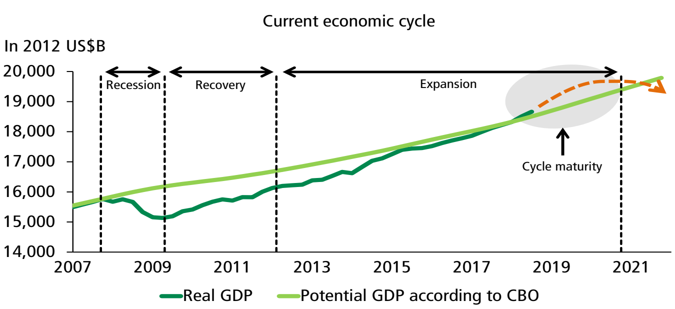
Sources: National Bureau of Economic Research and Desjardins, Economic Studies

It also took a long time for excess production capacity to be used. This is achieved when real GDP outstrips potential output. The potential output level is a sort of long-term real GDP trend where production factors such as work and capital are deemed fully used. The annual change in this measure corresponds to the potential growth we touched on earlier.

Once potential GDP is surpassed, the economic cycle can be said to be maturing. This period lasts approximately three years on average. Since real GDP in the United States surpassed its potential in the spring of 2018, it means that the current cycle could run until early 2021 and that implies that the previous longevity record could be largely broken (graph 8). Nevertheless, this analysis has a healthy margin for error. Real GDP did not really have time to surpass its potential before the 2008–2009 recession began.

GRAPH 8

The economic cycle has entered its final phase



CBO: Congressional Budget Office

Sources: Bureau of Economic Analysis, CBO and Desjardins, Economic Studies

In Short, It Is Too Early to Be Talking about a Recession, but Caution Is Still Warranted

In this period of worry and uncertainty, it may be tempting to believe that the current economic slowdown could lead to a recession. That said, it still seems too early to infer such an outcome with a high degree of certainty. Economic growth did slow in a number of countries in 2018 and the horizon does look gloomy for the time being. At the same time, what must also be considered is that the expected break in monetary policy tightening will help the economy. Furthermore, the U.S. economy could still surprise, as the labour market continues to do well and wage growth has accelerated. Coupled with a possible ongoing stock market rebound and the easing of some risks, U.S. consumption could finally be one of the key global economic engines in 2019.

Meanwhile, we should no longer be looking through rose-coloured glasses and saying that the current economic cycle will never end. We have entered the final phase of the U.S. cycle. It could still last another several quarters, but the margin for error is large. The forthcoming economic data will most certainly be very closely scrutinized, and analyses will have to pay particular attention to pockets of weakness that could snowball.

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