This is the second post in my three-part series on the recessionary cycle and its leading indicators.

**Market Signals**

**High Yield Spreads**

High yield corporate bond spreads are often regarded as reliable signals for a recession in the U.S. economy. In recent history, a spike in high yield spreads has either preceded or coincided with economic recession, as shown in Chart 6. Currently, there is no apparent stress in the corporate market.

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**Chart 6: BarCap U.S. Corp HY YTW: 10 Year Spread As of June 30, 2015**

Note: Shaded grey areas indicate a recession. Source: Bloomberg

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**Labor Market Indicators**

In recent decades, business cycle expansion typically peaked when U.S. average hourly earnings accelerated to 4%, while the unemployment rate fell to below 5% (see Chart 7 and Chart 8). These series, like any other economic data, are simply indicative of the boom-bust nature of the economy and tell us that a boom usually peters out when income growth and the unemployment rate reach certain threshold levels.

- U.S. Average Hourly Earnings (YoY)
- S&P 500 Earnings Per Share (%)

Source: Thomson Datostream
The wage rate currently remains very subdued, and any pickup in hourly earnings should be viewed in a positive light. So far, consumers continue to refuse taking on new debt, and therefore are confining their spending to the natural rate of income growth. Substantial time is needed before income and spending can reach the levels typical of a cyclical top.

The unemployment rate, however, is rapidly approaching levels that are usually indicative of Fed monetary tightening. However, the rapid fall in the unemployment rate could be deceptive because the decline occurs against the backdrop of a very depressed participation rate. The U-6 unemployment rate—which includes part-time workers—still stands at 10.8%, compared to previous bottoms of 6.9% and 8.0% in 2000 and 2007, respectively.

**Global Reserves**

Fluctuations in global non-gold reserves often signal what is going on in the world economy, mainly because global official reserves not only form high-powered money for the rest of the world economy, but are also closely linked to trade flows which are highly sensitive to global business cycles. A sharp decline in global reserves growth almost always indicates a steep downturn in global trade or a growth slump in the world economy, as shown in Chart 9 below:
I believe some caution is warranted here. Since global reserves are linked with trade, their fluctuations are strongly influenced by two factors: trade volume and the U.S. dollar’s valuation. A global trade boom and/or a major decline in the dollar could result in a strong surge in global reserves. Similarly, a global trade slump and/or a strong dollar could produce a major down cycle in global reserves. Prior to the 2000s, when the emerging world was mostly pegged to the U.S. dollar, a surge in the dollar often led to inadvertent monetary tightening, economic contraction, and financial crises in the developing world.

Global reserves have gone through a major deceleration since 2014—even contracting recently. The deceleration primarily reflects the sharp gain in the dollar since late 2014. Of course, global trade has also weakened as a result of the euro-zone crisis and a sharp slowdown in Chinese investment demand, but not yet to the extent of signaling an impending recession in the developed world.

Chart 10 shows that global reserves in special drawing rights (SDR) terms continue to expand, which is consistent with global export growth in volume terms. Note that SDR are foreign-exchange reserve assets with a valuation based on a basket of currencies selected by the International Monetary Fund. Of course, global reserves and SDR have declined sharply from the levels seen in 2010-2012, suggesting that the world economy has been reset at a new, albeit greatly reduced pace.
Commodity prices are a coincident indicator for global manufacturing cycles. On average, a 30% fall in the CRB index is consistent with a contraction in global manufacturing and trade. However, it is useful to separate a global manufacturing contraction from broad-based economic recession. Although global recession must come with trade and manufacturing contraction, the opposite is not necessarily true. In other words, it is possible to have a global trade and manufacturing contraction without a broad-based recession.

The CRB index has dropped 40% since 2011, due to the combination of a strong dollar and sharp deceleration in global nominal growth from the rapid recovery of 2009-2010, (see Chart 11 below). The latest downturn in the CRB index since 2014 is related to the impact of the strong dollar, although global manufacturing and trade have stayed subdued as well.

Regardless, the behavior of the CRB index is consistent with global manufacturing recession or trade stagnation. Any significant decline from its current levels should be read as a warning signal that the major economies of the world are slipping into broad-based recession.
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