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It’s time to get ready for the next recession

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Recessions occur every six years or so, on average. It’s been nine years since the last recession ended. By this time next year, the current economic expansion—if it continues—will be the longest in US history.

The economy is strong right now, and could grow even stronger during the next 12 months. The outlook darkens in 2020, however – and the best time to prepare for a downturn is during the peak months that precede it. “This is something that is clearly on the mind of many of our clients,” says Joel Prakken, chief US economist for research firm Macroeconomic Advisers. “We’re trying to alert our clients to the very real possibility of a downturn.”

The next contraction may not be as potent as the Great Recession that lasted from late 2007 to the middle of 2009 and featured the worst financial crash since the 1930s. But it could be transformative nonetheless, with wrenching upheaval in the job market, abrupt changes in the value of some investments, and political turmoil as policymakers grapple with new constraints on the government’s ability to respond.

To help Americans prepare, Yahoo Finance is publishing a series of reports previewing the next recession: When it might occur, what it will be like, who will be most affected and what will come after. We’ll examine likely changes in the job market, and things workers can do now to raise the odds of staying employed and getting ahead. We’ll explore the next recession’s likely impact on stocks and other investments, real estate, business strategy and technology. We’ll offer guidance for younger workers who will be toughing out their first downturn. And we’ll probe for the types of opportunities that might materialize for those positioned to capitalize on them.

Tight labor markets and inflation

With the unemployment rate at 3.8% – close to a record low — it might seem an odd time to worry about a recession. But tight labor markets actually precede recessions, and in some ways contribute to their occurrence, as this chart of the unemployment rate, with recessions shaded in gray, demonstrates:

There's nothing wrong with a low unemployment rate. But as workers grow scarce, wages rise, which means companies need to charge more for products and services, which generates more inflation. The Federal Reserve responds by raising interest rates, to prevent inflation from getting too high. Higher rates, in turn, depress investment and spending, stress some borrowers and cause some loan defaults. This pattern, in itself, doesn't necessarily cause a recession. But toss in external factors such as an energy shock, an asset bubble or bad government policy and the economy can easily contract for half a year or more, which is the traditional definition of a recession.

Many of these factors are in play today. The Federal Reserve is already raising rates, as it tries to normalize monetary policy after several years of extraordinarily low rates and other unusual measures meant to combat the Great Recession. Wage growth now averages 2.9% per year, which doesn't sound high, but is still the strongest since 2008. Inflation is 2.8%, also not high, but it's more likely to go up than down, especially if wages continue rising.

Policy mistakes

It will probably take more than modest increases in wages and inflation to trigger the next recession. So what might do it? Scott Minerd, chairman of Guggenheim Investments, told Yahoo Finance recently that excessive amounts of corporate debt—now at the highest levels ever, as a percentage of GDP–could induce the next downturn, as borrowers struggle to repay what they owe and some go bust. Others think a big swing in energy prices—either up, or down—could tip the economy over, either because soaring prices will disrupt business and household budgets, or plunging prices will wreck the US energy sector, which is bigger than it used to be. President Trump's protectionist policies could stress the economy at the wrong time. One outlier theory is that a "retail apocalypse" involving bankruptcies, store closures and mass layoffs could become so severe that it brings down the whole economy.

Many economists think tax cuts and spending hikes enacted by Congress during the last six months could end up being just the sort of policy mistake that does more economic harm than good. Those stimulus measures will boost growth this year, and perhaps next year as well. But by late 2019 or early 2020, the tax-cut stimulus may have worn off, with

government spending due to fall from temporarily raised levels and federal debt swelling by more than $1 trillion per year. “We’ll have tightening monetary policy and tighter fiscal policy, and the Fed might even be behind the curve if inflation is rising faster than anticipated,” says Prakken. “That will create a significant period of vulnerability in 2020 and 2021.”

Economists seem to be coalescing around 2020 as the next recession’s due date. In a survey by the National Association of Business Economists, two-thirds of respondents pegged 2020 as the start date of the next recession. In a recent Wall Street Journal survey of economists, 59% said it would arrive in 2020, with 22% saying 2021. **Bernard Baumohl, chief global economist for the Economic Outlook Group,** is gloomier. He recently raised his odds of a recession in 2019 from 25% to 55%, telling clients that solid economic numbers like the low unemployment rate are “illusory” because they’re linked with unsustainable levels of government debt.

What will a recession look like?

Whenever it arrives, what will the next recession look like? Probably not like the last one, which involved a massive housing bust, a 57% dive in the stock market and an unemployment rate that reached 10%. The housing market is far healthier now than it was during the bubble that preceded the last recession, and new regulations prevent many of the abuses that led to the stock-market crash.

But all recessions have commonalities, such as layoffs, falling asset prices and aggressive government stimulus efforts. The unemployment rate could easily hit 7.5% during the next recession, which is about the average for downturns. Stocks, currently overvalued by some measures, could fall 25%. Home values won’t crash, but they could flatten out as some buyers lose their nerve and others lose their jobs.

In the decades following World War II, recessions were essentially pauses in the economy, with things picking up where they left off when the downturn ended and companies hiring back many of the workers they laid off. But a new pattern emerged starting with the recession that began in 1990. Many employers now use recessions as an opportunity to retool their workforce and permanently cut costs. That’s one reason the three recessions since 1990 have all been followed by “jobless recoveries” characterized by weak job growth, with the trend intensifying over time.

There will probably be another jobless recovery following the next recession. “Layoffs will be an opportunity to replace people with a lot of the new automation technology,” says Louis Hyman, director of the Institute for Workplace Studies at Cornell University.

"I think it's going to be tough." Key skills, focusing on technology, will probably be even more crucial to getting ahead than they are now.

Economists also worry that the government will have fewer tools available to combat the next recession and help struggling families than it has had before. The Federal Reserve typically slashes short-term interest rates by about five percentage points during recessions, to stimulate lending and spending. But rates may not be high enough to provide that much headroom next time around. The Fed will probably cut short-term rates to nearly 0, as it did during the Great Recession, but it could be starting from somewhere between 3% and 4%. A smaller cut means weaker stimulus, and a longer and deeper recession.

Congress also does its part during recessions, typically approving fiscal stimulus such as tax cuts, additional spending or enhanced safety-net benefits. But that could be harder with the national debt now at $21 trillion—about 106% of GDP—and deficit spending pushing that up by nearly $1 trillion per year. During the economic boom of the late 1990s, tax receipts boomed and the government logged an annual surplus for four years in a row. But that last happened in 2000, and the national debt has exploded since then. At some point—nobody's sure when–excessive debt may limit Washington's ability to spend and perhaps force it to raise taxes. Such austerity would worsen a recession if it hit at the wrong time.

The best way to prepare for a recession is to live modestly, save money, minimize debt and preserve your flexibility to move if that's necessary to go where the jobs are. That might mean putting off a home purchase or other big commitment that could anchor you in place. Still, it's not always possible or desirable to live like a monk when there's tuition to pay or a family emergency, and you could really use a vacation to recharge the batteries. That's why we'll have more detailed follow-on stories examining different ways the next recession could affect ordinary families.

Recessions also create opportunities, for those able to ride them out. Investors with cash on hand can buy low as stock prices drop. Homes become more affordable as prices moderate and interest rates fall. Businesses have access to a broader pool of workers. And employers shifting strategies become interested in new forms of innovation. We can't predict everything about the next recession, but we know one thing for sure: the sooner you get ready for it, the smother the ride will be.

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