THE ANATOMY OF A RECESSION

One person's perspective

By Kim Radok

Introduction

The following is my perspective on the "how and why" recessions occur, the preceding indicators and suggested action to survive them. The purpose of this article is to share experience, knowledge and insight for the many business professionals that have either forgotten the pain of the previous recessions, not experienced one in their working life and/or believe the "modern world is recession proof". As a result, many of these individuals may consider themselves to be immune to the catastrophic ramifications.

Understanding and acting on the following information may help you protect your financial and emotional well-being.

What is and What Happens in a Recession?

According to Wikipedia, a recession is defined as:

… a recession is a business cycle contraction which results in a general slowdown in economic activity.[1][2] Macroeconomic indicators such as GDP (gross domestic product), investment spending, capacity utilization, household income, business profits, and inflation fall, while bankruptcies and the unemployment rate rise. In the United Kingdom, it is defined as a negative economic growth for two consecutive quarters.[3][4]
Recessions generally occur when there is a widespread drop in spending (an adverse demand shock). This may be triggered by various events, such as a financial crisis, an external trade shock, an adverse supply shock or the bursting of an economic bubble. Governments usually respond to recessions by adopting expansionary macroeconomic policies, such as increasing money supply, increasing government spending and decreasing taxation.

Another and perhaps more easily understood version of a recession is the following explanation.

Once businesses and consumers realise that they are actually in a recession, whether from self-belief or government and media announcements, people react in fear. The public sector also responds to these fears and uncertainty toward the economic future. As a result, non-essential spending is curtailed, which is more commonly described as "tightening one's belt."

In doing so, the lack of "consumer confidence" relates to severe cash flow reduction throughout the mainstream retail sector, causing a chain reaction into the manufacturing and importation industries. As the recession progresses, of course the other sectors follow.

The sales volume of products and services slow, thereby reducing company profits into losses. Reductions in business spending and investments become necessary or deemed to be necessary. In fact, many businesses may still have the capacity to keep spending and investing in their business. As the fear factor takes over however, they withdraw in to their "survival" mentality.

Even a healthy business in this state may also retrench their employees or suspend future recruitment. (Failing businesses have little choice, in an attempt to maintain a level of profit or reduce losses.) Fewer jobs translate into less cash flow in all sectors and the snowball effect grows to the demise of the nation's overall economy.

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The Years Between Recessions

The people that guide their companies through a recession tend to be grateful for their survival and remain cautious in the immediate aftermath. These survivors remember how they kept abreast of the market indicators and took precautionary action. They also do not forget the hard work, tough decisions and strategy changes, and perhaps a bit of good luck, which helped them get through the recession.

Post-recession, at first the grateful survivors maintain the operating disciplines that helped them survive the recession. In time, they return their business to profit. However, as their positive situation continues to improve, some survivors will relax too early, or even forget the lessons learnt. Therefore as the pain of the recession and the memories of business failings dwindle, and organisational memory fades, business practices and disciplines become less rigorous. In addition, risk management expenses become again, (incorrectly) seen as unnecessary costs. The fact the money spent is an investment on building the foundations of maintaining a solid business is forgotten.

However, for the less skilled or diligent, of course businesses fail. Failures of any kind are usually the most important lessons of all. In this instance, lessons that could have/should have been learnt and possibly passed onto future generations are therefore lost. Unfortunately, such important experiences would not have been recorded, studied, and possibly deemed as little value in “today’s business world”.

As the period of time increases from the previous recession, and with it, the arrogance of short term thinkers increase. Meanwhile, others ignore the hard facts that recessions are a natural part of the economic cycle. As a consequence, fewer professionals know how to prepare for, or operate a business through difficult periods.

The fallacy that nothing is to be gained by looking backwards, is therefore another reason why the next recession is a foregone conclusion – for those with experience know, history repeats itself!

The Average Time Between Recessions is 10 Years

As of May 2018, we have moved approximately five months past the 10-year cycle since the last recession.

Should we panic now? No, as panic causes greater loss. Rather, calculated and measured planning and response always delivers a better outcome.

No one can accurately predict when the next recession will occur. Most start with a series of events, (indicators) which lead to future and greater negative consequences. In addition, the factors which indicate potential problems in the economy become more visible. (Current examples are detailed shortly). Finally, there is that one final event which triggers the reality that a recession is inevitable.

The 1930’s recession and the 2008 GFC are fine examples of when a number of lessor negative events occurred prior to the final occurrence which tipped the world economies into catastrophic downturns. In the case of the 1930’s depression, it was the stock market crash. For the GFC, it was the unscrupulous practices of mortgage brokers and their associated lending institutions, which lead to the demise of the Lehman Brothers in the US. Many more of the US “giant companies” would have followed had the Bush administration not injected 236 billion dollars to ‘bail them out” to save them. In each case, these events amounted to “the final straw that broke the camel’s back,” – as the adage goes.

Should we be aware of the next possible recession and our ability to survive it? The answer is of course, a resounding yes.

The next recession is hopefully far enough ahead to give those that believe it is imminent, with a chance to prepare and survive intact – both emotionally and financially. The proviso is of course, they must be willing to quietly and assertively prepare – and act NOW.

Have we Seen the Beginning of the Next Recession?

Waiting to act until the next recession is declared, is of course, too late. Identification, planning and, (of course) action needs to be taken before a pending recession is deemed probable. If one doesn't eventuate, so be it! On a worst-case-scenario, you will have restructured and developed a more solid, secure and profitable business anyway.

The media, combined with world events, suggest the beginnings of the next recession may not be far away. In the last year for instance, pre-recession indicators include the:

- ❑ collapse in the value of Bitcoin and other cryptocurrencies values, plus associated scams;
- ❑ recent and ongoing volatility of global share markets;
- ❑ threat of trade wars and the breakdown of globalisation trade;
- ❑ tightening of reputable business finance sources and credit squeezes, including lending institutions tightening their 'lending criteria';
- ❑ the increase of rates and charges on home loans which is already occurring;
- ❑ number of "liar" and fraudulent housing loans in global markets;
- ❑ large amount of sovereign, consumer and commercial debt, both exposed and hidden;
- ❑ number of large corporate, regional and smaller business becoming insolvent;
- ❑ reduction in global housing and land values and resultant problems;
- ❑ increasing commentary warning the global financial systems may not be as strong as desirable:
- ❑ the negative findings during the royal commission on Australia's banking institutions which add costs to all lending as bankers seek to maintain their eye-watering profits;

The above warnings vary for each recession. However, this indicative list of examples, are the type of factors which indicate the next recession may not be far away.

It's important to note there are commentators which suggest, by looking for a recession, we will actually create one. In my view, this is false thinking and if we look behind their words, we will usually see vested interests and/or hidden agendas.

There's absolutely no shame in being a little conservative during periods of volatility, (which we are certainly experiencing currently). After all, it's your business, assets and finances at stake. Therefore, some conservatism and preparation is never foolish, because if nothing else, as stated earlier, your actions help to create a stronger business.

At the end of the day, whether you're an employer or employee, you don't want the business to fail. Therefore, it's advisable to understand those risks, which are the most dangerous to your business.

How will the Next Recession Pan Out?

As stated earlier, prior to any acknowledgement of the next recession, a number of adverse events will have already taken place. These events will have caused a ripple effect of negativity and financial uncertainty spreading throughout the economy. For instance, debtors which slow down their payments and defaulting will cause loss to their creditors. As consumers lose spending confidence/power, they will withdraw from non-essential spending.

In fact, it is not until about three to six months after the commencement of the recession that the real problems become evident. As a result, two simultaneous pincer movements will take place, affecting the business community. Nervous suppliers will start demanding instant payment, or “cash upfront” from their debtors to ensure they’re able to pay their creditors. At the same time, most businesses will look around in desperation for the next sale in order to survive.

In many cases, sales, credit and risk management disciplines will be ignored in the desperate search of sales. As a result, unnecessary risks will be taken. Of course, there will be plenty of customers willing to buy on credit. There will be fewer customers with the cash able to “pay up front”, or to take advantage of even the best value sales propositions. In either case, profits will be compromised.

Meanwhile, the fraudsters, those who plan not to, or cannot, pay their debts will just close down their business. Many of these people will often start a new venture under another entity.

Very few of these people will be held accountable because most creditors will decide the cost of legal action outweighs the potential gain; better known as “wasting good money to chase bad.” As a consequence, those business people that should be identified as phoenix operators, fraudsters or incompetent, will largely go unreported. Their actions however, will definitely contribute to the overall economic collapse.

Meanwhile, many business owners will try and “hang on” for as long as possible, only to join the expanding list of insolvent companies anyway. In doing so, they destroy even more value for everybody.

Steps to Mitigate the Negativity of the Next Recession

If you believe a recession is imminent, the first thing to do is not to show any signs of panic. Amongst the secrets of survival is to act quickly and quietly – before other business people and their financiers commence their own recovery practises.

In taking action early, you seek to achieve four basic objectives:

1 Reduce debt owed to you;
2 Reduce debt owed by you;
3 Rebuild or enhance your payment reputation;
4 Save and build cash reserves.

1 If debt is owed to you, try and collect it in a calm, yet assertive manner. Never, ever blame the customer or an event for being a little more insistent and “professional” in the collection of outstanding debts.

Consider offering a discount to encourage your customer to pay early, (devise a good reason for the discount). It’s always better in the long term to have the money in your bank, even at the small additional cost caused by your discount offering.

It is also wise to collect your outstanding debts early in case your customers enter into insolvency administration, because any money they owed you, is lost. In addition, if they become insolvent within 6 months of you receiving any payments; you may be liable to repay a ‘preference payment’ to the insolvency administrator.

Entering a recession with a large dollar value of old outstanding invoices is a significantly negative factor for survival. There’s nothing more disheartening than watching the value of your Debtors Ledger dissolve in value on a daily basis.

Finally, promptly write-off any known or suspected bad debts to reduce your profits as soon as possible. There will be more than enough bad debts issues and other write-offs available if a recession does eventuate.

2 Reducing any debt you owe, especially if the debt is secured, is essential.

If your debt is secured, take care to ensure the value of the "securing assets" do not decrease materially. The last thing you want is for the balance of any debt to be greater than the lending value margin of the securing asset. The banks and the most solid alternative financiers tend to panic and act without thinking during a recession because plain logic and/or reasoning is often not evident when they perceive their money is at risk.

If you fear foreclosure, get professional help and consider selling the asset to pay the debt rather than allow the financier to sell the asset. Allowing the financier to sell your asset is just another guaranteed way of losing even more money

3 You do not want to start a recession with a reputation as a slow payer, a known bad risk or as a difficult customer. There are two aspects which cause suppliers the most problems with any customer.

The first is a customer which has the funds to pay promptly but never pays within the agreed terms.

The second is when the customer becomes known for being uncooperative and unable to resolve issues of unpaid invoices, claims enquiries and unprocessed claims efficiently.

4 Building cash reserves is critical for surviving a recession and you need to have the funds available in your bank account as soon as possible.

Do not be swayed by people who say "cash is a lazy asset." These people have vested interests and usually want your cash or have out-of-date ideological perspectives on the value of cash as an asset. Cash in the bank gives you immense power in all circumstances, especially in recessions.

Conclusion

Recessions are a natural part of business. There is a recession, on average, every 10 years. Recessions are not pretty and lead to adverse outcomes for many business people and their customers.

As of May 2018, we have passed the 10-year anniversary of the last recession by five (5) months. Despite the passing of this anniversary, now is not the time to panic as that only contributes to your future losses.

If you concede the next recession is not far away, now is the time to quietly start working on collecting any outstanding debts, pay off debts owed and increase your cash reserves. Waiting for the recession to start, is not a good option.

Of course, you cannot, and should not stop pursuing the expansion of your business. Some of the best opportunities occur in volatile times. The proviso is of course that any opportunities are strategically feasible and do not put you in a fragile financial position. This applies to new and existing customers.

Finally, let us hope the next recession is far enough away for you to achieve all your business and financial survival objectives.

If you would like to discuss this article in more detail, please contact Credit Matters Pty. Ltd.

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