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Independent Thinking

Recession Watch: savings only temporary respite for US

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Headlines

- In the past consumer confidence has tended to start falling around nine months to a year before a peak in US economic activity
- It is likely that recent US economic activity has been supported by a willingness among households to eat into their pandemic savings, with the personal saving ratio falling dramatically in January of this year — nine months after consumer confidence began to fall
- In our central scenario the running down of savings does not continue for long, as interest rates rise, and broader measures of wealth fall — we estimate it would normally take a shift in sentiment that causes US households to save an additional $50 or more each week to push the US into recession
- The Bank of Japan this week announced a widening of the bands around its 0% target for the ten-year JGB yield — effectively a tightening of monetary policy, and one sufficient to cause a near 20-basis-points rise in yields, close to half the amount we think would be triggered by a total abandonment of yield-curve control
- Data from China for the month of November, on industrial production and in particular on retail sales, highlight the economic disruption caused by the recently abandoned zero-COVID policy
- With cases rising rapidly, this disruption is likely to continue at least in the short term, either as people withdraw from activities through fear of illness, or as renewed lockdowns are imposed

Last week we completed a series of meetings with our clients where we presented the main findings of our *Global Outlook, Winter 2022*. As usual there was lively discussion, and perhaps the main challenge to the views we set out related to the weight we attached to a recession in the US, which had remained unchanged at 70% since September, despite some positive news since then on both GDP and inflation.

As we show in the US GDP fan chart below, both our central path for US economic activity, and our mean path which takes all scenarios into account, lie substantially below the consensus among other economists, which is for stagnation rather than outright contraction. It is fair to say that US growth exceeded our expectations in Q3. While US consumer confidence has fallen dramatically, that fall has taken place over many months; and timely indicators of economic activity, such as non-farm payrolls, remained strong at least until November — when they rose by 263,000 on the month. ‘Surely if the US economy was going to enter recession as a result of depressed consumer confidence it would have done so by now?’, was implicitly the view of some clients.

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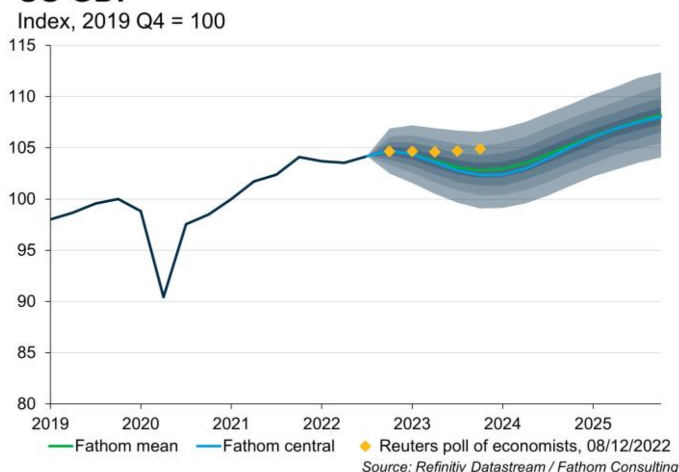

To a degree our views were guided by precedent. Levels of consumer confidence in the US, the euro area and the UK have fallen to levels from which recession has never been avoided since the data were first collected around 50 years ago. This relationship is understandable, with domestic households accounting for 68% of all expenditure in the US, 63% of all expenditure in the UK and 53% of all expenditure in the euro area. Moreover, while both the US and the UK have once managed to bring inflation down from today's levels without triggering a recession, that was as long ago as 1952.

Fathom has other reasons for sticking to its gloomier-than-consensus view. We have recently put together a series of charts that track US data either side of peaks in economic activity as defined by the NBER. Looking at the data on non-farm payrolls, we find these typically flip, after calibrating to the size of today's workforce, from an increase of around 240,000 in the month when activity peaks, to a decrease of around 200,000 in the month after activity peaks. The employment data, then, do not give us a lead on recession. They may at best tell us that a recession has not yet started, although like some other macroeconomic data they can be prone to pro-cyclical revisions, being revised down when growth is slowing and vice versa — see my previous Recession Watch 'Identifying recessions with uncertain data'.

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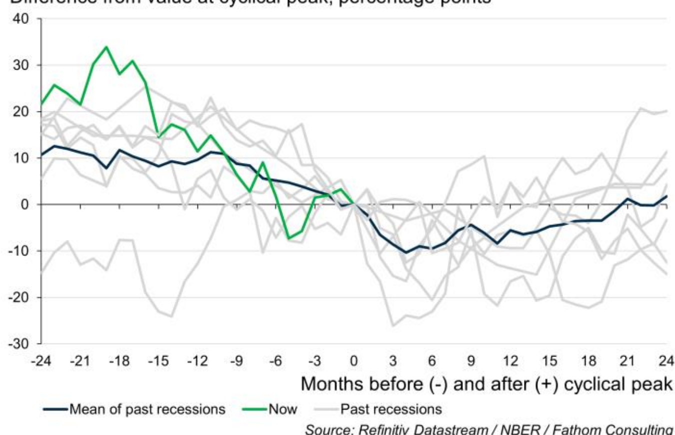
The chart below shows how US consumer confidence has typically behaved either side of a peak in economic activity. While each of the seven recessions in our chart is different, on average consumer confidence starts to fall nine to twelve months ahead of a peak in economic activity. Statistical tests confirm that levels of consumer confidence contain information that helps to predict future GDP growth, while the reverse is not true.[1] After staging a partial recovery from COVID-related lows, US consumer confidence peaked in April 2021, and has fallen significantly since then as inflation has continued to rise. Statistical tests suggest that respondents to consumer confidence surveys are affected to a degree by money illusion, with a percentage point increase in consumer price inflation lowering confidence by more than a percentage point increase in wage inflation raises it. Even if wage inflation had kept pace with consumer price inflation, which it has not, it is likely that confidence would nevertheless have fallen.



We might have expected that the fall in consumer confidence would feed through to a decline in consumer spending, and with that economic activity, within the first few months of 2022. But consumer spending has held up. The resolution to this puzzle almost certainly lies in the personal saving data. The chart below illustrates not just the scale of the savings that were built up during the pandemic — effectively the difference between the green line, representing the average saving ratio in the five years leading up to the pandemic, and the blue line — it also shows that recently a chunk of those savings has been unwound, as the blue line has fallen below the green line. It is perhaps significant that the saving ratio fell by 2.8 percentage points in January of this year, from 7.5% to 4.7%, one of the sharpest falls on record, and it has continued to decline. If US households had been either unwilling or unable to dip into their savings from the beginning of this year, that would have represented a significant decline in aggregate demand that would likely have pushed the US into recession within a few months.

1. More formally, we find that US consumer confidence ‘Granger-causes’ US GDP growth, but US GDP growth does not ‘Granger-cause’ US consumer confidence.

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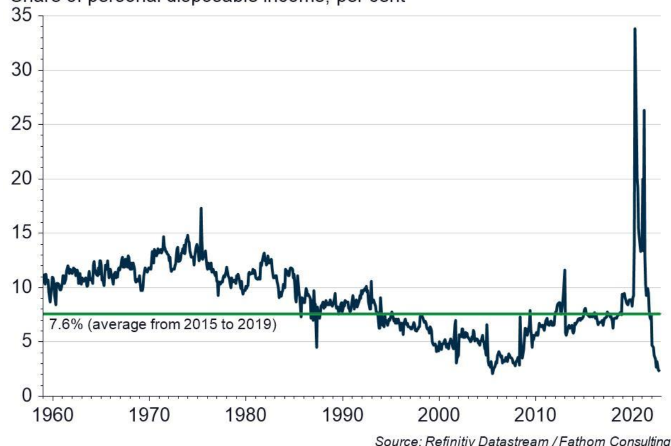
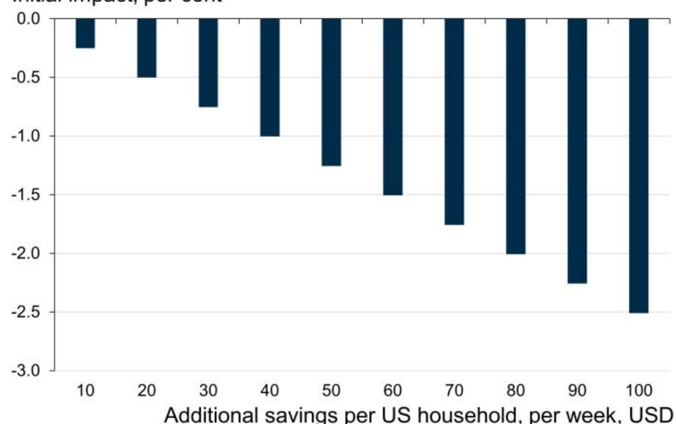


That US households have had the resources to maintain their spending despite close to two years of falling real wages is undoubtedly a positive. But the question remains: for how long they will be willing to continue in this way in a period of rising interest rates, when broader measures of wealth, both financial and physical, have been falling? Predicting recessions is far from easy — interested readers may wish to see my recent blog post on this topic, '[Crying wolf, take 24?](#)'. That is because they are often caused by a sudden switch in sentiment, which in turn can become self-fulfilling. If US households start to fear for their own job security, for example, they might all choose to save a little more, precipitating the economic downturn. My chart below shows the first-round impact on US GDP in a world where each US household chooses to save a little more each week. Starting from a position where the US economy was growing at trend, which we estimate to be a little over 1% per annum, it suggests a scenario where households choose to save an additional $50 per week could be enough to cause a period of stagnation, with larger increases threatening recession.



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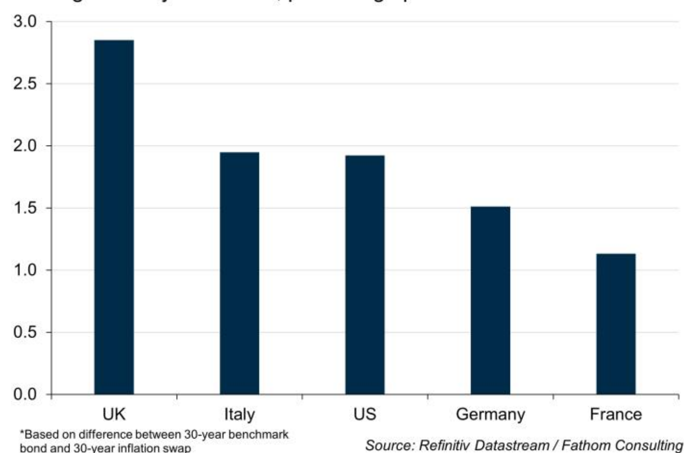
The idea that recessions can become self-fulfilling, when households (fearing difficult times ahead) choose to save more and spend less, is known as the paradox of thrift. Popularised by John Maynard Keynes, it is one argument that is often used in favour of increasing state spending during a recession. The difficulty just now is that government financing costs have risen sharply in many countries this year, in real terms and over long horizons. There is perhaps a perception that, with both the Federal Reserve and the Bank of England beginning outright sales of the assets they purchased during the GFC and the pandemic, and the ECB announcing its intention to implement a similar policy of Quantitative Tightening from next March, the one-way bet on yields has been removed as monetary policy concerns come to dominate, at least for now.



At its policy meeting on Tuesday 20 December the Bank of Japan also, and quite unexpectedly, took a step towards tighter monetary policy. Although it continues to target a yield of 0% on ten-year JGBs, it will now tolerate a range of 50 basis points either side of the target, rather than a range of 25 basis points. Immediately following the announcement the yield jumped almost to the top of that range before falling back somewhat, closing almost 20 basis points higher at 0.42%. In a recent *Recession Watch* 'What if Japan releases the brakes?' William Hynes argued that, if the Bank of Japan were to abandon its policy of yield-curve control, and simply keep its stock of JGBs constant, then ten-year yields might rise by 40-50 basis points. We have just seen close to one half of that move in a single day. Like many other central banks, the Bank of Japan is treading a fine line in determining the policy stance needed to restore inflation to target. Japan's fiscal policy has been loose for two decades. Fathom's proprietary Financial Vulnerability Indicator (FVI), shows a growing risk of a sovereign crisis in Japan over the next year, driven in part by rising bond yields and widening budget deficits. At the same time, by continuing to set an ultra-loose monetary policy at a time when other central banks were tightening aggressively, the yen has borne the brunt, pushing headline CPI inflation to 3.7% in October, its highest level since the early 1990s, excluding the aftermath of the 2014 sales tax hike.

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Finally, last week saw the publication of several important Chinese data releases relating to activity in November, before Beijing effectively abandoned its 'zero-COVID' policy earlier this month. Industrial production was up by 2.2% compared to a year earlier, having risen by 5.0% in the year to October, while retail sales had fallen by 5.9% compared to a year earlier, having fallen by 0.5% in the year to October. The deteriorating retail sales figures in particular are pertinent, as they draw attention to the country's continued reliance on overseas demand, put at risk by the global economic slowdown, and on local government infrastructure spending, put at risk by China's property bubble. Last week Chinese leaders concluded their 'Central Economic Work Conference', at which they decided once again to rebalance towards domestic demand, describing the external environment as 'complex and grave'. In particular, they planned to strengthen the role of the private sector in the economy — a move which would be at odds with President Xi's more usual interventionist approach — and to support housing demand to ensure healthy growth of the real estate sector. The second of these, if it were successful in encouraging even greater leverage, would only add to the risk of a banking crisis in China, which we currently put at 15% over the next twelve months. While the abandonment of the zero-COVID policy should ultimately improve China's economic prospects, reports based on internet searches for the word 'fever' point to very rapid growth in infections, particularly in the capital, with authorities no longer publishing data on cases they describe as 'asymptomatic'. This is likely to lead to further disruption to economic activity into the new year, whether due to caution on the part of individuals, or renewed lockdowns, which themselves would risk provoking further unrest.

Further reading

Recession Watch: markets two steps ahead of the data

Recession Watch: what if Japan releases the brakes?

Recession Watch: is 'zero COVID' on the way out?

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