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Independent Thinking

Recession Watch: US doing all it can to avoid recession

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Headlines

- Last week's strong January data mean the central scenario from our *Global Outlook*, *Winter 2022*, which saw the US economy enter recession in Q1 of this year, now appears unlikely
- Back in June we described two conditions that would need to be met for the US economy to avoid recession: households would need to eat into their pandemic savings, and inflation expectations would need to fall back to target rapidly, allowing wage increases to moderate
- Both of these conditions have been met
- In light of the overwhelming historical precedent, we are not yet ready to rule out a US recession entirely
- Nevertheless, in our upcoming *Global Outlook, Spring 2023*, we are likely to push back the point at which the US enters recession, if it does at all, and reduce the weight we attach to those scenarios where it does

Data released at the end of last week have caused us to reassess at least the near-term prospects for the US economy. In our *Global Outlook, Winter 2022*, finalised in early December, we described a central scenario that saw the US economy enter a relatively mild recession, beginning in Q1 of this year. That now seems unlikely. Last Friday we learned first that the US economy added 517,000 jobs in January, far in excess of the Reuters Poll consensus of 185,000. But it was not just one month of surprisingly strong employment numbers. Just as economists were systematically surprised by the persistence of inflation through late 2021 and into early 2022, they have more recently been systematically surprised by the resilience of the US labour market, with the change in non-farm payrolls averaging some 100,000 more than expected in each of the past twelve months. Later that same day, the ISM survey of non-manufacturers composite index rebounded sharply in January from a surprisingly weak December reading. The US economy has got off to a flying start in 2023.

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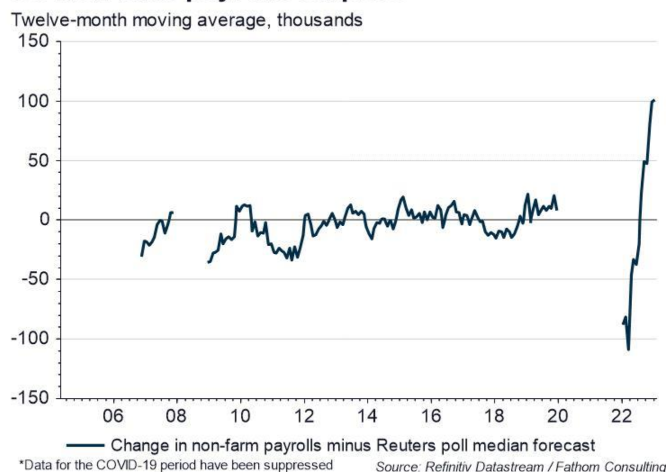
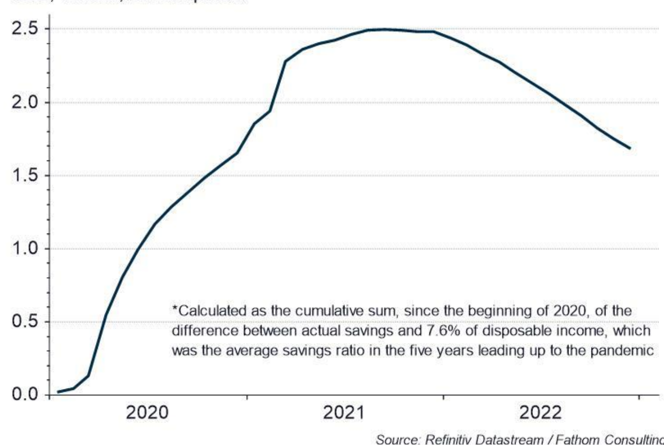


It was about a year ago that we first became concerned by the prospects for a US recession. By early summer, we gave it close to an evens chance, and described two conditions that we felt would be necessary, in the face of falling real incomes and rising interest rates, for the US economic recovery to continue uninterrupted. First, in a scenario we labelled ‘Time to dissave’, US households would need to eat at least a portion of their pandemic savings. Second, inflation expectations would need to fall quickly back to target. Were this not to occur, we said, it was likely that material upward pressure on wages would lead to large second-round effects from the initial price spikes, requiring a much larger monetary policy response.

Both these conditions have been met.

It was in January 2022, just as CPI inflation moved ahead of wage growth, that the US household savings ratio suddenly dropped sharply below its pre-pandemic average of 7.6%. From that point on, our estimate of US pandemic savings began to fall. One year on, they had fallen by around one third, suggesting that US households could continue to decumulate their pandemic savings at the current pace for a further two years.



If we look at more timely measures of US wage and price inflation than the usual headline measures that are reported on a twelve-month basis, such as the three-month annualised percentage change in each, it is clear not only that both wage and price inflation have been falling, but that real wages are now rising. More encouraging still, if we look at the Atlanta Fed's decomposition of CPI inflation into what they call 'sticky-price' and 'flexible-price' components, it is not just flexible-price inflation that is falling: sticky-price inflation is falling too.[1] When firms choose to change their prices only infrequently, perhaps because of the substantial costs involved in doing so, then they are likely to give more careful consideration to the outlook for inflation. In that respect, the sticky-price component may be more forward-looking than the flexible-price component. Sticky prices are likely to capture the second-round effects of the larger, flexible price changes.

1. The Atlanta Fed defines a flexible-price CPI component as one whose price is changed, on average, more than once every 4.3 months. The remainder are sticky-price CPI components.

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So the US economy is evolving in just the way we said it would need to do if a recession were to be avoided. Those two conditions were necessary. They may not, however, be sufficient.

We can be reasonably confident that the US will not enter recession in the current quarter. And the odds of a US recession occurring within our three-year forecast horizon have almost certainly fallen since we published our *Global Outlook, Winter 2022*. What we continue to find troubling is the scale of the historical precedent. We have reminded our clients on a number of occasions that the US has never avoided recession with consumer confidence as low as it has been in recent months. It has once avoided recession with inflation as high as it has been in recent months, but that was as long ago as 1952. This time we add to our list of comparators an analysis of previous US hiking cycles, shown in the chart below, where each coloured line represents an individual cycle.

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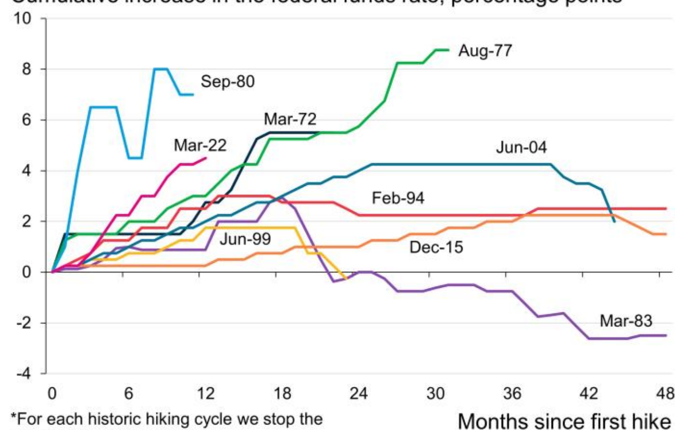

We are currently working our way through the ninth US hiking cycle since 1970. Of the eight completed cycles, three did not lead to a recession within four years — those were the ones that began in March 1983, February 1994 and December 2015 (we are not counting the COVID pandemic, which in any case was just over four years after the December 2015 hiking cycle began). For the five hiking cycles that did lead to a recession within four years, we have stopped the line short at the point where the economy entered recession. There are at least two points of interest:

- The current hiking cycle is the second fastest on record. The fastest on record was the one that began in September 1980, which also lead to the fastest recession, with activity peaking just ten months later, in July 1981.
- The three hiking cycles that did not lead to a recession within four years all saw a smaller cumulative tightening than we have seen to date in the current cycle. Every time that the US federal funds rate has risen by as much as it has over the past year, the US had entered recession within a few years.

Finally, despite last week's good news about near-term US prospects, our own version of the New York Fed's yield curve model continues to suggest that investors in fixed income markets consider a recession in twelve months' time to be more likely than at any time since the early 1980s.

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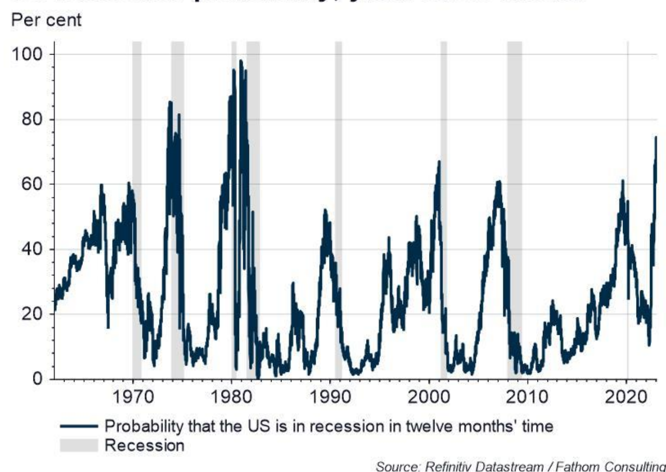

Where does this leave us? It is widely recognised that recessions are hard to predict, and this is something I have written about several times in the past. They are non-linear events, often triggered by a sudden change in behaviour, perhaps following a sudden reappraisal of the economic outlook by many firms or many households. Nevertheless, we feel we must continue to try. To date, the US economy has evolved just as we said it must if recession were to be avoided — US households have begun eating into their pandemic savings, and they could continue to do so at the current pace for a further two years. CPI inflation and wage inflation have both fallen, including 'sticky-price' inflation which is likely to capture second-round effects, and yet CPI inflation has fallen further, boosting real incomes. That makes recession unlikely in the near term, and definitively less likely than we imagined at the time of our *Global Outlook, Winter 2022*.

One indicator that continues to flash red is the level of long-term real rates of interest. These have risen materially, by 200 basis points or more, in many major economies, including the US. A decades-long decline in long-term real rates of interest, which many had attributed to demographics, had supported valuations that otherwise appeared stretched in many asset markets, including residential property markets. House prices have begun to fall sharply in some countries. In Sweden they have fallen some 12% since the summer. They have fallen for five months in a row in both the US and the UK. In our *Global Outlook, Spring 2023*, which we shall be presenting to clients next month, we are likely both to push out the point at which the US enters recession if it does at all, and to reduce the weight we attach to scenarios that include a US recession.

Further reading

TFiF: crying wolf, take 24?

Recession Watch: identifying recessions with uncertain data

Global Outlook, Winter 2022: blinded by the pivot

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