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Independent Thinking

Recession Watch: the pause for breath

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Headlines

- Recent data suggest the risk of recession is lower than previously thought, but it remains our central case for the UK and the EU
- The UK posted zero growth in Q4, likely to be revised down
- The US hangs in the balance still, with equity markets and sentiment sending negative signals, but payrolls and activity data pointing the other way
- Medium-term expectations of US inflation show no signs of stickiness but, compared to other countries, US inflation has been flattered by the currency
- Your regular reminder: there is no official definition of what constitutes a recession
- Short-term forecast for the US suggests a couple of negative quarters are still likely, and annual growth will dip to zero before recovering
- Standing back from the noise and some of the more aerated commentary, this sort of pattern is to be expected after the COVID convulsion: a pause for breath, so to speak

The news over the last week or so has been good on the whole, with the UK posting zero growth in 2022 Q4 and US payrolls very strong. If anything, these data suggest the risk of recession has waned still further: but it remains real. In the UK in particular, there is some weak evidence of pro-cyclical revisions to GDP data (as outlined in Andrew Brigden's Recession Watch of 23 November 2022), although the degree of procyclicality has reduced over time and it is possible it has disappeared altogether. That means the Q4 data might be revised down in subsequent prints. If that does happen, it would imply two consecutive quarters of negative growth in the UK last year. However, it is not clear that the 'technical recession' is a relevant concept any more in a world where trend growth in the UK is probably sub-1%: instead, we would look for a significant pick-up in unemployment as a marker of recession in the UK. Thus far, there is no evidence of that happening; but, unhappily, there is very little comfort we can draw from that, since unemployment tends to be a lagging indicator of recession.

Our central case for the UK and the EU still sees a recession, but the US hangs in the balance. In this note we focus on the US.

The signals in equity markets and economic sentiment (as measured by Fathom's Economic Sentiment Indicator or ESI, a composite of measures of consumer and business confidence) are both negative, and we can show that the ESI contains significant information for the future path of GDP growth. But the negative signal in the ESI is smaller than it was back in 2012, at which time the US avoided recession. And US equity markets have recovered slightly from their lows, though they remain volatile. These are negative signals, undoubtedly: but we cannot infer that a recession is definitely coming from these data alone.

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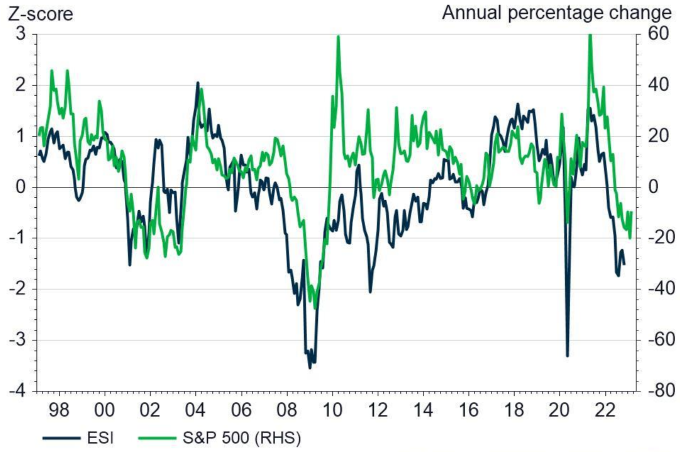
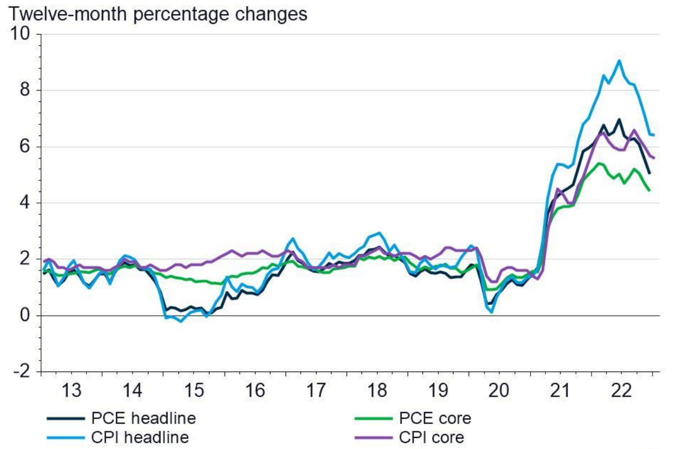
US Economic Sentiment Indicator and S&P 500



Source: Refinitiv Datastream / Fathom Consulting

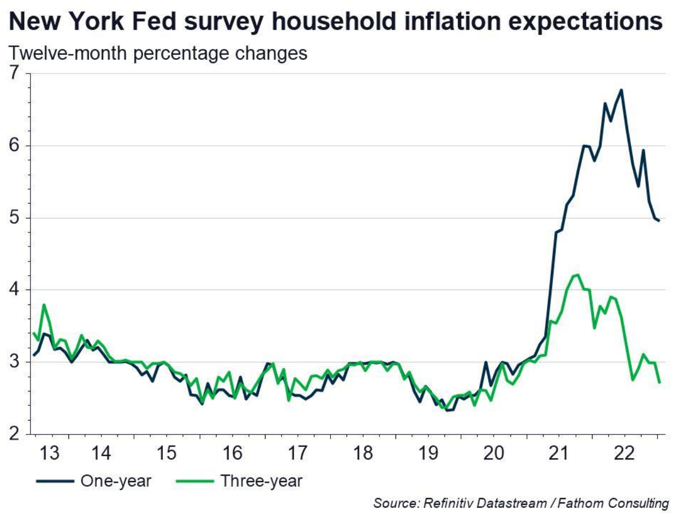
The big question in the US and elsewhere is as ever: how sticky will inflation prove to be, after the first-round effects of higher energy, food and goods prices induced by the pandemic and by Russia's invasion of Ukraine have washed out of the annual rate? The answer, in the US, appears to be a reasonably benign one. All measures of inflation are now falling, and a gradual drift back towards the target looks the most likely outcome from here.

US measures of prices

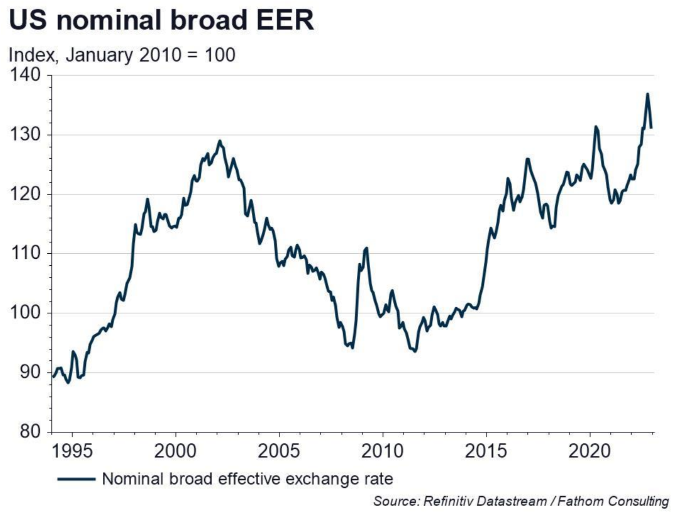


Source: Refinitiv Datastream / Fathom Consulting

More encouraging still, most measures of medium-term inflation expectations are already back to where they were pre-pandemic, including the New York Fed measure pictured below.



It should be pointed out that, compared to other countries, US inflation has been flattered by movements in the value of the dollar. The heightened risk of global recession in recent months has (as usually happens in these circumstances) caused FX investors to shift into the 'safe haven' of the dollar – a move amplified by the relatively aggressive anti-inflation stance adopted by the Fed. The rise in the value of the dollar implies less inflationary pressure from import prices in the US – which were already comparatively insulated from the energy price shock that drove a wedge between natural gas prices in the EU and the US.



And the relative (if belated) hawkishness of the Fed has helped to stabilise US inflation expectations in the medium term to a greater degree than is true in the EU or the UK. The Fed funds rate remains a long way below the Taylor rule-implied rate, but the gap is narrowing and is now close to a 'normal' range, as the chart below illustrates.

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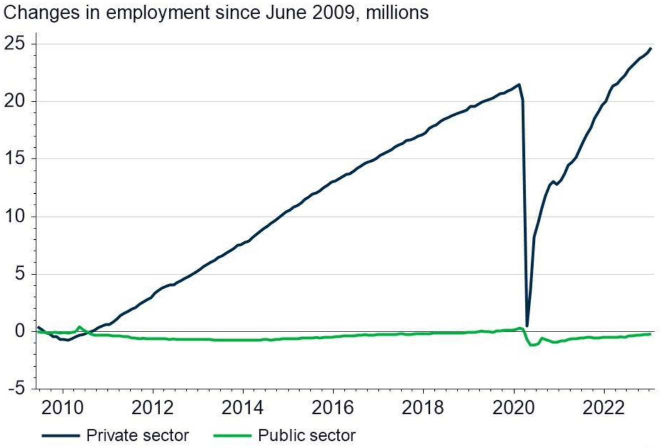
US interest rate

Source: Refinitiv Datastream / Fathom Consulting

Meanwhile, the signal from the US labour market is very positive still. Payrolls typically do not have good lead-indicator properties for oncoming US recessions – they reveal that we are in recession after the fact, but not usually that a recession is on the way. That said, the labour market is extremely tight still and there is no evidence that the US is in recession yet. Indeed, payrolls are now close to their pre-pandemic trend, both in the private and public sectors.

US nonfarm payrolls



Source: Refinitiv Datastream / Fathom Consulting

Can we be sure that the US has avoided recession? No, not yet. Putting together the data on payrolls, equity markets, economic sentiment and GDP growth in a simple Vector Auto-Regression (VAR), which is usually the best way of producing a short-term forecast, we find that the US is likely to experience a couple of quarters of contraction during the course of 2023, and the annual growth rate will drop to zero before recovering. Would that be a recession? It is hard to say: there is no official definition of recession, and the NBER judgements are made in hindsight. Our view is that the US will flirt with recession during 2023 but will probably just avoid it. This theme will be developed in more detail in our forthcoming *Global Outlook, Spring 2023*. And after the massive cycle induced by the pandemic, some ripples in growth are to be expected, and should not cause too much concern. Not in the US, at any rate.

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Further reading

- Introducing Fathom's Global Outlook service
- Recession Watch: identifying recessions with uncertain data
- Recession Watch: US doing all it can to avoid recession
- Recession Watch: Goldilocks and the macro bears

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