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Independent Thinking

Recession Watch: is the Fed tightening going to plan?

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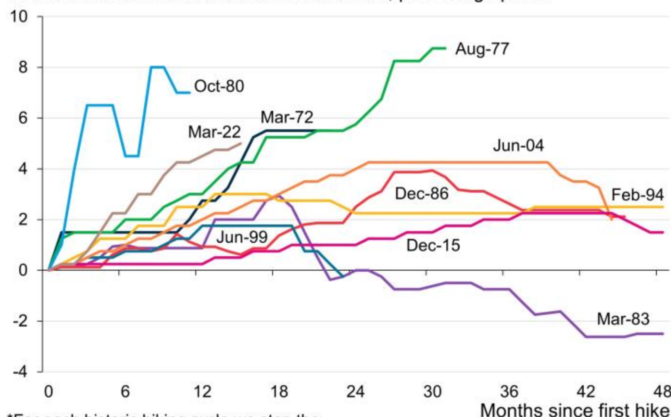
Headlines

- We trace out the impact of previous Fed tightening cycles
- Private housing starts and durables consumption typically respond to higher interest rates within a few months, with total consumption slowing after a year, and payrolls after a year and a half
- We can be confident that residential construction has reacted, if anything, even more rapidly than usual to what is the second-fastest Fed tightening since at least the 1970s, but the COVID pandemic makes interpreting trends in other series difficult, if not impossible
- Core inflation, to the extent that it is slowing at all, is doing so only gradually in most major economies, while labour markets remain tight in absolute terms
- In these uncertain times the odds of a policy mistake, in either direction, are high

In Fathom's *Global Outlook, Spring* 2023, finalised shortly before the failure of Silicon Valley Bank, we labelled our single most likely scenario 'Recession postponed'. Most major economies appeared to have started the year on a firmer footing than we had expected. Nowhere was this more true than the US, where business surveys pointed to a strong rebound in service-sector activity, and the economy looked to have added some half a million net new jobs in January alone. The COVID recovery period aside, that was the strongest reading since early 2010 when the employment figures were flattered by temporary hiring of additional workers to carry out the US census. With the latest macroeconomic data much stronger than one might expect, if a recession were imminent, yet with an inverted yield curve, combined with historical precedents suggesting a recession would be hard to avoid, we concluded that the euro area and UK were likely to enter recession in the first half of this year, with the US joining them in the second half.



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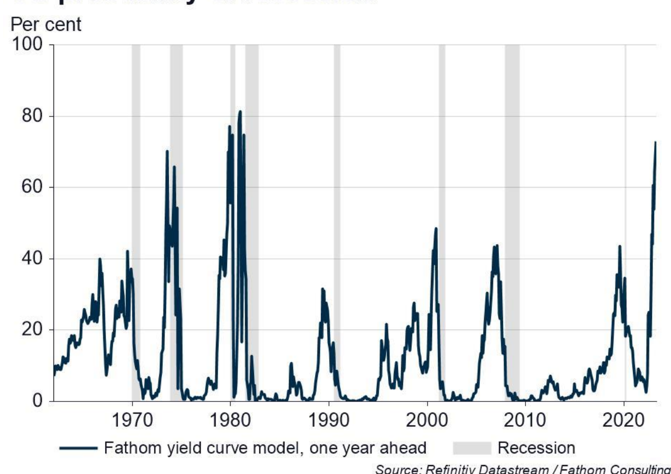
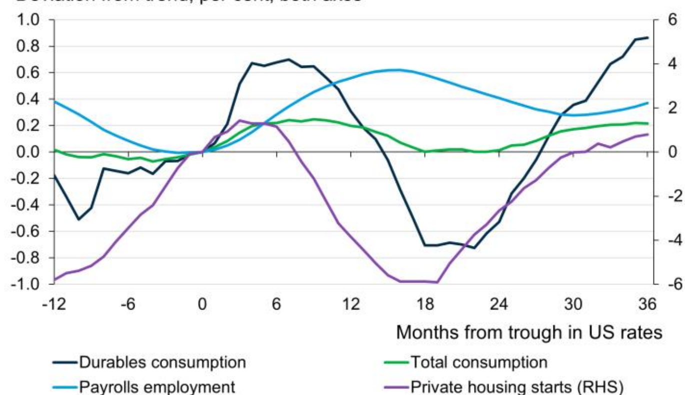
How have developments over the past two and a bit months affected our judgement? Historical precedents, of course, remain compelling. We have had two further increases in the fed funds target rate, albeit of 25 basis points rather than 50 basis points. As our first chart shows, the current tightening cycle remains the second most rapid since at least the early 1970s, with the FOMC moving faster only during the cycle that began in October 1980, in the early days of Paul Volcker's term of office. It is also the second most rapid if instead one plots the cumulative increase in the real fed funds rate, or the cumulative increase in the real fed funds rate relative to the estimate of the neutral real rate provided by Holstein, Laubach and Williams. Only three of the nine completed cycles did not lead to a recession within four years, and in each of those three cases the cumulative tightening was at least 200 basis points less than we have seen to date. The US yield curve, along with those of other major economies, remains inverted. Indeed, the implied probability that the US is in recession in twelve months' time has risen from just over 50%, as we finalised our previous forecast, to almost 80% today.



How do the macro data behave during a hiking cycle?

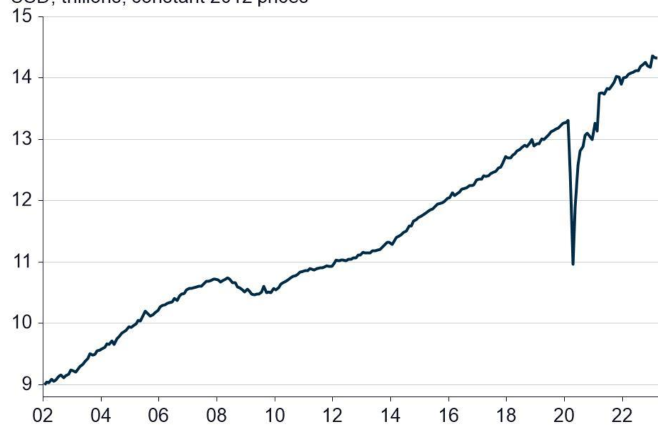
Nevertheless, there is a perception that the macro data, particularly in the US, appear stronger than one might expect this far into a tightening cycle. That rather loose statement begs the question: what should one expect to see in the macro data this far into a tightening cycle? We look to address this question in our third chart, which shows how some of the most closely watched monthly macro data have evolved, on average, through US hiking cycles since the 1980s. Each underlying series has been smoothed and then de-trended. Our chart suggests that, on average, all four tend to follow a cycle that has some intuitive appeal. The most interest-sensitive series are the first to respond, with de-trended housing starts, which will depend on expectations of interest rates far into the future, peaking within three months of the first hike, levelling off, and then starting to slow. De-trended durables consumption peaks a month or two later, again before levelling off, and then starting to slow. The cycle in total consumption is more muted, with the peak relative to trend occurring further into the tightening cycle. Finally, payrolls employment is the last of the four to respond, with de-trended employment peaking close to a year and a half after the first increase in interest rates.



How have those series behaved, relative to trend, during the current cycle? That question is very difficult, if not impossible, to answer for two reasons. First, it is never easy to identify the trend in a series in real time. The trend level of, for example, GDP can only ever be estimated with some degree of confidence several years after the event. Second, the COVID pandemic caused many macro series to behave in ways that had never been seen before. Identifying, for example, the level of US durables consumption relative to trend in normal times would be difficult. Doing so after the pandemic, when substantial excess savings have built up among US households and when spending patterns have shifted, perhaps permanently, is doubly so.

What we can say from the four charts below is that the most interest-rate-sensitive series — the one we would have expected to move first — has done so. The level of private housing starts peaked in April 2022, one month after the first increase in interest rates. Private housing starts fell sharply over the next few months, although the pace of the decline has now slowed. Durables consumption has been broadly flat for the past year or more, nevertheless it appears high in level terms relative to the post financial crisis trend. Total consumption, by eye, appears close to its post financial crisis trend and shows no sign of slowing. Payrolls employment fell precipitously as the pandemic hit, unwinding close to 20 years of jobs growth in the space of a couple

of months. Although the subsequent recovery has been impressive, at a glance employment is yet to return to its post financial crisis trend. That is not surprising, given the sharp reduction in participation that took place through the pandemic. Perhaps the more salient point is that payrolls again surprised on the upside in April 2023, just as they have in all but one of the past fifteen months.



Where does this leave us when it comes to tracking the impact of the Fed tightening? All we can really say with confidence at this point is that private housing starts have fallen sharply and even sooner than one might expect. Durables consumption would typically be slowing by now, relative to trend, as would total consumption. It is hard to say whether either of those things are happening. Payrolls employment would typically be continuing to rise at this stage of the tightening cycle, and at above trend rates. It probably is.

Measuring slack in the labour market

With patterns of consumption changing dramatically through the pandemic, and with the fall in participation making it hard to draw firm conclusions from the jobs data alone about the strength of the labour market, a clearer picture of the degree of economic slack and the extent to which this is changing as interest rates rise, might come from a simple comparison of the number of vacancies with the number of people unemployed. On this metric, although we can see some signs of an easing of labour market tightness in the US and the UK, and to a lesser degree in the euro area, all three labour markets remain historically very tight, suggesting upwards pressure on wages is likely to persist. The latest data on wage inflation continue to point to second-round effects, with wages rising at a pace that is inconsistent with a rapid return to the 2% inflation target, most notably in the UK. Also, while core inflation looks to have slowed in the US it has done so only gradually and it is not clear whether it has slowed at all in the euro area or UK.

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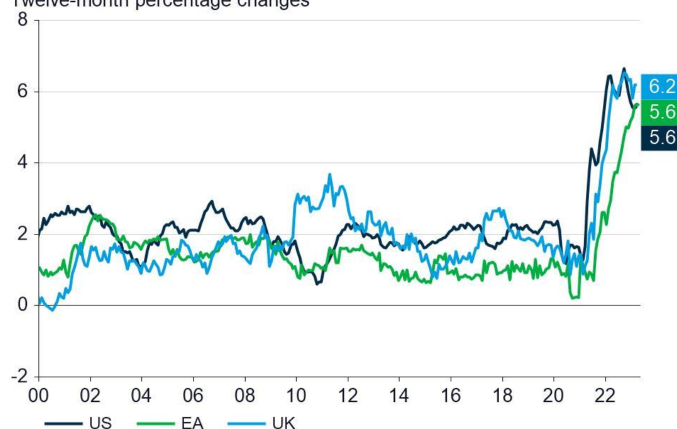
Labour market tightness

Ratio of vacancies to unemployment

Source: Refinitiv Datastream / Fathom Consulting

Core CPI

Twelve-month percentage changes



Source: Refinitiv Datastream / Fathom Consulting

If anything, the disconnect between the macro data and the financial markets data that we identified in our *Global Outlook, Spring 2023* has intensified. While US nonfarm payrolls continue to surprise on the upside, and the US consumer shows few if any signs of a meaningful retrenchment, the odds that the US is in recession in twelve months' time have not been higher since the early 1980s, according to our version of the Fed's yield-curve model. In most major economies, core inflation, to the extent that it is slowing at all, is doing so only gradually, and labour markets remain tight in absolute terms. We have now started work on our *Global Outlook, Summer 2023*. In this uncertain environment, the odds of a policy mistake appear high. Wary of the consequences for the banking sector of further increases in interest rates, the Fed along with other central banks may err on the side of caution and pause too soon, with the result that inflation, although no longer in double digits, remains materially above target for some time. Although this may benefit the public finances of heavily indebted economies, high inflation is generally unpopular with voters, even if the alternative is higher unemployment. And there are risks, of course, in the other direction. As my colleagues Andrea Zazzarelli and Dimos Andronoudis pointed out last month in '*Let's talk about the credit cycle*', investors to date have focused only on the interest rate risk faced by banks. Little attention has been paid to credit risk, which is likely to increase as more firms, and more households, need to refinance their obligations at higher interest rates.

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Further reading

Recession Watch: the three C's in crises

Recession Watch: the size of prospective rate cuts

Recession Watch: the banking system's known knowns

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