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Recession Watch: sunny mood in markets

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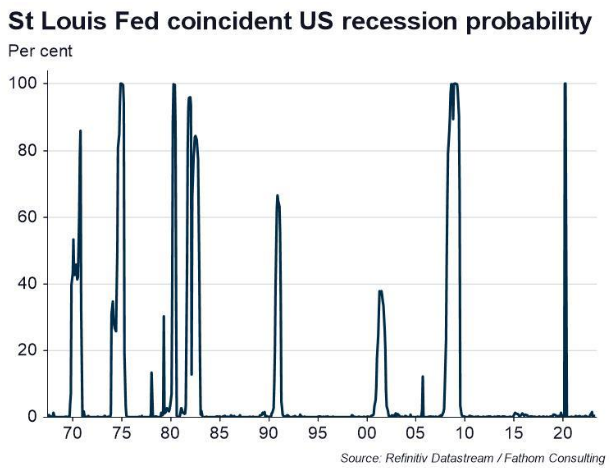
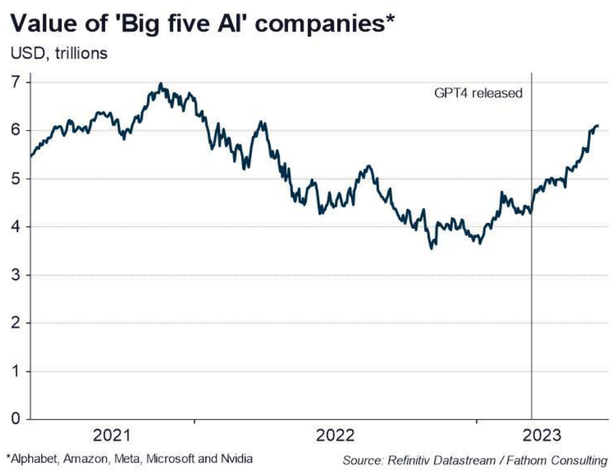
Headlines

- The US economy has dodged recession for now, helping to lift risk assets
- Despite another upside surprise for headline payrolls, there are signs the labour market is cooling
- Base effects open the door for a Fed pause but not a pivot (yet)
- Recession and sticky inflation are two key uncertainties, leaving risks in both directions to the outlook for the fed funds rate

The S&P 500 was more than 20% off its cyclical lows during trading on Monday, buoyed up by easing US recession fears and increasing expectation of a Fed 'pause', combined with technological optimism about the possible benefits from AI. Whether this is a bear market rally or a new bull market, it is too early to tell. The outlook for inflation and all its associated implications for Federal Reserve policy will continue to prove critical, as they have done for several quarters now. May's US labour market report surprised to the upside, marking the 13th time out of 14 that the initial print has been higher than the median expectation among economists polled by Reuters. It adds to a range of coincident data suggesting that the US economy continues to shrug off rate hikes and banking turmoil to avoid recession. Of course, investors must consider the risks that goods news ends up being bad news if strong output data continue to keep price pressures elevated.





Despite the headline employment figure in May's payrolls print beating expectations, there were signs of cooling elsewhere in the report. The unemployment rate increased by 0.3 percentage points, the largest monthly increase since April 2020. Meanwhile, average hourly earnings were up 0.3% on the month. On a three-month annualised basis, wage growth was 4%. This marks a decent cooling from early 2022, when it was above 6%, but is still some way above its average in the five years to December 2019 (2.8%).

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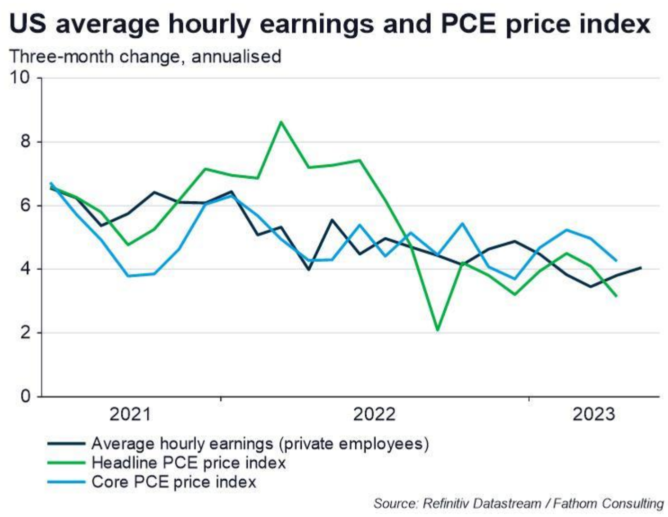
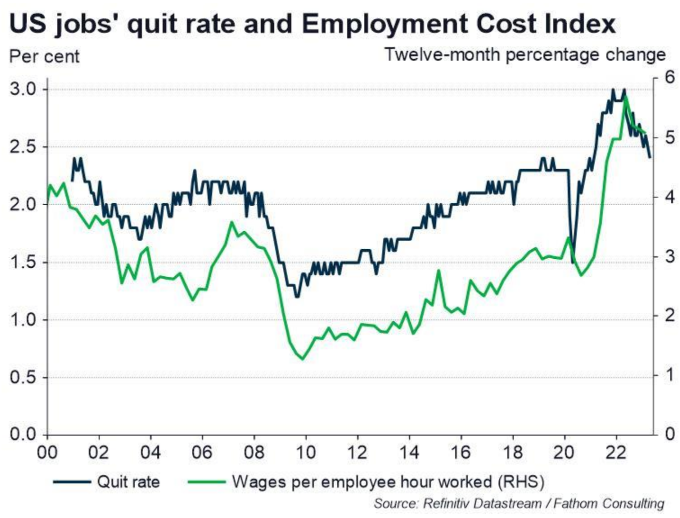


Alternative metrics of labour market tightness have also eased. The quit rate, which tends to correspond well to wage growth, has softened to 2.4% in April, off cyclical highs of 3%. A key question is how far this softening will continue, and whether that will be enough to bring inflation back to its 2% target. It cannot be ignored that other signs of labour market tightness, such as the vacancy-to-unemployment ratio, continue to point to an historically tight labour market. Meanwhile, initial jobless claims are hovering near cyclical lows.



The recent, weak ISM non-manufacturing report for May has probably solidified the likelihood of a Fed ‘pause’ that was already in prospect. After a rapid hiking cycle, the real fed funds rate is now in positive territory, whether you annualise the outturns in actual inflation or use expectations as judged by investors. Many policymakers have pointed to uncertain lags in monetary policy as a reason to take a breather on further rate hikes. Those in favour of such a move appear to be in the ascendancy and will benefit from the optics of favourable base effects over the summer. Indeed, if prices continue to increase at their average rate so far this year, headline inflation will fall below 4% in June for the first time in more than two years. With that figure due for

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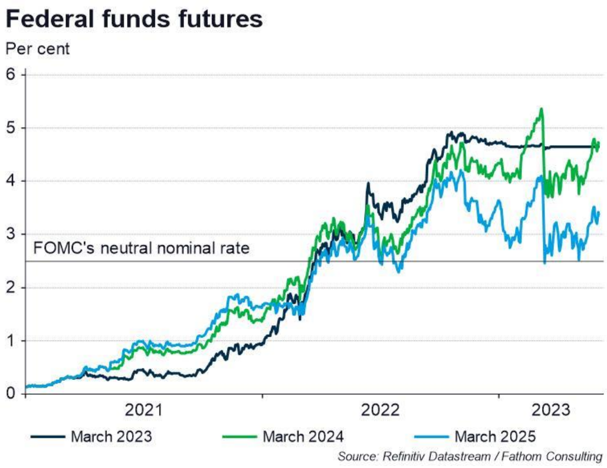
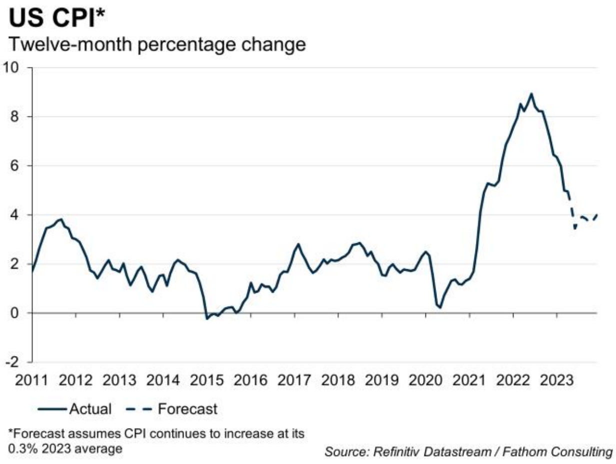
release on 12 July before an FOMC meeting in the same month, it should give the FOMC until their September meeting to calibrate its next move.





As investors have increasingly priced out recession fears, so too have they pushed out the date when they expect rate cuts. Over the past month, Fed funds futures have priced out around 100 basis points in cuts by March 2024. However, history is on the side of those that expect a pivot sooner rather than later. The Fed does not tend to stay at cyclical highs for very long. Last time round, the FOMC was cutting rates within seven months of ending its hiking cycle. Whether that sort of move repeats itself will reflect in large part whether the US goes into recession, or if a downturn has been delayed or avoided altogether, as well as the path for inflation and whether it proves to be stickier than investors currently anticipate. With all that in mind, the outlook for US policy rates over the next year remains highly uncertain, with big risks in both directions. We are finalising our *Global Outlook, Summer 2023* this week and look forward to discussing it with clients in the coming days.

Further reading

- Recession Watch: is the Fed tightening going to plan?
- Which came first — credit crunch or recession?
- Global Outlook, Spring 2023: the Good, the Bad and the Ugly

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