Recession? When, not If, is what matters.

“Expansions don’t die of old age, they are murdered by the Fed”. - Rudy Dornbusch

From NYT:

We May Be on Track for a Recession Just as the 2024 Campaign Kicks Off

April 14, 2022

By **Steven Rattner**
Mr. Rattner served as counselor to the Treasury secretary in the Obama administration.

The debate over whether the recent surge in inflation is transitory or permanent has been settled. Now the question is whether the Federal Reserve can tame increasing inflationary turbulence and bring the economy to a soft touchdown.

Mounting evidence suggests a hard landing — in other words, a recession. We need our economic policymakers to move quickly before the likely damage, already in progress, escalates. Just Tuesday, for example, the Labor Department reported that prices rose by 8.5 percent in March over the previous year, up from 7.9 percent in February.

And that’s without the full impact of inflationary pressures emanating from the war in Ukraine. Meanwhile, shortages of goods (supply chain problems) continue while escalating wage rates — a good thing in other contexts — are putting more upward pressure on prices.

To respond, the Fed will need to raise interest rates aggressively, quickly and far more forcefully than markets and many economists expect.

Let’s go back to Economics 101. Our inflation problem stems from too much demand relative to available supply. Increasing supply is invariably a slow process.

To reduce inflation — and this is the part that’s rarely said aloud — we must reduce demand. That means forcing Americans to spend less. Which in turn leads to fewer jobs and slower wage growth, historically to the point where we tip into recession.

That’s not desirable, but it is the price we pay for poor economic policies delivered by the White House, by Congress and by the Federal Reserve. Those poor policies include far too much budgetary stimulus as we addressed Covid challenges. The $1.9 trillion American Rescue Plan passed in the early days of the Biden administration will go down in history as an extraordinary policy mistake. And the Fed — an esteemed, independent steward of our monetary policy — similarly overestimated the amount of support the economy needed and pumped trillions of dollars into the system.

As a result, we have gotten way behind the curve on inflation; the Fed will have to raise interest rates considerably more than if the problem had not been allowed to arise.

In the past, addressing an inflation problem necessitated the Fed raising interest rates above the inflation rate. Even using the Fed's preferred inflation measure, which is now tracking at 6.4 percent, that would mean rates far higher than the Fed's current prediction of 2.4 to 3.1 percent by the end of 2023.

Rising interest rates slow the economy in several ways. Higher rates make large purchases bought on credit, like homes and automobiles, less affordable, thereby reining in demand and cooling prices. For their part, businesses would borrow less. And the stock market would also be hit, as investors shifted capital to take advantage of more attractive interest yields on bonds.

Softer home values and a potentially declining stock market would trigger a reverse wealth effect: Feeling less well off, Americans would spend less. All of this would ripple through the economy, ultimately resulting in less economic activity.

Optimists — including the Biden administration — argue that the current supply-demand imbalance can be addressed on the supply side of the equation. That is fantasy. Intel has, happily, announced plans for a new semiconductor plant in Ohio, but that facility won't be operational until 2025. Nor will attacking oligopolistic practices in the meatpacking industry or the escalating cost of hearing aids have any measurable effect on overall prices.

Then there's the other important supply input: labor. Bringing more Americans into the labor force could moderate the pace of wage increases but not nearly quickly enough or on the order of magnitude needed to ease the current worker shortage.

What can policymakers do to avert a recession? At this point, regrettably little. The best approach would be to begin tightening before expectations for future inflation become embedded. Among the most compelling lessons of the double-digit inflation of the late 1970s is that it is far more difficult to unwind an inflation problem than to forestall it.

Those moves to unwind should include fiscal policy. Rather than increasing the near-term budget deficit, the White House should heed the advice of Senator Joe Manchin and couple new social programs — however meritorious — with an equal measure of deficit reduction.

I don't believe that a recession is imminent; there's too much capital sloshing around in the system for that to be likely. The Harvard professor Jason Furman estimates that Americans still have $2.3 trillion above prepandemic trends stashed in their bank accounts, largely as a result of special government payments and underspending during the pandemic lockdowns.

The much-desired soft landing that would obviate the need for more painful measures is theoretically possible, but history is not on its side.

The former Treasury secretary Lawrence H. Summers has observed that over the past 75 years, every time inflation exceeded 4 percent and unemployment was below 5 percent, a recession ensued within two years.

Bond markets also accurately predicted past slumps. When 10-year interest rates fall below two-year rates, recessions have, on average, occurred in about 18 months.

With both conditions having been true this month — at least briefly — that would suggest a downturn just as the 2024 presidential campaign season is getting underway. A potential electoral nightmare for Democrats to ponder.

From Friday's Global Investment Strategy report:

Is A Recession Inevitable?

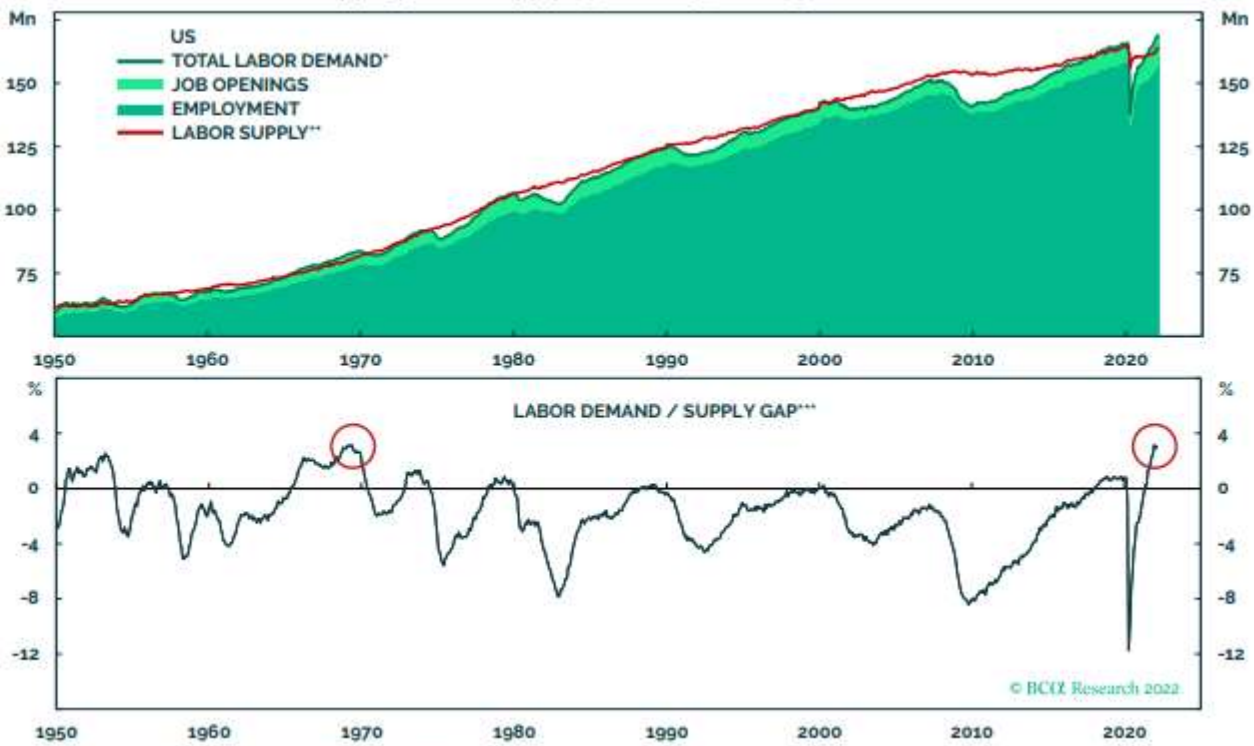
Jobs Aplenty

The US unemployment rate fell from 3.8% in February to 3.6% in March, bringing it close to its pre-pandemic low of 3.5%. Adding job openings to employment and comparing the resulting sum with the size of the labor force, the excess of labor demand over labor supply is now the highest since July 1969 (**Chart 1**).

Granted, the labor force participation rate is still one full percentage point below where it was prior to the pandemic. If the participation rate were to rise, the gap between labor demand and supply would shrink. Some of the decline in the participation rate is permanent in nature, reflecting ongoing population aging, which has been compounded by an increase in early retirements during the pandemic (**Chart 2**).

Some workers who dropped out will probably re-enter the workforce. **Chart 3** shows that employment among low-wage workers has been slower to recover than for other groups. With expanded unemployment benefits no longer available, the motivation to find gainful employment will escalate.

CHART 1
Labor Demand Is Outstripping Labor Supply By The Largest Margin Since 1969

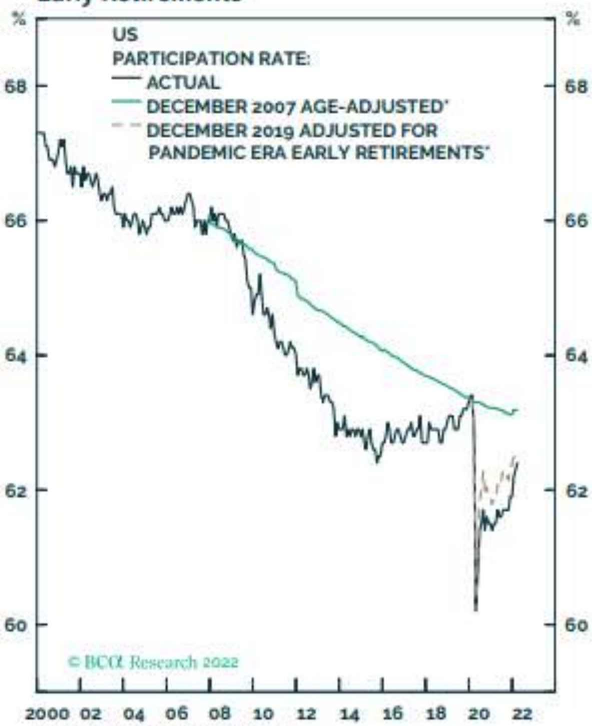


* SUM OF JOB OPENINGS AND CIVILIAN EMPLOYMENT.
** DEFINED AS THE CIVILIAN LABOR FORCE.
*** DIFFERENCE BETWEEN LABOR DEMAND AND SUPPLY AS A PERCENTAGE OF THE LABOR SUPPLY.

Nevertheless, it is doubtful that the entry of low-wage workers into the labor force will do much to reduce the gap between labor demand and supply. Low-wage workers tend to spend all of their incomes. Thus, while an increase in the number of low-wage workers will allow the supply of goods and services to rise, this will be counterbalanced by an increase in the demand for goods and services.

CHART 2

Not All Of The Decline In Labor Participation During The Pandemic Was Due To Increased Early Retirements

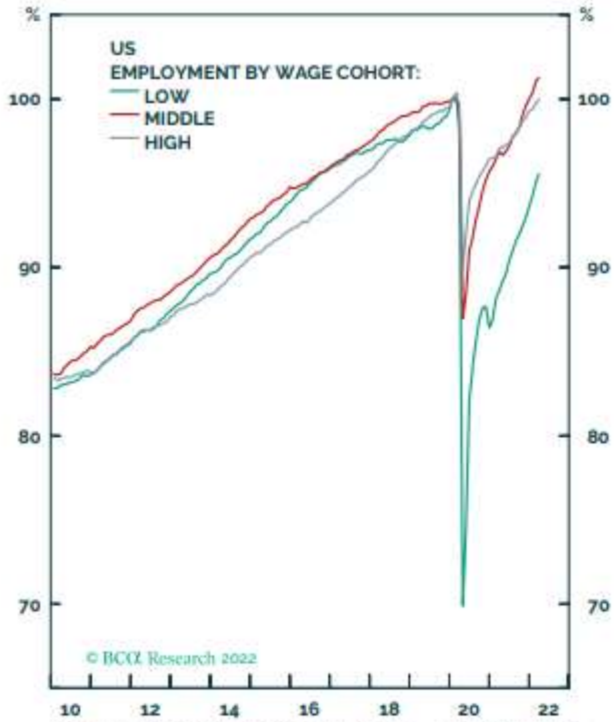


* BASED ON BCA CALCULATIONS.

NOTE: DECEMBER 2007 AGE-ADJUSTED ESTIMATES THE DECLINE IN THE PARTICIPATION RATE PURELY AS A RESULT OF THE AGING OF THE POPULATION. IT ILLUSTRATES WHAT THE OVERALL PARTICIPATION RATE WOULD BE IF THE PARTICIPATION RATE ACROSS DIFFERENT AGE COHORTS WAS HELD CONSTANT AT DECEMBER 2007 LEVELS WHILE THE CHANGES IN THE POPULATION'S AGE STRUCTURE FOLLOWED THEIR ACTUAL PATH.

CHART 3

Low-Wage Workers Have Not Returned In Full Force



NOTE: ALL SERIES REBASED TO JANUARY 2020 = 100%. LOW-WAGE, MIDDLE-WAGE, AND HIGH-WAGE COHORTS REFER TO EMPLOYMENT IN INDUSTRIES WHERE THE AVERAGE HOURLY EARNINGS STOOD AT LESS THAN $20/H, BETWEEN $20-30/H, AND MORE THAN $30/H, RESPECTIVELY, IN JANUARY 2020.

To cool the labor market, the Fed will need to curb spending, and that can only be achieved by raising interest rates.

Trying to achieve a soft landing in this manner is always easier said than done. The US has never averted a recession when the 3-month average of the unemployment rate has increased by more than a third of a percentage point.

Rising unemployment tends to produce a negative feedback loop: A weaker labor market depresses spending. This, in turn, leads to less hiring and more firing, resulting in even higher unemployment.

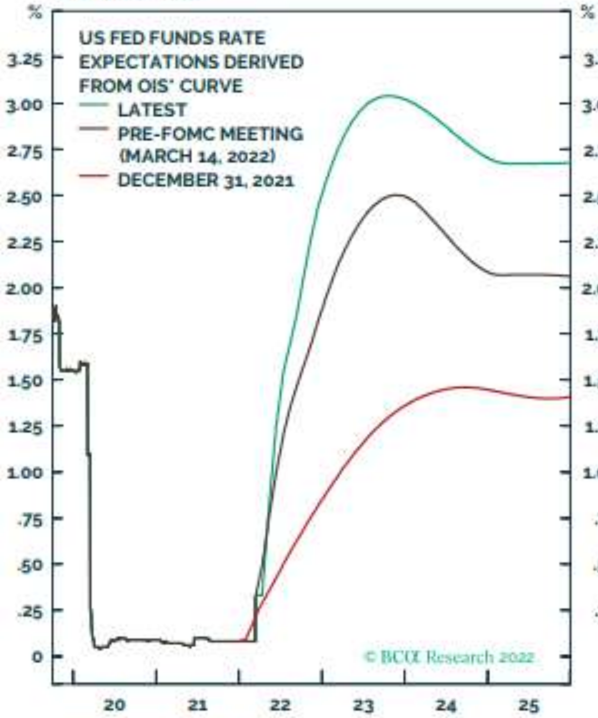
Where is the Choke Point?

How high will interest rates need to rise to trigger such a feedback loop? Markets currently expect the Fed to raise rates to 3% by mid-2023 but then cut rates by at least 25 basis points over the subsequent months (**Chart 5**). (Note how rapidly investors are increasing their interest rate expectations.) So, the market thinks the neutral rate of interest – the interest rate consistent with a stable unemployment rate – is around 2.5%.

The Fed broadly shares the market's view. The median dot for the terminal Fed funds rate stood at 2.4% in the March Summary of Economic Projections (**Chart 6**). When the Fed first started publishing its dot plot in 2012, it thought the terminal rate was 4.25%.

CHART 5

The Markets See The Fed Funds Rate Reaching 3% Next Year



* OVERNIGHT INDEX SWAPS.

CHART 6

The Fed's Estimate Of The Terminal Rate Has Fallen Over The Years

* SOURCE: FEDERAL RESERVE.

NOTE: 5-YEAR/5-YEAR FORWARD TREASURY YIELD SHOWN SMOOTHED EXCEPT FOR LATEST DATA POINT.

CHART 7

Consumers And Businesses Are Set To Spend More

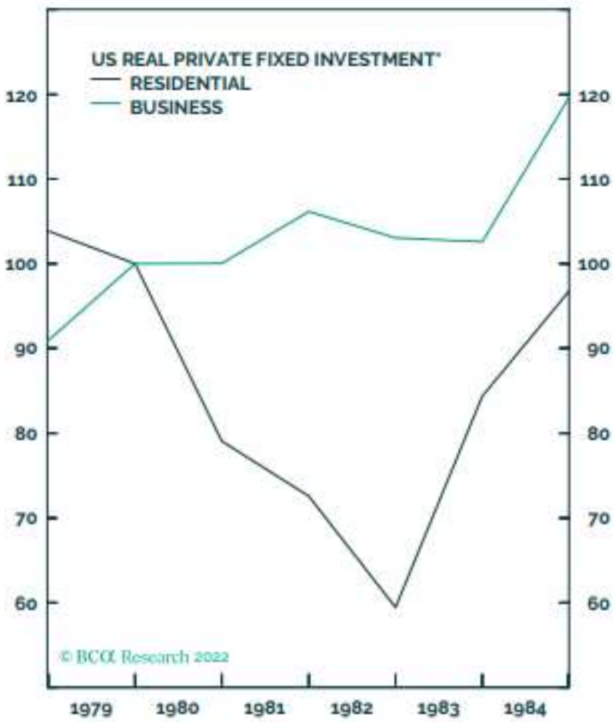
* SOURCE: FEDERAL RESERVE, FINANCIAL ACCOUNTS OF THE UNITED STATES.

** SOURCE: AVERAGE OF CAPITAL EXPENDITURE EXPECTATIONS IN 6 MONTHS FOR THE DALLAS, KANSAS CITY, NEW YORK EMPIRE, PHILADELPHIA, AND RICHMOND FED REGIONAL SURVEYS.

Low Imbalances Imply a Higher Neutral Rate

CHART 9

Rising Interest Rates In The Early 1980s Had Much More Of A Negative Effect On Housing Than Business Investment



* SHOWN REBASED TO JAN. 1979 = 100.
SOURCE: BUREAU OF ECONOMIC ANALYSIS (BEA).

CHART 10

The Jump In Mortgage Rates Has Weighed On The Housing Market

* MORTGAGE BANKERS ASSOCIATION. SHOWN AS A 4-WEEK MOVING AVERAGE.
** NATIONAL ASSOCIATION OF HOME BUILDERS.

... Simply put, when an economy is suffering from major imbalances, it does not take much monetary tightening to push it over the edge.

The private-sector financial balance measures the difference between what households and firms earn and spend. A recession is more likely to occur when the private-sector financial balance is negative — that is, when spending exceeds income — since households and firms are more prone to cut spending when they are living beyond their means.

In the lead-up to the Great Recession, the private-sector financial balance hit a deficit of 3.9% of GDP in the US. Leading up to the 2001 recession, it reached a deficit of 5.4% of GDP. Today, the US private-sector financial balance, while down from its peak during the pandemic, still stands at a comfortable surplus of 3% of GDP.

Rather than looking to retrench, households and businesses are poised to increase spending over the coming quarters (**Chart 7**).

Private-sector financial balances are also positive in Japan, China, and most of Europe.

Watch Housing

At the 2007 Jackson Hole conference, Ed Leamer presented what turned out to be a very prescient paper. Titled “Housing is the Business Cycle,” Leamer concluded that “Of the components of GDP, residential investment offers by far the best early warning sign of an oncoming recession.”

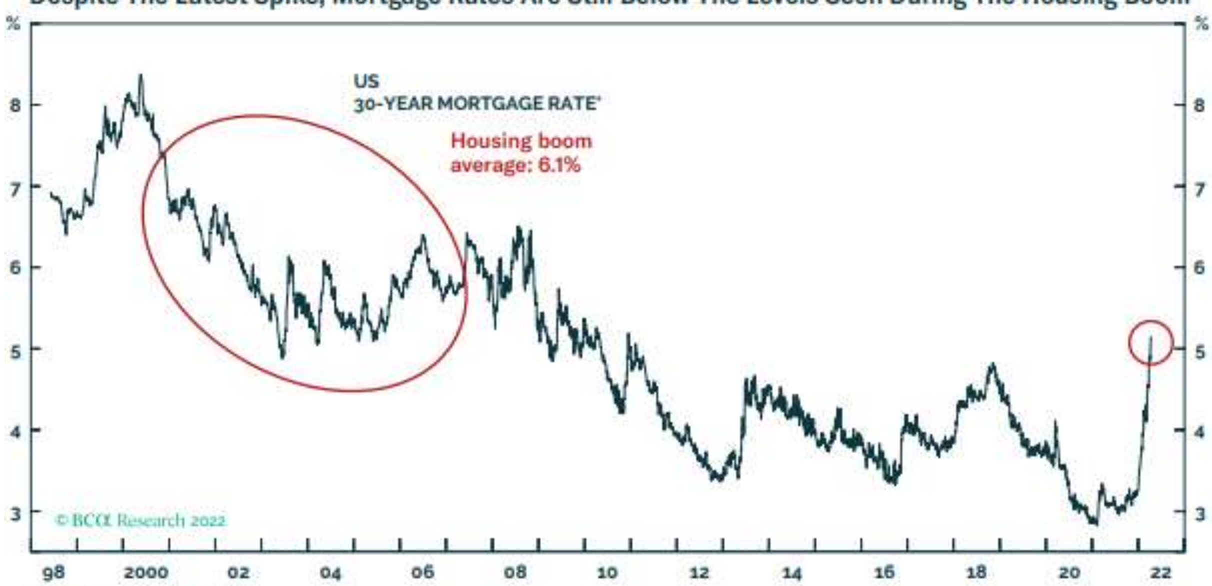
Housing is a long-lived asset, and one that is usually financed with debt. To a much greater extent than nonresidential investment, the housing sector is very sensitive to changes in interest rates.

When the Fed hiked rates in the early 1980s, residential investment collapsed but business investment barely contracted (**Chart 9**). The jump in mortgage yields has started to weigh on housing (**Chart 10**). Mortgage applications for home purchases have fallen by 25% from their highs. Pending home sales have dropped. Homebuilder confidence has dipped. Homebuilder stocks are down 29% year-to-date.

Housing is likely to slow further in the months ahead, even if mortgage yields stabilize. ... changes in mortgage yields lead home sales and housing starts by about six months. The key question for investors is whether the housing market will enter a deep freeze or merely cool down.

We think the latter is more likely. The 30-year fixed mortgage rate has increased nearly two percentage points since last August, but at around 5%, it is still below the average of 6% that prevailed during the 2000-2006 housing boom (**Chart 12**).

CHART 12
Despite The Latest Spike, Mortgage Rates Are Still Below The Levels Seen During The Housing Boom



* SOURCE: BANKRATE.COM.

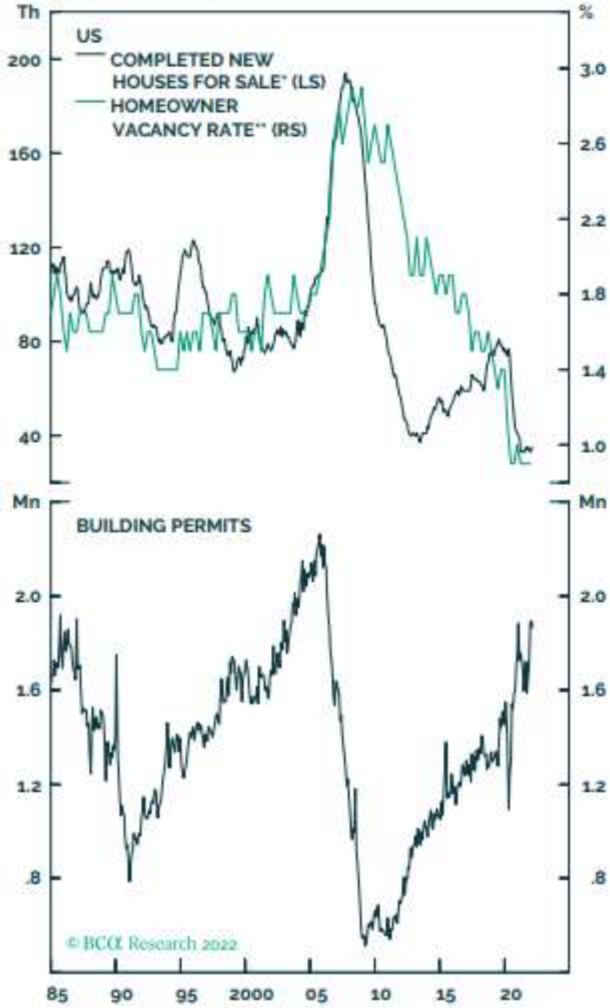
Moreover, unlike during the housing boom, when homebuilders flooded the market with houses, the supply of new homes remains contained. The nationwide homeowner vacancy rate stands at record lows. Building permits are near cycle highs (**Chart 13**).

Granted, real home prices are close to record highs. However, relative to incomes, US home prices have not broken out of their historic range (**Chart 14**).

Home affordability is much more stretched outside of the United States. The Bank of Canada, for example, has less scope to raise rates than the Fed.

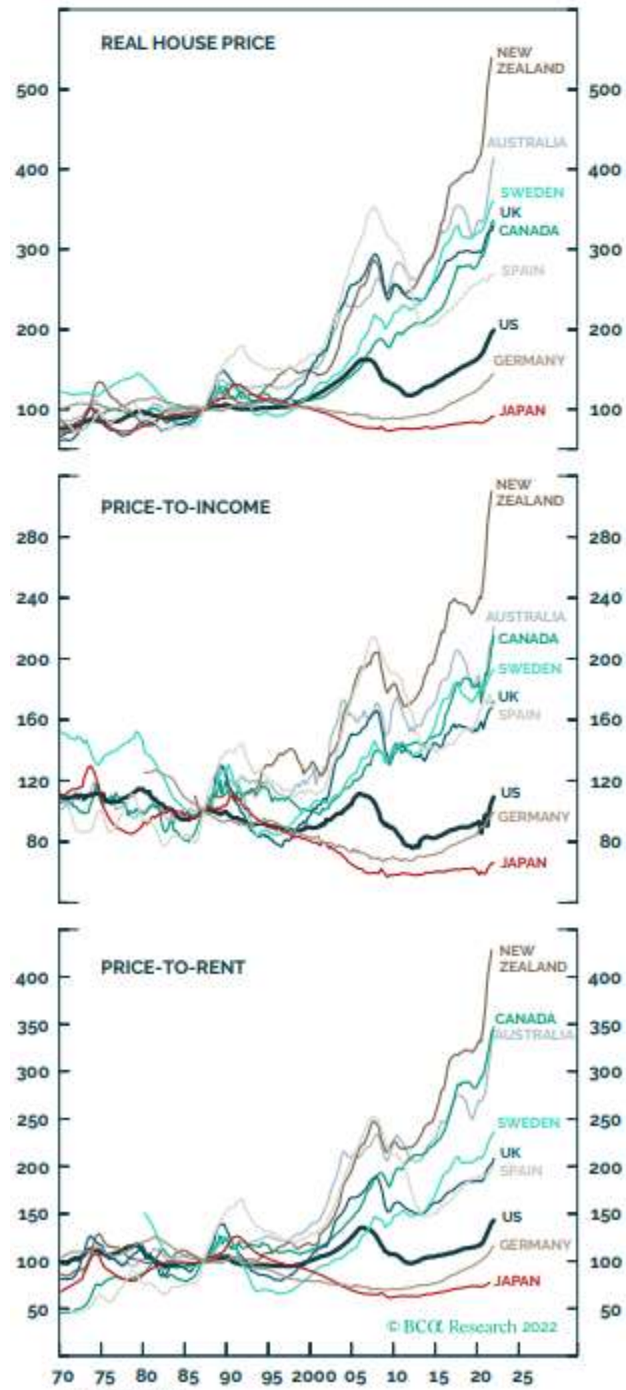
Investment Conclusions

CHART 13
The Homeowner Vacancy Rate Is Near Record Lows



* SOURCE: US CENSUS BUREAU.
** SOURCE: US DEPARTMENT OF COMMERCE.

CHART 14
Homes In The US Are Relatively Cheap



SOURCE: OECD.
NOTE: ALL SERIES REBASED TO Q1 1987 = 100.

As investors, we need to be forward looking. The widespread availability of Paxlovid later this year — which, in contrast to the vaccines, is effective against all Covid strains — will help boost global growth while relieving supply-chain bottlenecks. Shipping costs, used car prices, and ISM supplier delivery times have already come down from their highs.

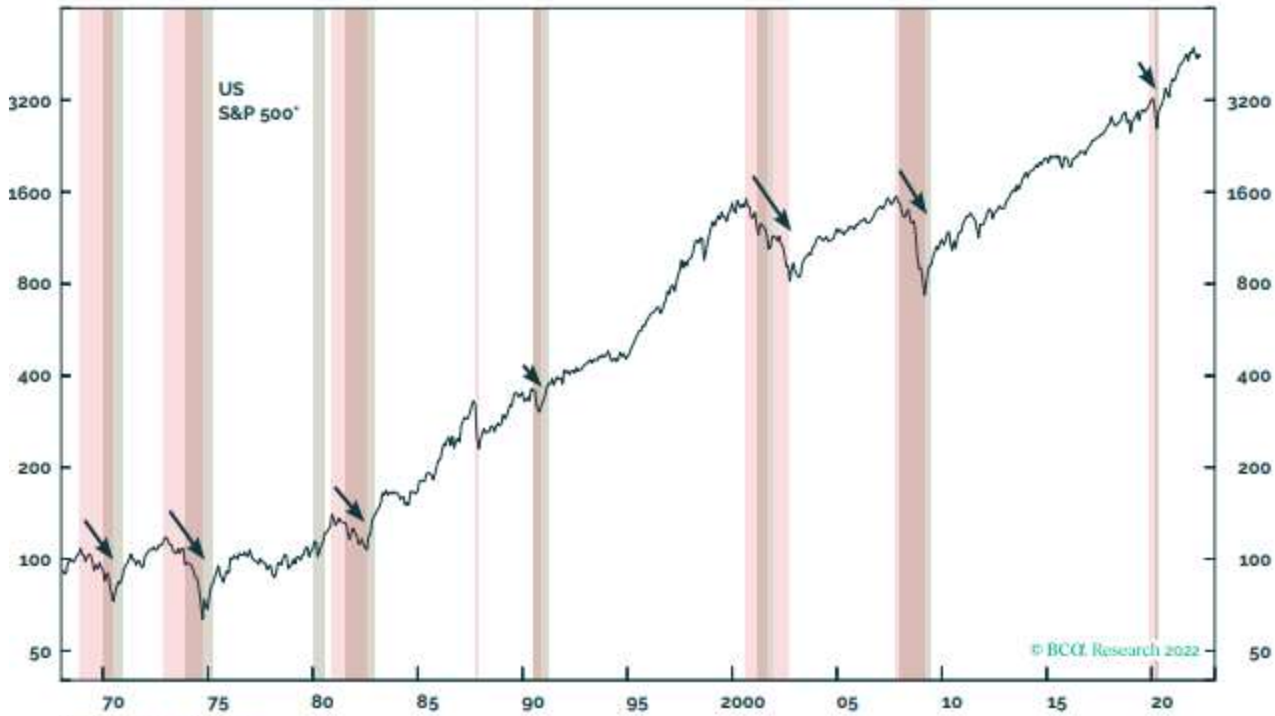
Central banks have either started to raise rates or are gearing up to do so. However, monetary policy is unlikely to turn restrictive in any major economy over the next 12 months. Stocks usually go up outside of recessionary environments (**Chart 16**).

Global equities are trading at 17-times forward earnings. The corresponding earnings yield is about 630 basis points higher than the real global bond yield – a very wide gap by historic standards.

Investors should remain modestly overweight equities over a 12-month horizon and look to increase exposure to non-US stock markets, small caps, and value stocks over the coming months.

CHART 16

Stocks Tend To Fare Well When There Is No Recession On The Horizon



* SHOWN IN LOG SCALE.

NOTE: LIGHT RED SHADING INDICATES BEAR MARKETS; GREY SHADING INDICATES NBER-DESIGNATED RECESSIONS.

Government bond yields are unlikely to rise much over the next 12 months (we have been, and continue to be less sanguine) but will increase further over the long haul. ...