Good Things Hardly Come Twice - How About Bad Things?

by
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Some of you hear alarm bells ringing: the Dow Jones lost over 1,100 points in a single day, and the S&P 500 is down almost 19% from a year ago (a decline of 20% is considered to be a bear market). Oil prices, not adjusted for inflation, have not been this high since the Great Recession of 2008-2009. The consumer sentiment index from the University of Michigan is at levels not seen for over 10 years at the depth of the Great Recession (February 2009); and before that, you have to go back over 40 years to May 1980 to find similarly low levels when the U.S. economy was in the first part of, what we refer to as, the "double dip recession."

Recessions are rare: there have only been 12 such episodes after the end of World War II. It is even less common to experience a double dip recession: over the last 100 years, it only happened twice. The most recent episode was in 1980 and 1981. Back then, the first downturn coincided with high and rising energy prices and inflation (the inflation rate reached 15% in monthly data). The gasoline prices went up, just like now, due to a war - at that time between Iran and Iraq. The second part of the double dip was the result of the Federal Reserve and its Chairman Paul Volcker deciding to fight inflation by raising short-term interest rates significantly. You must get a feeling of Deja Vu looking at the current state of the U.S. economy except that his name is Jerome Powell.

Let's gather the facts to determine if we are in for another double-dip recession. We already experienced a GDP decline during the first quarter of 2022. As a result, we just need another three months of negative growth to follow to complete the double dip of 2020 and 2022. We will not get GDP (output) data for the second quarter of 2022 until the end of July, and we therefore have to rely on forecasters at this point. The Federal Reserve Bank of Atlanta has developed a forecasting model for current quarter GDP (GDPNow), which incorporates information regarding quarterly GDP as it becomes available. It then uses historical relationships to estimate current GDP. This model currently calls for 2.4% positive growth, which is significantly below the level that most professional forecasters had predicted for the April to June 2022 period only a short while ago. The Blue Chip consensus forecast is actually a bit higher (closer to 3%), but there are others who are not less optimistic.

We also use a forecast model to determine whether we are in the last year of an expansion - a different alarm clock, if you wish. And our alarm clock is not ringing yet. The variables we consider are: (i) the interest rate spread between 10-Year Government Bond and the 30-Day Treasury Bill. A negative spread signals a recession to start within a year but currently it continues to be positive. The yield curve could invert if the Federal Reserve raises the Federal Funds Rate

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too fast and repeatedly but there is no sign of this currently. (ii) Rising unemployment rates compared to the previous year average. As recessions are approaching, this measure will turn positive, meaning that the labor market is deteriorating, abstracting from month-to-month movement. (iii) Housing starts over the last year are an important indicator. As long as the U.S. economy shows positive growth in housing starts, builders are optimistic about the future, and this contributes to an overall positive outlook. (iv) Average Weekly Hours in Manufacturing do not show a current decline in this important sector that is sensitive to economic fluctuations, although we adjust this measure by the historically declining share of this sector. (v) *Consumer confidence* is the only category which sends us serious warning signals currently. We look at the change in consumer confidence from 4-months ago, and consumer confidence has fallen since July a year ago. There is a final variable we typically consult, the U.S. housing stock built since the start of the last expansion. We give this less weight currently because the expansion is only about two years old.

Bottom line, with the exception of consumer sentiment, there is, in our view, no reason to be overly concerned about the economy from here over the next 12 months. The likelihood of a recession is simply not high. Now if the interest rate spread changed as a result of future increases in the federal funds rate, then watch out. But until then, just turn around on your pillow and worry less. Leave the fire extinguisher in the closet.

You may wonder why we do not include the stock market as our leading indicators. There are two reasons for it. The first follows Nobel Prize winner Paul Samuelson's remarks that the stock market frequently produces false alarms about recessions. The more profound insight is that it does not add additional information once we include the above mentioned variables.

A final word from the history books that has us worried a bit. Someone may mention to you that there was another double-dip recession almost exactly 100 years ago. The first dip was from August 1918 to March 1919 and it followed another pandemic: the outbreak of the Spanish Flu in early 1918. The second and more serious downturn subsequently occurred from January 1920 to July 1921. However, the doctors who could have responded to the alarm bells ringing in those days simply did not have the medicine tools available ("countercyclical economic policy") that today's doctors have. We have some trust in the Federal Reserve generating a soft landing for the economy.