Opinion **Unhedged**

# A US recession is on the table

Not the most likely outcome, but no mere tail risk either

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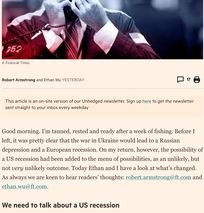

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Robert Armstrong and Ethan Wu YESTERDAY

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Good morning. I'm tanned, rested and ready after a week of fishing. Before I left, it was pretty clear that the war in Ukraine would lead to a Russian depression and a European recession. On my return, however, the possibility of a US recession had been added to the menu of possibilities, as an unlikely, but not very unlikely outcome. Today Ethan and I have a look at what's changed. As always we are keen to hear readers' thoughts: robert.armstrong@ft.com and ethan.wu@ft.com.

## We need to talk about a US recession

Here is the outlook from our favourite Wall Street economist, Don Rissmiller of Strategas:

> Our base case is a 2023 mid-cycle slowdown (50 per cent odds) as the private sector helps the Fed bring inflation under control (eg, bottlenecks ease). With the domestic labour market still solid, and JOLTS job openings elevated, it remains difficult to make a US recession our base case. Yet if the Fed overdoes tightening, growth would falter (35 per cent odds). An upside surprise case would involve productivity increasing and growth proving robust (15 per cent odds)

A roughly one-third chance of recession is what Goldman Sachs economists are looking at too:

> While our baseline forecast assumes that further service sector reopening and spending from excess savings will keep real GDP growth positive in the coming quarters, uncertainty around the outlook is higher than normal, and we view the risks of a recession as broadly in line with the 20-35 per cent odds currently implied by models based on the slope of the yield curve

Probabilities that are high but not above 50 per cent are hard to think about. The temptation is to chuck a 35 per cent possibility into the unlikely bucket and forget it. But if it comes to pass, and you are not prepared, you have only yourself to blame.

What has changed, such that the probability of a US recession is being taken seriously? Oil prices up 30 per cent in a bit over two weeks are like the most important attention-focuser. Wheat and corn prices, up 17 per cent and 10 per cent respectively over the same period, don't help much either. But rumblings of a slowdown extend beyond commodities.

A bit of context first. Remember that the heady growth of the early reopening is fading fast. The consensus seems to be that the economy is growing closer to its long-term trend rate. The Atlanta Fed's GDPNow real time estimate for growth in the current quarter is just above zero. And this is before — long before — the impact of higher commodity prices could have penetrated the economy:

Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the Blue Chip survey.

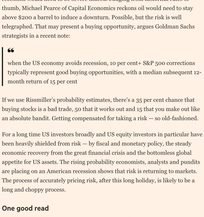
We are just not that far from a contracting economy. Both consumers and market participants know it, which unfortunately only makes a contraction more likely.

The latest reading of the Michigan consumer sentiment survey hit a new post-financial crisis low. No surprise, given that inflation is keeping real wage growth negative.

Yes, the yield curve remains positive — just:

### You call that a curve?

10-year Treasury yields minus 2-year Treasury yields




Source: Federal Reserve
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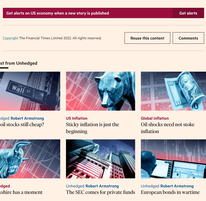
But credit markets, while still loose by historical standards, are tightening at a lively pace. It sure looks like corporate bond traders are thinking that economic conditions could get worse. Here is the spread of yields on BBB bonds (the lowest rung of investment grade) over Treasury yields:

### A whiff of risk

ICE BofA BBB US option adjusted spread

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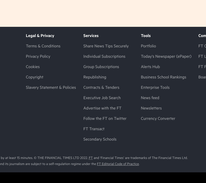
Strong corporate earnings have underpinned the ball case for equities through this year's turbulence. But data from Citi's equity strategy team shows that analysts' earnings revisions, overwhelmingly positive just a few weeks ago, are about evenly split between increases and decreases:




Source: FactSet, Citi Research

At the same time, no one should expect the slowing growth, weak consumer sentiment, flattening yield curve, widening spreads or earnings downgrades to scare the Fed off the path to higher rates. What we are seeing in the US is probably best characterised as a reversion to normal activity levels from feverish highs. Given recent CPI numbers, that is not enough to make the Fed back down. The market is pricing in close to seven quarter-point policy rate hikes by the end of the year, according to Bloomberg. The Fed won't save the day unless the day gets a lot worse.

There are good reasons, though, that while the risk of a recession is rising, few observers treat it as their core scenario. Though analysts may be increasing their estimates less often, the earnings picture still looks decent. Forecasters expect earnings per share for the S&P 500 to expand 17 per cent over the next 12 months, according to Bloomberg data. Recent surveys suggest businesses are responding to rougher waters by protecting margins with price hikes. Capital expenditure remains strong, too.

Most importantly, it is hard to see a recession taking hold while the employment picture is so strong. Growth in payrolls and labour force participation have come with high nominal wage gains. And though the data is a bit old, it looks like those wages are being spent. Consumer spending and retail sales grew 2.1 and 3.8 per cent in January, respectively. Meanwhile, Congress is passing a $1.5tn bill that approves new spending on the military, schools, housing and other projects. Tens of billions in fresh government demand could flip the US fiscal impulse — which recently has been a net drag on growth — positive.

Given all this pre-existing strength, a commodities shock big enough to cause a recession would need to be severe indeed. Judging from historical rules of thumb, Michael Pearce of Capital Economics reckons oil would need to stay above $200 a barrel to induce a downturn. Possible, but the risk is well telegraphed. That may present a buying opportunity, argues Goldman Sachs strategists in a recent note:

> when the US economy avoids recession, 10 per cent+ S&P 500 corrections typically represent good buying opportunities, with a median subsequent 12-month return of 15 per cent

If we use Rissmiller's probability estimates, there's a 35 per cent chance that buying stocks is a bad trade, 50 that it works out and 15 that you make out like an absolute bandit. Getting compensated for taking a risk — so old-fashioned.

For a long time US investors broadly and US equity investors in particular have been heavily shielded from risk — by fiscal and monetary policy, the steady economic recovery from the great financial crisis and the bottomless global appetite for US assets. The rising probability economists, analysts and pundits are placing on an American recession shows that risk is returning to markets. The process of accurately pricing risk, after this long holiday, is likely to be a long and choppy process.

## One good read

Russia scholar and Stalin biographer Stephen Kotkin in conversation with David Remnick.

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