The Flip Side episode 55 – Can the US economy outrun a recession?

Jeff Meli: Welcome to the Flip Side. My name is Jeff Meli. I'm the head of Research at Barclays. I'm joined today by Marc Giannoni, our Chief US Economist. Thanks for joining me, Marc.

Marc Giannoni: Thanks for having me, Jeff.

JM: Now, today we are going to talk about the potential for the US economy to experience a recession this year, driven by the rapid increase in interest rates engineered by the Federal Reserve over the past 16 months. This recession has long been expected by professional forecasters, including by our own US economics team, here at Barclays, as stubbornly persistent inflation has forced central banks across developed markets to tighten monetary policy. So far, though, the economy has remained surprisingly resilient, and the timing of this so-far hypothetical downturn keeps getting delayed.

MG: You are right that the economy has shown considerable resilience so far, supported by solid household consumption growth. But I don't think it is correct that we have seen no signs of the economy slowing: some parts of the economy have begun to weaken. I continue to believe that the sharp increase in interest rates will lead to a recession – it is just taking longer than expected.

JM: I disagree Marc. I do not believe the economy is going to contract any time soon. The Fed does not have the same level of control over the economy as we are trained to believe, and there are lots of reasons why this economic cycle is very different from our historical experience, and that together mean higher rates just will not have the expected effect on activity.

MG: Well Jeff, let's start with our official forecast. We are now expecting a shallow recession to start in Q4 this year, with GDP registering a cumulative decline of just 0.5% in Q4 23 and Q1-Q2 2024 and a relatively modest increase in the unemployment rate. We expect it to hit 4.2% at end-2023 and peak at 4.7% in mid-2024.

JM: This is both delayed from our original forecast, and really quite mild. For example, in many economic cycles, the lowest the unemployment rate gets is somewhere above 5%, and we are expecting the unemployment rate to peak below that level.

MG: Yes, like I said, this would be a shallow recession. And the reason is that the US economy has quite a lot of momentum. To give a sense of the numbers: the most recent data shows that real GDP grew 2.0% in Q1 23, supported by strong private demand, with consumer spending growing a robust 4.2% annualized over the quarter. Although private demand and consumer spending appear to have decelerated somewhat in Q2, the available data indicate that the growth is still pretty strong: for example, real disposable income growth is running over 2% annualized in the three months to May.

Jeff: Well Marc, these headline stats are not suggestive of an imminent recession. Keep in mind that the latest data is strong despite concerns that the collapse of SVB and the general turmoil in regional banks in the US, which was the subject of the last Flip Side, would exert a significant drag on economic activity and the labor market. This economy has shown it can weather some significant shocks!

MG: Not so fast: when we go a bit deeper, we do see evidence that the rapid rate hikes are having an effect. One example is residential investment**,** which has been declining at a fairly rapid pace for over a year. This is often the first place we see the effect of higher rates: recall that mortgage rates rose sharply from around 3% in early 2022 to over 7% in just a few weeks, and they are still that high. As we would expect, key measures of housing activity such as new home sales, resales of existing homes, and single-family housing starts all turned down last year.

JM: I'd note Marc that these measures have been stabilizing in recent months. But even if the sharp increase in mortgage rates reduces some measures of housing demand, it looks like the effect on activity has been muted. For example, we have not seen the layoffs of construction workers that typically occur during a hiking cycle. That negated the usual multiplier effects that would occur as the workers who get laid off curtail their spending. The absence of a construction layoff cycle significantly reduces the potency of monetary policy.

MG: Yes, I agree, this may be in part because homebuilders entered this cycle with a record stock of houses still under construction and were understaffed in the face of the surge in housing demand during the pandemic**.** But that backlog is falling, and I expect the job losses will follow. We've also seen business fixed investment slow in recent quarters, likely reflecting higher interest rates and a tightening in bank lending conditions. The manufacturing sector, more broadly, has been in contractionary territory since late last year, at least according to the purchasing manager indices. We expect that substantial cuts in production lie ahead, given the sharp declines in new orders, with aggregate demand continuing to rotate from goods to services, and the inventory restocking cycle having run its course.

JM: Generally manufacturing would be a natural place to see the effect of higher interest rates: it is a capital-intensive activity by definition. But right now, fiscal policy is providing some significant momentum in the opposite direction. Just two examples – the CHIPs act, which encourages domestic semiconductor manufacturing, and obviously there is a spate of investment and ideally manufacturing that will come off the back of that. And then there are all the climate subsidies built into the inflation reduction act, or IRA, which will encourage a lot of green investment, so I am not convinced that these production cuts will actually materialize.

MG: But beyond the current state, the core reasoning behind our expectation of a recession is that there is no other path to taming inflation.

JM: But Marc, inflation has already fallen: the latest data is closer to 4%, down from nearly 10% at its peak!

MG: Yes, inflation is well off the peak and that's very good news. But keep in mind that the target level of inflation set by the Federal reserve is 2%, and they are sticking to that target. The reductions from here necessary to reach that target will be much harder to achieve, because most of the current price pressure is in services. While core goods price inflation initially surged in 2021, in the face of supply chains disruptions and material shortages, it moderated substantially with the normalization of supply chains. It was running at 2.0% y/y in May compared to 12% y/y in early 2022.

JM: This decline was widely expected and was the reason why so many people believed the surge in inflation would be transitory: supply chain disruptions and material shortages would all eventually ease. It just took too long for this normalize to occur, and now inflation is firmly imbedded in the economy.

MG: That is correct: while goods inflation has fallen, core services inflation has increased significantly to 6.6% y/y in May, up from 4.1% in early 2022. Some of that is due to housing prices, but even excluding housing, services prices are increasing over 4% annualized. I think services price inflation won't fall unless we enter in a mild recession. Here I see three challenges for the Fed:

- First, inflation in core services appears to be more persistent and sluggish than core goods inflation. It simply takes more time for it to revert back to levels consistent with the Fed's target.

JM: That's because this is not due to some external shock: like a port closure or a shortage of raw materials. Inflation of this type can be a vicious cycle, what happens is workers start demanding raises that line up with recent inflation experience and then that in turn forces companies to raise the price of their goods and services and so you sort of enter this self-fulfilling prophecy.

MG: And that ties into the second challenge: inflation in core services appears more closely linked to tightness in the labor market and to domestic conditions than is the case for core goods, which depend more on intermediate products including imported products. And third, demand for services is less sensitive to interest-rate changes than the demand for durable goods consumption. As a result**,** sustainably reducing services inflation will require rates to be higher for longer, such that income growth slows, consumption growth slows, and we see an easing of the labor market. Those are just synonyms for recession! Again, we think this will be needed to lower price pressures, especially in services.

JM: This is less of a forecast given the path of economic fundamentals than a view about what fundamentals must be in order for the Fed hits its inflation target.

MG: That is correct: while the Fed will not deliberately try to cause a recession, its determination to reducing inflation will cause it to maintain a relatively tight policy stance even if the economy weakens. In a way, the weakening of the economy is a feature the of the disinflationary policy rather than a bug. The Fed is not going be convinced that it has vanquished inflation after seeing low [inflation] prints for a couple of months. Instead, it will need to see a long string of weak inflation prints (maybe up to 6 months) before it gets confident that inflation is reverting to its target.

Jeff: That is actually a good segue to my perspective, which is that we won't see the slowdown you predict. Your view is premised on a fundamental assumption: that the economy will respond to interest rates in the "typical" fashion: higher rates means less activity.

MG: Well Jeff, that's not really an assumption: we have many years of evidence and lots of theory for why interest rates affect the economy.

Jeff: But the recent experience casts some doubt on this premise. Let's go back in time to the pre-covid time. Remember that in 2019 and 2018, interest rates were near 0, and even being cut. In fact, this was true across the developed world: recall that Europe and Japan had negative interest rates; this low-rate policy existed for nearly a decade. Why? Because inflation was well below the typical target of 2%. Policy makers were desperate to get inflation up. We even had a term for the lack of price pressure: missingflation.

MG: Yes, that was partly a puzzle, and central bankers were trying all sorts of measures to get inflation higher – ironic of course now that we have the opposite problem.

JM: My point is that we had monetary policy across the developed world that should have – using the historical data you cited – led to high inflation. We also had record low unemployment rates. Yet all that monetary stimulus just wasn't working. Now, fast forward through the covid inflation shock – like you say, the exact opposite problem. But over a year into a record-setting pace of rate hikes, and the economy just isn't slowing. Do we see a pattern here?

MG: I'm not so sure. There are lots of potential explanations for why the economy was slow to respond to monetary policy in both instances: for example, the disinflation associated with globalization pre-covid, and the fact that monetary policy was constrained by the zero lower bound on interest rates, in the aftermath of the global financial crisis. Right now, consumers are still benefitting from all the fiscal stimulus that was passed during covid. Even with the tightening over the past year, aggregate household net worth was still over $32trn higher in Q1 23 than it was in Q4 19 before Covid hit.

JM: I will go further Marc. There is a long list of cyclical and structural reasons why the current economy is just less sensitive to interest rates now than was the case in the past. You named a few. Notably: all the fiscal stimulus is likely to keep supporting spending.

MG: That is true – spending can remain high, and saving rates low, for another several quarters before consumers before consumers exhaust these excess savings.

JM: Here is another cyclical issue that is limiting the effect of higher interest rates: there are currently shortages of workers at the lower end of the wage spectrum. Those workers are usually the first to lose their jobs as rates rise and the economy slows. And they are the last to get them back once the economy recovers. But companies are hesitant – rightly, in my view – to reduce their labor force, because they are already short-staffed, and they are worried they won't get the workers back when they need them.

MG: The labor market has been strong, but like housing, it has also been normalizing:

- Nonfarm payroll employment gains are gradually coming down, although at a very slow pace. They were running at a 3mma pace of 283k in May, down a bit from the 320k average in the preceding three-month period.
- aggregate hours worked fell 0.1% from February to May, reflecting declines in the average workweek.
- the unemployment rate rose to 3.7% in May and initial claims for unemployment benefits have edged up a bit in the first half of June.

JM: For the record Marc, 280k jobs/month is still well above steady state job creation. And while we've heard lots of anecdotes about layoffs at some high-profile companies, notably in tech, those workers, unlike lower paid services workers, don't stay out of work for long. I don't believe the historical experience is much of a guide to the path of the labor market that we're experiencing today that has all sorts of covid idiosyncrasies.

MG: Well, I agree in part – that's why we don't expect the unemployment rate to rise much. But even 1% higher means a lot of job losses.

JM: Here is a structural reason rates are less relevant: our economy has become increasingly services oriented, and the services sector is just less sensitive to rates. Services don't require a factory, equipment, etc. all of which needs to be financed and thus become more expensive when interest rates are higher. I mean you are forecasting a slowdown in manufacturing, and yet the unemployment rate to stay below 5% -- that would have been impossible in prior cycles!

MG: There was a boost in goods consumption during the early stages of covid, when restaurants were closed, and households bought a lot of home furniture and electronic equipment. But that has reversed with the so-called revenge spending: consumers are eager to travel, dine out, and get entertained, and trend towards services has continued. As the services generally require more workers to produce, this has contributed to the tightness of the labor market: services have most of the labor shortages, with job openings highest in education and health, in professional business services, leisure and hospitality, and trade and transportation services.

JM: One final point: so far, financial markets have not been helping the Fed. The market has repeatedly been pricing in rate cuts down the line, as the Fed has been raising its policy rate. In effect, longer-term rates have not moved up nearly as much as the overnight Fed funds rate.

MG: That is true, and most borrowing happens at longer maturities, so the inversion of the yield curve where the longer-dated yields are below the overnight rate set by the Federal Reserve, means that the hikes are not fully reflected in the actual borrowing. Typically, this is the case when investors expect a recession – such that they think the Fed will have to cut rates in the future. In this case, the Fed's inflation-fighting credibility may actually be making their job tougher!

JM: Equity markets have also been robust – the S&P is up well over 10% this year, which further bolsters consumers. And the housing market has some weird twists to it: recall that during covid there was a surge of home buying.

MG: Home prices rocketed up across the country as households rethought their housing needs during the pandemic, and they have remained pretty high.

JM: Yes, but all that homebuying was being financed by record-low mortgage rates. Sure, right now mortgage rates are higher – many, many households locked in low rates. And they are not selling their homes now! They are way in the money on those mortgages – and in fact, given how high rates are, they can earn more on any new savings than they are paying in mortgage interest, which in a strange way provides a further boost to consumers. You put these pieces together, it is not clear to me that the Fed has the fine-tuned control over the economy like we are trained to believe. This cycle is just different, and on top of that, the economy is slowly but steadily changing. Maybe monetary policy is not all-powerful after all!

MG: I agree that services activity is not very responsive to the Fed's tightening in policy. Are you saying that there is no level of rates that would cause a recession?

JM: No, I am not saying that, obviously very extreme levels of rates would cause a slowdown in activity. What I'm saying is that the level of rates necessary to get the last 1-2% of inflation out of the system is not something the Fed can stomach—they aren't going to raise rates to 10% or higher just for that sort of gain on inflation, for political and economic reasons. We should instead get prepared for a period of above-target inflation. It is the opposite and analogous to the pre-covid period: we experienced persistent below target inflation, because the Fed wouldn't take the extreme steps, like negative rates that other central banks tried, that might have gotten them to target.

MG: I disagree. I think the Fed knows very well what happened in the late 1970's when they let elevated inflation get embedded into higher inflation expectations. So far, they have been lucky that inflation expectations have remained fairly well anchored. But the longer inflation remains elevated, the greater the risk that inflation expectations become unanchored and move up. The Fed is terrified about this possibility, and they are in a race with inflation expectations. I am confident they will implement a policy that is sufficiently restrictive to bring inflation back down to 2% over the next 2-3 year. This is why we think they will raise rates again twice by 25bp this year and keep rates the policy rate elevated for longer than most people expect.

JM: Well, we will certainly be watching this closely. Thanks for joining me, Marc. Clients of Barclays can read our latest take on the forces at work in the US economy in our latest Global Outlook, entitled US Exceptionalism, available on Barclays Live.