

Focal Point

US: How much of a recession risk?

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Our Focal Point series explores topical issues on macro, markets, and investment

- Persistent inflation overshoots and the Fed's aggressive normalisation are weighing on the US outlook. After expanding by just above 2% this year, we expect that in 2023 GDP will grow by 0.9% only, with a high likelihood of a slight quarterly contraction during H1. Risks are tilted to the downside.
- Our forecast carries an around 45% risk of a recession next year. Healthy private sector balances may partially offset the impact of tighter financial conditions. Yet, high debt and weak fiscal support may burden the recovery.
- In our baseline scenario, evidence of weakening activity and recession risks will ultimately moderate the Fed's policy tightening. We see the effective fed funds rate ending the year at 3.1% and peak at 3.4% in Q1 2023.

Over the last weeks, global growth prospects have worsened significantly. While the direct fallout of the war in Ukraine on the US is relatively limited, high fuel prices dampen consumption. In this context, the Fed vows to fight inflation by raising rates at a speed not seen in the last 40 years. According to Fed Chair Powell, the economy is strong enough, and the risks of recessions are limited. However, he admitted that the Fed might miss even a "softish" landing in the end, principally for reasons beyond its control.

We have lowered our growth forecast, with GDP growing by just above 2% this year and below 1% in 2023. We see at least a 40% risk of a recession over the next twelve months. In turn, the cracks appearing in the economy during the year's second half will contribute to easing core inflation, leading to a less steep path for the Fed funds rate than projected in the June FOMC meeting.

In what follows, we first take stock of the current situation of the US economy, then assess the roots of a possible recession, quantify its probability, and sketch the implications for monetary policy.

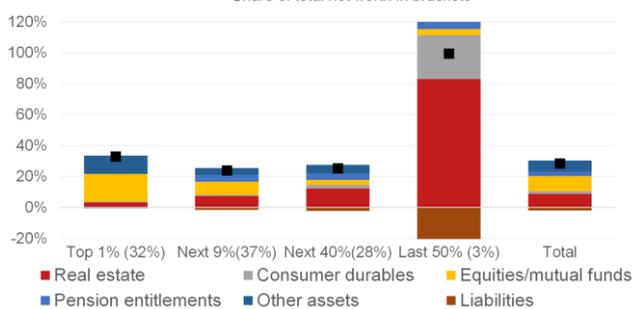
Can we count on US consumers?

Q1 GDP data were heavily distorted by net trade and. Before the monetary tightening starts weighing on demand, the expectation of more robust growth in Q2 and Q3 hinges critically on resilient consumption, as uncertainty will dampen investment and government expenditure is set to fall by more than 10% during the fiscal year 2022. While inflation is squeezing real income and denting sentiment, consumption continues to grow steadily (2.1% yoy in May). Confidence in the strong support from consumption to growth is based on the robust labour market, and the pool of savings households

have accumulated during the pandemic. Employment is growing at a strong but decelerating pace, and wages are expanding, especially at the bottom of the income distribution. The evolution of savings across wealth classes is critical in assessing how effective they can support consumption. The increase in liquid wealth (bank deposits, equity, and mutual funds) that can be deployed to fuel consumption is concentrated among the wealthiest households with the lowest propensity to consume. Households in the lowest half of the distribution have already increased a lot of durables holdings, real estate stocks, and above all, they have increased their leverage (see chart).

Change in net worth by wealth distribution

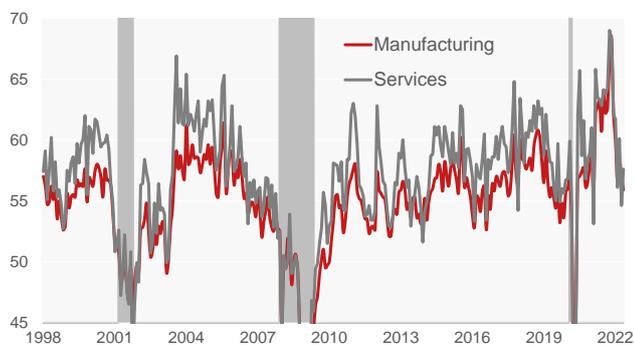
Q4 2019 - Q1 2022. Black square: %chg in net worth.
Share of total net worth in brackets



Source: Federal Reserve, GIAM

Therefore, most of the impulse for consumption must come from labour income. The latest figures on job offers, hiring and quits in May portray a market where workers still have a strong say on wages. Initial claims for unemployment benefits remain low, but the four-week average of new claims has increased for 14 consecutive weeks, the longest rise since the COVID recession. Moreover, the spike in mortgage rates is already impacting construction activity, as expected, and probably sought by the Fed. More broadly, the more forward-looking components of business surveys point to a deeper deterioration.

ISM indexes: new orders component



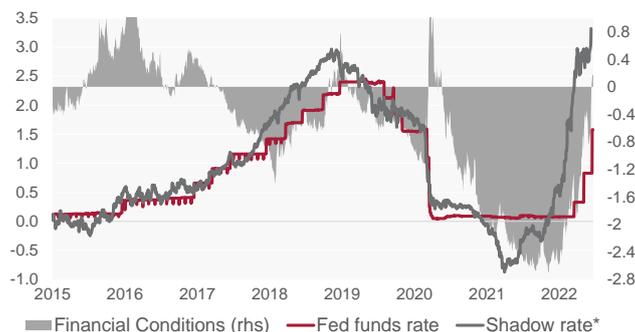
Source: Datastream, GIAM

Expectations of new orders in manufacturing and services

industries have fallen to levels not far from those prevailing before the late 2019 slowdown and the 2016 soft growth patch. Accordingly, we see quarterly GDP growth peaking during the summer before slowing down to just below 0% during Q2 2023.

Even if the Fed has just started its tightening cycle, the worsening in financial conditions is already evident. According to most indexes (and especially those related to the yield curve), financing conditions are at least as tight as it was at the peak of the last rate rise cycle in late 2018. So impacting deeper squeeze on activity can be expected at the start of next year.

Fed funds rate and financial conditions



* computed using the 2y to 10Y Yield curve
Source: Fed Board, Datastream, Goldman Sachs, GIAM

How far can the Fed go without triggering a crash?

The projections presented at the latest FOMC meeting point showed a strong willingness to raise the policy rate towards its estimated neutral level (2.4-2.5%) by the end of the year. The unprecedented series of supply shocks that have shaken the economy over the last two years call for caution when considering any measure of neutral or equilibrium value. With this caveat in mind, we see the Fed funds rate rising quickly into contractionary territory, with probably the strongest and fastest tightening in 30 years. In our baseline scenario, the effective shadow policy rate will increase by more than 500 bps in slightly more than one year. This also change in the "shadow" rate includes the equivalence in terms of Fed fund rates from the impact of the unwinding of bond purchases. The policy rate is then set to remain there throughout 2023.

History shows that when this happens, a recession follows in most cases. However, a closer inspection indicates that the most recent recessions were caused by something else, usual imbalances in the financial system, on top of monetary policy tightening. On this front, the current situation appears less problematic than before the 2007/08 financial crisis. Despite high corporate debt, private sector balance sheets look in good shape, especially regarding the incidence of interest payment on income.

Policy and neutral rate

Dotted: projections

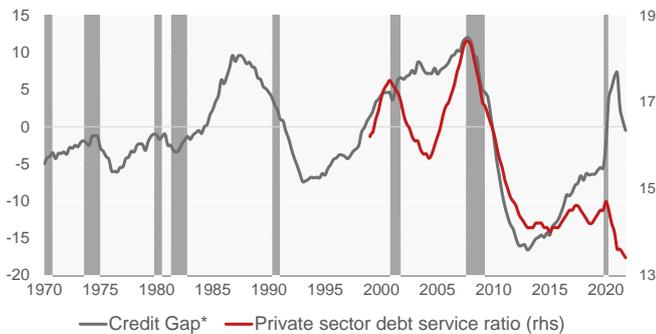


*Atlanta Fed shadow rate for the Zero Low Bound periods
Source:FRB, Atlanta Fed, NY Fed, GIAM

Tightening cycle	Chg in FFR	Recession starts in	Mths after end of tightening	GDP Drop	Neg. Quarters out of total	What else?
Feb 1983 - Aug 1984	315	---	---	None	Strong growth	
Mar 1988 - Apr. 1989	325	Aug-1990	16 mths	-1.4%	2/2	S&L Bank crisis
Dec. 1993 - Apr. 1995	310	---	---	None	Soft Landing	
Jan 1999 - Jul. 2000	190	Apr-2001	9 mths	-0.1%	2/3	Dot Com Bust
June 2004 - Jun. 2006	425	Jan-2008	19 mths	-3.8%	5/6	Real Estate Crash
Oct. 2015 - Jan. 2019	225	Mar-2020	14 mths	-10.1%	2/2	COVID

The recent stress tests carried out by the Fed show that, on paper, the US banking sector can withstand a more severe drop in risk asset prices and activity contraction. In a scenario characterised by a 4-pp increase in unemployment, a 4% drop in GDP and a 55% decline in equity prices, the largest US banks would still end up with double of the minimum capital requirement

Credit gap and debt service



*Deviation of the credit to GDP ratio from its long term trend
Source:Bank for Int'l Settlements, GIAM

The plunge in equity prices experienced year-to-date could remind us of the recession following the 2000 dot com crash. However, equities and other risk assets are now heavily concentrated in the wealthiest households. Therefore, a contraction in financial wealth would likely have a minor impact on their propensity and ability to consume.

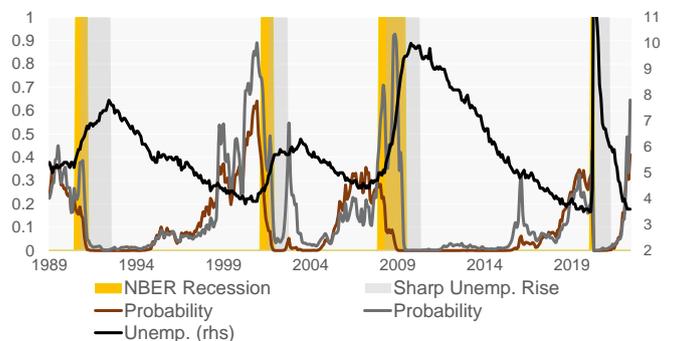
Those betting on a soft or "softish" landing look at a situation like the early/mid-1990s, when monetary policy tightening succeeded in curbing inflation with a marginal impact on growth. However, the comparison with the current situation

is a bit stretched. First, the tightening would be much stronger in a highly leveraged economy with very low borrowing costs for almost 15 years. Secondly, the productive system is probably more fragile than in the past due to the supply shocks that have hit it. Therefore, the economy's capability to withstand a sharp increase in borrowing costs could be more limited. The overall good state of the private sector balance sheets can cushion the blow and limit the length of the recession. That said, limited policy stimulus could lead to a slow recovery: The Fed would have little scope to cut rates and possibly be forced to another round of QE to further loosen financial conditions. Moreover, the possibility of fiscal support is likely to be hampered by looming political stalemate. With the Congress likely to fall in Republican hands, the administration could do little on the fiscal side to kickstart the economy.

At least 45% risk of recession in the next 12 months

Therefore, as Powell himself admitted in his recent hearing before the Congress, the possibility of a recession cannot be dismissed. However, given the peculiar nature of the shock that caused each recession, on top of tighter monetary policy, predictive models based on too narrow a set of variables can give largely different and conflicting results. Therefore, we use information from the yield curve, credit spreads on top of inflation, and the unemployment rate. To train our predictive models, we use two definitions of recession: the standard provided by NBER and another, which seeks to gauge the length and depth of a recession. We define a recession as a period of very rapid yoy increase in the unemployment rate (see Appendix for details). Both models show that, regardless of their definition, the possibility of a recession has increased markedly over the last few months; that of an NBER recession is around 45%, while that of a sustained rise in unemployment exceeds 60%.

Recession risk

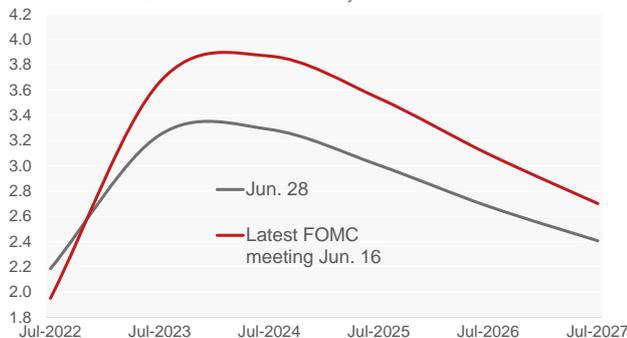


Source:St. Louis Fed, GIAM

This is consistent with the heightened fears markets expressed, which have recently brought down commodity prices and added further stress to risk assets. This, in turn, is leading to a repricing of how high the Fed funds rate can go. Expectations for the peak in rates have declined significantly since the June meeting, reflecting higher concerns for growth, and now forward based on OIS point to outright rate cuts already in early 2023. Information from the yield curve, after accounting for risk and term premia (using a [measure published](#) by the San Francisco Fed), shows that the markets expect the Fed funds rate to peak at 3.3% by the summer 2023. This view is similar to our baseline scenario: a sharp slowdown of the economy and higher fears of a recession will cap the rate rise to 3.1% by year end (against 3.4% shown in the dots) and to a peak of 3.4% (vs. 3.6%).

Expected Path of the Fed funds rate

Derived from a model of the yield curve



Source: San Francisco Fed, GIAM

Appendix

To translate into Fed fund point equivalents the changes in the yield curve, we consider its 2y-10y segment, to avoid the distortions to the short end during the period when the policy rate was at zero, take the first three principal components and use them in a regression where the dependent variable is the fed funds rate. The equation is estimated until December 2007 to avoid the QE period and the coefficients used to construct the “shadow” rate.

We also replicated or adapted a few recent studies by the Federal reserve staff:

The [high-frequency estimate](#) of the neutral rate is derived from a nonlinear regression of the quarterly HLW estimate of the neutral rate on the yield 2, 5 and 10 year Treasury Yield. The estimated coefficients are then applied to the monthly yield series to obtain the monthly neutral rate.

The recession probability model is based on a [recent paper](#), in which recession is defined as every period in which the yoy change in unemployment is in the two top deciles of the historical distribution (i.e. is higher than approx. ¾ point). When choosing the predictors, in order to use all the information on the yield curve, instead of a fixed spread (like the 10yr-3mth), we use as regressors the first three principal components; the credit market variable is the spread between the Baa rate and the 10 year yield, and we add annual headline inflation and the unemployment rate.

IMPRINT

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