Economics

IN FOCUS

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US Recession fears: A picture book

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They're baaack. We never joined the crowd forecasting a US recession in 2023, a consensus view that proved far too gloomy. But while far from a majority, such forecasts are now making a comeback in the wake of the recent uptrend in the jobless rate, and again, we find ourselves among the optimists. The July payrolls figures triggered the "Sahm Rule", as any equivalent rise in unemployment since 1960 has been associated with a recession onset. Other labour market indicators, including jobless claims and nonfarm payrolls growth, haven't been as negative, and some of those warning of a recession backed off that call after strong retail data. Moreover, if the wisdom of crowds gives you some comfort, it's clear that investors, as a group, aren't anticipating a recession, and we have the pictures to prove it.

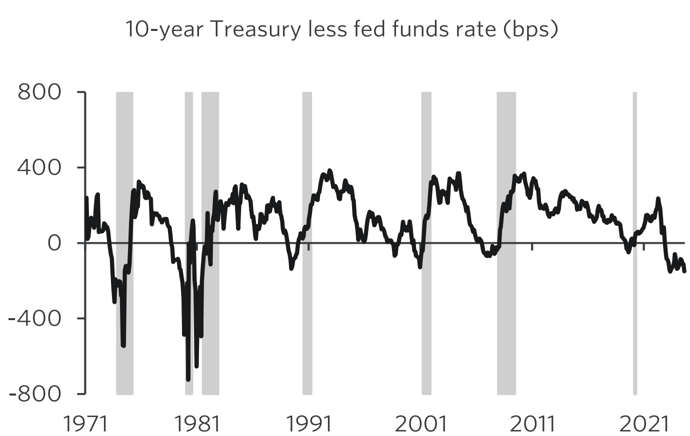
Let's start with a snapshot of the Treasuries yield curve. Parts of it are no longer inverted, because the market is pricing in a sequence of rate cuts that have lowered two year yields. But if we take the slope between 10 year Treasuries and the fed funds rate (which has yet to change), it's still highly negative, as it often is when a recession in looming (Chart 1).

But that needn't indicate that the market expects an outright recession, just as the same warning sign in 2023 failed as a recession alarm bell. It could instead be looking for the Fed to cut rates sufficiently to avoid an economic downturn, and that appears to be a better fit to other financial market indicators today.

For one, if we look at where the futures market is pricing the fed funds rate at the end of 2026, it's still at 3.1%. That's a substantial policy easing, but nowhere near the rock bottom levels that have been associated with recessions in recent decades (Chart 2). It's not below the FOMC's last published estimate of the long-run neutral rate of 2.6%, and is close to our own estimate of the neutral rate. A recession in the next two years would almost certainly see the Fed take rates into outright stimulative territory.

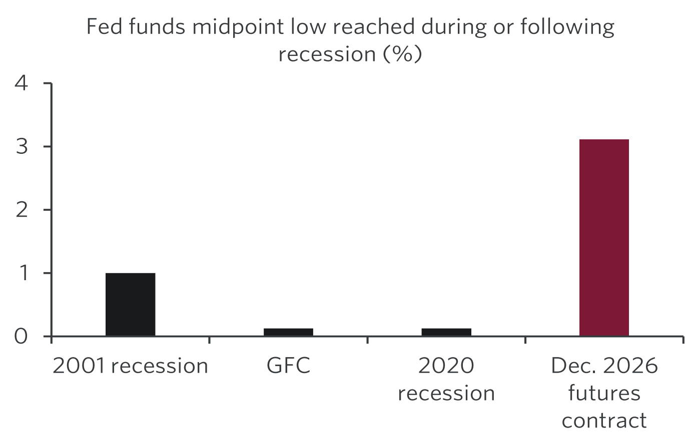
An easing path towards a 3% overnight rate could easily be warranted both as a precautionary measure to prevent a recession, or simply as a reward to the economy for having achieved the Fed's 2% inflation target. Markets are priced for

Chart 1: 10-year to fed funds inversion persists



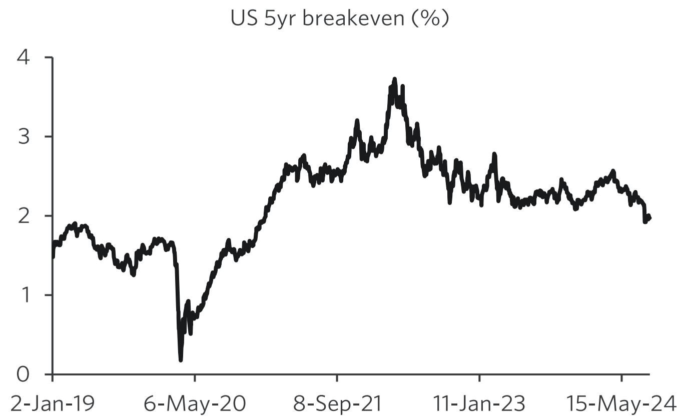
Source: Bloomberg, CIBC

Chart 2: Expected funds rate well above recessionary levels



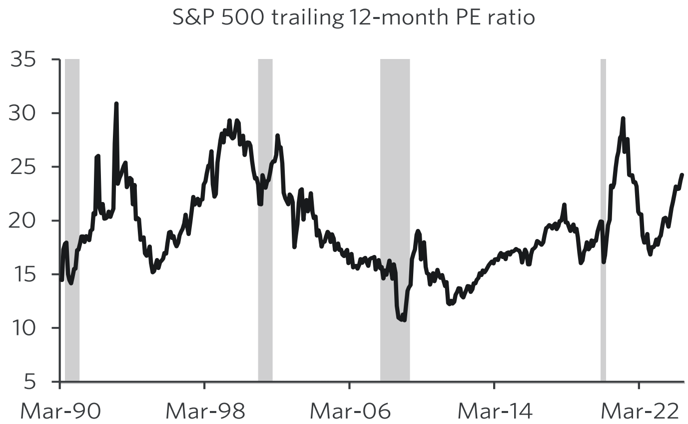
Source: Bloomberg, CIBC

Chart 3: Inflation expected to be on target



Source: Bloomberg, CIBC

Chart 5: Equities not pricing-in a recession



Source: Bloomberg, CIBC

inflation in the next five years to run exactly at the Fed's target (Chart 3), having fully erased earlier fears of persistent inflation. Typically, a recession would see inflation expectations drop to below the target level. Moreover, if, as seems likely, the Fed shares the view that inflation is destined to settle at 2%, keeping rates at current levels, implying a punitive real short rate of 3%, would be unsustainable and an unnecessary drag on growth and employment.

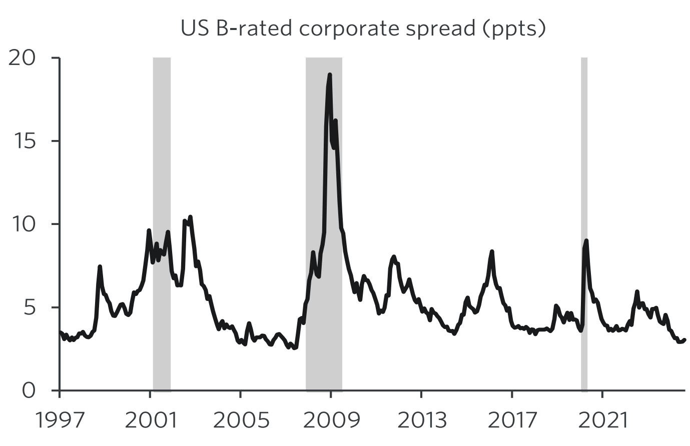
The bond market also expresses its views on recession risks in the corporate space. Recessions trigger defaults and heightened credit risks that widen spreads between corporate issues and Treasuries. While spreads are off their lows, they're still tight relative to what we see in a recession (Chart 4).

Finally, we can look at equities. While Wall Street stocks have had their jittery moments, there's clearly no material fear of a recession. Trailing earnings multiples haven't plunged (Chart 5), and while that's been helped by lower bond yields, it's unlikely that investors would be paying that much for each dollar of trailing earnings if they were anticipating that future earnings would be dramatically weaker.

So the bottom line is that investors, as a group, aren't buying into the US recession story at this point. Instead, the market's behaviour is consistent with our view that rates are coming down because inflation has been vanquished, and that an easing in policy would help avoid a true economic downturn.

Markets aren't always right of course. But given that they are forward looking, those who see only a moderation in growth, rather than an outright US recession, can take some comfort that they're in good company.

Chart 4: Corporate spreads not signalling recession



Source: FRED, CIBC

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