

## **“Red Light - Green Light!” - Now: Yellow Light?**

by

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First the Coronavirus downturn of March 2020 to April 2020, which we previously compared to the “Red Light - Green Light” episode of the popular Netflix series “Squid Games.” Note that we did not refer to this episode as a “V-shaped recession” like some economic forecasters did. This was not a “lights off - lights on” episode that only lasted two to three months. When we tried to switch the lights back on, some lights were no longer shining; this goes both for firms and workers. For example, California still has not reached labor force and employment levels that prevailed prior to the pandemic. By contrast, the Inland Empire has more than fully recovered its pandemic job losses, primarily due to the success of the logistics industry and changes in preferences on how people shop. As for the nation, employment was fully restored in August, and while GDP has fully recovered from its plunge in the first half of 2020, it remains below the pre-pandemic growth trajectory.

Then came the high inflation rate, fueled both by large stimulus payments and supply chain problems. Once the stubbornness of high inflation was recognized, the Federal Reserve commenced a series of relatively large interest rate hikes to bring down both the inflation rate and the expected inflation rate. The latest one occurred on September 21, notably a third consecutive three-quarter percent increase that moved the Federal Funds Rate to the range of 3% to 3.25%. Interest rates that you can relate to, such as those paid on credit cards, car loans, mortgage rates, and other types of consumer and business lending are expected to rise in line with the rate set by the Fed.

The ultimate question from these events is, will we see a “soft landing,” meaning a reduction in the inflation rate without a recession, or will the economy face a different fate? If not, will the U.S. economy experience a double-dip recession similar to what we saw in the late ‘70s and early ‘80s? Or are we already in a recession, given that GDP fell during the first two quarters of 2022?

Earlier this year, we were skeptical about the U.S. moving into a recession, despite mixed signals on the economy’s health. Although GDP fell during the first half of 2022, the labor market did not show any signs of slack. Job growth continued at an impressive rate, and other economic indicators continued to advance. However, as economic data continues to roll in, we have revised our outlook slightly. While we are still not calling for a recession within the next 12 months, the probability of such an occurrence has increased. We want to describe what we see now and explain why our economic sensors still have not started to sound the alarm.

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Let's compare the current situation with that only half a year ago, at the end of March. Back then, our forecast model estimated that the probability of a recession within a year was close to 0%. There were some yellow lights then, notably the outlook for GDP and the fact that inflation had not yet subsided. But there were also many more green lights at the time. Now six months later, our forecast model has indeed increased the probability of recession. But even with the most recent reports on the economy, it attaches only a low seven percent probability to the likelihood of a recession starting in a year.

As we see it, the main drivers and the information they reveal for the slightly increased probability are:

1. The yield curve, which measures the spread between the yields on the 10-year Treasury Note and 30-day Treasury Bill, has narrowed from +1.80% in March to +0.41%. An inverted yield curve, meaning the spread becomes negative, dramatically increase our recession probabilities. Green light just turned yellow. Keep an eye on this sensor, it is our main indicator.
2. Housing starts are virtually unchanged compared to a year ago, a sign that this important component of the economy has shifted into neutral. Yellow Light. We predict housing prices to fall given the higher mortgage rate payments - households will see a reduction in terms of the price that they can afford for a given monthly payment set aside, for example \$3,000. Some consumers won't be able to afford bidding for houses at all, and therefore sales will also decline. There are also fewer incentives for builders to start new housing projects.
3. The sharp drop in consumer confidence, which may bring a slowdown in consumer spending. The consumer sector accounts for two-thirds of total spending in the economy. The drop in consumer confidence is measured by the University of Michigan Consumer Sentiment Index. Bright Red. Compared to a year ago, the index has gone south, big time. The reading is more pessimistic than during the height of the Great Recession. High inflation rates can only be part of the explanation. The Economist points to the following additional explanations: disappointment about the fact that the end of COVID-19 has not brought us the booming economy, and that nominal disposable income is falling given the end of the government handouts. Adding inflation to this, then inflation adjusted average disposable incomes have fallen even more dramatically.
4. The flattening of the unemployment rate. Yellow light. The so-called Sahm index compares recent unemployment rate changes to those from a year ago. As the unemployment rate flattens out or even increases slightly, and the average from a year ago continues to decline, the Sahm index warns of a recession in the next 12 months.
5. The level of average hours worked in the manufacturing sector from a year ago is almost unchanged. Yellow light. Manufacturing is more sensitive than service sectors to economic

cycles which makes it an excellent sensor for the underlying strength or weakness of demand for U.S. goods, both domestically and abroad.

Recessions are a part of every economic cycle, and can be disruptive to many, if not all, sectors of the economy. The aim is to anticipate both the timing and magnitude of the next recession so as to prepare for it. Think of it as a volcanic eruption. There are severe consequences if you are not adequately warned of an imminent outbreak. The evidence above suggests that the chance of a recession has increased at this time, but remains quite low for now. No need to leave the island yet.