US Macroeconomics

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Don’t Look in the Rearview Mirror

Real GDP and employment, two of the most closely followed economic releases by financial professionals, tell us nothing about where the economy is going. Rather, they tell us where the economy has been. They are coincident or lagging economic indicators. The fact that growth was a positive 1.1% last quarter or that employment gains have averaged 345k over the past three months does not tell us where the economy will be a couple of quarters from now.

As we discussed yesterday, **real GDP expanded at a solid 2.3% in Q2 2008 after the economy entered what would be the deepest downturn since the Great Depression in January 2008**. Financial history also shows that nonfarm payrolls are positive right up to the peak in economic activity at which point they turn sharply lower once the downturn has begun. Consequently, investors must continue to focus on those variables that are anticipatory and tell us about the economy’s underlying momentum.

The three series we continue to watch intensely are the **Index of Leading Economic Indicators** (LEI), the **2s/10s treasury curve** and the Fed’s **Senior Loan Officers’ Survey** (SLOS). The LEI is now down 12 months in a row and nearly 8% below where it was in March 2022. The weakness has been broad-based, with 70% of the subcomponents pushing the series downward. This tells us that a recession is unavoidable at this point.

The 2s/10s treasury curve remains inverted at around -55 basis points (bps), thus marking the 10th month of inversion. While the slope is up from a cyclical low of -110 bps in March, this is only because the futures market is discounting a pivot toward Fed easing later this year. In other words, the bond market expects the 2-year treasury, which is currently yielding around 4%, to yield a lot less over the 18 months beginning this November. **The negatively sloped yield curve is a primary reason why the SLOS showed a sharp tightening in lending standards as of this past January**.

When the next SLOS is released on May 8th, it is almost certainly going to show much tighter lending standards for small- and medium-sized banks because the report will capture the SVB collapse. Like the LEI and the yield curve, lending standards are leading indicators of economy and the labor market. Until the Fed reduces interest rates, the curve will remain inverted, lending standards will stay tight, and money and credit creation will slow. In turn, this will feed negatively into the LEI.

It must be noted that just because this is a widely advertised recession — the Wall Street Journal had reported that roughly 60% of surveyed economists predicted a 2023 downturn — does not mean there will not be one. Instead, **investors must ask themselves what kind of recession (and recovery) are we going to get?** This is the key question.

Will the expected downturn be short and shallow, or will it be long and deep? Perhaps it will be mild but with a jobless recovery. Or maybe the recession will be deep with a V-shaped recovery? For now, we are in the short and shallow camp because we expect the Fed to make an aggressive pivot toward easing later this year once the unemployment rate breaks above 4%. To be sure, we are not there yet as the unemployment rate still sits at 3.5%. And the Fed is not there either. If anything, Chair Powell is likely to err on the hawkish side, repeating that inflation is too high and needs to fall much further. Hence, interest rates will stay restrictive until that happens.

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