Is the economy headed for recession?

An Allegory

The economy is like an old pickup truck, heavily laden with produce. At times, absurdly overloaded with baskets of apples and crates of cabbages. When the truck "hits a bump", produce might fall off the truck if it is heavily laden and the bump is sufficiently jarring.

In this allegory, baskets of produce represent jobs and loans. The bumps the truck hits represent unexpected, downward shocks to NGDP. If the nominal bump is hard enough, some loans will fail and jobs will be lost, think of a crate of cabbages (jobs) sliding from the top of the heap and knocking off a basket of apples (consumer loans) with it. The Fed's job is to be forward-looking and try to avoid bumps or compensate when you hit them. In this way, forward guidance and monetary operations could be seen as the steering wheel, trying to avoid bumps, while compensatory growth to get back to trend could be seen as the breaks and accelerator, to smooth out bumps you do hit.

If you, as a farmer who drives his produce to market, go long enough without hitting a bump, you grow lax. When the ride has been smooth for a while and sales are strong, you start taking some risks stacking extra crates and baskets in the back. This makes your cargo more vulnerable to bumps.

When nominal income is volatile, firms and borrowers are careful about taking on debt, and maintain large cash balances, to smooth

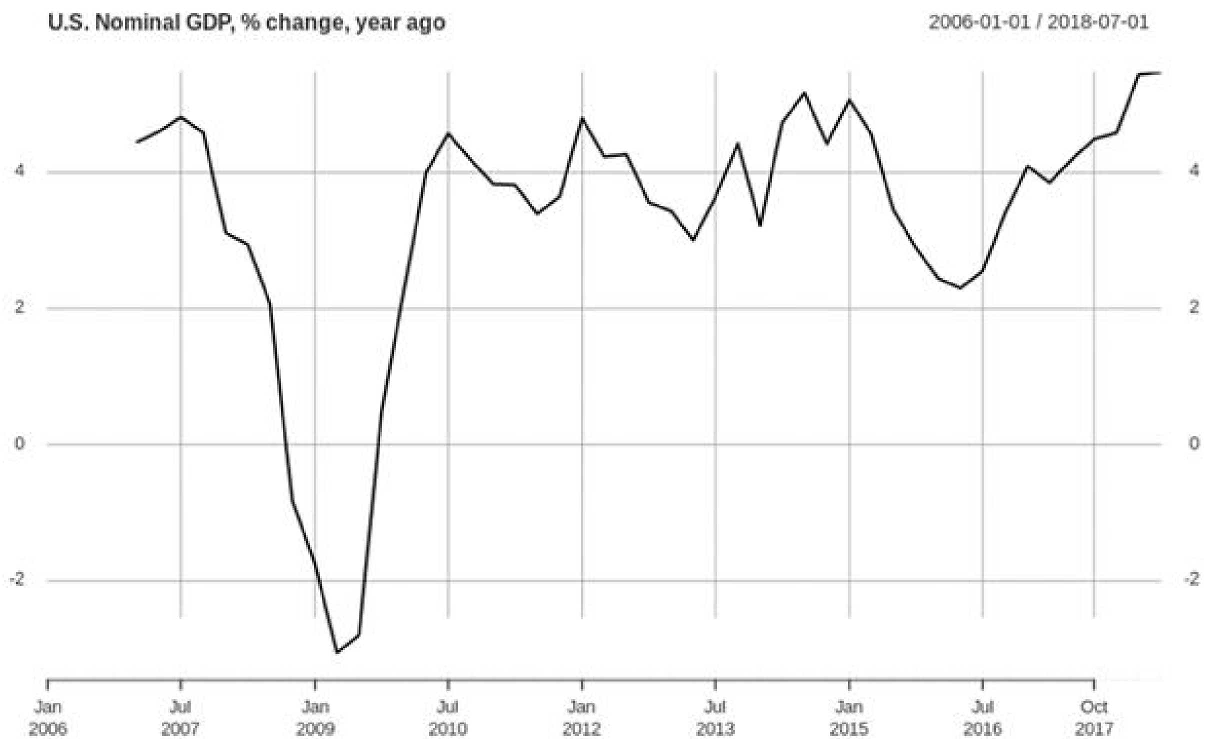
out volatile income. Hong Kong, before integrating with China, was an example of this. The pegged currency, dependence on trade and tiny size of the city-state made its aggregate nominal income quite volatile, yet there was not as much business cycle volatility as you might have assumed, because this volatility was anticipated.

Before 2008, the US economy was quite sensitive to slowdowns in nominal growth. A bout of slow nominal growth, not necessarily an absolute decline in the level of income, would kick off a cascade of layoffs, defaults, and corporate bankruptcies. After 2008, so many of the precarious 'baskets and crates' had been 'knocked off the truck' that the economy could take a solid nominal punch without going into recession.

We saw this in the 2014-2016 period when year-over-year nominal GDP growth sank, in one quarter, nearly as much as it had during the 2001 recession, yet unemployment merely halted its downward trend. There was no recession in 2015/16 because the economy was already **somewhat depressed**, and a "double dip" had been feared for years. In 2015/2016, firms, especially banks, were still keenly concerned about another recession, and had been hiring, lending and otherwise taking risk carefully. One wonders if this is the case today.

The R Word

The NGDP plot looks as good as it has in more than a decade. Year-over-year income growth is holding over 5.4% for the past two quarters and judging by our NGDP model, the Atlanta Fed's GDPNow, and the Hypermind market, set to post good numbers this quarter and next. Yet we see clickbait headlines on financial media sites speaking of recession.



Those proclaiming imminent recession point to the inverting yield curve. Yields on 3-month Treasuries have nearly caught up with those of the 10-year. Historically, this situation has more often than not foretold a recession within the next year. Such an association with yield spreads and recession is consistent with the view that long-term yields are a forecast for future short-term yields. When short-term yields are close to long-term yields, that’s a forecast that the current Fed tightening campaign is at its end, that current monetary policy is expected to strangle the economy, necessitating a period of rate cutting, which is usually associated with job loss and loan failure.

Bringing the economy 'up' as high as the Fed has (and really it isn't so high) might have made it more fragile. The current levels of business investment and consumer borrowing must collectively assume something like 4.5% NGDP growth, higher than we've seen on a sustained basis since the last recession. If NGDP growth comes crashing down to 3% or 2%, as it did in 2015/16, it's safe to assume this will result in more than a flat-lining of the unemployment rate. The NBER might even deem it a recession.

We can calm our nerves by looking at shorter-term spreads. The 2-year/3-month spread is at 0.5%; this means roughly, that markets expect 50 basis points of rate hikes over the next two years. This is not consistent with a recession. If there were to be a recession, the fed would have to cut rates, and it would probably not get them back to the current level of around 2.25% in such a short period, let alone 50 basis points above where short rates are today. Still, two years and only 50 basis points of further rate rises is paltry and means the market doesn't think the economy is strong enough to endure a slew of further rate increases.

The yield curve is not destiny; it nearly inverted in 1986 and inverted in 1998 without a recession. Our NGDP model suggests moreover that markets expect NGDP growth around 4.2% over the next year, which will hardly cause a recession. This is consistent with what the 2-year/3-month spread tells us, two more rate hikes, followed by a period of crummy growth, say averaging between 4% and 4.5% nominal. The market tumble in the past month and a half is the market realizing that the Fed won’t be chasing a hot economy in 2019, reining in 5%-6% nominal GDP growth, the way Greenspan did before he handed the reins over to Ben.

There is clearly a lot of market uncertainty, given the wild swings we have seen. Our job is to read the markets, not to out-guess them, and this is all we can responsibly do. As it stands today, markets are not forecasting a recession.