

## CIO Viewpoint

## US recession – are we nearly there yet?

### Investment Solutions

14 October 2019

**By many measures, this may look an odd time for investors to be thinking about the timing of a US recession. Unemployment is close to a 50-year low, the S&P500 has gained 55% in the last five years and consumption is proving resilient. However, there are powerful and sometimes contradictory factors at play.**

The US President, battling impeachment, repeatedly claims credit for “the best economy in US history” while his opponents vie for the Democratic nomination to run against him next year. At the political level, as the Nobel-prize winning economist Paul Krugman [recently wrote](#), it used to be simple; American presidents were re-elected when the economy was expanding, and lost their jobs in a recession or when unemployment rose.

Like many investors, we are looking for signs that the decade-old bull market is weakening. After beginning a rate-raising cycle in 2015, lacklustre inflation, a slowing global economy and trade disruptions with China persuaded US Federal Reserve to reverse course this year. This month, it is widely expected to cut interest rates for a third time. Still, the President has been a vocal critic of Fed policy. “They don’t have a clue” Mr Trump [tweeted](#) 9 October, and blamed the US manufacturing slowdown on the Fed’s failing to cut interest rates faster to weaken the dollar.

Trump wants a weaker dollar to boost exports, one of his key policy bets. The US/China trade dispute is testing his “best economy” claim and repeated escalation has [nullified](#) the benefits from the January 2018 tax break for most Americans, Trump’s only legislative success to date.

The US has now called off threats to impose new tariffs this week in return for a commitment from China to raise purchases of American farm products, greater currency intervention transparency and openness to foreign financial service companies. The truce, if it holds, calms the worst immediate fears of more escalation, although there is no sign that tougher problems such as intellectual property, forced technology transfer or state subsidies, have been touched upon.

Consumer spending accounts for more than two-thirds of US economic activity, and for now, appears to be holding up. It rose 1.1% to a record in the second quarter while consumer sentiment, measured by the University of Michigan, this month rose to its highest level since July. Any impact from the tariffs, which started out on raw materials and quickly spread to consumer goods, may prove significant in the presidential election, if not fully solved soon, and potentially even act as a catalyst for a recession.

### Factories falter

The tariffs are also taking the blame for a deterioration in US manufacturing. The US ISM (Institute for Supply Management) index in September fell 1.3 points to a ten-year



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### Key takeaways

- The US faces political turmoil and contradictory economic signals
- We are watching for signs that the decade-old bull market is weakening
- US consumer spending is holding up and unemployment is still low but manufacturing and services are in decline
- The Sahm Rule offers a new indicator
- While there is some weak data, we see no short-term recession threat.

**Important information:** Please read the important information at the end of the document.

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low of 47.8, well below expectations. Within that, measures of employment, production and new orders all declined over the month. The more-than three-decade old ISM factory survey has only fallen lower six times, the last time in March 2009.

For things to worsen, we're watching for signs that it bleeds into consumer purchasing power as measured through jobs and wage growth data, oil prices, housing and savings rates.

US unemployment is at 3.5%, a 50-year low, and data published 4 October showed revised non-farm payroll job increases are consistently above 150,000 per month and average hourly earnings have risen 2.9% over the last year.

Nevertheless, real average hourly [earnings](#) declined 1.2% over the 12 months through September and there are signs that the US economy as a whole is slowing. The ISM's Non-Manufacturing purchasing managers' index fell in September to 52.6, its lowest reading since August 2016.

### Oil, housing and savings

Traditionally an oil price spike has invariably preceded a US recession. This was true in 1958, in the 70s, early 80s, of the 1990-91 first Gulf War as well as 2008. Recent tensions in the Middle East have only temporarily lifted oil prices, and once adjusted for inflation the real cost of oil to consumers remains much lower than two or three decades ago. This makes oil a much less likely trigger today as the US approaches self-sufficiency.

Another element in favour of continued consumer spending is the confidence demonstrated by new home sales, which increased 6.4% through August, compared with the same eight months a year earlier. House sales have responded quickly to cheaper credit so for now there is no sign of the drop in residential investment that preceded the Great Financial Crisis.

The average [savings rate](#) should also provide a reasonable buffer, rising to 8.1% in August, well above its 20-year average of 6%.

### An old tool

Historically, an inverted US yield curve (when short-dated Treasury yields are higher than long-dated yields) has proven a

reliable recession indicator, for example in the early 2000's and in 2007. Today, 3-month Treasuries and the 5-year note are both yielding 1.67%, and the curve has flattened compared with a month ago. But not every maturity is converging and so rather than sending a clear recession signal, we need to look elsewhere.

### A new rule

One measure gaining much [attention](#) is the Sahm Rule, named for Claudia Sahm, Chief economist at the Federal Reserve Board of Governors. The rule says that an economy is in, or about to enter a recession if the unemployment rate's three-month average has risen by at least half a percentage point above its low of the past 12 months. The rule, [adopted](#) by the Federal Reserve Economic Data this month, holds true for every US recession since 1970 (see chart). Ms Sahm's goal was to provide a tool to trigger economic stimulus without waiting for enough data to pass through a political approval process.

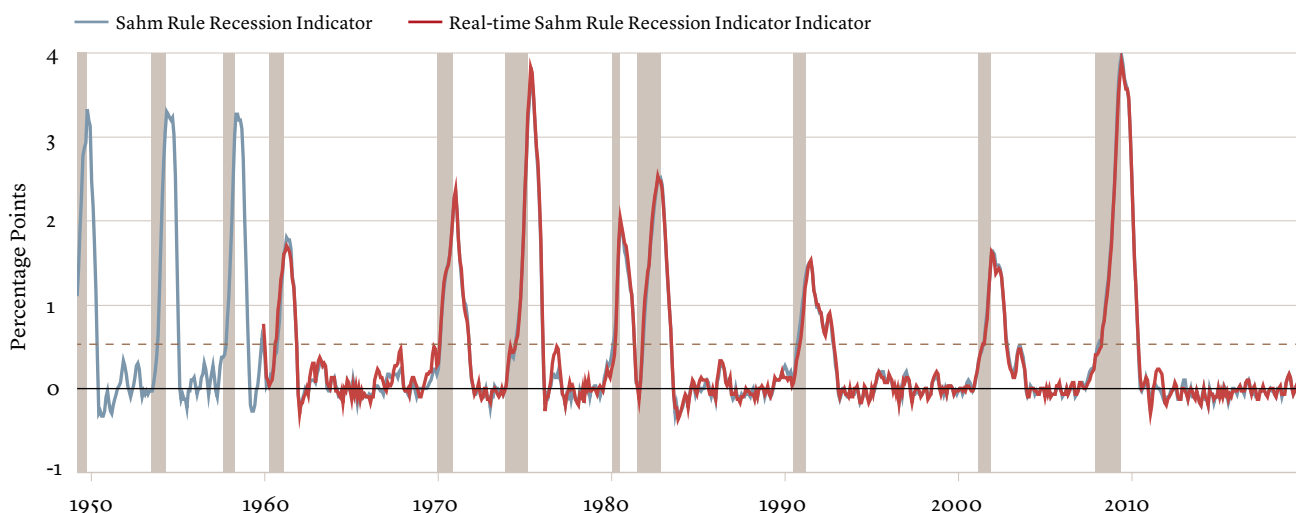
Using this tool, the answer to the back seat, recession-destination question, "are we nearly there?" is "not yet." At the Sahm indicator's current reading of 0.0, there is a 5% chance of a recession within three months and a 20% probability within 12 months. For clarity, that probability rises to 97% at every time horizon when the reading is 0.50 or above.

### Room for manoeuvre

We should also not forget that there is still some policy resilience built into the US economy. Unlike many central banks, the Fed still has some margin to cut interest rates, even if those cuts are not as rapid as advocated by the President.

For now, there are few indications that a recession is on the horizon. The US job market remains strong, companies are not laying off workers and purchasing power and consumption are holding up. While [headline growth](#) is forecast to slow to below potential in the coming quarters, offering a more sober outlook, it does not yet spell recession.

Chart – The Sahm Rule does not point to a recession



Source: Sahm, Claudia, [research.stlouisfed.org](http://research.stlouisfed.org)

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