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US Macroeconomics

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Walking into a Recession

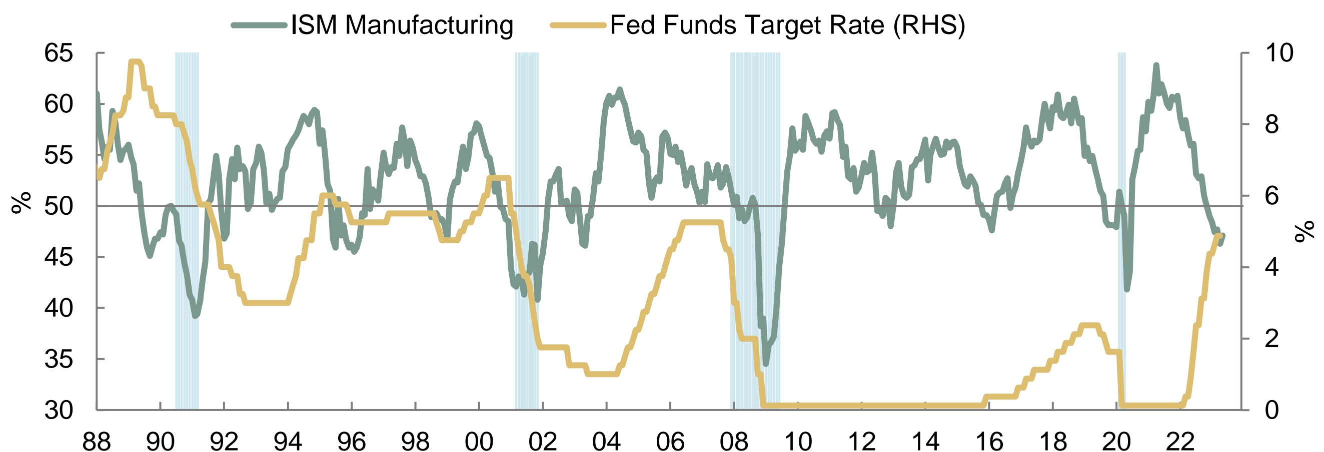
The factory sector remains in recession, which is evident from the latest manufacturing ISM data for April. The survey registered its sixth sub-50 reading in a row at 47.1 versus 46.3 in March. This is the longest stretch of contraction since the period from September 2008 to July 2009. Such readings are associated with a recession. Look at what happened in the runup to the 1990-91, 2001 and 2008-09 downturns. Will this time be different?

The last couple of times when the ISM had a similarly long stretch of underperformance was 1995-96 and 1998 but the economy avoided a recession. Why? In each instance, the Fed quickly pivoted to rate cuts, reducing the funds rate 75 basis points (bps) during both episodes. See the accompanying chart below. In response, the factory sector turned upward. Kudos to the Fed. Unfortunately, this is not the case today.

The Fed is set to raise interest rates another 25 bps following this Wednesday's FOMC meeting, thus bringing them to a range of 5 to 5.25%. In the last 13 months, the funds rate will have risen 500 bps, making the current tightening cycle one of the fastest and largest on record. Is it any wonder the factory sector is shrinking? We were not able to find another time in history when the manufacturing ISM was down six months or more in a row and the Fed hiked interest rates.

To make matters worse, **the Fed is unlikely to signal a policy pivot anytime soon especially considering the latest inflation and wage data**. Last quarter's core PCE deflator and the employment cost index both surprised to the upside. Powell cannot signal a turn in policy later this year because financial conditions would ease—interest rates would fall, credit spreads would tighten, the dollar would soften, and the stock market would rally. This is the argument Fed policymakers have made many times before.

Thus, **we expect Chair Powell will reinforce the need to keep rates restrictive until policymakers are more confident that core inflation is trending back to 2%**. The problem with this line of thinking is that by the time investors are sure the inflation is going back to 2%, the economy will be in a recession and potentially a deep one. Remember that inflation is the most lagging of economic indicators. One can only imagine how long it will go if there is a deep recession beginning later this year. Between now and then, the manufacturing ISM is poised to probe new lows.



Sources: FRB, ISM, Haver, SMBC Nikko

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