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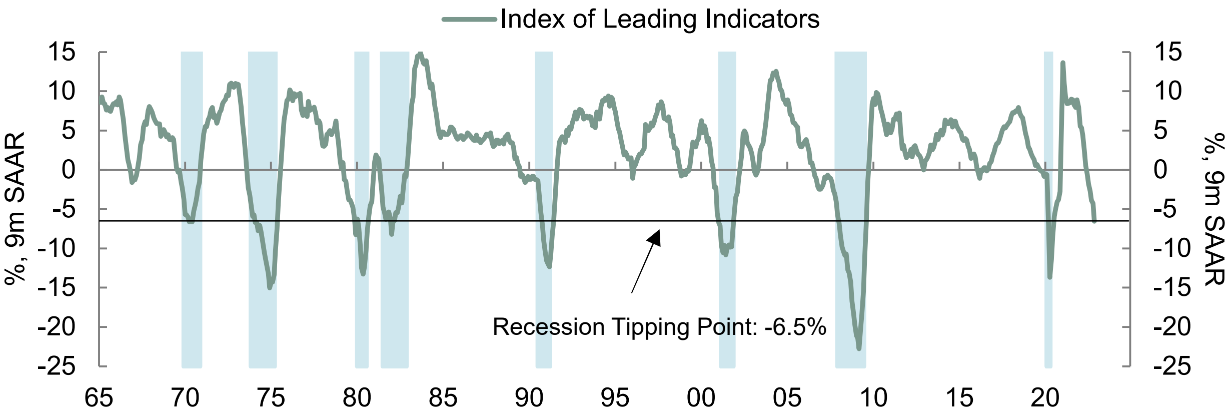
At the Recessionary Tipping Point?

We recently learned that the Index of Leading Economic Indicators (LEI) fell 1.1% in November, the ninth drop in a row and the biggest non-pandemic-related decline since March 2009 (-1.7%). **In the past, recessionary tipping points typically have been signaled by six consecutive declines in the LEI, so the current string of losses is particularly troubling**. Indeed, over the last nine months, the LEI has fallen at a 6.5% annualized rate. As we can see in the chart below, the economy has always either been in recession or soon entered recession when this has happened before. This time is unlikely to be different given the fact the Fed has been aggressively raising interest rates and shrinking its balance sheet.

Monetary policy works with long and variable lags. **While the housing market is already in recession, other parts of the economy have not fully felt the full impact of the Fed's actions which only began nine months ago**. Moreover, according to the median dot on the fed funds histogram, policymakers are pledging to do more, as they project another 75 basis points in rate hikes in 2023. The fact the economy likely expanded briskly last quarter provides little solace.

As of December 23, the Atlanta Fed GDP Now Model predicted a 3.7% gain in Q4 2022 real GDP growth. However, as we have previously documented, **the economy frequently generates healthy gains in economic output around the onset of recession**. For example, real GDP grew 3.9% in Q4 1973 which remarkably was the quarter the economy entered recession. The same event occurred in Q3 1981 when the economy grew 4.5% in the quarter the economy entered recession. Even the recent 2001 and 2008 downturns showed a near similar pattern. Real GDP grew at relatively fast 2.4% and 2.5% rates, respectively, in the quarter immediately before these downturns began.

The reason GDP is not a good gauge of future activity is because most of its subcomponents are either coincident or lagging indicators of economic activity. In other words, GDP does not tell us where the economy is headed but rather where it has been. Investors care about the inflection points, which is why the LEI is so valuable. Going forward, the key issue is how deep the projected downturn will be. The 1974-75 and 1981-82 recessions were severe. And the 2008-2009 downturn was the deepest to that point in the post-WWII period. The 2001 recession was the mildest on record. Because we expect inflation to fall faster than many predict and the Fed to pivot much quicker than what their official forecasts show, we are currently in the "mild" recession camp. Stay tuned.



Source: Conference Board, Haver, SMBC