The Economy and Financial Markets in 10 Slides

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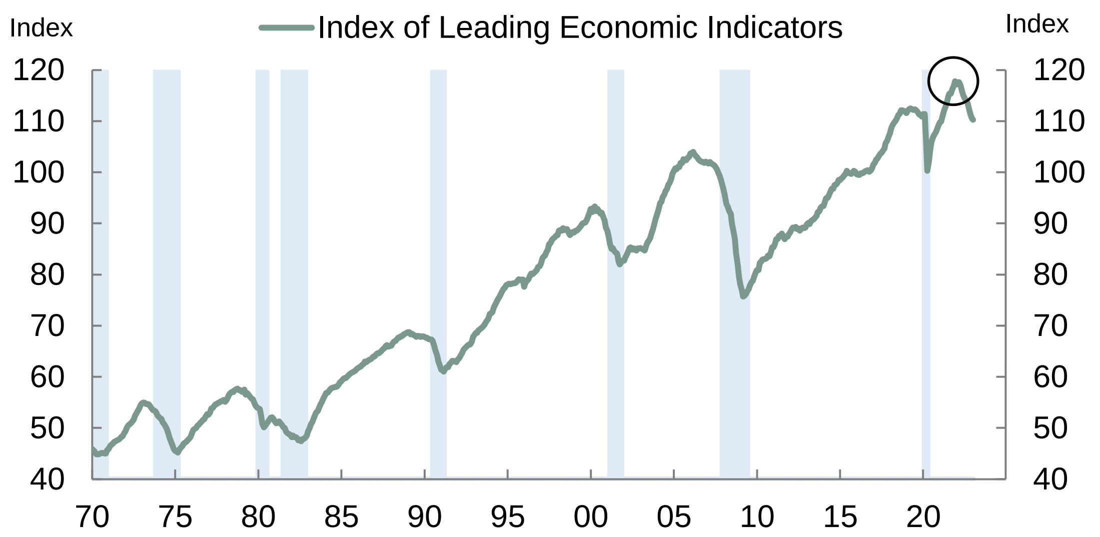
When Does the Recession Begin?

Historically, the Index of Leading Economic Indicators (LEI) tops out 11 months before the peak in GDP. But the lead time can be much longer, as it took 21 months from the 2006 peak in the LEI to the 2007 peak in real GDP. If past is prologue, the economy is on track to enter recession by this coming September.



Source: Conference Board, NBER, SMBC Nikko

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Watch the Unemployment Rate

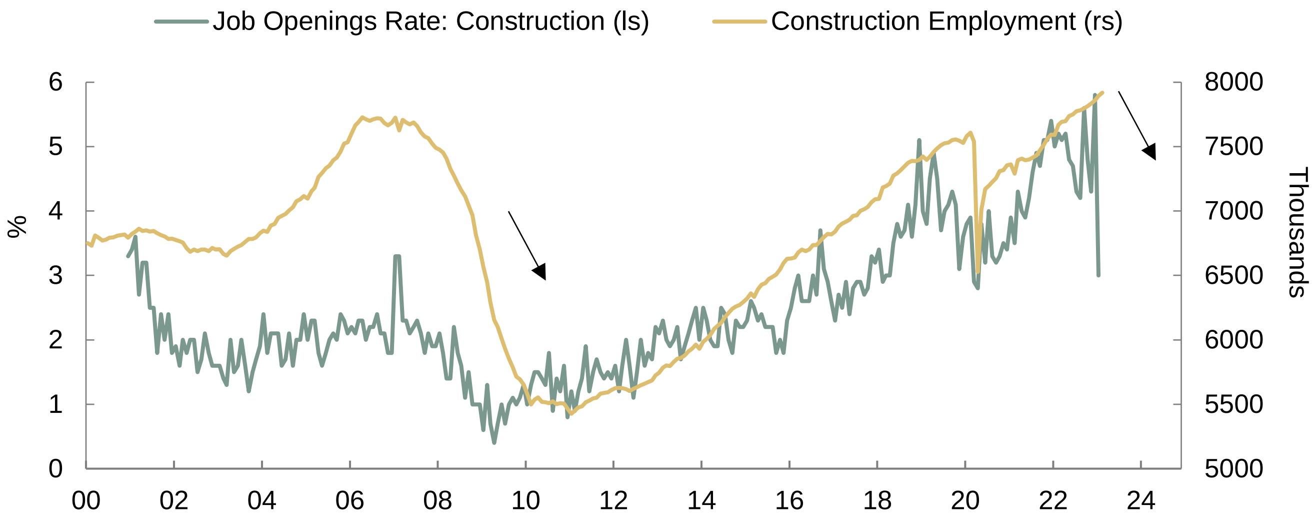
The unemployment rate is also an excellent leading indicator of the economy. In the past, it bottomed six months before the onset of recession, rising an average of 40 basis points from its cyclical low. This means that if the unemployment rate rises to near 4%, a recession would almost certainly have begun.

Trough in Unemployment	Peak in Economic Activity	Lead Time	Rise in U3 from Trough to Recession Onset (bps)
May 1948	November 1948	6	30
June 1953	July 1953	1	10
March 1957	August 1957	5	40
February 1960	April 1960	2	40
May 1969	December 1969	7	10
October 1973	November 1973	1	20
May 1979	January 1980	8	70
July 1981	July 1981	0	0
March 1989	July 1990	17	50
April 2000	March 2001	11	50
May 2007	December 2007	7	60
	Avg ->	6	40

Sources: BLS, NBER, Haver, SMBC Nikko

On the Cusp of Labor Market Weakening

The construction sector is a leading indicator of the labor market and the broader economy. While construction jobs have increased 13 months in a row and are at an all-time high, jobs openings plunged last month. This points to a significant pullback in employment. Indeed, we estimate that over 700k construction jobs are at risk, which is large enough to push the unemployment rate up nearly half of one percentage point.



Source: BLS, Haver, SMBC Nikko

The Bond Market Always Knows

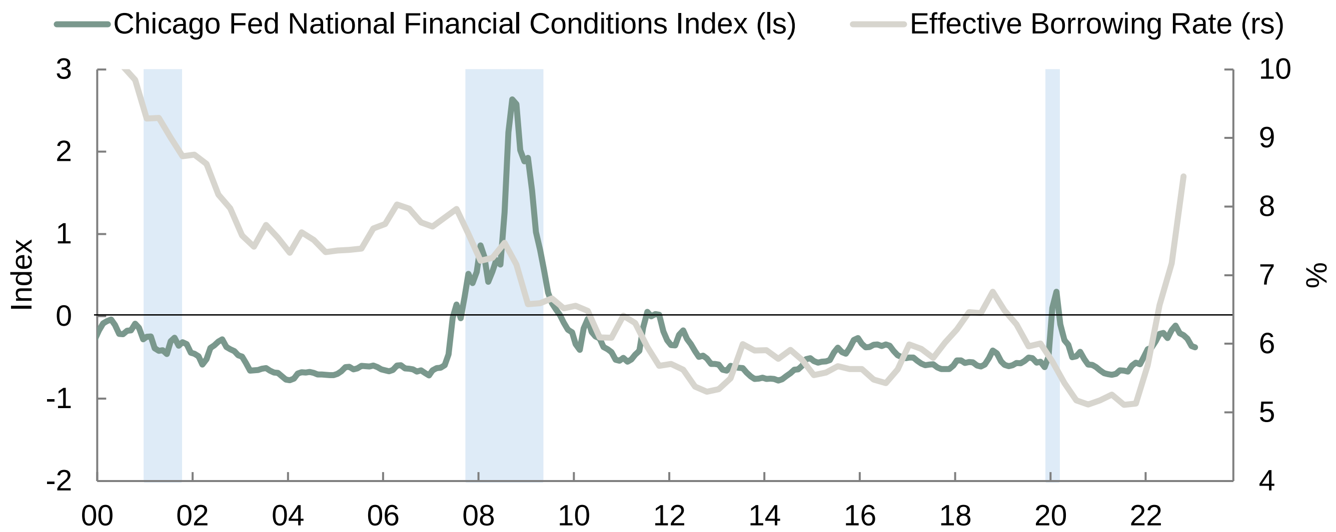
When the 2s/10s treasury curve inverts, a recession always ensues. The average lead time from inversion to peak economic activity is 13 months. Since the curve inverted last July, this implies an August 2023 recession start date.

Date of Yield Curve Inversion	Peak in Economic Activity	Lead Time
September 1956	August 1957	11
July 1959	April 1960	9
December 1968	December 1969	12
March 1973	November 1973	8
September 1978	January 1980	16
September 1980	July 1981	10
January 1989	July 1990	18
February 2000	March 2001	13
February 2006	December 2007	22
	Avg ->	13

Sources: Federal Reserve, NBER, Haver, SMBC Nikko

The Fed is Looking at the Wrong Metric

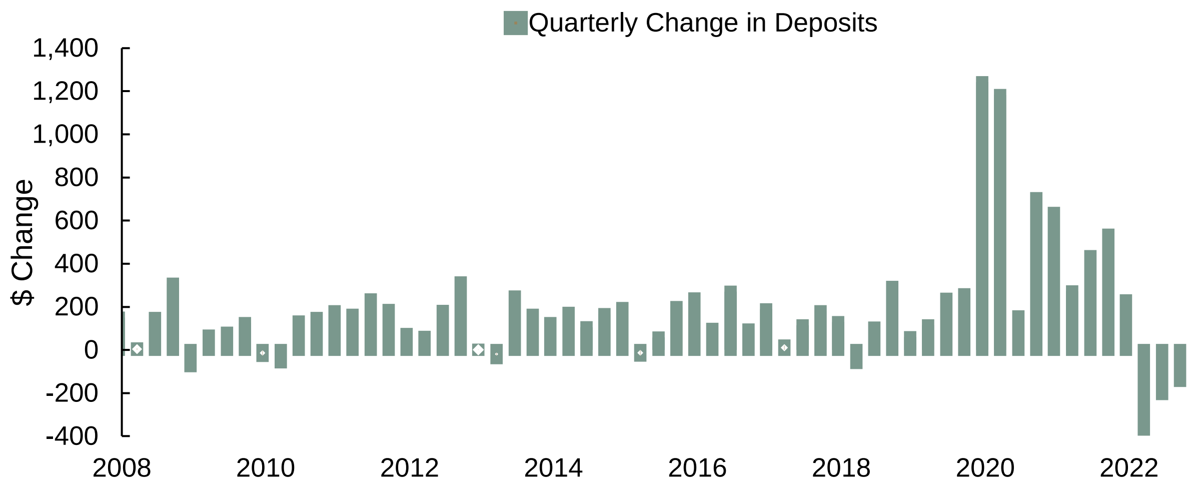
Monetary policymakers have remained hawkish because their measures of financial conditions have not tightened much. But this is clearly inaccurate because financial conditions for US consumers, who account for 70% of GDP, are extremely tight. Household borrowing costs are at their highest reading in two decades. Moreover, the consumer may also have difficulty obtaining financing if small- and medium-sized banks tighten lending standards.



Source: Bloomberg, Federal Reserve, SMBC Nikko

Massive Outflow of Deposits

Last year, commercial banks lost a record number of deposits mainly because bank customers took their business elsewhere in search of higher yields. Unfortunately, this trend has accelerated, and now there are concerns about systemic risk. The Fed needs to provide more liquidity thereby lowering funding costs. And a broader government guarantee for depositors may also be needed.



Source: FDIC, FRB, Haver, SMBC Nikko

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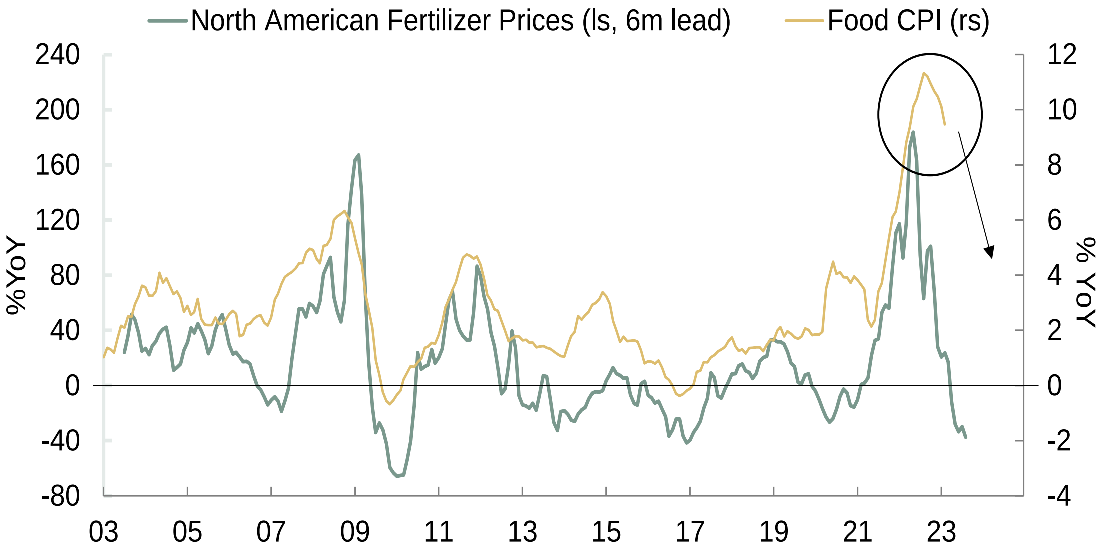
Inflation Peaked

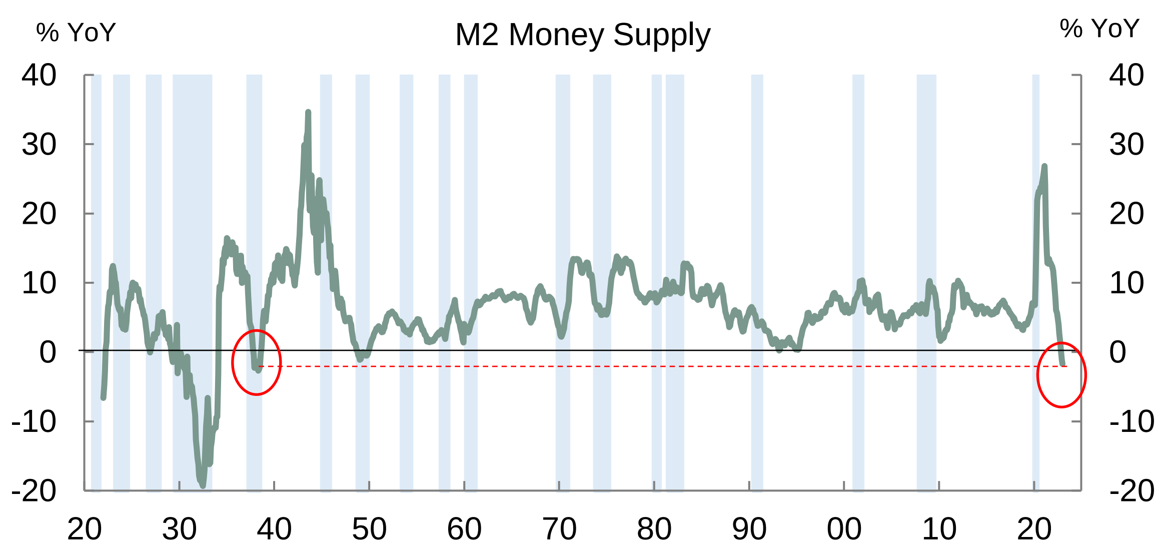
Food prices account for nearly 14% of headline inflation, and they were a key factor pushing prices higher last year. Fortunately, the collapse in fertilizer prices bodes well for lower food costs in the months immediately ahead. Energy costs are moderating, too, and there is increasing anecdotal evidence that housing costs are moderating as well.



Source: Bloomberg, Green Markets, BLS, SMBC Nikko

A Record Surge is Followed by a Record Decline

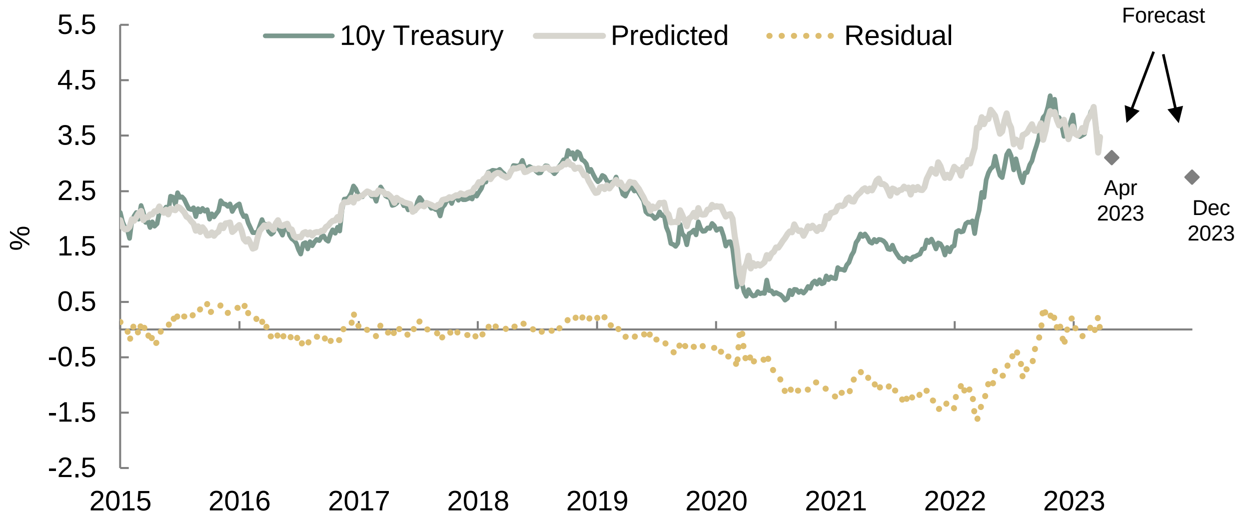
The money supply had soared to heretofore heights as the Fed monetized unprecedented fiscal largesse. But now that the printing press is running in reverse, M2 has collapsed. This tells us that aggregate demand should slow, and price pressures should meaningfully moderate. With recession on the horizon and systemic risks to the financial system having risen, the Fed needs to pivot from its imprudent hawkish stance.



Source: Bloomberg, Federal Reserve, SMBC Nikko

Whither Long-Term Interest Rates?

The yield on the 10-year treasury note is largely a function of the one-year forward fed funds contract and the breakeven inflation rate. These two variables explain 90% of the 10-year yield. Based on our near-term projections of fed funds and inflation, fair value on long-term rates is 3.10%. But if the Fed cuts rates as much as we expect, the yield on the 10-year could fall to 2.75% by yearend.



Source: Bloomberg, Federal Reserve, SMBC Nikko

How Low Can They go?

When the Fed cuts, they tend to cut a lot. According to our calculations, there have been 15 easing cycles since 1960. The average amount the fed funds rate drops is 411 basis points. This suggests that rates could head back below 1% if there is a deep recession. If so, the bond market has plenty of room to rally.

How Much does the Fed Cut in Cutting Cycles?

First Fed Rate Cut (Month)	Total Cuts (Bps)	Occurring over… (Months)
March 1960	280	17
December 1966	197	8
September 1969	547	18
October 1973	556	20
January 1980	479	7
February 1981	438	2
July 1981	1059	20
September 1984	563	24
November 1987	81	4
June 1989	681	40
July 1995	75	7
September 1998	75	3
January 2001	550	30
September 2007	513	16
July 2019	75	3
Avg->	411	15

Sources: Federal Reserve, Haver, SMBC Nikko

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