The Fed's Wishful Thinking

Whenever the unemployment rate begins its ascent, it will almost certainly breach 5%. There have been 11 recessions since 1945 excluding the 2020 pandemic-related downturn. In eight instances the unemployment rate troughed below 5%. These periods were 1948, 1953, 1957, 1960, 1969, 1973, 2000 and 2007. Only three times did the rate not break below 5%. These periods were 1979, 1981 and 1989.

The unemployment rate is shown in the chart below along with recession bars and a horizontal line at 5%. The Fed's current forecasts are inconsistent with history.

Over the next 18 months, monetary policymakers have central tendency predictions on unemployment from 4.3% to 4.9%. The range of forecasts, which includes outliers on both sides of the distribution, still only goes from 4.0% to 5.2%. These estimates are much too low for an upcoming recession.

As we can see in the chart below, the lowest peak in the unemployment rate was 6.1%, which happened two times — once in 1954 and again in 1969. The next lowest peak occurred in 2003, when the unemployment rate topped out at 6.3%.

These increases began from low levels (2.5% in 1961, 3.4% in 1969 and 3.8% in 2000), like where the labor market is today. The current unemployment rate is just 3.4%, a five-decade low. When unemployment begins to move up, it moves up a lot. Are there caveats? No.

Some may argue that today’s low labor force participation rate means that we will avert a similarly large increase as in the past. But participation was substantially lower in all the business cycles prior to 1980 and yet unemployment soared when the US entered a downturn anyway.

Others may argue that unemployment will not go up much if we experience only a “mild” recession. But this happened in 2001 and unemployment went from 3.8% to 6.3%.

It is time for the Fed to sharpen its pencils and redo its forecasts ahead of next month’s forecast update.
Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. ("SMBC Nikko"), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko's economist(s). The views, statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko, it does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views, statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.