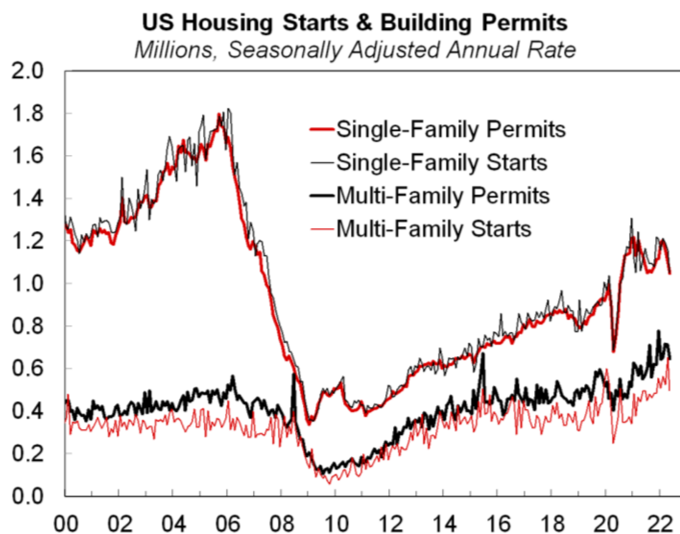
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. June 21, 2022

OPTIMIST OR PESSIMIST?

Economists have a reputation for being pessimists, to the point that economics is called “the dismal science.” I don’t think that’s fair. I think economists, in general, have a very balanced view, looking at both the positives and the negatives. But because many of the people we work for are optimists, we seem pessimistic by comparison. You probably don’t get hired to run a business if you’re not an optimist, and you certainly won’t start one. (Those folks need an economist or a pessimistic CFO for balance!)

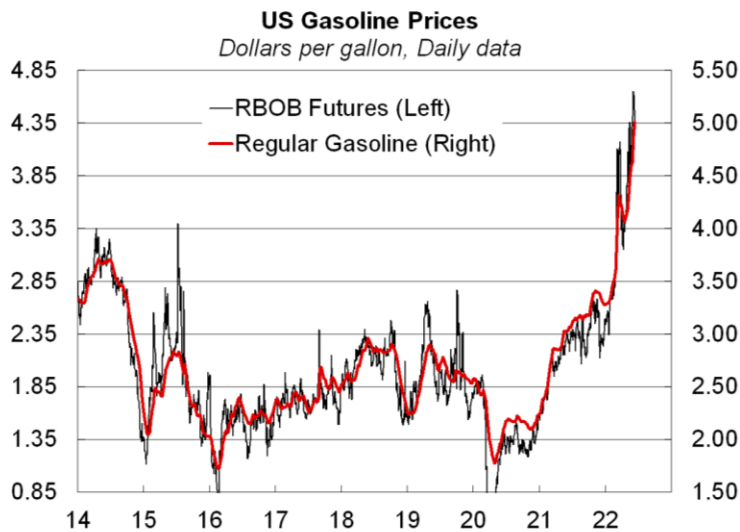


My forecast for the U.S. economy could be viewed as either optimistic or pessimistic, depending on your time frame. To the pessimists who think we’re already in a recession or soon will be, I’m an optimist. I’ve been optimistic about growth in 2022 – too optimistic. I thought that motor vehicle sales and production and residential construction would surge as supply constraints eased, bolstering the rebound in travel and entertainment as COVID fears receded. That hasn’t happened; the failure to build more cars and houses has been a huge disappointment. Demand for cars and houses have been very strong, but supply constraints never eased. Now, with mortgage rates having surged to 13-year highs, home construction will decline because of falling demand rather than rising because of rising supply. While vehicle sales aren’t likely to decline – they’re already at recessionary levels – they won’t rise as much as I had expected. Housing starts fell 14.4% in May, albeit from a 16-year high. Single-family housing permits, the most important number in the housing report, fell 5.5% and are down 13.0% from February’s recent high. Vehicle sales, which jumped in April, fell in May.

But to the optimists who expect a “soft landing” – slower **but positive** growth that brings inflation down without a recession – I’m a pessimist. I’ve argued since last November’s newsletter that it will probably take a recession to get inflation back down to the Federal Reserve’s 2% target, and I’ve had a recession somewhere in my forecast even longer than that. I’ve gradually moved the starting date for that recession from 2025 to the second half of 2023, and I acknowledge that it could come sooner. Judging by the reactions I get at my speaking engagements, most people who hear that think I’m a pessimist.

Right now, there is plenty of pessimism about the U.S. economy, and not primarily among economists. The University of Michigan Consumer Sentiment Index fell this month to its lowest reading **ever**. Consumer spending doesn’t always follow sentiment, but retail sales fell 0.3% in May. Retail sales data aren’t adjusted for inflation. If they were, the decline would have been much larger. The National Federation of Independent Business reported that the percentage of business owners expecting better conditions over the next six months fell in May to its lowest level in the 48-year history of the survey. The S&P 500 stock price index is now down 24% from its January peak. The NASDAQ Composite is down 33%. Stock prices are a useful leading indicator, even if they give some false recession signals.

The declines in sentiment and in (real) retail sales are due to the rise in gasoline prices. Even though crude oil prices are below their 2008 high and, in real terms, are below their 2011-2014 levels, gasoline prices are at record highs in both real and nominal terms. That's because we've run out of refining capacity. ExxonMobil is currently building a new refinery unit in Beaumont, Texas. Except for a small and specialized condensate splitter, the last refinery built in the United States began operating in 1977.



Not everything is bad. Payroll employment rose by 390,000 in May. It was the smallest increase in 13 months but still much larger than what is needed to absorb growth in the working-age population. Initial claims for unemployment insurance have risen since April but are still near all-time lows. Since 1969, claims have hit bottom an average of 12 months before a business-cycle peak. Industrial production in U.S. manufacturing hit a 14-year high in April. It slipped 0.1% in May, but an Institute of Supply Management manufacturing index (PMI) well above the neutral level of 50 suggests continued growth. While industrial production is considered a coincident indicator, it has peaked before the overall economy in most recent business cycles. Its recent strength is not consistent with an imminent recession. Manufacturers are likely to benefit from inventory rebuilding. Despite reports to the contrary from Walmart, Target, and Amazon, government data show that inventories are still lean. My subscribers report strong demand and big order backlogs and say they could sell more if they could get more material and workers.

These data don't suggest a near-term recession, but the main reason I'm forecasting a recession in 2023, not in 2022, is that I believe monetary policy works with what Milton Friedman called "**long** and variable" lags. Interest rates are still low, by historical standards and relative to inflation. The yield curve is not inverted, i.e., the federal funds rate is below the yield on 10-year Treasury notes. Historically, the yield curve has inverted 8-17 months before a business-cycle peak. The Federal Reserve has accelerated the pace of interest-rate hikes – it boosted the federal funds rate by three-quarters of a percentage point last week after the May report on consumer prices dashed hopes that inflation had peaked – but it is unlikely to raise the funds rate enough to invert the yield curve until late this year or early next year.

An inverted yield curve has preceded every recession since 1960, which makes it hard to forecast a recession before 2023, but maybe the yield curve has failed us this time. If that's true, it's for one of two reasons. First, market interest rates, particularly mortgage rates, have risen sharply since the Fed started talking about tightening last November. Maybe the markets have already done much of the Fed's work for them and will cause a recession before the Fed can invert the yield curve. Second, high energy prices – oil, natural gas, and especially gasoline – might be enough to cause a recession independent of the Fed's actions. I've always thought economists have overstated the importance of interest rates and understated the importance of energy prices. A 2022 recession without an inverted yield curve would support that view.

Taking everything into account, I've reduced my growth forecast for 2022. Because many workers have not returned to the labor force and because immigration has fallen sharply in recent years, potential growth is less than I thought and less than the Congressional Budget Office estimated. Problems abroad are also affecting economic activity in the United States. As a result, my 2022 growth forecast is moving down towards other economists' forecasts. (Their inflation forecasts have been moving up towards mine.) While the risks of falling into a recession in 2022 have risen, I still think the next recession is most likely to begin in 2023. As the late MIT economist Rudiger Dornbusch taught us, "The crisis takes a much longer time coming than you think and then it happens much faster than you would have thought."

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