Current Economic Conditions

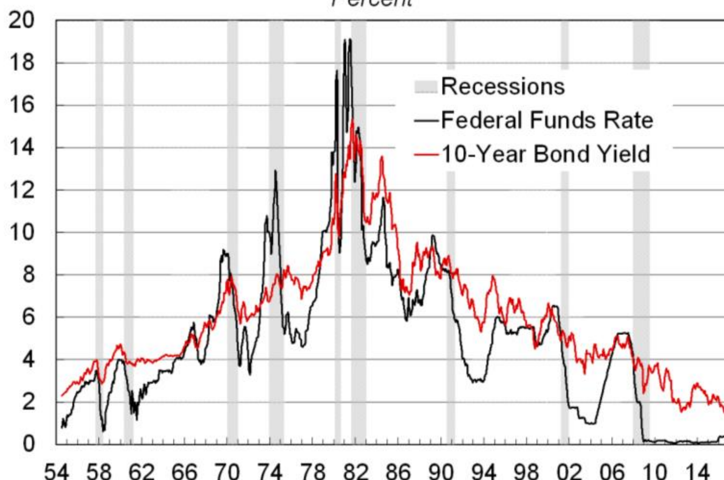
Robert C. Fry, Jr., Ph.D. September 19, 2016

THE EXPANSION IS SLOW, BUT NOT IN DANGER OF ENDING SOON

A series of bad data reports for August and a 394-point decline in the Dow-Jones Industrial Average on September 9 could prompt you to ask if the U.S. economy is entering a recession. A look at several indicators that have reliably signaled recessions in the past suggests that that is highly unlikely and that the next recession probably won't begin for several years. The bad data reports probably reflect difficulties in seasonally adjusting data for the prime vacation months of July and August. Stock prices fell because rising bond yields reduce the present value of future earnings, not because they are a threat to growth.

Worries about a downturn in the economy started with the release of the Institute for Supply Management's August manufacturing PMI (purchasing managers' index) on September 1. The PMI fell below 50, albeit just to 49.4, indicating a contraction in the manufacturing sector for the first time since February. Its production and new orders component indexes also fell into the 49-50 range. The weakness in manufacturing was confirmed later in the month when the Federal Reserve reported that industrial production in U.S. manufacturing fell 0.4% in August, reversing July's increase. The ISM's non-manufacturing PMI also was much weaker than expected in August, indicating that growth in the services sector, while still positive, slowed significantly. Later the same day, automakers reported that motor vehicle sales declined in August to a weaker-than-expected 16.98 million seasonally adjusted annual rate. Payroll employment grew by 151,000. While this is more than enough to absorb growth in the working age population, analysts have yet to adjust to this demographic reality and considered this a disappointing report. Retail sales fell 0.3% and were down 0.1% even if auto dealers and gas stations are excluded.

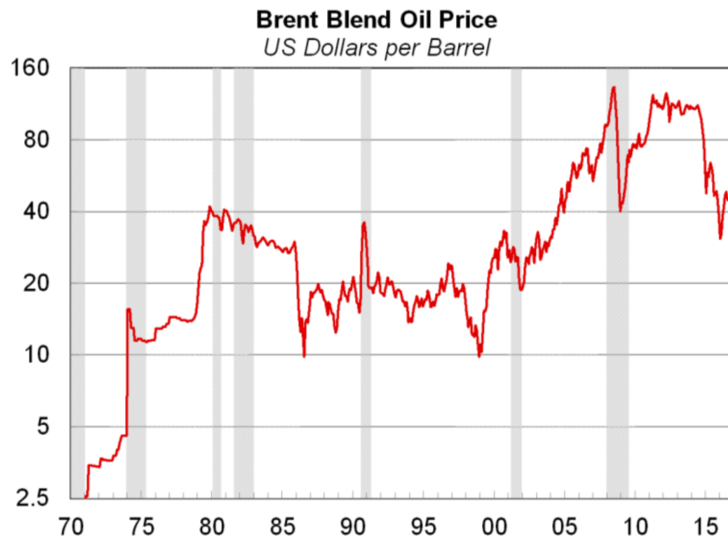
To a large extent, weakness in August was the mirror image of strength in July. The ISM manufacturing production index fell from 55.4 to 49.6. The non-manufacturing production index, the ISM index that best correlates with real Gross Domestic Product, fell from a very strong 59.3 to 51.8. Vehicle sales fell from a 17.79 annual rate, the strongest of the year, to a 16.98 rate. Payroll employment grew 275,000 in July, but "only" 151,000 in August. All of these data are seasonally adjusted, i.e., adjusted to remove the impact of regular seasonal fluctuations so that you can compare any one month to any other. But if, say, auto companies cancel or move their normal summer shutdowns and schools move their opening and closing dates, seasonal adjustments based on past history might yield a misleading result. July data suggested the economy was stronger than it was; August data suggested it was weaker than it was. Averaging data for the two months might give you a more accurate picture of the economy.



All U.S. recessions since World War II have been preceded by significant increases in interest rates. Data on the federal funds rate – the overnight interest rate that the Fed targets – are available back to July 1954. Since then, there has never

been a recession that was not preceded by an increase in the funds rate of at least 2.49 percentage points from its most recent cyclical trough. (Since 1960, there hasn't been a recession without at least a 2.82 percentage point increase.) The funds rate fell as low as 0.07% in 2013 and 2014. History suggests that a recession is highly unlikely until the Fed pushes the funds rate to at least 2.5% and doesn't become likely until the funds rate rises above 3%. Fed officials have repeatedly announced that they plan to raise rates very gradually in the current tightening cycle. That means it will likely take a long time for the federal funds rate to increase enough to trigger or signal a recession.

The spread between long-term and short-term interest rates has also been a reliable indicator of coming recessions. Since 1969, there has never been a recession that was not preceded by an "inverted yield curve" where the federal funds rate rose above the yield on 10-year Treasury notes. Only once, in 1966 and 1967, has there been an inverted yield curve that wasn't followed within 20 months by a recession. (There was a significant slowdown in the economy in 1967 that would have been a recession if not for the government spending associated with the Vietnam war.) As I write this, the yield on 10-year Treasury notes is around 1.70%. The federal funds rate has been hovering around 0.40%. That leaves the spread at 1.3 percentage points, about a quarter-point wider than its historical average of 1.06 percentage points. This suggests that if Treasury yields don't respond to short-term rate hikes, it would take more than five quarter-point hikes in the federal funds rate to invert the yield curve and signal a recession. Of course, if the economy is truly weak, a hike in short-term rates could cause Treasury yields to decline, warning the Fed against further rate hikes. But if short-term rate hikes raise expectations of future interest rates, Treasury yields could rise, leaving the Fed further away from inverting the yield curve.



All recessions since 1973 have also been preceded by at least a **tripling** in the price of crude oil from its most recent cyclical low. (The double-dip 1980 and 1981-82 recessions were preceded by the same tripling in oil prices.) The monthly average price of Brent Blend crude oil fell to a cyclical low of $30.70/barrel in January. If the price of oil rises above $90, I'll probably issue a recession forecast, especially if the Fed reacts to the higher inflation associated with rising oil prices by hiking interest rates. However, Brent is currently around $46/barrel, a level that is low enough to support consumer spending, but high enough to have halted the decline in U.S. drilling activity.

Perhaps the world has changed, and the U.S. economy could fall into a recession without a big increase in interest rates or oil prices. If that happens, the bursting of an asset bubble would be the most likely culprit. However, I'm not going to bet against 70 years of history. Thus, I'm not forecasting a recession. In fact, given my lower-for-longer forecast for oil prices and the lack of capacity pressures that could spark a rise in inflation that would force the Fed to raise rates faster than I expect, I think the current economic expansion has several more years to run. In the past, recessions have begun about six years after the Conference Board's index of leading economic indicators rose above its pre-recession peak. That still hasn't happened in this expansion! Slow expansions tend to be long expansions.

If your industry is awash in excess capacity and you aren't the low-cost producer, it probably doesn't make sense to invest heavily in new plant and equipment; and with the trend rate of growth as slow as it is, it's hard to imagine capacity utilization rising quickly. But if you're holding back on investing because you're afraid of a recession (or because you're calculating your project economics using an excessively high discount rate that is not based on current market rates), please reconsider. Business investment has been a glaring weakness during this economic expansion. We need more of it, not less.

Copyright © 2016 Robert Fry Economics LLC. All rights reserved.
Distribution, reproduction or copying of this copyrighted work without express written permission of Robert Fry Economics LLC is prohibited.