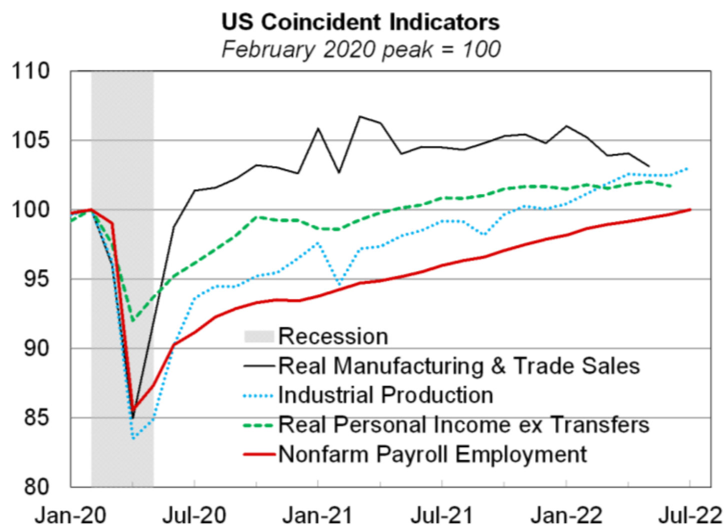
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. August 19, 2022

DETERMING THE DATE OF THE BUSINESS-CYCLE PEAK

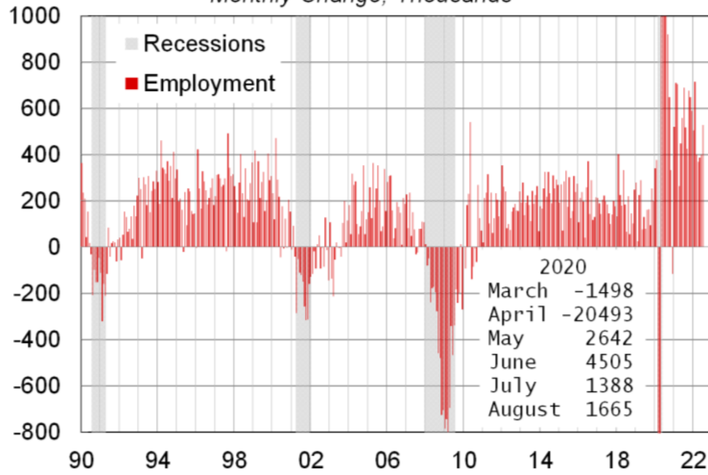
U.S. Real Gross Domestic Product declined at a 0.9% annual rate in the second quarter, the second straight quarterly decline. This has prompted many armchair economists to declare that the U.S. economy is in a recession. But the two-consecutive-quarters-of-declining-GDP "definition" of recession is just a rule of thumb that usually works. It is not, and never has been, the official definition of recession in the United States. The peaks and troughs of U.S. business cycles are determined by the Business Cycle Dating Committee of the National Bureau of Economic Research. (A recession is simply the period between a peak and the next trough.) The NBER defines a recession as "a significant decline in economic activity that is spread across the economy and lasts more than a few months," and adds that "the determination of the months of peaks and troughs is based on a range of **monthly** measures of aggregate real economic activity published by the federal statistical agencies." [Emphasis added. GDP is a **quarterly** series.]



Traditionally, the NBER based their recession dates on four measures of economic activity: nonfarm payroll employment, industrial production, real manufacturing and trade sales, and real personal income less transfer payments. These four measures are summarized in the Conference Board's Coincident Economic Index®, which was originally a government index. The coincident index rose 0.3% in July, **to a new cyclical high**. According to this index, the U.S. economy was still growing – and was therefore not in a recession – through July. In recent years, the NBER has added two more measures of economic activity to the data set they use to date business cycles: civilian employment (from the household survey used to determine the unemployment rate) and real personal consumption expenditures.

While the Coincident Economic Index® says the U.S. economy was not in a recession in July, a detailed look at the six indicators used by the NBER leaves a little more ambiguity, with some indicators suggesting a peak in economic activity and the onset of a recession. Real manufacturing and trade sales peaked in March 2021, but that was a one-month blip caused by American Rescue Plan. Sales fell back over the next two months, then rose through January 2022 before turning down again. Real personal consumption expenditures, which account for about 70% of GDP and are the only component of GDP that are reported monthly, peaked in April and fell in May and June. Real personal income less transfers rose through May but fell in June. Civilian employment peaked in March. It fell in April and June, but rose in May and July, leaving it slightly below its March peak.

These four indicators suggest that the U.S. economy might have peaked in April or May (although it would take just one good month to push civilian employment, real personal income less transfers, and real personal consumption expenditures to new highs). But industrial production and payroll employment



both rose to new cyclical highs in July, with industrial production up 0.6% and employment up 528,000! The NBER doesn't say they put more weight on payroll employment than on the other indicators, but it is extremely unlikely that they will declare that the U.S. economy is in a recession when nonfarm payrolls are rising by half a million a month.

It is worth noting that all these data series, with the exception of civilian employment, are subject to future revision. Data revisions could shift the peaks in these series either forward or back. However, it would take a **huge** revision to get payroll employment to peak before July. Consequently, I think July is the earliest possible date for the business-cycle peak. It is far more likely that the annual GDP revision to be released in late September will eliminate one or both the declines in GDP in the first two quarters of 2022. As I noted last month, the first-quarter decline in GDP is not consistent with solid growth in Gross Domestic Income, not to mention big increases in employment and industrial production. (Second-quarter data on Gross Domestic Income will be reported later this month.)

While coincident indicators suggest the economy wasn't in a recession in July, leading indicators continue to signal that it will be before long. The Conference Board's Leading Economic Index®, which peaked in February, fell 0.4% in July, its fifth consecutive decline. Building permits for single-family homes fell 4.3% to a 25-month low. Existing home sales fell for a sixth straight month, also to a 25-month low, and were down 20.2% year-over-year. The Federal Reserve is likely to raise the federal funds rate above the 10-year Treasury yield in September, inverting the yield curve. A recession should not be a surprise. I've argued in this newsletter since at least last November that it would take a recession to get inflation down to the Federal Reserve's 2% target, and I've had a recession in my forecast even longer than that.

I still believe it will take a recession to get inflation down to 2%, but I'm looking for a mild-to-moderate recession like the 1990-91 recession, not a severe recession like the 1973-75 and 1981-82 recessions, the latter of which followed the short but sharp 1980 recession. While there are similarities between the current inflationary episode and the 1970s (e.g., blaming rising food and energy prices for inflation that was caused primarily by bad policies), there are also important differences. First, the population is much older. New adults, who create a surge in demand for housing, home furnishings, and motor vehicles, are inflationary. Older adults, who are more able to defer purchases if prices are "too high," are disinflationary. Second, globalization has opened an inflation relief valve that converts some excess demand into a larger trade deficit rather than into higher inflation. You can argue whether USMCA is a little better than NAFTA or a little worse, but it's close enough that a major step towards globalization has not been reversed.

But the biggest difference between the 1970s and today is that when Paul Volcker took over as Fed Chair in 1979, core PCE inflation had been above 2% for **13 years**. A whole generation of managers thought prices only went up, and their resistance to cutting prices increased the economic costs of getting inflation down. When the Fed started raising rates this March, inflation had been above 2% for **one year** and was much less entrenched. Managers now know that prices can (and often should) go down. Because of an older population, greater globalization, and greater downward flexibility in prices, I believe inflation can be brought down at a much smaller economic cost than in the 1970s. While I wouldn't make too much out of one month's data, the July Consumer Price Index should give us some hope that inflation will come down without a severe recession. However, I still think getting inflation down to 2% without at least a mild recession is too much to ask for. I expect that by the middle of 2023, maybe sooner, coincident indicators will join leading indicators in calling a business-cycle peak and the beginning of a recession.

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