Current Economic Conditions

Robert C. Fry, Jr., Ph.D. November 18, 2022

THE YIELD CURVE IS INVERTED

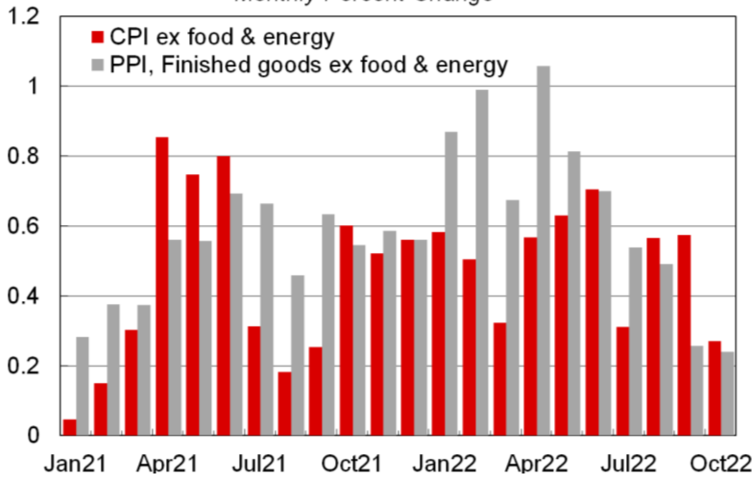
This month's economic data releases reminded me of a cartoon I used to use in my presentations on the economic outlook. It showed a TV newsman reporting that "conflicting economic indicators were up 8.4% last month." I was tempted to use that as my title this month, but since I've used it at least twice in the past, I decided not to. One could cherry-pick this month's economic statistics to make the case that the economy is still growing too strongly and that the Federal Reserve has much more work to do in tightening monetary policy to bring down inflation **or** to make the case that the economy is slowing rapidly and that the Fed needs to slow down or stop. One thing is clear: the yield curve is now inverted (i.e., short-term interest rates are above long-term interest rates) and likely to stay that way for a while. Another thing is less obvious but important: economic indicators often send conflicting messages when the economy is close to a turning point.

The dissonance in this month's data began with the monthly employment report. Nonfarm payroll employment rose by 261,000. While that was the smallest increase since 2020, it was still much more than is needed to absorb growth in the adult population and thus unsustainably strong. In contrast, civilian employment, from the survey of households used to calculate the unemployment rate, fell by 328,000. Statistically, civilian employment is a noisier, more volatile, series, so we shouldn't make too much of one month's data, but civilian employment tends to lead payroll employment at turning points. For now, however, other labor-market data tilt in favor of the payroll survey. The Job Openings and Labor Turnover Survey (JOLTS) reported 10.7 million job openings at the end of September, nearly twice the number of those counted as unemployed. Layoff announcements at major employers like Amazon, Disney, and Meta raise concerns about a weakening labor market, but initial claims for unemployment insurance, the best weekly measure of economic activity, show the labor market remained strong and tight in early November.

The strongest economic report this month has been the 1.3% increase in retail sales in October, roughly twice expectations, with upward revisions to September sales. This report was consistent with strength in light vehicles sales, which came in at a 14.9 million seasonally adjusted annual rate, the best since January, but it was totally inconsistent with disappointing reports from some major retailers, most notably Target, which pointed to slowing sales.

Industrial production in U.S. manufacturing rose for a fourth straight month in October, but it was up just 0.1%, and gains in prior months were revised down, shifting the cyclical peak (so far) from September back to April. October declines were especially large for wood products and nonmetallic mineral products, two industries that supply building materials for the rapidly weakening housing sector. Building permits for single-family houses, the most important measure in the monthly housing report, declined for an eighth straight month in October, leaving them 30% below their February peak.

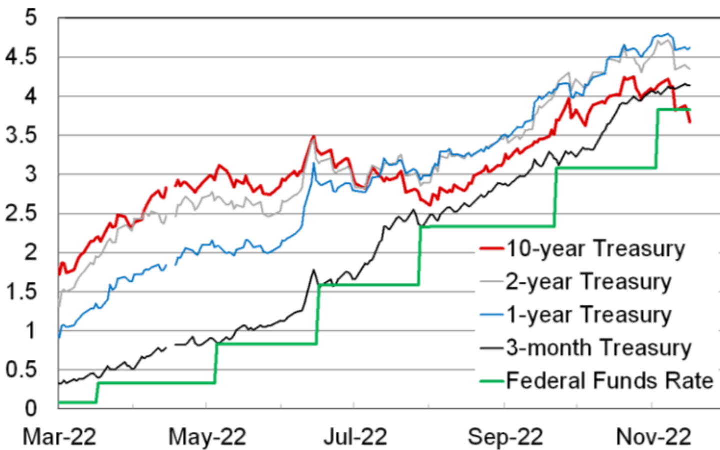
The best economic news this month has come on the inflation front. The Consumer Price Index, excluding volatile food and energy prices, rose just 0.3% in October, much less than expected and the smallest increase in more than a year. Stock traders reacted to the report by pushing the S&P500 stock price index up 5.5%! on the day of the report. It would be easy to dismiss one good month of CPI data – especially given the sharp decline in **measured** health insurance costs – if it weren't for two good months



of Producer Price Index data. The Producer Price Index for finished goods, excluding food and energy – my favorite measure of underlying inflation – rose 0.24% in October after rising 0.26% in September. Over the prior 17 months, the index had risen by an average of 0.67% per month and had never risen by less than 0.46%. There seems to have been a clear downshift in inflation in recent months, and declines in rents, shipping costs, and import and export prices suggest a further slowing in inflation in 2023.

The apparent downshift in inflation triggered a decline in the yield on 10-year Treasury notes from 4.22% on November 7 to 3.69% on November 16. But the "small" increases in price indexes in the last two months still annualize to an inflation rate above the Fed's 2% target, and several Fed officials have reiterated their belief that further increases in the federal funds rate target are needed to get inflation under control. Consequently, short-term interest rates have not come down with long-term Treasury yields. As a result, the yield on 10-year Treasuries is now below short-term interest rates, i.e., the yield curve is inverted. An inverted yield curve has preceded every recession since 1970 and is probably the single best leading indicator of recessions.

While some Wall Street analysts focus on the spread between yields on 10-year and 2-year Treasury notes, I've never seen any evidence that that is the best segment of the yield curve for forecasting recessions. Most of the research I've seen, including that done by my graduate-school classmate Arturo Estrella at the Federal Reserve Bank of New York, indicates that the spread between 10-year Treasury yields and the 3-month Treasury-bill rate is the best predictor of recessions. Recent research from Wells Fargo favors the 10-year/1-year spread, and some of us show charts of the 10-year Treasury yield and the federal funds rate. Until recently, only the 10/2 and 10/1 spreads were inverted. With the recent decline in 10-year Treasury yields, **all** these spreads are inverted. Unless these inversions are reversed quickly, which I don't expect, they signal a coming recession. Historically, the lag from an inverted yield curve to a business-cycle peak has been between eight and 18 months, which is consistent with a recession beginning in the second half of 2023, but declines in housing permits, stock prices, the Conference Board's Leading Economic Index, and other leading indicators I follow suggest that the recession will begin in the first half of 2023.



When Fed Governors and Federal Reserve Bank Presidents continue to warn of further rate hikes, **even after the yield curve is inverted**, they are implicitly acknowledging that a recession is needed to get inflation down to their 2% target. That means a recession is their base case, not a downside risk scenario. Strong corporate and household balance sheets and pent-up demand for motor vehicles could delay the onset of the recession for a few months beyond the early-2023 downturn in my forecast, but the conflicting signals from economic indicators this month are typical at turning points, suggesting the downturn is coming soon. Regardless of the starting date, the Fed is unlikely to let the U.S. economy get through 2023 without a recession. The faster inflation comes down, the shorter and milder that recession will be.

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