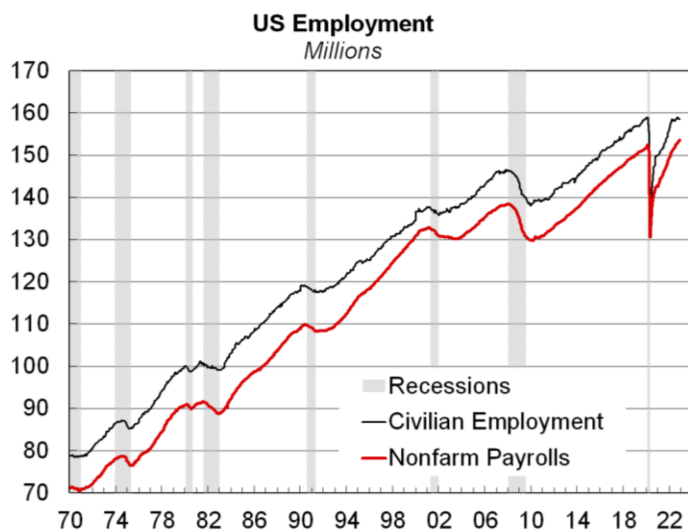
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. December 16, 2022

THE ECONOMY IS STRONGEST JUST BEFORE THE RECESSION

English theologian Thomas Fuller wrote in 1650 that "It is always darkest just before the day dawneth." Those who remember their eighth-grade astronomy know that isn't true. What is true is that an economy is always strongest just before a recession. A recession is defined as the period from a business-cycle peak to the following business-cycle trough. By definition, the level of economic activity is strongest at a business-cycle peak. Consequently, statements that "we can't be going into a recession because business is too strong" (or unemployment is too low) are nonsensical.



Many measures of economic activity have continued to set new highs. Payroll employment rose by 263,000 in November – to another record high – and initial claims for unemployment insurance, the best weekly measure of economic activity, suggest further job gains in December. Real personal consumption expenditures, which account for 70% of real Gross Domestic Product, rose to a record high in October (latest data available), as did personal income excluding transfer receipts. The Federal Reserve Bank of Atlanta's GDPNow "nowcast" of fourth-quarter (annualized) GDP growth is currently at 2.8%. That would take the level of real GDP to a record high. But cracks are starting to develop. Civilian employment fell for a second straight month in November. Retail sales and industrial production in U.S. manufacturing both fell 0.6%.

While coincident indicators show the economy continued to grow into the fourth quarter, leading indicators continue to point to a coming recession. The Conference Board's Leading Economic Index has fallen eight months in a row. Since that index usually turns down about six months before a business-cycle peak, it is signaling that a recession is overdue. Housing permits, which are a component of the Conference Board index (and many other leading indexes), peaked in December 2021 and are pointing to a business-cycle peak between October 2022 and February 2023. The real (inflation-adjusted) M2 money supply, which was once part of many leading indexes, is down almost 7% year-over-year. That's the biggest decline in seven decades! The University of Michigan's consumer sentiment index has been at recessionary levels since gasoline prices surged earlier this year.

The spread between the 10-year Treasury note yield and the 3-month Treasury bill rate, perhaps the best leading indicator of recessions, "inverted" last month. It is now signaling a recession that, with normal lags, would begin in the second half of 2023. But based on the preponderance of the evidence from leading indicators and weakness abroad, I think the recession arrives sooner than that. My forecast, which includes declines in GDP and industrial production beginning in the first quarter of 2023, is consistent with a business-cycle peak **this month**. While the exact timing of the recession is uncertain – I could be a month or two late or a few months early – I have little doubt that the U.S. economy will be in a recession

in 2023. (It is possible that a recession starts soon, as I expect, but that it doesn't show up in the data for several months, after the data have been revised on the basis of more complete information.)

Although Federal Reserve officials cannot **explicitly** forecast a recession (because such a forecast would be a self-fulfilling prophecy), they are **implicitly** forecasting a recession. According to the Summary of Economic Projections (the "dot plots") released on December 14, the median forecast of Federal Reserve Governors and Federal Reserve Bank Presidents for the unemployment rate at the end of 2023 is 4.6%, 1.1 percentage points above the 53-year low last hit in September. The unemployment rate has never risen by more than 0.5 percentage points without the economy falling into a recession.

Signals of an impending recession that will reduce employment, production, income, and consumption are certainly bad news, but we got a second straight month of good news on the inflation front in November. The headline Consumer Price Index rose just 0.1%. The "core" CPI, which excludes volatile food and energy prices, rose just 0.2%, less than expected and the smallest increase in more than a year. Excluding shelter costs, which continue to rise in the CPI even though more-timely data on rents and house prices show them falling, the core CPI **fell** for a second month in a row.

The recent downshift in inflation probably reflects the working-off of excessive inventories through discounting and the reversal of price increases that really were transitory, such as shipping costs and car prices. It appears that prices are more flexible, **in both directions**, than they used to be and than most economists realize. Greater upside flexibility meant prices (and inflation) rose more rapidly than the Fed expected in 2021. Greater downside flexibility means inflation and, in many cases, prices are coming down more rapidly than many economists (and other pessimists) expected. That's good news in its own right because high inflation is a bad thing, but it's also good because it would allow the Fed to stop raising interest rates and start cutting rates sooner than would be the case if prices were sticky and inflation remained stubbornly high. That would minimize the depth and duration of the coming recession.

So far, though, the Fed has ignored the downshift in inflation and has continued to make the case that interest rates need to remain "higher for longer" to get inflation down. The median forecast in the Survey of Economic Projections suggests that the Fed will raise its federal funds rate target by another three-quarters of a percentage point **and then keep it there through the end of 2023**. Perhaps they're oblivious to the downshift in inflation because they're focusing on year-over-year increases in prices indexes rather than on more-timely (but noisier) month-to-month changes. Or maybe they think they must quash expectations of rate cuts in the second half of 2023 to prevent declines in bond yields and increases in stock prices that would stimulate the economy and make it harder to get inflation down.

Despite their "higher-for-longer" messaging, I think the Fed will feel compelled to start cutting interest rates once it is clear that the economy is in recession. My forecast has the Fed cutting interest rates significantly in late 2023. Further good news on inflation would increase the chance that I am right. But that's all prospective. For now, strong growth in payroll employment, a low unemployment rate, and high year-over-year inflation rates will keep the Fed in tightening mode. I've been arguing for more than a year that it will take a recession to get inflation down to the Fed's 2% target. Fed Chair Jerome Powell's December 14 news conference suggests it will also take a recession to get the Fed to stop raising interest rates. To quote two other Englishmen, John Lennon and Paul McCartney, "It won't be long."

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