Macro theme

Roadmap to recession

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In this macro theme, we lay out paths for the most important key figures in 2019 that can be expected to materialise in the event that the US is heading for a recession in early 2020, as the yield curve indicates. The current key figures roughly compare with where they have been ten months before previous recessions, but a trigger is probably needed for the expected slowdown to become a recession. The charts in this macro theme can be used during the year to see if key figures in fact follow a roadmap to recession.

Yield curve indicates that US recession is ten months away

The yield curve indicates that the next US recession is ten months away. The most important economic key figures are also within the range at which they have normally been ten months before a recession. This is not a prediction of an upcoming recession, however, as most of the key figures are coincident at best. A trigger is needed for the expected slowdown to become a recession.

Most watched indicators weaken quite late ahead of recessions

This theme shows the most likely paths for the most important key figures for the remainder of 2019 in a scenario where the yield curve's prediction of a recession in early 2020 materialises. The most watched indicators weaken quite late ahead of recessions.

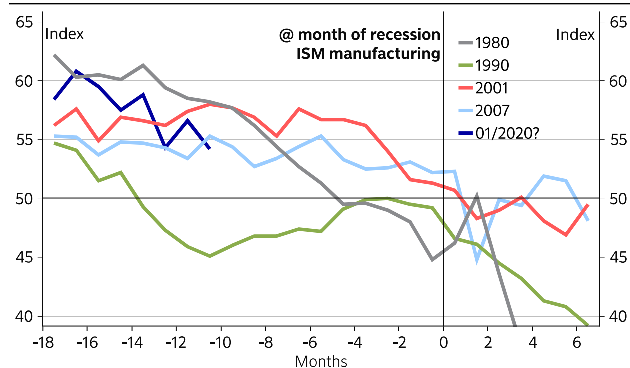
A trigger is needed for a recession to materialise

A trigger is needed for the expected slowdown to become a recession, be it a housing market crash like for the 2008-09 recession, an equity market fall-out like for the 2001 recession, or from the Fed tightening too much like for those in 1980 and 1990. Further rate hikes are needed for the Fed to be the trigger this time around. An alternative trigger would be if the Fed makes overly optimistic choices regarding balance sheet policies, with a continuation of a slower and passive version of quantitative tightening (QT).

Relevant links

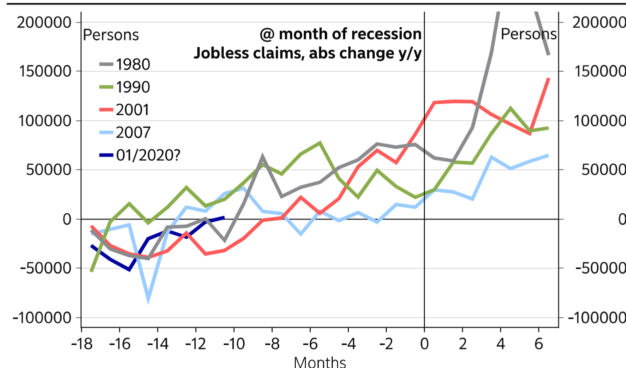
- Macro theme: Two years to the next US recession? That's what the yield curve says
- Macro theme: Balance sheet relief

ISM AHEAD OF RECESSIONS



Source: Nordea and Macrobond

JOBLESS CLAIMS AHEAD OF RECESSIONS



Source: Nordea and Macrobond

IMPORTANT INFORMATION AND DISCLOSURES AT THE END OF THIS REPORT

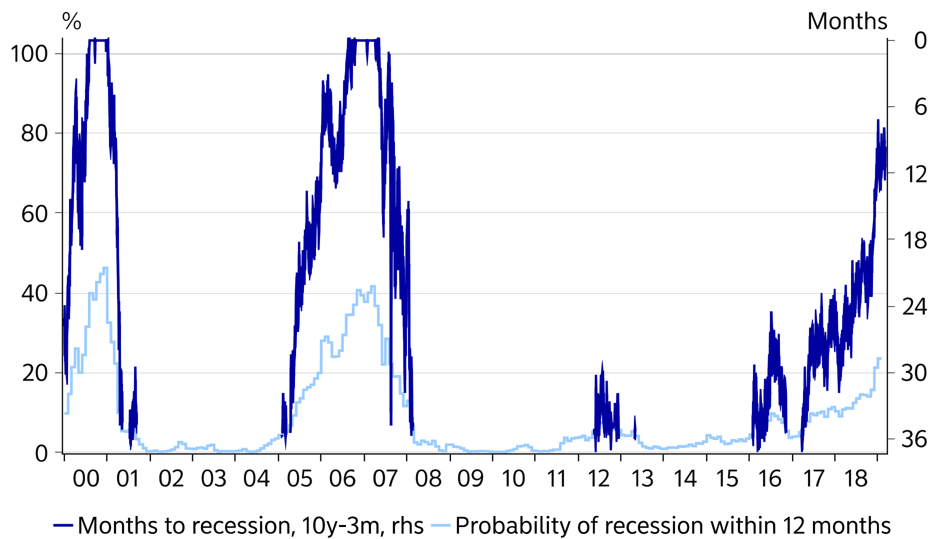
Roadmap to recession

In the following, we assume that the prediction of the yield curve will prove correct and we cross-check the current key figures with where they have been ten months before previous recessions. We also look at potential triggers for the expected slowdown to become a recession.

Ten months to the next US recession, the yield curve says

The next US recession is ten months away, according to our favourite "recession timing" model based on the yield curve, while the likelihood of a recession within the next 12 months is 24%, according to the New York Fed model.

YIELD CURVE: NEXT RECESSION AT THE START OF 2020



Source: Nordea and Macrobond

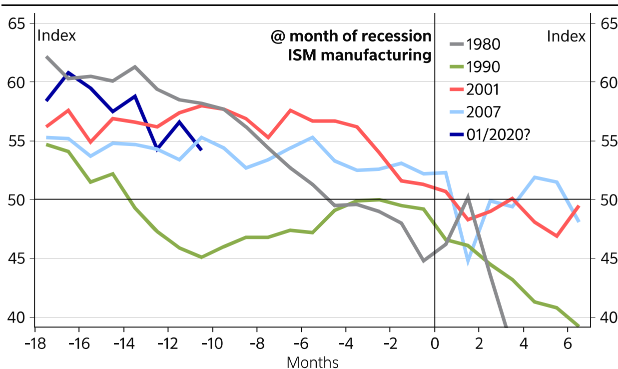
Most key figures are within range

ISM around 54 and payrolls around 200k are not unusual readings ten months before a recession

The range of the **ISM manufacturing index** ahead of previous recessions has been quite wide, and it is far from unusual to have a level around 54 ten months before a recession. Ahead of the 2001 recession, the ISM manufacturing index was at 54 just three months before and a reading below 50 is not a given ahead of a recession.

Nonfarm payroll readings are even more volatile and we hence choose to show a six-month moving average. The current level of around 200k is not unusual ten months ahead of a recession and payrolls usually weaken quite late before a recession, only turning negative afterwards.

ISM MANUFACTURING



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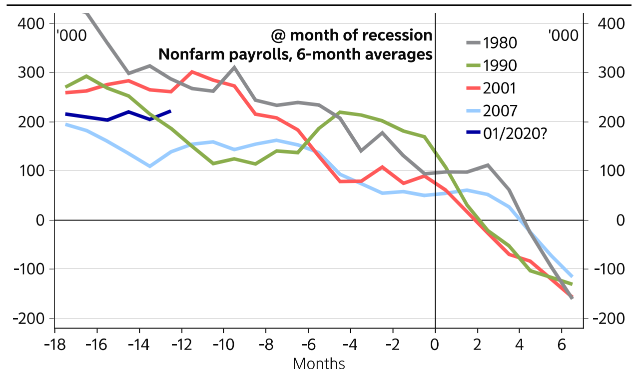
NONFARM PAYROLLS

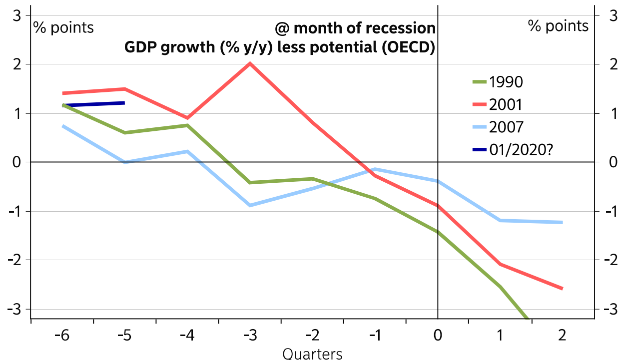


Source: Nordea and Macrobond

Other indicators are also broadly where they are expected to be if the yield curve is right

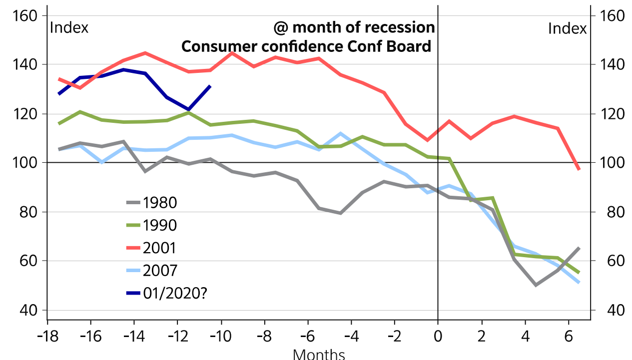
Other indicators are also broadly within range of where they should be if the yield curve's prediction is to prove correct. **GDP growth** should decelerate throughout the year, **consumer confidence** should gradually come down **and initial jobless claims** should increase faster. Only **the ISM non-manufacturing** index is above its historical range at this time ahead of a recession and will most likely have to drop faster than ahead of previous recessions.

GDP GROWTH



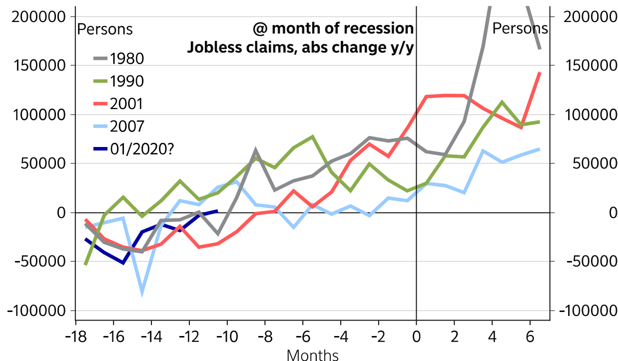
Source: Nordea and Macrobond

CONSUMER CONFIDENCE



Source: Nordea and Macrobond

INITIAL JOBLESS CLAIMS, CHANGE



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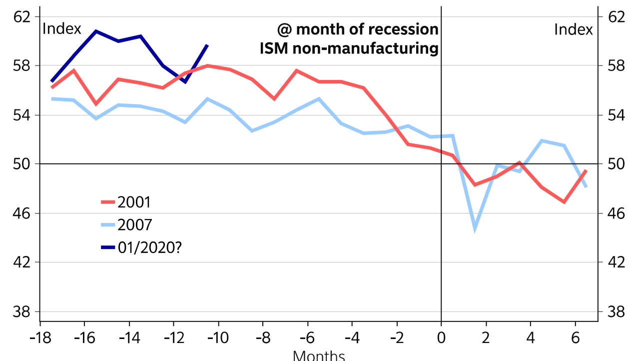
ISM NON-MANUFACTURING



Source: Nordea and Macrobond

A trigger is needed for the expected slowdown to become a recession

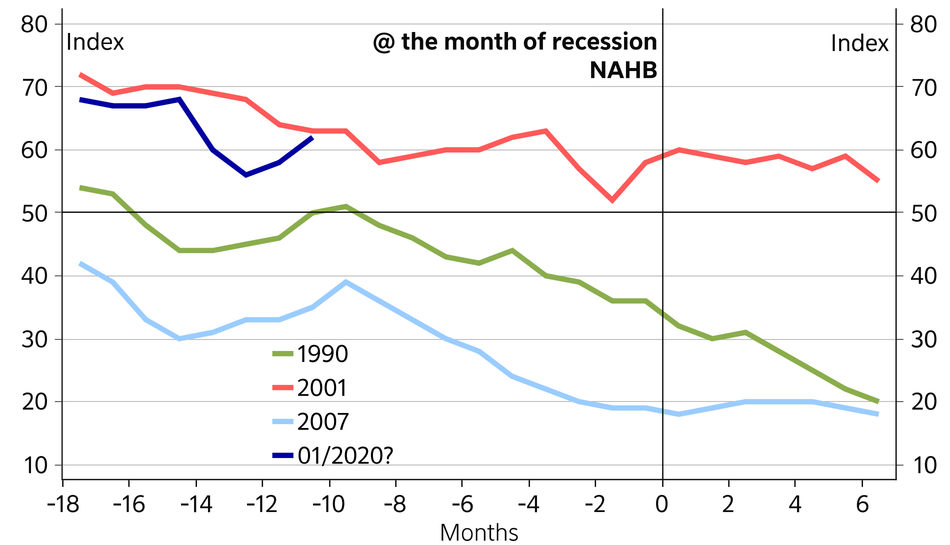
A trigger is needed for the expected slowdown to become a recession

While several of the key indicators above are at levels where they normally have been ten months before a recession, one cannot make the claim that they are signalling one this time around. For a recession to happen, a trigger is needed. And the triggers typically vary. While the housing market and the burst of the housing bubble was the main factor fire-starting the Great Recession in 2007, the equity market and the dot-com crash was the trigger of the 2001 recession. And while both of these two recessions were supported by tight monetary policy, the 1990 recession (and the 1980 recession even more clearly) stands out in retrospect as one driven by the Fed overdoing tight monetary policy. In this section, we therefore take a closer look at potential triggers and evaluate them in a historical context.

Trigger 1: The housing market

Housing market, like in 2008-9

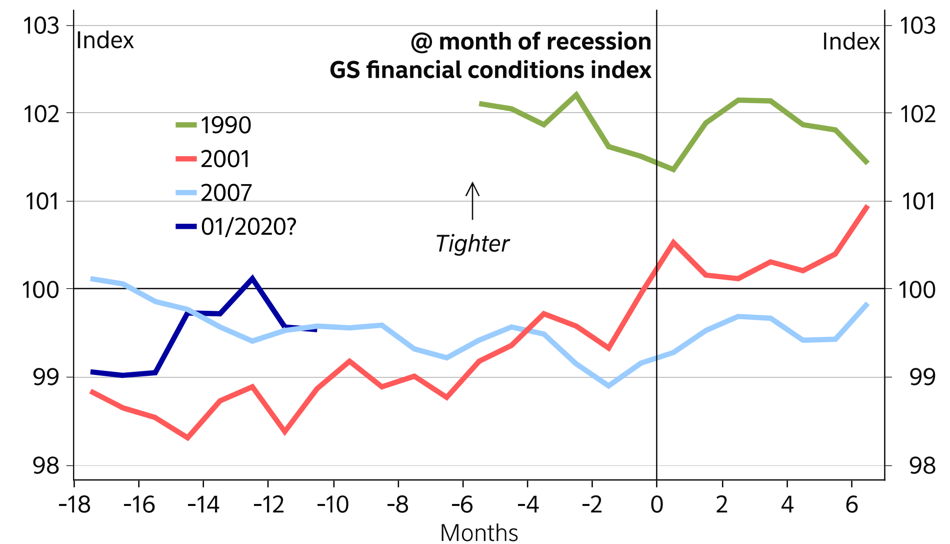
The following graph shows the NAHB housing market index now and ahead of the last three recessions. The index is on a par with the 2001 recession, but since this recession was driven by the equity market bursting and not the housing market, comparing with this episode is of little relevance. Comparing with the 1990 and 2007 recessions, the level of the index is clearly above what it was then. However, the dynamic over the past few months does resemble these two episodes. It will therefore be interesting to follow this index going forward. For the housing market to trigger a recession ten months from now, we need to see a clear trend downwards in the coming months. So far, however, and based on this index alone, it is hard to say that the housing market raises any clear warning signs.

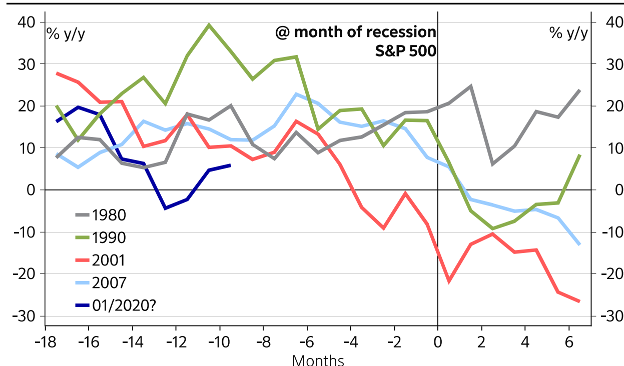


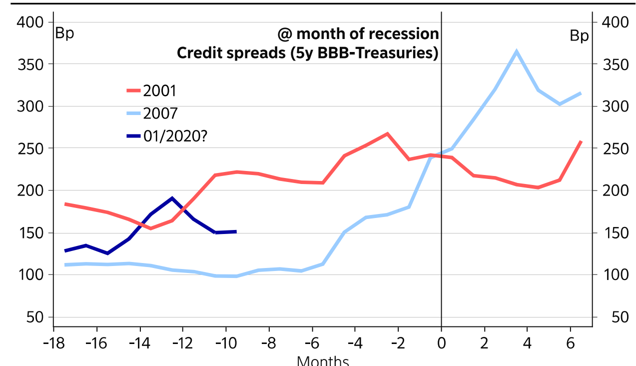
Equity blowout, like in 2001

Trigger 2: Equity blowout

Tighter financial conditions scared markets during the latter part of last year, with both the equity and credit markets selling off. As a consequence, recession fears increased dramatically and contributed to the Fed's change to a more patient stance. Financial conditions are not particularly tight at the moment, compared with similar periods ahead of previous recessions, but both equities and credits could become triggers for the next recession if it turns out that current prices are much too high.







Fed overdoing it, like in 1980 and 1990

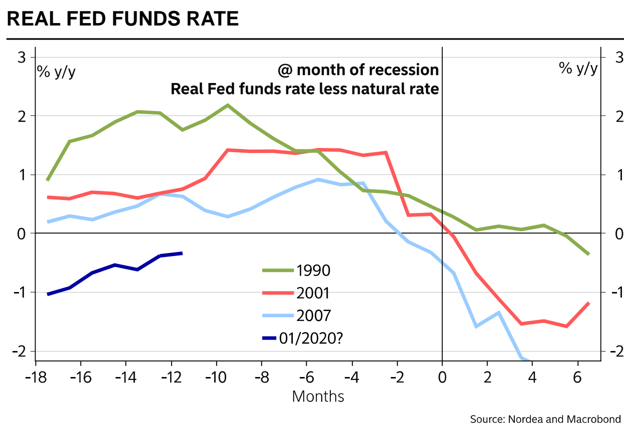
Trigger 3: Fed overdoing it

"The business cycle doesn't die of old age; the Fed kills it," the saying goes. The charts below highlight two indicators of monetary policy tightness: the real Fed funds rate relative to an estimate of the neutral rate, and growth in real M1. For the Fed to be the trigger for a recession, monetary policy needs to be clearly in restrictive territory.

In the last three recessions, the real Fed funds rate has been above an estimate of the neutral rate, and growth in real money supply has been clearly negative ten months ahead of the recession. We are still not there yet, so further rate hikes are probably needed for monetary policy to become too tight according to these indicators. A driver for this to happen would probably be a significant further uptick in price and wage inflation.

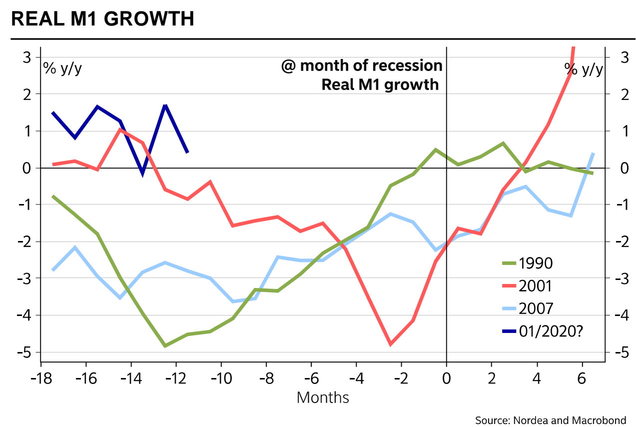
Another driver could be the continuation of the QT programme, which could drive down the growth rate of real M1, as in the chart below and/or add to significant tightening of financial conditions, like in the latter part of last year. In the Macro theme: Balance sheet relief, we look at the choices that the Fed has to make later this year and how these could affect excess reserves and financial conditions.

REAL FED FUNDS RATE



Source: Nordea and Macrobond

REAL M1 GROWTH



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