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Investment Research

Why hasn't there been a recession?

US economy

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- Since last summer, the consensus expectation has been that the US economy would enter a recession fairly soon, yet that has not happened.
- We review 10 reasons why the economy has avoided a recession. They boil down to monetary policy only recently becoming moderately restrictive, the private sector being in fundamentally good shape, and the economy having evolved to become less cyclical.
- Disentangling the consequences and normalization of extreme pandemic-related dislocations from normal late-cycle behavior has made assessing the economy more difficult. The result is noisy, low-quality data giving poor signals.
- We should not expect a standard recession in this unorthodox cycle; e.g., the manufacturing sector has already mildly contracted and could start recovering by year-end. The economy may instead experience rolling recessions across different segments.
- The net result could be a very modest recession overall with unusually low job losses, an outcome very similar to a soft landing. Such a recession is unlikely to start much before the end of the year.

Source: UBS

By far the most common question that we have been asked over the past year is, "Do you expect a recession?" The Federal Reserve's aggressive rate-hiking cycle has led many investors to conclude that a recession is inevitable and necessary for the Fed to achieve its goal of getting inflation back to 2%. In Bloomberg's most current survey of professional economists, 65% expect a recession to start in the next 12 months (Fig. 1). This percentage has been at least 50% since last August, so the clock is ticking for those expectations to be right. Consequently, if a recession occurs (and one has not started so far), it will be the most anticipated one in our lifetime.

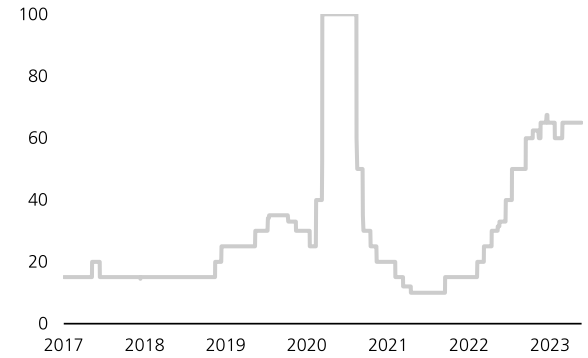
Table 1: 10 reasons there hasn't been a recession

1. Monetary policy is not restrictive enough to cause a recession
2. Fiscal policy is marginally expansionary and fueling investment
3. Strong household balance sheets are supporting spending
4. The economy lacks clear excesses that make it vulnerable to a recession
5. Credit conditions have tightened, but they are not overly tight
6. Labor demand and supply dynamics are keeping the market tight
7. The pandemic has distorted cycle analysis and made data noisy
8. Sector-specific rolling recessions may preclude full recession
9. Services dominate the US economy, and they're still growing solidly
10. The US economy has evolved over time to be less cyclical and recession-prone

With so many economists and investors anticipating a seemingly inevitable recession that still has not come to pass, the obvious question is: Why not? This may not be the most relevant question for investors, who should be forward-looking and focused on if and when a recession will occur. But examining why a recession has not occurred is helpful, if not necessary, for forecasting whether, when, and why one could occur in the near to medium term.

Fig. 1: Majority of economists expect a recession

Economists expecting a recession to begin within 12 months (in %)



Source: Bloomberg, UBS, as of 28 June 2023

We tackle this question by identifying 10 factors that collectively help to explain why the US economy has avoided a recession. The first set of factors suggest that monetary policy has not been restrictive enough for long enough to tip the economy into recession, while fiscal policy has been expansionary. The next set pertains to economic fundamentals, including household finances, corporate balance sheets, and labor demand that are all stronger than is typical leading up to a recession, thereby providing a cushion against growth headwinds. The third set highlights the unique characteristics of this pandemic-distorted economic cycle that have resulted in non-synchronous boom-and-bust patterns across different segments of the economy. This has made the data especially noisy and overstated the extent to which the economy is deteriorating versus just normalizing after pandemic-related shocks. The final set of factors points to structural changes to the US economy over the past five decades that have made it less prone to recessions, which also reduces the usefulness of lessons from historical business-cycle patterns.

While we focus on analyzing why a recession has not occurred, this exercise illuminates the potential characteristics of a recession should one occur, and the factors most likely to make this a reality. Because of extreme pandemic-induced dislocations to spending patterns and supply chains, the economy may experience a series of rolling recessions across different segments rather than a deeper synchronized contraction across the whole economy. The housing market is already showing signs of recovery after a deep slowdown, and the manufacturing sector could start to expand again by year-end. Thus, a clearly identifiable recession will require consumer spending and small-business activity to crack, likely because monetary policy is restrictive for long enough. But that possibility appears to be at least two to three quarters away, especially with the Fed pausing its rate hikes and real income growth now positive. The one thing that we can say with confidence is that this cycle has already been unique, and that is likely to continue.

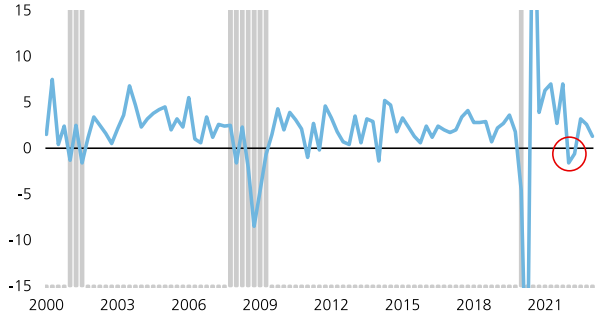
Recession definition

In this report, we use the National Bureau of Economic Research (NBER) definition of a recession: a significant decline of economic activity that is spread across the economy and lasts more than a few months. The activity measures include declines in real personal income; real personal consumption expenditures; real retail sales; nonfarm payroll employment and employment as measured by the household survey; and industrial production. The NBER is responsible for officially dating US recessions, and so far it has not determined that a recession has begun. That said, there is often a long lag between when the NBER says a recession started and when it actually formally makes that declaration, as it waits for overwhelming evidence of economic contraction.

The NBER definition differs from the popular "technical" recession definition of two or more consecutive quarters of negative GDP growth. The two criteria usually overlap, but not always. The NBER determined there was a recession from March to November 2001, but there were not two consecutive quarters of negative GDP growth. More recently, GDP contracted in the first and second quarters of 2022, but the NBER did not deem this a recession (Fig. 2). That is because the negative GDP growth was due to large negative net exports and inventory changes. Real private sector demand grew positively in both quarters, while total payrolls increased by over 2.5 million workers. Thus, GDP is an incomplete and occasionally misleading measure of US economic activity.

Fig. 2: Negative GDP isn't always a recession

Quarterly US GDP growth (in %), shading NBER-defined recessions



Source: Bloomberg, UBS, as of 28 June 2023

Why no recession? Ten factors

There are many reasons why the US economy has avoided a recession over the past year. We have identified 10 factors that summarize the most relevant reasons, in our view. They are not all equally important, but each has played a role, and their influence could increase or fade over the next year.

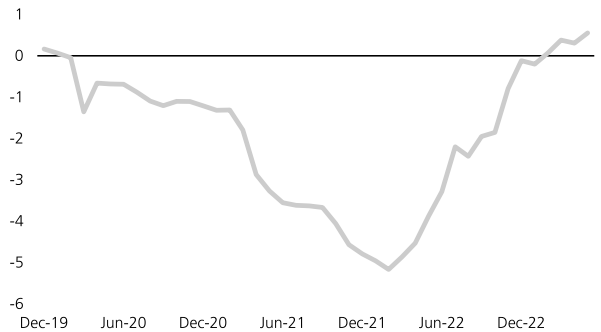
1. Monetary policy is not restrictive enough to cause a recession

Starting in March 2022, the Fed raised the federal funds rate by 500 basis points in a 14-month span, its fastest pace of rate hikes since the early 1980s. The 5.25% upper bound on the fed funds rate is also its highest level since it peaked at the same rate in the 2006–07 rate-hiking cycle prior to the global financial crisis (GFC). In addition, the Fed has been shrinking its balance sheet for the past year. Thus, it is logical to presume that monetary policy is restrictive for the economy and that rates are high enough to trigger a recession.

By many measures, monetary policy is only moderately restrictive, and it has been that way for less than six months—neither condition likely being sufficient to tip the economy into recession. This is evident in an estimate of the real fed funds rate—the nominal rate minus core personal consumption expenditures (PCE) inflation—which only turned positive this year (Fig. 3). The Fed's estimate of the long-run "neutral" policy rate is 2.5%, which can be thought of as the interest rate that would be appropriate in "normal" economic times, or when the economy is in "equilibrium." This equilibrium rate is informed by a quantitative model that estimates the real neutral fed funds rate, which is currently about 0.5%, 2 percentage points lower than it was prior to the GFC (Fig. 4). While the actual nominal funds rate is more than double the 2.5% estimated nominal neutral rate, the real funds rate is much closer to the 0.5% estimated real neutral rate.

Fig. 3: The real fed funds rate only turned positive in 2023

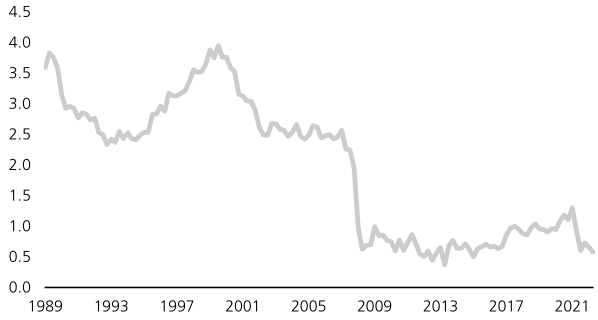
Nominal fed funds rate minus core PCE inflation (in %)



Source: Bloomberg, UBS, as of 28 June 2023

Fig. 4: The real neutral fed funds rate is estimated to be about 0.5%

Holston-Laubach-Williams natural rate of interest in the US (in %)

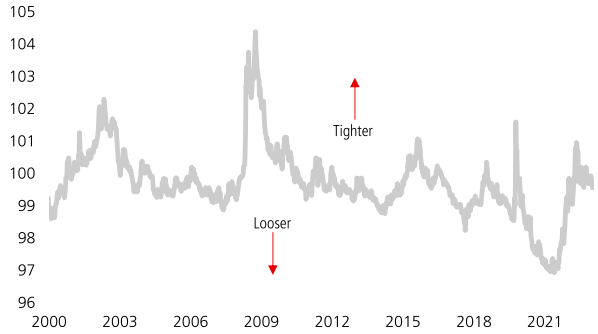


Source: Bloomberg, UBS, as of 28 June 2023

Other prominent measures of monetary policy tightness are financial conditions indexes, which actually suggest that monetary policy has gotten easier in 2023. These indexes are based on various asset prices and financing costs, such as the 10-year Treasury yield, broad equity indexes, credit spreads, and the US dollar. Higher yields, wider spreads, lower equity prices, and a stronger USD all lead to tighter conditions, which are a drag on economic growth. The Fed's goal in 2022 was to tighten financial conditions in order to slow growth, and by most measures it was successful. But conditions have eased since the fourth quarter, which is actually stimulative for the economy, albeit it with a two- to three-quarter lag (Fig. 5).

Fig. 5: Financial conditions have actually eased in 2023

Goldman Sachs US financial conditions index



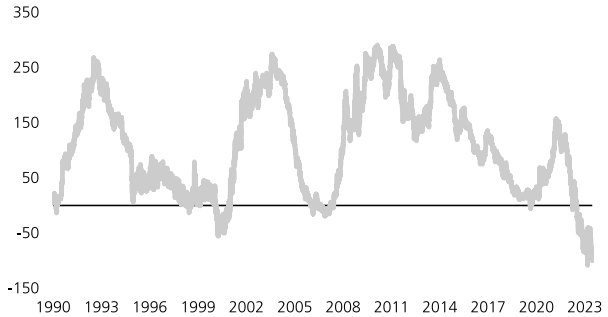
Source: Bloomberg, UBS, as of 28 June 2023

The inverted yield curve, where short-term rates are higher than long-term rates, is a potential counter to these claims that monetary policy is not that restrictive. An inverted yield curve has previously been a reliable leading indicator of recessions, and many recession prediction models rely heavily on this relationship. The curve has been inverted since July 2022, as measured by the difference between 2- and 10-year Treasury yields (Fig. 6).

It is important not to confuse this relationship for causation rather than correlation. The curve is inverted because investors expect the Fed to be successful in getting inflation down near 2%, thereby allowing it to bring rates back down to the long-run neutral level. If a recession does occur, it will be because the Fed raised rates too much, not because long-term rates are too low. Investor expectations for rate cuts are keeping the 10-year yield below the 2-year yield. In fact, this is helping the economy avoid a recession, not contributing to one. An upward-sloping yield curve at a 5% fed funds rate would imply a 10-year yield that is at least 140bps higher than it currently is, which would be a much bigger drag on the economy, since the 10-year yield is a widely used benchmark lending rate. Bottom line, an inverted yield curve is correlated with conditions that often precede a recession; it is not itself a cause of the recession.

Fig. 6: US yield curve remains deeply inverted

10-year US Treasury yield minus 2-year US Treasury yield (in bps)



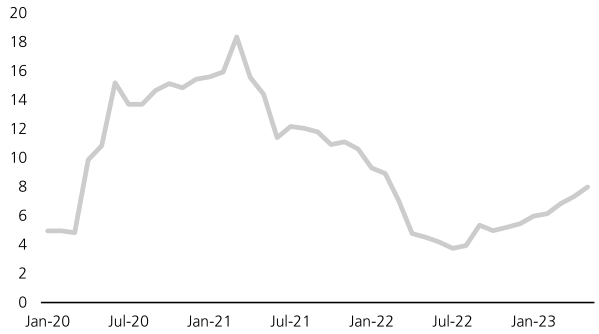
Source: Bloomberg, UBS, as of 28 June 2023

2. Fiscal policy is marginally expansionary and fueling investment

Fiscal policy was highly expansionary in 2020 and 2021 as a result of large government transfer payments. With these payments ending in 2022, year-over-year measures of fiscal policy turned restrictive. Fiscal policy has implicitly turned expansionary again over the past six to nine months, as proxied by the increase in the federal deficit as a percentage of GDP (Fig. 7). This means that fiscal policy has been more of a tailwind than a headwind for economic growth this year. The recent legislation that resolved the debt ceiling standoff will result in lower non-defense discretionary spending, especially in inflation-adjusted terms. That impact will only be felt in fiscal year 2024 starting 1 October, and the Congressional Budget Office (CBO) estimates that it will result in only a USD 69 billion reduction in the deficit.

Fig. 7: Fiscal contraction stopped last summer

US federal budget deficit (% of GDP)

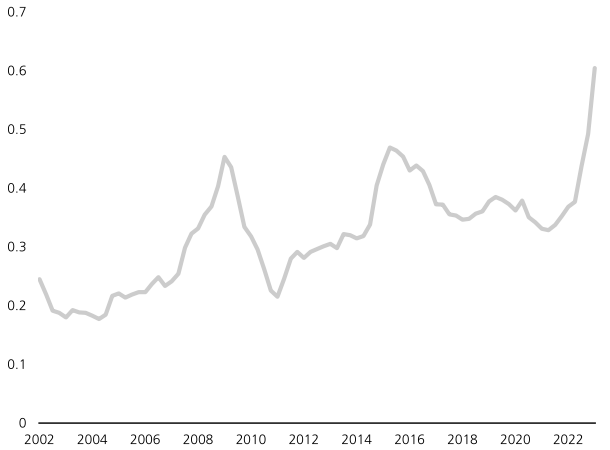


Source: Bloomberg, UBS, as of 28 June 2023

Fiscal policy has also had an indirect positive impact on growth this year as a result of recent industrial policies encouraging private-sector investment. For example, the Inflation Reduction Act was expected to provide about USD 390 billion in tax credits and outlays to speed up the transition to green energy and electric vehicles. But consumers and businesses have rushed to take advantage of its tax breaks and subsidies, which has already resulted in the CBO increasing the expected cost of the incentives by about USD 180 billion. Similarly, the CHIPS Act has spurred actual and announced investments in new factories totaling nearly USD 200 billion. Even though manufacturing output has been weak over the past year, construction spending in manufacturing industries is running more than double the level from a year ago (Fig. 8).

Fig. 8: Manufacturing investment has surged

US manufacturing construction investment (% of GDP)



Source: Bureau of Economic Analysis, UBS, as of 28 June 2023

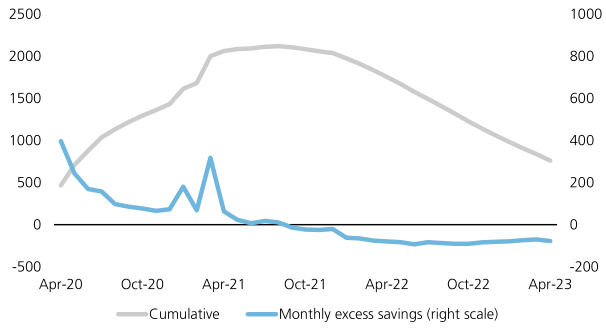
3. Strong household balance sheets are supporting spending

The pandemic recession of 2020 had the unusual outcome of households in aggregate exiting the recession in much stronger financial shape than when they entered it. This stemmed from the enormous government support to households in the form of stimulus checks, enhanced unemployment benefits, and the Paycheck Protection Program, resulting in household income actually increasing despite the loss of more than 20 million jobs during the lockdown period.

Consequently, household savings surged, reaching more than USD 2 trillion in excess savings at the peak in 2021 (Fig. 9). More recently, households have been gradually using up those excess savings, but there should be enough left to support spending through the end of the year. On top of this, household wealth has soared by around USD 38 trillion since the start of the pandemic (Fig. 10), helped by rising home prices and equity markets, which supports spending and the ability to take on additional debt.

Fig. 9: Excess savings have supported the consumer

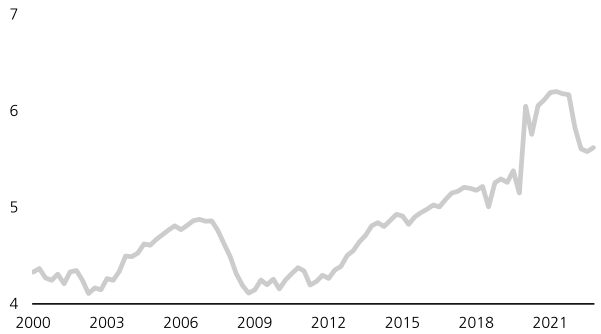
US household excess savings (in USD billions)



Source: Bloomberg, UBS, as of 28 June 2023

Fig. 10: Asset price appreciation caused a jump in total wealth

US household wealth (% of GDP)



Source: Bloomberg, UBS, as of 28 June 2023

One of the Fed's desired outcomes from hiking rates is to slow consumer spending in order to cool the economy. Yet the impact of higher rates on household finances has been relatively modest. For one, the debt service ratio, which measures the percentage of disposable income used on debt payments, is still near a 40-year low of around 9%, which is below the 13% level during the GFC. Similarly, higher rates have made it more difficult to afford monthly payments on new mortgages, but most homeowners locked in very low rates on 30-year fixed-rate mortgages prior to the Fed's hiking cycle. Only about 10% of mortgages were adjustable-rate at the beginning of 2022, meaning the rise in 30-year mortgage rates to around 7% would not matter for 90% of homeowners with a mortgage. The overall takeaway is that consumer spending has not been particularly rate-sensitive—another reason why the drag on growth from tighter monetary policy has been less than anticipated.

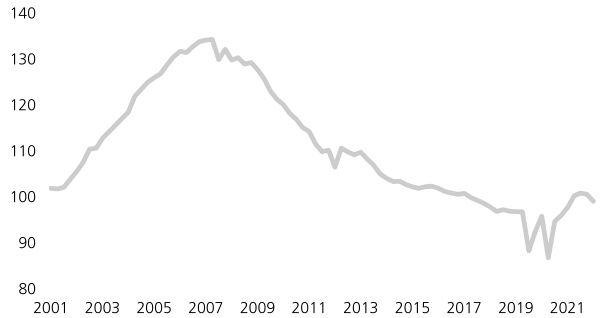
4. The economy lacks clear excesses that make it vulnerable to a recession

In a typical economic cycle, excesses in the private sector tend to build up as the expansion goes on, especially during the strongest periods of growth. Both households and companies get overly optimistic about their prospects. This leads households to spend too much, often borrowing to do so, while businesses over-invest in new capacity and hire too many workers. As the economy overheats, the Fed raises rates to control inflation, borrowers struggle to service their debts, and this triggers a downturn in the cycle.

This cycle is far from typical. While we do view the economy as being in late-cycle, there are not a lot of the usual excesses in the private sector. Ratios such as household debt to disposable income or corporate debt to GDP are not stretched (Fig. 11). Even some evidence of stress, such as rising delinquencies on consumer loans and corporate bankruptcies, are far from recessionary levels (Fig. 12). Nor is there evidence of corporate over-investment, especially after a muted capital expenditure cycle in the pre-pandemic decade. There are debt excesses in the public sector, with the federal government increasing its total debt by over USD 8 trillion from the first quarter of 2020 to the first quarter of 2023, largely to fund transfer payments to support households and businesses. This does not pose nearly the same recession risk as comparable increases in private sector debt.

Fig. 11: Household debt loads appear manageable

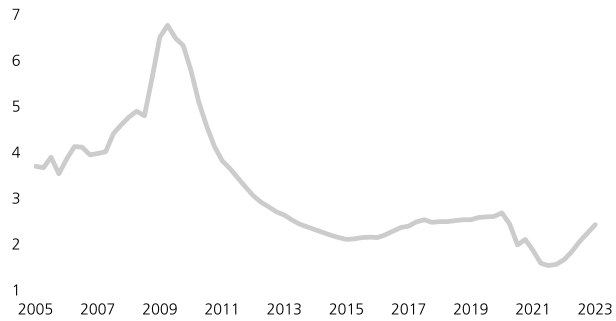
US household debt to disposable income ratio (in %)



Source: Bloomberg, UBS, as of 28 June 2023

Fig. 12: Credit card delinquencies are rising, but off a historically low base

US credit card delinquency rates (in %)



Source: Bloomberg, UBS, as of 28 June 2023

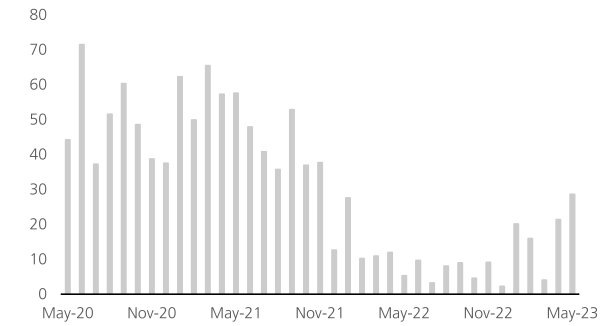
5. Credit conditions have tightened, but they are not overly tight

One of the best leading economic indicators is credit growth, because access to credit is the lifeblood for increasing consumer spending and business investment. Thus, banks tightening their lending standards throughout 2022, as shown by the Fed's Senior Loan Officer Opinion Survey (SLOOS), suggested that access to credit was already getting more difficult even before the recent bank failures. The latter would just compound the problem. Indeed, the latest readings from the SLOOS are in line with what was seen during previous recessions.

Despite tighter standards, most companies continue to have good access to credit, at least so far. One indication of that is larger companies' ability to issue new corporate bonds in the public debt markets. At almost the midyear mark of 2023, investment grade corporate bond issuance is on pace to exceed its 2022 total and nearly match that of the 2021 total. High yield corporate bond issuance nearly ground to a halt after the Silicon Valley Bank bankruptcy, but new issuance of USD 28.6 billion in May was the highest monthly total since November 2021 (Fig. 13). Not only are companies able to raise capital, but they can do so at spreads that are lower than at the start of the year (Fig. 14). The story is not that much different for small businesses. In the latest National Federation of Independent Business (NFIB) survey of small businesses, only 1% reported that they were unable to borrow their desired amount.

Fig. 13: The market for high-yield bond issuance has re-opened

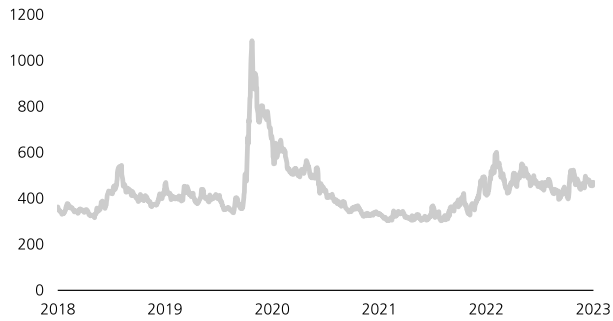
Monthly US high-yield debt issuance (in USD billions)



Source: ICE BofA, UBS, as of 28 June 2023

Fig. 14: High-yield bond spreads have fallen year-to-date

US corporate high-yield bond spread (in bps)



Source: ICE BofA, UBS, as of 28 June 2023

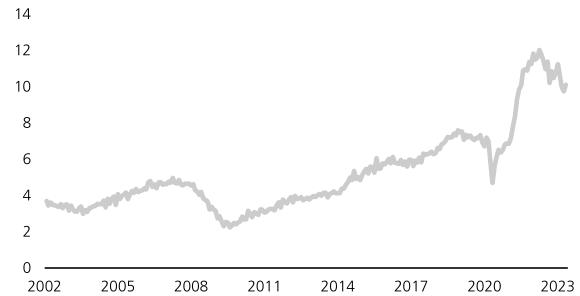
The bottom line is that even though borrowing costs are higher after 500bps of Fed rate hikes, credit conditions have not overly tightened and appear manageable in an environment of generally strong economic conditions and good profit margins in most industries.

6. Labor demand and supply dynamics are keeping the market tight

One striking aspect of the post-pandemic recovery has been the ongoing strength in demand for workers, resulting in a labor market that remains very tight. This robust demand is arguably the number one reason why the economy has stayed out of recession so far. More than 25 million jobs have been created since the current recovery started in May 2020. According to the JOLTS survey, there are still more than 10 million unfilled positions as business demand for workers appears insatiable (Fig. 15). While total payrolls are now around 4 million higher than their pre-pandemic peak, extrapolating the pre-pandemic trend rate indicates that payrolls are still about 2 million less than they would have otherwise been.

Fig. 15: The demand for workers has subsided, but remains near historic highs

US JOLTS survey of job openings (in millions)

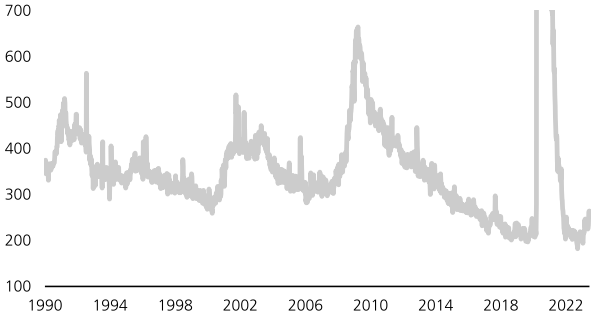


Source: Bloomberg, UBS, as of 28 June 2023

It does appear that conditions have softened somewhat this year, based on a broad range of labor market indicators. A recovery in the labor force participation rate and an influx of immigrant workers have helped to fulfill some demand —a positive development for both economic growth and disinflation. Weekly initial jobless claims, one of the best leading indicators for labor market strength, have ticked up. However, this is from exceptionally low levels, and claims remain modest relative to typical pre-recession levels (Fig. 16). Although some prominent companies have announced large layoffs since the fourth quarter, many more businesses still quote their biggest problem as finding workers, and most appear reluctant to shed workers given the difficulty they had in hiring over the past two years. These labor market dynamics are why those investors who still expect a recession generally think that labor market pain will be modest, with the unemployment rate rising far less than the 2.5–3% in a typical recession.

Fig. 16: Jobless claims remain below pre-pandemic norms

US weekly initial jobless claims (in thousands)



Source: Bloomberg, UBS, as of 28 June 2023

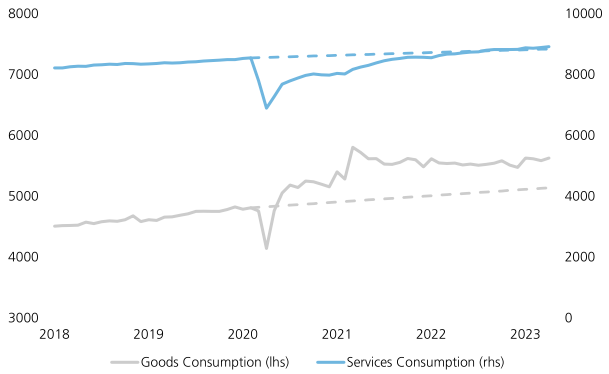
7. The pandemic has distorted cycle analysis and made data noisy

The pandemic and now post-pandemic economy is unlike anything that economists and investors have ever experienced. This has made it even more difficult to determine both how well the economy is performing and the likelihood of a recession. Investors have relied on analysis of prior business cycles to draw conclusions about this one, which has biased them toward a negative economic outlook. This approach is misleading for three reasons.

First, the economy experienced extreme dislocations during the height of the pandemic and has spent the past two years trying to return to post-pandemic normalcy. A good example of this is consumption patterns. Spending on goods exploded during the pandemic when people bought items that they could use at home, while services spending fell dramatically as those activities were greatly constrained. Those patterns started reversing in 2022. The result is that the goods-related sectors that boomed for 18 months have experienced a significant slowdown, while the opposite occurred for services-related sectors. Now, over three years from when the pandemic began, total goods and services consumptions are converging back to their pre-pandemic trend levels (Fig. 17). In other words, spending patterns are returning to long-term patterns, and this normalization has looked a lot like deterioration for goods-producing parts of the economy.

Fig. 17: Spending on goods and services is getting back to normal

Spending on goods and services vs. pre-pandemic trend (in USD billions)

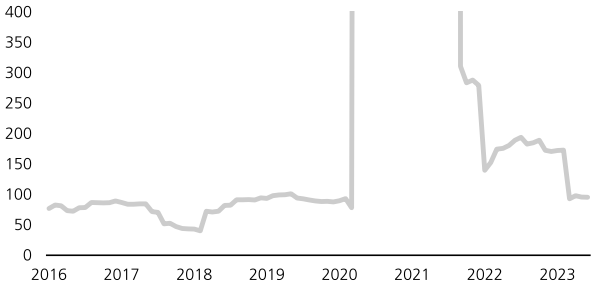


Source: Bloomberg, UBS, as of 28 June 2023

Second, major economic data, such as monthly job growth and inflation, have been incredibly volatile as the economy has swung from one extreme to another. In the first year of the pandemic, the early months had job losses and gains well over 1 million. Even in early 2022, job growth exceeded 500,000 for some months. The data has also been subject to substantial revisions, all of which has made it difficult to get a good real-time read on how the economy is actually trending. Since investors have been expecting a recession, there has been a tendency to view weak data as more credible because it validates expectations. This is perhaps why consensus expectations for monthly job growth have been below the actual number for 14 straight months. The good news is that data volatility is returning to pre-pandemic levels now that economic activity is normalizing. That is evident in the 12-month rolling volatility for monthly nonfarm payroll growth, which is now back to its pre-pandemic levels (Fig. 18).

Fig. 18: Job growth volatility has returned to pre-pandemic levels

Trailing 12-month standard deviation of nonfarm payrolls (in thousands)



Source: Bloomberg, UBS, as of 28 June 2023

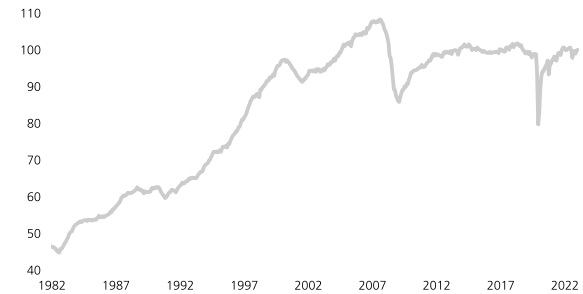
Third, the data is also noisy and of lower quality because of seasonal adjustments, large subsequent revisions, and low response rates to surveys. The pandemic has complicated seasonal adjustments because it caused extreme distortions in almost all data series, with the impact most pronounced in the March-to-June period of 2020, when the pandemic recession began and ended. Thus, what looks like bad news on the surface may simply be the result of new seasonal patterns. The quality of survey-based data has also gotten worse because the percentage of people responding to government surveys has fallen dramatically in some cases, making the results inherently less reliable. This leads to constant revisions as new information becomes available —another reason why it is more difficult to say what is happening in the economy in real time. Moreover, sentiment surveys indicate high levels of pessimism about the economy, but such "soft data" often moves inversely with inflation and has proven to be too negative when there is an extraneous risk, such as the debt ceiling, dominating economic discussions.

8. Sector-specific rolling recessions may preclude a full recession

The first year of the economic recovery during the pandemic was often called K-shaped because of the diverging fortunes of goods sectors, which boomed, and services sectors, which were hit much harder and were far slower to recover. The manufacturing sector was able to recover relatively quickly because of goods demand. Once spending patterns started to revert to normal in 2022 and the demand for goods fell, manufacturing output soon followed. As a result, manufacturing output has contracted since last fall and has effectively been in a recession (Fig. 19). Now that spending on goods, especially autos, has been rising again in 2023, the manufacturing sector should be able to avoid a deep slump and start to recover by year-end.

Fig. 19: Manufacturing output has returned to pre-pandemic levels

Manufacturing output index

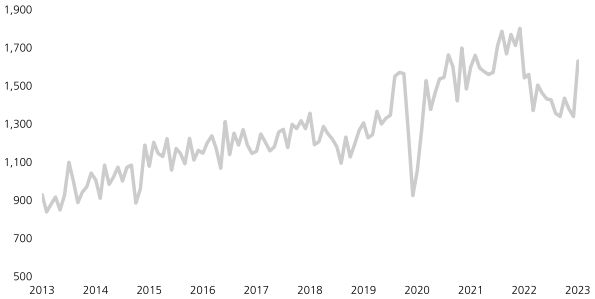


Source: Bloomberg, UBS, as of 28 June 2023

Even though real spending on goods fell and the manufacturing sector contracted, services spending has been strong enough to keep the economy out of recession. The services sector was also strong enough to withstand steep declines in residential investment, which fell about 20% in 2022 (Fig. 20) after mortgage rates soared from below 3% to over 7% at their peak. More recently, strength in multifamily housing has helped to offset weakness in single-family homes, with total new housing starts picking up sharply in recent months. Stability in the housing market is also evident in housing prices, which on average are no longer falling.

Fig. 20: Housing starts are beginning to reaccelerate

Housing starts, seasonally adjusted annualized rate (in thousands)



Source: Bloomberg, UBS, as of 28 June 2023

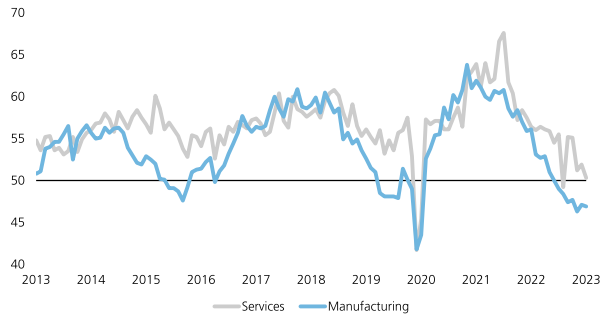
Thus, the economy has experienced slowdowns or outright recessions in specific segments as it normalizes from the pandemic. The slowdowns are not occurring simultaneously across all sectors, and that may continue to be the nature of this stage of the cycle: a series of small, sector-specific recessions that roll non-sequentially throughout the economy rather than the entire economy at the same time. This could keep the economy from experiencing a broad-based recession.

9. The services sector dominates the US economy, and it is still growing well

In a typical business cycle, the manufacturing sector tends to lead the rest of the economy, and that has been the case this cycle. The ISM manufacturing index fell below 50 last November, and in our view it is fair to say that the manufacturing sector is now in recession (Fig. 21). Meanwhile, the ISM services index is still above 50, and only in the past three months has it fallen sustainably below 55. Both indexes are consistent with consumer spending patterns, with the slowdown in goods consumption that began by the end of 2021 preceding the manufacturing sector contraction, while solid services spending growth has kept the sector in expansion territory.

Fig. 21: Manufacturing has slowed much more than services

ISM PMIs for services and manufacturing; 50 = netural

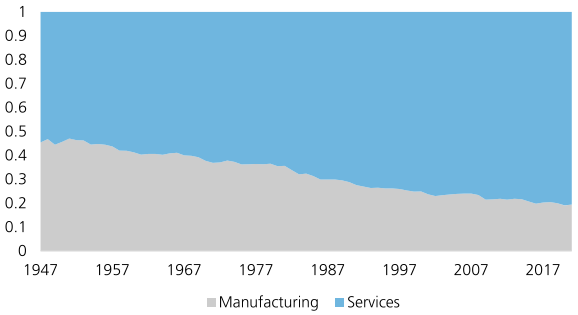


Source: Bloomberg, UBS, as of 28 June 2023

The economy has avoided a recession not just because services sector strength offsets manufacturing sector weakness, but also because the US economy is dominated by services activity. It constitutes roughly 81% of the total private sector output, while the manufacturing sector now represents only about 19% of the private sector (Fig. 22). Consequently, how well the economy performs is far more dependent on the strength of the services sector than the manufacturing sector. In fact, industrial production contracted over 5% in 2015–16, yet the economy was able to avoid a recession because of continued growth in the services sector. A similar dynamic this year has led to the same outcome so far.

Fig. 22: The manufacturing sector's share of the private sector continues to shrink

Sector value added by industry (% of private sector output)



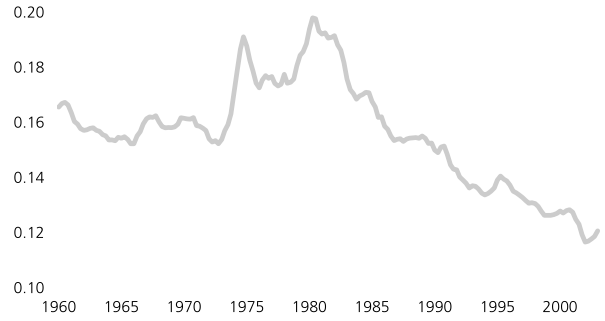
Source: Bureau of Economic Analysis, UBS, as of 28 June 2023

10. The US economy has evolved over time to be less cyclical and recession-prone

Developments that are often missed when evaluating the business cycle and probability of a recession are the structural changes to the US economy over the past 50 years. The shift to being primarily a knowledge-based services economy has been occurring for decades, while the manufacturing sector's share has fallen by more than half since 1968. A byproduct of the smaller share for manufacturing is that inventories as a percentage of GDP have declined by 40% since 1980 (Fig. 23), a drop that also reflects the advent of just-in-time inventory management. By their nature, many services have little or no inventory —there is no inventory of unsold haircuts or meetings with financial advisors. Consequently, while inventory cycles still exist, their relevance for the overall economic cycle is diminished.

Fig. 23: Inventories' role in the economy has structurally declined

Nonfinancial corporate inventories (% of GDP)

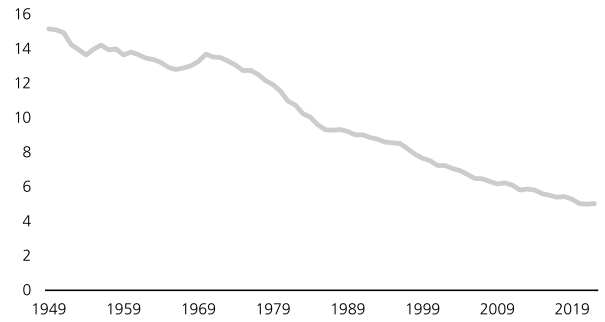


Source: Bloomberg, UBS, as of 28 June 2023

A related evolution is that the economy has become less energy-intensive, requiring only about 35% as much energy to produce a dollar of GDP today versus 1970 (Fig. 24).

Fig. 24: Economic activity is far less energy-dependent today than 50 years ago

Primary energy consumption per real dollar of GDP (in thousands of BTUs)



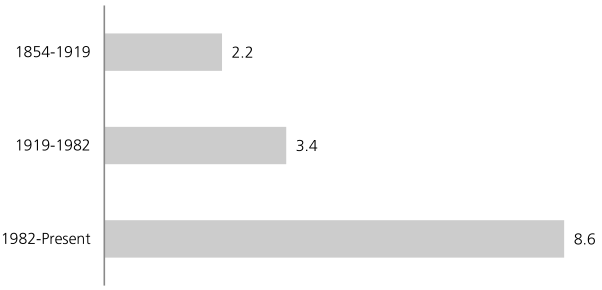
Source: US Energy Information Administration, UBS, as of 28 June 2023

All these developments have made the economy less interest rate- and oil price-sensitive, and more flexible to adapt quickly to shifting demand. The direct consequence is an economy that is less cyclical and prone to recessions, barring adverse shocks. After all, the trend is for the economy to grow over time due to productivity gains and a steady increase in the labor force based on slow-moving demographic and immigration trends. Something has to happen for a recession to occur, whether it is a pandemic, banking crisis, or other highly disruptive event.

The best illustration for how these structural changes in the economy have reduced recession risk is the substantial increase in the average length of expansions over the past four decades (Fig. 25). From 1854 to 1982, the average expansion lasted 2.8 years, with the average being 2.2 years from 1854–1919 and 3.4 years from 1919–82. But the four expansions since 1982 lasted 8.6 years on average. The evolution of economic activity that has contributed to the lengthening of expansions is unlikely to suddenly change in the post-pandemic economy. Consequently, any evaluation of recession risk, especially if calibrated on a long history of economic cycles, must take into account this structural recession headwind.

Fig. 25: Economic expansions have grown longer

Average length of economic expansions (in years)



Source: NBER, UBS, as of 28 June 2023

Where does the economy go from here?

The consensus forecast coming into 2023 was that a recession would start in the first half, or at least that growth would have bottomed around midyear and then started to recover by year-end. Here at the midway point of 2023, a recession has not started. While growth has slowed, it is still running close to the long-term trend rate. Growth is likely to slow further in the second half, but it is far from certain that the economy will fall into recession, or when that would happen. Current growth momentum is strong enough that it is unlikely that a recession starts before late fourth quarter at the earliest, barring an adverse supply shock or credit event.

Projecting how the 10 factors could evolve from here informs our assessment of the likelihood and timing of a recession. The structural changes to the economy, including the dominance of services activity, are very unlikely to reverse, and certainty not within the cyclical forecast horizon. Post-pandemic normalization trends should continue, which is disinflationary, and the data should benefit by becoming less volatile and noisy, though that does not imply anything about recession risk. For a recession to start, it will be because of the first six factors focused on policy and economic fundamentals. They are likely to evolve in the following ways:

1. Monetary policy will get more restrictive by early 2024. Fed Chair Jay Powell has said that the FOMC intends to raise rates another 50bps, while the market is pricing only an additional 25bps. Even if the Fed is done hiking, the real fed funds rate will continue to rise as a byproduct of inflation falling, unless the Fed cuts rates. While monetary policy becomes more restrictive in both scenarios, the nominal rate will go up only marginally. By contrast, the real fed funds rate could surge to 3% by the end of the year, with headline inflation likely to rapidly decline. That implies quite restrictive policy in 2024 if the Fed does not start cutting rates.
2. Fiscal policy should become marginally more restrictive over the next year, though the magnitude is uncertain. The debt ceiling deal imposed caps on spending growth, which will take effect in the 2024 fiscal year starting 1 October. The deal also ended student loan forgiveness, with payment obligations resuming 1 September. The monthly payments are estimated to be several billion dollars in aggregate, which will be a hit to consumer spending. The main uncertainty pertains to the potential offset from increased private sector investment stemming from the Inflation Reduction Act and the CHIPS Act. The announced plans have exceeded expectations thus far, and more private investment could follow, thereby positively amplifying the fiscal multiplier.
3. Household balance sheets should remain healthy over the next year. Excess savings will continue to run down, and at the current pace could be depleted some time in the first half of 2024. Real wages are now rising, which will allow consumers to increase their savings rate without altering spending plans. Household total wealth has also gotten a boost this year from the rise in stock and bond prices, while average house prices have stopped declining. Finally, while the marginal borrowing cost is much higher today than two years ago, because the large majority of outstanding household debt is locked in at low fixed rates, the average borrowing cost will rise only gradually.
4. Private sector excesses should remain manageable for a while. The year-long expectation for a recession has motivated many companies to prepare for that contingency, shoring up their financing and managing costs and capital to reduce their exposure to recession risks. The same is not broadly true for households. Rising delinquencies on credit cards and auto loans speak to some consumers stretching themselves to maintain spending.
5. Access to credit can dry up very quickly when macro conditions deteriorate, especially in public debt markets. This makes it hard to predict if, or when, credit conditions will become restrictive for growth. Fed officials have indicated that bank capital requirements will increase, which will likely constrain credit, and while the timing is not known yet, banks will begin to prepare well in advance. Small businesses are the most vulnerable segment to tighter credit because they rely on floating-rate bank debt loans, not fixed-rate publicly issued bonds. So far, small-business lending does not appear to have declined much over the past year, suggesting that these businesses have found other ways to finance activity.
6. The labor market is likely to remain relatively tight for the foreseeable future. Labor supply is constrained by demographics and immigration, and, if anything, may decline rather than increase as participation rates reach pre-pandemic levels. Labor demand should fall in a slowing economy, but even a 3 million decline in job openings would only get the labor market back to the same balance as at the start of 2020. Companies may also engage in labor hoarding, retaining workers even as demand slows because of the struggle of having to hire them in the first place.

Based on these factors, the likelihood of a recession hinges most on monetary policy getting more restrictive and eventually causing consumer spending to fall. That may

take at least two more Fed rate hikes, but there is also the possibility that monetary policy is operating with an extended lag this cycle, and the tightening thus far will be sufficient to cause spending to crack. The other plausible recession channel is that credit conditions continue to tighten, which would weigh most on small businesses. Since they account for most of the excess demand for labor, this scenario could entail a rapid cooling of the labor market.

The most likely factor to keep the US out of a recession is the tight labor market. The demand for labor may decline only gradually, but as long as it does enough to get supply and demand closer into balance, the Fed may be satisfied that inflation pressures will stay contained. Germany provides an informative lesson here. It has entered a recession, but its unemployment rate has stayed near historically low levels. Considering that the German economy is more manufacturing-driven than the US, and thus more exposed to the slowdown in goods consumption, its recession risk was arguably higher. If Germany's labor market can stay tight in a recession, then the tight US labor market could help it avoid a recession.

The bottom line is that the pandemic and post-pandemic US economy has behaved in highly unusual ways, and investors should not expect the next stage, which could be a recession, to be any different. It may well be a "jobless-less" recession, where growth, spending, and investment contract modestly, but unemployment rises barely above 4%. This is not much different from what a soft landing would look like. Whatever scenario ultimately plays out should become apparent in the next six months.

Appendix

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