

Global Macro Report, 22nd May 2024

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How High is US Recession Risk? Is Growth Slowing? Have the US & EU Decoupled?

Summary Extract:

- Despite capitulation by one of the highest profile bears this week (i.e. Mike Wilson, MS chief strategist), various well known economists retain their US recession call (including Nancy Lazar, Albert Edwards and David Rosenberg). Key (well-known recession forecasting) indicators also continue to point to an imminent recession. The yield curve remains inverted; Sahm's rule has been triggered in 40% of all US states; while the Conference Board's leading economic indicators continue to contract (month on month). Is it the case that the recession was delayed in 2023 by an aggressive fiscal loosening? Or are other factors at work?
- In this analysis, we dig into all ten categories of US recession indicators (that we focus on) and assess their wider message. In particular we show evidence which contradicts the 2024 recession calls (and recession indicators), and which has an equally strong track record. Indeed recessions, at their heart, occur when the corporate sector is stretched and under pressure. **That is simply currently not the case.**

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How High is US Recession Risk? Is Growth Slowing? Have the US & EU Decoupled?

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1. Summary & Conclusion

“Unemployment has jumped in 19 states, making a national recession almost inevitable, Lazar said....

... Piper Sandler's Nancy Lazar warned of tighter credit and the full fallout from the Fed's rate rises.”

Source: May 20th 2024, Business Insider <https://www.businessinsider.com/us-economy-outlook-recession-unemployment-lazar-states-inflation-wealth-spending-2024-5>

With the recent sharp fall in the US Citibank economic surprise index (fig 1), questions are being raised about the real strength of US economic growth. Q1 GDP data disappointed, coming in at 1.6% (vs. consensus of 2.5%); the ISM services index moved below 50; the combined ISM manufacturing and services employment sub-indices moved further below 50 (fig 14 in appendix); while the Michigan consumer ‘expectations less current situation’ model continues to signal recession (fig 2). Added to which, the yield curve remains inverted (22 months after its initial inversion), credit growth is anaemic and monetary policy appears tight.

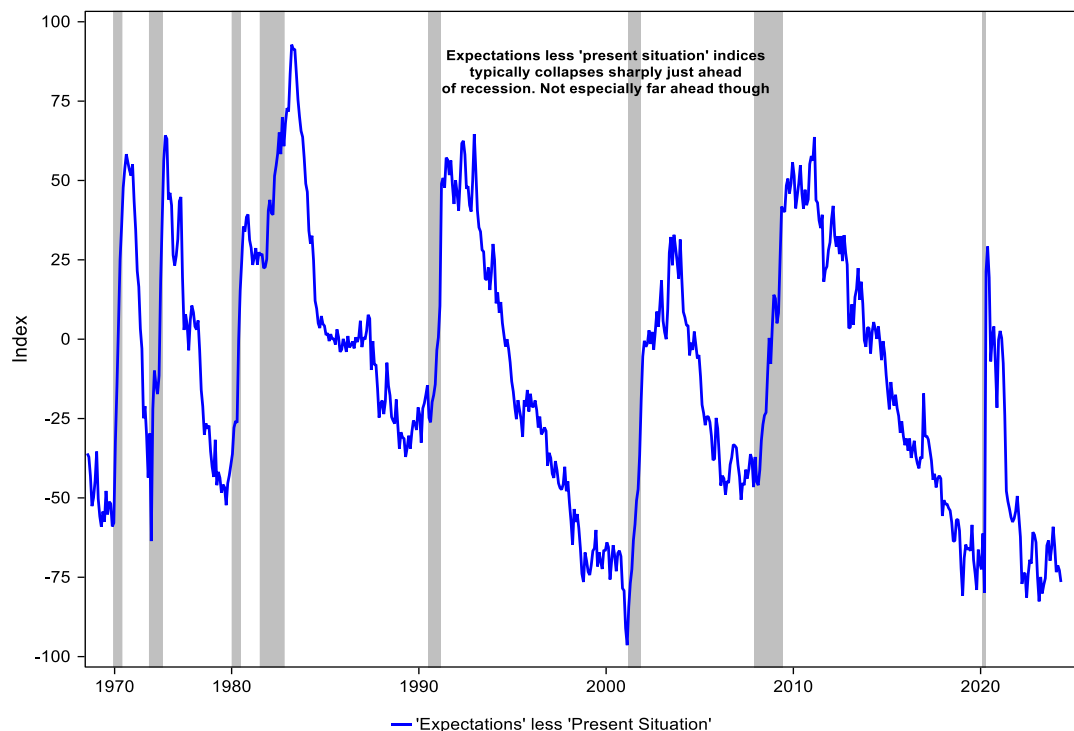
Fig 1: US economic surprise index shown with the S&P500



Source: Longview Economics, Macrobond

With that, certain commentators (despite the shift in attitudes in the BAML survey¹) continue to express confidence that a US recession is imminent. Nancy Lazar (Piper Sandler), for example, cites the jump in unemployment in 19 states, and tighter credit (see quote above). David Rosenberg (formerly of Merrill Lynch/well known bear) remains equally convinced of an imminent US recession; while, according to Barron's "JP Morgan's Kolanovic Is Now the Biggest Bear Standing. It's a Lonely Stance" **Source:** <https://www.barrons.com/articles/jpmorgan-kolanovic-bear-stock-21bd5abf>.

Fig 2: US Conference Board expectations less current conditions indices



Source: Longview Economics, Macrobond

¹NB the latest BAML FMS finds that '78% think recession is unlikely'.

²Albeit the eurozone economy has been stagnant for the past 12 months (& experienced a recession in 2023).

So **how high is US recession risk?** And is it as high in Europe², which is closer to cutting rates (according to market expectations) and potentially decoupling further from the US?

Below we assess the key US recession indicators.

2. Key Recession Indicators

1. Key US Recession Indicators

On the latest update of our key categories of recession indicators, **US recession risk has continued to diminish** (table 1). Last year, most categories were signalling recession (see 2023 column). By January this year, only three of the 10 categories were suggesting that a recession was imminent (i.e. our liquidity indicator, credit conditions and the leading economic indicators (LEIs)). On the latest assessment that total has fallen by one, such that only two categories are now highlighting that risk (i.e. 'LEIs' & 'liquidity indicator'), while 'credit conditions' is the category which has improved, as commercial banks have eased lending criteria (following on from loosening financial conditions). Notably, in that respect, financial conditions remain very easy (e.g. see the current HY corporate bond spreads; Kansas City Financial Stress Index or the Bloomberg US financial conditions index – fig 9 – which is at one of its 'loosest' readings on record). NB Financial conditions typically lead credit conditions by approx. 3 – 6 months.

Table 1: Longview US recession indicator categories (shown at key points³)

		1990	1995-96	1998	2000-01	2007-08	2012	2015	2023		Jan-24	May-24
		Category of indicator signalling recession? (Y/N)										
1	Corporate sector health	Y	N	mixed	Y	Y	N	Y	N		N	N
2	Liquidity indicator	Y	N	Y	Y	Y	N	N	Y		Y	Y
3	Credit conditions	Y	N	mixed	Y	Y	N	N	Y		Y	N
4	Financial conditions	Y	N	N	Y	Y	N	N	N		N	N
5	Housing	Y	N	N	N	Y	N	N	Y		N	N
6	Household net wealth	N	N	N	Y	Y	N	N	Y		N	N
7	Manufacturing	Y	N	N	Y	Y	N	N	Y		N	N
8	Conference Board LEI	Y	N	N	Y	Y	N	N	Y		Y	Y
9	Oil price	Y	N	N	Y	Y	N	N	N		N	N
10	Michigan sentiment	Y	N	N	N	Y	N	N	Y		N	N

Source: Longview Economics

³ In particular during prior recessions (1990, 2000-01 & 2007-08) and various mid-cycle slowdowns (1995-96, 1998, 2012 and 2015).

2. The Liquidity Indicator (category 2 in table 1)

This model is one of the two mentioned above that is still signalling an expected US recession. It's primarily composed of **monetary models**, like the inversion of the yield curve and real M1 money supply. Those two factors typically correlate well – fig 10 (as both are expressions of tight money). They are also both currently signalling recession. The steepness of the US yield curve, measured using the 10 year less 2 year section (the most accurate part for recession forecasting) started signalling recession in July 2022 (other than a signal for one day in April 2022). As such, it's been inverted for 22 months. Of all the prior successful signals (i.e. since the start of the data in 1976), the longest time from the initial signal to the start of recession was 2 years (from Dec 2005 to Dec 2007). The other signals that

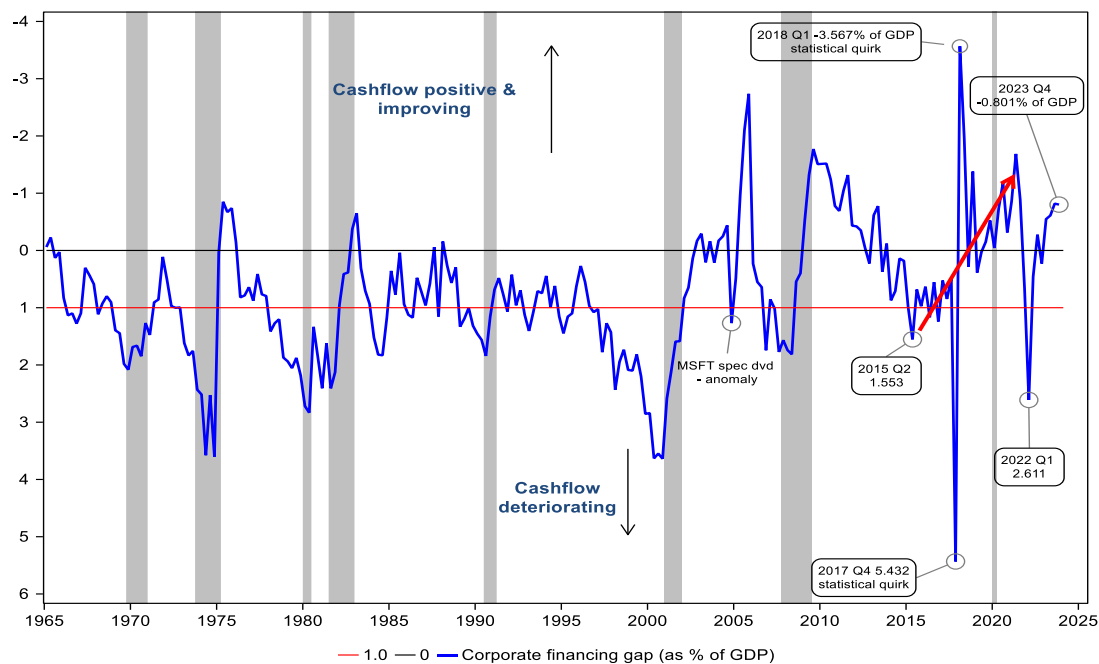
worked were 10, 13, 16 & 19 months ahead of the recession start date). As such, on that comparison, the signal is still potentially valid.

3. Corporate Sector Cashflow (part of category 1 above in table 1)

One key measure of cashflow health is the corporate sector financing gap⁴. This has always been in deficit ahead of recessions (see fig 3 – NB south of the red line is a 1% or greater cashflow deficit/north of the zero line is a surplus). Currently the model is showing a significant cashflow surplus (fig 3).

Overall, it's a good indication of how much companies are likely to respond to tight monetary policy. If they have a financing gap (i.e. a deficit), it implies in aggregate they need to borrow (and are, therefore, more likely to cut back on costs if money/monetary policy tightens). If they have a cashflow surplus, there's no need to borrow and, therefore, much less compulsion to cut costs/cut back on investments (hence a much reduced risk of recession⁵).

Fig 3: US corporate sector financing gap (as % of GDP)



Source: Longview Economics, Macrobond

⁴ N.B. the corporate sector financing gap is derived from flow of funds data and looks at the whole US domestic listed and unlisted corporate sector. It's calculated by taking total US NIPA corporate profits, then adding back depreciation (given it's an accounting item) and deducting actual capital expenditure and dividends (given they are cashflow items). There are also some smaller technical adjustments while this measure doesn't account for/deduct the cost of share buybacks.

⁵ Since, by definition, recessions occur when companies cut costs/shed labour, which then creates negative feedback loops into the economy (and more cost cutting by other companies).

4. Corporate Sector Margins and Profitability

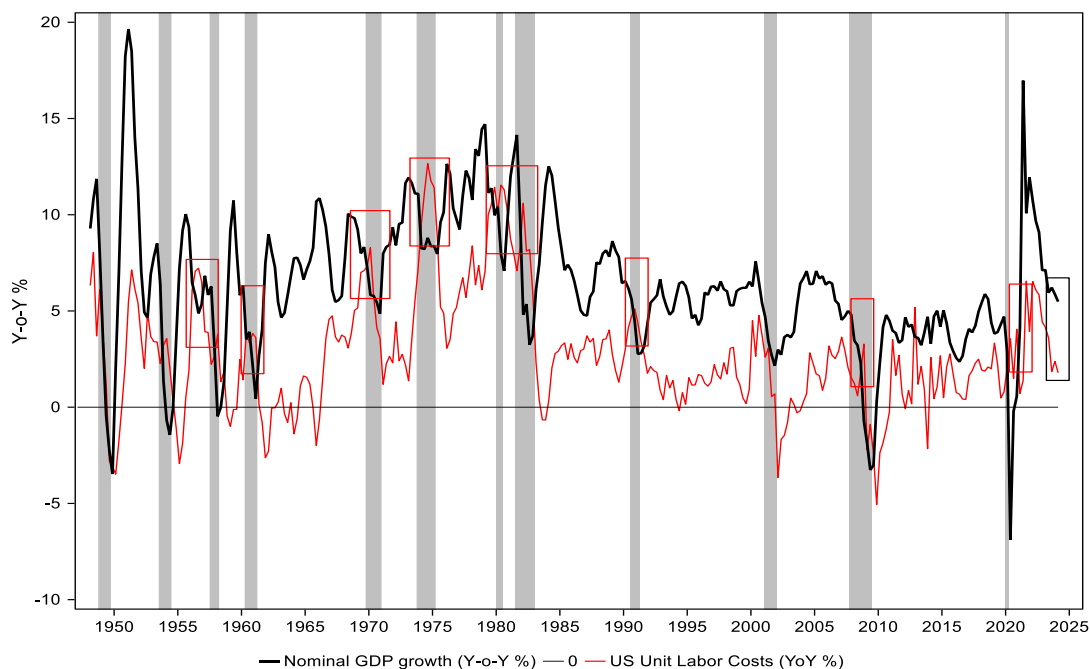
US corporate sector margins appear robust.

A macro model of those margins using nominal GDP growth and unit labour cost growth explains most of the trend in company margins. In this model, nominal GDP growth acts as a proxy for US corporate sector revenue growth. ULC growth, meanwhile, combines wage inflation (the key input cost for most American businesses) with their productivity growth.

Currently, the gap between those two lines on this model remains significant (5.5% nominal GDP growth vs. 1.8% ULC growth – fig 4), suggesting that margins should stay high. Productivity growth is also a good ‘standalone’ proxy for net income margin trends (and is another confirmation that margins are underpinned/should remain high – fig 13 in appendix).

In contrast, and as fig 4 shows, in recessions nominal GDP growth falls below unit labour cost growth. That then encourages cost cutting as it generates a margin squeeze with profits coming under pressure (which then, in turn, creates the cost cutting environment which is a recession).

Fig 4: US corporate sector macro margin model (nominal GDP vs. ULC growth)



Source: Longview Economics, Macrobond

Reflecting the above robust margins, NIPA (national GDP accounts) corporate sector profits continue to trend higher. Ahead of recessions, those profits usually decline (often for several quarters – fig 5). See extract below from our 2016 analysis which assesses this recession indicator, amongst others (Longview Letter no 104, 2016: “[What Works, What Doesn’t](#)”). Confirming that uptrend, the

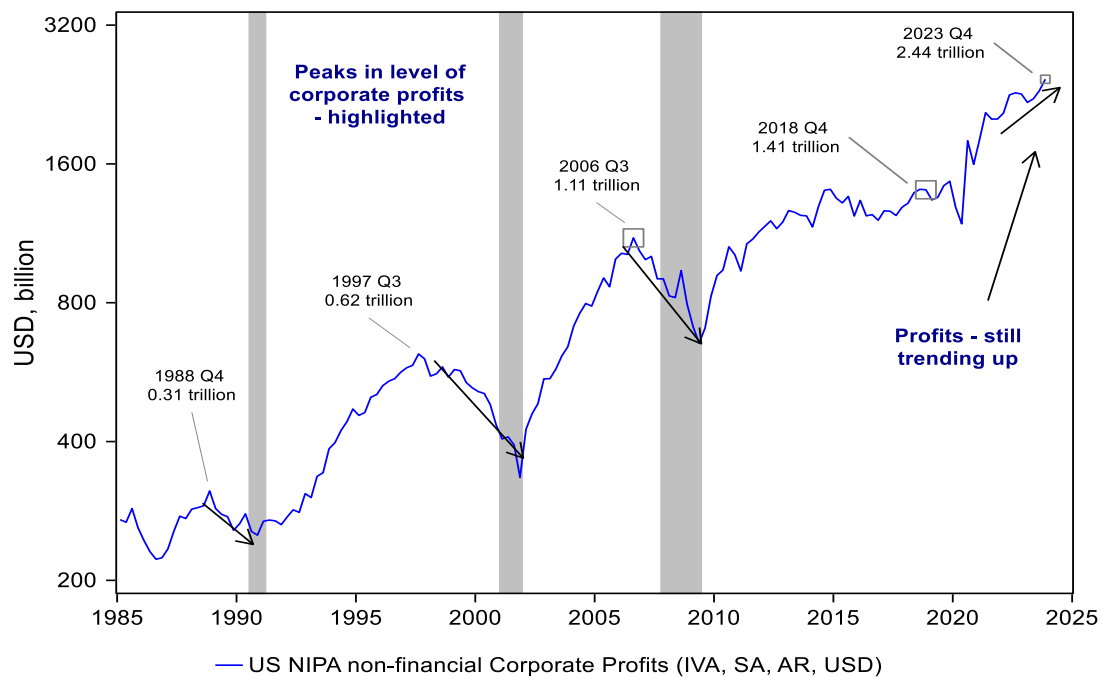
latest round of US quarterly earnings releases (from the listed sector/S&P500) is encouraging with earnings surprising to the upside relative to expectations (+8% surprise) and still growing (+5% annual growth).

Key quote:

“All recessions (except for the 1973 – 75 & 1981-2 recessions) are preceded by a contraction in corporate profits, albeit sometimes only just (in terms of timing). US national accounts corporate profits typically start to contract ahead of the start of a recession or, at times, are coincident with the start of the recession. The range of time from the start of the profits contraction to the start of the recession is between zero quarters up to 12 quarters (i.e. 3 years). There is only one false signal since the start of the data series (i.e. the mid-1980s). The 1967 and 1998 profits contractions were, though, significantly ahead of the start of the recession (i.e. 11 – 12 quarters).”

Source: “Forecasting US Recessions: ‘What Works – What Doesn’t’”, Longview Letter no 104, 16th September 2016

Fig 5: US NIPA (national accounts) corporate profits (level, US\$)



Source: Longview Economics, Macrobond

5. Corporate Sector Balance Sheets

Corporate sector balance sheets are strong. Net debt is low (relative to GDP – fig 11); cash and cash equivalents are high (fig 12); net debt issuance (according to flow of funds data) is also low (close to zero – NB it typically rises into recessions); while monthly high yield and high grade debt issuance is now running at a normal pace. None of which points to stress in the corporate sector (and is consistent with tighter high yield corporate spreads in recent quarters).

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Overall, therefore, the corporate sector appears healthy at this juncture. Margins are high and underpinned by good productivity growth; cashflow is positive; net debt levels are low; net debt issuance is low; and profitability is trending higher (which is all consistent with an ongoing economic expansion).

6. Other Key Categories (of recession indicators) -> Benign

All the other categories mentioned in table 1 (and not already covered) are generating benign signals with respect to the outlook for the US economy. The oil price (which often spikes ahead of, and into, recessions) has been broadly rangebound for the past 18 months (mostly between \$75 - \$90 on WTI, whilst the total cost of US oil has been around 2% of GDP, i.e. at relatively low levels); the household wealth effect (which was a major headwind in 2022) is now trending higher (latest growth rate is +8% Y-o-Y); housing data is stable (albeit at low levels), having fallen sharply in 2022/early 2023; while the manufacturing component (no. 7 in table 1) is also improving as shown, for example, by ISM surveys (especially the 'new orders less inventories' model, which is trending higher).

Indeed, according to the ISM inventories data, the inventory cycle troughed in December last year (NB using the 6 month smoothed reading). In that sense, it looks as though a new inventory upswing has begun (in recent months) – fig 6, especially given the move higher in new orders (which typically leads the direction of inventories).

Fig 6: ISM manufacturing inventories (1 & 6 month smoothed)



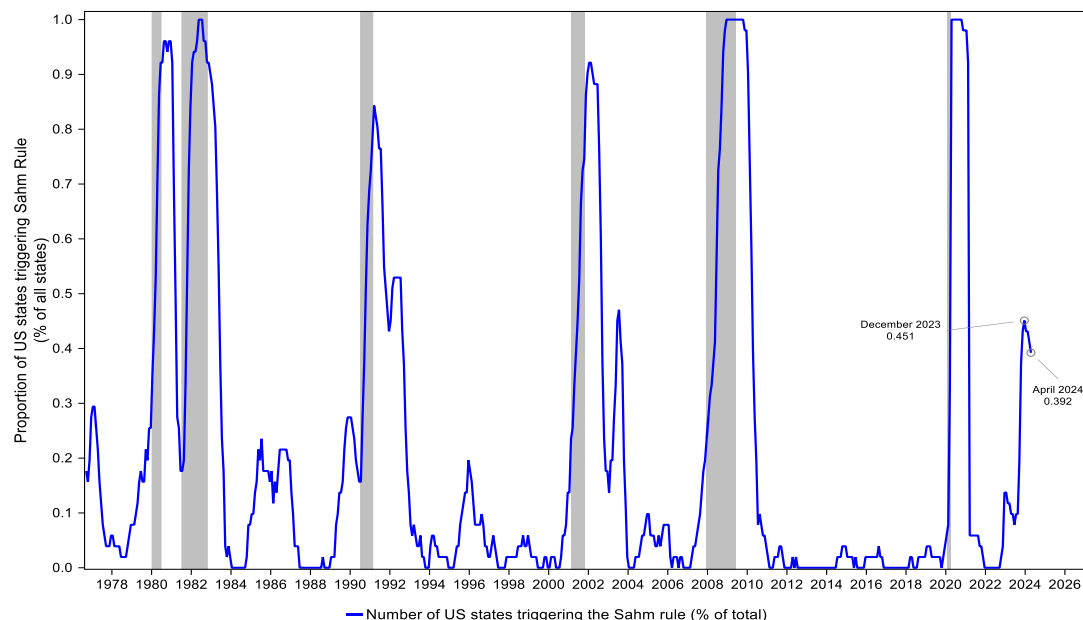
Source: Longview Economics, Macrobond

7. Labour Markets -> Fraying at the Edges

Outside of our 10 categories of recession indicators laid out in table 1, there is widespread evidence that the labour market is deteriorating (e.g. see ‘Kansas City Labour Market Index’, amongst others). This, of course, is generally the last piece of the recession dynamic. That is, once the labour market meaningfully rolls over, then consumption comes under pressure and, given its dominance of GDP, an economic contraction starts.

That labour market pressure was central to Nancy Lazar’s comments (see quote on P1). Below we have recreated a version of the underlying state by state analysis of the US economy. This is the ‘Sahm’ rule⁶ applied to individual states and then aggregated.

Fig 7: Proportion of US States triggering the Sahm rule (% of total)



Source: Longview Economics, Macrobond

⁶NB The Sahm rule is that if the unemployment rate has risen by 0.5pp or more in the past 12 months, then a recession is happening (or imminent).

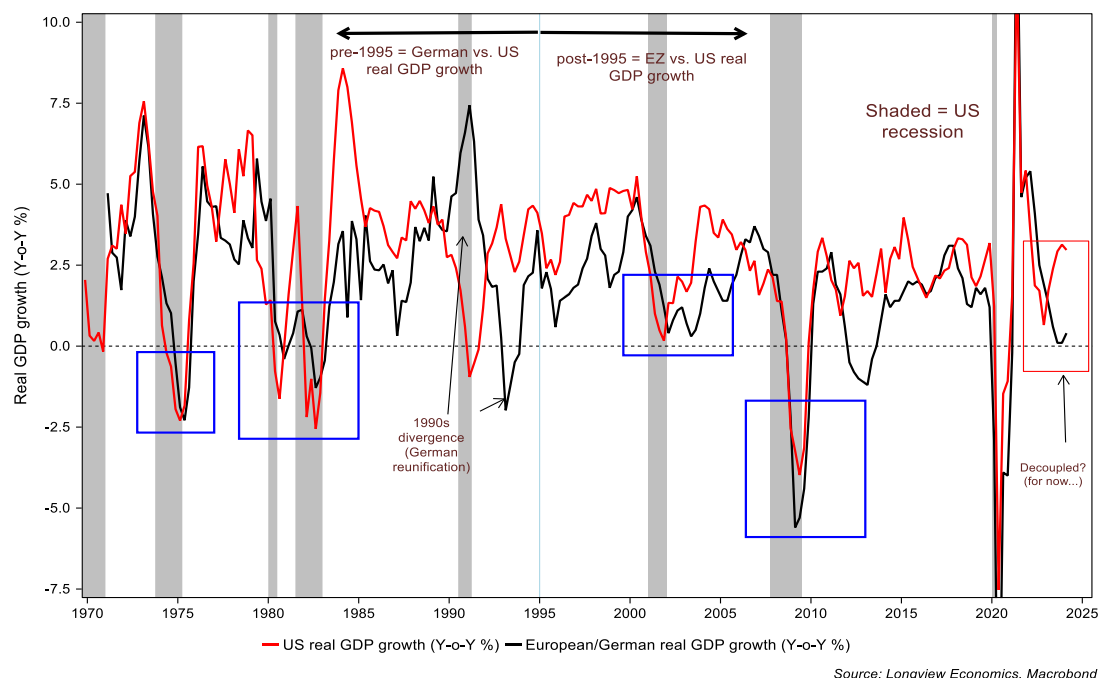
The chart is shown with US recession bands (in grey). On the surface it looks like a compelling argument for recession – i.e. the indicator is high; has been rising; and is at a level which is almost always consistent with recession.

One point to note, though, is that the indicator **normally reaches its peak at the end of the recession** (see end of the 1991, 2001 & 1980’s recessions). Most recently that occurred in December 2023 (since then it’s fallen consistently). Naturally there’s a risk that it starts to re-accelerate to the upside. As the chart shows, though, that would be a rare occurrence (especially given the loose financial conditions, strong corporate cash flow and other positive factors, as laid out above).

Conclusion: The US & Eurozone economies tend to move in sync (consistent with the market saying: “when the US sneezes, the rest of the world catches a cold”). In the past year and a half, though, as EZ GDP growth has slowed (and the EZ experienced a recession), the US’s growth rate has accelerated (fig 8).

Much of that reflects: i) higher levels of excess pandemic savings in the US (than in the Eurozone) – which have now been drawn down in the US; ii) large fiscal stimulus in the US in 2023, whilst according to the IMF, the Eurozone experienced a fiscal tightening; & iii) household savings ratios that have moved in opposite directions (in the past 12 months). In the US, for example, the savings ratio has fallen from 5.3% (May 2023) to 3.2% (latest monthly data). In the EZ, in contrast, the savings ratio is at its highest since the pandemic.

Fig 8: US & EZ real GDP growth (Y-o-Y %)



Given the softening labour market, the US fiscal tightening in 2024 (which we outlined in the ‘Longview on Friday’ published 3rd May 2024), coupled with the low household savings ratio and still tight monetary policy, we **expect US growth to disappoint in 2024 (relative to consensus)**.

Reflecting the ‘Key Points’ laid out above, though – and the underlying structural balance sheet and corporate sector strength – **we don’t expect a US recession in 2024. Indeed we retain the probability at 20%** (for this year), as a reflection of the softening labour market and still contracting LEIs, but we haven’t increased it from that level.

In Eurozone, in contrast, rates are likely to be cut as early as June. In which instance the rate of GDP growth should start improving by year end (if not

before). As such, some form of short lived decoupling is plausible (although not likely significant for markets).

Section 3: Miscellaneous Charts

Fig 9: US financial conditions index (source: Bloomberg)

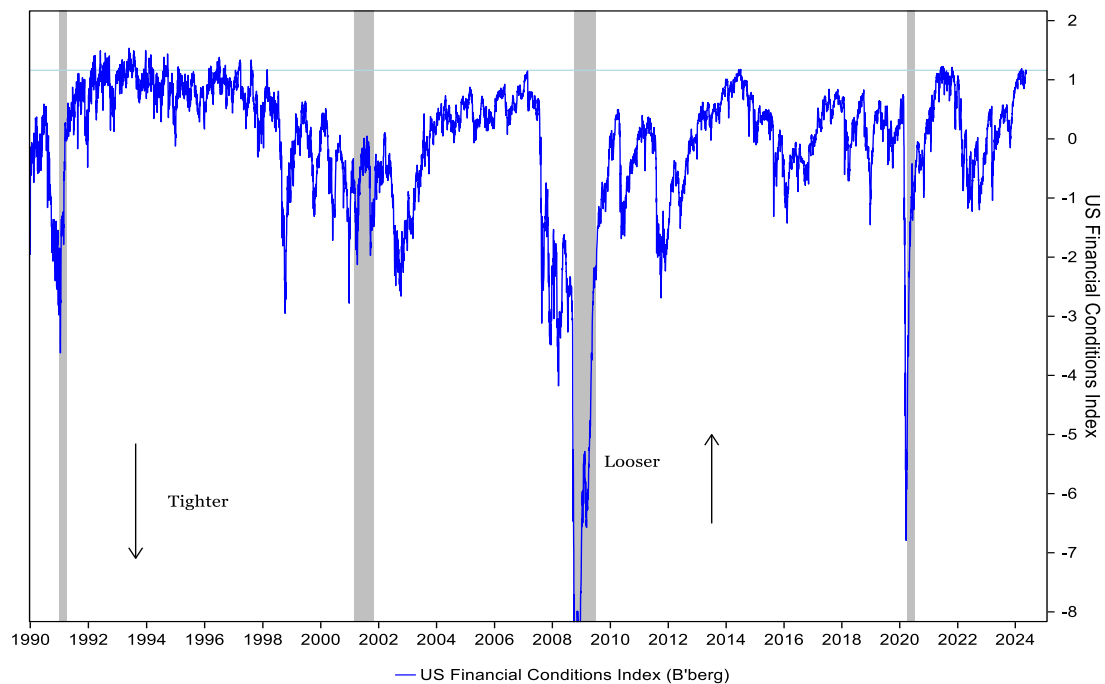
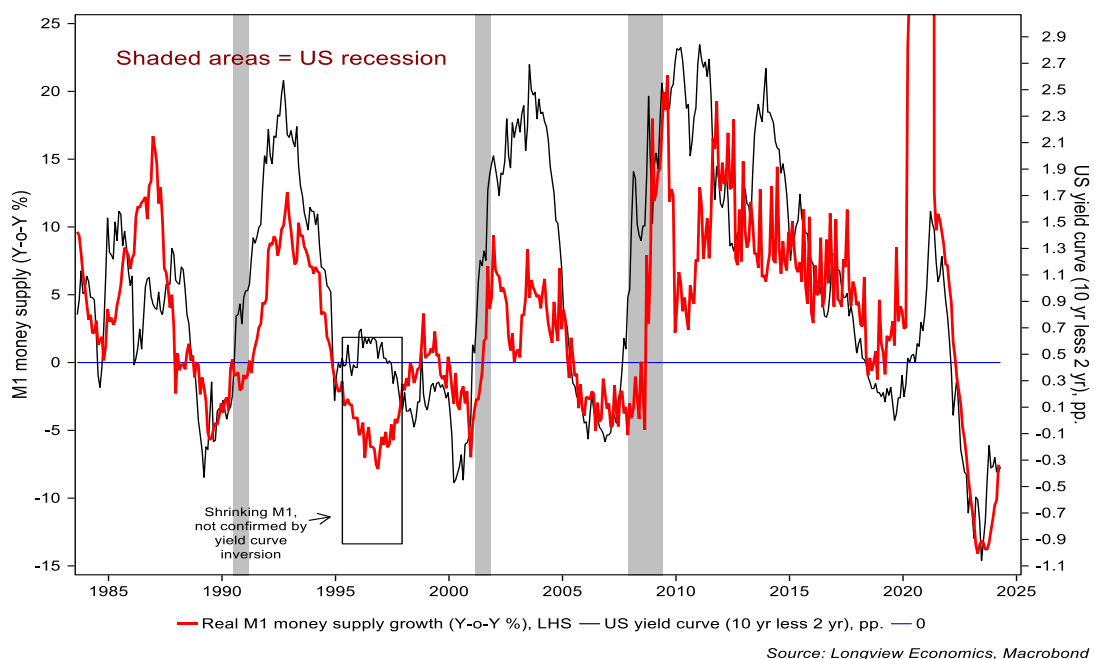
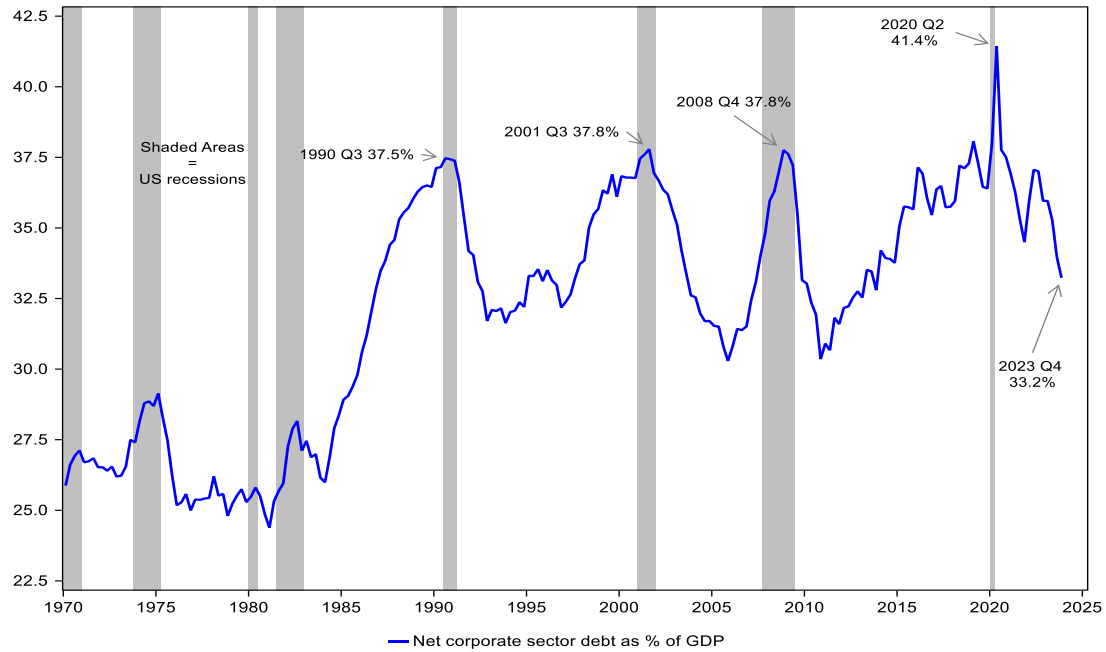


Fig 10: Real M1 money supply shown with yield curve steepness (2s10s)



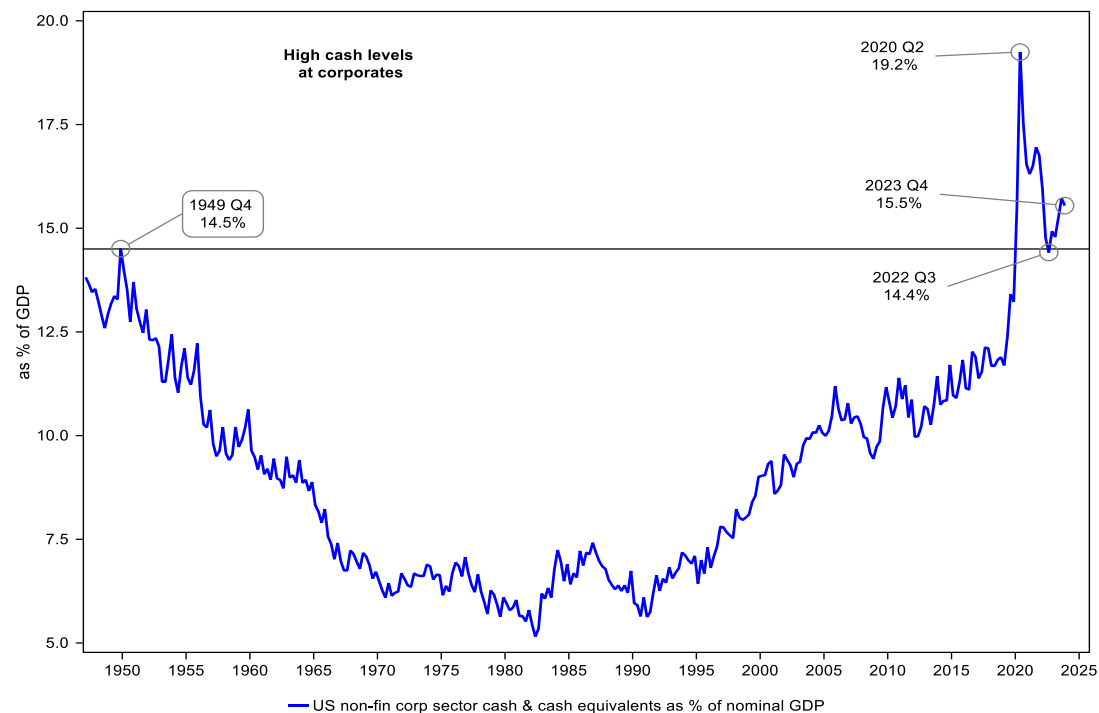
Section 3a: Measures of US Corporate Sector Health

Fig 11: US corporate sector debt net of cash and cash equivalents (% of GDP)



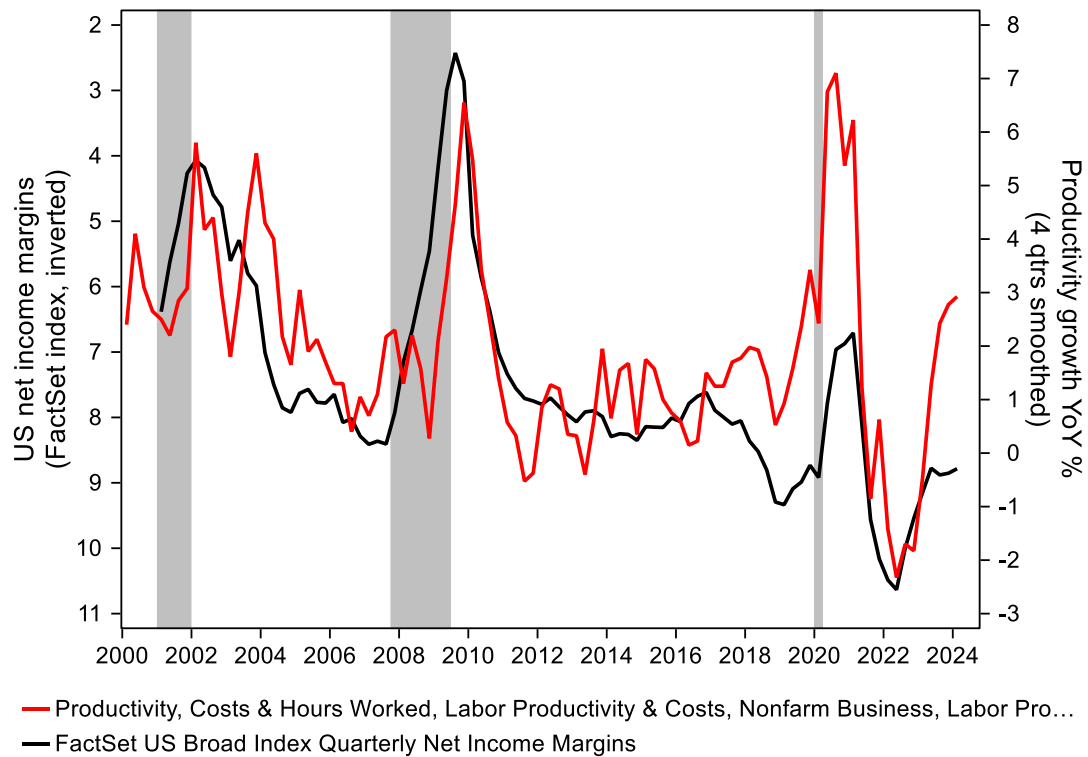
Source: Longview Economics, Macrobond

Fig 12: US corporate sector cash and cash equivalents (% of GDP)



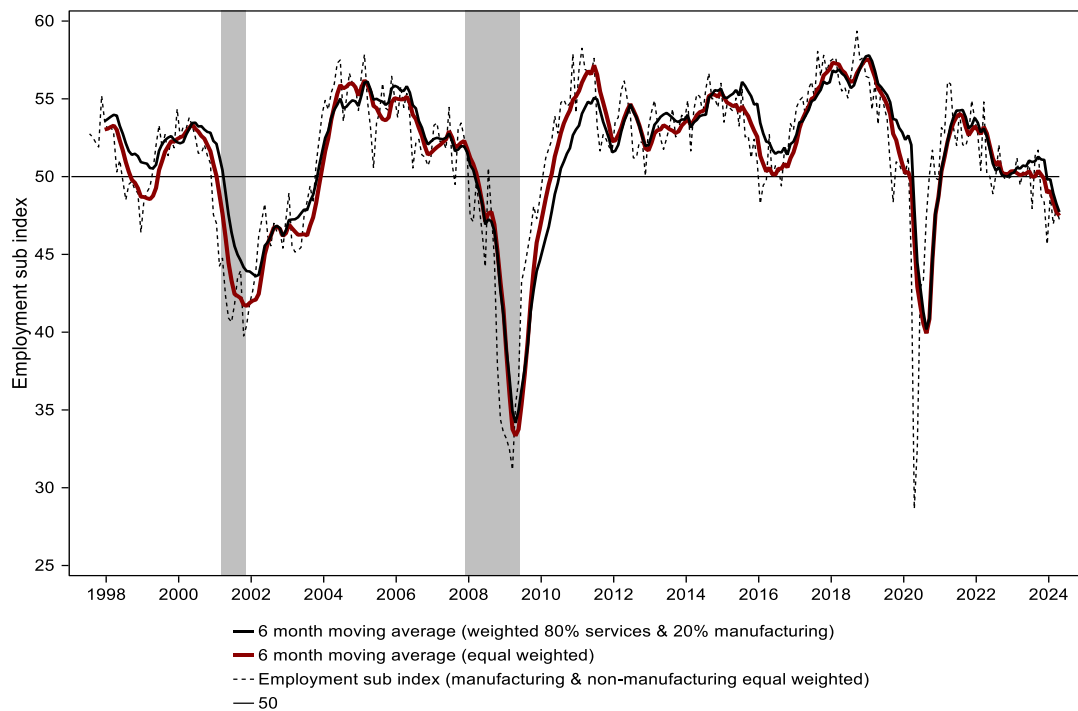
Source: Longview Economics, Macrobond

Fig 13: US productivity growth shown with US listed sector net income margins



Source: Longview Economics, Macrobond

Fig 14: ISM employment indices (blended and smoothed)



Source: Longview Economics, Macrobond

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