Macro theme

US slowdown and recession risks

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The market narrative of a US economy that has bottomed may prove to be premature. Indeed, leading indicators still point to a slowdown and the yield curve has sent its powerful recession signal. In this macro theme, we make the case for a US slowdown in the first half of 2020, prompting the Fed to cut rates. An update of the 'roadmap to recession' theme from March confirms that a trigger is needed for the US to fall into recession and recession probability models show that only financial indicators have sent recession signals, so far.

Prepare for slowdown

Global manufacturing activity has stabilised in recent months, leading the Fed to conclude that no more rate cuts are likely to be appropriate and, in turn, prompting long-term bond yields to rise on both sides of the Atlantic. However, we do not buy into the 'nothing to see here' narrative; we still expect a US slowdown to unfold and occasional recession fears to return, which should in turn lead the Fed to cut rates one more time.

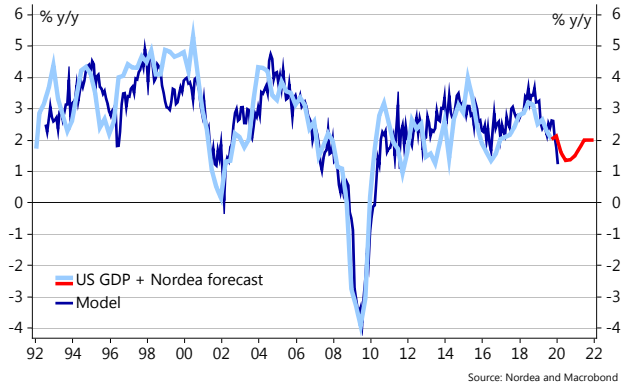
Roadmap to recession 2.0

The yield curve sent a strong recession signal earlier this year upon inverting and the most watched key figures are still on the roadmap to recession that we laid down in March. However, we do not see the trigger for a recession yet, which is why we stick to forecasting a slowdown.

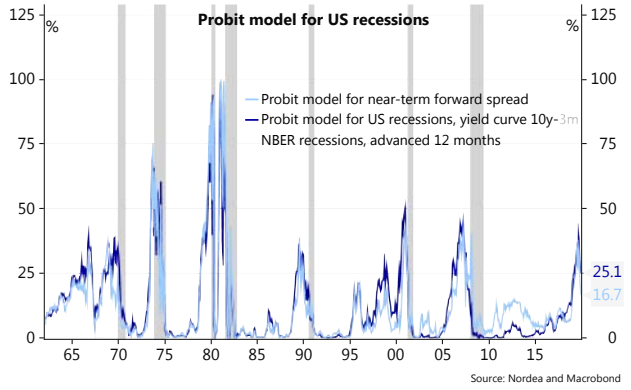
What is the probability of a recession looming?

On top of our roadmap to recession, we expand our recession analysis by introducing recession probability in different time horizons and based on various leading indicators. In general, we find that financial indicators give better early warning signals of recessions than economic key figures. Overall, we see the risk of a looming recession as significant but not alarmingly high.

DOWNSIDE RISK



RECESSION RISKS ARE STILL IN PLACE



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Lukewarm cocktail in 2019

The US economy has slowed down in 2019 due to a lukewarm cocktail of spillovers from the Fed overdoing rate hikes and balance-sheet normalisation in 2018, the ongoing trade war, and the fading effects of very easy fiscal policy stemming from Trump's tax reform and the 2018 Budget Act.

From high to normal growth...

...from normal to slow

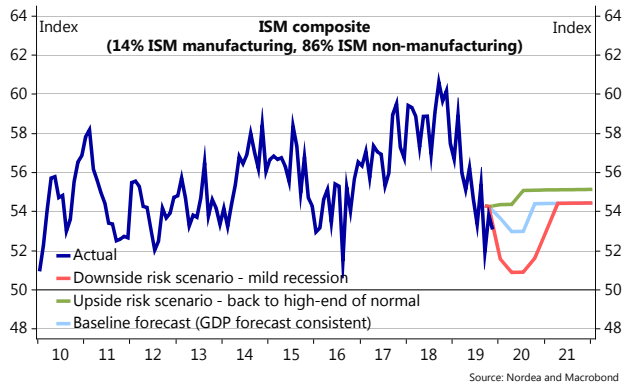
The slowdown has been from high levels, ie levels **above** potential growth, to more normal growth rates, so far, and more or less in line with our forecasts. In the coming quarters, we expect growth to slow down **below** potential, which is the primary reason why we think the Fed is not done with its easing yet.

A slowdown is already here in ISM terms

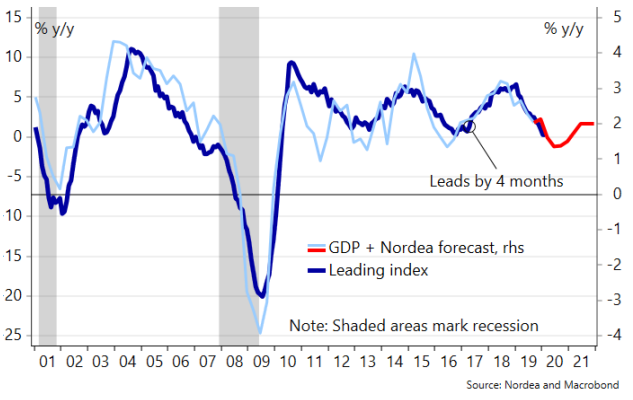
A slowdown does not necessarily take a lot of additional weakening of the ISM. In the left-hand chart below, we translate three GDP growth scenarios into scenarios for the ISM composite index: our baseline slowdown, a mild recession, and a faster-than-expected return to the high end of normal growth. A slowdown scenario corresponds to an ISM composite index of around 53-54, ie around current levels. Thus, the ISM staying put for a few quarters could be enough for our GDP slowdown scenario to play out.

The mild recession scenario, on the other hand, would require the ISM composite to continue its downwards trend towards the 50 level, although a mild recession could happen with the ISM composite slightly above 50 as well. The upside scenario would imply the ISM composite increasing to levels around 55.

OUR ISM SCENARIOS



CONFERENCE BOARD LEADING INDICATOR



Several leading indicators point south

Our main slowdown scenario is based on several leading indicators. For example, the Conference Board's leading index – which is also one of the best recession indicators on a three-month horizon in a standard probit framework – follows our slowdown forecast almost 1:1 (see chart above). When dissecting the ten contributing components to this leading index, it is evident that housing and the financial variables are currently the positive factors, while the manufacturing sector and the labour market components are the negatives.

Interestingly, at least seven out of the ten indices were negative one month prior to the past four recessions. Currently, five out of ten components are negative.

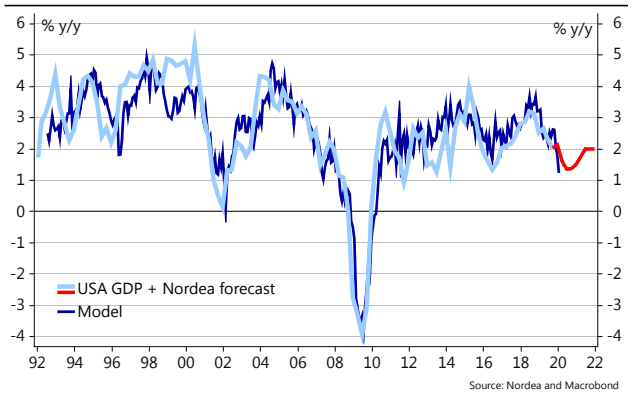
Our own constructed leading indicators signal a clear risk of a downward correction

On top of the Conference Board's leading index, we construct two leading indicator models ourselves (see charts below). One focuses on the very short term (three-month horizon), while the other focuses on the medium-term (six-nine month horizon). The models – which are based on a variety of variables from the labour market, financial condition indices, housing and business surveys – both point to clear downside risk in

the short term. Only in the medium term should we expect to see some stabilisation. This is therefore also what we have pencilled into our ISM and GDP forecasts.

If we are right on this slowdown scenario, we think this would prompt the Fed to, in its own words, "materially" reassess its economic outlook, effectively forcing the Committee to deliver another rate cut in March.

OUR SHORT-TERM GDP MODEL SUGGESTS DOWNSIDE RISK...

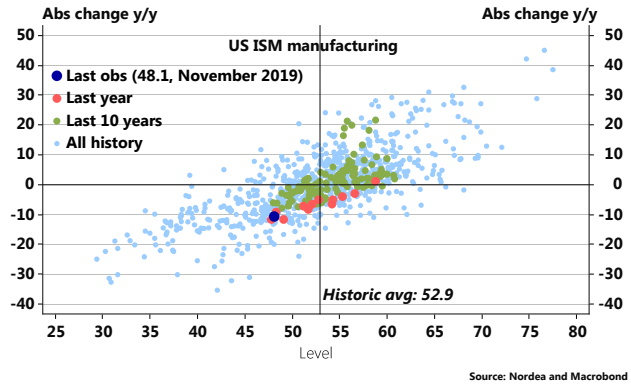


...WITH SOME STABILISATION IN THE MEDIUM TERM

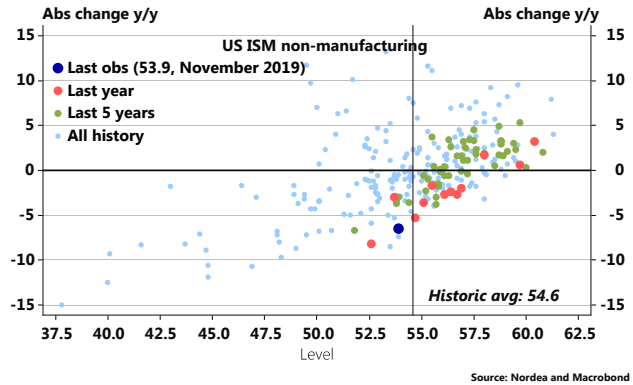
ISM prints below its historical averages

As mentioned above, the ISM Composite is already at levels corresponding to growth being below potential. Both the manufacturing and non-manufacturing indices are thus below their historical averages, with the former well below. Hence, we do not buy into the seemingly widespread narrative that we have already seen the bottom when it comes to US growth.

ISM MANUFACTURING IS WELL BELOW HISTORIC AVERAGE...



...AND SO IS NON-MAN. AFTER DECLINES THROUGHOUT 2019



Risk of spillovers to the service sector...

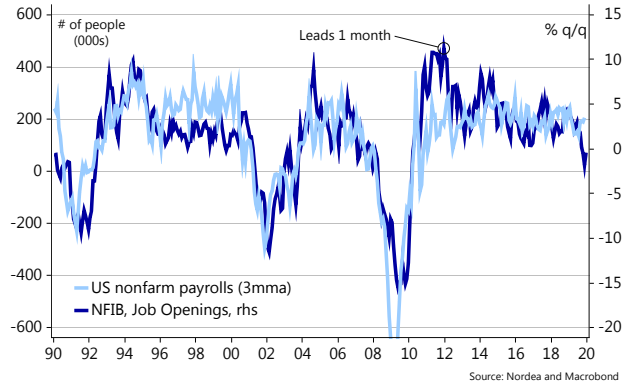
So far, the slowdown has mostly been driven by the recessionary manufacturing sector, while the much broader and more important service sector has been resilient. However, we are seeing signs of spillovers to the service sector.

...and the labour market

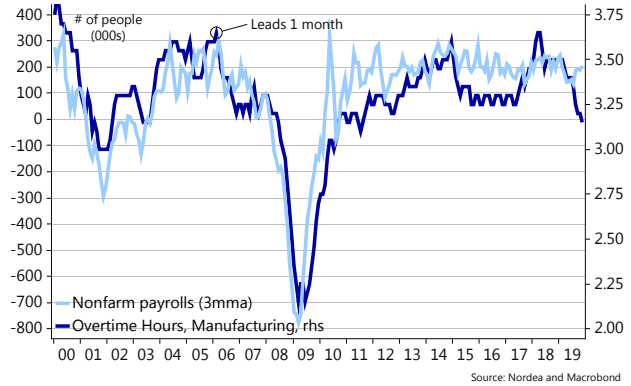
Most notably, leading indicators on nonfarm payrolls are pointing south, with both worked overtime hours and job openings sending clear warning signals. Hence, in our view, the recent strong November report was more of a fluke and likely to be revised down. We therefore think the six-month average of payrolls should slow down to below 100,000 in the first half of 2020.

When looking at another much-followed key measure in the labour market – jobless claims – they continue to be stable, and so one could argue that there should be no worries linked to the labour market. However, we would argue that the cocktail of less hiring and stable jobless claims is not unusual at this point in the economic cycle. Thus, in times of fading demand, firms simply initially stop hiring before they turn to more costly layoffs. Consequently, job openings are, in our view, a better leading indicator than jobless claims. Again, this indicator is sending lukewarm signals (see chart below).

MOMENTUM IN JOB OPENINGS SUGGESTS LOWER PAYROLLS



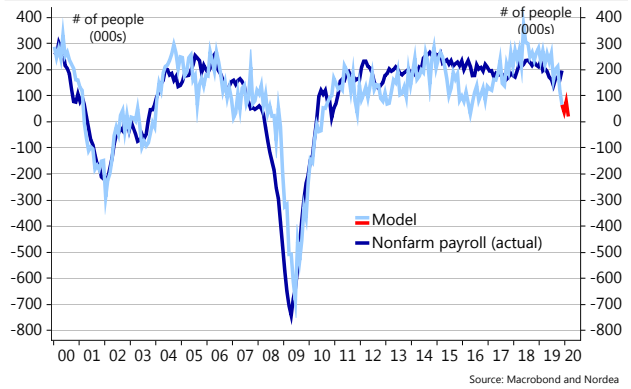
...AND SO DO OVERTIME HOURS WORKED



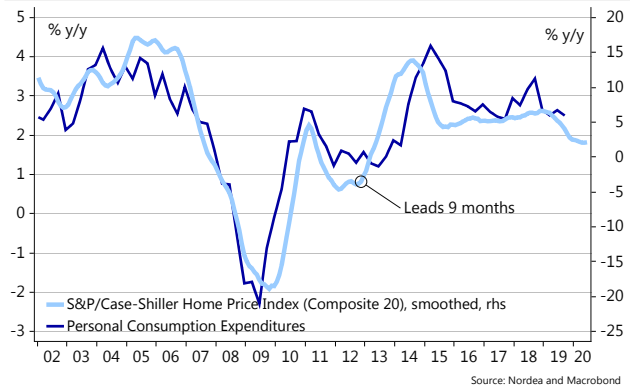
Private consumption should slow in coming quarters

We are also seeing some signs that personal consumption, which constitutes almost 70% of GDP, could begin to slow down. For instance, lagging effects from the softening in the housing market indicate downside risk in the coming quarters (although not to worrying levels, see chart below). Furthermore, if we are right about the outlook for the labour market, fading personal consumption expenditure should materialise.

OUR NFP MODEL POINT TO A SLOWDOWN

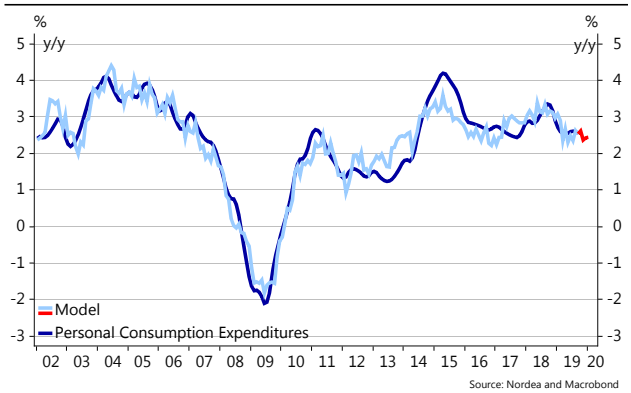


HOME PRICES LEAD PERSONAL CONSUMPTION

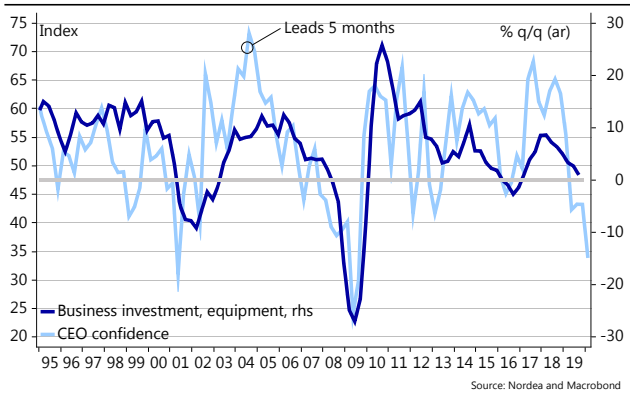


Our own personal consumption model consisting of various surveys, retail sales, the saving rate and credit impulses also suggests softening demand ahead. Given the fact that the robustness of the US consumer has been a key driver of growth above potential, and FOMC members have often mentioned the resilient consumers as a clear argument against any potential recession, a slowdown in personal consumption would indeed be a worrying signal for the Fed.

WEAKER PERSONAL CONSUMPTION AHEAD?



CEOS INDICATE INVESTMENTS FALLING OFF A CLIFF



The weakness in business investments is worrying

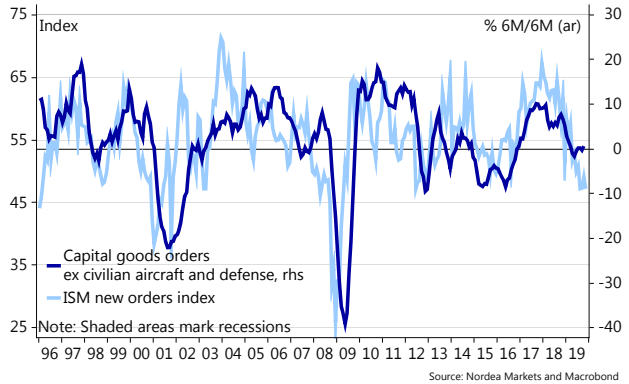
An already worrying signal for the Fed is the development of business investments over the past year. Thus, the Fed has on several occasions mentioned the soft momentum in business investments as a factor that could lead to a more substantial growth slowdown than otherwise projected. Judging by our (and some of the Fed's own) leading indicators, business investments are most likely to remain weak and may

even soften more in coming quarters (see chart above).

Corporate profits are getting squeezed

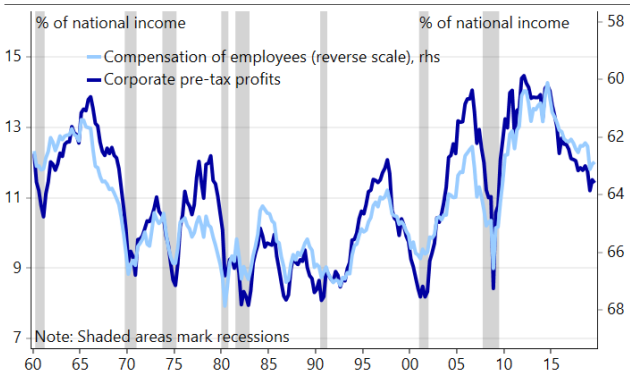
Moreover, businesses are not only reluctant to invest and seeing decreasing capex (see chart below), but their profits are also being squeezed. Large declines in profit margins like those we have seen over the past few years usually precede recessions, with the average time from a peak in profit margins to a recession being eight quarters (see chart below). We are currently well past that peak now, although admittedly longer cycles such as the current tend to have longer lead times.

DOWNSIDE RISK TO CAPEX AND DURABLE GOODS ORDERS



Source: Nordea Markets and Macrobond

CORPORATE PROFITS HAVE PEAKED



Source: Nordea Markets and Macrobond

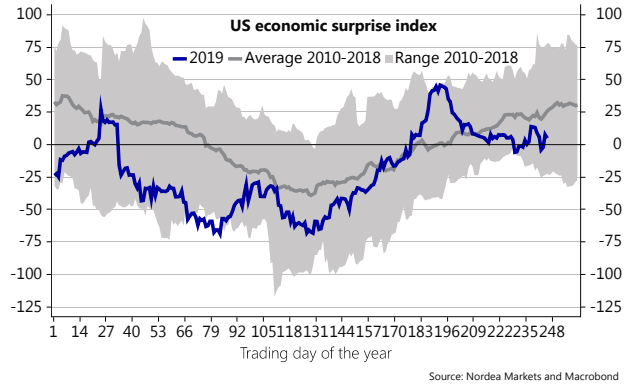
In total, we think there are plenty of factors supporting our view that the US economy has not yet bottomed out and that we should expect to see growth slowing down in the coming quarters.

That said, we see the risk to our view as roughly balanced. While we will cover the downside (recession) scenario extensively in the next section, we think it is also fair to point out a few upside risks to our forecast (as illustrated by the green line in our ISM scenario chart in the beginning of this section).

The Fed's liquidity injections and seasonality in US key figures are upside risk in Q4 and Q1

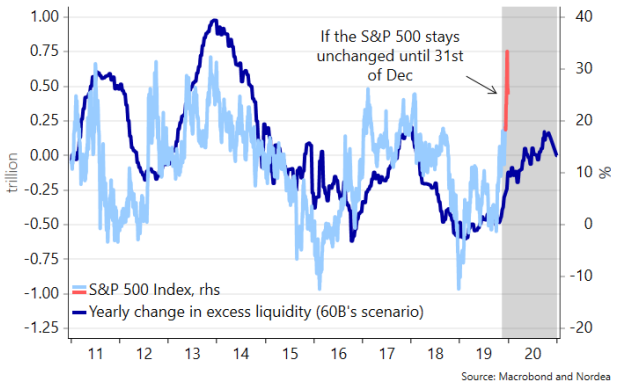
We see mainly two things supporting the upside risk scenario. First, although we do not deem recent liquidity operations from the Fed as a new round of QE, the equity market seemingly does not care (yet) (From QE to QT to "new normal"). The liquidity injection has thus been a clear driver of increased risk appetite, which in turn should, all else equal, temporarily underpin US key figures in Q4 and Q1. Second, US key figures tend to surprise positively in these two quarters. Therefore, if the pattern persists this time around, it would be difficult for our short-term slowdown scenario to materialise and consequently also for the Fed to deliver a cut in March, as we otherwise predict.

KEY FIGURES TEND TO SURPRISE POSITIVELY IN Q4 AND Q1



Source: Nordea Markets and Macrobond

MARKETS ARE PARTYING LIKE IT IS QE4



Source: Macrobond and Nordea

Roadmap to recession

The yield curve sent a strong recession signal earlier this year upon inverting, and the most watched key figures are still on the roadmap to recession that we laid down in March. However, we do not see the trigger for a recession yet, which is why we stick to forecasting a slowdown.

The most watched key figures are bad recession indicators

In this section, we dig deeper into our downside risk scenario, focusing on the risk of a recession. In doing so, we revisit our Macro theme: Roadmap to recession.

A trigger is needed for the US to fall into a recession

The main conclusion from the roadmap to recession theme is that the most watched economic indicators weaken quite late ahead of recessions and are likely to be flagging a recession when it is already there.

We still forecast a slowdown

Another key conclusion is that a trigger is needed for the US economy to fall into recession, like the housing market for the 2008-09 recession, the equity market for the 2001 recession and the Fed tightening too much in the recessions of the 1980s and 1990s. At the moment, an equity sell-off looks the most likely of the three, but the next recession may also have a fourth and different trigger. We have yet to see a trigger for a recession, which is why we are still forecasting a slowdown. However, current levels of the most watched key figures do not exclude the possibility of an early 2020 US recession.

Updated roadmap to recession

The updated roadmap to recession charts show that the current situation is similar to the run-up to previous recessions even if we stick to the assumption that the next recession starts in January 2020. The vertical lines in the charts below show each of the key figures at the time of the recessions, while the run-up to the previous and next recessions is shown to the left of that line.

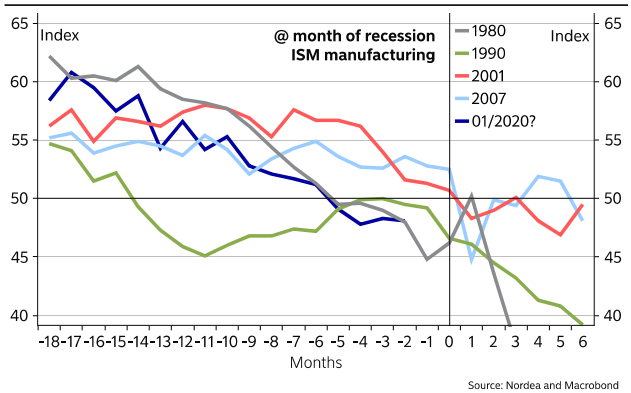
ISM manufacturing has already weakened as much as it did ahead of previous recessions

ISM manufacturing has already weakened by more than it had at the same time ahead of the previous four recessions. The main question is whether the global manufacturing shock can be a trigger for a US recession. At this point, we do not think so. It will cause the economy to slow further as the weakness spills over via the labour market to the service sector, but it probably will not be enough to trigger a recession.

Payrolls, ISM non-manufacturing and GDP have slowed but not by enough to signal an imminent recession

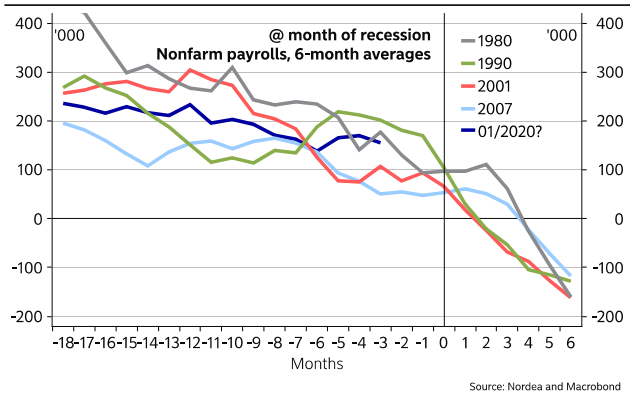
The extent to which the service sector will slow is the next big question. Nonfarm payrolls are still increasing at a decent pace, while ISM non-manufacturing has dropped from very high levels to levels just below its historical average. However, both variables tend to weaken very late in the run-up to a recession. GDP growth has slowed to a level that is close to potential in Q3 and additional weakness going forward would constitute a slowdown.

ISM MANUFACTURING



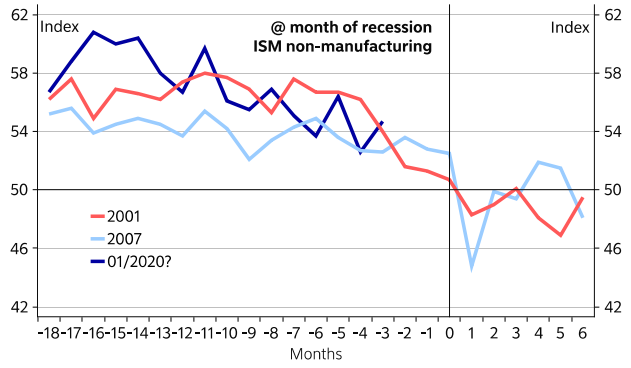
Source: Nordea and Macrobond

NONFARM PAYROLLS



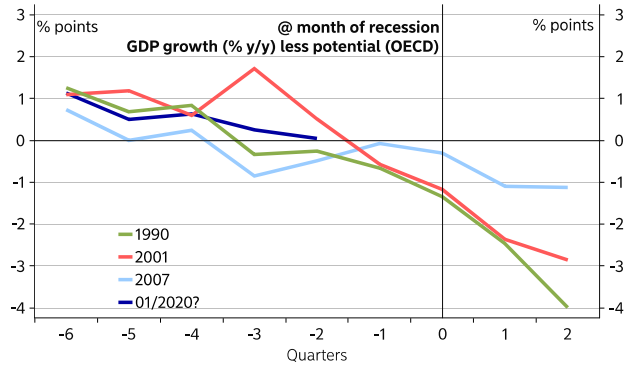
Source: Nordea and Macrobond

ISM NON-MANUFACTURING



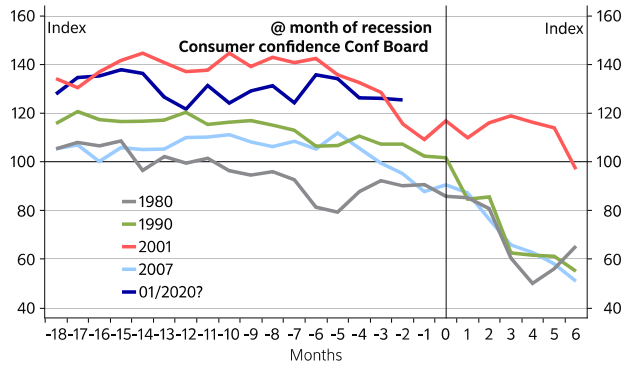
Source: Nordea and Macrobond

GDP GROWTH LESS POTENTIAL GDP GROWTH



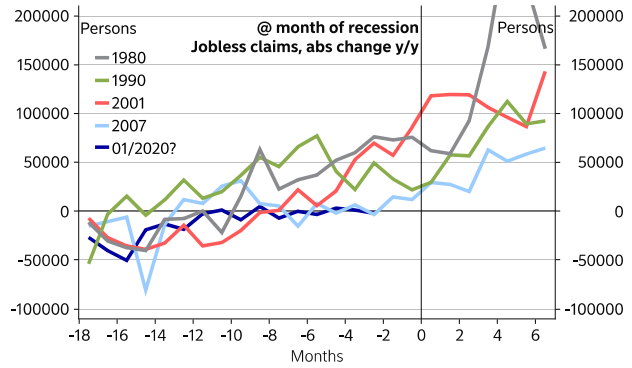
Source: Nordea and Macrobond

CONSUMER CONFIDENCE



Source: Nordea and Macrobond

INITIAL JOBLESS CLAIMS, CHANGE



Source: Nordea and Macrobond

A trigger is needed

The end of Fed quantitative tightening (QT) has reduced the recession risk

As mentioned above, we have yet to see a trigger for a potential recession, which is the reason we still forecast a slowdown and not a recession.

We had pointed to the Fed's balance sheet normalisation as an underrated driver of global manufacturing weakness and tightening financial conditions, but the Fed has since put the fire hose to that concern. At this point, the most visible potential trigger could be an earnings recession prompting an equity market sell-off.

Three triggers for recent recessions: housing markets, equities, and Fed over-tightening

Three triggers explain the recent recessions: the bursting of the housing bubble was the main factor that started the Great Recession in 2007, while the equity market and the dot-com crash was the trigger for the 2001 recession. And while both of these recessions were supported by tight monetary policy, the recessions of the 1980s and 1990s stand out in retrospect as being driven by the Fed tightening too much.

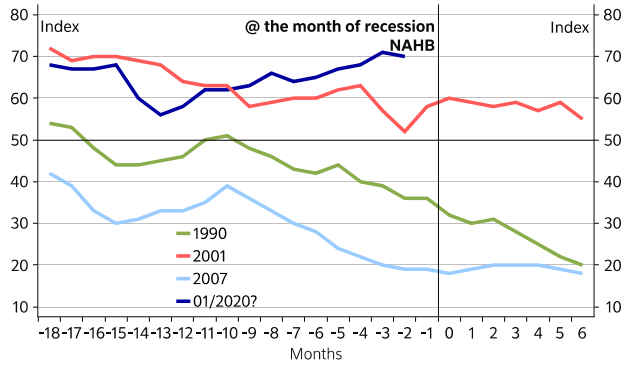
No trigger at the moment...

At the moment, the housing market seems to be gaining momentum while monetary policy is easy when comparing the real Fed Funds rate with r* and when comparing real M1 growth to its history in the run-up to past recessions. Equities are still rising and although we do not expect that to last, it remains to be seen whether an upcoming sell-off will be big enough to trigger a recession.

...but the yield curve has sent a recession signal

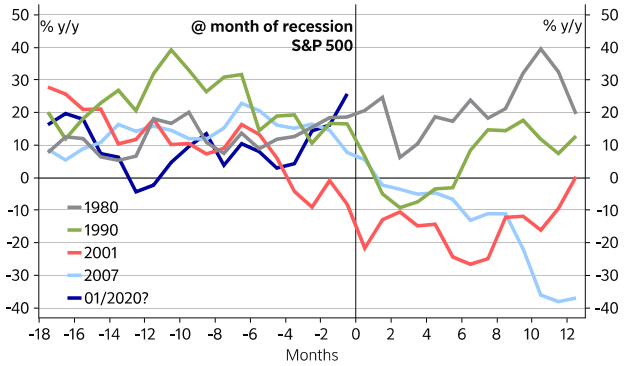
Only the yield curve has raised the flag and signalled a recession earlier this year. The recent steepening of the yield curve does not take away the signal, as it is similar to the run-up to previous recessions, when the yield curve steepens as monetary policy becomes easier.

2007 RECESSION TRIGGER: HOUSING MARKET



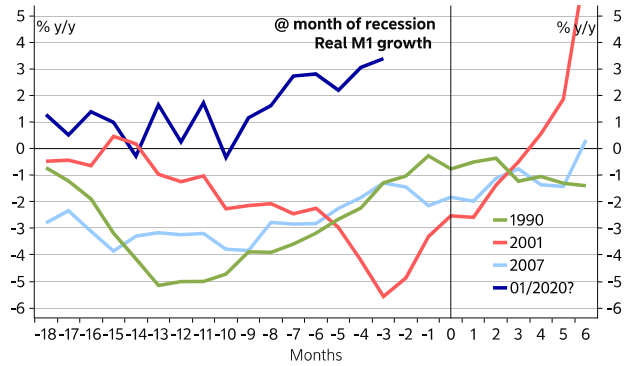
Source: Nordea and Macrobond

2001 RECESSION TRIGGER: EQUITIES



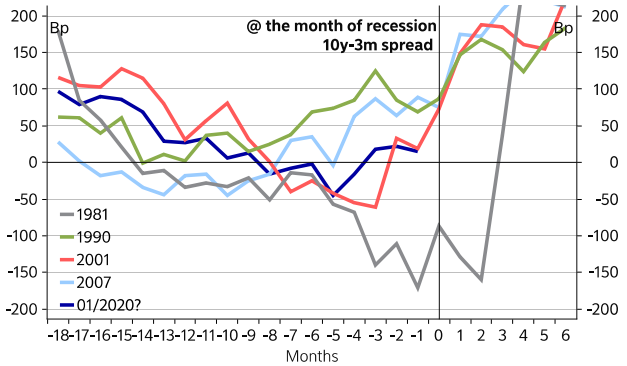
Source: Nordea and Macrobond

1980s & 1990s RECESSION TRIGGERS: FED OVER-TIGHTENING



Source: Nordea and Macrobond

YIELD CURVE



Source: Nordea and Macrobond

Recession – real versus financial signals

We introduce probit models, which give probability estimates of a recession looming in different time horizons, based on various leading indicators. We find that financial indicators give better early warning signals of recessions than real economic indicators, as most of the latter react very late in the run-up to a recession, and as different parts of the economy can cause recessions.

The yield curve is the best indicator in a long time horizon

"Yes, it's the yield curve, s....."

When it comes to predicting US recessions on a 12-month horizon, there is nothing with anything near the predictive power of the yield curve. From an econometric point of view, the ten-year treasury yield less the three-month T-bill is the one to watch (see more here), while the Fed's preferred measure is the "near-term forward spread" (three-month T-bill six quarters forward less the three-month T-bill spot).

Using the spread between ten-year treasury yields and three-month T-bills, the risk of a recession starting in 12 months is 25%, according to standard probit models from the New York Fed, for instance. Using the "near-term forward spread", the probability decreases to 17%, according to our estimates.

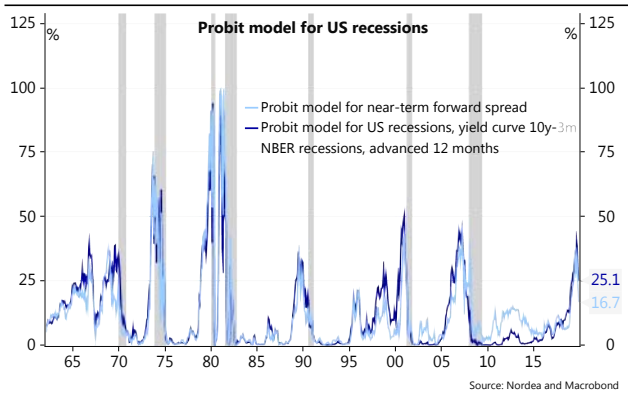
Is it different this time?

Many will argue that "this time is different", as the yield curve has been affected by unconventional monetary policy since the global financial crisis, with QE distorting term premiums. On top of this, we are seeing lower neutral rate estimates and lower longer-term inflation expectations.

Adjusted for term premiums, the risk is low, but the predictive power is also not as strong

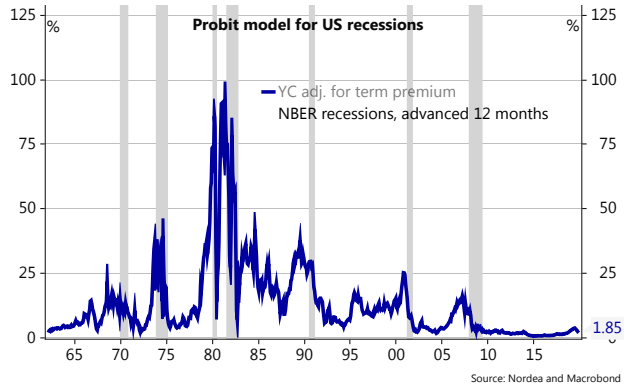
Adjusting the ten-year-three-month spread model for term premiums puts the probability of a recession in 12 months at a mere 2.5%. However, the adjusted yield curve's recession predictive power is also not as strong. So while we acknowledge that structural changes could have affected the yield curve, we would still argue that the yield curve is by far the best leading indicator of recessions.

YIELD CURVE STILL INDICATES HIGH RISK OF A RECESSION



Source: Nordea and Macrobond

BUT NOT WHEN ADJUSTED FOR THE TERM PREMIUM



Source: Nordea and Macrobond

The Conference Board's leading Indicator makes a great short-term indicator

Looking at other recession indicators, the Conference Board's leading indicator makes a great coincident recession probability model and a decent model predicting recessions three months out, but not further out in the future. In a three-month horizon, the risk of a recession is currently 12%, according to our estimates.

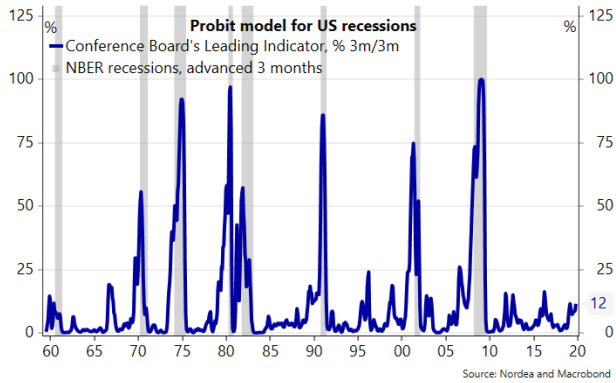
The index consists of ten sub-indicators: three financial and seven economic indicators. Splitting the sub-indicators into two recession probability models shows that the real economic indicators constitute the best recession probability model in the near term, while the financial market sub-indicators represent the best recession probability model further out.

Real economic variables indicate low recession risk

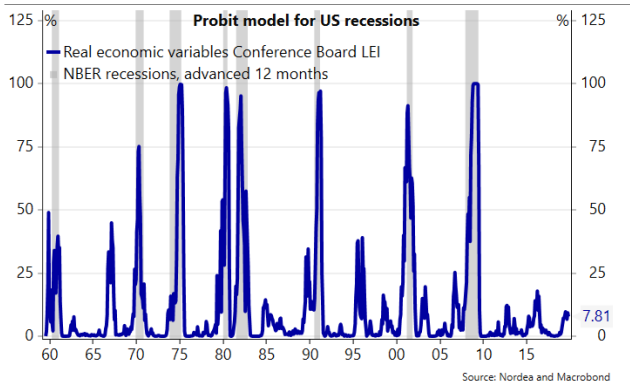
In other words, the real economy does not yet point to significant risks of an upcoming recession (only around 8%, see chart below), but then again it may not provide any warning before a recession is already here. Financial indicators, on the other hand, point to significant risks of a recession six to 12 months ahead, although its signals may

be distorted after QE.

THE CB LEI RECESSION PROBABILITY IN THREE MONTHS



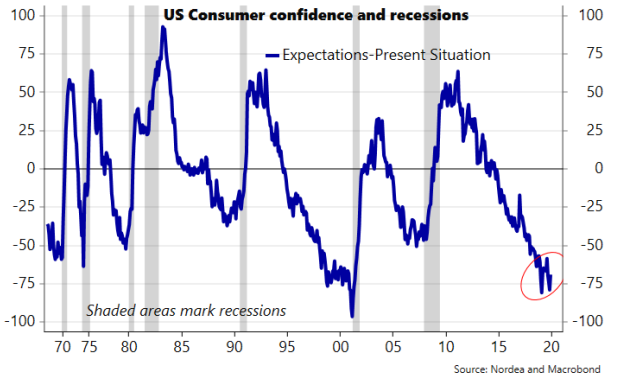
REAL ECONOMIC VARIABLES SIGNAL LOW RECESSION RISK



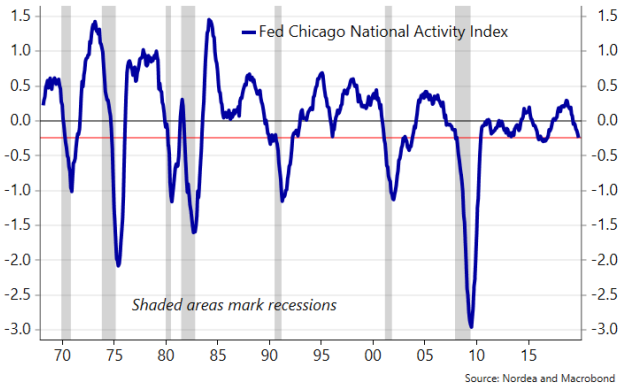
The risk of a recession is low in the short term, but recession fears should linger in 2020

Overall, our findings suggest that the risk of a recession in the short term is relatively low, while in a six to 12-month horizon significant risks persist. Consequently, although we do not forecast a recession happening in 2020, we do believe the recession risks will be a recurring theme, which in turn may continue to put a lid on business investments and capex, thereby supporting our baseline slowdown scenario.

CONSUMER EXPECTATIONS VS PRESENT SITUATION



CURRENT LEVEL OF CHICAGO FED NATIONAL INDEX NORMALLY COINCIDES WITH A RECESSION (7/9 HIT RATIO)



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