QNB Economics
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Should we worry about a US recession?

The latest US activity and labour market data show real strength. Highlights include well-above average business surveys, near record consumer confidence and a strong non-farm payrolls report in May showing well over 200k jobs generated. Last year's tax cuts are further adding to growth impetus.

Q1 GDP growth was a solid 2.2% q/q annualised while consensus forecasts see Q2 growth as topping 3% q/q annualised. For 2018 as a whole, consensus forecasts remain clustered around 2.8%. To put this in context, the US Federal Reserve sees long-term potential growth around 2% per annum.

Worries about a recession might therefore seem odd given the economy's current strong performance but there are reasons for concern. The current upswing, which is dated as having started back in April 2009 is now some 110 months old and counting. It is already the second longest expansion since World War 2. The unemployment rate, which at 3.8% is flirting with 20-year lows, also suggests an expansion that is long in the tooth. The unemployment rate historically hits record lows just before recessions.

And there is some evidence that old age kills off expansions. The longer the expansion, the lower the unemployment rate moves and then the more likely a recession becomes. Equally, there is also qualitative evidence that once expansions get past around 10 years, 'duration dependence' fades. Australia famously has not seen a recession since 1992 while Japan also enjoyed avoided recession between 1975 and 1992.

What typically causes expansions to die however is not simply old age but central bank policy mistakes and underlying macro-economic imbalances that cause them. The classic policy mistake is a central bank keeping monetary policy too loose for too long, allowing the economy to overheat.

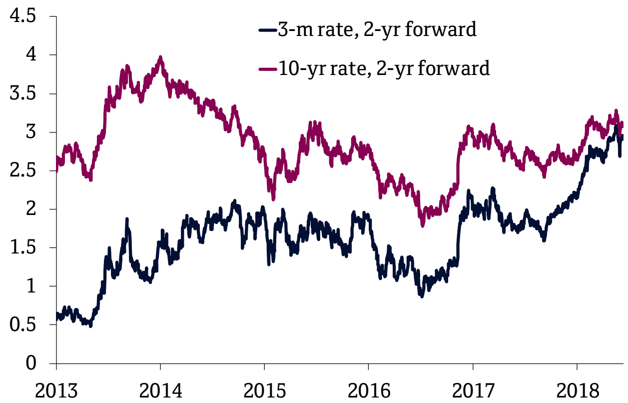
Accelerating inflation then causes the central bank to play catch up with policy rates pushed up well above long-run norms, usually some 100-200bp, to slow the economy and bring inflation down. And as interest rates are a relatively blunt instrument and the lags from policy to real economy are long and variable, precise calibration is impossible and recession usually ensues.

In turn, this explains why an inverted yield curve (when short-term rates are above longer-term rates) is a classic lead indicator of recession. Each of the last three US recessions for example have been preceded by an inverted curve.

For the time being, US monetary policy remains a long way from being tight. Even after this week's well-telegraphed 25bp rate hike, the Fed Funds target range only stands at 1.75-2%, almost 100bp below the Fed's latest estimate of a long-run equilibrium or so-called 'r*' policy rate of around 2.75-3%. Accordingly, although the US Treasury curve has flattened over the last year, it is still comfortably in positive territory with 10-year yields back close to 3%, some 70bp above 1-year yields and some 50bp above 2-year yields.

Importantly, despite the increasing tightness of the labour market, inflation indicators so far remain largely benign and markets see little prospect of the Fed moving to outright restrictive monetary policy and the yield curve significantly inverting. Implied short-term forward rates level off just above 3% in around 2 years' time, suggesting that the Fed's tightening cycle is expected to top out after another 4-5 25bp hikes over the next 2 years by which time the yield curve will be extremely flat but will not have inverted.

US Treasury Forward Interest Rates
(%)



Sources: Bloomberg, QNB Economics

For something to shift this benign outlook where the policy rate moves up to, but not decisively above perceived neutral levels, there must be a shock. The increasingly tight labour market is the obvious candidate. Lax fiscal policy adds to inflation risks. Wage inflation, running at an unthreatening 2.8% y/y rate, is therefore the key US data to track moving forward.

But even if wage inflation does accelerate decisively towards 4% y/y, several silver linings could still elongate the cycle. First, currently elevated US corporate margins could absorb higher labour costs in the short term, particularly in sectors like retail where competitive pressures are acute.

Second, the Federal Reserve has signalled that it is willing to tolerate a modest overshoot of its 2% inflation target to compensate for the long period of sub-2% inflation this decade; a sensible approach that should help anchor longer-run inflation expectations at the 2% objective. At 1.8% y/y, currently, the Fed's preferred inflation gauge still has some room to pick up.

Lastly, the supply-side of the economy could positively surprise. US corporations are now investing rapidly in new capital stock for the first time since the Great Recession of 2008-2009. If the current capex boom continues and dovetails with continued rapid technological change, productivity could accelerate in tandem with wages, lifting the economy's short-run potential growth rate and so its capacity to absorb higher interest rates.

All told, the US economy's current golden conjuncture of strong growth, moderate inflation and gentle rate hikes looks set to extend into at least 2020. Despite the US cycle's increasing maturity, recession fears are premature.

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