Recession risk: Is the longest economic expansion on record coming to an end?

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A recession in the next 12 months is still not our base case, but risks have risen materially.

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The recent escalation of a trade war with China has increased the risk of a U.S. recession. On August 1, President Trump proposed 10% tariffs on nearly all the remaining $300 billion of imports from China effective September 1. (Since then, he has postponed a sizeable portion of consumer goods tariffs to December 15.) These would be in addition to the $250 billion in goods that already face 25% tariffs. Markets reacted negatively, expecting a hit to growth and earnings. Long duration bonds rallied and various yield curves either flattened or went deeper into inversion. Even before the trade wars, equities had sold off following a confusing August Federal Open Market Commitee press conference in which Fed Chair Jerome Powell had struggled to communicate its decision to cut rates.

The impact of trade wars

In comparison with other countries, trade is a relatively small component of the U.S. economy. Import tariffs can lower real incomes and therefore lower demand, but consumers can shift toward buying domestically produced goods and this substitution can buffer the effect of trade on growth.

But the impact of trade wars on confidence is a bigger source of investor uncertainty. The sell-off in equities and rush to safe havens such as Treasury bonds, gold and yen are signs of damage to confidence. Trade conflict also lowers capital spending (capex) as firms may decide to wait for trade policy uncertainty to end before undertaking major capital investments. In addition, supply chains are likely getting disrupted and reconfigured as U.S. producers try to find alternative sources of imported goods that are targeted by tariffs.

Yield curve inversion

The combination of a potential monetary policy mistake and trade wars has increased the risk of a recession, but we are not calling for one yet. Bond markets are signaling recession via the inverted yield curve. The inversion of the yield curve is a reflection of market sentiment on the likelihood of an economic slowdown and the likelihood that the Fed will cut rates. In the past, yield curve inversions have correctly predicted recessions because the Fed has continued to tighten even after an inversion. That is unlikely to be the case now. The Fed has already cut interest rates once and has communicated the willingness to do more cuts if warranted. It is quite likely that in the face of more market volatility as a result of trade issues, the Fed will cut rates further.

This may not be enough to prevent a recession if trade issues are not resolved. Business confidence is key to maintaining continued growth in capex and to see through current hiring plans. Survey measures of CEO confidence show a decline in confidence since the re-escalation of tariffs in May. Note, however, that consumer confidence has stayed largely unaffected. As long as the labor market is strong, jobs are plentiful and easy to find, consumer confidence is unlikely to falter.

Bottom line

Lower rates by themselves are not likely to spur hiring and generate growth. The current economic expansion is already the longest on record and is in the middle of a global manufacturing slowdown with the Fed trying to engineer a soft landing. We need *both* monetary easing and de-escalation of trade tensions for the expansion to continue.

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