Is the U.S. economy heading to a recession?

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The Fed takes a potentially aggressive path in its effort to tame inflation, and investors fear recession is on the horizon.

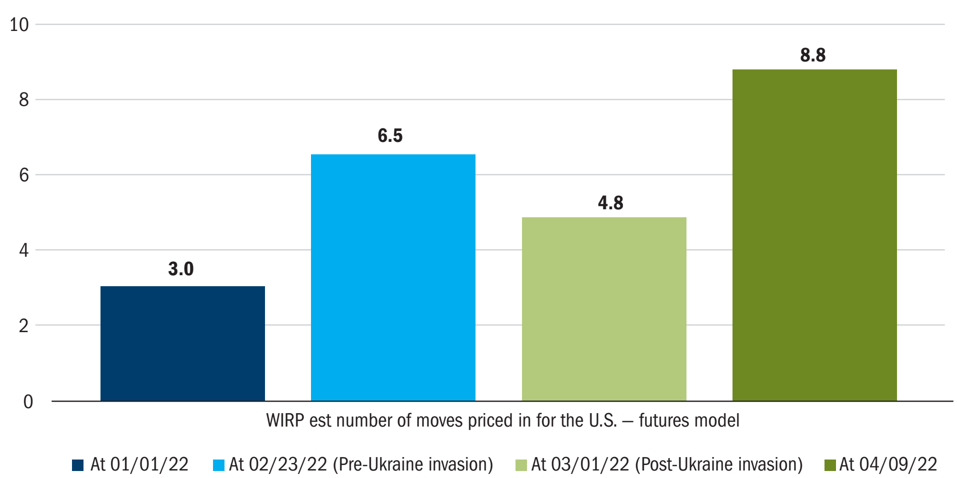
Key points:

1. The Federal Reserve is pursuing an aggressive monetary policy to combat inflation.
2. Some yield curves are inverted, but this does not necessarily mean a recession is forthcoming.
3. Recessions have different drivers, so they can differ in severity, duration and their impact on markets.

The Fed gets real about inflation

For the last two years, inflation has been a bogeyman for the markets — higher and stickier than expected. At the outset of 2022, markets expected the Federal Reserve to pursue a measured schedule of interest rate increases and to end quantitative easing. But recently, to combat higher than expected inflation, the Fed has been telegraphing a more aggressive position. After pricing in very few interest rate hikes at the beginning of the year, markets are now expecting nine hikes (including a couple 50bps hikes in the second quarter) bringing the federal funds rate to 2.00%–2.25% by the end of the year.

Exhibit 1: Estimated number of Fed hikes in 2022, Bloomberg WIRP



Source: Macrobond, Bloomberg and Columbia Threadneedle Investments

Yield curve inversion can be a faulty predictor

Recession fears became headline news with the recent near inversion of the 2s10s Treasury curve. But in our view, a single yield curve inversion on its own is an imperfect recession predictor: An inversion may precede a recession, but not all inversions culminate in a recession. Additionally, among the many permutations of bond pairings that one could look at to understand the yield curve, not all the curves are flattening or inverting. At present, about 20% of the yield curves that we follow are close to inversion (the short end of the yield curve has been steepening). Historically, this number has been closer to 90%+ prior to recessions.

Moreover, the fundamentals of the U.S. economy remain strong. The labor market, in particular, continues to post solid gains, adding about a half million new jobs every month, with jobless claims hovering at historically low levels. We expect this consumer strength and resulting consumer spending to continue supporting U.S. economic growth. The Purchasing Managers Indices (PMIs), which reflects the sentiments of manufacturers, is also still indicating confidence in an expanding economy.

However, there is a growing list of risks to growth, with the ending of fiscal and monetary stimulus and sanctions on Russia and the war in Ukraine. We expect growth to slow down sharply to “near trend growth rates” from the very high growth rate last year. The Fed is trying to engineer this slowdown, but the fear is they may overshoot. Given these risks and the Fed’s newly aggressive posture, it is not at all surprising that the possibility of an economic recession is on the minds of investors.

First quarter GDP numbers released in late April showed an unexpected decline of 1.4%, but this was mostly technical and not necessarily recessionary. Overall growth was dragged down by a surge in imports — which has a negative impact on GDP — as ports reopened and supply chains improved to allow goods into the U.S. Excluding the quirkiness of GDP accounting and inventory adjustments in the quarter, underlying trend growth, as measured by private domestic demand, was solid and still above trend. In fact, capital spending by companies added to growth and residential investments did not detract despite higher mortgage rates. In the coming quarters, rising rates and declining real incomes could take a bite out of consumer spending and result in further slowdown.

Not all recessions are the same

Suppose the signals from the bond markets are accurate, with the hiking cycle culminating in 2023, followed by a recession in the second half of 2023 or early 2024. It’s important to understand that not all recessions are the same in terms of duration or severity.

- The most painful recessions of late have been “financial recessions” — those precipitated by a bursting bubble in the financial sector. These are characterized by large declines in GDP, the biggest drawdowns in equities and other risk assets, and tend to last longer. Examples of these include the 2007–2008 financial crisis or the technology-led recession in early 2000s. Currently, we see low risk of such a financial-market-led recession. While speculation and potential contagion from sanctioned Russian assets in a globally interdependent financial system are a risk, the banking system is well-capitalized, and there are no signs of liquidity issues or credit excesses that need to be wound down.

- A “classic” or real-imbalances-led recession caused by unwinding of consumption or capital investment bubbles also seems unlikely given the strength of the U.S. consumer. These recessions are typically short-lived with a mild contraction in GDP and about average (25%) equity drawdown. In the U.S. currently, consumer confidence is reflecting worries about inflation but also shows support from the strong labor market. While inflation is reducing real incomes, resulting in a slowdown in spending, it is not clear that this is recessionary. Meanwhile, business sentiment is holding up and there is not substantial evidence of business spending collapsing. Indeed, given oil prices, we expect rig activity to expand and add to capex. Other segments of business activity may see some slowdown such as housing construction, but overall household and corporate balance sheets do not portend a problematic unwinding of excesses.

- A central-bank-led recession is induced by over-tightening of monetary policy. There is an understandable and real risk that inflation has persisted long enough such that policymakers are playing catch-up (i.e., the Fed is "behind the curve") and will end up tightening interest rates well above what the economy can handle. Such recessions are similar to classic recessions in terms of equity and growth drawdowns and duration. Of the handful of examples we have for such recessions, impact is lopsided due to the Great Depression, which has widely been recognized as a central bank policy error. Calibrating monetary policy precisely enough to slow growth but not to cause a downturn is a significant challenge for the central banks given the relatively blunt tools at their disposal. In our view, current recession concerns are based on this last prospective path for the economy.

Risk assets can still do well, even when the yield curve is correct

Even if one does extrapolate a forthcoming recession based on yield curve inversion, our work shows that stock prices tend to appreciate between curve inversions and recessions. As the table on asset class returns below shows, the period between an inversion of the 2s10s Treasury curve and a recession (when it has occurred) has frequently seen equities rise, and sometimes quite strongly. Keep in mind that the table below is based on very few observations, and each episode of recession is different (as indicated above).

Asset class returns (%)

From the first inversion of the yield curve to the ensuing recession's start

First inversion date	Aug-78	Sep-80	Dec-88	May-98	Dec-05	Aug-19
Recession date	Feb-80	Aug-81	Aug-90	Apr-01	Jan-08	Mar-20
S&P 500 Index	9.6	4.2	29.1	6.1	16.9	2.6
Commodities	87.8	-30.9	13.6	6.9	9.8	-7.0
2-Year Treasury	–	4.8	15.6	17.3	11.5	1.8
10-Year Treasury	–	-4.2	18.6	17.1	10.9	4.2
U.S. Corporate Investment Grade	-7.4	-4.3	19.6	17.5	8.8	4.6
U.S. Corporate High Yield	–	–	6.6	0.6	14.0	1.9
U.S. Municipal Bonds	–	-7.0	16.7	16.9	8.4	3.1
U.S. Mortgage-Backed Securities	-2.3	-6.7	21.6	21.1	12.3	2.9

Source: Bloomberg (U.S. 10-yr.–2-yr. Yield Curve, S&P 500 Price Returns, BCOM Price Returns, FTSE U.S. Treasury Total Returns, Bloomberg Fixed Income Total Returns)

How to chart the course from here

Inflation data and the Fed's reaction to it remains a key metric to watch. Do growth and inflation gauges moderate enough in the coming months to reduce rate hike expectations and avoid overtightening? Answers to these questions will help determine the course of market performance for the remainder of the year. In the meanwhile, in our own multiasset portfolios, we stay the course — remaining modestly overweight equities, underweight fixed income and overweight alternative asset classes, such as commodities.

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