Post #10: US Economy. The flavour of the downturn. ECI April-2023 update.

My last post on the US economy in January 2023 showed that the economy was poised for a sharp downturn which would accelerate into the Fall. Since then, our ECIs have dropped further which is an indication that the coming downturn will be more severe than we previously reported.

https://www.linkedin.com/posts/carlos-alegria-b68878a_useconomy-activity-7005584955074359296-00Iu

This post provides an update on what we anticipate for the US economy in the following months. It takes into consideration the current Fed policy stance and the developments in the banking sector with the collapse of SVB and Signature Bank in the US, and the rescue of Credit Suisse in Switzerland.

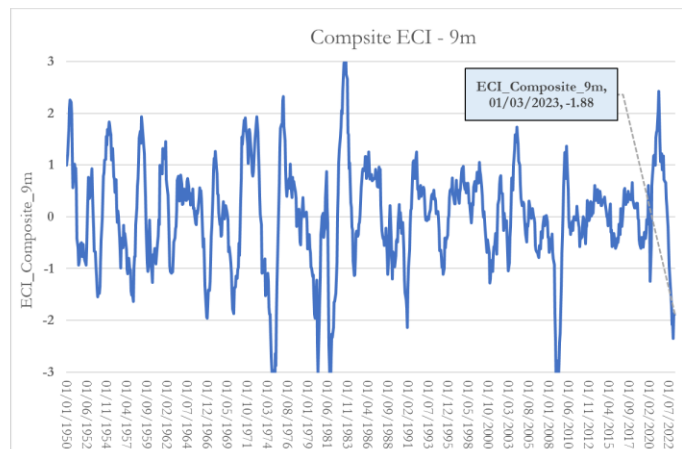
1. April – 2023 ECI report summary

Our ECIs have degraded further since January and point to a deep economic downturn in the coming months. Our 9-month and 12-month April ECIs point to a coming recession that is expected to bottom around the 3rd or 4th quarter of 2023.

Apr-2023

ECI indicator	Value
ECI_Composite_3m	-1.19
ECI_Composite_6m	-1.59
ECI_Composite_9m	-1.88
ECI_Composite_12m	-2.10
ECI_Composite_15m	-2.64

The value of the 9-month ECI was -1.88 which suggests a recession in similar magnitude to that experienced in the 1990/1991 savings and loans debacle, as shown in the figure below.



We do not know the full extent of the recession as there is still the possibility of a systemic crisis developing which would tip the coming recession into depression-like territory. We discuss the likelihood of a banking crisis in part 4.

2. Nominal vs Real GDP and Fed policy.

As I've discussed in a previous post, the US economy has likely been in a technical recession since early 2022, as shown by the negative real GDP growth rates in the 1st and 2nd quarters of 2022. Real GDP recovered in 3rd and 4th quarters of 2022, albeit at growth levels close to zero.

Due to the surge in inflation that started late 2021, nominal GDP growth was robust, and the uncertainty around the deflator that should be used to estimate real GDP, makes real GDP numbers alone a questionable metric for measuring the overall economy and consequently calling an official recession.

Economic stagnation with moderate inflation would be the best description for the status of the US economy since early 2022.

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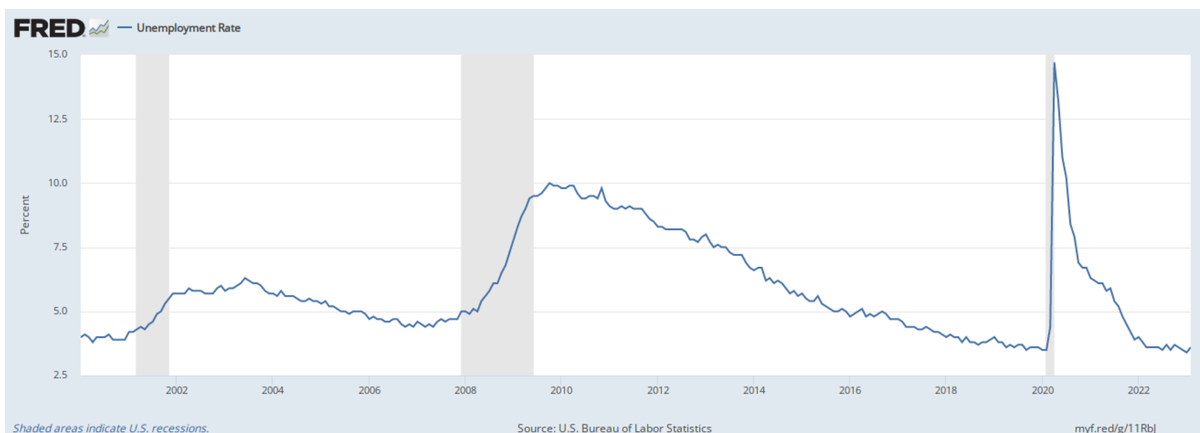
The main target for Fed policy has been the persistent inflation that surfaced by late 2021 as a consequence of the record quantitative easing during the Covid-19 pandemic. Pent-up consumer demand from the pandemic lockdowns caused a record boom in economic activity, and at the end of the resulting inventory cycle, the Fed initiated an aggressive rise in the funding rate. At that point, some economists stated that the economy was already stagnating, and therefore an aggressive Fed policy could result in a painful recession. With inflation rates reaching close to 10% by mid-2022, the Fed did not have much choice other than to pursue an aggressive monetary tightening.

As of writing this post (April 2023), the fact that unemployment rates continue at record low levels (see figure below), and inflation rates are still stubbornly high (around 5.5% YoY), explain the current hawkish Fed policy stance.



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If the dual Fed mandate is that of price stability and full employment, it is difficult to come up with policy arguments towards a change in the current policy stance. As the US economy appears to be at full employment, price stability should be the Fed's main policy target.

3. Policy mistake?

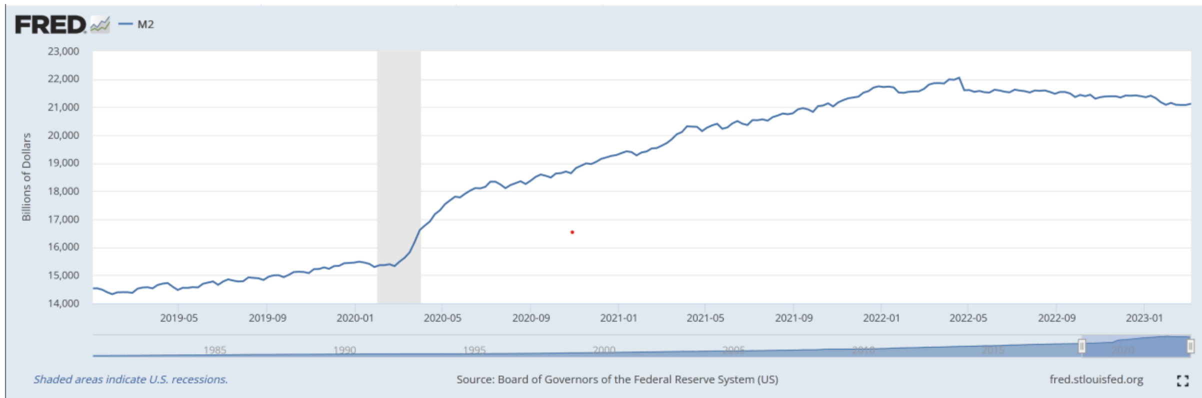
The recent rise in the Fed's fund rate to the 4.75% to 5.00% range, at the last FOMC meeting[1] on the 22nd March of 2023, was the latest step of a rapid rise that started a year ago, in March of 2022, from a low of 0.25% to 0.5% range.

The current Fed funds rate is far too high for the economy to support. I expect that the current potential (real) growth for the US economy is, at a maximum, around 1% due to the fact that unemployment rates are at record low levels, so growth must rely on productivity gains and demographic changes. As long-term productivity growth rates are about 1% or less, and the workforce growth rate has stagnated[2], the prospects

[1] See the FOMC press conference here: https://www.youtube.com/watch?v=y3dt5ZyL2OU

[2] Unemployment rates are stubbornly low (even with economic stagnation in 2022) due to the rise of disabled workers and missed worktime since 2021, which led to lower productivity. We believe that the main factor behind these trends are Covid-19 vaccine damage that injured and disabled a substantial portion of the workforce, as described here

for robust economic growth going forward are slim. With the current Fed funds rate at 5%, and inflation returning to its target range (close to 2%), there is a huge gap between the funding rate and the potential for the economy. Inflation is already on a downward path and the decline in M2 since April of 2022 indicates that by late 2023, "deflation" might be a word that comes back into use.



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Our ECIs have been pointing to a strong economic downturn since December, and its most recent values (shown above) point to a deep recession ahead. The current data indicates that the economic downturn is likely to accelerate in the coming months and hit a bottom around October/November this year.

We believe that the current Fed policy stance is a mistake that could aggravate the coming economic downturn and potentially lead to a full-blown banking crisis. The second risk is that of the dollar as an international reserve and funding currency, which could lead to sovereign crisis. If these risks materialise, then a 2008-style crisis could unfold.

4. Banking scare: SVB, Signature, Credit Suisse

The rapid rise in interest rates has led to balance sheet markdowns of a variety of financial institutions that carry interest rate risk, which led to the recent collapse of SVB and Signature bank, and is putting pressure on many smaller, regional banks in the US.

The spillover effects from the collapse of the US banks has led to contagion in Europe, where the banking system has more potential for a systemic failure. The first victim, Credit Suisse, was rescued by an emergency merger with UBS, with bail-in clauses being activated. Deutsche Bank is in line to go next, and the domino effect will likely not stop there.

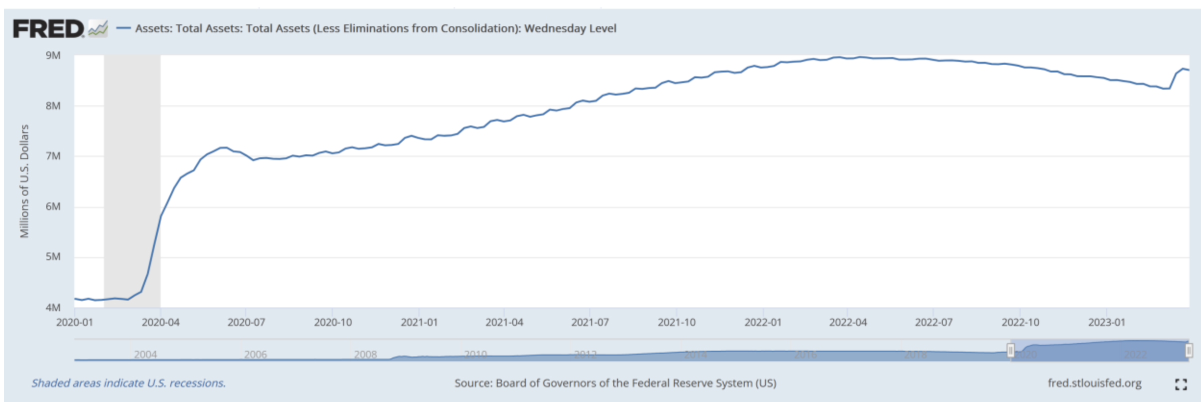
So far the banking turmoil has not led to a systemic crisis and market participants remain relatively calm, as can be seen in the figure below, where the St. Louis Fed financial stress index is shown. The index is currently at similar levels as seen in late 2007, when the subprime mortgage market in the US was starting to implode.

(https://phinancetechnologies.com/HumanityProjects/The%20VDamage%20Project%20-%20Human%20%20Cost.htm).

https://fred.stlouisfed.org/graph/fredgraph.png?g=11JY5

With the coming economic downturn (as shown by our ECIs), coupled with the current Fed policy stance, we can expect higher financial stress in the months ahead, perhaps to the levels last seen in 2008.

At the current moment we cannot anticipate if a full-blown financial crisis will materialise. The reason is that central bankers seem to have thrown away the concept of moral hazard and market discipline and decided to become active players in deciding which banks to save and which to let fail. This means that it is possible that central banks could support the banking systems by expanding their balance sheet indefinitely and by any amount. The recent expansion of the Fed's balance sheet (shown in the figure below) is an example of what could, and likely will occur at a larger scale once the economic downturn becomes painful enough.



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The long-term consequences of such actions are uncertain. The under-writing of risk-taking gives rise to nefarious incentives, as the banking system will be *de facto* centrally managed by the central bank. In the short term however, these actions will likely determine the flavour of the coming economic downturn, because if the economic crisis does not lead to a financial contagion, then it is likely that the recession will be drawn out over time.

5. The flavour of the coming recession

Each recession is different as history does not seems to repeat itself (but it does seem to rhyme). The analysis of the causes for the recession become obvious after the facts occur, as the weak spots in the

economy and financial systems are discovered by price adjustments that lead to reallocation of capital. However, for each recession it is difficult to anticipate its characteristics (its "flavour") while the recession is ongoing. In this section I'll write a few thoughts that attempt to capture the flavour of the coming recession.

- Recession with no systemic financial crisis?

Central bankers appear to be prepared to avoid a financial crisis at all costs by back-stopping systemic institutions. If such policy actions are successful, then the coming recession is unlikely to develop into a full-blown financial crisis. Furthermore, in our April ECI report we show that the housing market is still showing signs of strength which provides support for consumer demand.

- Recession with high employment?

We estimate that the rise in disabilities since 2021[3] amounted to 0.93% of the 16-64 year-old workforce. Furthermore, missed worktime rates increased by 0.7% from 2019 to 2022, a 50% increase. From these datapoints we estimate that the current 3.6% unemployment rate is in fact equivalent of a rate 2.6% as the lost of productivity of disabled individuals and missed worktime needs to be replaced.

This means that it is likely that the coming recession could be associated with low unemployment rates. We could have a period of negative real GDP with conditions where the labour market is tight. This would add to pressure on wages and therefore for the Fed to continue pursuing a tight monetary policy. There could be a disconnect between the financial markets (that are backed by the Fed) and the real economy, which will likely be favourable to larger institutions with easy access to financing, at the detriment of smaller corporations.

- Protracted economic crisis?

As I've shown in section 1, our ECIs point to sharp recession in the coming months. The latest ISM manufacturing PMI[4] reading of 46.3 in April is a real-time confirmation of the continuation of the slowdown of the real economy. We expect these numbers to continue dropping in the coming months.

The policy actions by the Fed in containing the needed economic readjustment and avoiding a clearing of excessive risk-taking and bad allocation of resources, could mean that zombie corporations are kept alive. This could lead to a protracted economic crisis where due to the expansion of the Fed balance sheet, and uncomfortable level of inflation would likely persist.

Please note that all these points could go both ways, as in the midst of a recession, contagion effects tend to appear from unexpected places. Our ECIs will pick up these developments over time and allow us to understand how the crisis will unfold.

[3] The reason for the rise is disabilities and missed worktime rates is likely associated with the mass Covid-19 vaccination programme, as we discuss in our website.
http://www.phinancetechnologies.com/HumanityProjects/Projects.htm#Nav_USAbsences
http://www.phinancetechnologies.com/HumanityProjects/Projects.htm#Nav_Disabilities
[4] https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/