Wealth Management

U.S. Recession Scorecard

April 2023

A U.S. recession moves ever closer

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Three of our seven leading indicators of U.S. recession continue to signal an economic downturn is on the way. Two others are still firmly in expansionary territory but are moving (slowly) in the wrong direction. The two employment-related indicators—weekly unemployment claims and the unemployment rate—are at or near their cycle lows and not yet threatening to generate a negative signal.

The indicators that have flipped to recessionary status so far point toward a recession getting underway by late Q2 or early Q3 2023, in our view.

Yield curve (10-year to 1-year Treasuries)

The position of short-term interest rates relative to long-term rates—a.k.a. the shape of the yield curve—has been the most reliable leading indicator of a U.S. recession. Before the start of every recession for the past 75 years, the 1-year Treasury yield has risen above the 10-year yield, indicative of the arrival of tighter credit conditions. About a year after this crossing occurs, on average, a recession begins.

The 1-year yield rose above the 10-year yield decisively last July. The negative gap has widened further

U.S. recession scorecard

Indicator	Status: Expansionary	Status: Neutral	Status: Recessionary
Yield curve (10-year to 1-year Treasuries)			✓
Unemployment claims	✓		
Unemployment rate	✓		
Conference Board Leading Economic Index			✓
Free cash flow of non-financial corporate business	✓		
ISM New Orders minus Inventories			✓
Fed funds rate vs. nominal GDP growth	✓		

Source - RBC Wealth Management

For important and required non-U.S. analyst disclosures, see page 5.

All values in U.S. dollars and priced as of market close, March 31, 2023 unless otherwise stated.
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over the intervening seven months. **The history of this indicator suggests the U.S. economy will be in recession by summer 2023.**

Adding weight to the “tight money” message coming from the yield curve, January’s Fed Senior Loan Officer Survey revealed that a growing majority of U.S. banks have continued to raise lending standards on almost every category of business and consumer loan, extending a trend begun about a year ago. The bank turmoil of the past several weeks is likely to add to the upward pressure on lending standards.

The survey also disclosed that a majority of banks are reporting reduced demand for commercial and industrial loans as well as for credit card and car loans, presumably in response to the much higher interest rates that now prevail.

ISM New Orders minus Inventories

The difference between the New Orders and the Inventories sub-indexes of the ISM Purchasing Managers’ Index has turned negative near the start of most U.S. recessions. But it has also registered occasional false positives—signaling a recession was imminent when none subsequently arrived. Moreover, this indicator only relates to activity in the manufacturing sector (some 15% of the U.S. economy) and is derived from a survey rather than hard data. Therefore, we view this as a corroborative indicator—one to pay attention to if other longer-term indicators are implying a recession is on the way. It has been negative since May 2022 from which point it has steadily worsened. **This measure has never reached this depth before without a recession eventually following.**

Conference Board Leading Economic Index

Historically, this series has given reliable early warnings of recession. When the index has fallen below where it was a year earlier, a recession has always followed—usually two to three quarters later.

This indicator turned decisively negative in Q3 2022, shifting it to the red column on our scorecard. It strongly suggests a U.S. recession will be underway sometime in Q2 2023.

Unemployment claims

This series set its monthly low, so far, for this cycle in March 2022 at 178,000. The cycle low for claims has typically been registered about 12 months before the start of the next recession. So, if no lower reading is posted in the coming months, its history would suggest a recession could get underway this spring.

As it happens, new monthly claims sagged sharply in January (down to 192,000) and got much closer to the cycle low posted last March. They look to have stayed at about the same level through February and March. If a new low for claims were to be posted in the coming months then this particular “clock” would have to be reset, pushing out the expected start date of the coming recession. However, so far, the weekly claims numbers have remained above the old lows. It would take a sustained stretch of weekly claims below 180,000 to turn this indicator back to an unequivocally positive rating.

Unemployment rate

The unemployment rate set a new five-decade low of 3.4% in January, but it has bounced back up to 3.6%. In our view, a move above 4.0% for the unemployment rate would signal a recession is on the way. Once that signal is given, on average, it has been eight to nine months from the lowest monthly reading until a recession gets underway, although there have been several instances where the time gap was only two to three months.

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Free cash flow of non-financial business

This gives an indication of the ability of such businesses in aggregate to finance capital spending for expansion. Whenever it falls below where it was a year earlier a decline in corporate capital spending has typically followed, as has a recession. This number dipped slightly in Q4 2022 but remained elevated and appears a long way from giving a negative signal.

Fed funds rate vs. nominal GDP growth

It has always been the case that before a U.S. recession has started the fed funds rate has risen above the six-month annualized run rate of nominal GDP. (Nominal GDP is GDP not adjusted for inflation.) That run rate has been declining since peaking in Q2 2021. By Q4 2022 it was down to 7.2% but still well above the funds rate, which at the time was up to 4%. Now the fed funds rate is up to 5%. We expect nominal GDP will slow further and by Q3 of this year will have fallen below 5%, meeting that precondition of all previous recessions of the past 70 years.

Weighing up the current positioning of all seven indicators and projecting their likely paths over the next couple of quarters continues to point to a growing probability the U.S. will enter recession sometime late in the first half or in Q3 of 2023, in our view. However, absent some notable weakness in the employment data in the coming months, the start date could easily move out later into the second half.

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