U.S. Recession Scorecard

August 5, 2022

Trouble with the curve

One of our most reliable, long-leading indicators of U.S. recession—the spread between the 1-year Treasury yield and the 10-year yield—has flipped to negative and is now strongly suggesting a recession is on the way. Another, the Conference Board Leading Economic Index, could do the same within the next few months, while a third, ISM New Orders minus Inventories, moved into the "red" column two months ago.

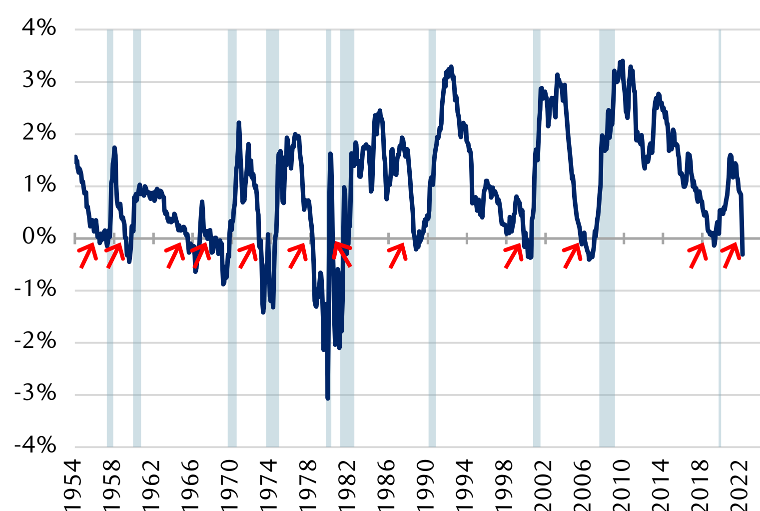
The remaining four are all still firmly positive but moving (slowly) in the wrong direction.

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

With the decisive inversion of the yield curve in July, the probability of a recession getting underway sometime in the next 12 months has increased greatly. One-year Treasury yields moving above the 10-year yield has preceded the start of every recession for the past 75 years, with an average lead time of roughly 11–13 months.

[Historical note: While every recession has been preceded by an inversion, not every inversion has produced a recession. The one exception was the inversion of late

Yield differential between the 10-year and 1-year U.S. Treasury notes



Yield curve inverts	Recession begins	Interval
December 1956	August 1957	8 months
September 1959	April 1960	7 months
April 1968	December 1969	20 months
March 1973	November 1973	8 months
September 1978	January 1980	16 months
September 1980	July 1981	10 months
February 1989	July 1990	17 months
April 2000	March 2001	11 months
January 2006	December 2007	23 months
August 2019	February 2020	6 months
Average		**13 months**
Median		**11 months**

Note: Arrows indicate where yield curve inverts; shaded areas indicate U.S. recessions

Source - National Bureau of Economic Research; data through 7/31/22

For important and required non-U.S. analyst disclosures, see page 5. All values in U.S. dollars and priced as of market close, July 13, 2022, unless otherwise stated.
Produced: August 5, 2022 12:19 pm ET; Disseminated: August 5, 2022 12:50 pm ET

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1965. It was followed by a plunge in real GDP growth from 10.1% to just 1.4% one quarter later. Even slower growth followed for the next four quarters but without the economy ever slipping into recession. However, corporate profits fell and the S&P 500 retreated by 22% at its worst point.]

Recessions have always been associated with periods of earnings decline—on average, since the 1950s, S&P 500 earnings have fallen by 24% from peak to trough. And the index itself has done somewhat worse, dropping an average of 31%.

The yield curve's greatest virtue as a recession indicator, beyond its sheer reliability, is the fact that it has usually given a long early warning signal—between 11 months (the median) and 13 months (the mean) ahead of the recession's start date. In fact, the interval between inversion and the onset of recession has usually been so long that very often the curve has de-inverted (i.e., the 1-year yield has moved back down below the 10-year yield) before the recession even started. However, a recession has typically arrived anyway.

Looking at the yield curve history by itself, we believe the most likely start date of the next recession would be sometime in Q2 or Q3 of next year. It certainly could begin before that, but we think it is highly unlikely a recession is already underway. To quote RBC Capital Markets, LLC's Chief U.S. Economist Tom Porcelli: "… contrary to what many people say, two consecutive quarters of declining GDP does not a recession make." The National Bureau of Economic Research, which makes the official call, is looking for a decline in activity spread across the economy. As Porcelli points out, that criterion has not been met at this point, despite many things already feeling recessionary.

It's worth noting that from the standpoint of the stock market, the bull market peak has, on average, occurred four to six months after inversion. There have been some exceptions where the peak came in before inversion. However, if the recession were not to start until the second or third quarter of next year, as several of these indicators would point to, then the possibility of a new high for the S&P 500 can't be ruled out in the intervening months, in our opinion.

Conference Board Leading Economic Index

This may turn out to be the next shoe to drop. When this index falls below where it was a year earlier a recession has always been on the way, usually a couple of quarters down the road but sometimes much

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Indicator	Status		
	Expansionary	Neutral	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

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sooner. If this index just stays where it was in June, then it will breach that barrier this quarter. However, it has come close to giving a "recession is coming" signal a number of times in past cycles only to rebound sharply without falling into negative territory. So anticipating the line being crossed ahead of time hasn't always been useful—stay tuned.

And as for all the rest …

The other readings remain as they were. Weekly unemployment claims are an important series to watch. Recessions usually start about a year after they set their low. The most recent low reading was 178,000 in March and they are well above that at 250,000 in July, although that is still one of the historically lowest readings ever. If claims don't fall back below the March posting, then a recession could be expected to arrive in the first half of next year.

The unemployment rate remains at its cycle low of 3.6% and would have to get above 4.5% in the next few months to signal a recession was close to starting.

Free cash flows of non-financial corporate businesses as a percentage of GDP remained very elevated at the end of Q1. We won't see the Q2 data until late this month, but we have seen some components of this calculation which suggest this indicator will stay in the "green" column for some time yet. Over the past 80 years there has been only one instance of a recession starting before this indicator went negative. On average, the lead time has been about a year.

Finally, in past cycles, the fed funds rate has always moved up to a point that puts it higher than the year-over-year run rate of nominal GDP growth either before or shortly after a recession has gotten underway. Today it is a very long way below that growth rate, which measures the growth of GDP without adjusting for inflation. Looked at that way, the U.S. economy was 9.3% higher in Q2 than a year earlier (down from 10.6% in Q1). By the end of this year the nominal GDP growth figure should be down to between 7% and 8%. We think the earliest an aggressive Fed could get the funds rate higher than the nominal growth rate of the economy would be the middle of next year.

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