GLOBAL
Insight

RBC Wealth Management

U.S. Recession Scorecard

July 7, 2022

Things are changing

Inflation readings that are disturbingly high, as well as aggressive Fed rhetoric about future rate hikes, have many commentators observing that "recession risks are rising." Most, like RBC Global Asset Management Inc. Chief Economist Eric Lascelles, are stating that risks are high a U.S. recession will arrive "sometime over the next eighteen months." Others, such as RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli, argue the start of a recession could be much closer.

Our U.S. recession scorecard (see below) is designed to look forward six to 12 months. So far it **mostly** continues to give the economy an expansionary green light. However, last month we downgraded one of our seven leading indicators of recession—ISM New Orders minus Inventories—to Neutral. Today, we are further downgrading it—to Recessionary. In addition, we are downgrading two other leading indicators—the Yield Curve and the Conference Board Leading Economic Index—to Neutral. The rationales for the shifts are described below.

If the U.S. economy can avoid slipping into recession over that time frame, as the scorecard is still (but more weakly) suggesting, the Global Portfolio Advisory Committee believes equity markets can regain their footing.

U.S. recession scorecard

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

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 6, 2022 unless otherwise stated.
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U.S. RECESSION SCORECARD

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

This is the big one for us because it has been the most reliable leading indicator of recession. 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.

Just a couple of months ago the positive gap between the 10-year Treasury yield and the 1-year yield was a comfortable 85 basis points (bps), down from 155 bps a year earlier. Then the gap narrowed abruptly to just 35 bps as the accelerated Fed rate hike path became reality with the 75 bps fed funds rate bump in June. This past week it slumped to less than 10 bps. It has not inverted but could at any time. Therefore, we are shifting this indicator to Neutral. But it should be remembered that "close doesn't count" with the yield curve. It takes an inversion to make a recession historically "inevitable"—and then only after an average additional wait time of about a year. We note that the yield curve has usually "normalized" (i.e., de-inverted) before a recession starts, so inverting and then normalizing can't be taken as an indication the recession has been "called off." However, it would suggest the recession will eventually end—and they have, on average about 11 months after the curve normalized.

Unemployment claims and unemployment rate

These two indicators should be looked at together. The smoothed trend of the monthly average of unemployment claims has typically turned higher two to six months ahead of the unemployment rate's upward turn, giving fair warning of an approaching recession some months in advance. It has produced occasional false signals, but none of those were subsequently confirmed by the unemployment rate.

The smoothed trend of the unemployment rate has usually turned upward at the start of a recession, or immediately before. Although it gives very little in the way of early warning, its negative signals have always been visible at the start of an economic downturn rather than months into it. This is especially useful because the start date of a recession is usually only announced definitively by the National Bureau of Economic Research about a year down the road.

The unemployment rate would have to move above 5% and the number of claims almost double from current levels over the next several months to turn their respective trends higher.

Conference Board Leading Economic Index

This indicator signals a recession is on the way when it falls below where it was a year earlier. It has always done so at least three months before the start of a recession, often six months before, and occasionally even earlier. The LEI has fallen close to a crossing point a number of times in the past before rebounding sharply. It is one of the most reliable recession indicators we follow, but takes an actual crossing to give a negative signal.

The LEI looks to have peaked for this economic cycle in Q2 2021 and has been declining ever since. However, we don't think this indicator could turn negative on a 12-month basis before the end of Q3 2022 at the earliest. In the past, from its most recent level, it has always taken a year or longer (sometimes years longer) for it to work its way down to zero. However by the end of Q3, we believe the LEI will be facing a very tough comparison against the prior-year reading. Because of that looming close proximity, we will be watching the intervening monthly data closely—the June data is scheduled to be released on July 21—and for now are downgrading to Neutral.

U.S. RECESSION SCORECARD

Free cash flow of non-financial corporate business

This indicator measures the free cash flow generated by non-financial corporate businesses as a percentage of GDP. It has given only one false positive signal in more than 65 years. In all other cases when this indicator has fallen below zero, a recession has followed—typically, two to three quarters later. It looks to be in no danger of signaling an approaching recession anytime soon, in our opinion.

ISM New Orders minus Inventories

The difference between the New Orders component and the Inventories component 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. As of the release of the May data, the three-month moving average of the spread between New Orders and Inventories fell below zero—by just one-tenth of a point—resulting in last month's shift to Neutral. With the June data release days ago, the indicator has fallen more deeply into negative territory persuading us to reclassify it as Recessionary.

Fed funds rate vs. nominal GDP growth

Since 1954, the fed funds rate has typically moved above the nominal (i.e., not adjusted for inflation) year-over-year growth rate of GDP prior to the onset of recession. It is not an ideal timing tool, but a fed funds rate in excess of nominal GDP growth has been a precondition of all U.S. recessions, except for two where the negative crossing occurred just as the recession was getting underway.

At the end of Q1, the nominal GDP growth rate stood at 10.6%, significantly above the 1% fed funds rate. We expect the year-over-year nominal GDP run rate will slow to between 7% and 8% by the end of 2022, and decrease further to between 4% and 5% by late 2023. Only a dramatic shift into a higher gear by the Fed would likely get the fed funds rate above the nominal GDP growth rate before the middle of next year.

Still mostly positive

A few weeks ago the seven indicators were unanimously giving the U.S. economy a "thumbs up," albeit more weakly than they had been last year. We have entered a period of deterioration where several are threatening to give negative signals, and all are less positively situated than they were a few months ago.

However, our most reliable leading indicators of recession, for now, have not turned negative and it is not inevitable they will do so, in our opinion. The yield curve, which is perilously close to inverting, has always done so before an associated recession got underway—on average 11 to 13 months before. Importantly the peak of the bull market for stocks has typically occurred three to six months after inversion.

Research resources

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