GLOBAL
Insight

Wealth Management

U.S. Recession Scorecard

September 2023

Status quo … almost

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After a summer with no Recession Scorecard changes, ISM New Orders minus Inventories is being shifted to Neutral (yellow) from Recessionary (red).

Two of the other six indicators—and the two most reliable—remain decisively in the negative red column, meaning each has passed a threshold value beyond which, historically, a recession typically has arrived within a measurable time horizon. Two others were moved into the cautionary yellow column in the spring because they were close to giving an outright negative signal and seemed likely to do so within a few months. The remaining two indicators, still green, continue to suggest there is some way further to go in the economic expansion.

The average time gap from giving a negative signal to the onset of recession for the two indicators that are rated as outright negative so far point toward a recession getting underway as early as this summer, in our view. However, both have histories with instances of much longer signal-to-recession intervals. **Note that the official start date of any recession may not be announced until many months or quarters after the fact**.

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

The 1-year Treasury yield rose above the 10-year yield decisively in July

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 6.

All values in U.S. dollars and priced as of market close, August 31, 2023 unless otherwise stated.
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U.S. RECESSION SCORECARD

2022, and the negative gap widened further over most of the past year. **The average historical experience of this indicator after crossing into negative territory suggested the U.S. economy would have been in recession by this summer.**

Yield curve inversion is an unequivocal indication that credit conditions are tightening, a fact underscored by the message delivered consistently for five consecutive quarters by the Fed's Senior Loan Officer Survey (most recent issue released on July 31). A majority of U.S. banks continue to raise lending standards on almost every category of business and consumer loans including commercial and industrial loans for businesses of all sizes, credit card loans, consumer installment loans, mortgage loans, and commercial real estate loans.

The same survey also revealed that most banks are reporting reduced demand for commercial and industrial loans, as well as indicating a reduced willingness to make such loans. Most are also requiring higher credit scores for consumer loans and larger down payments for car loans as well as increasing the premium charged for loans to riskier businesses. Also, in the most recent survey a substantial majority indicated that conditions would remain tight or even be tightened further through the second half.

The negative spread between the 1-year yield and the 10-year yield reached its widest point this cycle so far in June at 158 basis points (bps). It has since narrowed noticeably to 120 bps opening the possibility the period of "de-inversion" may have begun. The return trip to "normal" from "inverted" usually gets underway just as the recession is starting or a few months before. There is also a reasonable correlation between how long the total period of inversion runs and how long the ensuing recession lasts. This latest inversion is at 13 months and counting.

ISM New Orders minus Inventories

The difference between the New Orders and 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. For those reasons, we look at it as a corroborative indicator rather than a decisive one taken on its own.

After setting its most recent low in September 2022, this series has steadily moved higher and August 2023 data (we use a three-month moving average) has moved back above zero. As a result, we are shifting this indicator back to yellow from red. However, we note that the New Orders sub-index itself remains in contractionary territory and weakened somewhat last month. If the ISM new orders component by itself were to move up into an expansionary reading in coming months we would upgrade this indicator back to expansionary (green). That being said, **this measure has never before reached its most recent low set in deeply negative territory 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. As of July 2023, the index has fallen for 16 consecutive months moving ever more deeply into negative territory.

U.S. RECESSION SCORECARD

Its past record strongly suggests a U.S. recession will be underway sometime in H2 2023.

Unemployment claims

The monthly low for this cycle occurred in September 2022. 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 as early as this fall.**

Claims surged higher in June but settled back in July. The smoothed trend appears to be trying to turn higher, but has not yet reversed to up from down convincingly. The fact that both temporary employment and job openings are falling on a year-over-year basis adds to the likelihood the tide may be turning for unemployment claims. While we wait for that shift to be confirmed or for claims to subside once again, this ambiguity warranted shifting the indicator's status to yellow in April.

Unemployment rate

The unemployment rate jumped to 3.8% in August, its highest posting since February 2022. Monthly net job additions have been trending steadily lower since setting a cycle high that same month. Any move above 4.0% in the unemployment rate in the next few months would turn the smoothed trend of this indicator higher and, in our view, 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 posting (which was 3.4% in April) until a recession gets underway—although there have been several instances when the time gap was only two to three months.

Free cash flow of non-financial businesses

This gives an indication of the ability of such businesses, in aggregate, to internally fund any capital spending they want or need to do. Historically, whenever it has posted a year-over-year negative reading, a decline in corporate capital spending has typically followed, either indicating a recession is coming or deepening one that is already underway. This number declined in both Q4 2022 and Q1 of this year but remained well above a negative crossing point. We expect a further deterioration occurred in the Q2 data which will be released this month.

Fed funds rate vs. nominal GDP growth

The fed funds rate has risen above the six-month annualized run rate of nominal GDP either before or at the start of every recession in the past 70 years. (Nominal GDP is GDP not adjusted for inflation.) That GDP run rate has been declining since its pandemic reopening high of 23% recorded in Q4 2020. By the end of last year, it had slowed to 7.2% but was still well above the fed funds rate, which at the time had risen to 4%. Now the fed funds rate is up to 5.50%, and Q2 GDP data shows the six-month run rate of nominal GDP growth slowed to just 5.1%, barely meeting that historical precondition of recession. We expect nominal GDP growth will slow some more in Q3, which will widen the gap further.

Looking ahead

Weighing up the current positioning of all seven indicators and projecting their likely paths over the next couple of quarters, points to a growing probability the U.S. will enter a recession later this year, in our view.

Research resources

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