STRATOS
INVESTMENT MANAGEMENT

MEA CULPA?

COMMENTARY

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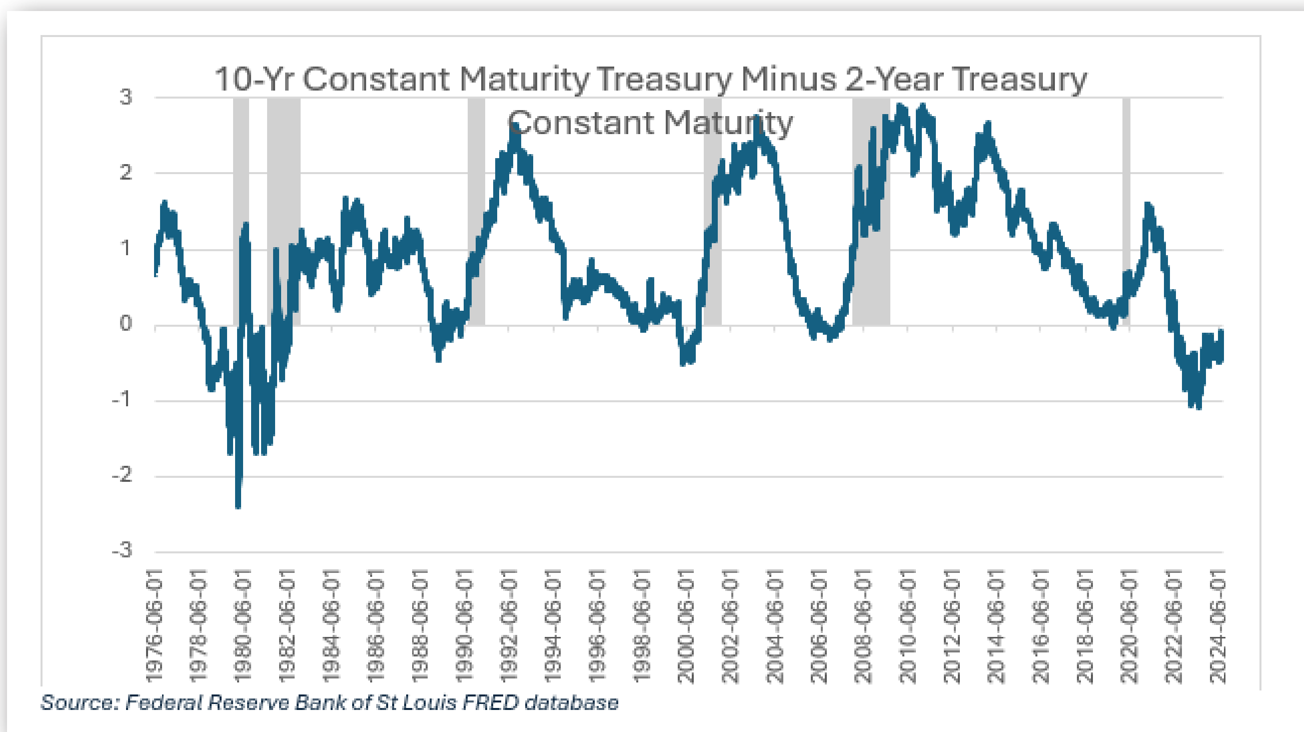
We believed that the US economy could avoid a recession and that the slowdown would most likely resemble the 2015 slowdown. That dip saw a series of what we would term rolling recessions hit various segments of the economy but did not translate into an "Official" recession as determined by the National Bureau of Economic Research (NBER). With the employment data out Friday morning, August 2, 2024, our expectation that we can avoid a recession might be in danger.... maybe.

Erroneous Signals

There have been troubling signals flashing for some time - including the negative spread between the two-year and ten-year treasury notes and the negative reading in the Leading Economic Indicators (LEI).

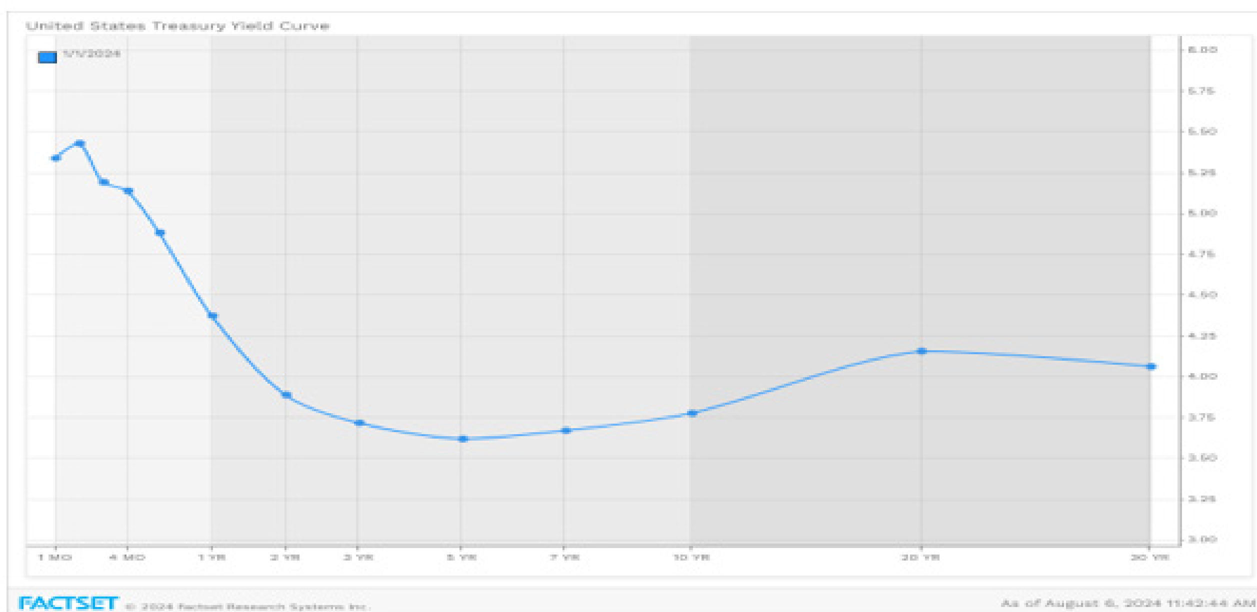
According to the market, when you look at the difference between the 10-year Treasury Note and the 2-Year Treasury Note, if the shorter-term note has a higher rate, then the yield curve (the yields at different maturity points) is inverted and the likelihood for a recession increases. Indeed, the data in the following chart would seem to bear that out....

And yet, that isn't a fully inverted yield



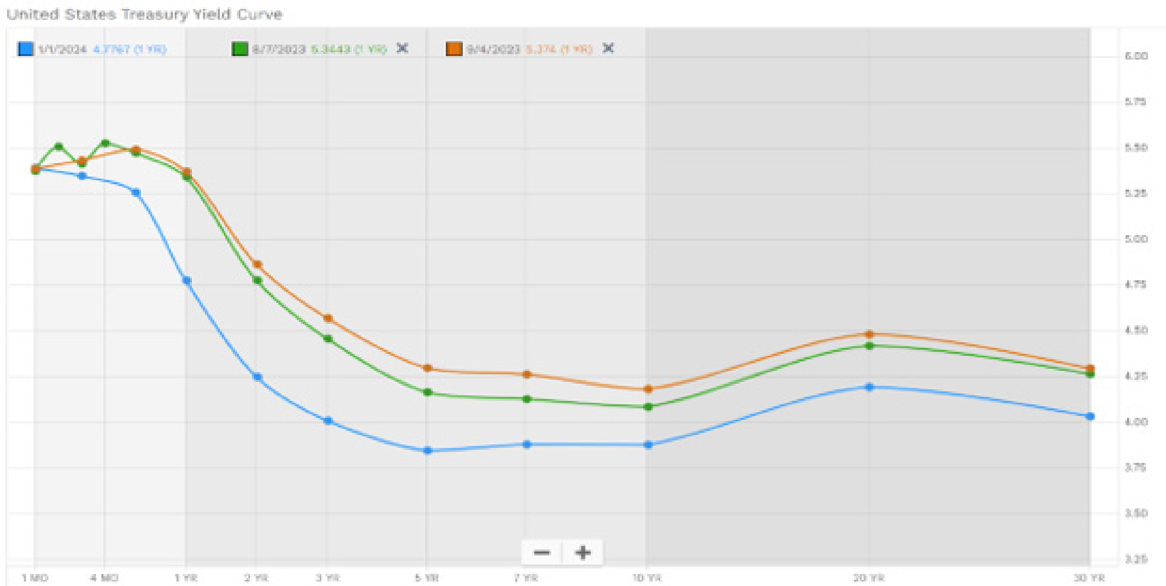
Source: Federal Reserve Bank of St Louis FRED database

curve, since it only encompasses that portion of the curve from two-years out. You can see that from a representation of the full yield curve from the beginning of the year as found in the chart below:



Source: FactSet

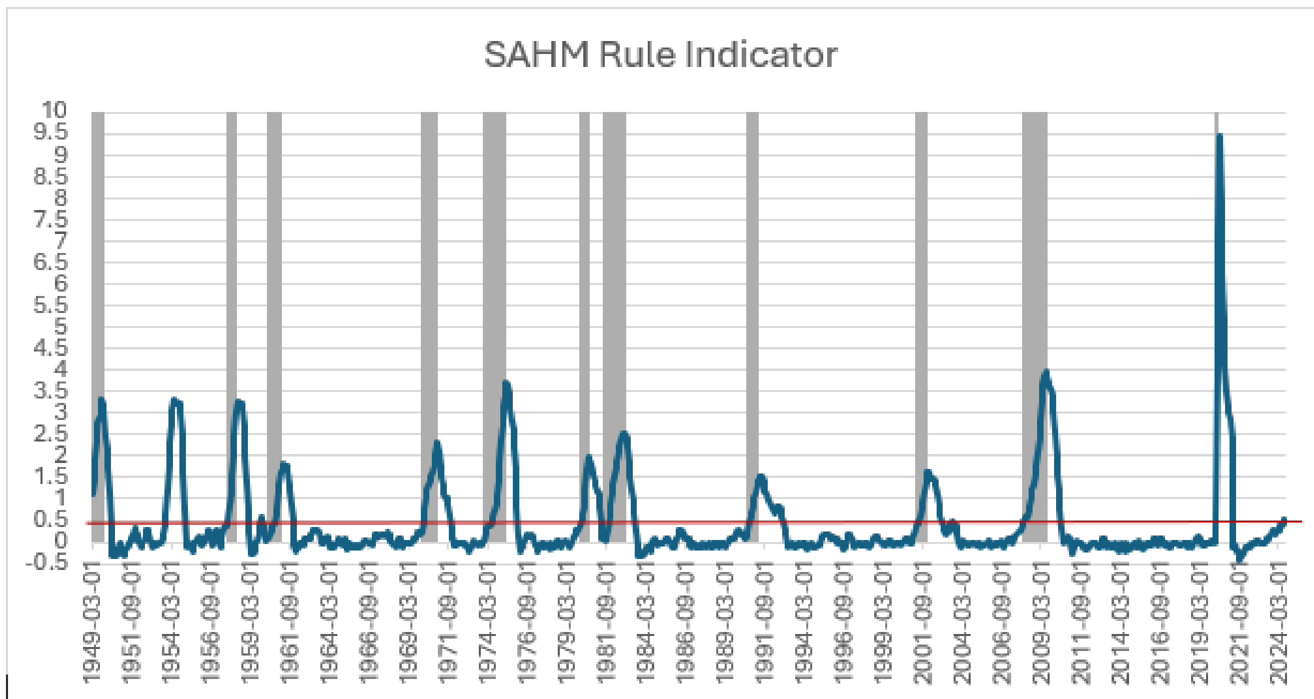
As you can see from the above yield curve (this is from January 1, 2024) the yield curve was, indeed, inverted. In fact, the entire yield curve has been inverted since September 2023 (See Yield Curves below), and the two to ten-year curve has been inverted even longer (since July 11, 2022).



The Leading Economic Indicators (LEI) have also been flashing recession since early 2022. [The LEI is a predictive tool maintained and distributed by the Conference Board and is a predictive tool that leads turning points in the business cycle by approximately seven months. The Conference Board utilize the “3 D’s Rule” (Duration, Depth and Diffusion) to interpret whether the data is signaling an impending recession when: 1) the six-month diffusion index lies below 50 and the LEI’s six-month rate of decline falls below the threshold of -4.4%.]

These early warnings have now been joined by a new signal that, at least until now anyway, has done a remarkable job of predicting recessions.

The “Sahm Rule” was named for former Federal Reserve and Council of Economic Advisors economist, Claudia Sahm. It relies on monthly unemployment data from the Bureau of Labor Statistics and states that, “When the three-month moving average of the national unemployment rate is 0.5% or more above its low for the previous twelve months, we are in the early stages of a recession.” As you will note from the chart above, we crossed over the 0.5% threshold with the August first data.



Source: Federal Reserve Bank of St Louis, FRED database

Does this mean that we are in a recession? If you looked at the market’s response to the employment news on August 2 and its violent downward move on Monday, August 5, you might be inclined to believe that the domestic economy has, indeed, crossed over into recession territory. Yet we believe that there may be a more nuanced explanation and one that, while allowing for the possibility that the economy will roll over into a recession, also allows for the possibility for a continuation of what we believe have been rolling recessions hitting various parts of the economy for nearly two years.

While unemployment certainly rises during periods of recession (see chart below), we need to keep in mind that while the current increase has pushed the unemployment rate to a recession signal (according to the Sahm Rule), it is still at a historically low level. In fact, if you compare it to the Noncyclical Rate of Unemployment (formerly known as the Natural Rate of Unemployment (NAIRU) also referred to as full employment) you will note that even at 4.3% it remains below what is typically referred to as full employment.

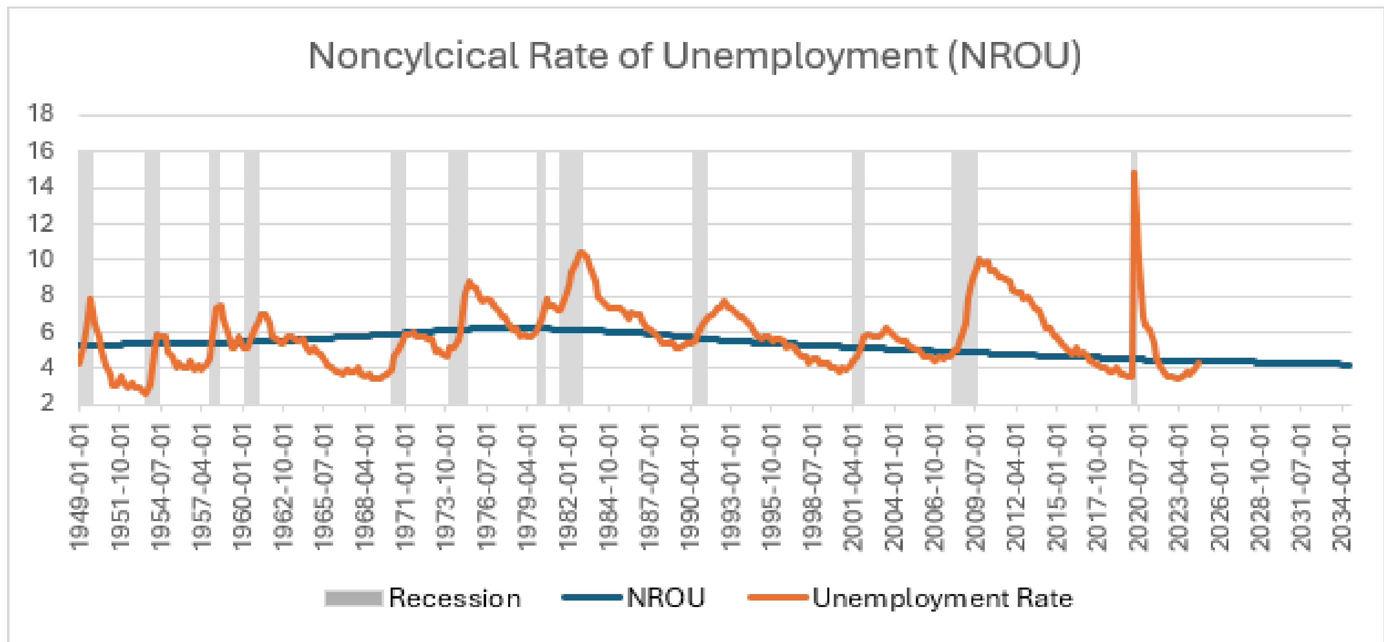


Figure 1Source: Federal Reserve Bank of St Lois, FRED database

Recent JOLTS (Job Openings and Labor Turnover Survey) data released on July 30 continues to show more job openings than unemployed people (8.184 million job openings versus 6.811 million unemployed or 1.2 jobs per unemployed person). While it is possible to have an economy that enters a recession with more job openings than unemployed people, we believe that it is improbable barring some unforeseen event. (Covid pushed us into recession with more jobs than unemployed. Interestingly, there were approximately 1.2 jobs per unemployed person when the global economy was shut down due to Covid.)

Is the economy slowing? Most assuredly. Will we or have we entered a recession? We don't believe so, but we are not in charge of making that call (that is done by the National Bureau of Economic Research) and we likely won't know for sure until we are near the end of the current downward cycle. That said, we also believe that the Federal Reserve will use the data as a rationale to begin cutting its Fed Funds rate at its September meeting with one or two additional cuts by year end.

Why did the markets go haywire with the employment data (and a big selloff in Japan Sunday night)? We have told investors over the years that Wall Street typically takes a ready, shoot, aim approach to unexpected information. In other words, markets react to new or unexpected information and then takes time to think about what it really means. In this case, markets came to believe that the unemployment data showed a more rapid and/or deeper slowdown than had been thought, meaning that the Fed was behind the curve and rather than having a "soft landing" the domestic economy was likely already in the beginning stages of a much deeper recession. We don't believe that is the case.

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