Is the US on the brink of a recession?

The US employment report published a week ago has stoked fears of a recession. We put the data into perspective and show whether the typical triggers of a recession are present.

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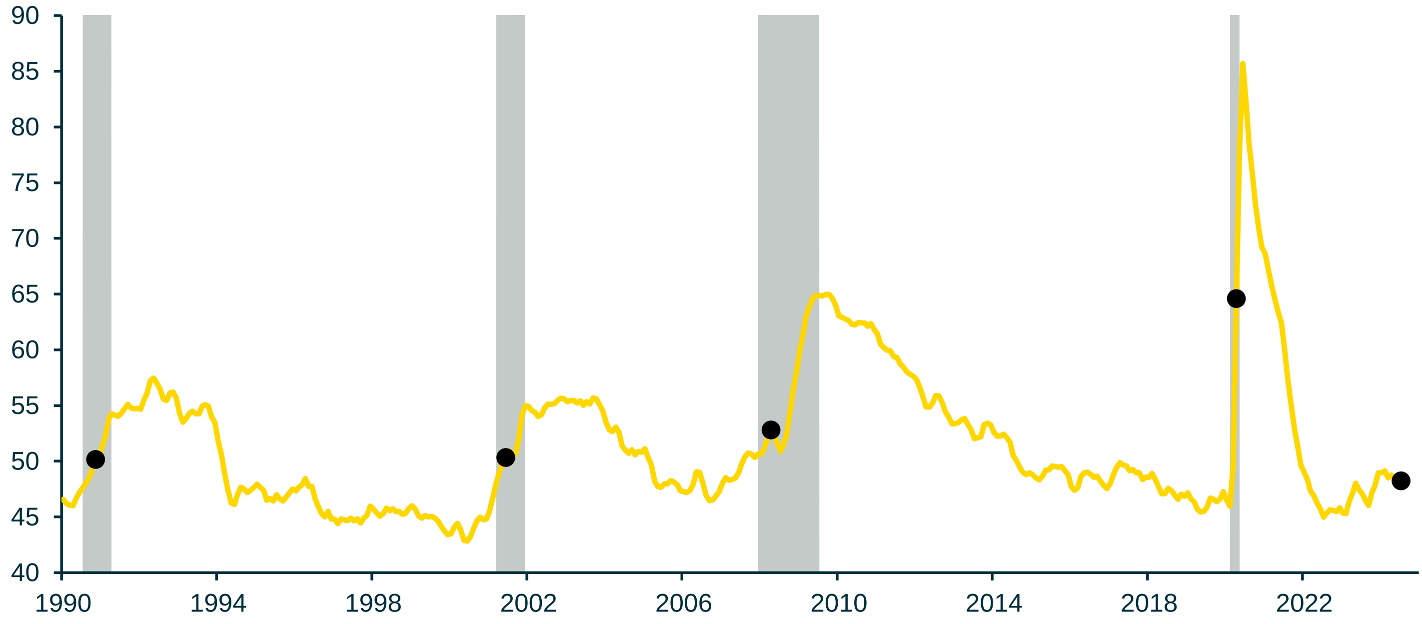
What are the recent jobs data telling us?

The US labor market data delivered investors a rude shock last Friday. Employment fell well short of expectations with an increase of 114 thousand. Above all, however, the renewed rise in the unemployment rate caused a stir. The increase to 4.3% triggered a much-noticed warning signal, the so-called "Sahm rule" [1]. According to this rule, a recession begins when the unemployment rate is at least 0.5 percentage points higher than the low of the previous twelve months. And in July, the rule indicated 0.53 percentage points (title chart). However, the Sahm rule is not a law of nature. We see a number of reasons in the current situation that diminish the significance of this rule:

- In the past, the critical threshold has always been triggered two to three months after the start of a recession. If this also applies this time, the economic cycle would have peaked in April. However, the indicators used by the NBER to determine an economic peak and the subsequent onset of a recession have continued to rise since then: Industrial production increased by 1.5%, private consumption by 0.6%, income by 0.5% and employment by 0.3%. In the early phase of a recession, these indices would have already fallen significantly.
- Unemployment rises in a recession because many employees are laid off. At present, however, the rise in unemployment is largely due to the fact that more people are looking for work, partly because of increased immigration. The proportion of people laid off as a percentage of all unemployed has therefore hardly risen in recent months, in contrast to previous recessions (Chart 1).

Chart 1 - No wave of layoffs on the US labor market yet
Job loser as a percentage of the number of unemployed, 3-month averages. Grey areas: Recession periods as defined by the NBER. Black dots: Sahm rule was triggered.



Source: BLS, St. Louis Fed, Commerzbank Research

The employment data for July may also have been distorted by Hurricane Beryl, which made landfall during the week the employment report was compiled [2] For a clearer picture, we should therefore at least wait for the next report.

In any case, employment did not fall in July, but continued to rise by 114 thousand, which is not a small number in view of long-term demographic projections. In the long term, around 80,000 to at most 100,000 new jobs per month are needed to provide the growing population with jobs. In recent years, this "speed limit" on the US labor market has probably risen to over 200 thousand jobs per month at times due to the enormously high level of immigration. However, monthly data from the Border Patrol indicate a slowdown in the rush, so that a sustained job increase of 100 thousand per month would by no means be a cause for concern in the medium term.

In any case, the labor market is not a trigger for a recession. Rather, it only shows the effects of a recession in the form of falling employment and rising unemployment. To answer the question of whether the US economy is on the brink of a recession, we look at the usual triggers of a crisis below.

Recession triggers: the usual suspects...

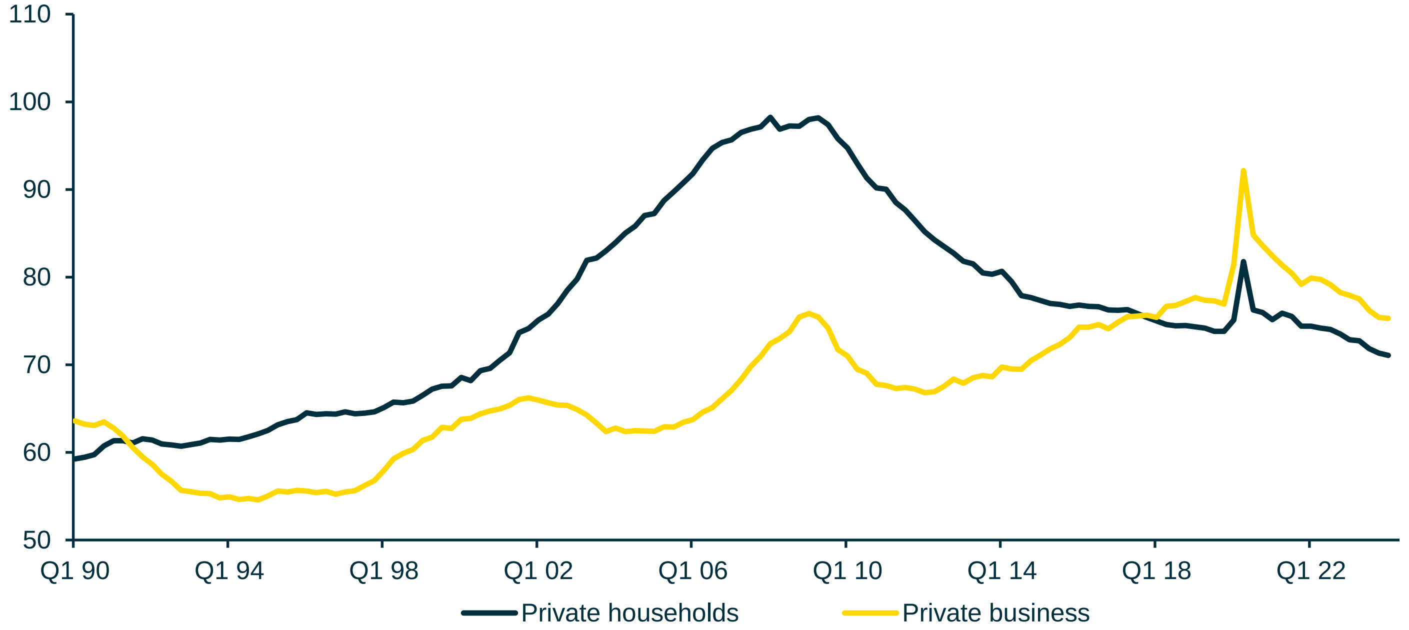
The 1973-75 crisis and the double-dip recession at the beginning of the 1980s were at least massively exacerbated by oil price shocks. A drastic rise in oil prices also exacerbated the crisis in 2008. However, there is currently no sign of an energy price shock. Crude oil and natural gas prices have fallen in recent months, and private household spending on energy and gasoline is quite low by historical standards.

Another trigger for recessions are bursting bubbles on the asset markets, such as in 2001 on the stock markets or in 2008 in real estate. Despite the recent correction, however, the stock markets are still close to their highs, and only a sustained drastic fall in prices could trigger a recession. The same applies to real estate prices, which are currently more than 6% higher than in the previous year. Against this backdrop, the wealth situation of households is solid.

Over-indebtedness of households or companies is often associated with bubbles. However, the available data does not provide any indication of this. Household debt has fallen steadily in relation to economic output (98% of GDP) since the high reached in 2008 and currently stands at 71% of gross domestic product (GDP) (Chart 2). Corporate debt has fallen again following the short-term increase during the coronavirus crisis and, at 75% of GDP, is roughly at the same level as five years ago. Of course, the overall solid situation does not rule out the possibility of imbalances in some areas – such as consumer loans to "risky" borrowers or parts of the bond market. However, problems in such submarkets are more of a limited problem.

Chart 2 - US private sector has its debt under control

Debt securities and loans as % of GDP, quarterly data



Source: Fed, S&P Global, Commerzbank Research

A restrictive fiscal policy could also be the trigger for a crisis. Although a certain degree of austerity would be appropriate in view of the high deficits in the US, there has so far been no willingness in Washington to change course on budgetary policy. Fiscal policy has therefore had no dampening effect on the economy in recent quarters and, according to calculations by the Hutchins Center, this is unlikely to change significantly in the coming quarters.

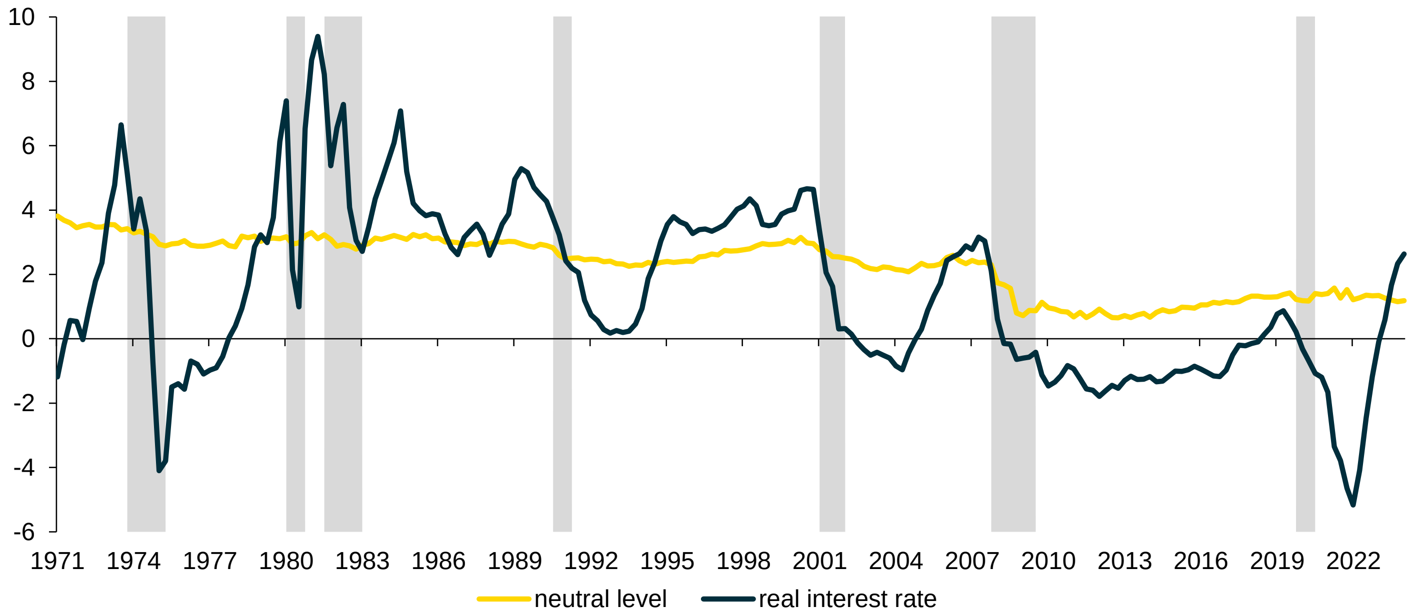
.. or is it the Fed again?

Typically, US recessions have been triggered by massive interest rate hikes by the Fed. This time too, the central bank raised the key interest rate by a total of 525 basis points between March 2022 and July 2023. The extent to which monetary policy dampens the economy depends crucially on the real interest rate. We measure this by the difference between the federal funds rate and the core inflation rate based on the consumer spending deflator. The Fed's inflation target of 2% also refers to this. This real interest rate has risen massively in the last two years (chart 3). Monetary policy is restrictive when the real interest rate is above its neutral level, i.e. the interest rate at which monetary policy neither stimulates nor slows down the economy. However, this is a theoretical value and cannot be observed directly; it must therefore be estimated. These estimates differ greatly and also vary over time. We therefore use the median of various estimates that are also used by the Fed [3]

Ultimately, the real interest rate of 2.9% (5.5% key interest rate minus 2.6% inflation) is above the neutral level of 1.2% calculated in this way. This could be enough to trigger a recession. However, similar developments in 1984 and 1995 did not lead to a recession.

Chart 3 - real interest rate has increased substantially

real interest rate: Federal Funds target rate minus core PCE inflation rate, in %. Neutral rate: median of four estimates (LW one-sided, LW two-sided, HLW, LM). Recessions shaded



Source: Fed, BLS, S&P Global, Commerzbank Research

Financial conditions are not so bad

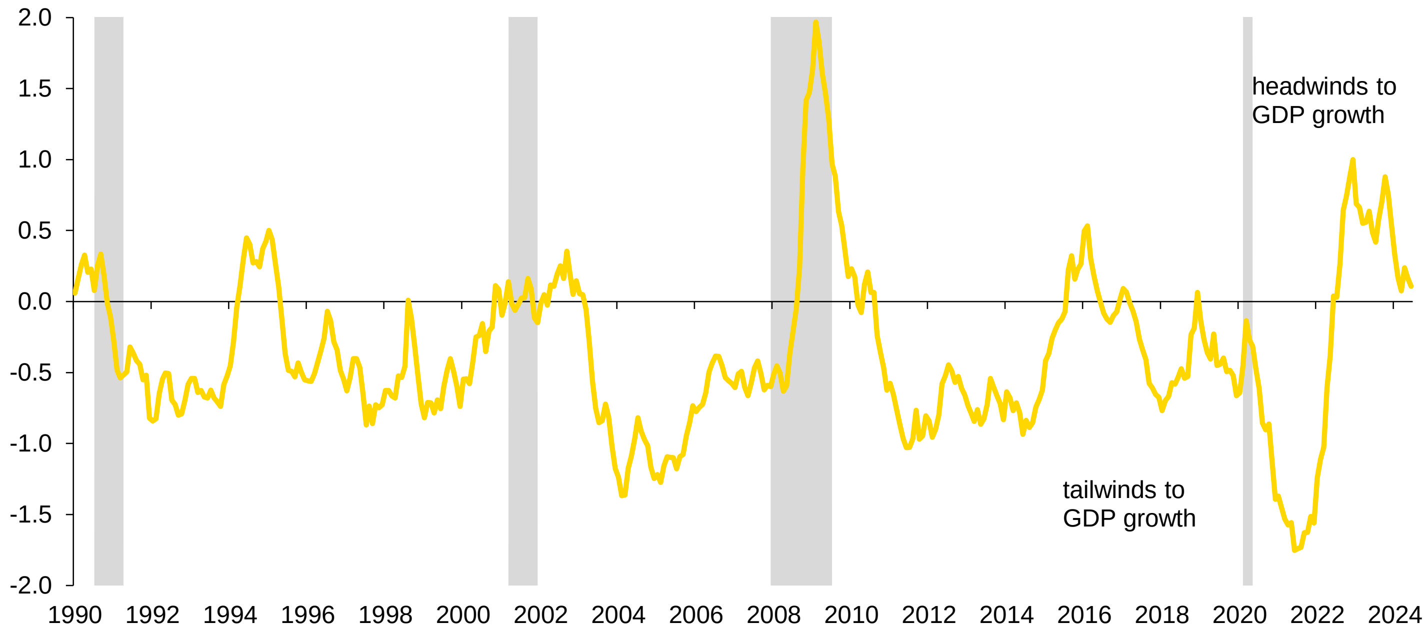
Monetary policy alone is therefore not enough to draw a clear conclusion as to whether a recession is imminent or not. Long-term yields, share prices, the external value of the dollar and other asset prices are also important. Based on such variables, the Fed has constructed a broader indicator (**Financial Conditions Impulse on Growth, FCI-G**) on the basis of its macro model, which depicts the growth impulse resulting from the key interest rate and financing conditions. [4]

According to this indicator, financing conditions have indeed had a significant negative impact on GDP growth in the last one and a half years. However, this negative impetus has already eased considerably. It would be atypical for a recession to follow despite this (Chart 4).

This conclusion is also supported by the Fed's Senior Loan Officer Survey. According to this survey, banks had tightened lending conditions considerably at times. However, banks have been much more relaxed for a year now. This is also not consistent with a recession.

Chart 4 - Headwinds from financial conditions have faded

Financial Conditions Impulse on Growth (FCI-G), contribution to GDP growth over the next year in percentage points. Recessions shaded



Source: Fed, Commerzbank Research

Fed: Warning lights are blinking, but no recession yet

All in all, there are some warning signs of a possible recession, including the Sahm rule discussed above. However, we are sticking to our assessment that a recession will be avoided and that the US economy will instead merely expand at a slower pace than the long-term average over the next few quarters. In particular, the still quite favorable financing conditions speak against a recession. The market has therefore priced in too many interest rate cuts by the Fed, even though officials have already signaled very clearly that a turnaround in interest rates will follow at the next meeting in September.

[1] The rule was established by Claudia Sahm, a US economist who worked for the Fed from 2007 to 2019. It is based on the three-month average of the unemployment rate. It also uses real-time data, i.e. as it was available at the time, rather than the figures available today, which may have been revised. (back to text)

[2] For example, 461 thousand people stated that they were unable to work due to bad weather. However, only around 40 thousand are usual in July. The difference cannot simply be added to the official number of payrolls, as some of these people's jobs were nevertheless recorded. However, calculations show that on average around 10% of the special effect is reflected in the number of jobs. This would still mean that the official job increase of 114 thousand could be understated by several tens of thousands. (back to text)

[3] We use the Holston/Laubach/Williams (**HLW**), Laubach/Williams (**LW**, one-sided and two-sided) and Lubik/Matthes (**LM**) estimators. (back to text)

[4] The yields on corporate bonds and Treasuries, mortgage interest rates, the external value of the dollar, an equity index and a house price index are considered for the financing conditions. The approach also takes into account time lags of up to three years (back to text).

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