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Soft Landing, No Landing or Recession?

When is the recession coming? This has been the key question on investors' minds. Two indicators that have been successful in determining previous economic inflection points hint of one coming soon. However, there are extenuating circumstances that could push the timing of the next downturn further out into the future. We do not believe that a recession will be avoided, and that one will begin by early next year, because monetary policy is extremely tight. Eventually, it will work to meaningfully dampen aggregate demand.

The Index of Leading Economic Indicators (LEI) peaked in December 2021, and the Treasury yield curve defined as the difference between 2- and 10-year notes inverted in July 2022. Both metrics have historically been good predictors of economic inflection points, but the lead times are variable and can be quite long, thus the need for market participants to remain patient.

The average lead-time from the peak in the LEI to the peak in the economy is just 11 months but the lags vary. For example, there was a record 21-month lead from the peak of the LEI in March 2006 and the peak in the economy in December 2007. A similar lead-time in this business cycle lines up with a September 2023 peak.

There have been 11 yield curve inversions that lasted an average of 12 months before the onset of recession. **The current curve inversion stands at 15 months**. However, there were two long lead times of 20 months ahead of the 1973 to 1975 and early 1980s downturns. Applying a similar lead time tells us the economy should peak by February 2023, which is more than five months away. But it is possible that recession can be pushed out even further owing to the unusual set of factors in this business cycle.

For example, net corporate interest expense as a share of corporate profits is falling despite rising interest rates, a historical anomaly. This will not persist indefinitely because firms will eventually have to roll over existing debt. Government spending is running at a record fast pace despite a near-record low unemployment, also a historical anomaly. This means the Fed will keep rates higher for longer, potentially not lowering interest rates when private sector fundamentals suggest otherwise. And finally, most homeowners have a mortgage rate below 4% so they have been insulated from rising interest rates. But other borrowing costs are up substantially, and the housing market is set to grind to a standstill, which is not good for growth.

However, **money and credit creation are slowing because of tightening commercial bank lending standards**, and monetary policy is in restrictive territory. Moreover, the Fed is pledging to keep interest rates "higher for longer" until there is more certainty that inflation is moving back toward their 2% target.

Another reason for the delay in the onset of a downturn is the massive injection of Fed liquidity. Arguably, the regional banking crisis this past spring would have led to larger financial contagion and recession if not for the Fed's aggressive intervention when its balance rose by nearly $400 billion. The Fed saved the day, at least for now. So where does this leave us?

Until we move further past the longest endpoints of when the LEI (this month) and the yield curve (this February) suggest an economic peak is at hand, investors should remain cautious on the outlook. Often when recessions have struck in the past, they typically have caught both market participants and policymakers off guard. We doubt this time is any different. We would be much more sanguine on next year's growth prospects if household interest rates were not so high. They are clearly restrictive as illustrated by the multi-decade highs in auto, credit card, mortgage, and personal loan borrowing rates. Eventually this will slow demand.

Consequently, of the various scenarios, we believe that probability of recession is still the likeliest. Stay tuned.