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A Slowdown Without a Technical Recession?

Economic INSIGHT

With inflation's upward ascent still unimpeded, domestic activity is cooling as consumers' purchasing power is eroded, and businesses' ability – and willingness – to invest is undermined. Amid a slowdown in production and wild volatility in financial sectors, many market participants fear a recession is lurking around the corner or worse, is already upon us. Looking at the decline in topline GDP January to March and with second-quarter activity likely to fall short as well, the U.S. economy may be entering at least a layman's definition of a recession – two consecutive quarters of negative activity.

While the precise definition of an economic recession may vary depending on the source, the average American is bracing for a significant, and possibly prolonged, downturn in domestic conditions as the Federal Reserve (Fed) continues its march to higher interest rates. Monetary policy makers remain committed to bringing down *"too high"* price pressures regardless of the costs – even if such repercussions include an indisputable recession by any measure.

WHAT'S IN A NAME?

As investors debate whether or not the U.S. is in a technical recession, the more important, or at least more fundamental, question remains: What is a recession? The most common answer, or the reply one is most likely to receive during a cocktail party is simply two consecutive quarters of negative growth.

What then is the difference between a recession and a depression as the two terms are often used interchangeably? Is one simply a prolonged version of the other? Those around during the Truman, or later, the Reagan years would likely respond: *"It's a recession when your neighbor loses his job; it's a depression when you lose yours."*

While not wrong, neither answer, however, is as thorough a response as perhaps is required to fully understand the granular nature of such an important economic phenomenon as a recession.

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THE WHO, WHAT, WHERE OF A RECESSION

A recession is officially determined by the National Bureau of Economic Research (NBER) Business Cycle Dating Committee. The NBER was originally founded in 1920, and the Committee was later created in 1978. The eight committee members are appointed by the president of the NBER and are widely accepted as experts in macroeconomics and business cycle research. Through analysis and examination, the Committee seeks to identify the peaks and troughs of a business cycle that frame a recession, which itself is the period between a peak of economic activity and its subsequent trough, or the lowest point in the cycle.

According to the NBER, an official recession involves a significant decline in economic activity that is spread across the economy and lasts for a modest period of time, usually more than a few months. Furthermore, because a recession is not isolated to one sector and instead must influence the broader economy, the Committee *emphasizes "economy-wide"* measures of economic activity be used in defining a period of recession.

The determination of recession is based on a range of monthly measures of aggregate *real* economic activity including real personal income less transfers, nonfarm payroll employment and household employment, real personal consumption expenditures, wholesale-retail sales adjusted for price changes, and industrial production. The Committee notes there is no hard and fast rule regarding what measures contribute information to the process or how they are weighted in their decisions. Two of the measures, however, that have historically had the highest weightings are real personal income less transfers and nonfarm payroll employment.

ARE WE IN RECESSION?

When gauging the status of the cycle, if the economy is experiencing a simultaneous, meaningful, and prolonged decline in the majority of these key components, the Committee contends, there is generally a good chance of a technical domestic recession. With that in mind, is the U.S. economy already in recession?

- Negative gross domestic product (GDP)? Check. At the start of the year, GDP fell 1.6% for the first quarter, the first contraction since the second quarter of 2020. Going forward, while the official read on second quarter GDP won't be released until July 28, according to Atlanta Fed GDPNow forecast, growth from April to June expectedly fell 1.5%. This would mark a one-quarter low in domestic activity and the second consecutive quarter of contraction.
- A decline in retail sales and real consumption? Check, check. Last Friday, the latest retail sales report reported a 1.0% rise in June, the strongest pace in three months. Year-over-year, retail sales rose 8.4% in June, the most in four months. Adjusting for

GLOSSARY

FOMC: Federal Open Market Committee

GDP: Gross Domestic Product

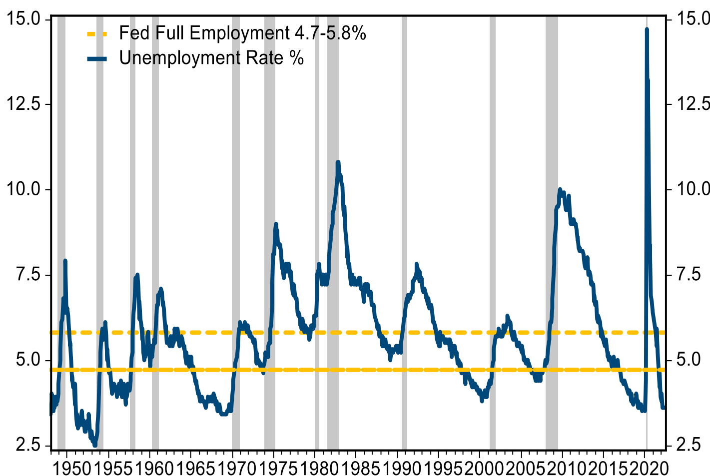
ISM: Institute of Supply Management

NBER: Producer Price Index

inflation, however, *real* retail sales declined 0.3% for the month and dropped 0.5% year-over-year, the fourth consecutive negative print.

Additionally, the latest read on consumer spending – goods and services expenditures combined – rose 0.2% in May, down from a 0.6% increase in April. Adjusting for inflation, however, and again looking at real consumer spending, activity fell 0.4%, the weakest pace in five months. Although, on an annual basis, consumer spending both nominal and real remain in the black, up 8.5% and 2.1%, respectively.

- A slowdown in manufacturing? Yes. The latest read on the Institute of Supply Management fell from 56.1 to a reading of 53.0 in June. While still in expansionary territory with a reading above the breakeven rate of 50, production activity has slowed to a two-year low with a marked reduction in new orders and supplier deliveries, as well as employment dropping further into contractionary territory at 47.3. May's decline in the jobs component marks the first below-50 reading since November 2020.
- Diminishing real income growth? Absolutely. The latest May income report showed personal income rose 0.5% following a similar increase the prior two months and 5.3% over the past 12 months. Accounting for cost increases, however, real income declined 0.1% in May, a two-month low. Furthermore, over the past 12 months, real income is off 1.0%, the third consecutive month of decline.
- And finally, increased unemployment? Not exactly. In the latest June employment report, while the U.S. jobless rate did not decline further, it also did not increase, holding steady at 3.6% for the fourth consecutive month, the lowest since February 2020. Nonfarm payrolls, meanwhile, continue to advance with an average increase of 457,000 over the past six months. Of course, even with stellar job creation since the start of 2021, one could argue the past 18 months has simply been job replacement as opposed to job creation with the nation still struggling to fully recapture the 22 million jobs lost during the COVID-19 recession. Still, even if job *growth* is considered moot, the jobless rate has not and does not indicate a growing level of unemployment.



Source: Bureau of Labor Statistics/Haver Analytics

As aforementioned, marked weakness in the labor market remains a key component of identifying a recession, or at least differentiating recessionary conditions from a more general downturn in domestic activity. In fact, the NBER has never officially declared a recession without a loss of employment – often a significant loss of employment.

FOR THE FED

Of course, whether or not the U.S. is officially in recession is inconsequential for the average American. Hardship is hardship regardless of the classification, be that stagnant growth, depressed activity, or as former Federal Reserve Chairman Alan Greenspan once described a downturn, *"a cumulative unwinding of economic activity."*

It is furthermore irrelevant for the Fed in terms of how the Federal Open Market Committee (FOMC) is likely to continue to address policy going forward. In fact, most members seem to simply accept the fact that a recession is an inevitable part of the business cycle. Not something to avoid or fear, but rather embrace, or at the very least accept as an unavoidable component not only of natural fluctuations of economic activity, but as a welcomed alternative to the scenario of hyperinflation. During the latter, growth could remain positive and avoid a recessionary drop in output, but prices risk pushing higher if left unchecked by the central bank, eventually moving into uncontrollable double-digit territory. Thus, with that as an alternative, a decline in growth, coupled with a reduction in price pressures appears to be the most desirable outcome, or the least bad option.

"I would caution that that no one canceled the business cycle, so one can never fully rule out a recession – it's just a question of timing," said Richmond Fed President Thomas Barkin on June 21, speaking to the Richmond chapter of the Risk Management Association.

CONCLUSION

With all eyes on inflation and an eventual goal of reducing price pressures, a slowdown in growth appears to be a forgone conclusion. But will growth slow enough, or has it already slowed enough to meet the technical definition of recession? Only time will tell. Or better said, market participants will simply have to wait and see if the NBER eventually deems it so.

In the meantime, the Fed appears poised to continue its upward trajectory in rates with at least a second-round increase of 75 basis points – maybe more – next week. In June, the FOMC meeting minutes indicated there was no mention of recession among policy makers. This time around, with the risk of a material slowdown a growing fear among market participants – and central bankers themselves – the discussion of recession, or more broadly a meaningful decline in activity, is likely to be a more prominent component of the discussion. That being said, there seems an obvious anomaly as policy makers increasingly focus on the rising risk of an economic downturn, while the actionable policy debate will no doubt center on the Committee's need to continue or potentially ramp up the size of future rate hikes beyond June's 75 basis points.

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