U.S. Economic Outlook: Beware Lagged Effects

8 December 2023

Key Takeaways

- The economy is at the crux of this cycle, the most difficult period of headwinds. We expect the lagged effects of Fed tightening to slow economic growth during the first half of next year and we continue to maintain our base case of a recession as we move through this period.
- While the ClearBridge Recession Risk Dashboard has remained in red or recessionary territory for the past 16 months, a buoyant labor market, ample fiscal support and monetary policy starting from a deeply accommodative level have all bolstered the economy in 2023.
- Signs of weakness in the labor market and consumer fatigue are early warning signs that activity could slow in the new year. We believe consumption, which drives two-thirds of GDP, could face gathering headwinds in 2024, weakening a key support for economic growth.

Trajectory of Labor Market, Inflation Key Areas to Watch

The U.S. economy has persevered through the strongest monetary tightening cycle since the early 1980s, with 100 basis points (bps) of additional rate hikes in 2023, following 425 bps in 2022. However, we think the next three quarters (inclusive of the current one) will be the crux of this cycle, the hardest part of a climb where all the most difficult moves are concentrated. We expect the lagged effects of Fed tightening to weigh on the economy in the first half of next year and we continue to maintain our base case of a recession until we get through this period.

We were well within the consensus view last year in calling for what became "the most anticipated recession ever." Yet 12 months later, we are still awaiting a meaningful downturn in economic activity. Our North Star, the ClearBridge Recession Risk Dashboard, has now been flashing a red or recessionary signal for 16 months. At present there are nine red and three yellow indicators, which provide the foundation for our base case views even as consensus has shifted into the soft landing camp (Exhibit 1). Importantly, a long duration between the initial red signal and a recession taking hold is not unheard of, as the economy does not always take a straight line down.

There are many potential reasons why the economy held up better than expected this year, including a robust labor market that has supported consumption and ambitious fiscal spending programs still making their way through the economy's bloodstream. We expect these positive impulses to dampen in 2024, setting the economy on more fragile footing as the calendar turns over. Another risk the economy will be facing in the new year is the delayed effect of monetary tightening, which famously acts with long and variable lags. Given high inflation and ultra-low rates, monetary policy likely did not reach restrictive territory until the end of 2022, meaning the full effects of higher rates should continue to weigh on the economy in the first half of 2024, given common wisdom of lags to monetary policy ranging up to 18 months.

Exhibit 1: ClearBridge Recession Risk Dashboard

		November 30, 2023	October 31, 2023	September 30, 2023
Consumer	Housing Permits	✖	✖	✖
	Job Sentiment	✖	✖	✖
	Jobless Claims	●	●	●
	Retail Sales	●	●	✖
	Wage Growth	✖	✖	✖
Business Activity	Commodities	✖	✖	✖
	ISM New Orders	✖	✖	✖
	Profit Margins	✖	✖	✖
	Truck Shipments	●	●	●
Financial	Credit Spreads	✖	✖	✖
	Money Supply	✖	✖	✖
	Yield Curve	✖	✖	✖
	Overall Signal	✖	✖	✖

⬆ Expansion ● Caution ✖ Recession

Source: ClearBridge Investments.

While a recession was the consensus view last year, with the benefit of hindsight, it was likely premature to expect one. History shows that, since the late 1950s, it takes an average of 23 months from the initial rate hike of a persistent hiking cycle to the beginning of an economic downturn. While it may feel like the Fed has been hiking for an eternity, the first hike of this cycle came only around 20 months ago, meaning we are still short of the historical average.

Exhibit 2: Long and Variable Lags

Start of a Persistent* Hike Cycle	Start of Recession	Recession Within 3.5 Years?	Duration of Hiking Cycle (Months)
Nov. 1958	April 1960	Yes	17
July 1963	Dec. 1969	No	76
Nov. 1968	Dec. 1969	Yes	12
Jan. 1973	Nov. 1973	Yes	9
Aug. 1977	Jan. 1980	Yes	29
Aug. 1980	July 1981	Yes	11
March 1984	July 1990	No	75
March 1988	July 1990	Yes	27
Feb. 1994	March 2001	No	85
June 1999	March 2001	Yes	20
June 2004	Dec. 2007	Yes	41
Dec. 2016	Feb. 2020	Yes	38
		Average for All Hiking Cycles	**37**
		Average When Recession Started within 3.5 Years	**23**

*A Persistent Hike Cycle is the period when the majority of Fed rate hikes occur in a tightening cycle. The date of the initial rate hike in the tightening cycle may not align with the start of the Persistent Hike Cycle. Source: FactSet, Federal Reserve.

Some impacts of monetary tightening are already weighing on the economy. In fact, the labor market is showing cracks, with our job sentiment indicator — which measures whether jobs are hard to find — rolling over, a trend that has historically been followed by a recession. While the consumer has been rock solid

since the pandemic, we are seeing signs of balance sheet fatigue in terms of rising delinquencies across credit cards, auto loans and even mortgages, along with more selective spending patterns. And it's important to note that consumption has historically remained strong right up to — or even past — the start of a recession.

We suggested last year that the Fed's success in bringing down inflation would determine the chances of a soft landing. The Fed has made substantial progress and the annualized six-month rate of core PCE now stands at 2.6%, approaching the Fed's 2% target. However, it's rare in developed markets for inflation to be effectively tamed on the first try without a second wave of price increases. The U.S. has endured three major inflation episodes over the last roughly 100 years and all three included multiple waves of inflation; globally the prevalence of multiple waves stands at 87%, according to a recent study from Strategas Research Partners. We believe this is front of mind for the Fed, which will likely err on the side of caution, with the higher-for-longer policy we are currently experiencing one example of this.

On the positive side, while it is still too early to declare victory, inflation is on pace to come much closer to target next year, taking further hikes off the table and raising the question of cuts to bring the stance of monetary policy closer to neutral. If the Fed can get more confident on inflation, ultimately that should open the door for modest rate cuts in 2024 that could help spur an improved outlook later in the year or into 2025.

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