AOR Update: Not Always a Straight Line Down

6 November 2023

Key Takeaways

- Strong third-quarter GDP growth, boosted by robust consumption, further entrenched the soft landing consensus. We remain cautious, however, as consumption has historically remained strong right up until or even past the start of previous recessions.
- A resilient labor market has bolstered an already-strong consumer, helping to drive improvement in the Retail Sales indicator on the ClearBridge Recession Risk Dashboard from red to yellow during the month, while the overall signal remained a recessionary red.
- It has not been unprecedented for the dashboard to improve beneath the surface after a red signal emerges, only to later worsen. This occurred in 1990, for example. While economic and earnings data currently provide a mixed view, we expect clarity to emerge over the coming quarters as we move through the crux of this economic cycle.

Hardy Consumer Spending Drives Upside Surprise for 3Q GDP

Third-quarter U.S. GDP grew an astounding 4.9% year over year, well ahead of consensus expectations of 4.5%. This was the fifth strongest quarter of economic growth seen in the 21st century outside of the pandemic-influenced recovery in 2020 and 2021. On the back of this improvement, the soft landing consensus has become more firmly entrenched, with economic growth expectations for the fourth quarter of 2023 and 2024 both drifting a few tenths higher during October.

Personal consumption expenditures, commonly referred to as consumption or “C” in the GDP = C + I + G + NX equation, were robust in the third quarter. Consumption came in at 4%, accounting for over half of the growth in economic activity in the third quarter. Given the large weight of consumption in GDP, it is perhaps unsurprising that periods of strong economic growth typically coincide with periods of strong consumption growth. What is surprising, however, is that consumption has historically remained strong right up to — or even past the start of — a recession. In fact, consumption was positive in the quarter before the onset of each of the last eight recessions and stayed positive even as the recession started in five of those eight instances (Exhibit 1).

The current strength of the consumer has come as a surprise relative to expectations coming into the year. Spending power has been bolstered by a strong labor market that continues to add workers and is seeing slower but still substantial wage gains. Additionally, consumers have had a tailwind from accumulated savings, the balance of which appears to have been higher than previously understood based on the most recent revisions to the personal income and savings data. As a result of these catalysts, the Retail Sales indicator on the ClearBridge Recession Risk Dashboard has improved to yellow (Exhibit 2).

Exhibit 1: Consumer Spending Can Worsen in a Hurry

Real Consumer Spending and Historical Recessions (Q/Q SAAR)

Recession Start	-2 Quarters	-1 Quarter	Recession	+1 Quarter
1969 – 1970	2.6%	2.0%	3.2%	2.5%
1973 – 1975	**-0.2%**	1.4%	**-1.2%**	**-3.5%**
1980	4.0%	1.0%	**-0.6%**	**-8.7%**
1981 – 1982	1.3%	0.0%	1.9%	**-2.7%**
1990 – 1991	3.4%	1.2%	1.6%	**-3.0%**
2001	3.9%	3.5%	1.5%	0.8%
2007 – 2009	1.1%	2.7%	1.6%	**-0.5%**
2020	4.1%	2.6%	**-6.4%**	**-30.2%**
Median	**3.0%**	**1.7%**	**1.6%**	**-2.9%**
% Positive	**87.5%**	**100.0%**	**62.5%**	**25.0%**

Source: Federal Reserve, Census Bureau, Bloomberg.

Exhibit 2: ClearBridge Recession Risk Dashboard

		October 31, 2023	September 30, 2023	June 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.

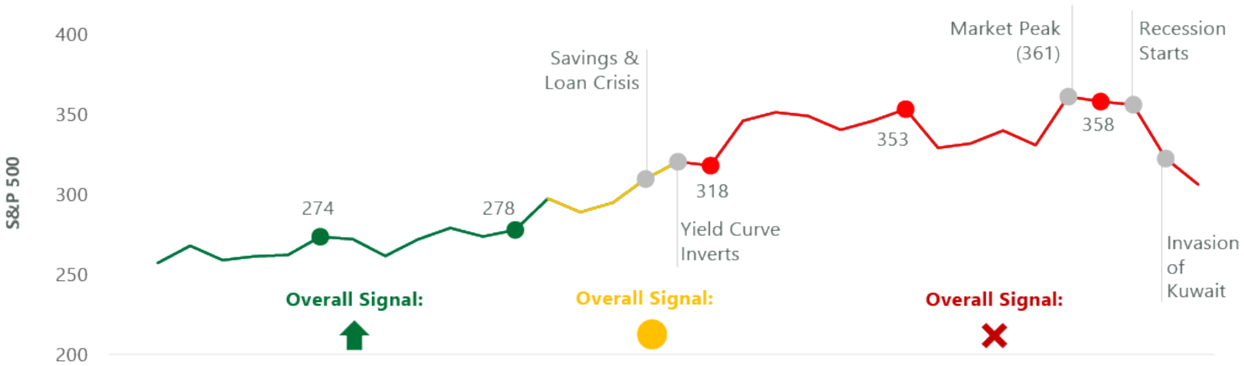
We believe several of the pillars supporting a stronger consumer are likely to fade in the coming quarters and thus an eventual return to a red signal for Retail Sales would not be a surprise. Although consumers accumulated more excess savings and spent it more slowly than previously thought, we believe most of that cash hoard remains in the hands of upper-income households who will treat that savings as extra wealth rather than extra spending power. While borrowing has also buoyed consumption, consumers are having a more difficult time accessing credit, with 60% of respondents reporting credit is harder to obtain versus a year ago, per the most recent New York Fed Survey of Consumer Expectations.

Further, consumers have been under-saving relative to the pre-pandemic norm, with the savings rate falling to 3.4% currently versus an average of over 6% in the 10 years before the pandemic. Perhaps strong confidence in the strength of the labor market has contributed to this low savings rate, which definitionally means a greater share of income is being spent. However, if the labor market cools, consumers could well elect to save a greater share of their income, which would also dampen consumption. This dynamic is part of why we refer to the Jobless Claims indicator on the dashboard as the "canary in the coalmine" for the economy.

However, we believe it is more important to follow what the data tells us than where we think it might be headed. This is the first positive signal change on the dashboard since conditions began to deteriorate approximately two years ago. Historically, it has not been unprecedented for the dashboard to improve from deeper red or "recessionary" territory beneath the surface, only to later worsen as a recession takes hold. One example was in 1990, when the worst reading for the dashboard came during the fourth quarter of 1989. While there were no underlying or overall signal changes in early 1990, there was meaningful improvement beneath the surface. However, a recession ultimately began in July 1990, and the dashboard turned around and started deteriorating during the same quarter before re-testing its "lows" during the following quarter and into early 1991. Put differently, it's not always a straight line down after an overall red signal has been triggered.

Coincidentally, the 1990 recession was one we flagged over a year ago — when the overall dashboard signal first turned red — as one potential historical parallel given the longer time horizon between the dashboard's red signal and the onset of a recession during that cycle. Our view at the time was that a recession was still not a foregone conclusion, particularly if inflation rapidly cooled and the Fed backed off earlier than expected. While neither of those things has happened, we still find the lessons from 1990 informative (Exhibit 3).

Exhibit 3: A Look Back at 1990



		Q2 1988	Q4 1988	Q2 1989	Q4 1989	Q2 1990
	Housing Permits	●	↑	●	●	✕
	Job Sentiment	↑	↑	↑	✕	✕
	Jobless Claims	↑	↑	↑	✕	✕
	Retail Sales	↑	↑	↑	●	✕
	Wage Growth	✕	✕	✕	✕	✕
Business Activity	Commodities	↑	↑	●	✕	✕
	ISM New Orders	↑	↑	✕	✕	✕
	Profit Margins	↑	↑	↑	●	✕
	Truck Shipments	↑	●	✕	✕	✕
	Credit Spreads	↑	↑	●	✕	✕
	Money Supply	●	✕	✕	✕	✕
	Yield Curve	↑	↑	✕	✕	✕

Source: ClearBridge Investments.

Looking ahead, we continue to believe investors are moving through "The Crux" of this economic cycle. Despite the strong third-quarter GDP print, economic and corporate earnings data continue to provide a mixed view on the health of the economy. The initial readout from the Atlanta Fed's GDPNow tracker suggests a substantial slowdown in the fourth quarter, although it is still too early in the quarter to put much stock into that reading. We continue to believe that clarity will emerge on the economy's fate over the coming quarters. As that unfolds, we will continue to follow the data — be it improving or deteriorating — and update our views accordingly.

About the Authors

Jeffrey Schulze, CFA
Director, Head of Economic and Market Strategy
- 18 years of investment industry experience
- Joined ClearBridge Investments in 2014
- BS in Finance from Rutgers University

Josh Jamner, CFA
Vice President, Investment Strategy Analyst
- 14 years of investment industry experience
- Joined ClearBridge Investments in 2017
- BA in Government from Colby College

ClearBridge Investments
ClearBridgeInvestments.com.au