AOR Update: Yellow Signal – Will Fed Speed Up or Slow Down?

August 1, 2022

Key Takeaways

- The ClearBridge Recession Risk Dashboard continued to weaken in July, with the overall dashboard signal turning a cautionary yellow as Retail Sales, Commodities and the Yield Curve all worsened.
- A recession is still not a foregone conclusion. In fact, of the past 12 yellow dashboard signals, three have been followed by a return to green expansionary conditions with a Fed pivot the typical catalyst for improvement.
- While equities have rallied in anticipation of moderating monetary policy, a shift will require clear and convincing evidence that inflation has rolled over along with other leading indicators suggesting further downside on the horizon.

Economy Contracts for Second Straight Quarter

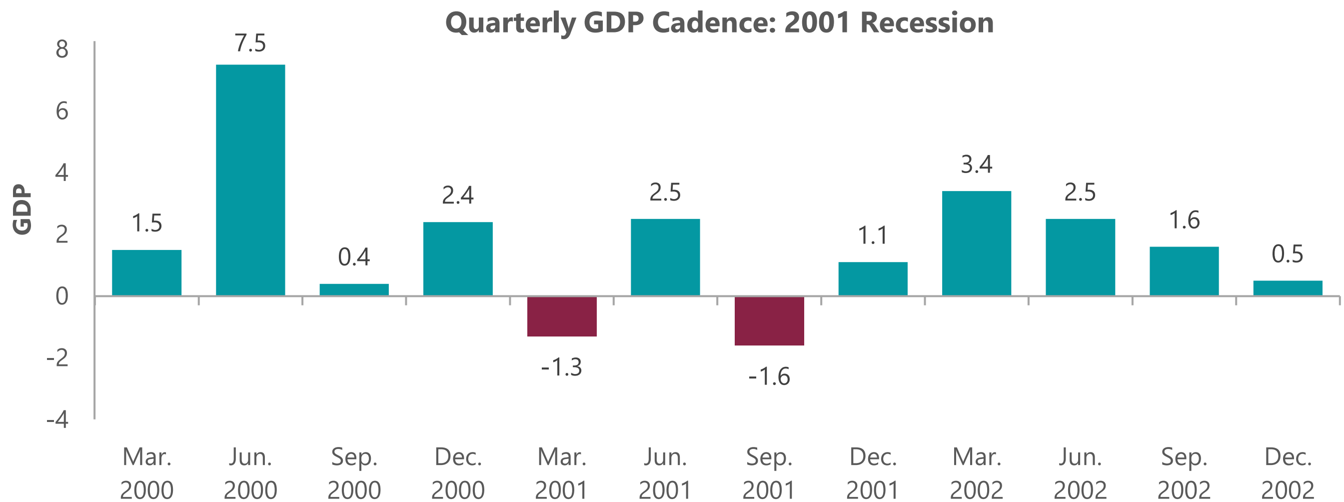
Yet another sign of a slowing economy came out last week with the advance release for second-quarter GDP showing a disappointing 0.9% contraction. Following a -1.6% first-quarter print skewed by very strong imports as supply chain bottlenecks improved, many investors are questioning if the U.S. economy has already entered a recession. By the traditional mantra, two consecutive negative quarters of GDP signal a recession. However, the official arbiter of business cycles — the National Bureau of Economic Research (NBER) — does not use that definition, as we recently highlighted, and instead focuses on:

...a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough.

In fact, two widely accepted recessions during the modern era did not meet the two consecutive negative quarter threshold, including the 2001 recession, which saw a negative quarter followed by a positive quarter and then another negative quarter.

In reviewing the NBER's definition, it appears unlikely that a recession began in the first half of 2022. This is particularly true considering that the economy created 2.74 million jobs during those six months, a pace about 2.5x what was seen on average during the decade following the Global Financial Crisis and before the COVID-19 pandemic (2010–19). However, the economy does appear to be rapidly slowing as the Fed moves to quickly normalise monetary policy and curb inflation, a dynamic we flagged in our special mid-month update in June.

Exhibit 1: Spot the Recession



Source: BEA, Bloomberg.

With data continuing to slow over the ensuing six weeks and another 75-basis point interest rate hike last week, it is unsurprising that multiple signals on the ClearBridge Recession Risk Dashboard have worsened. Following three changes last month, there are four indicator changes this month including the overall signal, which is now flashing a cautionary yellow. Underlying signal changes include Retail Sales and Commodities, both of which are now red, and the Yield Curve, which has worsened to yellow from green. Further, there has been deterioration beneath the surface in several indicators, with Housing Permits, Job Sentiment and Jobless Claims all "less green" than in previous months. Additionally, Money Supply is getting closer to red territory while ISM New Orders is on the border between yellow and red.

Exhibit 2: ClearBridge Recession Risk Dashboard

		July 31, 2022	June 30, 2022	May 31, 2022
Consumer	Housing Permits	Expansion	Expansion	Expansion
	Job Sentiment	Expansion	Expansion	Expansion
	Jobless Claims	Expansion	Expansion	Expansion
	Retail Sales	Recession	Caution	Expansion
	Wage Growth	Recession	Recession	Recession
Business Activity	Commodities	Recession	Caution	Caution
	ISM New Orders	Caution	Caution	Expansion
	Profit Margins	Expansion	Expansion	Expansion
	Truck Shipments	Expansion	Expansion	Expansion
Financial	Credit Spreads	Recession	Recession	Caution
	Money Supply	Caution	Caution	Caution
	Yield Curve	Caution	Expansion	Expansion
	Overall Signal	Caution	Expansion	Expansion

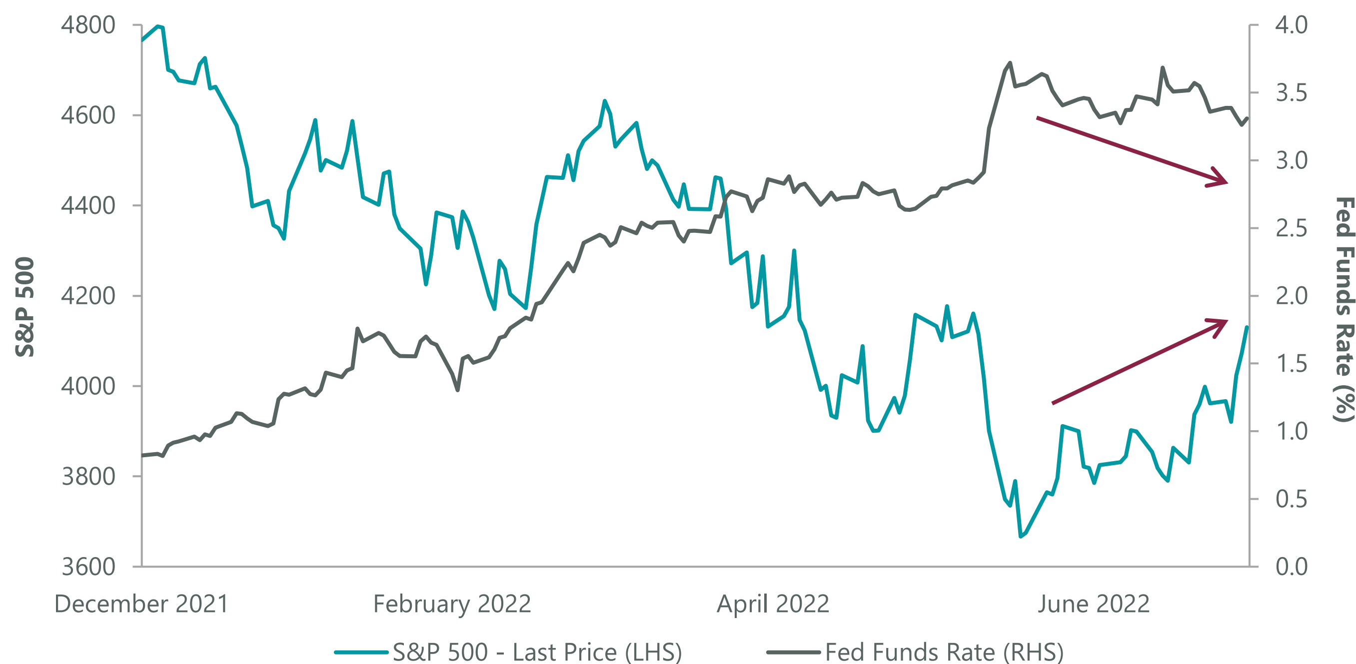
Expansion Caution Recession

Data as of July 31, 2022. Source: ClearBridge Investments.

A yellow overall signal equates to caution but does not mean a recession is a forgone conclusion. The dashboard has turned yellow 12 times historically, with eight coming before a recession and four instances where the economy avoided a recession. Of these four non-recessionary periods, three saw the dashboard return to green next (1995, 1998, and 2015–16) while one worsened to red (mid-1960s). We delved into these periods in a blog when the dashboard last turned yellow in 2019, but importantly in the three instances of the dashboard recovering, each occurred against a backdrop of a dovish Fed pivot. In 1995–96 and 1998, the Fed cut interest rates by 75 bps, and in 2015–16 the Fed hiked only once against a market that expected four hikes, effectively a net "loosening" of 75 bps relative to market pricing and expectations.

If the coming months see the economy avert a recession and the dashboard return to green, a Fed pivot will likely play a key role. The timing of the Fed pivot is a key debate in markets right now, and one that will likely impact whether a soft landing is achieved. At present, fed funds futures are pricing a 50-bps rate increase in September and a final hike of 25 bps in November, with a rate cut or two coming in the second half of 2023. Equities appear to be discounting this pivot, rallying as rate hike expectations have moderated by nearly 50 bps for December 2022 over the last six weeks.

Exhibit 3: Rate Hikes Influencing Equities



Data as of June 30, 2022. Source: Bloomberg.

What remains to be seen is if the Fed will actually pivot in the face of a slowing economy, particularly if inflation remains elevated. While the next CPI print should see relief from lower gasoline prices — down over 70 cents from their mid-June peak — both Core CPI and Core PCE have been steadily printing too-high-for-comfort figures over the last three to four months. Importantly, the Fed does not need to see inflation return to 2% to back off. A dovish turn instead requires a clear and convincing trend that inflation has rolled over along with leading indicators suggesting further downside. This trend has not emerged yet, although some leading indicators suggest it could by the end of summer. Ultimately, there is time to change the current path of the economy; however, the longer it takes for a pivot to be realised, the higher are the odds of a recession. With our apologies to Fed Chair Jay Powell, the "running clock" to bring inflation back toward the 2% target is not the only running clock investors should be keeping an eye on at present.

About the Authors

Jeffrey Schulze, CFA
Director, Investment Strategist

- 17 years of investment industry experience
- Joined ClearBridge Investments in 2014
- BS in Finance from Rutgers University

Josh Jamner, CFA
Vice President, Investment Strategy Analyst

- 13 years of investment industry experience
- Joined ClearBridge Investments in 2017
- BA in Government from Colby College

ClearBridge Investments
clearbridgeinvestments.com.au

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