For professional clients only
January 2019
Research & Strategy Insights

US to avoid recession, for now

Tighter financial conditions still point to material softening

David Page
Senior Economist US
Research & Investment Strategy

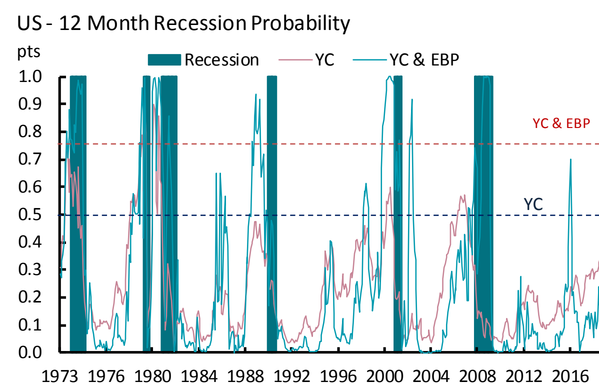
Key points

- Tighter financial conditions around the turn of the year have raised fears of a US recession.
- Estimated recession probability indicators remain below thresholds reached before previous downturns. For now, we do not expect a recession in the US over the next 12 months.
- The path of risk sentiment will be important from here. We consider a lot of bad news to have been priced in and look to some improvement over the coming months.
- Yet tighter financial conditions should further soften the growth outlook for 2019. We lower our GDP forecast to 2.2% for this year, leaving 2020 unchanged at 1.4%.
- We expect the Federal Reserve to tighten policy twice more this year.

Recession probability model says NO

The turn of the year saw market tensions rise over the outlook for the US economy. While a number of developments, including a less-dovish-than-hoped US Federal Reserve (Fed) hike in December and a shutdown of the US government, added to fundamental concerns, deterioration in financial markets caused most alarm. From mid-December, the US equity S&P 500 index extended losses beyond the 10% 'correction' territory that it had held for much of the quarter, extending to a 20% drop by Christmas Eve. US high-yield spreads, which had widened by 126 basis points (bps) to mid-December, widened a further 102bps to 544bps – their highest since February 2016 - and parts of the US yield curve, including the 3 month -10 year portion, inverted. All of these moves were seen as consistent with an impending US recession.

Exhibit 1: Inverted curve is a good indicator of recession



Source: Bureau of Economic Analysis (BEA), Federal Reserve Bank (FRB) and AXA IM R&IS calculations, Oct 2018

Financial conditions play a key role in determining the pace of US economic activity. Households are affected by wealth effects that help determine spending/saving decisions. Business sentiment and investment decisions are affected by signals from financial markets and both are fundamentally impacted by changes in credit availability that are in turn affected by financial conditions. Last year, we proposed that

the yield curve played a causal role in recessions[1]. Accordingly we have monitored developments closely.

Exhibit 1 illustrates our preferred recession probability indicators. Based on the slope of the yield curve[2] alone, we argue that the estimated probability of recession is coming close to – but importantly is still short of – levels that have historically preceded recessions over the coming 12 months. In December, the estimated probability of recession rose to 41%, where the 48% (1989) was the minimum probability that has historically preceded a downturn.

However, our preferred indicator combines both the yield curve slope and the excess bond premium[3]. Looking at this measure, our model estimates a 55% chance of recession. This falls even shorter than the 74% minimum probability associated with recession (2008). That said, we note that unusually during the financial crisis, this indicator only clearly signalled contraction once the recession was underway. Historically, while this measure has a higher minimum threshold to indicate recession (80%), it has signalled downturns later.

Moreover, both models use monthly averages. While our estimates for December fell short of previous minima, the first few days of January – while reversing the direction of the December low/highs respectively – look set to remain below previous minima with rates at 44% and 60% respectively.

Easier financial conditions would move indicators further from critical levels

With both models close to previous thresholds, the outlook for US activity will depend on the evolution of risk sentiment from here. As of now, we consider financial markets to have priced in a lot of bad news. Yet, while significant uncertainty persists, we believe the outlook is likely to improve over the coming months. Markets currently consider, for example:

US government shutdown. The US is currently undergoing its longest ever government shutdown as President Donald Trump tries to secure funding for his “Wall” from a reluctant Congress. The extent of the shutdown, the risk of affecting February’s tax rebates and future fiscal decisions scheduled for this year all add to concerns about this government impasse. However, we expect to see the government re-opened in January. With only 25% of government spending effected in this partial shutdown, resolution of the shutdown within this timeframe would likely limit the economic impact to less than 0.1ppt of GDP in Q4 and 0.2ppt in Q1 and should allay market concerns.

US trade negotiations. Markets have been alarmed by US protectionism. Yet negotiations this year have offered some hope of a more benign resolution, with China’s Vice Premier Liu He attending meetings in China in early January and set to continue talks in Washington next week. There is evidence that tariffs are impacting the Chinese economy; but equally evidence is growing that the US economy and financial markets are reacting to trade tensions. All of which increases the chances of both sides coming to a mutual agreement to avoid further economic deterioration.

China slowdown. Relatedly there has been mounting evidence of deceleration in the Chinese economy. In turn, this has resulted in additional stimulus from the Chinese authorities, including Reserve Requirement Rate (RRR) cuts and fiscal stimulus – tax cuts taking effect in early January and further fiscal stimulus being announced more recently. Such stimulus will likely take time to find traction in the Chinese economy and we do not expect this until Q2 2019. However, evidence of this should become increasingly visible over the coming months.

Eurozone slowdown. The Eurozone also decelerated markedly in 2018, not unrelated to the China slowdown. The pace of deceleration saw Italy fall into technical recession in H2 2018, while Germany narrowly avoided one (with 0.1% expansion expected to be announced for in Q4) and weak expansion (0.2% expected) across the Eurozone as a whole. However, this looks likely to have been exacerbated by idiosyncratic factors – Italy’s budget spat with the European Commission, France’s *gilet jaunes* impact on Q4 consumer spending and Germany’s vehicle emission standards change and low water levels on the Rhine. Each of these factors is expected to fade in impact over the coming quarters and we forecast a modest acceleration in quarterly growth from Q1 onwards.

Brexit. While in the midst of the political crisis we feared[4], the increased intervention of Parliament suggests that the worst-case “no deal” Brexit should be avoided, if Brexit indeed happens on 29 March 2019.

We fully acknowledge the uncertain nature of each of these issues but, on balance, we consider these likely to improve over the coming months. This would likely improve risk sentiment directly, or have the effect of easing financial conditions further via, for example, a further weakening of the US dollar. Such improvements would see our models suggest less chance of imminent recession.

[1] Page, D., Savage, J. and Venizelos, G., “Is the yield curve pointing to recession?“, AXA IM Research, 25 October 2018.

[2] We look at the 3m-Tbill rate and 10-year US Treasury Bond yield differential.

[3] Excess Bond Premium is calculated as the difference between the degree of credit spread associated with the current default risk and total spread. We use estimates of this provided by the Federal Reserve (Philadelphia).

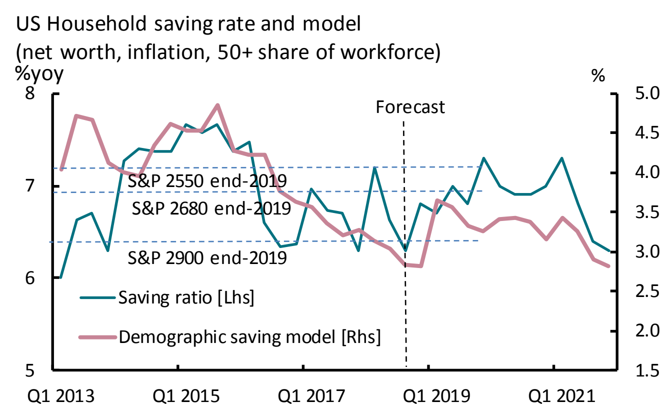
[4] Page, D., “Irreconcilable Brexit”, AXA IM Research, 30 January 2018.

No recession, but weaker growth

In November, we forecast an outlook for US GDP growth to slow to 2.3% in 2019 and more materially in 2020 to 1.4%. This compared to a consensus expectation for 2.6% and 1.9% respectively, which is barely changed today[5].

Since then financial conditions have tightened further. We estimate this impacting the economy through a number of channels, with the most important likely to be the impact on household spending. Exhibit 2 shows a range of estimates of where US equities could end 2019 and their impact on saving rates. Admittedly, with US saving rates having remained stubbornly high in recent years, households may not feel compelled to bolster savings to the same extent as in previous episodes if net wealth flags. However, based on historical trends, recent levels of the S&P 500 could raise US saving rates by 0.5-0.75ppt, reducing GDP by 0.4-0.7ppt.

Exhibit 2: Illustrative saving rate projections for different levels of S&P 500

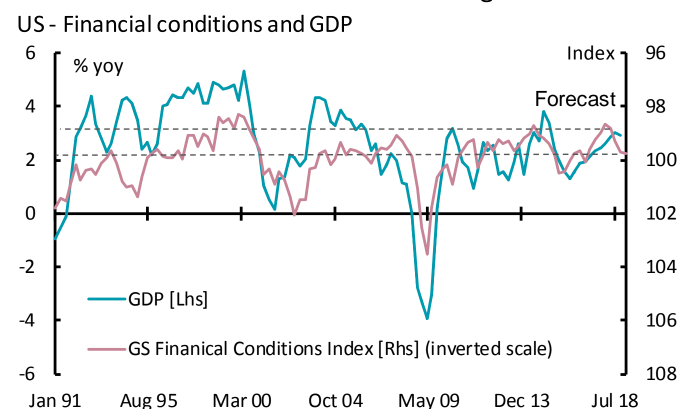


Source: BEA, Datastream, AXA IM R&IS calculations, Jan 2019

Similarly, we consider how movements in financial conditions have coincided with economic growth in recent years. Exhibit 3 shows one such relationship. The deceleration in financial conditions from their easiest at the start of 2018 to their tightest at the close of the year has historically been associated with a slowdown in GDP growth of around 1ppt.

A tightening in financial conditions is a key factor in our outlook for a greater-than-expected deceleration in economic growth this year and next. However, the further tightening towards end-2018 has increased our concerns. Accordingly, we have lowered our GDP growth outlook to 2.2% (from 2.3%) for 2019, although we have left our 2020 outlook unchanged. We also concede that our forecast assumes some recovery in risk sentiment over the coming quarters. If financial conditions remain as tight as at present over the coming year we would envisage still softer growth.

Exhibit 3: Financial conditions and GDP growth



Source: BEA, Goldman Sachs, AXA IM R&IS calculations, Jan 2019

Fed more patient, but likely to tighten further

We suggest that market weakness around the turn of the year was at least in part a reaction to December's Fed decision. While we and markets broadly expected the Fed to hike the FFR by 0.25% to 2.25-2.50%, we had expected a more conciliatory tone in reaction to the sharp correction in markets in the preceding days and weeks. While Fed Chair Jerome Powell acknowledged a reduced outlook for future rate hikes in the Summary of Economic Projections (dots forecast), he continued to emphasise the strong outlook of the economy and described the balance sheet policy as on "auto pilot".

Since then, the Fed Chair and a succession of Federal Open Market Committee (FOMC) participants have stressed that the Fed can afford to be "patient", that it will be reactive to conditions and that this also applies to balance sheet policy.

In the early days of January, financial markets priced a Fed rate cut as more likely than a hike in 2019, with markets pricing a 15% chance of a June cut at one point. With some recovery in risk sentiment, they now consider a hike more likely, but on balance expect policy to remain on hold in 2019.

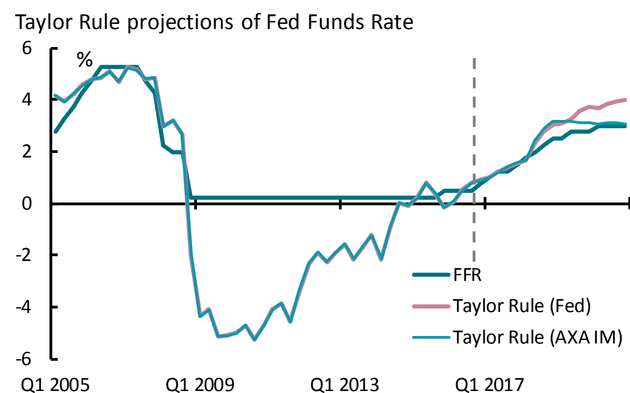
In reaction to the tightening in financial conditions in December, we reduced our outlook for FFR increases in 2019 to two (from three) and removed our expectation for a rate cut in 2020. Exhibit 4 illustrates that our revised rate outlook is consistent with our estimates of the Taylor Rule. Estimates of the Taylor Rule using our macroeconomic forecasts suggest less required tightening than using the Fed's projections. Indeed, our outlook for two more hikes before reaching a peak, are below the Fed's dots projection (two hikes in 2019 and a further increase in 2020).

We argue that such an outlook is consistent with expectations for the labour market. Despite our slower-than-consensus forecast, we still forecast GDP growth of 2.2%,

[5] Bloomberg consensus forecasts were updated to 2.5% and 1.9% respectively on 11 January 2019.

which we consider to be above the US's potential growth rate. Such growth would be consistent with a further reduction in the jobless rate and modest further upward pressure on wage growth. The Fed describes the current wage growth rate as consistent with its inflation goal and current productivity rates. Slower GDP growth over the coming years is likely to see slower productivity growth. Quickening wage growth and slower productivity growth together imply greater domestic inflation pressure. We expect the Fed to address this with further "patient" tightening.

Exhibit 4: Financial conditions and GDP growth

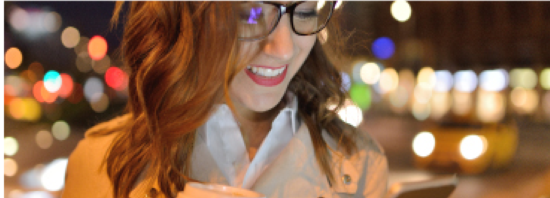


Source: FRB, AXA IM Research, Jan 2019

We make two caveats. The first is that we assume modestly easier financial conditions over the coming quarters. Based on our assumption that the Fed is likely to tighten policy in June and December. However, as the Fed has stressed it will react to changes in conditions, if conditions remain as tight as now, the Fed may not need to tighten further.

The second is that we expect the Fed to review its balance sheet policy. The Fed has added a new downside risk to its GDP outlook, according to the minutes of its December meeting, associated with "greater than anticipated negative effects from the monetary policy tightening to date". We doubt that such uncertainty stems from its implementation of FFR increases. Rather, we think this pertains to uncertainties associated with balance sheet policy – or quantitative tightening. Our expectation of two rate hikes for 2019 comes alongside an expectation for a broader review of the Fed's balance sheet policy.

Our Research is available on line:



Insights Hub

The latest market and investment insights, research and expert views at your fingertips

www.axa-im.com/insights

DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document. Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.

This document has been edited by AXA INVESTMENT MANAGERS SA, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 393 051 826. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

In the UK, this document is intended exclusively for professional investors, as defined in Annex II to the Markets in Financial Instruments Directive 2014/65/EU ("MiFID"). Circulation must be restricted accordingly.

© AXA Investment Managers 2019. All rights reserved

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826