The arguments for and against a US recession on this year's horizon

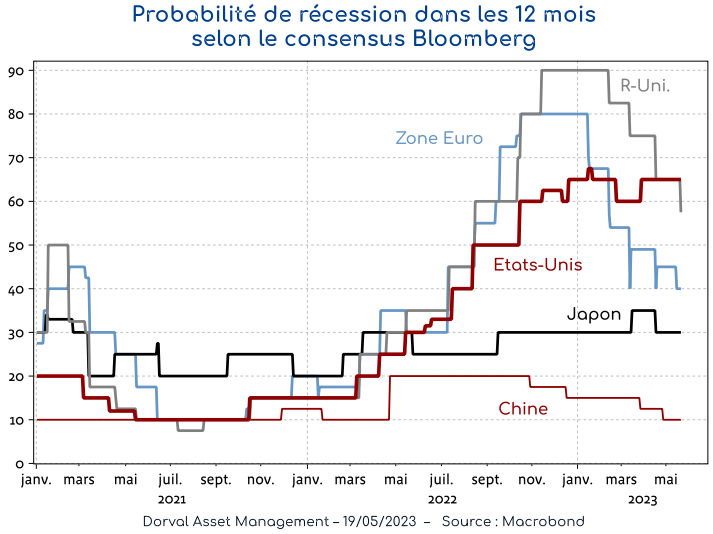
22 May 2023

Dear Clients and Partners,

While recession forecasts have significantly improved in Europe since the beginning of the year, they continue to show a high likelihood for the US (cf. chart 1). Below, we explain what supports this consensus and what might contradict it.

Three major events fostered global economic momentum in the first half of 2023. Firstly, a recession in Europe was avoided. The ability of European companies and states to adapt to the energy shock on a micro- and macroeconomic level largely explains this pleasant surprise (according to the OECD, favourable temperatures during winter account for only 20% of the result). Secondly, the abrupt end to the Chinese zero-COVID policy unsurprisingly led to a clear recovery in business in China. Finally, the "long-awaited" US recession has still not come about.

Probability of recession within 12 months according to the Bloomberg consensus

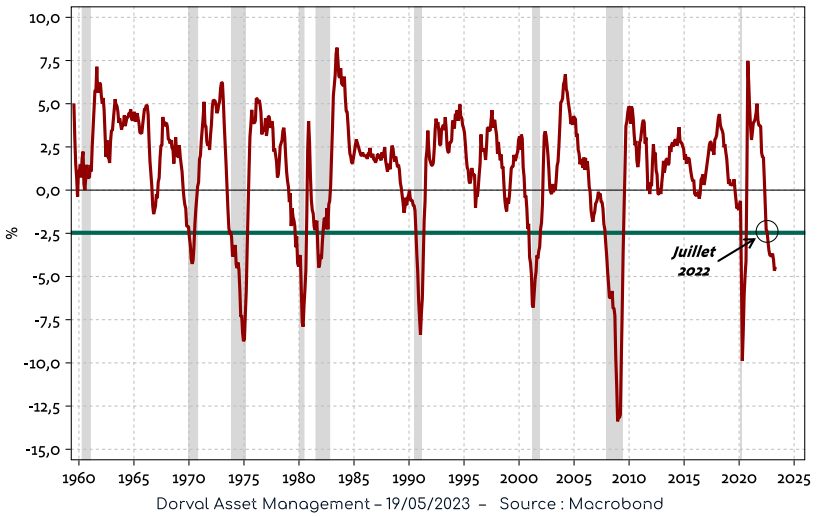


- *UK / Eurozone / USA / Japan / China*
- *Jan. / March / May / Jul. / Sept. / Nov. / Jan. / March / May / Jul. / Sept. / Nov. / Jan. / March / May*

However, the consensus among economists (and investors) regarding a US recession remains pessimistic. Of the 39 economists surveyed by Bloomberg in May, 33 are expecting a recession to begin in the United States this year. Made even more plausible by the US regional bank crisis, the overall outlook of the leading indicators compiled by The Conference Board further supports the prospect of an imminent recession (cf. chart 2). There are ten indicators, ranging from the S&P 500 to manufacturers' new orders, the yield curve, consumer confidence and the number of building permits. When the average of these leading indicators falls by more than 2.5% over six months (5% annualised), recession seems inevitable. This warning threshold was crossed ten months ago in the summer of 2022.

Since last summer, leading indicators have fallen below the warning threshold usually indicating a recession
Var. over six months of leading indicators in the United States, in %

Depuis l'été dernier, les indicateurs avancés sont passés sous le seuil d'alerte signalant habituellement une récession
Var. sur 6 mois des indicateurs avancés aux Etats-Unis, en %



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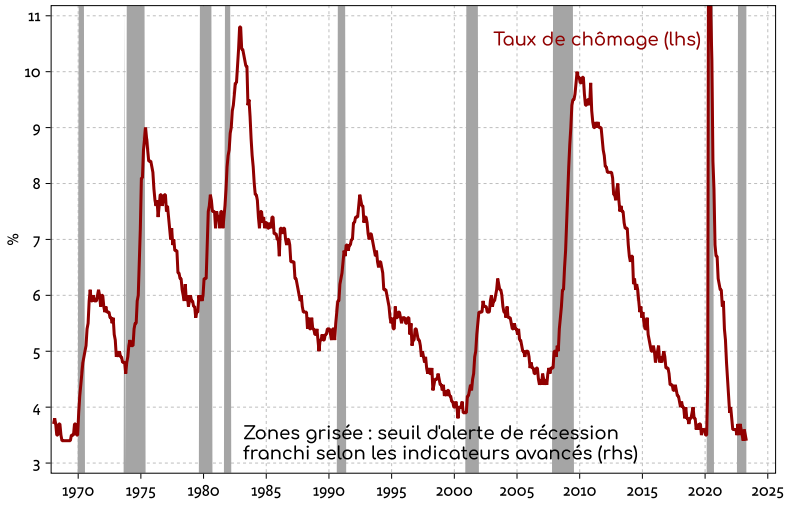
- *July 2022*

Previously, the longest amount of time between crossing the warning threshold and the date of entering a recession (according to the National Bureau of Economic Research) was four months in 1979/1980 and three months in 2000/2001. Another cause for concern is that the threshold has only ever been crossed while the rate of unemployment was already starting to increase (except in 1974 when there was a two-month gap). Since the summer of 2022, however, the rate of unemployment has continued to decline (cf. chart 3).

For the first time, US unemployment is still not rising, despite the warning threshold being crossed many months ago

Pour la première fois, le chômage US ne monte toujours pas alors que le seuil d'alerte est franchi depuis de nombreux mois



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- *Unemployment rate (lhs) / Shaded areas: recession warning threshold crossed according to leading indicators (rhs)*

This makes the current situation completely unprecedented, for reasons that we are very familiar with. The unique circumstances of the COVID-19 pandemic, followed by the reopening of businesses has considerably disrupted both the relevance and significance of many economic indicators. For example, it is rather striking that US consumer confidence, according to data from the University of Michigan, is as low as it was in 2008, despite full employment in the US.

Still, the majority of economists continue to talk about an impending recession because they believe that the positive effects of reopening businesses will soon fade and the negative effects of tighter credit conditions will be increasingly felt. The US economy thus risks facing a sudden fall, the likes of which Wile E. Coyote suffered many times – an image often evoked by Lawrence Summers.

These arguments about the vulnerability of the US economy are relevant, but there are others making a case for greater resilience. Firstly, disinflation is leading to increased purchasing power for Americans, with prices rising slower than wages since last summer (cf. chart 4). At the same time, disinflation also reduces interest rate risk. In addition, the negative impact on US residential real estate is partly mitigated by the very low housing inventory levels. Thanks to a stabilisation of mortgage rates, this sector has also seen an improvement in the business climate for several months (the NAHB index, which is followed closely, returned to the neutral level of 50 in May). Finally, US households and companies' balance sheets still seem strong enough to withstand interest rates that are certainly much higher than before COVID-19, but perhaps not so detrimental in real terms (after inflation).

Americans' purchasing power is starting to rise
Hourly wages deflated by consumer prices
Le pouvoir d'achat des américains commence à remonter
Salaires horaires déflatés des prix à la consommation

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Thus, the writing is far from being on the wall and we remain open-minded. We are maintaining a neutral allocation of equities in our global funds, with a balance between our basket of defensive securities and our more cyclical basket of energy transition securities. Our bond duration remains at zero due to the high prices and volatility of the sovereign debt markets. We are continuing to earn increasing returns on the non-equity portion, via commercial paper and Treasury bills issued in the eurozone.

Our exposure rates are as follows:

- Dorval Convictions: The equity exposure rate is 56%.

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