OXFORD ECONOMICS

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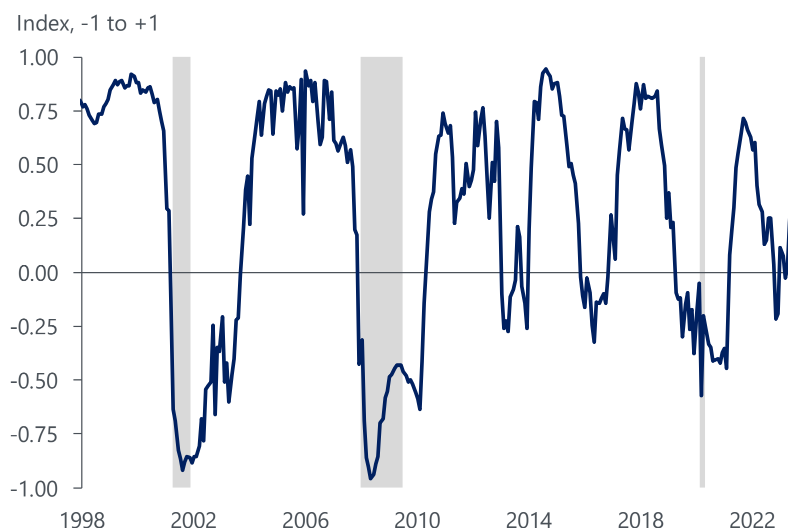
Research Briefing | US

Recession Monitor – Slow growth, but no recession ahead

- **In our latest forecast, we removed the mild recession from our baseline and now anticipate a prolonged period of below-trend growth. However, the risks of a recession are still elevated, so we will continue our recession monitor series, highlighting potential risks that could tip the economy into recession in the months ahead.**
- **To achieve a soft landing, the labor market will need to avoid a rapid rise in the unemployment rate. However, the uptick in the unemployment rate in October means it has now risen 0.3ppts from its low and is approaching the 0.5% threshold, or the "Sahm Rule", that has reliably identified the beginning of every recession since 1970. The Fed will hope this cycle proves the exception to the rule, as it would only require the unemployment rate to rise 0.1ppt to 4% over three consecutive months for the threshold to be reached.**
- **Despite the recent pullback in Treasury yields, our financial conditions index suggests conditions are tighter than a few months ago. With the Fed striking a hawkish line, we expect yields to remain elevated in the near term and for financial conditions to stay tight, weighing on growth. Rate-sensitive parts of the economy will weaken, but not enough to tilt the economy into recession, particularly when recent data suggests the largest squeeze from tighter lending conditions may have passed.**
- **Although we removed the recession from our baseline forecast, we think the risks remain elevated over the next 12 months. A potential government shutdown, if it occurred, would weigh on growth, while uncertainty over the 2024 elections could drag on investment and, therefore, economic growth. Should the conflict in the Middle East broaden severely, the fallout in energy markets has the potential to increase inflationary pressures and shave GDP growth enough to push the economy into a mild recession.**

Chart 1: US BCI signals momentum was ebbing heading into Q4



Source: Oxford Economics/Haver Analytics

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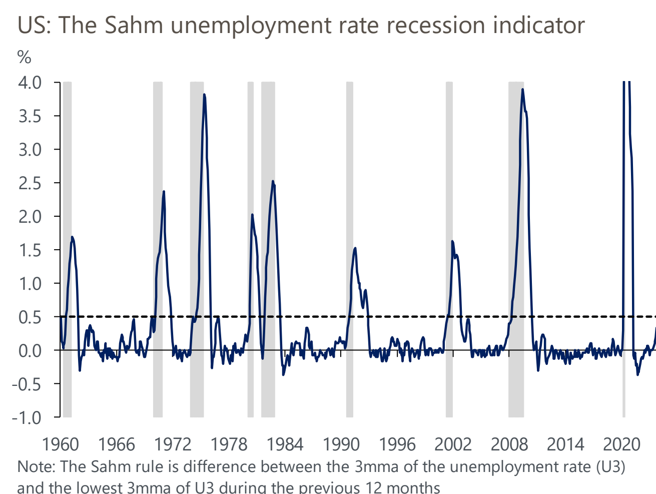
In contrast to the blockbuster Q3 GDP report, our business cycle indicator signals that the economy lost some momentum at the end of the quarter (**Chart 1**). The monthly decline in September was modest, but drop-off since July has been starker, with each of the five components showing weakness on an annual basis. Despite relative resilience in the labor components, personal income growth has slowed, with real disposable incomes falling for three consecutive months. Manufacturing activity remains in the doldrums. Our index remains far from recession territory, though, which we put around the -0.25 to -0.5 mark.

Incoming data points to a slowdown

The most recent timely data on the economy suggest that economic activity is slowing, raising recession risks. The October employment report showed a weaker-than-expected 150,000 payroll gain, although that in part was due to strike activity in the month. The unemployment rate ticked up 0.1ppt to 3.9%, and while it remains historically low, it has now risen by 0.3ppts from its low. The "Sahm Rule" reminds us that every time in the past 50 years that the unemployment rate has risen sustainably by more than 0.5ppts from its low, the economy has fallen into recession (**Chart 2**).

Chart 2: Sahm Rule approaching recession threshold



Source: Oxford Economics/Haver Analytics

The Sahm Rule is the difference between the three-month moving average of the unemployment rate and the lowest three-month moving average from the prior 12 months. At 0.33, the measure is close to the threshold, and if unemployment ticked up to 4% over a stretch of three months, it would be triggered. Of course, it is important to remember the rule is not a law of nature, but an observed relationship that has, thus far, been unbroken.

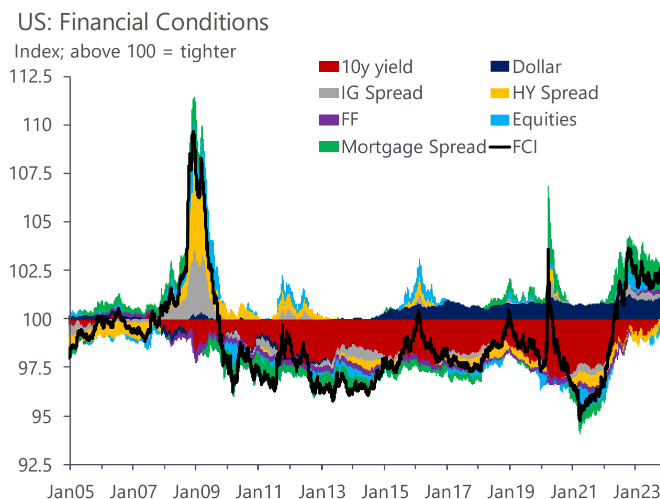
The current labor market already defies historic precedence; if there was a time for the relationship to break down, it might just be this one. Our forecast is for unemployment to gradually rise in the months ahead, peaking at 4.7% by Q3 2024 – a scenario that would trigger the Sahm Rule, though we still expect the economy to narrowly avoid recession.

Financial conditions still weighing on growth

The tightening in financial conditions over the past few months is a key reason to expect economic growth to slow over the coming months, though the recent drop in longer-term bond yields reduces the sting.

Even though 10-year Treasury yields have fallen by close to 40bps from their highs late last month, our financial conditions index still suggests conditions are much tighter than a few months ago, and with the Fed continuing to take a hawkish line, we expect yields to remain elevated in the near term (**Chart 4**). We expect activity in rate-sensitive parts of the economy, particularly the housing market, to weaken in the near term, but doubt that will be enough to drag the economy into recession, particularly at a time when the latest signs from the Senior Loan Office Survey suggest that the extent to which banks are tightening lending standards may have hit its peak for this cycle.

Chart 3: Financial conditions heading in the wrong direction for the Fed



Source: Oxford Economics/Haver Analytics

Probability of a recession still remains elevated

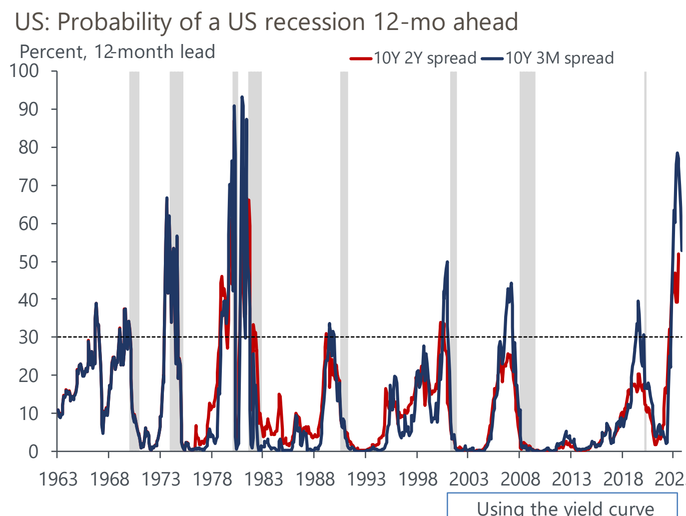
Lagged and uneven effects of tighter monetary and fiscal policy, as well as the behavior of consumers, make the outlook highly uncertain. Although we removed the recession from our baseline forecast, we think it remains a high probability over the next 12 months. The yield curve has become less inverted in recent months, but the current inversion implies that the near-term risks of a recession are high (**Chart 5**).

There are still plenty of tail risks out there. We argued before that a government shutdown will not sink the economy, but the continued showdowns over fiscal policy are likely to introduce more volatility into financial markets as policymakers continue to kick the can down the road, one stopgap at a time. Political uncertainty ahead of the 2024 elections could drag on investment and therefore economic growth.

A tail risk to the economy over the next 12 months is the threat that conflict in the Middle East broadens. Even then, the downside risks to the economy are more limited than they were in the past, in part because the US is now a net exporter of energy.

We modeled a severe scenario where a regional conflict limited oil supply, pushing up oil prices by 60%, sending equity markets down by 12%, while the additional inflationary risks from higher oil prices forces the Fed into raising rates again next year. Even in that severe scenario, the likely hit to US GDP is close to 1%, which would drag full-year growth down close to 0% and push the US into a recession, albeit a mild one.

Chart 4: Probability of recession remains elevated



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Source: Oxford Economics

Table 1 shows the measures of aggregate real economic activity used by the National Bureau of Economic Research to monitor the business cycle. The data are signaling that the economy is softening. The NBER includes GDP, but we exclude it from our Recession Monitor because it is a lagging indicator and is produced quarterly. **Table 2** shows the measures of financial market variables that are useful in assessing recession risks.

Table 1: NBER recession-dating indicators

Period	Real income less transfers	Real consumption expenditures	Real mfg & trade sales	Industrial production	Change household employment	Change nonfarm payroll
Sep-22						
Oct-22						
Nov-22						
Dec-22						
Jan-23						
Feb-23						
Mar-23						
Apr-23						
May-23						
Jun-23						
Jul-23						
Aug-23						
Sep-23						

Note: Color scales based upon an indicator's z-score versus a 2010-2019 trend. Yellow cells signify 'normal' levels for the indicator while green/red cells signify indicators above/below trend. Grey cells indicate data has yet to be released.

Source: Oxford Economics/Haver Analytics/Bloomberg

Table 2: Financial market data

Period	OE FCI (EOP)	BB High-Yield Corporate Average OAS	S&P 500 (EOP)	10yr / Fed funds spread (EOP)	10yr / 3mo spread (EOP)	10yr / 2yr spread (EOP)
Sep-22						
Oct-22						
Nov-22						
Dec-22						
Jan-23						
Feb-23						
Mar-23						
Apr-23						
May-23						
Jun-23						
Jul-23						
Aug-23						
Sep-23						

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Source: Oxford Economics/Haver Analytics/Bloomberg

Our BCI assesses dynamics in the economy in real time. It is a coincident indicator, with drops below the zero threshold corresponding with each of the eight prior recessions. The BCI has only fallen below zero twice without the economy entering a recession. Both instances were after the Great Recession when a debt-limit crisis (2013) and an oil shock (2016) weighed on the economy. We update the index each month and it is subject to revision as we incorporate new historical data.

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