Special Commentary — July 25, 2024

Recession & Discretion: Meet Your New Business Cycle Indicator

Economist(s)

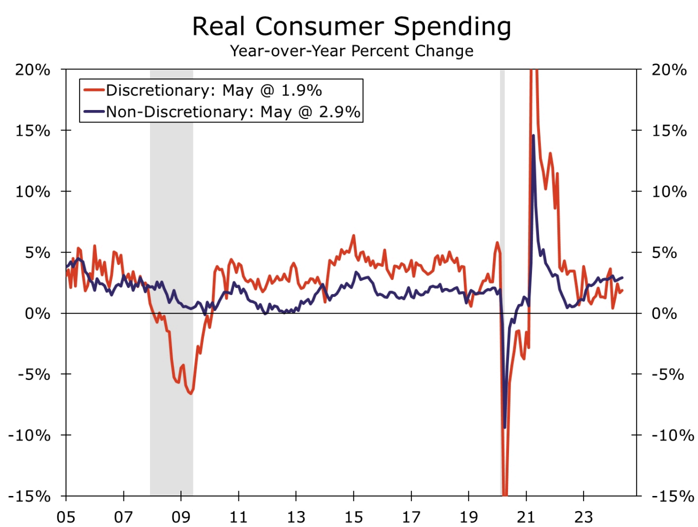
Tim Quinlan
Senior Economist | Wells Fargo Economics
Tim.Quinlan@wellsfargo.com | 704-410-3283

Shannon Seery Grein
Economist | Wells Fargo Economics
shannon.grein@wellsfargo.com | 704-410-0369

Summary

In this cycle, it has been not only safe, it has been profitable to ignore warnings from the LEI, the inverted yield curve and the ISM. This paper argues that it is not safe to ignore declines in discretionary spending.

The U.S. economy has pulled off a soft landing in defiance of multiple recession indicators that have been flashing red, in some cases for years. Recession can never be ruled out, of course, but even if one began today, the reputation of these once-trusted barometers has been tarnished. In this report, we describe how real discretionary spending serves as a better recession gauge.



Comfortably Numb

Business leaders and financial markets have grown perfectly comfortable with the fact that they are conducting business as usual even as the security alarm, the fire alarm and the smoke alarm are all going off around them. In 2005 the late American writer David Foster Wallace delivered a commencement speech and used a parable to describe how the most consequential aspects of our existence are hidden in plain sight all around us.

> There are these two young fish swimming along, and they happen to meet an older fish swimming the other way, who nods at them and says, “Morning, boys. How’s the water?” And the two young fish swim on for a bit, and then eventually one of them looks over at the other and goes, “What the [heck] is water?”

Lest we forget, let’s recap some signals that should be quite troubling for the economy:

- The yield curve has been inverted for more than two years.
- The Leading Economic Index has declined in 28 of the past 30 months.
- The ISM Manufacturing Index has been in contraction territory in 19 of the past 20 months.

There Is No Pain, You Are Receding

It has not paid to heed the advice of recession warnings. An investor who ignored the inversion of the yield curve when it began in early July 2022 and instead stayed fully invested in, say, the S&P 500, would today be up about 43%. Even if a recession were to begin today (which we do not expect), the value of the once-trusted barometers cited above would not be redeemed. As the famed investor Howard Marks once observed: “Being too far ahead of your time is indistinguishable from being wrong.”

Yet remembering the lesson of another story, *The Boy Who Cried Wolf*, complacency around warnings of danger can be problematic as well, lest people disregard even legitimate warnings. In this report we offer a better gauge for identifying recessions, one rooted in a very old concept. More than just a useful tool for spotting turning points, in this particular cycle, one characterized by resilient consumer spending, it also has the potential to shape monetary policy. That is a bold claim considering it is not directly tied to either of the Fed’s mandates of low, stable inflation and maximum employment.

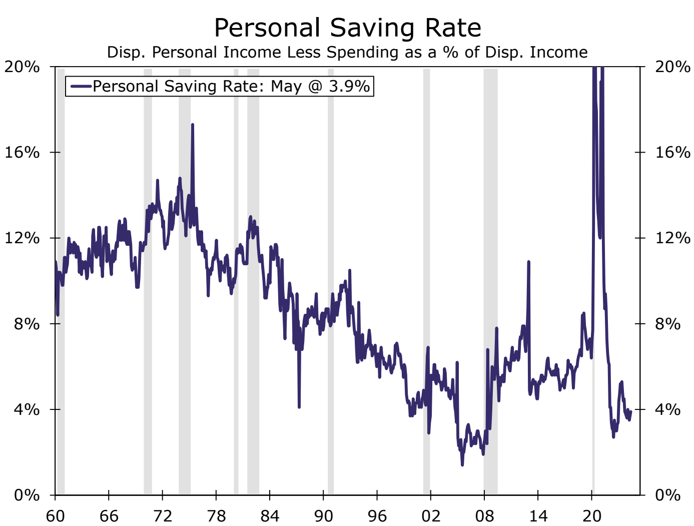
On the Turning Away: The Paradox of Thrift

The *paradox of thrift,* in plain English, is that an increase in saving may be harmful to an economy. That is because, counter-intuitively, total savings may fall as a result of individuals' attempts to increase their saving which lowers aggregate demand. Frugality is good on an individual basis, but if everyone cuts back at the same time, the economy will suffer.

Credit for the *paradox of thrift* is often assigned to John Maynard Keynes in his seminal work *The General Theory* in 1936, though he himself credits the origins to an essay from 1714 from called the *Fable of the Bees,* in which the hive collapses when bees stop pursuing self-interest.

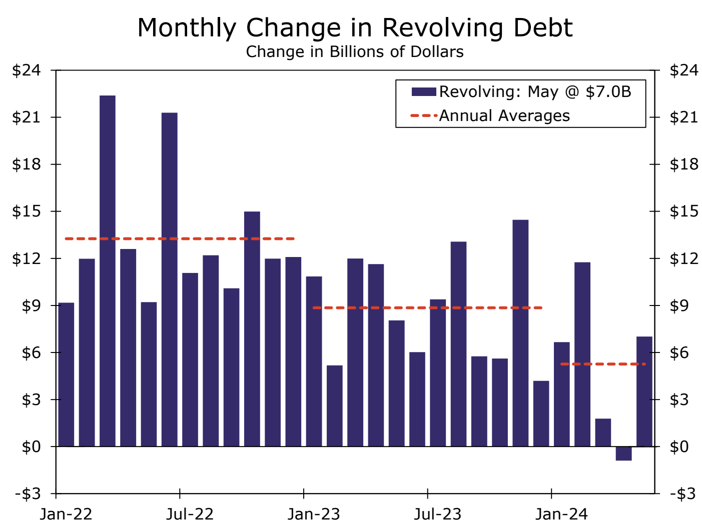
Conventionally, someone interested in measuring frugality could look at the saving rate, and indeed periods of sharp increases in the saving rate are associated with soft patches if not outright recession (Figure 1). Yet the saving rate has been less helpful in this cycle for a couple of reasons: excess savings and a surge in consumer credit.

Figure 1



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 2



Source: Federal Reserve Board and Wells Fargo Economics

Start with the excess savings dynamic. The combination of sharp pullbacks in spending due to stay-at-home restrictions in tandem with generous fiscal policy that showered households with stimulus payments resulted in a stash of cash. Pandemic-era savings then cushioned the consumer against the impact of higher interest rates and inflation, at least initially.

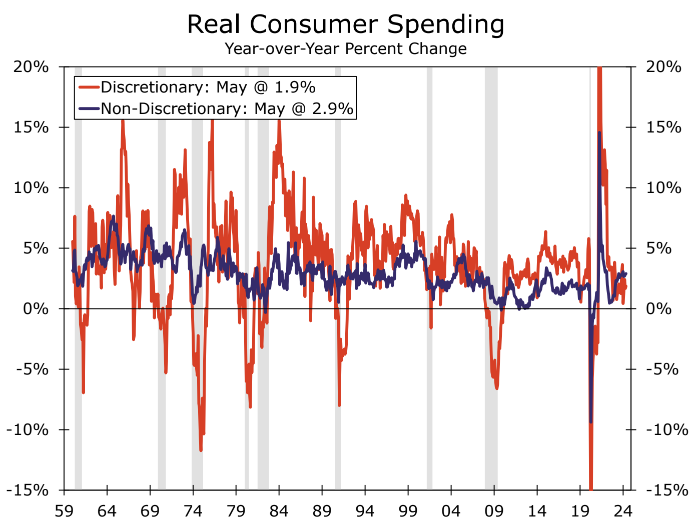
The San Francisco Fed says the pandemic era savings is gone at this point. Our simple trend analysis suggests some cash may still be sitting in savings, but suffice to say the role of excess savings as a driver in spending has run its course.

All else equal, consumers can appear to be spending more of their income during periods when credit is expanding. We have been living through such times the past few years as consumers borrowed like there was no tomorrow earlier in this cycle. That effect is waning. The average monthly increase in revolving credit has slowed from $13B per month in 2022 to $9B in 2023 to $5 billion per month year to date though May (Figure 2).

So rather than looking at savings as a signal of frugality, we focus on the spending side. Here we find that households are growing more choosy as the purchasing power fades. In a bit of a role reversal from the YOLO mindset earlier in this cycle, consumers are now prioritizing needs over wants. Spending on non-discretionary goods and services is now outpacing discretionary spending. History tells us this doesn't end well.

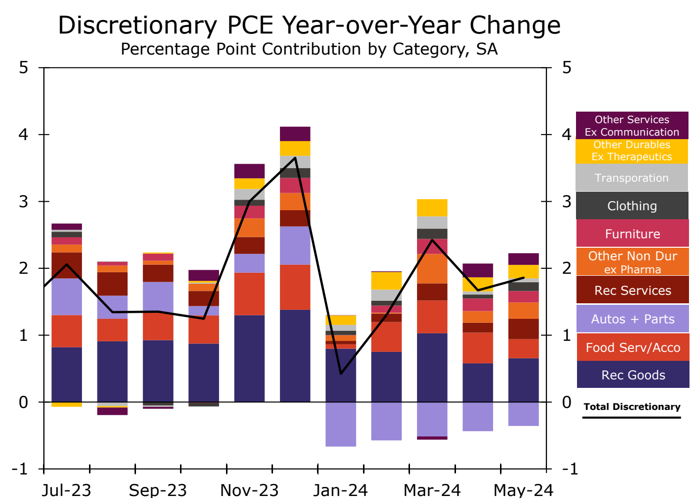
In more than 60 years, there has never been a recession without real discretionary spending falling on a year-over-year basis (Figure 3). What about false positives? Turns out, they are rare. It has only happened twice, and both were short trips across the zero line. The most recent was more than 35 years ago in 1987, and the other was 1967. Real discretionary spending has been awfully close to breaking through the zero line this year.

Figure 3



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 4



Source: U.S. Department of Commerce and Wells Fargo Economics

Relative to last year, consumers are spending far less on autos specifically, which have been an outright drag on discretionary consumption (Figure 4). Elsewhere, the details of discretionary spending paint a picture of a consumer that is more circumspect about where the money is going every month and are finally growing more discerning when it comes to their budget. This is particularly evident in leisure-related activities. Recreation services, food services & accommodations (restaurants & bars) and other services are all contributing less to annual discretionary spending growth so far this year. Transportation services is the only major category of discretionary services to accelerate year-to-date. This broad softening in services is key for the Fed trying to cool service-sector inflation.

For the Fed, the goal is to elicit a moderation in spending rather than an outright decline in it. To that end, the evidence suggests that goal is in sight. Consumer spending has largely normalized. While households are still spending way more than they were prior to the pandemic, the shares of spending dedicated to goods and services have returned to where we would have anticipated they would be today in the absence of COVID. This is to say, there is no longer an 'overspending' occurring in either goods or services. That is helping to alleviate some price pressure even as it contributes to an overall moderation in consumption. Moderation is good, contraction is bad. That is the lesson from the fact that outright declines in discretionary spending are associated with recession.

Consumer Discretion is Advised

Even when long-expected rate cuts finally arrive, policymakers need to be mindful that the resilience that has defined the consumer in this cycle has been sustained by factors that are no longer propping things up. Yes, it is important to make sure consumer spending is truly tamed; that is key to preventing above-target inflation from coming back. But monetary policy always has a lagged effect. Those lag times are variable, and this time they were longer than usual due in part to special factors such as stimulus and a massive uptake in consumer credit. But special factors are the sand in the hourglass, and they have nearly run out. Even though inflation and employment are the sole mandates, the Fed cannot afford to look past softening discretionary spending. It has been not only safe, but profitable to ignore the LEI, the yield curve and the ISM; however, our view is that it is *not safe* to ignore declines in discretionary spending.

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Grein	Economist	704-410-0369	Shannon.Grein@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Jeremiah Kohl	Economic Analyst	212-214-1164	Jeremiah.J.Kohl@wellsfargo.com
Aubrey George	Economic Analyst	704-410-2911	Aubrey.B.George@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Ali Hajibeigi	Economic Analyst	212-214-8253	Ali.Hajibeigi@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures

This report is produced by the Economics Group of Wells Fargo Bank, N.A. (“WFBNA”). This report is not a product of Wells Fargo Global Research and the information contained in this report is not financial research. This report should not be copied, distributed, published or reproduced, in whole or in part. WFBNA distributes this report directly and through affiliates including, but not limited to, Wells Fargo Securities, LLC, Wells Fargo & Company, Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Europe S.A., and Wells Fargo Securities Canada, Ltd. Wells Fargo Securities, LLC is registered with the Commodity Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. WFBNA is registered with the Commodity Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC and WFBNA are generally engaged in the trading of futures and derivative products, any of which may be discussed within this report.

This publication has been prepared for informational purposes only and is not intended as a recommendation, offer or solicitation with respect to the purchase or sale of any security or other financial product, nor does it constitute professional advice. The information in this report has been obtained or derived from sources believed by WFBNA to be reliable, but has not been independently verified by WFBNA, may not be current, and WFBNA has no obligation to provide any updates or changes. All price references and market forecasts are as of the date of the report or such earlier date as may be indicated for a particular price or forecast. The views and opinions expressed in this report are those of its named author(s) or, where no author is indicated, the Economics Group; such views and opinions are not necessarily those of WFBNA and may differ from the views and opinions of other departments or divisions of WFBNA and its affiliates. WFBNA is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this report, neither WFBNA nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this report, and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. WFBNA is a separate legal entity and distinct from affiliated banks, and is a wholly-owned subsidiary of Wells Fargo & Company. © 2024 Wells Fargo Bank, N.A.

Important Information for Non-U.S. Recipients
For recipients in the United Kingdom, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority (“FCA”). For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 (the “Act”), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU (“MiFID2”). The FCA rules made under the Act for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. For recipients in the EFTA, this report is distributed by WFSIL. For recipients in the EU, it is distributed by Wells Fargo Securities Europe S.A. (“WFSE”). WFSE is a French incorporated investment firm authorized and regulated by the Autorité de contrôle prudentiel et de résolution and the Autorité des marchés financiers. WFSE does not deal with retail clients as defined in MiFID2. This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED - MAY LOSE VALUE - NO BANK GUARANTEE