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The Smoke Signal Is Still Burning: Is Recession Coming?

Economist(s)

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Summary

In 2022, we released a three-report series to showcase useful tools for predicting recessions, the duration of recessions and monetary policy pivots. To quickly summarize, Part I dove into our Probit framework. Part II looked at historical trends with the 10-year/1-year Treasury yield spread. Part III incorporated the prediction power of the fed funds rate and the 10-year Treasury yield. This report presents updated results. In short, all of our tools are signaling a recession is more likely than not within the next year.

Probit Framework

- Our preferred Probit suggests there is a 55% chance of a recession during the next four quarters, based on data through February. Historically, whenever this Probit's probability has breached 50%, the U.S. economy experienced a recession within the next year.

10-year/1-year Treasury Yield Spread

- Last year, our preferred 10-year/1-year Treasury yield spread breached its recession-prediction threshold in August. The spread has remained negative since then, suggesting there is a 91% chance of a recession during the next 12 months. The inversion has steepened, averaging -118 bps in February, or the deepest monthly inversion since September 1981.
- Given the pattern of longer inversion durations matching up with deeper recessions, we believe that 12 consecutive months of a negative spread between the 10-year and 1-year Treasury yields is a solid benchmark to predict deeper-than-average recessions. With the 10-year/1-year spread negative for eight months straight, we suspect the likelihood of a deeper-than-average recession is rising.

Fed Funds Rate and 10-Year Treasury Yield

- The fed funds rate/10-year Treasury yield threshold breached back in March 2022, suggesting a recession and/or a Fed policy pivot is in the near-term picture. Since 1955, every time the fed funds rate has breached the 10-year Treasury yield's cycle low, a recession and accompanying change in monetary policy has occurred within the next 18 months.

Are We Still Dreaming of a Soft Landing?

To combat decades-high inflation, the FOMC has raised rates at the fastest pace since the 1980s. Will the sharp tightening result in a recession or a soft landing? At present, underlying strength in the labor market and inflation suggest the Committee has room to raise rates further. At the same time, recent developments in the financial sector could have lasting consequences in the form of wider credit spreads and tighter lending standards. Together, these dynamics have the potential to weigh on overall economic growth and bolster the likelihood of recession this year, in our view. Last year, we released a three-report series to showcase a few useful methods for predicting recessions, the duration of recessions and monetary policy pivots—this report provides updates for the three major tools highlighted in the series.

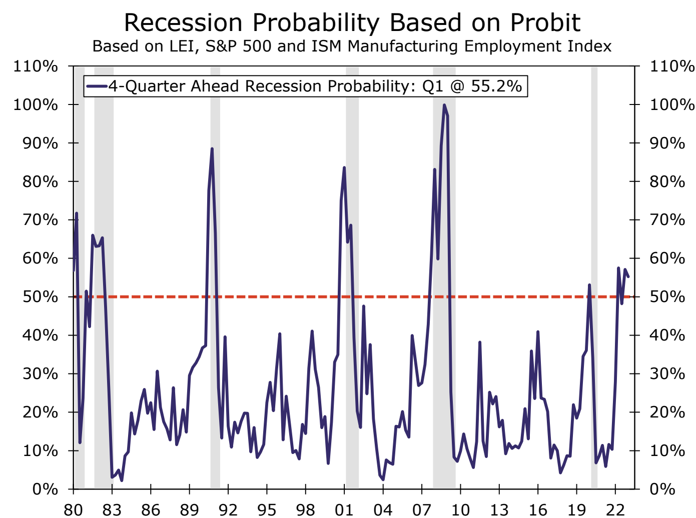
Survey Says... Hard Landing

In Part I of the *Is Recession Coming?* series, we updated our Probit framework. Specifically, we created new Probits based on the Consumer Price Index to better capture today's inflation risk, and we expanded the framework's forecast horizon from six months ahead to 12 months ahead. In total, we created eight different Probits to capture information across the major sectors of the economy. An average of those eight would suggest the average recession risk to the overall economy.

Our preferred Probit shows a 55.2% probability of a recession in the next year (Figure 1), based on data through February.[1] Historically, whenever this Probit's probability has crossed 50%, the economy experienced a recession within the next four quarters. The average probability of all eight Probits is 53%. In short, our Probit framework suggests a recession is more likely than not during the next four quarters.

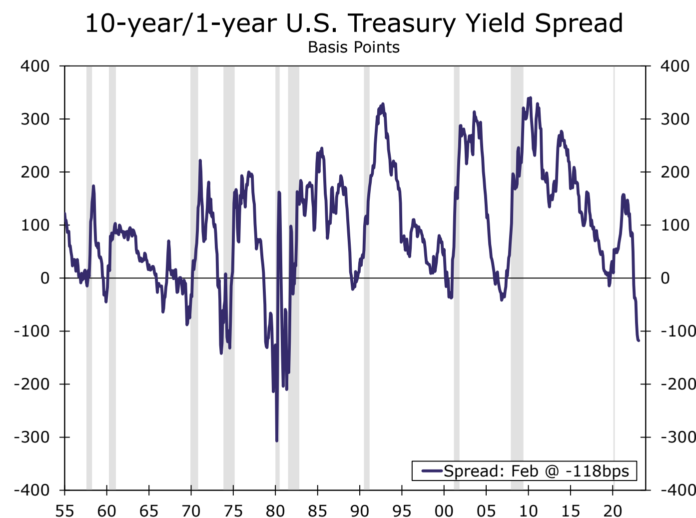
In Part II, we evaluated the effectiveness of a few yield curves at predicting recessions. Using a recession-prediction threshold of two consecutive months of inversion, the spread between the 10-year and 1-year Treasury yields predicted all the past 10 recessions, with an average lead time of 12 months. This spread breached the recession-prediction threshold back in August 2022 and has remained negative on a monthly basis since then (Figure 2).

Figure 1



Source: The Conference Board, Bloomberg Finance L.P., Institute for Supply Management and Wells Fargo Economics

Figure 2



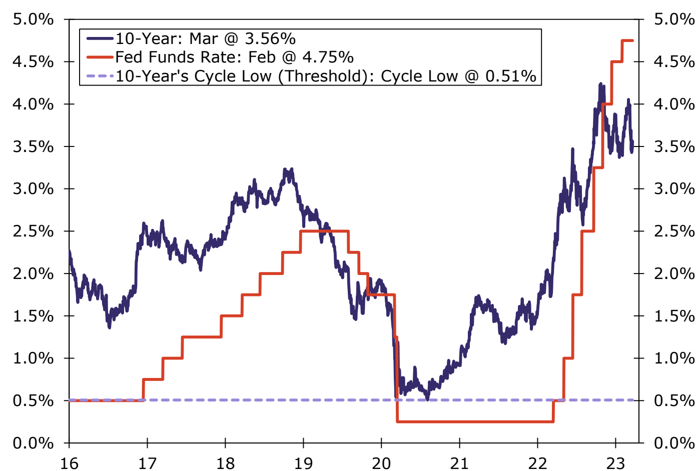
Source: Bloomberg Finance L.P. and Wells Fargo Economics

In data going back to 1957, the estimated accuracy of the 10-year/1-year spread to predict recessions is 91%. Put differently, if the spread breaches the recession-prediction threshold, then there is a 91% probability of a recession starting within 12 months. In addition, longer inversion durations have historically matched up with deeper recessions. We found that 12 consecutive months of a negative spread between the 10-year and 1-year Treasury yields is a solid benchmark to predict deeper-than-average recessions.

Through February, the 10-year/1-year curve has been inverted for eight consecutive months. The last time the spread has been negative this long was back in 2006-2007, when the curve was inverted for 12 straight months ahead of the Great Recession. Furthermore, the 10-year/1-year spread has recently moved deeper into negative territory. February's reading of -118 bps is the deepest inversion since September 1981. The inversion's depth and duration suggests an upcoming recession may not be mild.

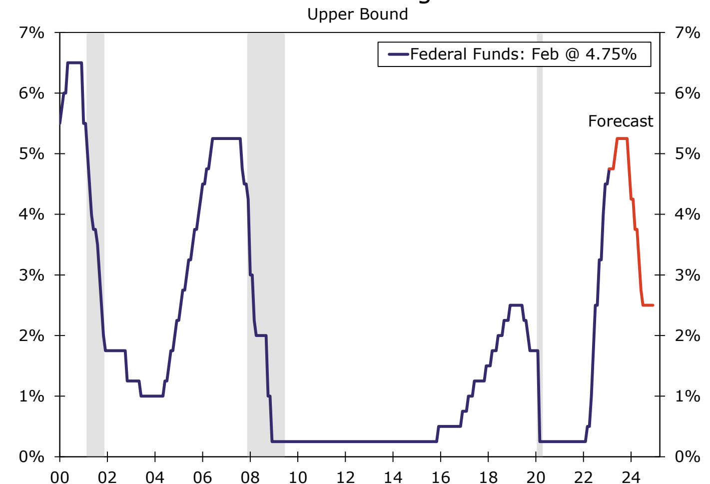
In Part III, we incorporated some of our previous work from 2017 on the prediction power of the 10-year Treasury yield and the fed funds rate. Essentially, we found that in a rising interest rate environment, when the fed funds rate touches or crosses the lowest level of the 10-year Treasury yield in that cycle—the threshold—a recession or a monetary policy pivot is likely to ensue in the next 18 months. As shown in Figure 3, the fed funds rate crossed the 10-year Treasury yield's cycle low back in March 2022, when the FOMC kicked off its current tightening cycle.

Figure 3



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 4



Source: Federal Reserve Board and Wells Fargo Economics

In short, all three tools point to a recession within the next year. The signals align with our group's macroeconomic forecast, which calls for a modest recession to start in the second half of this year. As mentioned previously, the FOMC has hiked the fed funds rate at a pace not seen since the 1980s, raising the range by 450 bps since last March. At present, strong labor market and inflation data are supportive of the FOMC hiking the fed funds rate even further. We suspect the cumulative effect of the Fed's tightening will materially hit demand later this year, tilting the U.S. economy into a recession starting in Q3-2023.

The recent tightening in financial conditions that has ensued following the collapses of two large U.S. banks leads us to believe the FOMC will stay on hold at its March 22 meeting to ensure the situation is under control. Beyond March, and assuming authorities are able to contain the banking crisis (which is our baseline assumption), we expect the FOMC to lift the fed funds rate to a terminal range of 5.00%-5.25% by June (Figure 4). Even with the financial sector's turmoil contained, we suspect wider credit spreads and tighter lending standards will stick around, which raises the probability of a recession. Indeed, Ben Bernanke, along with Douglas Diamond and Philip Dybvig, won a Nobel Prize in 2022 for their work that showed bank failures leave significant scars on the real economy due to banks' integral role in the allocation of capital across the economy.[2]

Endnotes

1 Our preferred Probit is based on the Leading Economic Index, the S&P 500 and the employment component of the ISM manufacturing index. (Return)

2 Scientific Background on the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2022: Financial Intermediation and the Economy. The Royal Swedish Academy of Sciences, October 2022. (Return)

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