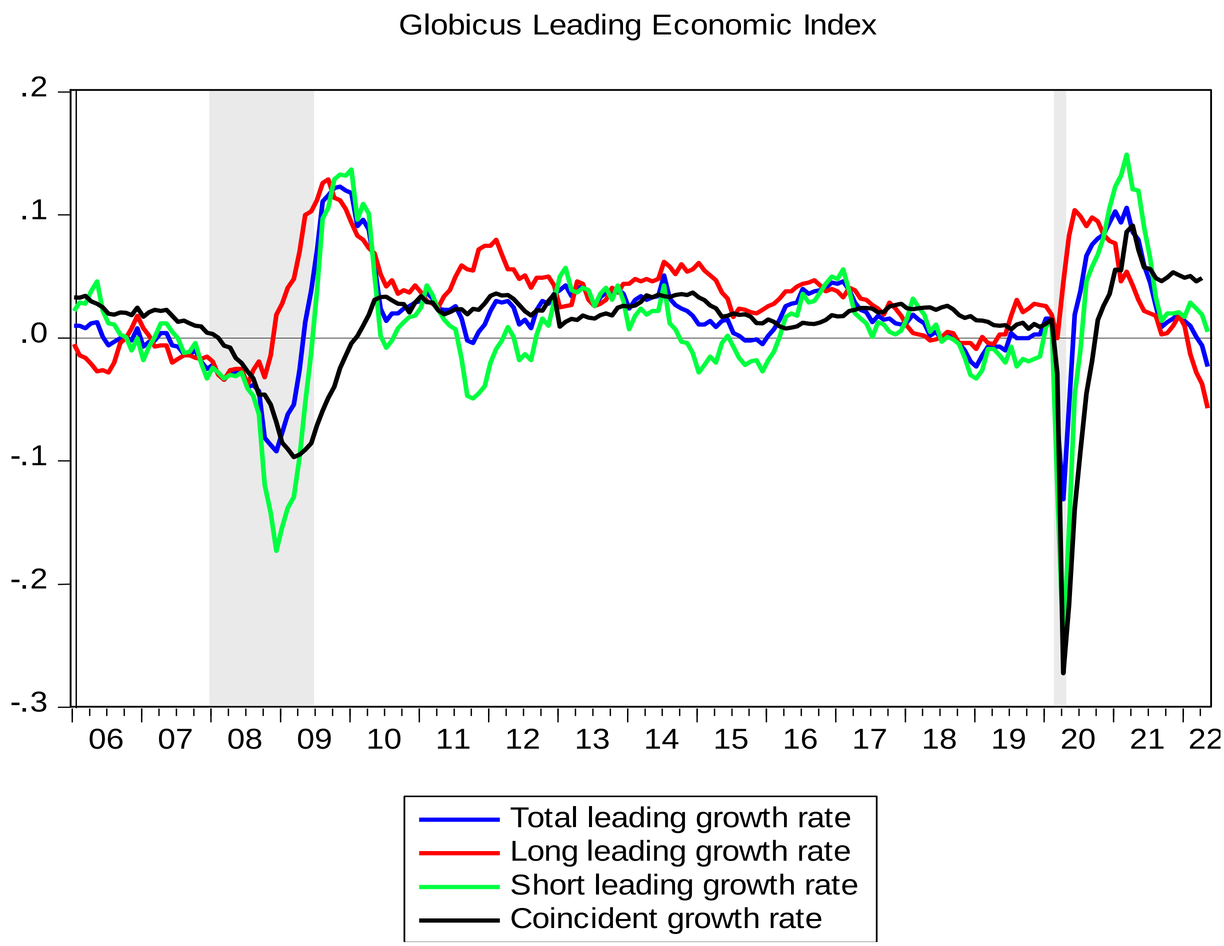
Recession by Christmas 2022

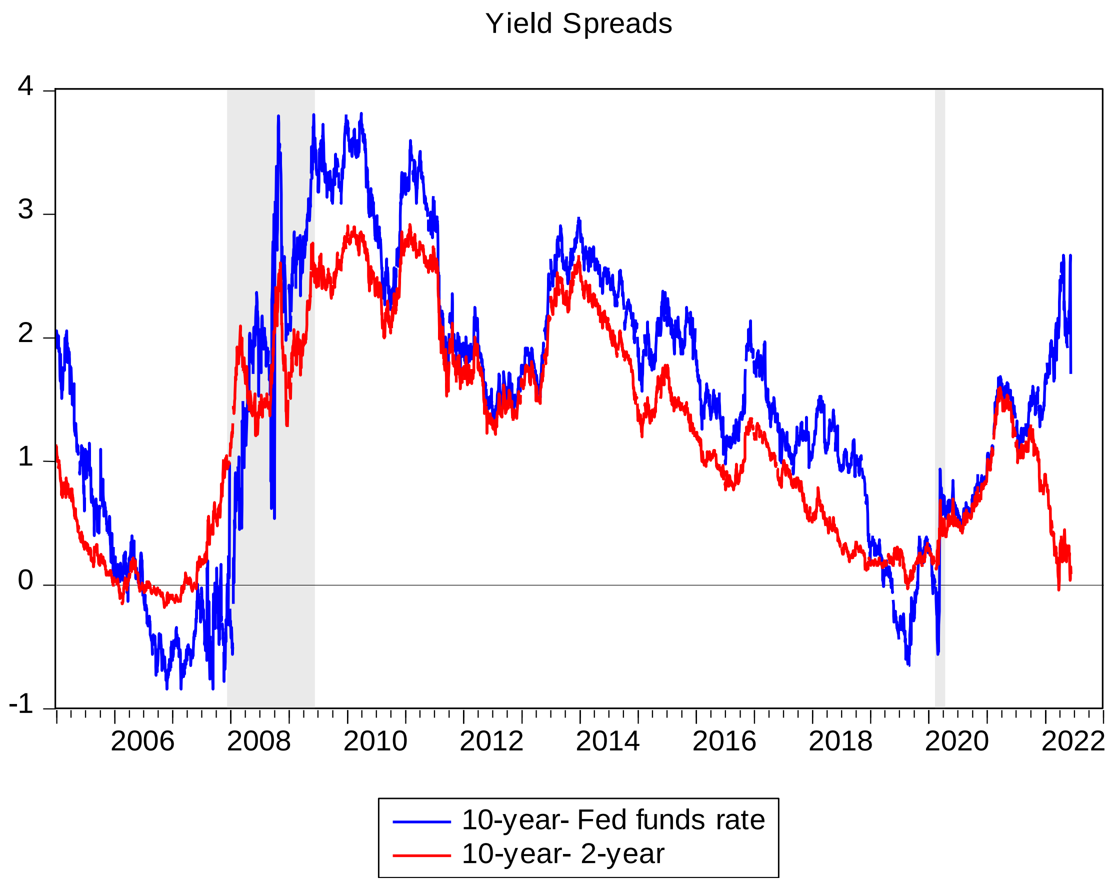
Globicus Leading Economic Indexes deteriorated further in May, suggesting an increasing risk for a recession. The Coincident Index, still extraordinarily strong, increased modestly in April.



The total leading index's smoothed 6-month growth rate (smgr) fell to -2.4 in May from -0.7 in April, the second consecutive monthly fall, new and revised data showed. The long leading index slid to -5.8 in May from -3.8 in April, its fourth straight m/m slide. The short leading index, while still positive, dropped to 0.4 smgr in May from 1.8 in April. The coincident index, a measure of the current economic activity, recorded a 4.8% smoothed growth rate in April, the latest month for which data are available, slightly up from 4.5% in March.

Economic growth, measured by the coincident index, is significantly stronger than earlier this century, due to the massive pandemic stimulus packages and easy monetary policy. The average growth rate from 2010 to 2020 was 2.05 smgr, less than half of April's smoothed growth rate. Still, the leading indexes indicate that the risk of a recession is increasing, and a recession could start at the end of this year.

An inverted yield curve usually precedes any recession, particularly the spread between 10-year bond and the Fed funds rate. This spread narrowed to 170 basis points following the Fed's 75-bp hike on June 15. The 10year–2year spread usually tightens before the Fed funds spread and the 10/2 spread is barely positive after the Fed's hike.

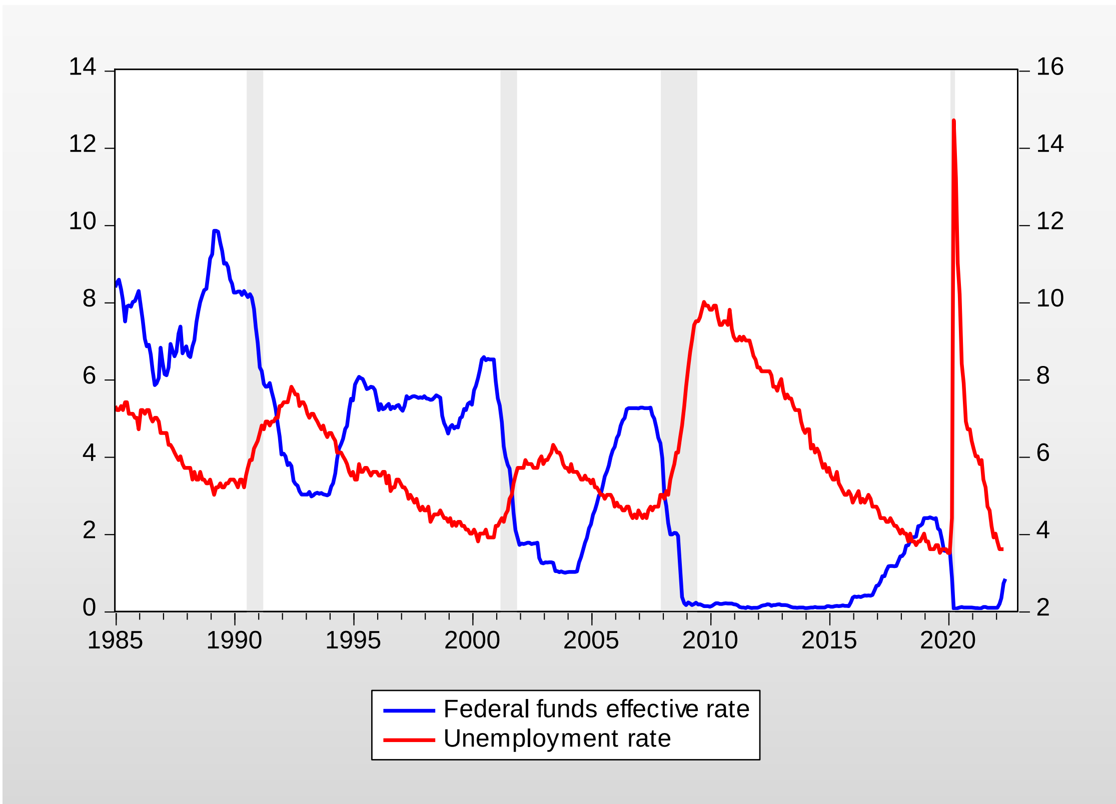


A rise in initial jobless claims is another short-term indicator to monitor. Claims are still low but have started to inch up.

With the highest inflation rate in four decades, it is difficult to see that the Fed will back down from its planned rate hikes and quantitative tightening as they did in

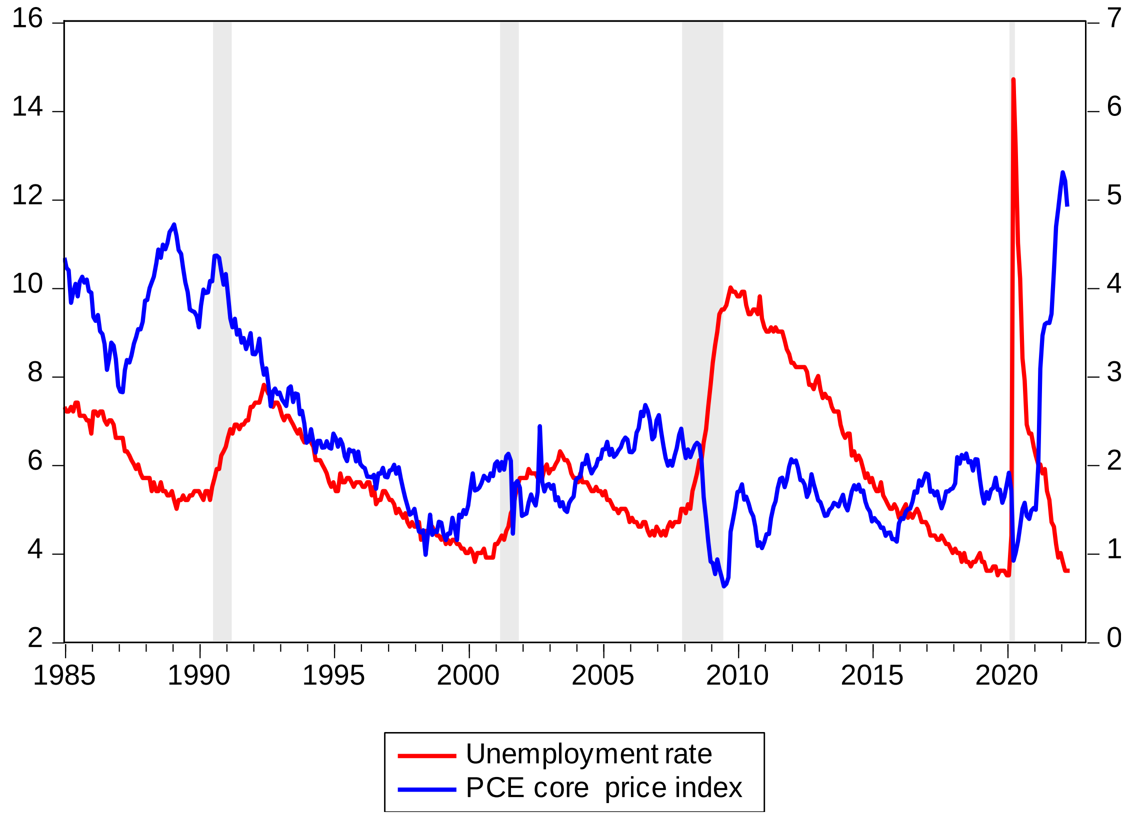
2019, at least not until the recession is upon us. It is difficult to understand how the Fed can predict that unemployment only will increase to 3.7% in 2022, 3.9% in 2023 and 4.1% in 2024 from May's 3.6%, while PCE core inflation comes down from 5.6% to 2.4% and 2.2% for the same period.[1]

From the chart below, we can see that the lag from when the Fed starts increasing the Fed funds rate to rising unemployment rate can be long; this may be the reason for the Fed's optimistic forecast.



The unemployment rate does not immediately respond to the Fed's tightening policy. Instead, a rise in unemployment rate usually coincides with the beginning of a recession. Therefore, we may not see much of inflation relief in the next few months. Only when the recession starts, will the unemployment rise substantially as shown in the chart below, and that has historically brought down inflation. And an increase in the unemployment rate may be the only way to significantly reduce the inflation.

[1] Summary of Economic Projections, Page 2.
https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220615.pdf

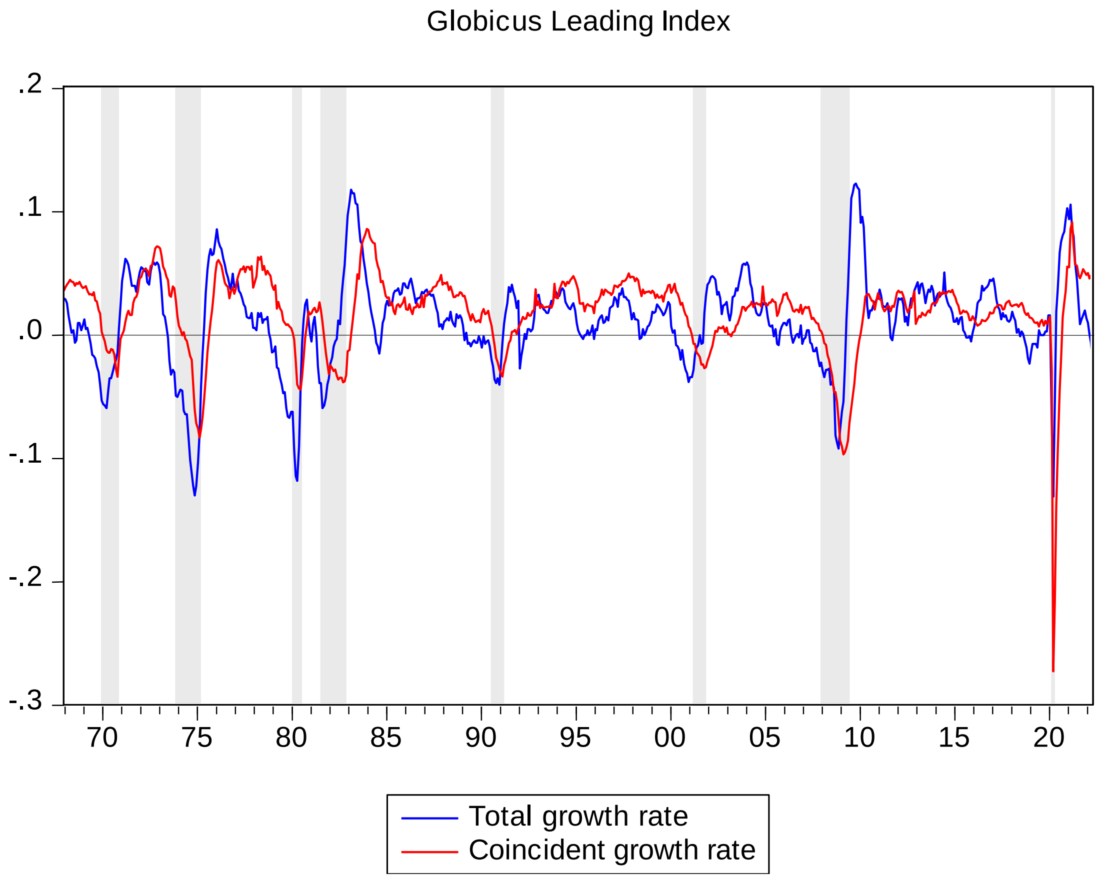


How reliable is the model? The Globicus LEI model was designed in 2010 and has not been optimized or changed since then. This, we believe, makes the model more objective as the variables are not selected to influence the prediction. One could certainly find variables in ex-post estimation that would work better in predicting each recession. But overoptimizing the model will not make the model more accurate in predicting the next recession.

Below are the model's results since 1968. The blue line is the model's total leading growth rate, designed to forecast economic activity and recessions. The red line is the coincident index, designed to measure economic activity.

The Globicus coincident index uses the same variables as NBER's Dating Committee uses to date the recessions. The shaded areas are the recessions according to NBER's Dating Committee, the official arbitrator of recessions.

From the chart, the leading index turns negative and precedes the coincident index before all recessions. The average lead for the total leading index is 7 months since the 1960-recession. The latest reading of this index is for May 2022, so adding 7 months will take us to December.



The model had a false positive or indicated that the recession was imminent in 2019-20. The recession was probably avoided as the Fed stopped raising rates in 2018 and lowered its Fed funds rate at the end of 2019, following strong pressures from the Trump Administration. A short recession followed in early-2020, but that was due to the COVID-19 pandemic.

In summary, we expect the recession to start around December 2022, which is like the prediction we made a month ago. The Dating Committee, of course, will not declare the economy in recession until they see revised economic numbers for a more extended time following the start of the recession.

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Globicus Inc.

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