August 2, 2022

Are We In A Recession? The Fed Says No

Transcript

Bill Emmons: Hi, I'm Bill Emmons, and I'd like to talk about the FOMC meeting that took place July 26 and 27. One of the big questions in the press conference after the meeting was whether we're in a recession. The Fed chairman, Jay Powell, made it clear that he says no.

So, the main takeaways from this meeting included first, all Fed interest rate targets were raised by 75 basis points. Quantitative tightening is underway, but at a modest pace. In terms of economic outlook, the Fed does not currently see, nor does it expect a recession. It's true, household and business spending have slowed, but job growth remains strong, and unemployment is very low. In terms of the outlook for monetary policy, it's for more tightening, and that's because inflation is unacceptably high, reflecting both supply-side and demand-side factors. In the press conference, the chairman confirmed the Fed's outlook of about a 3.4% federal funds rate by the end of 2022, and market expectations appear to be aligned with that. Finally, quantitative tightening will proceed in the background; that is, not as an active tool of policy, it will accelerate somewhat in coming months.

So, to this question of recession, what is it? What defines a recession? A widely discussed rule of thumb that you may have been hearing is two consecutive quarterly declines in real gross domestic product, GDP. In fact, this applies right now because real GDP declined in both the first and second quarters of 2022. But Fed officials do not accept this definition, and it plays no role in their policy making. Instead, most economists and the Fed accept this quasi-official definition of recession, which is determined by something called the Business Cycle Dating Committee, under the auspices of the National Bureau of Economic Research. It's a qualitative determination made by a committee. Quoting from the website, "A recession involves a significant decline in economic activity that is spread across the economy and lasts more than a few months." The three criteria are depth, diffusion, and duration, so this will be a judgment made at some time if, in fact, a recession has begun.

So, let me do a little bit of a deep dive into these important measures of real GDP and employment. This picture shows, since World War II, the annual changes in real GDP, the broadest measure of economic activity, and of employment. You can immediately see that these two series move very much together. They're highly correlated. In fact, the correlation coefficient for this period is 0.84, very close to perfect correlation, which would be 1.0. But remember, neither of these indicators alone determines whether we're in a recession or not.

If you looked at each of the recessions that we've had—13 since World War II—you can see that the chances of having positive job growth, even as we're entering a recession as determined by that committee, is actually higher than you might think. Looking first in the 1940s, '50s, and early '60s—two of those five recessions began when the job market was still expanding. Looking at the '70s and early '80s—all four of those recessions began while the job market was expanding. And then, finally, in the '90s, 2000s and, most recently, the 2020 recession—two of those four recessions also had positive job growth as the economy entered a recession. So, summing it all up, 8 of the 13, or 62% of the time, we will be entering a recession even as we see job growth. So, you see that those things—neither GDP growth nor employment growth—are perfect indicators of what's happening with the recession. In the most recent period, you can see we, in fact, do have these two consecutive quarters of real GDP. Employment, however, is still growing.

So, why is the Fed continuing to tighten policy even as we do see some of these signs of weakness? Well, clearly, it's inflation. And, more broadly, it's the job of the Fed to prevent inflation and sometimes inflation shocks from becoming embedded in the economy, pushing up wages which then feed back through price through businesses trying to recoup those costs. So, this picture shows that the measure of inflation used by the Fed—the personal consumption's expenditures measure—has been running at a 7% rate. These are quarterly changes and expressed as an annual rate in 2022. The Employment Cost Index, the broadest measure of employment costs, has been running in the 5% to 6% range. Both of those are far above the range that would be comfortable, and they are moving up together, which has the potential to turn into something that is known as a wage-price spiral, and that's what the Fed is trying to avoid.

So, the schedule of interest rate increases continues. Starting in March of this year, the Fed started to raise rates and, looking forward, it appears that the Fed is likely to raise rates 50 basis points in September and 25 basis points each in November and December, bringing the rate to a range of 3.25% to 3.5%. Financial markets are very much in line with that. Interestingly, St. Louis Fed president, Jim Bullard, recently expressed a desire to see that rate move up to closer to 4%, at the top end of the range.

So, let me focus on implications for banks in a very specific sense…that is, what these interest rate increases have meant for unrealized losses on bank balance sheets. Smaller and mid-sized banks, what we call community and regional banking organizations—CBOs and RBOs—in fact, added a substantial volume of securities and interest rate risks before the Fed rate hikes began this year. On average, unrealized securities losses of at least 25% of capital, expressed as a common equity tier 1 ratio, existed on March 31 of this year, and that's according to analysis of Call Reports by the Federal Reserve's RADAR group, which stands for Risk Assessment, Data Analysis, and Research. Furthermore, about 10% of these RBOs and CBOs had unrealized losses of at least 50% of that CET1 quantity. Of course, CBOs and RBOs may opt out of realizing AOCI, which is the all other comprehensive income measure, for capital regulation purposes. But the earnings part of low-yielding securities and continuing bond market volatility do pose risk management challenges for banks.

So, what should we expect? A measure that I've highlighted in the past—the yield curve—has become inverted along most of the curve. And, historically, that has signaled a very high risk of recession…maybe later this year or beginning in 2023. And there are other signs of slowing economic growth. Nonetheless, the Fed will continue to tighten monetary policy until clear signs appear that inflation is heading down. Meanwhile, banks will be challenged by the slowing economy and continuing bond market volatility.

Thanks for listening, and we'll see you next time.

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