TAKE FIVE with Bill Emmons

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Did We Dodge the Recession Bullet?

Transcript

Bill Emmons: Hi, Bill Emmons, and today is Friday, December 13th. I would like to talk about the FOMC meeting that took place on the 10th and 11th. I want to ask the question, did we dodge the recession bullet? But first, takeaways from the meeting included a favorable economic outlook as signaled by the FOMC, driven by job growth and household spending. Inflation remains below target.

The fed funds target range was left unchanged, between 1½ percent and 1¾ percent, and the interest rate on required and excess reserves remained at 1.55 percent. Also, the Fed will continue its money market interventions, including large purchases of T-bills to supply reserves to the banking system, conducting overnight end-term repos, also providing reserves, and also conducting reverse RPs at 1.45 percent, which drains reserves.

The question is whether Fed rate cuts in 2019 will extend the economic expansion. At the press conference, Chairman Powell said, "Over the course of the past year, our views about the path of interest rates that would best achieve our employment and inflation objectives changed significantly. As the year progressed, we adjusted the stance of monetary policy to cushion the economy and to provide some insurance."

This shift has helped support the economy and has kept the outlook on track. Indeed, the FOMC has cut its rate outlook significantly. Looking back to September of 2018, the median FOMC member was looking for the fed funds rate above 3 percent, in fact at 3.4 percent at the end of 2020. That dropped a little bit by December 2018, but the really big declines came in 2019, so that, at the most recent meeting, December of 2019, there's been a 180 basis point decline in the projected fed funds rate at the end of 2020. For the end of 2021, that's 150 basis points—very large moves.

So, have we dodged the recession bullet as a result of these rate cuts? I think it's probably still too soon to tell. In fact, deterioration in economic data and surveys during early and mid-2019 has slowed, but many important indicators remain pretty soft. I'll look at two in particular. According to a Chicago Fed index that I've talked about in the past that contains 85 variables, the economy was on the verge of recession as of October. And, according to a New York Fed model that's based on the Treasury Yield Curve slope, recession risks remained elevated as of November.

And, if we look at that model, the most likely recession onset if this cycle follows the New York Fed model's forecast is probably about June 2020. So this is the Chicago Fed indicator. The blue bars indicate month-to-month data, and the red line is the 12-month moving average. This is a very simple indicator, pulls together these 85 variables and shows that, if the number is above zero, the economy is growing above its trend rate. If it's below zero, it's slowing or growing below its trend.

As you can see, this indicator reliably goes negative before each of the prior three recessions. And, looking at the most recent numbers, we are also headed in that direction. No recession at this point, but definitely moving in that direction. Then if you look at the New York Fed model, this shows the six recessions through the most recent one. And in each case, the lines show us that the recession risks increased as we in fact approached recession.

The blue dash line there shows the recession risk on average across all months since 1960. And each of the individual lines shows for each recession episode what that recession risk indicator was showing us. As the yield curve flattened, the recession risk increased. And if you put all of those together, the median of those six recessions is shown here in the red line.

And you can see that, when that indicator gets over about 30 percent, it pretty reliably shows that a recession will be occurring. Now let's lay the current cycle on top of that, assuming that a recession might begin in June of 2020. If that's what happens, this recession would then follow that historical pattern very closely. Now it's true that this recession risk indicator has tapered a little bit recently, which could tell us that this might be a mild recession.

So I think investors are on board with the Fed saying that there will be no rate increases or cuts early in 2020. In fact, only about a 9 percent chance of a cut at the January meeting, according to investors, rising slightly as we look through the March, April, and June meetings; even into July, less than a 50/50 chance of a cut or increase.

However, by September of next year, investors are saying a slightly better than 50/50 chance that the Fed would cut rates; then, in November, a little bit more; and then by December, a 63 percent chance that there will be at least one rate cut by the end of next year. And in fact, investors also suggest there's a one in four chance of two rate cuts by the end of next year. So the FOMC believes the strong job market and consumer spending will keep the economy growing at about a 2 percent pace in 2020 and beyond.

Chairman Powell also confirmed that future rate increases would require a significant inflation threat. But financial markets are expecting another rate cut late in 2020, and possibly even two cuts, with a one in four chance. Hence, it appears investors are still a bit more pessimistic about the economy than the Fed, although the two bodies have converged.

So, what should we expect? The FOMC is forecasting no great changes in 2020, and looking into 2021, possibly even a 25 basis point increase. The Fed continues to analyze conditions in the money markets and will intervene as necessary to maintain the fed funds rate in its target range. And yet, financial markets and these two Fed models I talked about suggest there could be some downward bias to the economic outlook. Thanks for listening, and we'll see you next time.

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