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Economics Group

Special Commentary

Social Distance Dating Advice

The U.S. economy is headed for imminent recession even if the four indicators used by the dating committee at the National Bureau of Economic Research do not yet show it. Dating the economic cycle is not easy. Now that recession is likely underway, here is our best advice on what to watch on the way down and when we may expect to find a bottom.

Source: Federal Reserve Board, U.S. Department of Commerce U.S. Department of Labor and Wells Fargo Securities
Shocks, By Definition, Come Without Warning
Since 1945 there have been 12 U.S. recessions that have lasted, on average, 10.8 months. In fact throughout that time period, the U.S. economy has been in expansion more than 85% of the time. The average expansion during that same time period is just under five years, and the longest, which began in July 2009, is just now ending.

In the lead-up to the COVID-19 crisis, there were very few economists, ourselves included, calling for recession. What explains this reluctance? Unevenness in the economy can be identified in advance, and we promised to be on the lookout for just such imbalances. Yes, the financial health of the corporate sector has been deteriorating and household balance sheets had some imbalances, like student loans, and we highlighted both. While government debt was high, it seemed far from a tipping point based on real yields and political sentiment. Even when there are imbalances in the economy, they can go on for some time unless something changes, such as monetary or fiscal policy becoming overly restrictive, a price shock (e.g., oil, trade), a war or a change in investor sentiment.

In this case, the emergence of the COVID-19 pandemic is a new sort of shock that came out of left field relative to all the risks analysts were highlighting in their annual outlooks only a couple months ago. An exogenous shock of this magnitude throws off economic models and financial markets; for proof look at the unprecedented speed with which equities entered into a bear market. If the speed and intensity of COVID-19 had been expected, it would not be a shock. Our own outlook has changed dramatically as well. In our January forecast, before news of a novel coronavirus circulating in China broke, we expected the U.S. economy to expand 2.1% this year; as of March 25, we look for a 2.4% decline.

So now that a recession appears all but unavoidable, what should we be watching to determine when we officially enter one? Two back-to-back quarters of GDP growth is a loose definition. But using quarterly data limits the specificity of timing and comes with a longer lag. The official call in the United States is up to the National Bureau of Economic Research (NBER), whose dating committee determines the start and end of each business cycle. It considers recession to be “a significant decline in economic activity...normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.” Except GDP, all these indicators are reported monthly.

Even now only one of these four horsemen of the apocalypse (industrial production) is signaling recession even as not just a U.S recession but indeed a broader global slowdown appear to be underway. This report looks at the four main indicators and offers a roadmap for keeping tabs on the economic cycle in real time as we seek a bottom in activity and hopefully before too long begin to climb out. Dating amid social distancing is not easy; this report is our best advice.

Employment: It’s Not Their Fault They Lost Their Job
A decline in employment is one of two measures that receive “particular emphasis” from the official recession dating committee. If employment is contracting, aggregate hours worked and output are likely falling as well. Before the recent volatility in financial markets and stepped-up efforts to contain the virus, the labor market was on solid ground; job growth in the three months through February averaged well over 200K and the unemployment rate sat at a 50-year low of 3.5%. But that is cold comfort when all signs point to a labor market that is quickly unraveling.

Some workers are fortunate in that they can do their work just as effectively from home, but many are not so lucky. Jobless claims jumped by 70K during the survey week for the employment report, which ended March 14, as restaurants were forced to close and retailers shuttered their doors (Figure 1). Along with deteriorating readings on employment in PMIs, we expect nonfarm payrolls to snap the 114 months of consecutive increases and decline by 45K in March (Figure 2). In other words, employment data are expected to be consistent with a recession starting as early as this month.
Source: U.S. Department of Labor and Wells Fargo Securities

Even if payrolls eke out an increase in March—which is still plausible given the survey covers only the first half of March—payrolls are set to tumble in April. Applications for unemployment insurance has overwhelmed state filing systems since mid-March and reports suggest initial claims on Thursday will soar to a couple of million for the week ending March 21—well above the worst week during the financial crisis. We expect employment to plummet in April, and along with cutbacks in hours for workers still on the payroll, aggregate hours worked looks set to collapse and contribute to a sharp reduction in household income and spending.

**Income: For Richer, for Poorer, In Sickness and In Health**

A sustained decline in real personal income, excluding transfer payments is another key ingredient of a recession. The dating committee excludes transfer payments, like Social Security and Medicare, to get at the underlying trend in income. For example, if the government’s response to the COVID-19 crisis involves direct payments to households, transfer payments may be the biggest driver of income growth in 2020, and mask the slowdown in true income.

Income growth has already cooled, if only slightly (Figure 3). For all of 2019, personal income grew $782 billion, which is down from $940 billion in 2018. The slowdown came from all major income categories. The key factor of personal income is employee compensation, which accounts for roughly 75% of personal income excluding transfers. With fluctuations here most closely tied to the labor market, this component looks like it is headed off a cliff, if our assumptions are correct regarding the slowdown in employment.

**As people lose their jobs they lose their main source of income.**
Real personal income growth is also correlated to the S&P 500 index, which experienced a sharp sell-off in recent weeks. One obvious interpretation of the recent market weakness would be that a slowdown in real personal income growth is in store this year (Figure 4). Moreover, a sustained sell-off in financial markets is indicative of broader softness in corporate profits. In this case, it is not yet immediately clear what the impact will be outside of the most affected industries like leisure & hospitality. At the same time, financial market weakness would affect income growth more directly through returns on assets, which account for about 20% of personal income excluding transfers. Look for that share to shrink in the wake of the selloff.

**Industrial Production: We’ve Been on the Rocks for a While**

The NBER defines a recession as a decline in total economic activity, and therefore places less emphasis on indicators of particular sectors. As a result, industrial production (IP) does not bear as much weight in recession dating as more encompassing measures of activity like employment or real income, especially as goods production has taken on a less-consequential role as the U.S. economy has shifted toward services and away from manufacturing.

Nevertheless, IP remains a timely barometer of how much the U.S. economy is producing. Industrial output rose 0.6% in February on the back of a jump in utilities output, but has generally floundered since late 2018. Changes in trade policy along with Boeing’s 737 MAX production stoppage have tripped up IP. Add in even a brief collapse in demand, social distancing among workers and supply chain issues as much of the world’s production is curtailed, and U.S. production looks set for a multi-month slide.

**Figure 5**

*Survey evidence points to depressed manufacturing activity.*

**Figure 6**

Source: Federal Reserve System, Institute for Supply Management, IHS Markit and Wells Fargo Securities

The rollover will likely come as soon as the March data, set for release on April 15. First, the weather-related bump from utilities is set to unwind, but IP will also likely be further depressed by offices sending workers home, stores temporarily closing, and factories running at a lower capacity. Speaking of which, purchasing managers indices for the manufacturing sector—which accounts for about three-quarters of IP—suggest factory output will fall. The New York, Philadelphia and Richmond Fed surveys showed shipments in March increasing at the slowest pace in three and a half years, while the preliminary Markit Manufacturing Index slipped below 50 for the first time since 2009 (Figure 5). Meanwhile, the cratering in oil prices during March does not bode well for new oil & gas drilling or mining support activities in the coming months (Figure 6). Overall, we look for IP to decline about 8% over the next couple of quarters before beginning to turn around toward the end of the year.

**Real Retail Sales: We Never Go Out Anymore!**

The NBER also uses inflation-adjusted manufacturing, wholesale and retail trade sales to help define a recession. But like industrial production, the dating committee places less emphasis on this component since manufacturing-trade sales excludes spending on services, or the bulk of U.S.
output. Nonetheless, if businesses are shedding workers, and household income is declining, sales are also likely to be suffering.

Real sales were already losing momentum last year amid a slowdown in personal income, but shelter-in-place restrictions popping up across the country are forcing consumers to stay home and curtail consumption. We may see a pop in February and March consumption, however, as consumers stock up on products amid restaurant closures, event cancellations and travel bans. But, don’t be fooled—we look for discretionary spending to tumble in coming months.

The expected spike in jobless claims as businesses cope with having to temporarily close their doors will limit consumption. So too will financial conditions, which have tightened dramatically in recent weeks plummeting to their lowest level since the 2008 financial crisis. That’s a red flag for real sales. When the availability of credit tightens, real sales slow in subsequent months as difficulty in tapping credit channels impairs consumers’ means to borrow (Figure 7).

But, perhaps the best place to look for the early signs of weakness as consumers withdraw themselves from the economy is consumer confidence. Containment efforts, job losses and flagging equity markets are sure to weigh on sentiment and outweigh any boost to real spending from the recent plunge in oil prices. It is likely we see sentiment falter as early as the final read of the University of Michigan’s March consumer sentiment index, to be released March 27. But, even if we don’t see a major hit till the April estimates, the intensifying containment efforts in the United States mean it is only a matter of time before the tide in confidence truly turns and brings spending down with it (Figure 8).

**Figure 7**

**Real Sales vs. Financial Conditions**

Year-over-Year Percent Change, Index (Inverted)

**Figure 8**

**Consumer Confidence**

Conf. Board Index 100=1985, SA, Univ. of Mich. Index 100=1966, NSA

Source: U.S. Department of Commerce, Federal Reserve Bank of Chicago, Conference Board, University of Michigan and Wells Fargo Securities

**Bottom Line: You’re Not Like All the Others**

Recessions typically rear their ugly heads when an economy has gotten out of balance (think tech stocks before 2001 or housing/lending before the 2008-2009). While it’s true that debt levels have been high in recent years, the ability of households and businesses to keep up with payments has not been in serious question. Instead, this recession is unlike others that have come before it inasmuch as the sudden slowdown was the inevitable result of deliberately stopping activity in order to save lives from the spread of a deadly virus. The bi-partisan support for major fiscal policy relief can be seen as a recognition of this, and the government’s perceived responsibility to backfill the missing spending that would have occurred in the absence of its forced shutdown. The exogenous shock that quickly plunged the economy into recession will fade only as these efforts succeed in mitigating the spread and an eventual vaccine restores our health, literally and financially. Determining either of these variables is outside the purview of economics, but like the rest of the world, we are learning fast and watching closely.