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Recession Risks

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With inflation at a forty-year high, broad in scope and increasingly built into expectations, the Federal Reserve (Fed) has lost the anchor of price stability. Officials there now accept that, to recover its lost goal, they will have to remove extant policy accommodation and ultimately impose restraint. Reducing inflation requires pulling the level of aggregate demand below the economy's potential to produce—intentionally inducing resource slack. The business cycle is inherently nonlinear around turning points, and even a small pickup in unemployment, well within the neighborhood of that necessary to disinflate, is typically associated with recession. Indeed, six of the seven times in the modern era that the Fed embarked on tightening spells, the US economy entered recession.

We believe this time should not be different, and we estimate there is a seven-in-ten chance the US economy turns down within four quarters. These are more forbidding odds than when we last revisited the topic because the inflation problem is evidently worse, and the Fed is showing more resolve in addressing it. At their most recent meeting, the members of the Federal Open Market Committee (FOMC) admitted that they have to do something hard—raise the policy rate well above 3 percent within the year—but they have not yet admitted all the likely consequences. In particular, their latest Summary of Economic Projections (SEP) includes the forecast of a 2 ¾ percentage point decline in inflation in 2023 as supply constraints lift that allows them to undercount the necessary expected firming. The SEP also sees the unemployment rate drifting up ½ percentage point, a historically reliable marker of recession.

The troubling aspect of the outlook is that the most probable way to avoid recession is if the Fed suspends its effort to disinflate before completely reclaiming its goal. We see this as a major risk in 2023.

Peak Inflation?

Two once-in-a-century events, a pandemic and a large-scale land war in Europe, were shocks to both aggregate supply and demand. Assessing the balance between and persistence of them proved difficult, and central banks mostly got it wrong in real time. The Fed in particular was more concerned about supporting demand because it believed that supply disruptions would prove fleeting as the lifting of health concerns allowed the return to work and disruptions to transportation chains were worked around. Thus, Fed officials joined "team transitory" and forecasted inflation would fall even as the unemployment rate tracked below its natural rate and the policy interest rate remained negative in real terms.

In the event, demand was supported by massive fiscal stimulus, supply-chain disruptions persisted, health hesitancy lingered as the virus mutated, and a significant volume of important commodities did not show up on the world market. Fed officials now expect that inflation has peaked around its current level of 8 ½ percent in terms of consumer prices and that modest slowing in aggregate demand returns it to around goal by 2024.

We fear that inflation has plateaued, not peaked, and that correcting the problem involves a harder and longer slog than even in the Fed's update outlook. Four mechanisms are primarily responsible:

1. Prices are increasing in most categories of the household basket, including categories that are traditionally very inertial, such as owner's equivalent rent. Once in motion, they stay in motion.

2. Even though wage growth has been robust, compensation has lagged well behind consumer prices over the past year. The efforts of workers to regain lost purchasing power will keep the cost-price spiral spinning.

3. Households and firms are increasingly building higher inflation into their expectations. The US has broken out of the Volcker-Greenspan zone of price stability and now changeable prices are a material concern in their decision-making.

4. Inflation is broadly higher with most trading partners, making it easier for firms to raise prices without concerns for market share and pressures in commodity markets showing through.

As the persistence of inflation sinks into the understanding of investors, they will appreciate the extent to which the Fed has to firm policy and put the economy at risk. This will prolong the difficulties of equity markets, longer-term Treasury yields should increase some more, and corporate spreads widen relative to that base. While almost all major central banks will be firming policy, the Fed heads the pack, further supporting the foreign exchange value of the dollar.

The Fed's Reaction Function

The Fed miscalculated epically in March. Chair Powell and his colleagues believed that they would capture market attention and reclaim their credibility with rate guidance of quarter-point firmings at the last seven scheduled FOMC meetings of 2022. While that forecast, indeed, represented an unprecedented policy pivot, firming of that limited magnitude could only be justified if inflation were also seen to slow considerably despite excess demand persisting and the real policy rate remaining negative. Public reaction largely ignored the Fed's policy intent, but rather focused on this macroeconomic justification, which was rightly criticized as incredible. Coming on the heels of incorrectly holding that the prior run-up in inflation would be transitory, the tone of Fed conversations reflexively darkened.

Despite the sterner tone from Fed Chair Powell at his press conference, officials probably feel constrained in expressing their pessimism about economic prospects. Under the hood of their latest communications, they seem to appreciate the extent of the policy problem, as witnessed by their sudden veering from the path of gradualism to raise rates ¾ of a percentage point. However, their economic forecasts still seem to be sugar coated. In the SEP published on June 15, inflation is recognized as more persistent in 2022, but it still falls markedly next year as supply constraints presumably (and unlikely in our view) lift. The rise in the median unemployment rate puts the economy in recession territory, but this regularity was unmentioned by Fed officials. Our forecast is darker still, with a smaller drop in inflation and a larger increase in the unemployment rate. Whether Fed officials have the internal discipline and external political support to continue to do whatever it takes to regain price stability is an open question. For all their expressed support of the goal of price stability, central bankers were increasingly more forceful in providing policy accommodation when the economy softened over the past few business cycles. This sets the bar higher for a quick policy reversal, at least as expected by politicians and investors. The Fed will be tested and may well stop short of returning inflation to 2 percent in favor of supporting employment in 2023 and 2024.

Debt & the Global Funding Crunch

Longer-term government yields and sovereign risk spreads have widened as the Fed marches deeper into its policy-firming spell. Such changes in the risk-free rate increase the discount rate applied to all future income of long-lived assets and typically lead investors to reassess future income streams. That is, monetary policy firming challenges business models, both of private firms expected to face a slowdown in earnings and of governments under more budget pressure. More for the latter and less for the former, national balance sheets deteriorated during the pandemic. The contraction in economic activity and ballooned health costs worsened budget balances in all countries and, in many countries, officials followed the lead of the US in providing unprecedented fiscal support to income, even among emerging market economies that previously moved policy pro-cyclically out of concerns about capital flows. The US example was striking: Because of federal government support, real disposable income grew at a double-digit pace in 2020 even as real GDP contracted.

As a result, debt has reached record levels relative to nominal activity in many economies. Investors have tolerated this situation up to now because interest rates in financial centers have been extraordinarily low and international official institutions appeared supportive of emerging market and developing economies. Those policy efforts, however, were mostly about forbearance (the Debt Servicing Suspension Initiative) or not applied (the Common Framework). As monetary policy firms worldwide, that tolerance will be tested. Already, spreads of the sovereign debt of emerging market economies have widened. Among advanced economies, sovereign bond investors are showing the weight of the strain, especially in the Euro area. The status of the former is especially difficult to determine given the opaqueness of the lending terms of the major participant in that market, China. It is likely there is a rolling renegotiation of terms underway. Where open finance is more prevalent, we expect a number of sovereign credit events over the next two years. Those events rarely go smoothly when global finance comes to a sudden stop.

Pre-existing conditions make the economic and financial situation in Europe the most perilous among the advanced economies. Coping with the coronavirus has been decidedly uneven. Supply disruptions, evidenced in markedly higher energy prices, contribute to pushing Euro area inflation higher. The Russian invasion of the Ukraine makes matters worse. Europe trades more with Russia, has larger banking exposures, and the European Union is the likely destination of the lion's share of the staggering number of Ukrainian refugees. Moreover, the impairment of global trade bulks larger in trade-centric Europe. Up to now, the macroeconomic concerns of the leading countries in the Euro area have argued for a low policy rate that lessens the microeconomic tension among the smaller economies with more questionable debt sustainability prospects. Even underneath this surface calm, intra-Euro area reserve flows, in the form of Target 2 balances, have reached an unprecedented scale. Going forward, expect to see political resentment within the Euro area to intensify along the North-South axis. As the alignment of national interests breaks down, pressure will intensify on the European Central Bank (ECB) to engineer sector sovereign support while firming policy in the aggregate. ECB efforts will probably forestall a sovereign credit event in Europe, but it will likely be at the cost of taking longer to return inflation to its goal.

A credit event in the US is even further remote, which is one of the advantages of being a reserve currency. However, American politics is most dysfunctional and agreement to put the federal budget on a more sustainable path seems well out of reach. The viability of the current policy trajectory, as well described by the Congressional Budget Office in its recent long-term budget outlook, requires investors (especially foreign ones) to make US obligations an increasing share of their portfolios at unattractive rates in both nominal and real terms. According to Stein's law, something that is unsustainable ultimately stops. Given the status of the US in asset holding and transacting, it ultimately may well take a long time. However, as the world political order seems likely to have a tall border of restriction and sanctions between some nations, alternatives to the US dollar will be forthcoming and the event horizon may shorten. And even before a major seismic shift in finance may come significant re-pricing of risk, which will be hard on holders of US dollars but put the necessary pressure on the US political class to make the unsustainable sustainable.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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