

Recession Not at Hand — Yet

As pressure mounts on the Fed to abort the rate hike cycle, risk is rising that the U.S. is “becoming Japan.”

Slip Slidin’ Away When it hiked rates last month, the Fed — along with major Wall Street houses — predicted four more rate hikes this year. But a stock price correction has a way of focusing the mind on the implausibility of such a course of action, to which markets now assign less than a 1% probability.

Because the disconnect has long been evident from a cyclical vantage point, we declared six months ago that “[t]he Fed’s rate hike plans are on a collision course with the economic cycle” ([USCO Essentials, July 2015](#)). Consequently, we observed two months ago, “[w]ith declining trend growth and a cyclical slowdown both bearing down, a full-blown rate hike cycle ... looks questionable” ([USCO Essentials, November 2015](#)). So where does the Fed go from here?

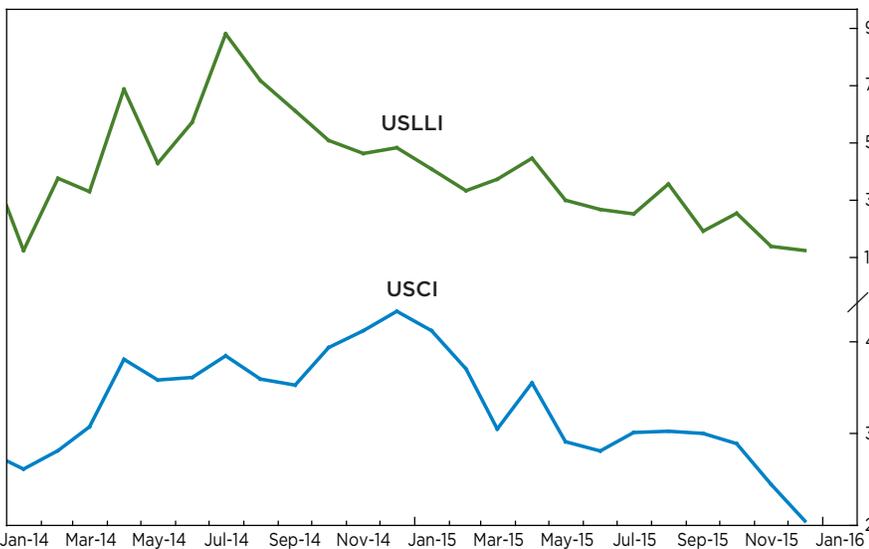
The primary basis for our earlier conclusion was the cyclical direction of economic growth, based on the growth rates of ECRI’s U.S. Long Leading Index (USLLI) and U.S. Coincident Index (USCI). It is therefore instructive to first examine the latest data on these indexes.

Although some economists continue to expect a pickup in U.S. growth, Chart 1 makes it glaringly obvious that the economy is still in a growth rate cycle (GRC) downturn, with USCI growth plunging since the summer, after having already peaked in December 2014 (bottom line). Moreover, with USLLI growth sliding to a 23-month low (top line), there is no end in sight for this GRC downturn. In other words, the slowdown is set to intensify for the foreseeable future, i.e., through the first half of 2016.

As to whether this deepening slowdown will culminate in a recession, the jury is still out. Whereas a recession signal requires the *level* of the USLLI to be in a pronounced, pervasive and persistent downturn, the magnitude of its decline from

The Fed is out of monetary policy ammunition and, for all practical purposes, at the mercy of the business cycle.

Chart 1: U.S. Long Leading and Coincident Indexes, Growth Rates (%)



its August high has so far been modest ([↗USCO Index Pages, January 2016](#)). Of course, that could very well change in the months ahead.

In fact, industrial production has again been falling in recent months and, as a report to be released at the end of this week will detail, U.S. Leading Manufacturing Index growth is now near a recessionary track. Contributing to its weakness have been the stiff headwinds from a strong dollar.

Meanwhile, the service sector has been in a GRC downturn since the beginning of 2015. Indeed, U.S. Coincident Services Index (USCSI) growth slipped in its latest reading to match its recent 15-month low. But USCSI growth is still stronger than it had been for almost seven years between May 2007 and March 2014 ([↗USCO Index Pages, January 2016](#)).

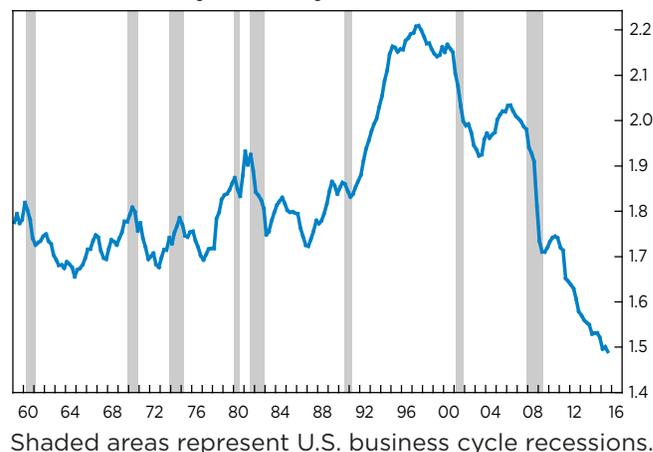
One reason is the support provided to the consumer by lower gasoline prices, driven by the 75% plunge in crude oil prices over the last 19 months. Even so, in line with the downturn in our U.S. Leading Index of Consumer Spending ([↗USCO Essentials, November 2015](#)), year-over-year (yoy) growth in real consumer spending has fallen to a 1½-year low (not shown).

Of course, oil prices can be a double-edged sword. After all, even a return to last summer's prices would amount to a doubling of current prices. The point is that a recession is likely to result if an oil price spike — perhaps due to geopolitical developments — results in a significant negative shock, arriving at a time when the U.S. economy is in a recessionary window of vulnerability indicated by a pronounced, pervasive and persistent downturn in the USLLI.

In sum, two distinct scenarios present themselves. In the “soft landing” scenario, USLLI growth would enter a cyclical upswing in the coming months, following which U.S. economic growth should begin to firm, perhaps by late 2016. Alternatively, the USLLI would fall into a cyclical downturn indicating the economy's entry into a window of vulnerability, within which any significant negative shock would trigger a recession. In either case, the GRC downturn will persist at least for the next few months, making it increasingly difficult for the Fed to keep raising rates.

Vanishing Velocity Following the seven recessions the U.S. economy experienced in the past half-century, money velocity typically turned up either immediately or within one to two years, and kept climbing until the end of the expansion. However, it did roll over a few quarters before each of the last two recessions began.

Chart 2: Velocity of Money



Its behavior during the current expansion has been quite different, in no small part because the expansion itself has been so atypical, encompassing three GRC downturns including the current one and the worst “non-recession” in history, when GDP growth averaged a scant ¼% in the second half of 2012. While money velocity did turn up immediately after the Great Recession ended, it peaked a year later, and has kept falling ever since. Indeed, it continues to plummet more than six years after the end of that recession, hitting a new record low in its latest reading (Chart 2). Furthermore, with a number of nowcasts projecting sub-1% annualized GDP growth in Q4 2015, it is likely to take yet another step down in its next reading.

In fact, money supply M2 growth peaked in early 2015, and has since stayed in a downswing. Even so, money velocity — the ratio of GDP to M2 — has kept falling. Therefore, unless velocity starts to recover after years of decline, it is even more improbable that GDP growth will pick up anytime soon. In essence, after years of monetary policy pulling growth forward from the future, the drivers of economic growth are simply failing to gain any traction.

When You Wish Upon R* The stock market correction has some worried that it is an omen of an impending recession. While that is certainly a possibility, cyclical downturns in stock prices have a much better one-to-one correspondence with GRC downturns — only some of which culminate in recessions. This helps explain why, as the late Paul Samuelson once quipped, “the stock market has predicted nine of the last five recessions.” What he failed to note is that the others were GRC downturns. Thus, the latest stock price correction,