U.S. Recession Scorecard

July 2023

On the path to a U.S. recession

There have been no changes to the Recession Scorecard in the past month. Three of the seven indicators remain in the negative red column, meaning each has passed a threshold value beyond which, historically, a recession typically has arrived within a measurable time horizon. Two others were recently moved into the cautionary yellow column because they were close to giving an outright negative signal and seemed likely to do so within a few months. The last two indicators, still rated green, continue to suggest there is some way further to go in the economic expansion—but it should be noted that both are less decidedly positive than they were a month ago.

Those indicators that have flipped to recessionary status so far point toward a recession getting underway by late Q2 or in Q3 2023, in our view. **It is worth remembering that the official start date of any recession may not be announced until many months or quarters after the fact.**

Yield curve (10-year to 1-year Treasuries)

The 1-year Treasury yield rose above the 10-year yield decisively last July, and the negative gap has widened over the past 11 months. **The history of this indicator after crossing into negative territory suggested the U.S. economy would be in recession by summer 2023.**

U.S. recession scorecard

	Status		
Indicator	Expansionary	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)			✓
Unemployment claims		✓	
Unemployment rate	✓		
Conference Board Leading Economic Index			✓
Free cash flow of non-financial corporate business	✓		
ISM New Orders minus Inventories			✓
Fed funds rate vs. nominal GDP growth		✓	

Source - RBC Wealth Management

For important and required non-U.S. analyst disclosures, see page 5.

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Adding weight to the "tight money" message coming from the yield curve, the Fed's most recent Senior Loan Officer Survey (released in May) further extended the year-long trend of a majority of U.S. banks raising lending standards on almost every category of business and consumer loan.

The same survey also revealed that a majority of banks are reporting reduced demand for commercial and industrial loans, as well as a reduced willingness to make such loans. A growing majority are also requiring higher credit scores for consumer loans and larger down payments for car loans.

ISM New Orders minus Inventories

The difference between the New Orders and Inventories sub-indexes of the ISM Purchasing Managers' Index has turned negative near the start of most U.S. recessions. But it has also registered occasional false positives—signaling a recession was imminent when none subsequently arrived. Moreover, this indicator only relates to activity in the manufacturing sector (some 15% of the U.S. economy) and is derived from a survey rather than hard data. That being said, **this measure has never before reached its current depth without a recession eventually following.**

Conference Board Leading Economic Index

Historically, this series has given reliable early warnings of recession. When the index has fallen below where it was a year earlier, a recession has always followed—usually two to three quarters later.

This indicator turned decisively negative in Q3 2022, shifting it to the red column on our Scorecard. The latest reading, for April, indicated a further deepening of its negative message. Its past record strongly suggests a U.S. recession will be underway sometime in Q2 or Q3 2023.

Unemployment claims

The monthly low for this cycle occurred in September. The cycle low for claims has typically been registered about 12 months before the start of the next recession. So, **if no lower reading is posted in the coming months, its history would suggest a recession could get underway this fall.**

Claims have recently bumped up well above that September low, suggesting the smoothed trend may indeed be reversing from down to up. The fact that both temporary employment and job openings are falling on a year-over-year basis adds to the likelihood that the tide is turning for unemployment claims. While we wait either for that shift to be confirmed or for claims to subside once again, this ambiguity warranted shifting the indicator's status to yellow back in April.

Unemployment rate

The unemployment rate posted its biggest monthly increase of this economic cycle in May, after revisiting January's five-decade low in April. Despite a robust 330,000 jobs added in the May payrolls report, unemployment (measured by the Bureau of Labor Statistics' household survey) surged to 3.7% from 3.4% the previous month. A move above 4.0% in the next couple of months would turn the smoothed trend of this indicator higher and, in our view, signal a recession is on the way. Once that signal is given, on average, it has been eight to nine months from the lowest monthly reading until a recession gets underway—although there have been several instances when the time gap was only two to three months.

Free cash flow of non-financial businesses

This gives an indication of the ability of such businesses, in aggregate, to internally fund any capital spending they want or need to do. Historically, whenever it has posted a year-over-year negative reading, a decline

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in corporate capital spending has typically followed, as has a recession. This number dipped slightly in Q4 2022 but remained elevated, and still appears some way from giving a negative signal. The Q2 reading will be released in early September.

Fed funds rate vs. nominal GDP growth

The federal funds rate has risen above the six-month annualized run rate of nominal GDP either before or at the very start of every recession in the last 70 years. (Nominal GDP is GDP not adjusted for inflation.) That run rate has been declining since its reopening high of 23% in Q4 2020. By the end of last year it had slowed to 7.2% but was still well above the federal funds rate, which at the time had risen to 4%. Now the fed funds rate is up to 5.25% and Q1 GDP data shows the six-month run rate of nominal GDP growth slowing to just 6.0%. We expect nominal GDP to slow further, and by Q2 or Q3 of this year will likely fall to or below 5%, meeting that historical precondition of recession.

Given that the gap between the fed funds rate and the economic growth rate has narrowed to such a degree, and our view that a negative crossing point likely will be reached within the next few months, we shifted this indicator from green to yellow back in April.

Bottom line

Weighing up the current positioning of all seven indicators, and projecting their likely paths over the next couple of quarters, continues to point to a growing probability the U.S. will enter a recession sometime late in the first half or in Q3 of 2023, in our view.

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