GLOBAL
Insight

RBC Wealth Management

U.S. Recession Scorecard

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Sliding toward an economic downturn

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Our Recession Scorecard, whose seven constituents were giving the U.S. economy a unanimous green-tinted thumbs up just 11 months ago, has been progressively sliding toward a more negative reddish hue. Three of our seven leading indicators of U.S. recession—two of them with perfect forecasting track records—continue to signal an economic downturn is on the way, and accordingly are in the recessionary red category on the Scorecard. Now two further indicators—monthly unemployment claims and the federal funds rate relative to the growth rate of the economy—look to be headed toward giving negative signals. We have shifted both from green to a cautionary yellow.

A sixth indicator, the unemployment rate, has meandered near a multi-decade low for the past 12 months, but even a modest bump up to 4% over the next couple of months is all that would be required to turn that trend higher. Such a trend shift has typically happened just as, or only a few months before, past recessions have gotten underway.

The remaining indicator—the free cash flow generated by non-financial businesses—is still well within expansionary territory but is moving (slowly) in the wrong direction.

U.S. recession scorecard

Indicator	Status		
	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.

All values in U.S. dollars and priced as of market close, April 30, 2023 unless otherwise stated.
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U.S. RECESSION SCORECARD

The indicators that have flipped to recessionary status so far point toward a recession getting underway by late Q2 or early 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 nine months. **The history of this indicator suggests the U.S. economy will be in recession by summer 2023.**

This so-called "inversion of the yield curve" has been the most reliable harbinger of a U.S. recession for many decades, occurring on average about a year before the economic downturn begins.

The 1-year Treasury yield rising above the 10-year yield is indicative of the arrival of tighter credit conditions. Adding weight to the "tight money" message coming from the yield curve, the Fed's most recent Senior Loan Officer Survey (released in January) revealed that a growing majority of U.S. banks have continued to raise lending standards on almost every category of business and consumer loan, extending a trend that began about a year ago. The bank turmoil of recent weeks has likely added to the upward pressure on lending standards. The next survey should be published in early May, and we expect it to show a continuation of the tightening trend.

The last survey also disclosed that a majority of banks are reporting reduced demand for commercial and industrial loans, as well as for credit card and car loans, presumably in response to the much higher interest rates that now prevail.

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. Therefore, we view this as a corroborative indicator—one to pay attention to if other longer-term indicators are implying a recession is on the way. It has been negative since May 2022, from which point it has steadily worsened. **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, in March, indicated a further deepening of its negative message. It strongly suggests a U.S. recession will be underway sometime in Q2 or Q3 2023.

Unemployment claims

This series has just undergone a revision of earlier data to account for some distortions introduced by the pandemic. The monthly low for this cycle, previously thought to have been registered last March, now appears to have occurred in September. The cycle low for claims

U.S. RECESSION SCORECARD

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 downwards to upwards. The fact that both temporary employment and job openings are falling on a year-over-year basis adds to our conviction that the tide is turning for unemployment claims. While we wait either for that shift to be confirmed or for claims to once again subside, this ambiguity warrants shifting the signal to no better than yellow.

Unemployment rate

The unemployment rate set a new five-decade low of 3.4% in January, but it has ticked back up to 3.6%. In our view, a move above 4.0% would 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 business

This gives an indication of the ability of such businesses, in aggregate, to internally fund any capital spending they want or need to do. Whenever it falls below where it was a year earlier, a decline 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 Q1 reading won't be released until early June.

Fed funds rate vs. nominal GDP growth

Every recession in the past 70 years has been preceded by the federal funds rate rising above the six-month annualized run rate of nominal GDP. (Nominal GDP is GDP not adjusted for inflation.) That run rate has been declining since peaking in Q2 2021. By Q4 2022, it was down to 7.2% but still well above the funds rate, which at the time had risen to 4%. Now the fed funds rate is up to 5.25% and the recently released Q1 GDP data shows the six-month run rate of nominal GDP growth slowing to just 5.9%. We expect nominal GDP to slow further, and by Q2 or Q3 of this year will likely fall 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 are shifting this indicator from green to yellow.

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. However, absent some notable weakness in the employment data in the coming months, the start date could easily move out later into the second half of the year.

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