Are We in a Recession? Depends on How You Define It...

U.S. GDP contracted at an annual rate of -1.6% in Q1 2022, and according to the latest GDPNow estimates from the Atlanta Fed, the economy contracted another -2.1% in Q2. The Atlanta Fed's GDPNow tool is not known for precise accuracy, but all signs point to two consecutive quarters of negative growth – the technical definition of a recession.[1]

If this data holds up and hindsight confirms a recession in the first half of 2022, it would be vastly different from the past 12 recessions the country has experienced since World War II. In every postwar recession, economic output fell while unemployment went up.

But that's not what is happening now.

Over the past six months, the unemployment rate has *fallen* from 4% to 3.6%, and demand for workers in the private sector remains strong. There is a good argument that the jobs market today is more robust than it was before the pandemic. In the years before the Covid-19 outbreak – when the economy was largely considered to be in great shape – there were an average of 1.7 million Americans collecting federal unemployment benefits. Today, that figure stands at 1.3 million. For context, during the 2008 Financial Crisis, there were over 6.5 million unemployed Americans receiving benefits.

The decline in output appears to be tied to households and businesses altering spending and investing plans based on shifting supply, demand, and price dynamics. Companies are struggling to manage inventories while consumers are grappling with rising prices. But it's also true that households are experiencing gainful employment and higher wages, while businesses overall want to retain or hire employees – not fire them. There have been over 10 million open jobs in the U.S. every month of 2022, which is nearly double the number of typical job openings in years before the pandemic.

Household finances also remain historically strong. At the end of Q1 2022, Federal Reserve data shows households had $18.5 trillion in cash in checking accounts, savings accounts, and money market funds. Before the pandemic, that figure was $13.3 trillion.

Banks are also not showing any signs of duress. The latest round of Fed 'stress tests' found that banks could easily handle the unemployment rate soaring to 10% and a collapse in the stock market and commercial real estate that would wipe out over $600 billion. Even with those unlikely shocks, banks would have capital ratios of 9.7%, which is over double the 4.5% required by law. An upward sloping yield curve also suggests that banks can lend profitably in the current environment:

Source: Federal Reserve Bank of St. Louis[2]

In my view, a technical recession in the first half of 2022 should not be taken as a sign that the economy is collapsing. Inflation pressures have certainly introduced headwinds that are altering consumer behavior and fundamentally slowing growth trends. But there are also major adjustments happening at the business and fiscal level that have muddied the GDP calculation but do not necessarily signal plummeting demand.

In Q1, for instance, surging imports subtracted from the GDP print even though many businesses were importing more goods in response to strong consumer demand. The overlooked metric is total trade, which went up solidly in Q1 with imports rising 11.5% and exports rising 7.2%. Inventories were also a major drag in Q1, as businesses stocked up in Q4 and pulled back substantially in Q1. And finally, as expected, government spending fell at a -2.7% annualized pace in Q1, which subtracted -0.48% from the headline GDP figure. These are not the types of fundamentals that worry me about the economy.

Bottom Line for Investors

Historically, recessions are best characterized by a marked decline in production and output, a rupture in the credit markets and household finances, and a significant amount of job loss. So far, we're only seeing one of these conditions (decline in output), which I think is more tied to the ongoing pandemic and war-related adjustments in business and consumer behavior – not to a systemic crisis.

To be fair, U.S. consumers started to pull back in Q2, which is a metric that should be watched closely going forward. Rising producer prices could also start to squeeze historically high corporate profit margins in the second half, which is where we might start to see more hiring freezes or even layoffs. These are the fundamentals to watch going forward, but I think the setup is tilted far in favor of experiencing a positive surprise, not a negative one.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. July 4, 2022. https://www.wsj.com/articles/recession-economy-unemployment-jobs-11656947596?mod=djem10point

[2] Fred Economic Data. July 5, 2022. https://fred.stlouisfed.org/series/T10Y3M#

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- **The decline of commodity prices**
- **Are we headed toward a recession even with a strong jobs market?**
- **Spending in the U.S. decelerates**

Commodity Prices Decline Sharply from Peaks

The last few weeks have produced a sharp selloff in commodity markets, with everything from oil to soybeans declining in lockstep from early June levels and with most finishing the quarter in negative territory. Natural gas prices soared by +60% from the beginning of April but ended the quarter down by -3.9%. Over the same period, copper fell by -22% and lumber prices dropped by -31%, while wheat, corn, and soybeans all also finished the quarter lower than where they started it. Oil prices have also notably come off of early June peaks – a barrel of crude at one point traded above $120 a barrel. West Texas Intermediate, which is the benchmark oil for the U.S., closed below $100 for the first time since early May. Commodity prices are notoriously volatile and can be affected by everything from the weather to geopolitics, but there is also the possibility that markets are anticipating more challenging economic conditions from here – especially as central banks around the world tighten monetary policy in an effort to cool demand. Another key factor on the demand side is China, which continues to pursue its zero-Covid strategy and does not appear likely to meet its goal of 5.5% GDP growth in 2022. A slowing China means less future commodity demand, which could be pulling prices lower.[1]

Is It Possible to Have a Recession in a Strong Jobs Market?

The Atlanta Federal Reserve's GDPNow forecasting tool estimates that U.S. GDP contracted at a -2.1% rate in the second quarter, which would mark the second consecutive quarter of contraction. This meets the technical definition of a recession, though whether or not the U.S. economy is declared to be in a recession depends on the National Bureau of Economic Research (NBER). Two consecutive quarters of output decline do not automatically trigger a recession declaration, as the NBER also considers factors like manufacturing activity and the labor market. But if Q2 GDP is indeed negative and the NBER confirms a recession in the first half of 2022, it would be vastly different from the past 12 recessions the country has experienced since World War II. In every postwar recession, economic output fell while unemployment went up. But that's not what is happening now. Over the past six months, the unemployment rate has *fallen* from 4% to 3.6%, and there is a good argument that the jobs market today is more robust than it was before the pandemic. In the years before the Covid-19 outbreak – when the economy was largely considered to be in great shape – there were an average of 1.7 million Americans collecting federal unemployment benefits. Today, that figure stands at 1.3 million.[2]

Spending in the U.S. Continues to Decelerate as Inflation Pressures Linger

U.S. consumers appear to be growing increasingly wary of higher prices. According to the Commerce Department, U.S. household spending continued to tick higher in May but the

pace of increase has fallen close to zero. Consumers are grappling with inflation at 40-year levels, with the CPI print in May showing prices went up at an 8.6% annual rate. Real-time data analysis from early June showed that credit and debit card spending figures fell further in early June compared to the end of May, as consumers hold back goods purchases and rethink travel and vacation plans. In many cases, consumers are starting to tap into savings accumulated during the pandemic to cushion the pinch of higher prices. According to JP Morgan, households still have a sizable cash cushion to work through compared to pre-pandemic, with checking and savings account balances of lowest-income households still 65% above 2019 levels.[3]

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[1] Wall Street Journal. July 4, 2022. https://www.wsj.com/articles/falling-commodity-prices-raise-hopes-that-inflation-has-peaked-11656811949?mod=djemRTE_h

[2] Wall Street Journal. July 4, 2022. https://www.wsj.com/articles/recession-economy-unemployment-jobs-11656947596?mod=djemRTE_h

[3] Wall Street Journal. July 5, 2022. https://www.wsj.com/articles/americans-tap-pandemic-savings-to-cope-with-inflation-11657013400?mod=djemRTE_h

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