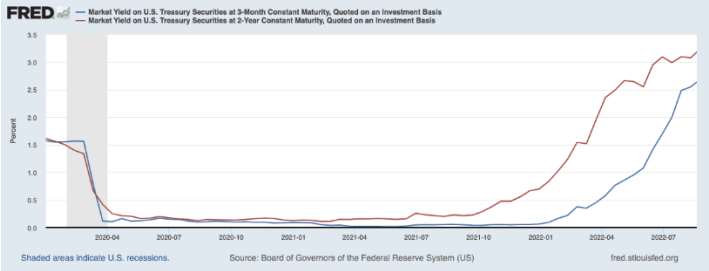
3 Signals That May Portend a Recession

Official statistics from the Bureau of Economic Analysis show the U.S. economy contracted by -1.6% in the first quarter and then again by -0.9% in Q2.[1] These data points meet the technical definition of a recession, which is two consecutive quarters of negative GDP growth. But that does not mean the U.S. was *actually* in recession. That's a determination made by the National Bureau of Economic Research (NBER), and they consider a wider range of factors beyond GDP, like productivity, gains or losses in the jobs market, and wages.

Considering the strength of the U.S. jobs market, rising wages, and robust consumer spending over the past year, I do not believe the US economy entered a recession in the first half of 2022. But looking ahead to the rest of the year, three important leading indicators are starting to send early warning signals. I think they're worth keeping an eye on.

1. **Inverted Yield Curve**

The 3-month and 2-year U.S. Treasury bond yields have bounced sharply off lows and are moving in a noticeable uptrend. Short-duration Treasury bond yields tend to rise when investors anticipate tighter central bank policies, which is essentially confirmation of what we already knew – i.e., the Fed has turned hawkish in an effort to tamp down inflation.



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

One of the risks posed by rising short duration Treasury bond yields is their effect on the yield curve. As a quick refresher, the yield curve represents the difference between long-term and short-term interest rates, which also serves as a proxy for loan profitability for banks. Since banks borrow at short-duration rates and lend at long-term rates (generally speaking), a steep yield curve creates higher net interest margins, which usually results in more credit, loans, and economic activity. On the flip side, an inverted yield curve signals it is more expensive to

borrow money short-term than long-term, which means something is likely awry in the credit markets.

Historically, the yield curve has been a good forward-looking indicator for the economy, which is why rapidly rising short-duration U.S. Treasury bond yields are worth watching closely. In the chart below, the yield curve is presented as the 10-year U.S. Treasury bond yield minus the 3-month U.S. Treasury bond yield. A declining line means the yield curve is flattening, and if the line falls below 0%, it means the yield curve is inverted. As seen below, any time the 3-month/10-year yield curve has inverted (fallen below zero on the chart), a recession has followed.

Source: Federal Reserve Bank of St. Louis[3]

In the current environment, the yield curve is not quite inverted just yet. But it's getting close.

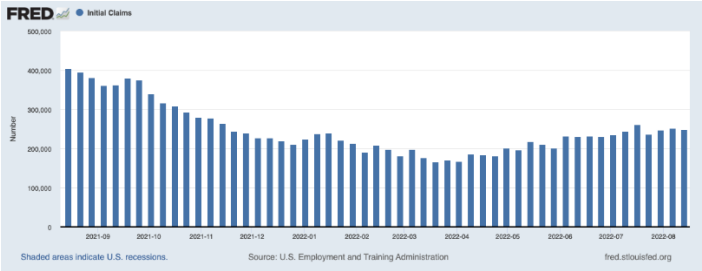
2. Declining Conference Board Leading Economic Index

Consecutive declines in the Conference Board's Leading Economic Index (LEI) have historically been a precursor to economic contractions. In July, the Conference Board LEI fell by 0.4%, which followed a -0.7% decline in June. Importantly, the LEI has fallen over the past six months by -1.6%, which indicates a greater trend and is worth monitoring.[4]

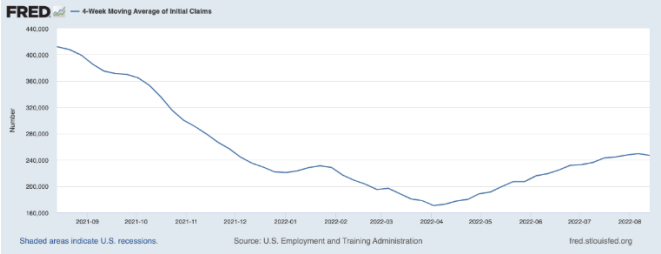
The key factors that appear to be driving the LEI lower are pessimistic US consumers, a slight dip in manufacturing orders, a slowing of housing permits and construction, and of course, the bear market. The Conference Board LEI includes the S&P 500 index, so the downdraft in the first half was a significant factor pulling down the LEI prints. The next couple of months will be important in determining whether this downtrend is sustained, which could signal a recession perhaps later in the year. Again, we're not there yet.

3. Rising Initial Jobless Claims

Initial jobless claims are a measure of how many new applications for unemployment benefits are submitted every week. This metric is a useful leading indicator because the data is high frequency, and also because it signals whether layoffs in the broad economy are starting to trend higher. A consistently rising initial jobless claims number signals the jobs market may be weakening, which usually means the economy is weakening, too. In the last six recessions, initial jobless claims started to trend higher about six months before the recession took hold. As readers can see in the two charts below, initial claims appear to have bottomed in March, and the 4-week moving average is trending slightly higher.



Source: Federal Reserve Bank of St. Louis[5]



Source: Federal Reserve Bank of St. Louis[6]

The upshot here is that initial claims are coming off historically low levels, and the number of available jobs in the U.S. economy continues to hover around 10 million. Worker shortages – not worker gluts – are still the prevailing issue in business.

Bottom Line for Investors

None of the above indicators are perfect recession forecasters, but they do help paint a picture of how the economy is holding up overall. In the current context, none of these indicators is flashing red, but they do seem to indicate more challenging growth conditions in the months ahead. For investors, this possibility does not necessarily translate to the need for allocation shifts within a portfolio. The stock market is a discounter of future growth conditions, and it is very possible that the drawdown in the first half – and the ongoing choppiness today – is the market already pricing in this economic weakness. By the time the recession arrives, if it ever does, the market may already have moved on.

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] BEA. 2022. https://www.bea.gov/news/glance

[2] Fred Economic Data. August 19, 2022. https://fred.stlouisfed.org/series/DGS3MO#

[3] Fred Economic Data. August 22, 2022. https://fred.stlouisfed.org/series/T10Y3M#

[4] Conference Board. August 18, 2022. https://www.conference-board.org/topics/us-leading-indicators

[5] Fred Economic Data. August 18, 2022. https://fred.stlouisfed.org/series/ICSA#

[6] Fred Economic Data. August 18, 2022. https://fred.stlouisfed.org/series/IC4WSA#

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- **The slowdown in global economies**
- **The labor market appears undeterred**
- **IPO market dries up**

Business Activity is Falling in Developed Countries Around the World

The composite purchasing managers index (PMI) is a useful indicator for gauging the direction of economic activity. Data compiled in the index is gathered via surveys of business leaders, with the questions focused on how activity has evolved with respect to new orders, hiring, prices, supplier deliveries, and other factors. Composite PMIs are not hard data like job numbers or retail spending, but they are reasonably effective at providing information about whether economic activity is picking up, slowing down, or stagnating. In the latest round of composite PMI data gathered in August, the signals were fairly clear: the global economy is slowing. The surveys indicated that business activity in the U.S., Europe, and Japan all fell in August, part of a larger trend that has taken hold this summer. Composite PMIs for the U.S. – which measure both factory activity and services activity – dropped to 45.0 in August, a decline from the 47.7 print in July. A reading below 50 generally signals a contraction. Abroad, the composite PMI for the eurozone was more encouraging, with a reading of 49.2 in August following a 49.9 reading in July. In Europe, manufacturing was weak but the services sector held up, perhaps as the summer tourism season and a strong dollar boosted activity. While an economic slowdown seems likely in the short term, the investment implications are less clear. The stock market tends to price-in economic weakness before it happens, which may have already occurred with the bear market in the first half.[1]

The Labor Market Appears Undeterred, At Least for Now

If an economic slowdown is indeed underway, the U.S. jobs market has not received the memo. The U.S. economy continues to have an abundance of jobs available, with 10.7 million unfilled jobs as of June 2022. Before the pandemic took hold in February 2020, there were 7 million job openings in the U.S. – which was largely considered a very strong figure. Workers in the U.S. economy today are not having a difficult time finding new work when they leave a job or are laid off – a typical unemployed worker had been out of a job for 8.5 weeks as of July 2022, which is down from 14.4 weeks in July of last year. Earlier in the pandemic, economists worried that the jobs market would follow a similar pattern as it did post-2008 Financial Crisis when unemployed workers spent an average of 27 weeks out of a job. This backdrop of plentiful jobs comes as layoffs are rising slightly, though they remain at low levels historically. Job-openings rates across many segments of the economy are higher than they were pre-pandemic, and there are still approximately two job openings for every unemployed person looking for work.[2]

The Market for Initial Public Offerings (IPOs) Dries Up

At the end of 2021, the IPO market had just completed a historic 18-month run. Interest rates were low, the U.S. economy was experiencing surging growth in its pandemic recovery, and

the appetite for high-growth, sometimes unprofitable companies were high. From January to August 2021, IPOs raised approximately $100 billion. The first half of 2022 looks wildly different. The war, inflation, and a hawkish Federal Reserve have sapped the 'risk-on' attitude of many investors, and the IPO market has dried up in the process. Through mid-August, traditional IPOs had only raised $5.1 billion, compared to the $100 billion over the same period last year. The last time the IPO market was this weak was 2009 when the economy was still badly bruised from the 2008 Financial Crisis. In a sense, the evaporation of IPO enthusiasm corresponds with what we would expect in a bear market, and it also could be a sign that excess risk and over-inflated valuations are getting flushed out of the system.[3]

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[1] Wall Street Journal. August 23, 2022. https://www.wsj.com/articles/global-economies-flash-warning-of-sharp-slowdown-11661247579?mod=djemRTE_h

[2] Wall Street Journal. August 24, 2022. https://www.wsj.com/articles/the-surprise-in-a-faltering-economy-laid-off-workers-quickly-find-jobs-11661333405?mod=djemRTE_h

[3] Wall Street Journal. August 22, 2022. https://www.wsj.com/articles/ipo-market-faces-worst-year-in-two-decades-startups-11661181427?mod=hp_lead_pos5

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