Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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What Debt Markets are Telling Us About a Recession

Economists, experts, and the financial media have been warning for over a year that a U.S. recession is 'just around the corner.' The economy continues telling a different story.

Last month, the Bureau of Labor Statistics reported that payrolls grew by 339,000, with the previous month's job growth being revised higher by 93,000. Workers are making more money, too – wages grew by 0.3% in May and 4% year-over-year, frustrating the Fed while showing little sign of deceleration. In all, real U.S. GDP grew by 1.1% in Q1 2023 (advance estimate) and 2.6% in Q4 2022, which all readers know isn't the stuff of recessions.[1]

To be fair, recession forecasts have not been unfounded. In past columns, I've pointed to the inverted yield curve as a historical precursor to economic downturns, and the spread between the yield on the 3-month U.S. Treasury and the 10-year U.S. Treasury has been in firmly negative territory for months now (see chart below). I've also pointed out that the Conference Board Leading Economic Index (LEI) has decisively turned over—now down 4.4% over the six months from October 2022 to April 2023—which has preceded the last several recessions.

Yield Curve Inversions Tend to Precede Recessions

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

Now there's yet another signal flashing recession – the U.S. debt markets. Readers should broadly think about the debt market as one responsible for moving money from banks and lenders to businesses and households, which is of course paramount to driving economic activity and new spending and investment.

In the wake of the Fed's interest rate hiking campaign and the regional bank stress this spring – the two of which are related – we're starting to notice banks requiring more collateral from borrowers as well as charging higher interest rates on loans. Lending conditions for companies, households, and especially real estate developers are now nearly as tight as they were at the height of the pandemic.

In the corporate world, sales of new bonds have fallen fairly dramatically, and corporate bankruptcy filings are also starting to rise as cash dries up, with the highest number of filings since 2010.

For households, interest rates are on the rise for credit cards, auto loans, and of course mortgages. Higher rates have also taken a toll on loans with adjustable interest rates, which we think has factored into more households falling behind on payments. As seen in the chart below, delinquency rates on consumer loans are on the rise:

Delinquency Rates on Consumer Loans

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

Nowhere has credit tightening been more apparent than in the commercial real estate market, however. In the realm of office space, landlords are not only collecting less revenue from tenants who are not returning to offices, but they are also facing higher interest expenses. Banks surveying the environment don't like what they see – the ratio of money lent to property value has fallen to a 30-year low, and the debt markets are signaling the trouble. Commercial mortgage-backed bonds with AAA credit ratings currently pay ~2% higher yields than comparable U.S. Treasury bonds.

Bottom Line for Investors

The aforementioned tightness in debt markets is yet another signal that a recession appears likely for the U.S. sometime in 2023 or early 2024. Frustrating many forecasters, however, is the flip side of the argument which has been the same for the past year – *a strong jobs market and higher wages may continue to be enough to stave off a downturn*. The U.S. consumer is the most important component of the U.S. economy, and to date 'full employment' and higher wages have been enough to keep spending afloat.

Whether the consumer can continue to keep the U.S. economy growing in 2023 remains to be seen. For markets though, it may not matter. I would argue a recession has been priced into stocks for some time now, and only a worse-an-expected downturn would be enough to send stocks tumbling again. A recession that's more 'garden variety,' which is what I'd expect, would probably not negatively impact stocks much at all, in my view. That type of recession is already too widely known and expected.

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. May 31, 2023. https://www.wsj.com/articles/where-is-the-u-s-economy-headed-follow-the-money-c79a6b1c

[2] Fred Economic Data. June 2, 2023. https://fred.stlouisfed.org/series/T10Y3M#

[3] Wall Street Journal. May 31, 2023. https://www.wsj.com/articles/where-is-the-u-s-economy-headed-follow-the-money-c79a6b1c

STEADY INVESTOR WEEK

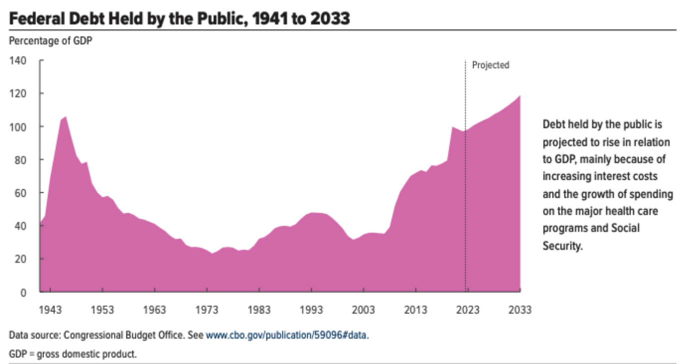
- **Debt ceiling saga is a wrap…for now**
- **U.S. labor market shows resilience**
- **Employment looks as robust as ever Service hiring remains strong**

Services Activity Cooling in the U.S., But Still in Expansion Mode

The Institute for Supply Management's purchasing managers index (PMI index) for May fell slightly, to 50.3. This is the lowest reading in 2023 for business activity in the U.S. service industry and signals that the economy's services sector is neither expanding nor contracting. As activity cools, hiring remains strong, however, as the May payrolls report showed increased employment in leisure, hospitality, and construction. According to Anthony Nieves, who heads up the ISM's survey, "*the majority of respondents indicate that business conditions are currently stable; however, there are concerns relative to the slowing economy*."[1]

Debt Ceiling Drama: Gone, But Not Forgotten

The recent agreement to suspend the debt limit through January 1, 2025, puts the issue of debt/obligation default to rest—for now. In our coverage of the debt ceiling showdown, we pointed out to readers that we (and the markets) have seen this movie many times. And we're likely to have to watch it again. Other than Denmark and the U.S., no other developed country passes spending plans *and then votes on whether to pay for the spending.* In Denmark, the debt limit is so high that political wrangling does not put the country's debt at risk, leaving just the U.S. as a country where this is an issue. As seen in the latest projections for federal debt over the next ten years – even with the cuts just agreed to in the latest deal – debt as a percent of GDP is expected to keep rising steadily. That makes the possibility of future fights over spending likely, which will almost certainly subject markets, investors, and taxpayers to another bout of drama and uncertainty—and potentially compromise the U.S.'s status as the stable center of global finance.[2]

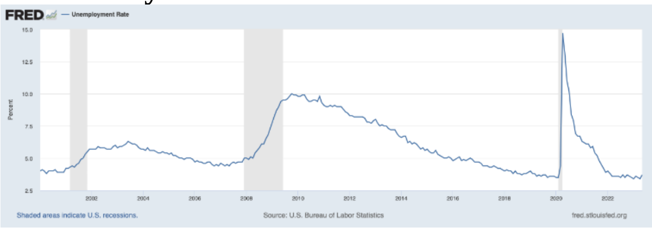


Source: Congressional Budget Office[3]

The U.S. Labor Market That Won't Quit

May's jobs report continued a strong trend that's been evident for years. The takeaway is that if there's a problem in the labor market, there are too few workers—not too few jobs. In May, payrolls rose by 339,000, nearly double analyst expectations. Previous months were also revised up by 93,000, signaling that the jobs market was even stronger than we understood it to be. Readers may point out that the unemployment rate rose for the month, from 3.4% to 3.7% (chart below). But that's more about statistical quirks than a faltering employment picture. For example, in one employment survey, the number of people with multiple jobs is only counted once, and unincorporated self-employed workers and workers on unpaid leave are also excluded. When adjusting for these quirks, the employment picture looks as robust as ever, with some 1.6 million jobs added in the first five months of this year. Some have pointed out that while employment is rising, productivity is falling, resulting in flat or possibly negative output growth. If productivity is weak, there is a reasonably good argument we could have a mild recession even with solid employment. In our view, that's the type of recession that shouldn't disrupt markets much at all.[4]

U.S. Unemployment Rate Remains Historically Low



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

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[1] ISM. 2023. https://economics.cmail20.com/t/d-l-vluotl-jdhijihhuy-o/

[2] Wall Street Journal. June 3, 2023. https://www.wsj.com/articles/biden-to-tout-debt-limit-deal-in-first-major-oval-office-address-a3ae7c22?mod=djemRTE_h

[3] Congressional Budget Office. 2023. https://www.cbo.gov/system/files/2023-05/59096-Budget-Outlook.pdf

[4] Wall Street Journal. June 2, 2023. https://www.wsj.com/articles/may-jobs-report-unemployment-rate-economy-growth-2023-65ae1e96?mod=economy_more_pos7

[5] Fred Economic Data. June 2, 2023. https://fred.stlouisfed.org/series/UNRATE#

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