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SPECIAL Market Missive

Is A Recession Inevitable?

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The "hot" start of this summer, at least on the East Coast, is not being reflected in a hot economy. The traditional definition of an economic recession is a decline in real gross domestic product (GDP) for two consecutive quarters. In 2020, we experienced such an event for the first and second quarters. So far this year, we have a first quarter decline in GDP of 1.5%. The first quarter of 2020 was minus 3.9%, the second quarter was down 32.4% but the third quarter rebounded 38.7%. The wide swings in GDP in 2020 were in response to an initial government shutdown of the economy and a knee-jerk response to the big negative second quarter through massive expansion of both monetary and fiscal policy.

In hindsight, that government response was excessive as a combination of surging energy prices and logjams in the global supply chain pushed inflation to record levels. In May of this year, the headline consumer price index rose 8.6% at an annualized rate and core inflation (ex food and energy) rose 6.3%. Incidentally, even though the raw energy number is excluded from the core calculation, the impact of higher energy prices affects all prices of goods and services. For example, restaurants are tacking on "economic" surcharges to cover rising costs. The rise in the price of gasoline had a particularly negative impact on consumer and business confidence (Small business optimism fell for the fifth straight month to the lowest level since April of 2020).

The government's response to this inflation could be just as reactionary as efforts to resuscitate the economy in 2020. The federal reserve raised interest rates with the latest announcement in June that the fed funds rate would go up by 75 basis points, an unusual increase given that the previous increase was 50 basis points and prior increases were 25 basis points. In addition, the Fed announced that it would shrink its balance sheet by letting bonds mature and not reinvesting the proceeds. On the fiscal side, there has been a huge swing in spending from stimulus to the withdrawal of that stimulus as reflected in record increases in tax collections.

These government policies are influencing the potential for economic growth. Weakness in financial markets have lowered consumer wealth that is producing a slowing in retail sales. Housing starts fell sharply in May—declining 14.4%, the Index of Leading Economic Indicators fell for the third straight month, the Federal Reserve of Philadelphia's manufacturing business conditions index declined by 3.3%, the first negative reading since May of 2020.

Another component of GDP is the relationship of exports to imports. When imports exceed exports, the difference is subtracted from GDP. The size of this difference accounted for the largest part of the change in the components of GDP in the first quarter pushing that calculation into negative territory. The latest estimate for GDP growth for the second quarter from the GDPNow model from the Federal Reserve Bank of Atlanta is ZERO! Despite these negatives, there are glimmers of hope and light at the end of the tunnel. Stay Tuned!