Is a Recession in the Cards?

Special Report | February 2024

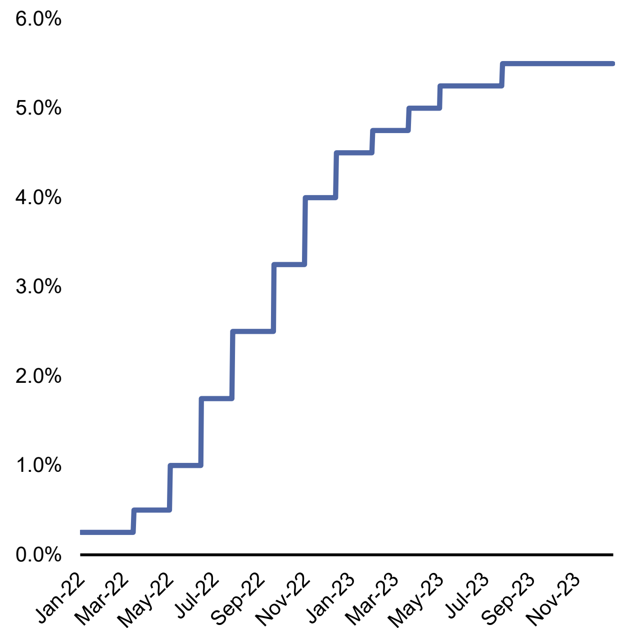
At PFM Asset Management, we consistently believed that despite the Federal Reserve (Fed) raising interest rates to bring inflation down to its 2% target, the U.S. economy had enough tailwinds to achieve a soft landing and avoid a recession. While this view was out of consensus for all of 2022 and most of 2023, recently, more economists have come around to our view. However, the risk of recession remains elevated. And, while our base case remains a soft landing, we explore the possibility of a recession in 2024 and if one occurred, whether it would be mild or a more severe economic downturn.

The Case for a Soft Landing

Since the Fed started to raise interest rates to decrease inflation, most economists forecasted that the United States would fall into a recession (Exhibit 1). In addition to aggressively hiking rates, the Fed continued to withdraw liquidity from the system by allowing its balance sheet to shrink (Exhibit 2). While we recognized that the risk of recession was elevated, our base case was and remains that a soft landing is achievable. This outlook was based on our view that inflation would moderate and our perception of favorable tailwinds for the U.S. economy.

Our view that inflation would moderate was based on our assessment that the significant increase in inflation, which began in 2021, was driven by extraordinary fiscal and monetary policies following the onset of the global pandemic, combined with a severe strain on supply chains.

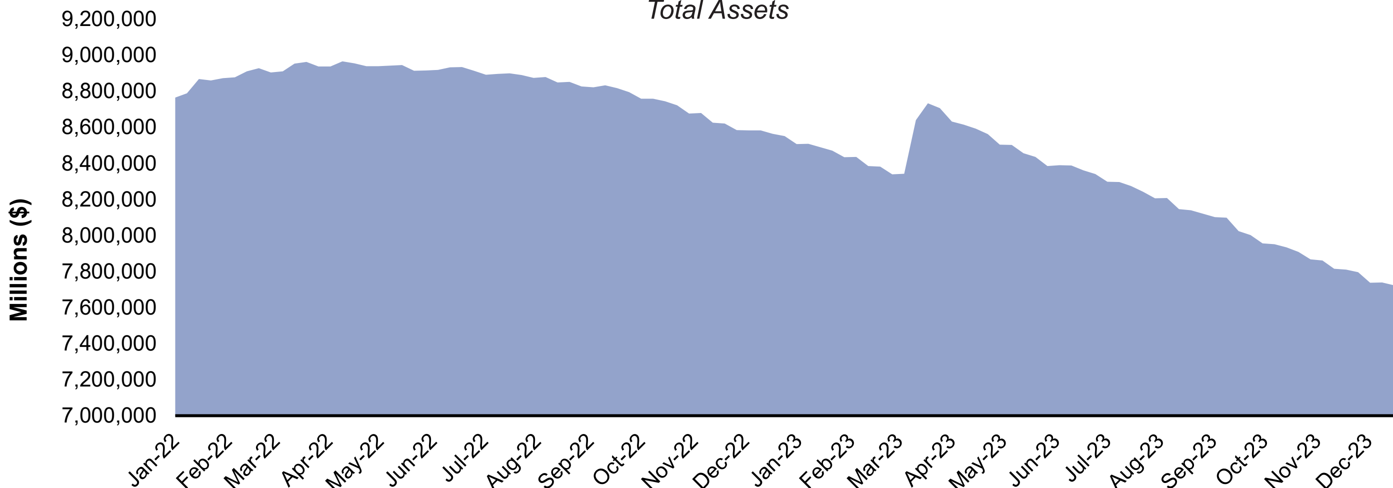
Exhibit 1: Federal Funds Rate



Source: Bloomberg.

Exhibit 2: Fed's Balance Sheet

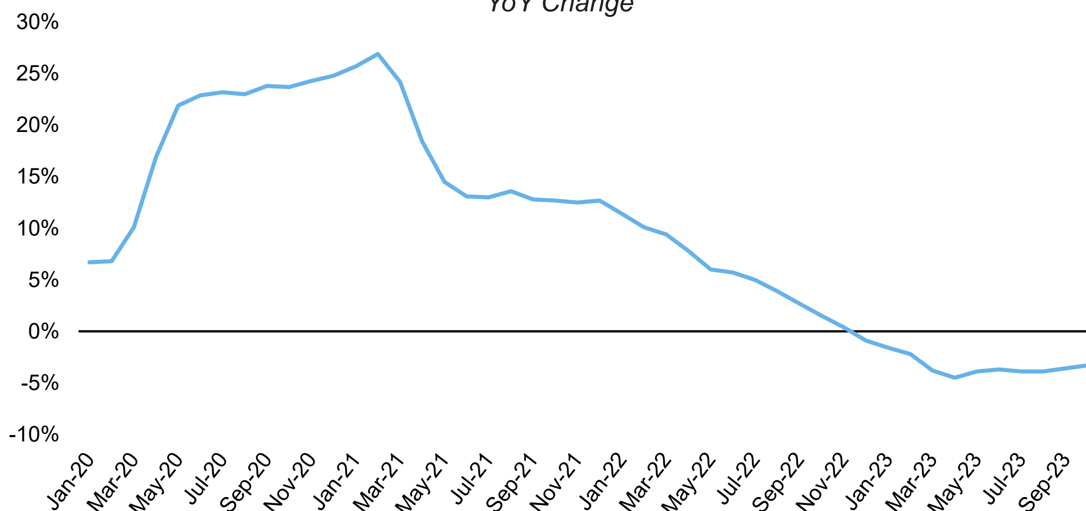
Total Assets



Source: Bloomberg.

Exhibit 3: M2 Money Supply

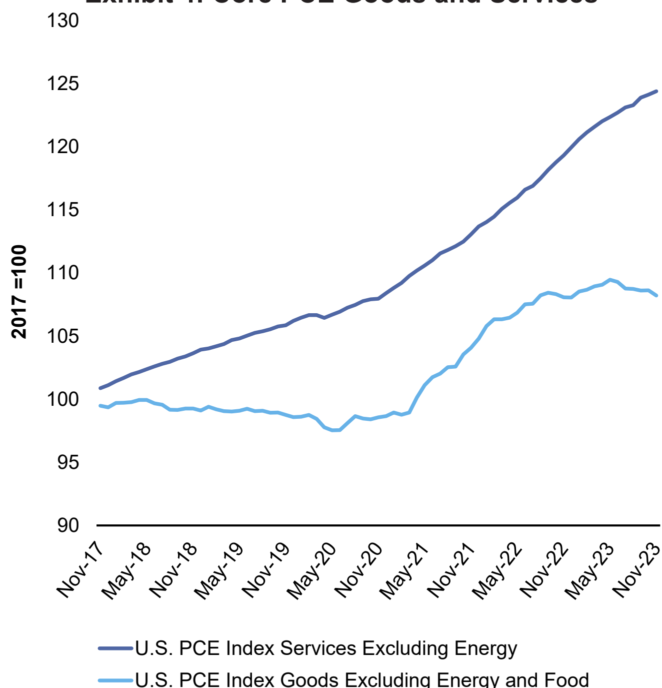
YoY Change



Source: Bloomberg.

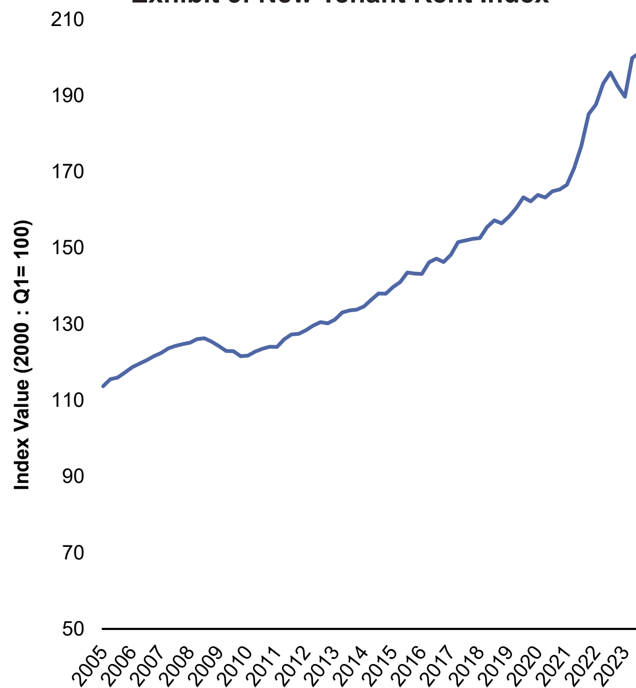
As a result of these policies, money supply increased significantly (Exhibit 3). Our analysis suggested that as money supply growth eased and supply chains slowly returned to historical levels, it will be conducive to goods inflation (Exhibit 4). At the same time, labor markets went through unprecedented change – the labor force participation rate fell to 60.1% in April 2020 compared to 63.3% in February 2020 as a result of the pandemic related pullback, and has recently recovered to 62.5%. This has put pressure on service-oriented sectors of the economy, leading to a higher ratio of job openings to the number of job seekers as well as higher wage growth. We are currently seeing a moderation in goods inflation and wage growth. Meanwhile, the shelter component of inflation continues to exert upward pressure on inflation due to the tight housing market, but we are seeing signs of rent pressure easing as well (Exhibit 5).

Exhibit 4: Core PCE Goods and Services



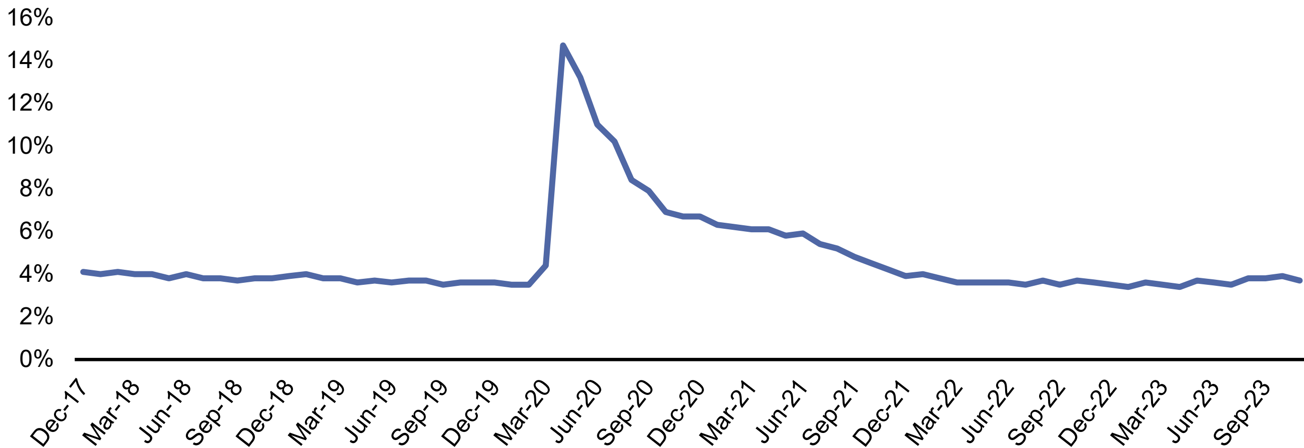
Source: Bloomberg.

Exhibit 5: New Tenant Rent Index

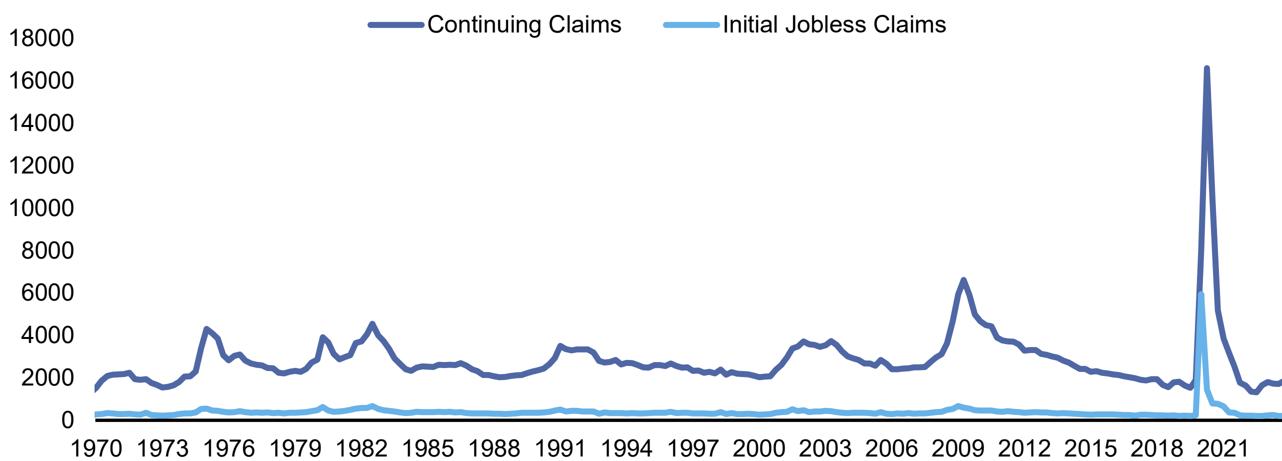


Source: U.S. Bureau of Labor Statistics.

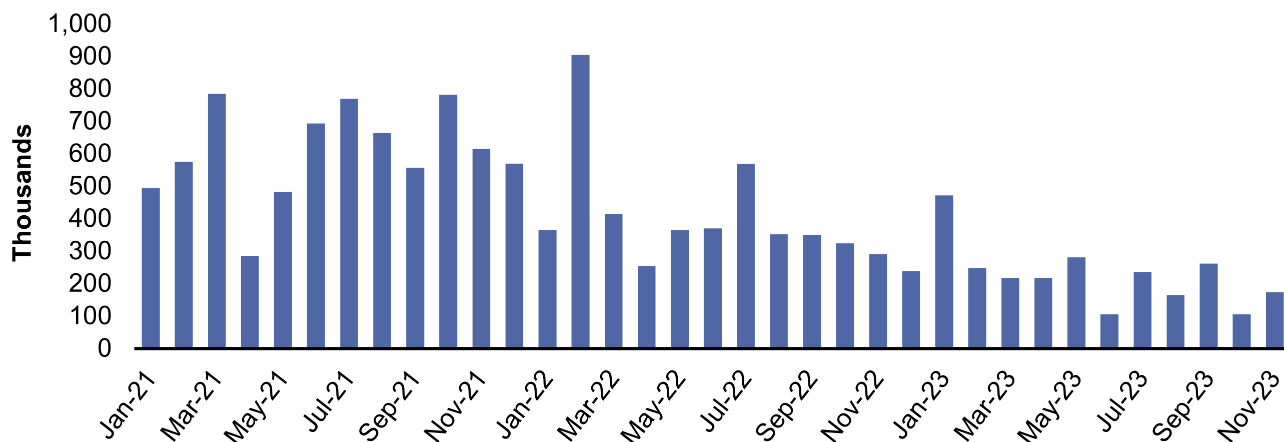
In addition to moderating inflation, our base case for a soft landing is supported by several favorable tailwinds for the U.S. economy. For example, the labor market remains healthy with a historically low unemployment rate. Weekly jobless claims and continuing claims also remain at historically low levels, and the U.S. economy has produced approximately 200,000 net new jobs per month over the past three months (Exhibits 6,7,8).



Source: Bloomberg.

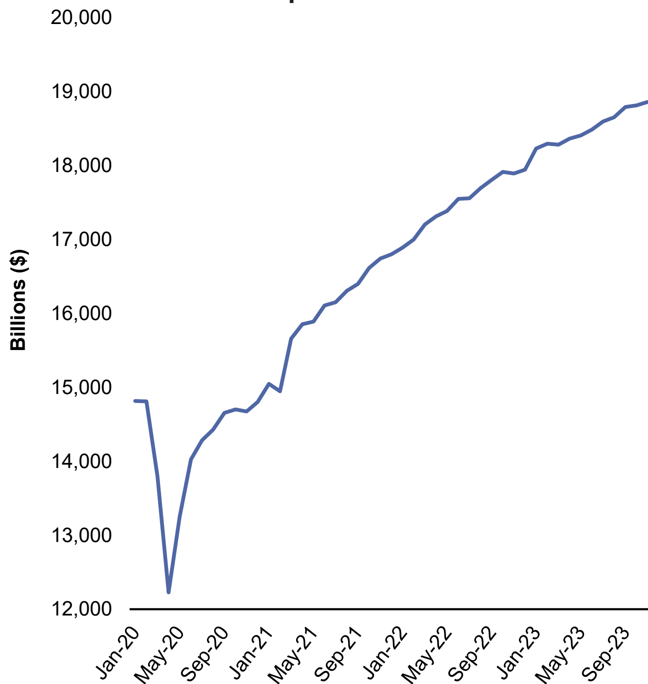


Source: Bloomberg.

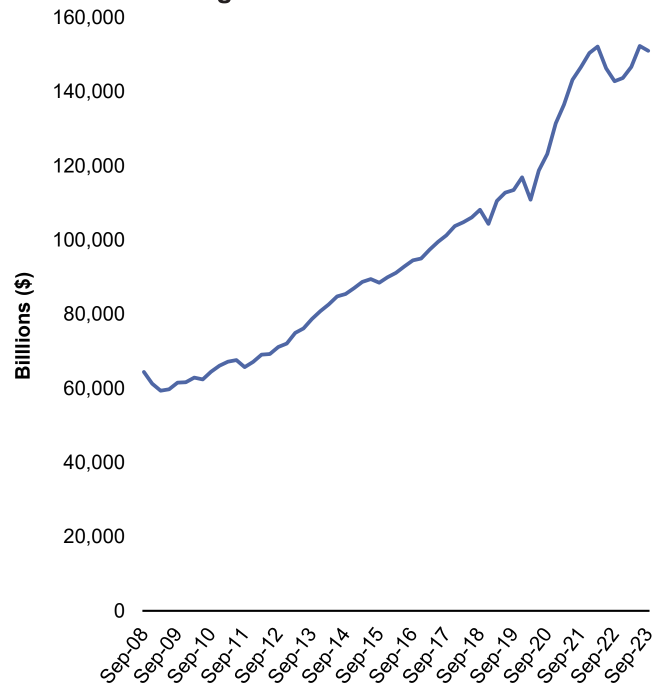


Source: Bloomberg.

Given that consumer spending accounts for approximately 70% of economic activity, and given the strong labor market, we expect the consumer to keep spending and by extension, help the economy avoid a recession (Exhibit 9). It should also be noted that consumer spending is supported by a significant increase in household net worth since the onset of the pandemic (Exhibit 10).



Source: Bloomberg.



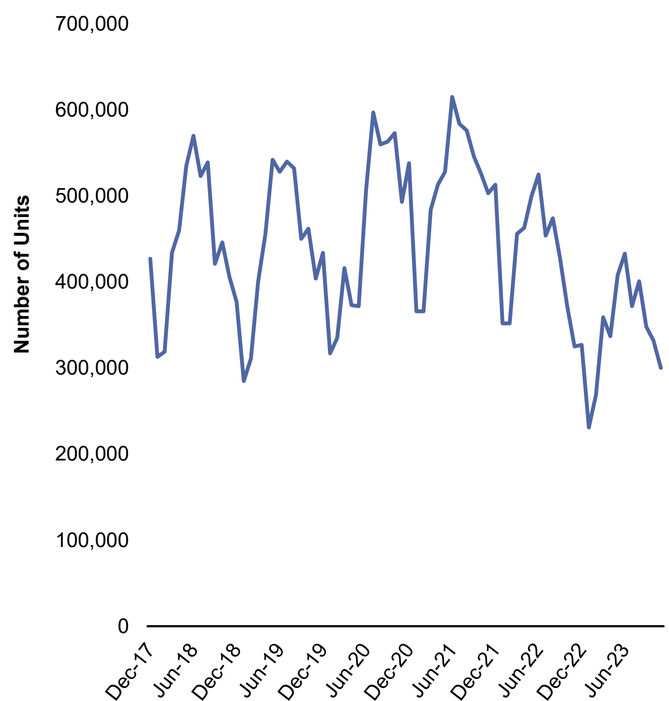
Source: Bloomberg.

Alternative Scenarios

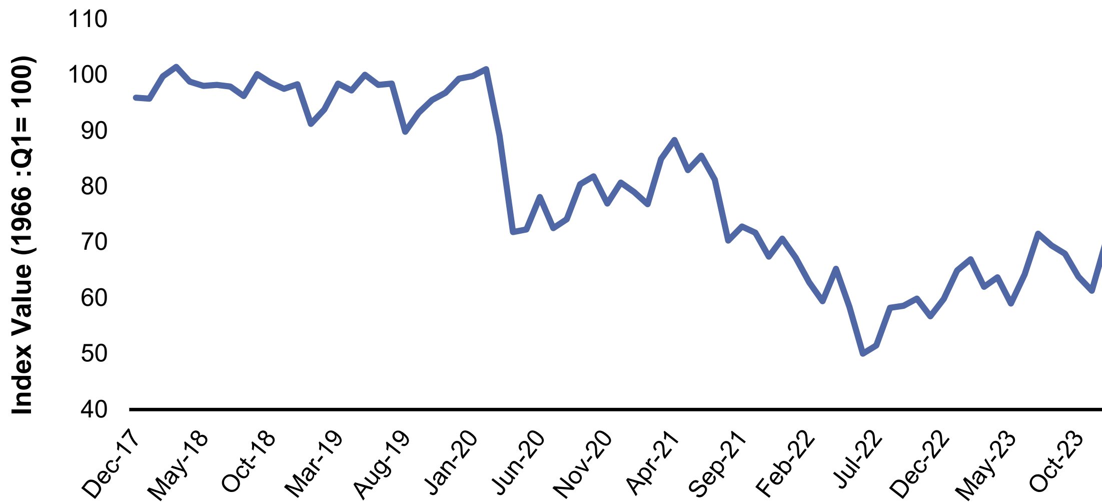
Again, while our base case remains a soft landing, the risk of recession is elevated. Historically, the impact of higher interest rates negatively impacts the economy with a lag period of nine to 18 months.

Several indicators that have accurately predicted recessions in the past are raising a red flag, including the Treasury yield curve, which remains inverted, and the Leading Economic Index, which is negative on a year-over-year basis.

In addition to these economic indicators, there are other signs that the economy is losing momentum, and that the consumer is perhaps not in as strong of a financial position as one might expect. For example, the housing market is experiencing stress due to higher mortgage rates (Exhibit 11). Consumer confidence is also fragile due to significantly higher prices for basic necessities (Exhibit 12 on the next page).

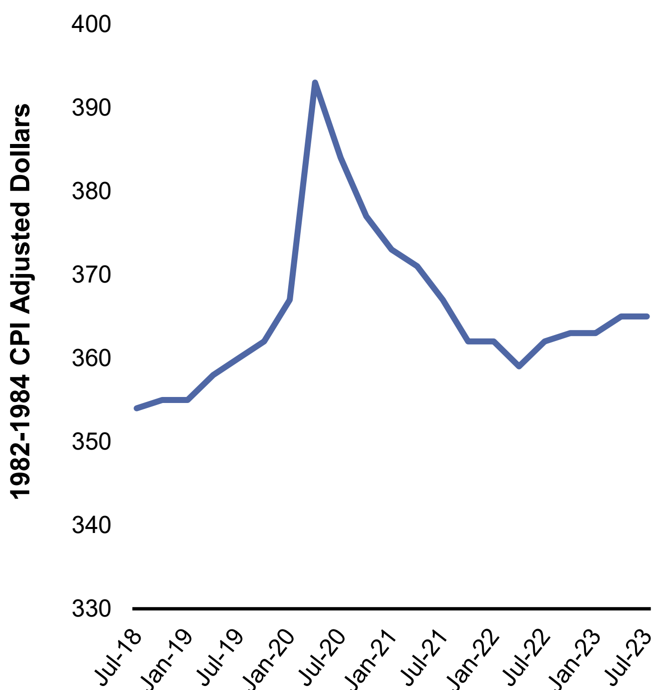


Source: National Association of Realtors.

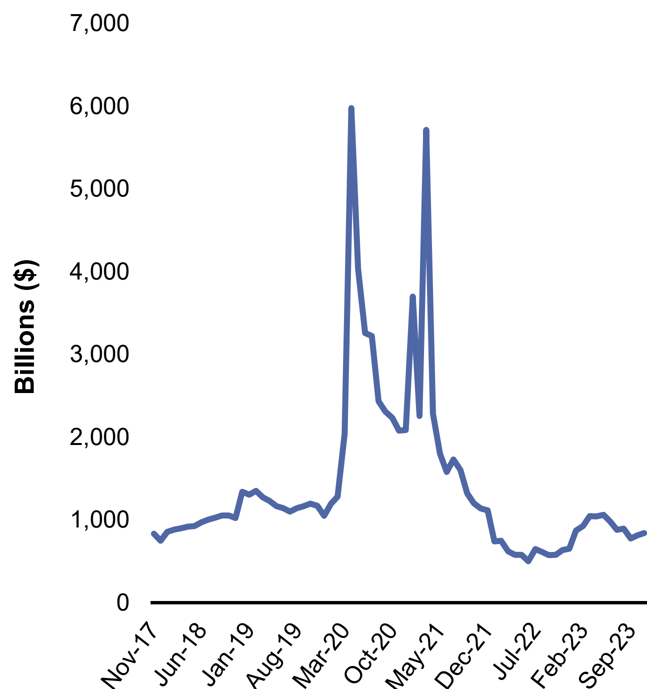


Source: Federal Reserve Economic Data.

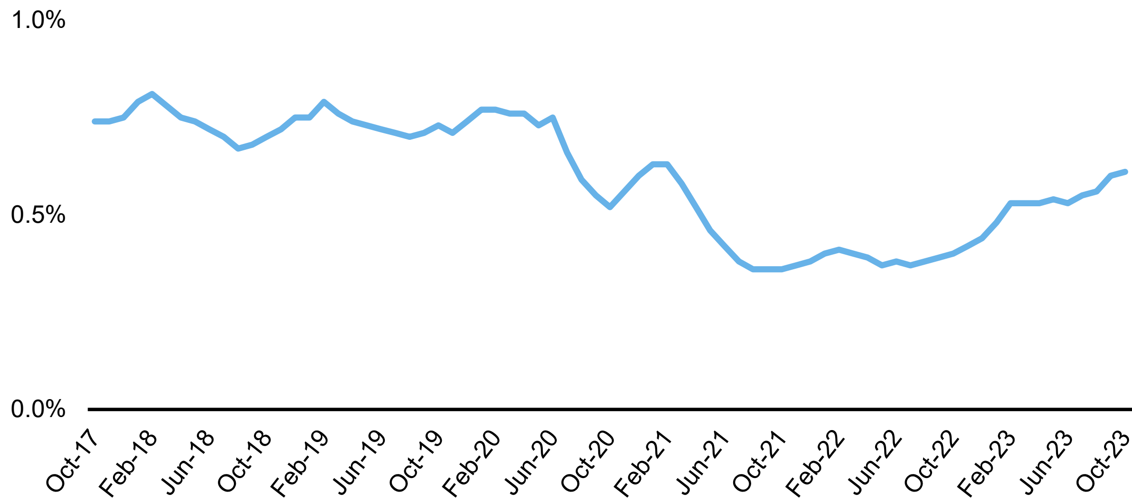
And, while wage growth has started to outpace inflation, consumers did suffer declining real weekly earnings over the past couple of years (Exhibit 13). Further, the so-called excess savings built up during the initial phase of the pandemic as the government provided financial support to some households, has been largely depleted (Exhibit 14).



Source: Bloomberg.

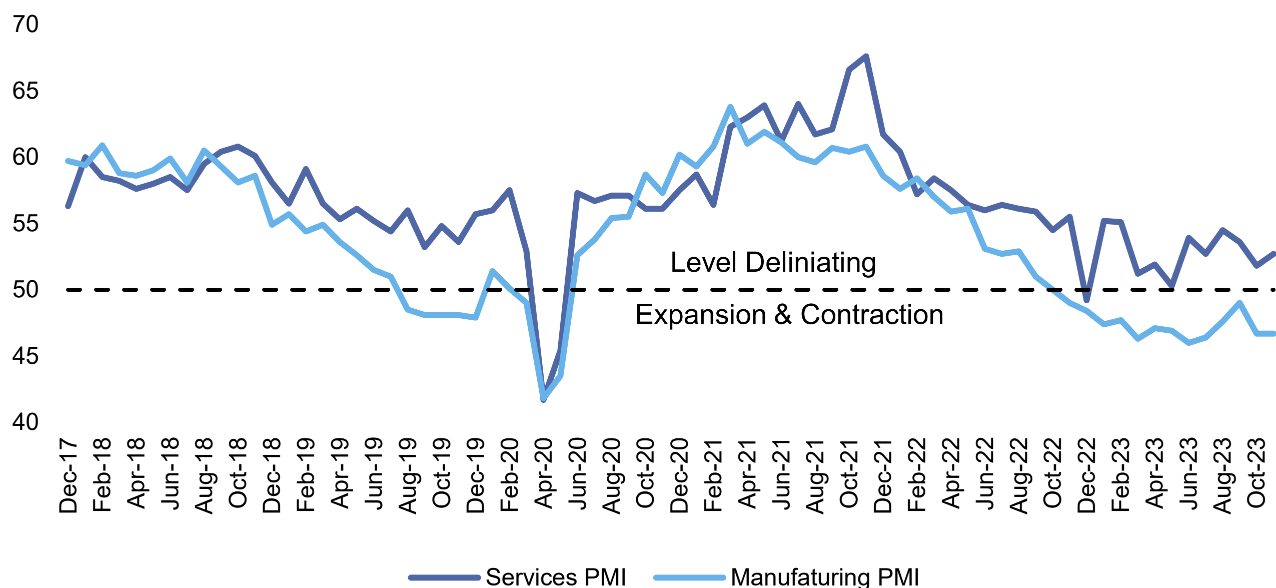


Source: Bloomberg.



Source: Bloomberg.

It should also be noted that consumer delinquencies are starting to rise, suggesting that some consumers are financially stretched and fragile (Exhibit 15). Adding to this, consumers with student loans will need to start making monthly payments after a hiatus which began in early 2020. Surveys of business activities as represented by the Purchasing Managers Index (PMI) suggest that economic activities are also moderating, and that manufacturing activity is contracting (Exhibit 16).



Source: Bloomberg.

Outside the U.S., the global economy is seeing a significant slowdown. The Eurozone is on the verge of stagnating and China continues to face headwinds which include elevated debt levels and a deflating real estate bubble. In addition, there are numerous geopolitical risks, including the war in Ukraine and the Middle East conflict.

As a result of the headwinds noted above, the U.S. economy could slip into a recession. However, should that happen, our expectation is that it would be a mild one. In the case of recession, the Fed would likely cut rates significantly since inflation has moderated and would likely end quantitative tightening (QT) and once again begin to expand its balance sheet.

Further supporting the case for a mild recession is that even if the unemployment rate rises, it is likely to remain low by historical standards given the starting point. Moreover, corporations are in a strong financial position with good profit levels and given that many refinanced their debt when rates were low. Finally, because 2024 is an election year, we suggest that the Biden Administration with Congress could provide some form of fiscal stimulus, or at least be dovish with regard to policy.

While the odds of a more significant downturn are lower, we do want to acknowledge that it is possible. One scenario leading to a deep recession would be an expansion of the Middle East conflict. Currently, we expect the conflict to remain fairly contained. However, there is a risk that it could expand to include non-state as well as state actors. If that were to occur, it is possible that the price of oil could rise to $150 per barrel or more. Such an increase in oil price would not only drive the global economy into recession, but inflation would reverse and rise. Under such a scenario, the Fed would not be able to cut rates to support economic growth since it would need to keep rates high and may even need to raise rates further to fight inflation. Should this transpire, a significant recession would be a near certainty.

We may also experience a significant recession due to the misallocation of capital over the past number of years. Specifically, since the financial crisis (in 2007-2009), the Fed and other major central banks have been conducting significant monetary experimentation. Domestically, the Fed cut rates to 0% and kept them there for a prolonged period of time. Meanwhile, other central banks including the European Central Bank (ECB), cut rates into negative territory, which was nearly unheard of before 2007. These lower levels of interest rates have led to investments in projects with lower return thresholds. As interest rates have risen, sectors with higher embedded leverage are faced with renewing debt at higher interest rates. At the same time, companies are forced to have more capital discipline in light of higher borrowing costs. As a result, a normalization of monetary policy could lead to pain and losses across certain sectors The real question is whether the pain could be contained or does it become systemic by impacting the banking sector. This is what happened during the financial crisis. Our expectation is that losses would likely remain contained, but this is not guaranteed.

Focus on the Long Term

As Dr. Spock of Star Trek fame said, “live long and prosper.” This is advice worth taking. By focusing on the long term, investors are less likely to overact to temporary movements in the economy and capital markets. The U.S. and global economy have seen many recessions, some of which were severe, and yet investors who stayed the course were richly rewarded. While we expect a soft landing and can present analysis supporting our outlook, the fact is that no one can guarantee that the economy will not fall into a recession in 2024.

The U.S. and global economy will also certainly experience recessions in the future. And, just as in the past, those recessions will eventually end, and the economy will grow once again. Similarly, the capital markets, which track asset prices, will ebb and flow. But over extended periods of time, it is likely that they will track higher.

Our expectation for U.S. equity returns over the intermediate term (defined as five years) is 7%. The data in our 2024 Capital Market Assumptions shows that some segments of the equity market, such as small-caps, are expected to achieve over 8% due to attractive valuations.[1] Bonds, which many had written off when rates were artificially low, are also expected to deliver fairly good returns over the intermediate term. Investment grade core bonds are expected to deliver a 6% total return, while high yield is expected to deliver equity like returns of 8%. Despite how the economy performs in 2024, by focusing on the long term, investors can indeed prosper.

1 PFMAM's 2024 Capital Market Assumptions available upon request.

To learn more or discuss in greater detail, please contact your PFMAM relationship manager.

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