

Episode 39

# Q3 2022 Economic outlook: Recession ahead?

## Chief U.S. Economist Lara Rhame tackles the big recession question + her quarterly outlook.

[00:00:00] Kara O'Halloran:

I have to ask the question just flat out. Are we in a recession?

[00:00:04] Lara Rhame:

Well, my answer is no. Not yet.

[00:00:15] Kara O'Halloran:

Welcome back to FireSide, a podcast from FS Investments. My name is Kara O' Halloran, and I'm a Director on the Investment Research team. Here it is, Thursday, July 28th. It is only a few hours after the GDP reading shows that the economy contracted in the second quarter, which marks the second consecutive negative GDP print.

[00:00:34] Kara O'Halloran:

So on today's episode, we are answering the question everyone's asking. Are we in a recession plus what we'll be closely watching in the third quarter, as we continue to assess the path of global economic growth and whether or not this recent data will change the Fed's hiking campaign. So to talk through all of this, I am excited to welcome the one and only Lara Rhame, our Chief U.S. Economist. Lara, thanks for joining.

[00:00:57] Lara Rhame:

Quite a list you had there, Kara.

[00:00:58] Kara O'Halloran:

I know we got a lot to cover, and I know it's a very, very busy day for you. You're a very popular lady. I appreciate you making the time for us.

[00:01:06] Lara Rhame:

Absolutely.

[00:01:07] Kara O'Halloran:

Alright, so let's get right into it. As I said, we got that negative, that second consecutive negative GDP print today. I have to ask the question just flat out. Are we in a recession?

[00:01:19] Lara Rhame:

Well, my answer is no, not yet, but to some degree, I almost don't know that it matters because the second quarter GDP report was really reflected in the economy. That's slowing down quickly. The Fed is raising rates aggressively and that was clear in the data. And when you break down that number, the headline fell 0.9%. We still had household consumption that was really up because consumers are aggressively spending on services, but durable goods purchases were down, that's gonna be your interest rate sensitive sectors. Business investment was weak.

Government spending fell. So the details really reflect Fed rate hikes having impact and the economy slowing.

[00:02:21] Kara O'Halloran:

I wanna dig into the details a little bit more. If we think back to the Q1 numbers, we saw, as you said, we saw we had strong consumption, then it was just offset by that net trade. And you said we had strong consumption in this report as well. But it doesn't seem like there was a ton of good news otherwise. So what do you find most worrisome?

[00:02:40] Lara Rhame:

I think, what is worrisome is this broad-based weakness. and here's where I wanna talk a little bit about the difference between the first quarter and the second quarter, because we did have negative growth in the headline GDP number in the first quarter as well. But there was broader strength in the economy in the first quarter. We, our trade deficit widened significantly. Remember all the way back to Q1, China was in lockdown.

[00:03:09] Kara O'Halloran:

Yeah.

[00:03:09] Lara Rhame:

So they really weren't not importing very much. So, I think what we just need to keep in mind is the fact that the Fed is trying to suppress demand. That's clearly working. There's probably more to come, but when we look at GDP, this is one measure of output. And when we really ask this larger question about recession. We're asking about the overall health of the economy and you have to, it's a \$24 trillion, it's a largest economy in the world.

[00:03:41] Lara Rhame:

It cannot be summarized in one number. We need to think about the labor market. We need to think about income. We need to think about wealth, industrial output. So, it's more than just this one output metric. And that's where, you're seeing signs, the labor market remains very strong. And for all of those reasons, we need to remember that it's... the question would imply a very simple answer. But in reality, usually our economy kind of stumbles in a lopsided way into recession. I think we may be stumbling there, but I'm not sure that we're there yet.

[00:04:22] Kara O'Halloran:

Yeah. So what are you real? let's laser focus on the third quarter.

[00:04:25] Lara Rhame:

Yeah.

[00:04:27] Kara O'Halloran:

What are you going to be laser focused on in terms of the data to kind of suss out whether or not we are or we have stumbled into that recession?

[00:04:35] Lara Rhame:

Yeah. The labor market still looks healthy. We added 1.6 million jobs. In the first quarter, we added 1.1 million jobs in the second quarter and job losses are a hallmark of recessions. Remember our economy wants to grow, so recessions are really a disruption. And really job losses are a sad, they're an unfortunate part of slowdowns. And, we've seen, I wrote in the quarterly that initial jobless claims, it's a small, weekly indicator that I watch regularly. To me, it's really the Canary in the coal mine. It's about 250,000. And again, this is a number. That tells us

how many people every week are going to the unemployment office and applying for unemployment insurance. So it reflects near term layoffs, near term job losses. And if that number starts to rise significantly, we know that, that tells us even faster than the labor than the monthly report does. if the jobs picture is deteriorating, so it's risen a little bit from truly historically low levels.

[00:05:45] Lara Rhame:

But if we get, if we rise much more from here, we're around 250 right now, if we get up to 300,000, I think you have to, at that point, check the box, that job losses are starting to become a real part of the economic landscape.

[00:06:01] Kara O'Halloran: All right. So I wanna pivot now to inflation still something that we are talking about ad nauseam. And we have talked a lot on this podcast. all of us have talked about inflation for the better part of a year and a half, but we've talked about a lot of the drivers of inflation on this podcast before. and spoiler alert, it's really coming from everywhere. I wanna kind of flip the script now, because we're still seeing those really persistently high inflation numbers. What has to go right to get those numbers down?

[00:06:31] Lara Rhame:

Yeah. it's funny that we ask that question, cuz that is exactly how I phrase it myself. because inflation right now, I ended, begin begins the third quarter at 9.1% year on year, highest since the early 1980s. And when I think about the fact that inflation for 25 years was at 2%. That's the Fed's goal to get it back there so much has to go right. To get it back to 2%. You need energy price deflation, which I do not expect given that Russia's, just still stomping their way across the Ukraine. you need durable goods price deflation, which given the zero COVID policy in China, production, disruption, supply chain, you name it.

[00:07:22] Lara Rhame:

I think it's still causing, a price premium for durable goods. And then finally rents have been a really the, I think the most troubling new innovation in inflation over the last two quarters and rents are now up 5% year on year. And ironically, the Fed's rate hikes are disincentivizing new home building, and that is going to make the problems in the housing market and the low supply in the housing market worse. So it's [00:08:00] actually going to continue to put, I think upward pressure on rents. And so I think, you have these multiple factors that need to return back, to either deflation or low inflation. And I don't think any of them are very likely and that's gonna be the problem. My year end inflation outlook for 2022 is 5%, but for 2023, it's still three and a half to 4%. And that is stubbornly high. It's high enough so that the fed is going to have trouble declaring victory.

[00:08:33] Kara O'Halloran:

And do you think that we're gonna get to a point, if we think about, I wanna talk about the fed near term in a second, but if we're taking kind of a longer-term view here and we're looking at whether it's next year, whether it's next quarter, I don't know. We'll get to this in a second. The Fed's probably going to have to pivot or pause their hiking.

[00:08:53] Lara Rhame:

Sure. But it doesn't sound like we're looking at inflation, that's gonna be anywhere near their target anytime soon. Do you think that we're gonna have to live with just higher inflation going forward or, what's your outlook there?

[00:09:04] Lara Rhame:

I think we're going to have to live with it for the next couple years, at least. And I don't think that we're going to have an easy stability at 2%, like we've had. I think there's going to be more volatility in the inflation numbers. So even if we will get periods where it could pull below 2%. I think it's just going to be more volatile. And that is something that we are just not used to as investors from the policy side. that is the volatility. That is what the volatility brings it's this broader uncertainty.

[00:09:36] Kara O'Halloran:

And what's causing so much of the volatility in financial market.

[00:09:39] Lara Rhame:

A hundred percent. Yeah.

[00:09:39] Kara O'Halloran:

Yeah. okay. So, like I said, let's go let's laser focus back on the third quarter again. So the fed hiked 75 basis points yesterday. So the fed funds rate is now two and a half percent upper bound... do you think today's GDP report changes your expectations for what they're gonna do in September?

[00:09:57] Lara Rhame:

I don't and I think that, markets are pretty focused on a 50, 50 basis point rate hike in September.

[00:10:05] Kara O'Halloran:

Oh 50%, that'd be something.

[00:10:06] Lara Rhame:

That would be something, for those at home that's 50 basis points. not 50%. so, taking us to, 2 75 to 3%. but beyond that, I think we become more data dependent and I think you know, the fed has this concept of a neutral fed funds rate and they peg that in a range of two to three. [00:10:30] We don't observe it. So it's their, estimated range of neutral. So when rates are below that think of, putting the gas, your foot on the gas in your car, and when rates are above it, think of stepping on the brake. Right. but neutral is kind of just coast. And they have made very clear all along that they wanna get us back to neutral as fast as possible.

[00:10:53] Lara Rhame:

And with yesterday's rate hike, they really did that. And September will still bring us to the top of that band, but that's [00:11:00] still, coasting for them. So I think this is where, right now the fed is expecting Powell yesterday pointed us to his dot plot of another rate hike. in December more rate hikes in 2023, and markets have swung the other way in the wake of today's data. I think that's the big thing that happened after today's data, right? The fed yesterday was continuing sort of to talk about rate hikes and the markets are saying, well we're maybe, yeah, we'll get September. maybe another 25 in the fourth quarter, but that's kind of it. And that's been, I think the big evolution after today.

[00:11:39] Kara O'Halloran:

Yeah.

[00:11:39] Lara Rhame:

That it's divergence between what the markets are expecting the fed to do and what the Fed wants to do.

[00:11:43] Kara O'Halloran:

Yeah. I mean, I think the fact that markets are rallying today, is it, it's the bad news is good news conundrum that we get in of, okay maybe the fed isn't gonna have to hike as much and that's good news for markets.

[00:11:54] Lara Rhame:

And I don't think that...

[00:11:55] Kara O'Halloran:

Bad news for the economy. Good news for markets.

[00:11:57] Lara Rhame:

And I don't think that markets. I think this is the market. forgetting that we're in an environment where inflation's at 9%

[00:12:04] Kara O'Halloran:

Because we haven't been in that environment in so long.

[00:12:07] Lara Rhame:

Yeah.

[00:12:08] Kara O'Halloran:

Okay. So we talk about the fed a lot, but the fed is not hiking in a vacuum. Right. So I wanna talk more about global central banks. we saw. The bank of Canada has hiked the bank of England, the ECB hiked for the first time in over a decade, the Swiss national bank we're seeing, so we're seeing hiking across the globe, but we're also still seeing accommodated policy in China and Japan. So after really a decade of coordinated monetary policy and really monetary easing, or accommodative policy, What is the impact in your view of this disjointed central bank, policy across the globe?

[00:12:45] Lara Rhame:

Yeah, well, the it's certainly, and I put a whole page about this in the quarterly, because to your point, we've, we're done with a decade and a half of coordination and the ECB hiking for the first time [00:13:00] in 11 years is a really big deal. And I, it reflects the fact that globally growth is challenged, that the us is not the only economy trying to deal with high inflation and that, it adds to both the, concerns about global growth. And it adds to volatility because you're just going to get, we've seen it in foreign exchange markets. We've seen it in commodity markets. That volatility is really, to me echoing around the financial market landscape. And that is because of these disparate global cycles. And I think that is really set to continue and just amplifies the challenges that investors are dealing with.

[00:13:44] Kara O'Halloran:

Yeah. And with this slowing global growth, we're seeing that reflected in the long end of the yield curve. the 10 years down to, I think maybe 265 basis points today, it peaked in this, in the last couple of months, its close to three and a half percent, which was a pretty, pretty high number [00:14:00] decade high, I think. but we're seeing that, we're seeing the global growth concerns expressed in the us yield curve.

[00:14:06] Lara Rhame:

Yes. I, this is something that to me is pivotal for investors to understand, because when we think about inflation at 9%, we like to say and remind people that it's the same, that it was in the early 1980s. But even if we have that economic memory, back in the early 1980s, the 10 Year treasury was at 13%. Today to your point, it's around two and three quarters, less than 3%. So we have no investment memory of this. We have no...

[00:14:46] Kara O'Halloran:

No precedence.

[00:14:47] Lara Rhame:

...yeah, we have no. and that, and I think that is what to me really is the best way to summarize the challenge. It's the challenge in the third quarter, and it's gonna be the challenge for the rest of the year.

[00:14:59] Kara O'Halloran:

Yeah. And I think it's a, another, a good time to remind everyone just how interest rates sensitive our financial markets are.

[00:15:07] Lara Rhame:

Yeah. We've talked about the challenges with core fixed income, and maybe things looked a little more attractive at three and a half percent yield, but you're right back down again. And duration and fixed income is obviously very high. You're exposed to volatility there, but even looking at equity evaluations this year, really a lot of the declines that we've seen we think are really this discount rate impact earnings have at least nominal earnings have remained pretty strong, but it really just is so rates go, so go the market or as rates go so go the market right now. and just the interest rate volatility is causing so much of that volatility that, that we've seen. And with so much uncertainty about global growth and inflation and all the things that we've talked about on this podcast. It's just, doesn't sound like it's going away anytime soon.

[00:15:51] Lara Rhame:

Yeah. I think the challenges to traditional assets are going to remain in place. On the equity side you've got the challenged [00:16:00] growth outlook on the fixed income side, you have enormous fed policy uncertainty and just continued, this downward pressure on long term rates. That hit income. And the whole thing is just being overshadowed by bad volatility.

[00:16:19] Kara O'Halloran:

Yeah.

[00:16:19] Lara Rhame:

It's gonna be challenging. It's gonna be interesting.

[00:16:22] Kara O'Halloran:

It has certainly been an interesting year so far. we can say that at least. all right, Lara, I think we can wrap it up there. thanks so much, as I said, I know you've so many people want some of your time today, so we really appreciate you spending a few minutes with us to walk us through all of that.

[00:16:37] Lara Rhame:

This was great.. Thank you.



[00:16:38] Kara O'Halloran:

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