First Trust
Monday Morning OUTLOOK

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Is the Recession Threat Dead?

Lately, it's been easy to see the optimism. As of the Friday close, the S&P 500 is up 15% so far this year (not including dividends) and up 23% (again, without dividends) versus the lowest bear-market close back in October.

Some investors attribute this to the Federal Reserve being very close to finished with the series of rate hikes that started back in March 2022. But that doesn't really make sense. If investors thought the Fed were finished (or nearly finished) because it had tightened monetary policy enough to induce a recession sometime soon then we don't think stocks would be going up like they have of late.

Instead, what makes more sense is that stock market investors think the Fed is nearly done *and* will not induce a recession, that it has somehow positioned monetary policy to be tight enough to bring inflation back down to its 2.0% target but not so tight that we have a recession.

We hope they're right about this; wouldn't it be great! Unfortunately, we still have strong doubts and think the US is headed for a recession. If monetary policy is tight enough to fix inflation, it's going to hurt economic output, as well.

Yes, CPI inflation has slowed down substantially in the past year. The consumer price index is up 4.0% versus May 2022 while it was up 8.6% in the previous year. But this slowdown is largely due to volatile categories like food and energy. "Core" CPI inflation, which excludes food and energy, has barely slowed, to 5.3% from 6.0% a year ago. So-called "Super Core" CPI inflation – which excludes food, energy, other goods, and rents – has slowed to 4.6% from 5.2%.

Other measures of CPI inflation calculated by the Cleveland and Atlanta Federal Reserve Banks, which are designed to measure the underlying pace of inflation, also suggest no major decline. In other words, we think recent optimism about inflation is overdone.

Which is not to say that the Fed itself hasn't sent mixed signals. The Fed decided to skip raising rates last week for the first time since early 2022, even though most Fed policymakers thought the Fed would raise rates by a (cumulative) half a percentage point later this year.

The general policy by the Fed of signaling multiple future rate increases while skipping a rate hike last week makes no sense to us. Instead, the Fed would be better off if, at each meeting, it moved the short-term interest rate target to a level where Fed policymakers were evenly split about the next move being a rate hike or a rate cut. Coaches tell young hockey players to skate to where the puck is going, not where it is right now. The Fed is doing the opposite.

Regardless, the Fed remains far from declaring victory over inflation. PCE prices – the Fed's favorite measure of inflation – rose 4.4% in the year ending in April; core PCE prices rose 4.7%. These figures are roughly 2.5 percentage points above the Fed's official target of 2.0%.

To put this in perspective, let's guess that the Fed would like to see PCE inflation at or near 2.0% within eighteen months (which would be late 2024). Looking back at the past sixty years, the only time the PCE inflation rate has dropped that much has been during or right after recessions. Maybe this time is different, but we remain skeptical.

This is true whether you think the Fed has already done enough to eventually wrestle inflation back down to 2.0%. We have consistently followed the M2 measure of money the last few years, which did the best job of warning us about inflation. That measure surged in 2020-21 but has dropped in the past year. If that drop continues, then it will eventually absorb enough of the prior excess surge in M2 to bring inflation down to the Fed's target (and maybe lower!). But that drop in M2 should also eventually throw us into recession, as well.

If you prefer to measure monetary policy by using short-term rates, and do not think they're high enough yet to bring inflation down to 2.0%, then you should also believe rates may go significantly higher from here. And yet markets are currently pricing-in a much more benign story for the months ahead.

The effects of monetary policy are long and variable, as Milton Friedman said many years ago. Right now, some investors may be drawing conclusions about its future path and effects way too early.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-20 / 7:30 am	Housing Starts – May	1.400 Mil	**1.400 Mil**	1.631 Mil	1.401 Mil
6-22 / 7:30 am	Initial Claims – Jun 17	260K	**255K**		262K
9:00 am	Existing Home Sales – May	4.250 Mil	**4.260 Mil**		4.280 Mil