TD Global Investment Solutions

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Dude, Where's My Recession?

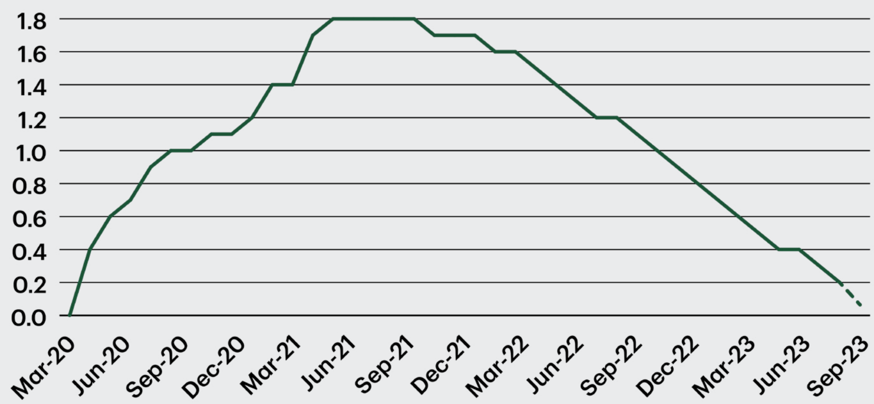
Since August of 2022 the Bloomberg consensus has placed a probability of 50% or more on a U.S. recession occurring within the next 12 months. However, despite 525 bps of tightening and a still hawkish Fed, a soft landing appears increasingly likely. How can we make sense of the economy's surprising strength?

We believe there are three reasons why U.S. activity has held up better than expected: the lingering impact of the aggressive COVID stimulus packages, the renaissance of industrial policy (which has led to a manufacturing construction boom), and the still accommodative stance of broader financial conditions.

COVID stimulus drove excess savings

The U.S. response to the COVID recession was fast and furious. As a result, personal income and savings immediately soared **(Figure 1)**. While this stimulus provided a tremendous impulse for consumption over the last three years, it has by now been entirely spent.

FIGURE 1 – Cumulative excess real savings (USD tn): Peaked at $1.8 tn in mid-2021.
Drawing down this enormous stockpile provided a huge tailwind for consumption through mid-2023.



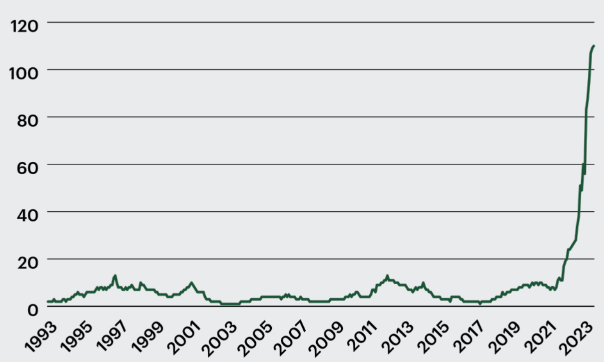
Source: Bloomberg Finance L.P., TD Epoch calculations

Industrial policy renaissance: booming manufacturing construction

The second reason is that industrial policy has returned, after a 50+ year hiatus, with the August 2022 passage of both the $280 bn "Chips and Science Act" and the $400 bn "Inflation Reduction Act" (the latter is horrendously misnamed as it primarily incentivizes green tech investment). One direct beneficiary is manufacturing construction, which is up 101% yoy, with the electronics sector especially strong **(Figure 2)**. Moreover, industrial policy spending is likely to remain robust through 2032, as these expenditures have been approved by Congress.

FIGURE 2 – Manufacturing construction: electronics (USD bn, SAAR).

Spending on facilities for manufacturing electronics has soared from $7 bn two years ago to $110 bn today.



Source: U.S. Census Bureau

SAAR: Seasonally-adjusted annual rate

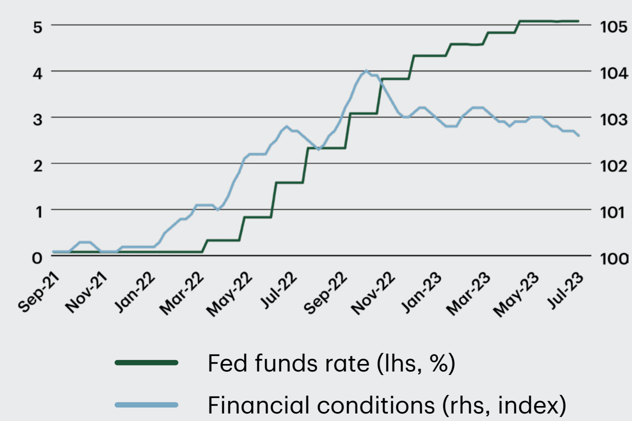
Overall fiscal spending, for which industrial policy is a component, has provided significant oomph for the economy in 2023, contributing roughly 3 ppts of GDP. This has offset much of the Fed's efforts over the last eighteen months, but fiscal expenditures are set to tighten over the next two years. To illustrate, consensus expects government spending growth to slow from 3% this year to 1% in 2024 and 2025.[1] This implies a significantly negative fiscal impulse coming down the pipeline.

Overall financial conditions vs the Fed Funds Rate (FFR)

Third, while the FFR has skyrocketed, the same can't be said of broader financial conditions, which are unchanged compared to July of 2022 **(Figure 3)**. To illustrate, the 10Y yield is a bit lower than it was last October and the high yield spread is narrower than its level of a year ago **(Figure 4)**.

FIGURE 3 – The FFR kept climbing higher but overall, but financial conditions peaked last October.

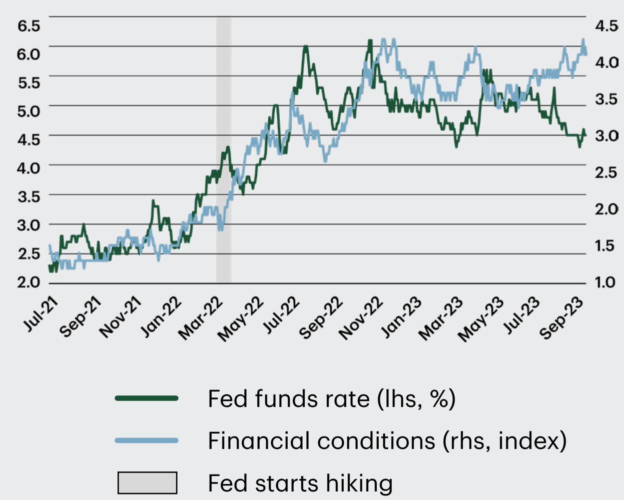
This has been a key driver of the economy's resilience.



Source: Bloomberg Finance L.P., Goldman Sachs Financial Conditions Index

FIGURE 4 – In theory a higher FFR leads to tighter financial conditions for U.S. consumers and businesses. However, this hasn't proceeded according to the Fed's playbook.

Even mortgage rates are flat over the last 9 months, which helps explain housing's relative strength this year.



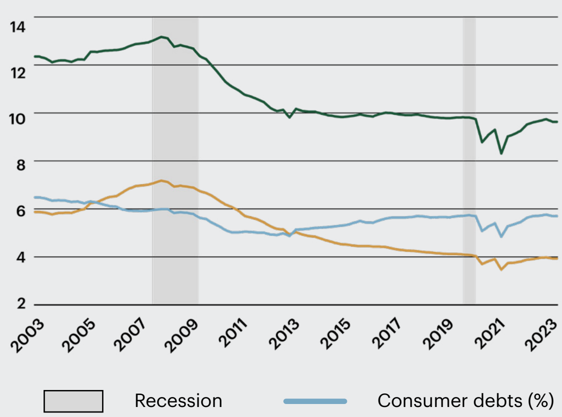
Source: Bloomberg Finance L.P., Goldman Sachs Financial Conditions Index

[1] This reflects the June 3 "Fiscal Responsibility Act", part of the debt limit deal, which sets a cap on federal discretionary spending for 2024 and 2025.

The relatively accommodative stance of overall financial conditions helps explain the resilience of both the consumer and corporates. To illustrate, the U.S. household debt service ratio is only 9.6% of income **(Figure 5)**. This ratio is not only below the 1980-2019 average of 11.2%, but beneath the lowest rate hit during that period (9.8%).

FIGURE 5 – Despite aggressive Fed tightening, U.S. consumers are spending comparably little on debt servicing.

Household debt service payments as a % of disposable income.



Source: Bloomberg Finance L.P.

The situation is even more extreme for U.S. businesses **(Figure 6)**. Moreover, corporate refinancing needs over the next two years are historically low, reflecting their issuance of so many bonds in 2020 and 2021 when rates were rock bottom. In fact, only 16% of corporate debt is slated to mature over the next two years.[2]

The relatively light interest burden facing consumers and businesses helps explain the surprising strength of the U.S. economy. However, the bad news is this means the Fed needs to maintain a hawkish stance until financial conditions tighten enough to tame hiring, services consumption, and wage growth.

Three scenarios for the next 12 months

With wage growth still over 5% and core inflation north of 4% we expect the Fed to retain a tightening bias for at least the next two quarters. While so much tightening, over such a short period, would normally have ensured a recession, nothing about this cycle has been normal. Moreover, forecasting nonlinear events like recessions is a mug's game. That is why we advocate humility and have adopted a scenario-based framework.

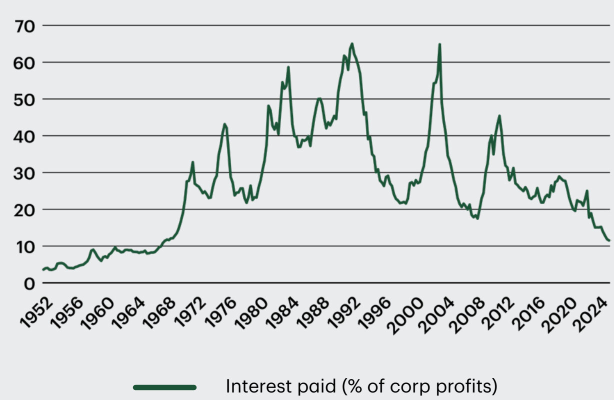
Investors always price in a soft landing (and occasionally they're correct)

Our first scenario calls for a soft landing (50% probability), similar to the experiences in 1984 and 1995. This scenario appears to be the current market consensus, which is not unusual as investors always expect a soft landing when the Fed is nearly done tightening. A soft landing implies sub-trend but positive GDP growth, inflation stuck at 3%, a hawkish pause from the Fed, and EPS growing by mid-single digits. This scenario also suggests a choppy SPX, with "fat and flat" (i.e., choppy but directionless) equity returns. Previous soft landings were terrific for equities, but this time valuations are already quite stretched, which we believe puts a cap on further upside.

The second outcome involves a "short and shallow" recession (40% likely), with slightly negative GDP growth, inflation decelerating below 3%, Fed cuts of 200-300 bps, and EPS declining by 5%-10% (but recovering quickly, within a couple quarters). For equity markets, this could be similar to the 1990 recession in which the SPX declined sharply for two months but then experienced an impressive V-shaped recovery.

FIGURE 6 – Corporate interest payments are at a 50-year low.

Net interest payments, as a % of profits, for U.S. nonfinancial corporate businesses.



urce: Bloomberg Finance L.P.

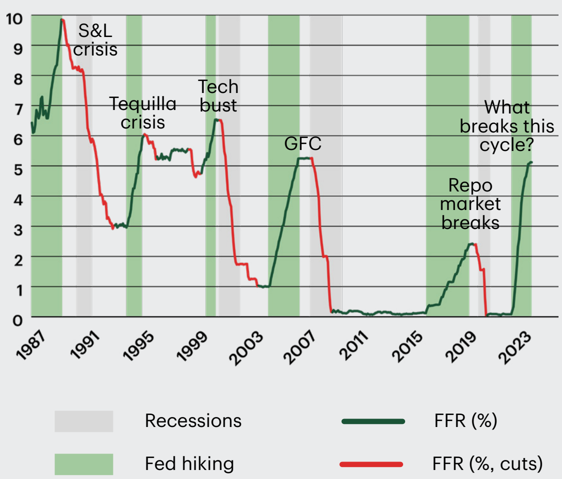
[2] Still, refinanced corporate debt will pay, on average, an additional 1.5 – 2.0 ppts above existing rates. This will boost interest expense by around 2% in 2024 and 5% in 2025, and likely have a marginally negative impact on capex, hiring, and so on.

When the Fed hits the brakes, someone almost always goes through the windshield

The third scenario is a hard landing (10% chance), in which something breaks, creating a credit event that cascades across financial linkages, and results in a freezing of funding markets. This is what happened on a massive scale in 2000-2002 and 2007-2009, although this time the imbalances are much less extreme **(Figure 7)**.[3]

FIGURE 7 – The Fed often hikes until something breaks: This, not declining inflation, is what typically drives Fed cuts.

Household debt service payments as a % of disposable income.



Source: Bloomberg Finance L.P.

In a hard landing GDP growth would be negative for an extended period of time, and EPS would slump by well over 15%. In such an outcome the Fed would be focused on financial stability rather than inflation and would quickly slash rates (by over 300 bps). Equity markets could plummet by 15%-30%, with a relatively slow L-shaped recovery.

While it is extremely difficult to know which of the three scenarios is unfolding, we believe there are four key recession indicators to watch like a hawk: (1) The Fed's Senior Loan Officer Survey, which is already close to recessionary levels and implies much weaker consumer and C&I lending, as well as dramatically wider HY spreads and significantly negative capex growth. (2) The NPL exposure of small banks, which account for 68% of CRE loans (but only 38% of overall lending). (3) Default rates on HY and leveraged loans which have inched up to 2019 levels but aren't yet anywhere near levels consistent with a recession. And (4) Consumer delinquencies, as they are creeping higher, especially for auto loans and credit cards.

Investment implications

The U.S. economy has been much more resilient this year than consensus had expected. However, most of the reasons for this surprising strength are fading. Moreover, the economy's durability has forced the Fed to maintain a hawkish stance, to ensure inflationary pressures don't reassert themselves.

It is also critical to keep in mind that monetary policy works with a lag that is famously long and variable. The Fed just started hiking 17 months ago and in previous cycles it has taken considerably longer (typically 21 to 42 months) for the tightening to bite. This suggests the possibility that the current cycle might not be that different, it's just that the FFR is a crude tool and takes a long time to produce its desired effect.

We believe a short and shallow recession is 40% likely and assign a 10% probability to a hard landing. However, it is impossible to have high conviction regarding the timing and depth of an eventual downturn. Rather, we prefer the above scenario-based approach which favors a cautious stance, focused on quality companies with a demonstrated ability to return capital to shareholders and/or to produce a return on invested capital in excess of their cost of capital.

[3] The key vulnerabilities this cycle are in private markets, commercial real estate, and smaller banks. On the other hand, the household and nonfinancial corporate sectors are in much better shape.

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