THE RECESSION NARRATIVE

Since the start of the year, media increasingly use the word recession and, over the same period, there was a significant increase in Treasury yields. The common driver behind these developments is, to a large degree probably, the more hawkish tone from the Federal Reserve. Unease about recession risk shows up in the latest quarterly Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia. Recession probabilities across the projection horizon have moved higher and they are now well above what we have seen in the past at this stage of the tightening cycle. Exceptionally high inflation requires aggressive rate hikes to bring it back under control. This implies a difficult balancing act for the Federal Reserve and explains the heightened concerns about recession risk.

The narrative that the US may enter recession is gaining ground. Since the start of the year, more and more Bloomberg articles mention the word recession (chart 1). Interestingly, over the same period, there was a significant increase in Treasury yields.

The common driver behind these developments is, to a large degree probably, the more hawkish tone from the Federal Reserve. Not only has it started a rate hike cycle, but it has also provided clear guidance of delivering several 50 basis points hikes during this year. Unsurprisingly, this has pushed bond yields higher, but it has also raised concern about recession risk.

This also shows up in the latest quarterly Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia. One of the survey questions concerns the probability of negative quarter-over-quarter growth in the current and the following four quarters[1]. Charts 2 to 6 show the evolution of these probabilities in the early stages of each rate hike cycle since 1994[2].

In general, the probability of a recession increases as the projection horizon lengthens and as the tightening cycle progresses: the risk of a recession in the near-term is higher when rates have already been increased more than once. Against this background, the recent developments are striking.Recession probabilities across the projection horizon have moved higher and for the latest observation, which concerns the survey released in May, they are well above what we have seen in the past at this stage of the tightening cycle[3].

This probably reflects a combination of two things. The first is the narrative that 'soft landings' are hard to achieve: in recent decades, tightening cycles have most of the time been followed by a recession.4 This doesn't mean that higher official interest rates were the only cause of the contraction of activity, but they certainly did play a role.

1. In charts 2-6 these are respectively referred to as RECESS1 and RECESS2 to RECESS5.
2. The charts do not show the complete cycle because the purpose of this text is to compare the current cycle in its early stage with previous experiences.
3. The 1999 cycle had high recession probabilities at certain horizons whereas at the current juncture, the entire probability curve is at a high level.
4. The 1994-95 cycle is the successful exception.

The second is that at the current juncture, inflation is exceptionally high, which would require more aggressive rate hikes to bring it back under control. This makes the balancing act of the Federal Reserve even more difficult than normally is the case and explains the heightened concerns about recession risk.

William De Vijlder

RECESSION STORY COUNT AND 10 YEAR US TREASURY YIELD

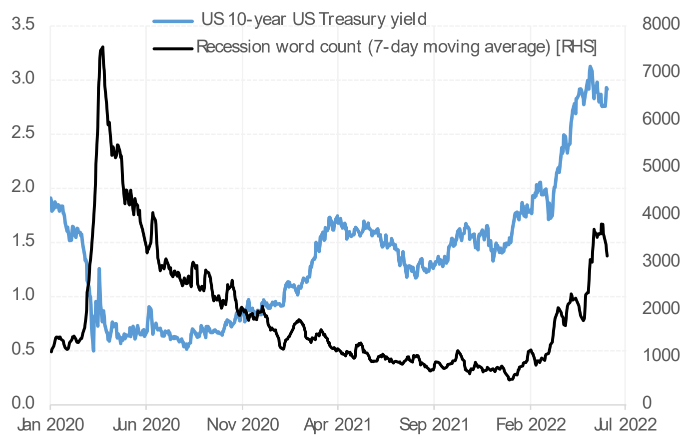
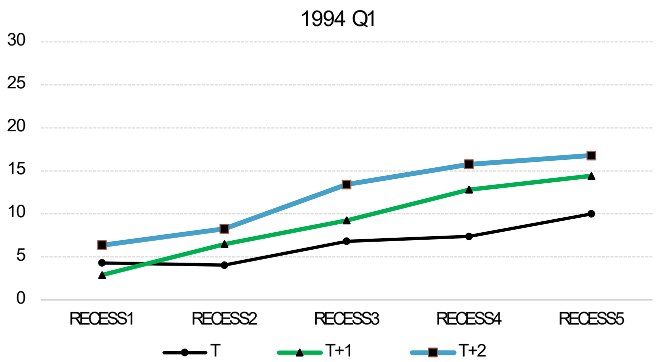


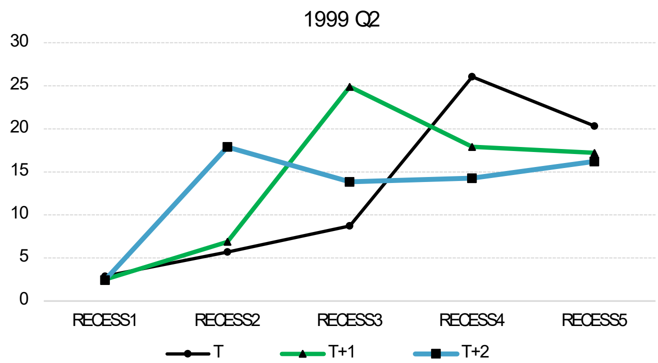
CHART 1

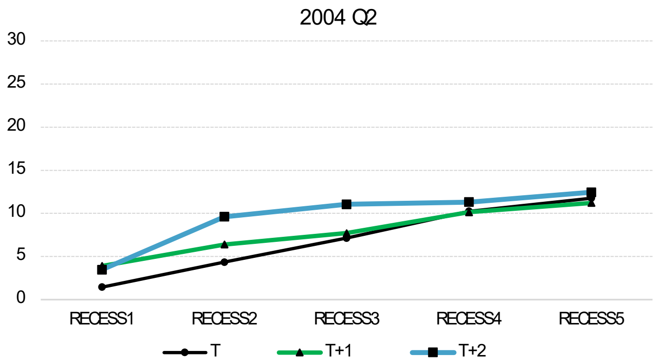
SOURCE: BLOOMBERG, BNP PARIBAS

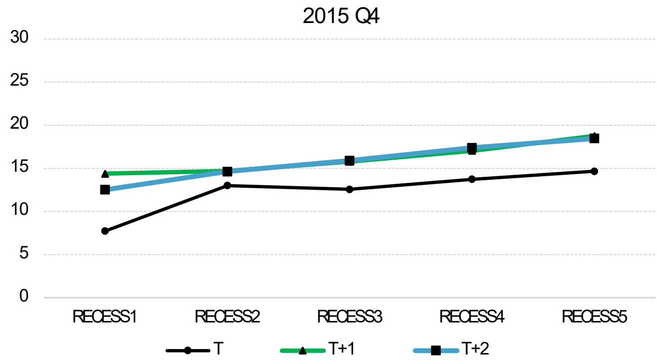
At the current juncture, inflation is exceptionally high, which requires more aggressive rate hikes to bring it back under control. This makes the balancing act of the Federal Reserve even more difficult than normally is the case and explains the heightened concerns about recession risk.

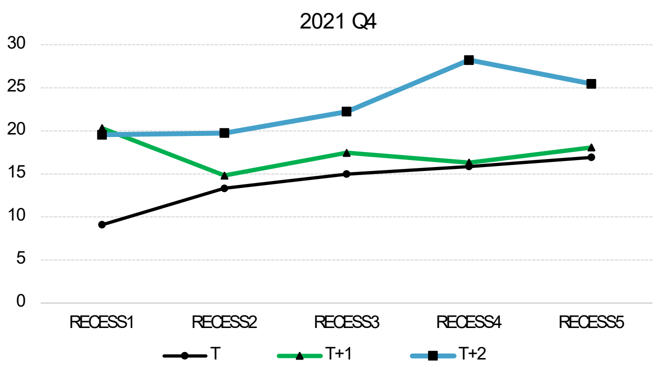
US RECESSION PROBABILITY*











*The quarter mentioned at the top of each chart corresponds to the start of a rate hike cycle by the Federal Reserve. The lines refer to the recession probabilities from the surveys during the quarter of the first rate hike (T) and the following two quarters (T+1, T+2). RECESS1 shows the probability of entering recession in the current quarter and RECESS2 does the same for a recession in the next quarter. For the current rate cycle, 2021 Q4 was chosen as starting point for the chart although the first rate hike occurred in 2022 Q1. This allows to show the big increase in the recession probability in the survey conducted during 2022 Q1.

CHARTS 2-6

SOURCE: FEDERAL RESERVE BANK OF PHILADELPHIA, SURVEY OF PROFESSIONAL FORECASTERS, BNP PARIBAS