Economics

Let’s Not Stress About the Next U.S. Recession

It’s probably not imminent, and won’t be severe.

By Bill Dudley
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It won’t be that bad. *Photographer: Dorothea Lange/Hulton Archive/Getty Images*

With recession anxieties climbing, people are increasingly worried about the Federal Reserve’s capacity to respond. I take issue with the premise: I don’t expect a recession this year, and when one does come I think it will be mild enough for the Fed to handle.

Three factors seems to be driving recession fears. First, recent data -- such as weak job growth and soft retail sales -- have shown the U.S. economy losing some momentum. Second, the Treasury yield curve recently partially inverted, that is some long-term bond yields fell below short-term yields. This is noteworthy because yield curve inversions have historically foreshadowed recessions in the U.S. Third, the current economic expansion is getting very long in the tooth -- in a few months it will be the longest in U.S. history.

Nonetheless, I'd argue that the risk of recession remains low. For one, some areas of concern are becoming less relevant. Financial conditions have rebounded as the stock market has recovered from its December rout. China is aggressively stimulating its economy again. And from my vantage point, the U.S. and China seem likely to reach a trade deal soon. This would help dispel uncertainty that has been causing businesses to defer investment.

Beyond that, worries about a yield curve inversion are misplaced. These anxieties would be more compelling if the Fed were causing the inversion by making monetary policy tight. That's not happening, as easy U.S. financial conditions demonstrate. The yield curve is flat because investors are more worried about economic weakness and deflation than about an unexpected increase in inflation. Bonds are viewed as a good hedge for stocks should the economy slip into recession.

I also take solace that the most important part of the U.S. economy -- the household sector -- is in very good shape. Incomes have been accelerating, boosted by job and wage gains. Household finances are relatively strong: Debt levels have grown slowly during this expansion, and debt payments take up the smallest share of income in many decades.

Finally, government spending is rising, thanks to last year's increase in federal discretionary budgetary caps. This boosts demand and stimulates economic activity.

All that said, I don't think recession fears will fade quickly. For one, economic growth is likely to be very slow in the first quarter, held down by the government shutdown, trade uncertainty, delayed tax refunds and perhaps some technical issues involving seasonal adjustment. And, there are still a few areas of uncertainty:

- Trade tensions with China could escalate and tariffs could increase;
- Inflation could accelerate more than expected, pushing the Fed to raise interest rates further;
- Congress could fail to extend the increase in the discretionary spending caps, forcing the government to cut expenditures.

Also, there is one area of vulnerability that could exacerbate any downturn: corporate debt. During this expansion, companies have levered up, borrowing money to buy back shares and deliberately allowing their credit ratings to decline. As a result, there has been a huge increase in the amount of debt rated “BBB,” a significant portion of which could drop into junk territory when the next recession hits. A big increase in the amount of junk bonds could cause indigestion as this market is small relative to the size of the investment-grade debt market. This could lead to a credit crunch that would exacerbate these companies’ troubles.

Also, the Tax Cuts and Jobs Act made the U.S. economy more vulnerable in two important ways. First, companies that lose money in a downturn can no longer get refunds against their prior years’ tax payments. Second, the legislation imposes limits on the deductibility of interest. As earnings fall, such constraints become more binding.

Despite these issues, I don’t expect the next recession, whenever it does come, to be anywhere near as harsh as the last one. Downturns associated with financial crises tend to be particularly painful, and I believe the U.S. has done enough to prevent a repeat of the 2008 disaster. Hence, the country is more likely to experience a garden-variety slump, which the Fed should be capable of handling. Even if the central bank has less scope for rate cuts should the federal funds rate peak at 3 percent or less, it has plenty of other tools -- such as forward guidance and quantitative easing -- to stimulate the economy should that become necessary. And, the rise in the nation’s indebtedness does not rule out the use of fiscal policy stimulus.

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