Goldman Sachs Exchanges

Why recession fears are likely overblown

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Allison Nathan: Global markets are selling off significantly as U. S. recession fears come to the fore. Is this an overreaction or have we reached an economic turning point? I'm Allison Nathan and this is Goldman Sachs Exchanges.

Today I'm speaking again with David Mericle, Chief U. S. Economist for Goldman Sachs Research, about the outlook for the US economy, the risk of recession and the Fed's path from here.

David, welcome back to the program.

David Mericle: Thanks Allison.

Allison Nathan: Let's start with Friday's jobs report because it obviously came in well below expectations, and it's really seemed to spook investors in the last couple of days. So what do you make of the and is this investor reaction overdone?

David Mericle: I think it was a weak report, but I do think that some of the fears were overdone. It was a weak report in the sense that job growth in both the establishment survey and the household survey was soft, too soft, I think, to keep up with labor supply growth. And the unemployment rate also rose two tenths.

Now, for a couple of reasons though, I would not take the July report at face value is kind of a new statement of where we are. There were some signs that job growth was depressed by some temporary factors. The Bureau of Labor Statistics said that the Hurricane Beryl was not an issue for the data. But there was a big increase in the number of people not at work because of weather. And we also saw a very large increase in temporary layoffs. So whatever it was, something temporary seems to have weighed a little bit on job growth. This simpler point. is that absent some big negative economic shock occurring very abruptly, you probably never want to infer too much from just one month's data, and if you look at the recent trend, my take would be that we seem to be creating about 150,000 jobs a month. Now that is roughly where we think trend growth of labor supply is going to be going forward because immigration, which peaked in 2023, seems to be slowing in 2024. So I'd say the place that we're at right now on job growth looks fine. It's just that over the last year, job growth has been trending lower, and we wouldn't want it to keep trending any lower.

Similarly, on the unemployment rate, I wouldn't take the increase entirely at face value. Seventy percent of job

growth of the increase in the number of people unemployed in July came from temporary layoffs, and there are a number of reasons that I'm a little bit less worried about the roughly six-tenths increase in the three month rate of unemployment than you might have been historically.

One of those is we're not really seeing permanent layoffs, and if you look across initial jobless claims, war notices. That's something that really holds up. In fact, the rate of permanent layoffs isn't just low, it's still about the lowest it's ever been in history. The importance of that is it reduces the risk of layoffs spiraling, of getting the sort of vicious circle of income loss leading to reduced spending, leading to more layoffs, that would really threaten to move very quickly, perhaps more quickly than policy makers could handle. We're just not seeing that.

The other reason that I worry a little bit less about the increase in the unemployment rate is that at least some of it seems to reflect temporary frictions in the labor market, most obviously just job finding challenges for recent immigrants themselves who unsurprisingly tend to be unemployed at a higher rate and their share in the population has really increased.

We think that's about 30 percent of the increase in the unemployment rate from the cycle low. And that's not necessarily indicative of labor demand being too low. So it was a soft report. I don't think where we are right now is necessarily problematic. But job growth has been trending lower. Slack has been trending up. , and until those two trends kind of stop and until we see things stabilize, there are some softer spots that are worth keeping an eye on.

Allison Nathan: And as you said, you should never make too much of any one report or data point. So how does this report jibe with other economic data we've seen recently?

David Mericle: So in Q2, the economy grew, we think about two and a half percent. In Q3, we're tracking at about the same place. And I think this is an important point that at some level, you know, It would be odd and surprising if labor demand were to drop off abruptly because overall economic activity continues to grow at a healthy pace. And if final demand for goods and services is still growing at a good pace, then you should need to add workers, not reduce the number of workers.

So broadly, I think that's right. Now, there are a couple of softer spots in the activity data as well that I think investors have been focused on. In particular, last week, we got a softer ISM manufacturing report that seemed to trigger market expectations for bigger rate cuts and maybe start off some of this concern that we've seen over the last week. I would just say, you know, if you're going to look at that, bear in mind that the survey data have now been misleadingly weak for a couple of years. And I think we have a better understanding of why that is now. People are frustrated with high inflation and sometimes that frustration comes across as pessimism in surveys.

Companies repeat back the recession gloom that they get from the press and that they hear in financial markets, and we've also speculated that after two years where we've just had very high economic volatility, big economic swings,

now that we seem to be moving back to normal trend growth a lot of companies report that in the surveys as kind of roughly unchanged activity.

So, there's clearly been a bias there for a couple of years. That's not new. I wouldn't take the survey data entirely at face value. And I would say that the hard data continue to show that the economy is growing at a good pace. Not as fast as in 2023. But in 2023, the rate of GDP growth at about 3 percent of job growth at 250,000 a month, those are just not sustainable numbers. Those were numbers that were propped up by the peak of the immigration boom. So it's important to distinguish between decelerating to a still healthy rate of growth, and actually seeing the data weaken more substantially.

Allison Nathan: I also want to ask you specifically about the data on the consumer because you and I just had a conversation on this podcast about the consumer. And there seems to be a perception that the bottom up message from companies during this earning season has painted a pretty grim picture about the US consumer, but you were pretty optimistic on the consumer. So what do you make of this grim picture? And does that bolster the case that we could be falling into a recession?

David Mericle: I think that's the other source of some of these market fears. Some of it is the weaker survey data. Some of it is the sense that bottom up messages from companies during earnings season are giving us an early warning sign that we're not yet seeing in the aggregate data

that consumer spending is dropping off. I would be quite skeptical of that interpretation for two reasons. First, I just don't think it's right that the overall message from earnings season is really that negative. You know, we have hundreds of data points, of course, you can always pick out some of the more negative or the more positive ones.

But if you look in a more neutral way at the aggregate message on company revenues on earnings season surprises, actually, the message is deceleration to be sure, but it's still healthy growth rate. Earnings surprises also in aggregate remain positive, so I think that the take that you often hear in markets is overweighting some of the more negative company anecdotes.

The other point that I would make on this is there is a lot that can go wrong if in translating from company level anecdotes to broader macroeconomic trends. A lot of companies report year on year growth rates. When those year on year growth rates change, that could be because something changed last quarter, but could also be because something changed a year ago.

It's also, of course, the problem that a company is not going to be representative of an industry or an industry of the economy. And I think that is an especially important thing to keep in mind at the moment because over the last year we've had the tail end of this goods back to services transition. So a lot of these negative anecdotes come from companies that sell goods, but of course you have to keep in mind that the flip side of weakness in the goods sector has been strength in the services sector.

A lot of these negative anecdotes also come from companies that raise prices disproportionately. But, you know, you're supposed to take a hit on volumes if you raise prices more than competitors. And so there, too, I think some of the weakness might just be the flip side of strength at other companies. There are other things that can go wrong as well. For example, I worry at the moment that when companies report softness in global sales, we might be conflating weakness abroad with weakness in the US. And there are just inevitably biases in these sorts of things where sometimes there might be a temptation, if your company's revenues are weaker to attribute that to weakness in the consumer broadly, rather than to kind of company level performance. Or there might be a temptation with hundreds of company level anecdotes available to you, pick out the ones that match, you know, popular narratives at the moment, like the recession narrative.

Allison Nathan: Well, let's dig a little bit more into that recession narrative and the odds that you're placing on a recession because you did adjust for 12 month recession odds from 15 percent to 25 percent in the last couple of days. So talk us through how you got to that 25 percent and give us some context. I mean, that's still pretty low from my opinion, but people really do seem to be quite concerned at the moment. So talk us through that.

David Mericle: Yeah, that's right. So I think there are two questions here. First question is why did we nudge up our recession odds a bit? And the second question is why are

we more optimistic than other people? Why do we have lower recession odds than consensus and probably lower recession odds than the average investor out there?

On the first question, you 12 months has been 15%. yeah. Yeah. Fifteen percent was well below consensus. It was roughly the historical unconditional average. So if you're just in a kind of typical uneventful period where nothing at all seems to be going wrong, nothing particularly remarkable is raising recession concerns, 15% is about where you would be. We raised that a little bit because of those trends that I talked about earlier, job growth has been trending lower and is now at the point where further declines would look like a problem to us. Slack has been trending up. It's no longer, uh, you know, a tiny increase in the unemployment rate. It's now six tenths on a three month basis. Again, I'm less concerned about those things, but we felt that having a recession probability just at the historical unconditional average was a little bit too low, that the risks are maybe a little bit higher than that.

Now, the second question, why is our 12-month recession probability below consensus? Why are we more optimistic than perhaps investors are? If you kind of look at the conversation in markets or recent market pricing. One issue is just, you know, I don't think there's any negative shock at the moment, and it's rare that the economy just rolls over spontaneously.

If you look back at kind of past deteriorations usually there was something identifiable going wrong. I don't see anything like that. I think we're decelerating for sure, but

the data would seem to suggest that we're growing at potential.

The other point that I would make is even if our reading of the labor market situation is a little bit off, even if labor demand has weakened a little bit too much, bear in mind that the Fed now has 525 basis points of room to cut. And with the inflation problem in my judgment, and I suspect in the Fed leadership's judgment, essentially solved at this point, there's really no reason to hold back. So if it does turn out that incoming data over the course of the next month or two look weaker than expect, they are, as Chair Powell said, very well positioned to support the economy by cutting interest rates.

So I don't see the overall economic data is particularly weak. I don't see any major financial imbalances, that I think are likely to unravel, and the Fed has a lot of room to cut. And those are the three key reasons that our recession odds are still lower than most peoples.

Allison Nathan: And how willing do you think the Fed would be to pull out all the stops, you know, jump in pretty dramatically if the economy looks like it's faltering more than we expect?

David Mericle: Yeah, I don't think they would hesitate at all. We did accelerate the rate cuts in our forecast to consecutive rather than quarterly cuts in September, November, December. Investors are already thinking the Fed might cut by 50 basis points in September, instead of

25. I think that's not unreasonable to be thinking about. That's a possibility. We're thinking 25 on the thought that the July employment report will turn out to be a bit of an outlier, that the August employment report will rebound, that job growth will be closer to the 150 neighborhood than the 110 neighborhood. But if I'm wrong about that, if there are further signs of weakness, or if the market selloff goes too far and Fed officials start to worry that it might be at risk of kind of creating its own reality, that the tightening in financial conditions, risks, hurting consumer spending or hurting economic activity, then I don't think they would hesitate at all to respond more forcefully.

Allison Nathan: And there seems to be some discussion about the Fed actually doing an emergency cut before the September meeting. How unusual would that be? And what would you need to see, you think, for them to do that?

David Mericle: Yeah, that's been a common question over the course of the last few days since the Friday report. Yeah. I think where that question is coming from is in retrospect, it looks like the decision not to cut in July, maybe they were a little bit too worried about inflation for a little bit too long. And so the thought is, well, if there's some regret, if things seem to be weakening too much, might they go ahead and do a meeting with off of the usual calendar in between meetings. Historically, if you look at past intermeeting cuts, this is actually also true of larger than 25 basis point cuts, usually there's some sort of immediate crisis you're dealing with, some sort of obvious

negative shock that makes it more obvious that you want to respond pretty forcefully off of the usual calendar schedule. So I don't think we're there yet. By the September date maybe we could see a larger cut if the data suggests that's necessary. But there too, what we've seen so far is less than you've seen, when they've made larger cuts in the past. Usually, in particular, the jobless claims numbers suggest that layoffs have really picked up, in a way that makes it clear that there's a problem that you want to, fight aggressively, that you want to deliver larger cuts to kind of push back against.

Allison Nathan: So it seems like you're saying recession fears have become a bit overblown, at least given what we know today.

David Mericle: I think that's right. I think there are certainly things to keep an eye on. The jobs numbers do need to stabilize here. We wouldn't want the unemployment rate to rise any further. There has been an upward trend now since last year. So, yeah, there are certainly legitimate things to keep an eye on. But, I suspect what we are seeing is more deceleration than an actual dip into recession. And at some level that was inevitable because 2023 was a pretty exceptional year.

Allison Nathan: Thanks so much for helping us sort through some of this, David, It's always so useful.

David Mericle: Thanks a lot, Allison.

Allison Nathan: This episode of Goldman Sachs exchanges was recorded on Monday, August 5th, 2024. I'm your host, Allison Nathan. And if you want to hear more from Goldman Sachs, listen to The Markets. Every Friday, we break down what's going on in the markets and what could come next. Check it out on your podcast platform of choice. Thanks for listening.

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