Will Fed policy trigger a US recession?
Goldman Sachs Exchanges
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Bill Dudley, former Federal Reserve Bank of New York President,
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Allison Nathan: Is the Fed behind the curve? And could that set the stage for a US recession ahead?

Claudia Sahm: If there is a recession in the next year or so, it is a huge unforced policy error, right? And I'm much more concerned about that now than I have been in the past.

Allison Nathan: I'm Allison Nathan and this is Goldman Sachs Exchanges.

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Allison Nathan: Every month I speak with investors, policymakers, and academics about the most pressing

market moving issues for our Top of Mind report from Goldman Sachs Research. This month, I'm taking a closer look at Fed policy and the US economy outlook. The most recent jobs report was much weaker than expected. In fact, it triggered the Sahm rule, which states that when the unemployment rate's three-month average rises half a percentage point or more above the last 12 months low, the US is already in a recession.

If that's the case, as it has been in every US recession since 1970, or if a recession materializes down the road, some pretty sharp questions will be asked about Fed policy. At Jackson Hole, Fed Chair Powell clearly signaled that the Fed was set to cut interest rates at its upcoming September meeting. But the fed funds rate remains quite high. And with inflation readings having come down significantly, some economists are wondering why the Fed hasn't started cutting already.

Our economists in Goldman Sachs Research believe that the Fed will cut its benchmark rate by 25 basis points in September, November, and December. Compared to most, they're relatively unconcerned about recession risk, putting 20 percent odds on a US recession in the next 12 months.

Which they say would decline to 15 percent, the default risk of recession at any point in time, if the August payrolls report due this week is benign.

They note that while the July jobs report was weak, other data are not showing signs of recession. To find out more, I spoke to three of the foremost experts on the US economy and Fed policy. Bill Dudley and Rob Kaplan are both former Federal Reserve presidents. Bill served as president of the New York Fed and vice chairman of the FOMC after spending a decade here at Goldman Sachs as our Chief US Economist. Rob is the former president of the Dallas Fed and current vice chairman of Goldman Sachs.

But first up is Claudia Sahm, the chief economist at New Century Advisors. She was previously an economist at the Federal Reserve where she created the recession indicator that now bears her name. I start by asking her for some background on the Sahm rule.

Claudia Sahm: So, I developed this recession indicator, the so called Sahm rule in early 2019. And it was part of a policy project on how to improve fiscal stimulus and we needed an indicator to turn on temporarily programs in a

recession. And what I did to construct the indicator was look at the historical record of recessions in the United States and the changes in the unemployment rate that happened with a particular eye to an indicator that was both highly reliable, because it was going to start off big, fiscal program. And triggered as early as possible in the recession.

But it was looking at historical patterns. I did use the data as they were published at the time, the real time data. So, to try to get away from, well, after the fact we see all these revisions. And going from 1970 on, it had, this was by construction, I was trying to make it reliable, it had a, you know, perfect record, would have at the time.

And then before 1970, there are a few false positives in the real time data. But recessions followed soon thereafter. But there were some close calls. And it's not, you know, things like the threshold, a half a percentage point increase over the prior year on a three-month average basis, that was selected because of the historical record. There's nothing intrinsic about a half a percentage point or the particulars of the formula, per se.

Allison Nathan: And we recently saw the indicator get triggered. So, tell us about that.

Claudia Sahm: The unemployment rate moved up 0.53 percentage points. So, that would trigger the Sahm rule. And so, then historically that is consistent with US economy being in the early months of a recession.

If we look at the broader context in which it triggered, the US economy is in all likelihood not in a recession. income is growing, consumer spending is growing, jobs growing. This is not an economy that's in contraction.

But that's what the, that's what the Sahm rule says. It's supposed to only turn on in a recession. It is not a forecast of a recession. It is supposed to be an indicator. So, it's something that should move pretty slow and only turn on inside of a recession. So, if it turns on outside of a recession, it may still be telling us something useful. And yet it, like, that's not what it was supposed to do.

Allison Nathan: So, is the rise in the unemployment rate that everyone's so focused on maybe giving us a misleadingly negative picture of the US economy?

Claudia Sahm: So, the reason the Sahm rule works is typically increase in unemployment rate, particularly when they get of a certain magnitude, are driven by less demand for workers. And whether that's in lay offs or not getting hired or, you know, various ways you get less demand for workers. Then that can feed on itself because those workers spend less and then there's less demand for other workers. And so, that is the feedback loop that leads into a recession. That is the recessionary dynamic that these small changes in unemployment rate are bad news picks up on. right?

Now, there are other reasons that the unemployment rate can go up that are good reasons. At least long-term good reasons. And that would be if you have an increased unemployment rate because you've had this burst in supply of workers, more workers, well then as the jobs catch up, the economy otherwise is in a good place, the jobs catch up, those workers get jobs. And then in fact you have more growth coming out of that because you have more workers. Right? So, it has a positive prognosis once you get those workers employed. Whereas the negative reasons unemployment goes up tend to spiral in a

recession.

And this was something, you know, when I developed the Sahm rule in 2019, I talked about this was always the Achilles heel of using an unemployment rate measure. There are times where, you know, labor force participation changes and that can move around the unemployment rate.

What's notable right now is these have been very big and abrupt changes. And so, that adjustment period to, oh, we have more workers online. You know- the jobs catch up. Like, that process just can't happen fast enough when you have million plus extra, unexpected workers, say from immigration, though that's not the only group coming off the sidelines. that supply shock moves so fast and was big enough that it overwhelmed.

But the Sahm rule, while it is overstating the degree of that weakening of demand for workers, some of that is there. Right? it overstated it. It moved past the half a percentage point threshold. But part of that came from this supply piece, which is not the recession story.

But it's not all good news, right? It's a real mixed bag. It's a complicated story.

Allison Nathan: So, let's dig through that mixed bag a little bit. We have seen hiring rates and quit rates declining as well. So, does that give you greater cause for concern when looking at the holistic data?

Claudia Sahm: So, absolutely. Right? And you know, any time you as an economist start in the "this time is different," like I have this indicator, it's worked for decades and decades and decades. And now, oh, it's not working. You have to be really careful.

The way in which employers express their demand for workers, they have lots of different levers to pull. And firing, laying off workers is actually, even just in a typical recession, one of the later levers you pull. Right? A recession towards the end does have a big contribution from layoffs to the unemployment rate. But again, the Sahm rule is focused on this early side of it.

So, there's just, in general, you shouldn't think, oh, well there hasn't been layoffs, so everything's fine with the labor

market. That’s not the case in recessions as you go into them. But then you have this extra piece of, well, there does appear to be some kind of an attitude change, at least anecdotally among employers of having laid off millions of workers by the week early in the pandemic, and then having so much difficulty rehiring, that there has been a reluctance to layoff workers.

And so, then that margin, if you have less demand for workers, you lean harder, employers are leaning harder on the hiring rates. And right now, there is a pretty notable disconnect between hiring rates that are back to levels of 2014 when the unemployment rate was well above where we are right now. And the firing rates, which are at very low levels.

So, you do have to be a little careful because this time could be different on many margins, which make it hard for us to read the data. And the declines in the hiring rate, and also the quits rate, which I think are a very good indicator of how strong workers assess the labor market to be, those are a way of saying, no, there really is weakening of demand for workers in here.

Allison Nathan: So, you all of this is building to the million-dollar question, which is how concerned are you that the US economy is going to enter a recession in the next 12 months?

Claudia Sahm: So, I'm always concerned. [Laughs] That's how bad things have happened. Macro economist. No. So, I feel very confident in saying, yes, it triggered in July of 2024. No, the US economy is not in a recession. But that is a really low bar in terms of good macro economic outcomes.

What I am concerned about, what I've been watching for I'm really concerned about the direction. Payroll gains are still solid. But they keep slowing. The unemployment rate is still low, particularly if you think about some of these temporary-- like the supply-- but it is rising. You know? So, it's that direction.

But the reason that my base case is not a recession is the understanding that at least a portion of this slowing that we're experiencing right now is a policy choice. Right? The Federal Reserve has their federal funds rate over 5 percent. It's been over 5 percent for a year now. And the reason it is

high is it was an attempt to bring inflation down.

It's like, what do we expect? Yes. Unemployment is rising gradually. There's been a lot of buffering. We haven't had the recession. We haven't had the pain that some thought we would or needed to even have. But it is still there, right? But if you're putting downward pressure on the US economy through somewhat higher interest rates, I mean, there's a release valve there. And the fact that that's a lever to pull and the Fed is in a position to pull it, I think they could have already, but you know, they are moving. That makes me more confident that things are still of a good place.

But I don't like the direction. My recession odds, though they fluctuate some, are higher now than they've been through the whole cycle.

Allison Nathan: Do you think the Fed is behind the curve though given everything you've seen?

Claudia Sahm: The framing of the behind the curve, I have a hard- I have a hard time with because at this point, it really doesn't matter. They can't go back and cut in July

or not. The path is clear in terms of their cutting. We're at a point where things are slowing down. And they don't need to. Like, the inflation, we are very close to target. So, at this point, if there is a recession in the next year or so, it is a huge unforced policy error. If the Fed pushes down on the economy, continues to, and we end up in a recession, well then it was completely unnecessary. And I'm much more concerned about that now than I have been in the past.

One of the things that the Fed had often messaged in various forms throughout the year, they want more good inflation data. More good inflation data. And essentially, that they have the luxury of time because the labor market is so strong. And that always struck me as a very risky proposition to, like, use the labor market as your kind of security blanket. And now we're to a place where anything that looks like that is just beyond risky behavior.

The Fed needs to move. I am not of a they are so far behind the curve we need to see 50s, we need to see 75. And yet, if the Fed doesn't move, it just ratchet up the risk. And for no good reason. At this point inflation is so low and the labor market has enough question marks around it, the worst possible outcome is a recession we didn't need.

It's a slow-moving institution. It’s a very little c conservative institution. And the leadership kind of selects for that trait. And it’s often a good thing. Like, you want people that are deliberate and thoughtful. But they waited quite a while. And so, I worry.

Allison Nathan: If the August employment report comes in much stronger than expected this week, will that change your views?

Claudia Sahm: A strong report will probably slow the Fed down. Then I’d worry more.

Allison Nathan: Really?

Claudia Sahm: You know, if the report is too good, I think it gives a false sense of confidence, potentially. Because you don’t want to react to one month too much. And things swing around. But again, unless you really can make a case that the direction of travel has leveled out, until that happens, and I don’t know how that happens when you still have the interest rates intentionally high to restrain demand. Right? So, I’m really not going to rest

easy until things have leveled out and the fed funds rate is notable lower than where it is now. Or we have made a really good case for the fundamentals have shifted in a way that the economy just tolerates, and needs to stay in balance, a higher interest rate.

Allison Nathan: So, Claudia says that despite what her namesake rule might suggest, the US is not currently in a recession. However, she does see some disconcerting signals from the labor market, and she cautions that the Fed must act decisively to avoid further weakening in the labor market that could lead to a recession.

Next, I spoke to former New York Fed President Bill Dudley. Claudia is not sanguine. But Bill is actually even more worried. He thinks a recession is more likely than not at this point. I asked what he made of the Sahm rule getting triggered.

Bill Dudley: Look, the Sahm rule, it's not magical. It's a statistical regularity. And the threshold was set at whatever level was necessary to generate accuracy in terms of its recession predictions in the past. That doesn't mean that that threshold necessarily mechanically applies in the

present.

But when the unemployment rate goes up a bit, historically it tends to not stop. And I think the corollary of the Sahm rule that I think is important, it's not just the trigger, but the fact that when the unemployment rate goes up beyond a certain point, the next stop is an appreciable rise in the unemployment rate.

So, if you look at history, it's gone up a half a percent on a three-month moving average basis. And then the next stop is 1.9 percentage points. So, that hole in the distribution is telling you that this is not just about a statistic. There's a process going on. If the labor market deteriorates beyond a certain point, it starts to scare households and businesses. Households pull back on their spending. Businesses pull back on their hiring in investment. That leads to additional economic weakness which causes this feedback loop to be self reinforcing.

So, when I talk about the Sahm rule, I spend as much time talking about this hole in the distribution which suggests that there is some sort of tipping point in the labor market. Now, whether we've hit it just because we've triggered the

Sahm threshold, I don't know at this point. I think the odds of recession are lower than what you would just mechanically say. I'd probably put it at 50 - 60 percent over the next 12 months.

The other thing that I also put a little bit more weight on than some people is going into recession, typically the data look better than what they ultimately turn out to have been. So, the government releases the GDP numbers. They release the unemployment data based on underlying assumptions of, for example, unemployment data, like, what's the creation of new businesses versus businesses that are failing. They just have to make an estimate of that.

And an economic turning point, when that typically happens is it turns out those assumptions turn out to be too optimistic. Sometimes these differences are quite significant. And so, the data that we think we're confident of today, that data could be revised downward.

Allison Nathan: Right. So, we could be in a lot worse of a situation than we think we are.

Bill Dudley: It's certainly possible. Certainly possible. But

yeah, rather than saying, oh, we're going to have a recession. We're not going to have a recession. The way I would put it is the risks have risen. And because the risks have risen, the Fed Reserve needs to put more weight on the employment side of their mandate. And that means the Fed needs to get from a tight monetary policy regime back to a neutral monetary policy regime more quickly rather than more slowly.

So, just as the Fed was behind the curve in terms of raising interest rates in this cycle, I think the Federal Reserve is a bit behind the curve now in reducing interest rates in response to these increased risks. I think a soft landing is certainly possible and certainly what the Chair Powell is going for. Cutting interest rates now would increase probability of a soft landing.

But here's where there's a problem. If they lag the monetary policy or long on variable on the way up, they're also long on variable on the way down. And so, historically, at least, it's been very hard for the Federal Reserve to intervene soon enough when there's economic weakness to prevent a full-fledged economic downturn.

If you look at history, the only time that the Fed has really had a soft landing in the last forty years or so is the mid 1990s. And what was interesting about that mid 1990s period was the Fed didn't actually push the unemployment rate up at all. The unemployment rate basically stabilized. So, there was never much risk of this negative self-reenforcing dynamic taking hold during that soft landing.

And what the Fed's trying to do now is replicate that mid 1990s experience. That's what they're going for. And we'll see whether they can pull it off or not.

Allison Nathan: And so, just to review again, the odds that you put a recession?

Bill Dudley: Probably 50 to 60 percent over the next 12 months. I mean, I think it's higher than normal. But I'm not going to take the Sahm rule and say, well, just because it's been triggered then that means we absolutely have to have a recession.

I do have to say though, I always feel a little uneasy when people say, well, this time it's different. Because we've seen many examples. I mean, the great financial crisis is the

best example. Going into that, everyone said, “This time it’s different for US housing. This time it’s different for mortgage underwriting.” And it turned out not to be different at all.

Allison Nathan: But those episodes, seem to be driven by big imbalances in the economy. I mean, that’s not what you’re saying here. Or are there imbalances in the economy that are contributing to your thinking?

Bill Dudley: Well, I think there aren’t big imbalances.

I mean, I personally feel like financial markets should be relatively well underpinned because, to your point about imbalances, I don’t think there’s a risk of a deep recession. I think if there’s a recession, it’s going to be a very mild recession because the household and business balance sheets are in, generally, pretty good shape because of the large fiscal transfers that we saw during the pandemic. And the Fed has plenty of room to cut. We’re at 5.25/5.5 percent on the federal funds rate. So, there’s plenty of room to cut. And with inflation not that far away from the Fed’s 2 percent objective, there’s the ability to cut if the economy shows weakness. So, I think worst case scenario is a mild

recession.

Allison Nathan: Finally, I spoke to Rob Kaplan, former president of the Dallas Fed and now vice chairman here at Goldman Sachs. He also acknowledges a softening in the economy. But seems less concerned than his former central bank colleague.

We started by talking about the Fed's dual mandate to foster price stability and maximum sustainable employment.

Robert Kaplan: The inflation battle isn't over. And because the cumulative level inflation is so high, it's very important that we continue the inflation battle because middle-class families, low/moderate income can't make ends meet. But we're seeing some softening overall in jobs. And we're seeing enough improvement on inflation that I can view them both as more balanced. And from a risk management point of view, our next view, I think in September, it's time that we start reducing the fed funds rate.

Allison Nathan: As you know, the July employment

report came in much weaker than expected and set off a lot of market volatility as a result. That was just days after the Fed had decided to keep rates on hold. When you're sitting at the FOMC and you're thinking about upcoming data, how does that factor into your decisions?

Robert Kaplan: My caution, everyone, is, and you'll hear this from Fed people, if I'm sitting at the Fed, first don't overreact to one data point. It could be misleading. It could be distorted. Could get revised. And that it's very possible that the August jobs report is going to turn out to look like a more normal jobs report. And this is going to turn out to be an aberration. So, that's the first thing.

The second thing if you're at the Fed is talk to contacts. Make sure you're talking to contacts, i.e. businesses out there, and see if this jobs report jives with what you're hearing. I think it does not. The job market is softening. Which we wanted at the Fed. But I don't think it's falling out of bed. So, be careful not to overreact, even rhetorically to it. And don't be surprised if August is not much more solid.

If I'm wrong, you've got all your options open at the Fed to

do more in September than 25 basis points.

Allison Nathan: But you don't think the Fed is behind the curve here?

Robert Kaplan: If they're behind, they're not behind by more than a meeting or two. That I would view as tactical. The mistake by the Fed that I'm more nervous about is a strategic mistake.

So, what's an example? In '21 and '22 I thought the Fed was 18 to 20 months late. That's a strategic error. If you're a meeting or two late, you can probably fix it with doing a little bit more in subsequent meetings. That's a tactical error. And I would differentiate between the two. But I would caution if I were at the Fed I'd be prepared to cut. And I would talk hawkish.

So, why would I do that? Because I want to keep my options open. Once I say and sound dovish, I've lost all my options. So, I would say, don't overreact to hawkish rhetoric. I think those same people that sound a little hawkish are prepared, likely, to cut in September and maybe November and December. But they're going to

sound a little hawkish, as I would too, because I want to have the option to make the decision.

Allison Nathan: So, what would be your advice to investors who are attempting to navigate the evolution of fed policy and the economy ahead?

Robert Kaplan: I call data the bouncing ball. It comes out several times a week. You know, PCE, CPI, PPI, GDP. If you want to be a data hound, there's unlimited amounts of data. Economists like it because you can put it into a model. However, it tends to be backward looking. It's stale. It's aggregated. And normally gets revised. So, you have a big reaction to it. Then a month later you find out it's been revised already.

I think you're much better off focusing on demographics, aging population, technology-enabled disruption, the energy transition, regulatory policy, and other structural factors. And I think you've got to look at the data, but don't be maniacally, narrowly focused on data.

Allison Nathan: It's interesting because in that last point, Rob does sound similar to both Bill Dudley and to Claudia

Sahm. All three economists, including the one who gave her name to a data-based rule caution that the numbers just don't paint the whole picture, which might be why economists' opinions vary so dramatically.

Let's leave it there. Thank you for listening to this episode of Goldman Sachs Exchanges. I'm Allison Nathan.

The interviews with Bill Dudley, Claudia Sahm, and Rob Kaplan were recorded on August 14th, August 15th, and August 19th respectively.

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