Beneath the Surface

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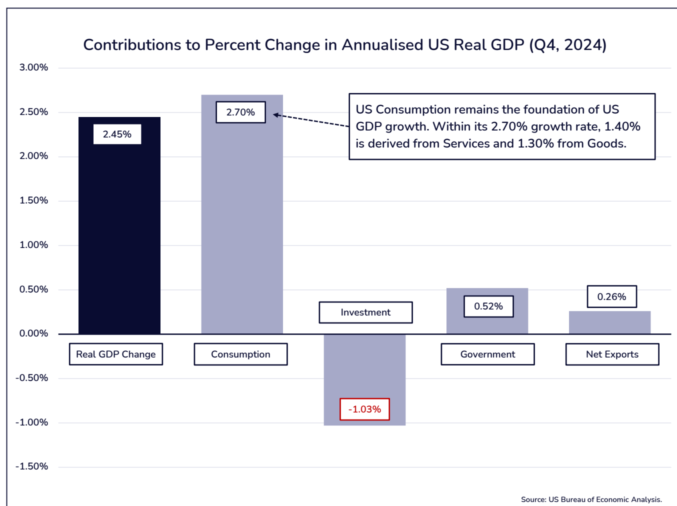
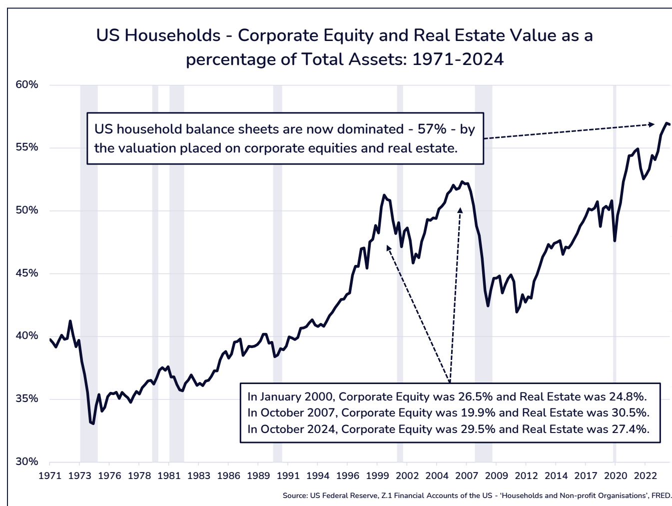
SIGNET

What Triggers a US Recession?

- The US economy, measured by real GDP growth, expanded by a reasonable 2.45% annualised in the fourth quarter of 2024 (chart, below left). This growth was dominated by consumption, with healthcare and real estate activity leading, and it was also attributed to upward revisions in government spending and – unexpectedly – net exports. Investment looks ugly, and this reflects a rather dire net national savings position that is in danger of turning outright negative. Despite strong consumption, US recession fears are escalating, mostly because of the recent political uncertainty (tariffs) and government action (DOGE). Riskier asset classes, such as equities, are adjusting to this environment. Is this a buying opportunity? Is the fear of contraction justified? Recessions don't just happen, unless there's a large exogenous shock to an economy. They are normally the consequence of a series of macroeconomic events – and often in a clear sequence – that create a self-reinforcing dynamic slowdown. The sequence might look like this: we experience a build up in (a) excessive private credit, and with it the misallocation of capital and irrational exuberance, given the limitations within the central bankers' economic model (DSGE). In their haste to catch up, the central bankers (b) tighten economic policy and hike interest rates. This results in (c) a rise in savings and a decline in borrowing and 'risky' asset prices, often with a time lag. We typically then experience (d) a slowdown in economic demand, leading to an earnings decline, and then (e) a weaker jobs market and wages growth. Lastly, we might expect to see (f) disinflationary conditions take hold. At some point between (d) and (f), the central bankers panic and slash interest rates. In short, it is a fall in business and household confidence – and private consumption – that normally causes recessionary conditions. Despite the positive hard data over the last two years, some of the leading soft data continues to flag caution: the Conference Board's Consumer Confidence Expectations Index, based on consumers' short-term outlook for income, business, and labour market conditions, dropped 9.6 points to 65.2 in March, the lowest level in 12 years and well below the threshold of 80 that usually signals a contraction ahead. What might trigger sentiment and consumption to collapse into a hard-data recession? A reversal of the 'wealth effect' would do it – a decline in asset prices. US households now have record amounts of wealth tied up into just two asset classes: corporate equities and real estate (chart, below right), and their current valuations are stretched at best.

- Crucially, as investors, we probably need to act before anyone – the central bankers or the National Bureau of Economic Research (NBER) – begins to caution us of a recession risk. Remember that US GDP was 4.22% in Q1 of 2000 and 1.39% in Q1 of 2008. In the summer of 2008, Ben Bernanke formally announced "*overall economic growth was quite slow but apparently positive in both the fourth quarter of 2007 and the first quarter of this year…we may see somewhat better economic conditions during the second half of 2008.*" The NBER formally declares recessions for the US on "*a significant decline in economic activity that is spread across the economy and that lasts more than a few months*" and not, contrary to popular belief, on two consecutive declines in GDP. The NBER didn't announce and date the GFC recession until December 2008, three months after the peak of the banking crisis (Lehman)! This was a useful 'buy' signal and the moment of real buying opportunity.





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