COLUMBIA THREADNEEDLE INVESTMENTS

Is the U.S. economy heading into a recession?

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The Fed takes a potentially aggressive path in an effort to tame inflation. Investors fear a recession may be on the horizon.

The Fed gets real about inflation
For the last two years, inflation has been a bogeyman for the markets — higher and stickier than expected. To combat higher than expected inflation, the Fed has been telegraphing an aggressive position on hiking the fed funds rate. Markets are now expecting nine hikes, bringing the central bank's overnight rate to 2.00%–2.25% by the end of 2022.

Recession fears on the rise
Recession fears became headline news when the yield on the 2-year Treasuries briefly rose above the yield on the 10-year Treasuries. Historically, some yield curve inversions have presaged a recession.

But a single yield curve inversion on its own is an imperfect recession predictor: an inversion may precede a recession, but not all inversions culminate in a recession. Taking a broader look at the economy, we believe that although the fundamentals remain strong — particularly the labor market — there's an expanding list of risks to growth, including the ending of fiscal and monetary stimulus, sanctions on Russia and the war in Ukraine.

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The Fed takes a potentially aggressive path in its effort to tame inflation, and investors fear recession is on the horizon.

Anwiti Bahuguna, Ph.D.
Head of Multi-Asset Strategy

Key points:

1. The Federal Reserve is pursuing an aggressive monetary policy to combat inflation.
2. Some yield curves are inverted, but this does not necessarily mean a recession is forthcoming.
3. Recessions have different drivers, so they can differ in severity, duration and their impact on markets.

The Fed gets real about inflation

For the last two years, inflation has been a bogeyman for the markets — higher and stickier than expected. At the outset of 2022, markets expected the Federal Reserve to pursue a measured schedule of interest rate increases and to end quantitative easing. But recently, to combat higher than expected inflation, the Fed has been telegraphing a more aggressive position. After pricing in very few interest rate hikes at the beginning of the year, markets are now expecting nine hikes (including a couple 50bps hikes in the second quarter) bringing the federal funds rate to 2.00%–2.25% by the end of the year.

Exhibit 1: Estimated number of Fed hikes in 2022, Bloomberg WIRP

Source: Alacrityland, Bloomberg and Columbia Threadneedle Investments.

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With this increased concern about recession, it's important to recognize that not all recessions are the same. They have different drivers, which can impact their duration and severity.

Not all recessions are the same

Type of recession	Drivers	Economic and financial impact	Examples
"Financial" recession	Bursting bubble in the financial sector	■ Large declines in GDP ■ Big drawdowns in equities and other risk assets ■ Tend to last longer	■ 2007–2008 financial crisis ■ Tech-led recession in early 2000s
"Classic" or real-imbalances-led recession	Unwinding of consumption or capital investment bubbles	■ Mild contraction in GDP ■ Average (25%) equity drawdown ■ Typically short-lived	■ Early 1990s
"Central-bank-led" recession	Over-tightening of monetary policy	■ Similar to "classic" recessions in terms of growth, equity drawdowns and duration	■ Great Depression ■ 1979–1981

Source: Columbia Threadneedle Investments

In the current environment, calibrating monetary policy precisely enough to slow growth but not to cause a downturn is a significant challenge for central banks given the relatively blunt tools at their disposal. Investors may be concerned that policymakers are playing catch-up and may end up tightening interest rates well above what the economy can handle.

Risk assets can still do well, even when the yield curve is correct

We've looked at how stocks tend to perform in the period between yield curve inversions and the start of a recession (when it has occurred). And while there are only a limited number of periods to consider, we found that frequently equities rise, and sometimes quite strongly.

Risk assets can still do well between yield curve inversion and recession

Asset class returns (%) from the first inversion of the yield curve to the ensuing recession's start

First inversion date	Aug-78	Sep-80	Dec-88	May-98	Dec-05	Aug-19
Recession date	Feb-80	Aug-81	Aug-90	Apr-01	Jan-08	Mar-20
S&P 500 Index	9.6	4.2	29.1	6.1	16.9	2.6
Commodities	87.8	-30.9	13.6	6.9	9.8	-7.0
2-Year Treasury	–	4.8	15.6	17.3	11.5	1.8
10-Year Treasury	–	-4.2	18.6	17.1	10.9	4.2
U.S. Corporate Investment Grade	-7.4	-4.3	19.6	17.5	8.8	4.6
U.S. Corporate High Yield	–	–	6.6	0.6	14.0	1.9
U.S. Municipal Bonds	–	-7.0	16.7	16.9	8.4	3.1
U.S. Mortgage-Backed Securities	-2.3	-6.7	21.6	21.1	12.3	2.9

Source: Bloomberg (U.S. 10-yr.–2-yr. Yield Curve, S&P 500 Price Returns, BCOM Price Returns, FTSE U.S. Treasury Total Returns, Bloomberg Fixed Income Total Returns). The S&P 500 Index tracks the performance of 500 widely held, large capitalization U.S. stocks. The Bloomberg Commodity Index is a measure of the broad commodity market. The Bloomberg U.S. Corporate Investment Grade Index measures the investment grade, taxable corporate bond market. The Bloomberg U.S. High Yield Corporate Bond Index represents the universe of fixed rate, non-investment grade debt. The Bloomberg U.S. MBS Index is a measure of the mortgage-backed securities market. The Bloomberg Municipal Index covers the USD denominated long-term tax-exempt bond market. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.**

Bottom line: Charting the course from here

Given the macroeconomic headwinds, we expect growth to slow to “near trend” levels this year from the very high growth rate in 2021. In fact, first quarter GDP numbers released in late April showed an unexpected decline of 1.4%, but this was mostly due to technical factors and not necessarily recessionary. Underlying trend growth, as measured by private domestic demand, was solid and still above trend. But in the coming quarters, rising rates and declining real incomes could take a bite out of consumer spending and result in further slowdown. Our base case is that we avoid recession, but the risks are rising.

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