The top down case for a US recession

The US data has undoubtedly been stronger than expected. This has led many forecasters and the market to price a soft landing as the modal outcome. However, from a top-down perspective, a US recession remains more likely than not.

Given the inherent uncertainty around the level of the neutral rate and monetary policy lags, the odds of the Fed setting monetary policy exactly right are relatively low. As a result, the risk management choices made by the Fed should be relevant in determining the ultimate outcome. Given that inflation peaked significantly above target, the Fed should err on the side of tightening too much, rather than too little.

A soft landing could still be achieved if the Fed is "lucky". In the current context, luck would be defined as the economy experiencing a positive supply shock that reduces the risk management trade-off faced by the Fed.

In turn, the likelihood of a positive supply shock depends on the extent to which the post covid inflation was mostly driven by negative supply shocks, or by excess demand. The supply side did play a role in pushing inflation higher and some of these factors have normalised (supply chain bottlenecks and the participation rate). However, other supply factors are likely to be more structural (reshoring and the climate transition) and, more importantly, excess demand played a significant role as well.

Thus, it remains likely that bringing inflation back to target will require the Fed to depress demand below potential. Taking into account the risk management considerations, this tightening cycle should ultimately result in a more substantial increase in the unemployment rate. In turn, this implies that the trough in policy rates in the next cycle should be below rather than above neutral.
The top down case for a US recession

The US data has undoubtedly been stronger than expected, as evidenced for instance by the Atlanta Fed GDP tracker for Q3 which is currently north of 5%. This has led many forecasters and the market to price a soft landing as the modal outcome. However, from a top-down perspective, a US recession remains more likely than not.

Figure 1: Q3 GDP trackers are currently consistent with growth well above potential

![GDP Tracker Chart]

Source: Deutsche Bank, Federal Reserve, Bloomberg Finance LP

Over the ~25 years prior to covid, core PCE inflation only briefly and marginally exceeded 2.5%. Post Covid, core PCE peaked above 5%. Given the inherent uncertainty around the level of the neutral rate and monetary policy lags, the odds of the Fed setting monetary policy exactly right are relatively low. As a result, the risk management choices made by the Fed should be relevant in determining the ultimate outcome. Given that inflation peaked significantly above target, it makes sense for the Fed to err on the side of tightening too much, rather than too little. That is the gist of the argument we made earlier this year. In practice, there is some evidence that this has already been the case. More specifically, the SLOOs “willingness to lend” is well through the levels at which the Fed would have already eased policy. Instead, the Fed delivered one more hike this summer.

Figure 2: ~25y prior to covid, US inflation only briefly and marginally exceeded 2.5%.

![Inflation Chart]

Source: Deutsche Bank, BEA, Haver Analytics

Figure 3: The Fed has erred on the side of tightening too much relative to the past 25 years

![SLO Chart]

Source: Deutsche Bank, Federal Reserve, Haver Analytics

Figure 4: Core goods vs. leading indicators

![Core Goods vs. Leading Indicators Chart]

Out of sample

Source: Deutsche Bank, Haver Analytics
A soft landing could still be achieved if the Fed is "lucky". In the current context, "luck" would be defined as the economy experiencing a positive supply shock that reduces inflation enough to alleviate the risk management trade off faced by the Fed. In turn, the likelihood of a positive supply shock depends on the extent to which the post covid inflation was mostly driven by a negative supply shock, or by excess demand.

The supply side certainly contributed to the rise in inflation post covid. This is best reflected in the supply chain issues and the decline in the participation rate observed during covid. These negative supply shocks have now been mostly unwound, as evidenced by pipeline inflation for core goods which is now in deflation and the labour force participation rate which is back at its pre-covid trend.

However, some of the negative supply shocks are likely to be more structural. More specifically, the climate transition is likely to be a more persistent negative supply shock as evidenced by the under-investment in US shale oil relative to the 2010-2014 period. Second, the geopolitical tensions are likely to result in a medium-term reassessment of supply chains beyond the short-term impact created by covid.

But more importantly, there is clear evidence that excess demand was a significant factor behind the rise in inflation. The very aggressive coordinated monetary and fiscal policies during covid (a.k.a helicopter money, a.k.a MMT) is the text book way of generating inflation by creating excess demand. That’s also supported by Fed estimates showing that supply and demand factors have equally contributed to the rise in inflation post-covid.
The scale of the coordinated monetary and fiscal policies response resulted in the largest deviation of M2 relative to trend since the 70s. Since the Fed started tightening policy, the M2 overhang has been declining steadily, but the adjustment is not yet complete. On current trend, the M2 overhang would be reabsorbed by early Q2-24. If this is a correct proxy for “excess demand”, it is likely that the pressure on the US economy would become more evident early next year.

In short, some of the negative supply shocks observed during covid have been unwound (supply chains and the participation rate). However, other post covid supply shocks are likely to be more structural (reshoring and the climate transition) and excess demand is likely to have been a significant contributor to the rise in inflation. Thus, it remains likely that bringing inflation back to target will require that the Fed depresses demand and brings GDP growth below potential. Moreover, from a risk management perspective, the Fed should err on the side of tightening too much rather than too little. Taken together, it remains likely that this tightening cycle will result in a more substantial increase in the unemployment rate. In turn, this implies that the trough in policy rates in the next cycle should be below rather than above neutral.
Appendix 1

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