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Economic Update: The U.S. Is Not In A Recession, But We Should Still Take Steps To Avoid One

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The U.S. economy is sending mixed signals. On the one hand, many economic measures look strong, even unusually so.

- Real GDP growth was a strong 3% in 2024 Q2 and, as of this writing, is on track for a solid Q3.
- The unemployment rate stood at 4.2% in August with a three-month average pace of job growth of +116,000 per month; these would have been practically textbook breakeven numbers for the economy before the pandemic.
- Employment and labor force participation levels remain high. In age-adjusted terms, in fact, employment and participation rates are around levels last seen in the days of the dot-com boom, likely among the highest peacetime labor utilization rates in the U.S. ever.
- Inflation is moderating, with core PCE inflation inching ever closer to the Fed's target. It reached 2.6% year-on-year as of July, and the remaining excess is overwhelmingly in housing, an area with well-known measurement lags.

Regardless of whether it is the likeliest outcome, an optimistic observer would have a hardheaded case to make for a soft landing.

At this point, it is also undeniable that several measures, especially measures of momentum, have cooled.

- Job growth, job openings, hires, and quits have all slowed, the latter metrics having slowed to levels below even where they were in 2019 or 2018 and back to 2017 or 2016 levels.
- The unemployment rate has risen almost half a point over the last year and by 0.8 points since January 2023; such a steep rise has always been associated with U.S. recessions in the past.
- It is true, and important to keep in mind, that layoffs have not yet risen at all. But layoffs are at best a coincident indicator of a recession rather than a leading one; once they rise, it's already too late.

A pessimistic observer could reasonably object that while the optimist might like where the U.S. is now, they cannot be confident about even the near-term trajectory given weak hiring and cooling jobs growth.

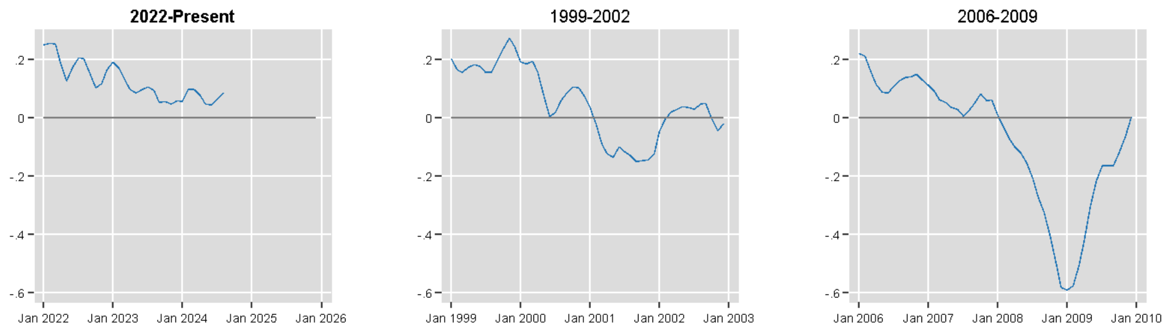
One way to try to make sense of these seeming contradictions is through a very narrow, backward-looking question: is the U.S. in a recession *right now* (or, more accurately, as of the latest data we have, which is always a bit lagged)?

The organization that dates the U.S. recession, the National Bureau of Economic Research (NBER), does not, despite widespread misconception, define a recession as two consecutive quarters of negative GDP growth. Instead, NBER looks at an array of six monthly measures that cover the labor market, consumer spending, and industrial production. I use a model called a dynamic factor model to extract the common signal over time from all six of these measures. I also include the change in the unemployment rate among them, since, despite not being explicitly named as an NBER measure, the unemployment rate is arguably the most widely-cited single U.S. business cycle indicator. The empirical accuracy of historical recession indicators based solely on the unemployment rate, like the Sahm Rule, strongly suggests it contains significant signal.[1] I decompose the unemployment rate into temporary, permanent, and reentrant unemployed. The resulting series or "factor" is graphed below; it's in units that do not have much independent meaning, but think of any reading above 0 as consistent with economic expansion, below 0 with contraction, and hovering around 0 as roughly consistent with being at trend growth.

[1] NBER does include household employment growth as a recession indicator, which comes from the same labor markey survey as the unemployment rate. However, the unemployment rate by definition adds the important context of measuring employment growth *relative* to labor force growth (or more precisely, 1 - EPOP/LFPR). There are also questions about the recent accuracy of household employment headcounts especially with regards to foreign-born employment; since these issues affect both employment and labor force measure, they mostly wash out for the unemployment rate.

Dynamic Factor Model of US Growth

Index points
Above 0 = Expansion // 0 = Trend // Below 0 = Contraction



Note: Incorporates August 2024 premliniary CES benchmark revisions through March 2024.

Dynamic factor model of monthly log change in NBER recession metrics: payroll employment, household employment, real personal income less transfers, industrial production, real personal consumption expenditures, and real retail and wholesale sales, as well as the monthly change in the permanent, temporary, and reentrant unemployment rates.

Source: BLS, BEA, FRB, NBER, author's analysis.

What's nice about the dynamic factor result is that even though it isn't calibrated directly to NBER recessions, its behavior reasonably lines up with them, suggesting that NBER truly does pay attention to the metrics it says it does. The factor crosses below 0 just before the March 2001 recession (middle panel) and almost exactly at the beginning of the December 2007 recession (right panel).

Right now, updated the August employment the factor is low (below 0.1), but significantly above 0 (left panel). The model therefore is conclusive: it sees the same deterioration in momentum evident throughout much of the individual economic data, but it's determined that this is not (yet) consistent with the amount of weakness in the past that has triggered recessions coincidentally.

This should give us comfort that a soft landing is still very much achievable. But we should view this reprieve from a recession as a time to take steps to insure against one, not as a premature victory lap. The biggest known short-run risk is financial conditions, and the biggest single factor is the risk of overly tight monetary policy. The labor market appears roughly in balance, and inflation is almost on target. Monetary policy, however, is not in balance, and even under the highest plausible estimates of R*, even an initial 50 basis point cut to the federal funds rate this week would leave

policy still restrictive, perhaps considerably so. The Fed could additionally ease through clear forward guidance of more cuts to come, but the Federal Reserve Board has been reluctant to commit to a firm rate cut trajectory given the risks around price reacceleration.

Policymakers should also take steps to build political support where they can for fiscal relief in the event of a recession. Hopefully, any downturn will not rise to the magnitude of the last two cycles and not demand the type of extraordinary countercyclical policy that was employed in the wake of the pandemic or even the Great Recession. But even a more conventional recession will be shortened by augmented and targeted support for workers and by temporarily strengthening demand. Inflation concerns will curb appetite for fiscal support, but the supply chain bottlenecks that exacerbated inflationary pressures during the pandemic have healed now, and a downturn would be strongly disinflationary to begin with. The U.S. saw the strongest pandemic economic recovery in the G7 over the pandemic in part due to the size of its fiscal response, so it would be a tragedy to abandon countercyclical fiscal policy entirely in the next recession, whenever it may be.

In the meantime, however, U.S. data will likely continue to both fascinate and confuse, looking strong from one angle and soggy from another.