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Principal Asset Management℠

# Soft landing or recession?

## Key economic indicators investors should consider when weighing the likelihood

JUNE 2023

During the modern era, the U.S. Federal Reserve Bank (Fed) has raised rates – over an extended period – eleven times (excluding 2022/23) as shown in Table1 below. Of those eleven periods, eight were followed by a recession, with an average lag time of nine months from the final Fed hike to the start of the recession. No recession ensued following the remaining three periods (i.e., a "soft landing"). So, what was different about those three periods?

**TABLE 1**

| Recession | End of Fed rate hikes | Lag (months) | Recession start | Recession end | Recession duration |
|---|---|---|---|---|---|
| No recession | Nov-66 | - | - | - | - |
| 1969–1970 recession | Aug-69 | 4 | Dec-69 | Nov-70 | 11 months |
| 1973–1975 recession | Aug-73 | 3 | Nov-73 | Mar-75 | 16 month |
| 1980 recession | Mar-80 | -2 | Jan-80 | Jul-80 | 6 months |
| 1981–1982 recession | Dec-80 | 7 | Jul-81 | Nov-82 | 16 month |
| No recession | Aug-84 | - | - | - | - |
| Early 1990s recession | Feb-89 | 17 | Jul-90 | Mar-91 | 8 months |
| No recession | Feb-95 | - | - | - | - |
| Early 2000s recession | May-00 | 10 | Mar-01 | Nov-01 | 8 months |
| Great Recession | Jun-06 | 18 | Dec-07 | Jun-09 | 18 months |
| COVID-19 recession | Dec-18 | 14 | Feb-20 | Apr-20 | 2 months |
| | Average Lag | 9 | | | |

Source: NBER.

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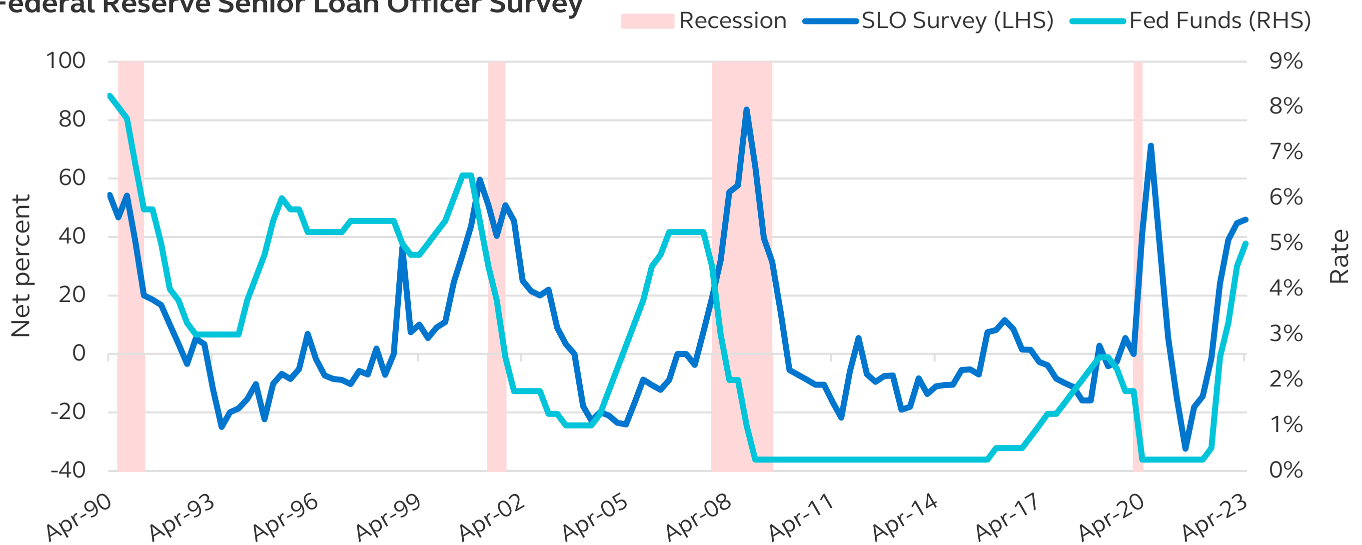
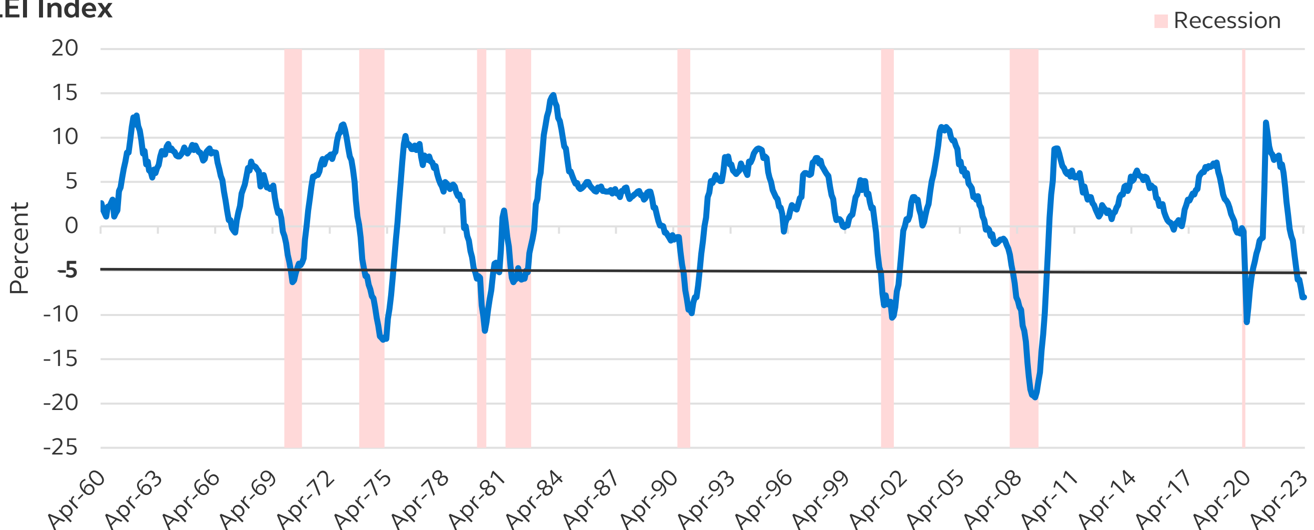
The full answer, of course, is a combination of several factors; however, there are four economic indicators that we believe best explain why those three periods resulted in a soft landing (and may help forewarn investors of the next recession):

1. Soft landings have a chance to occur when the Fed is tightening, but banks are not (1994-95), as evidenced by the Federal Reserve Senior Loan Officer Survey chart below. The survey bottomed-out in July 2021 and then turned positive (net bank tightening) in April 2022.




Source: U.S. Federal Reserve Bank. As of April 30, 2023.

2. Since 1960, whenever the Leading Economic Indicators Index (LEI) declined to -5 or lower, a recession has followed, as shown in the chart below. During the 3 soft landings, the LEI barely turned negative or remained positive (-0.7 in April 1967, 5.7 in December 1984, and -0.1 in January 1996). As of April 30, 2023, the LEI stands at -8.0.




Source: The Conference Board. As of April 30, 2023.

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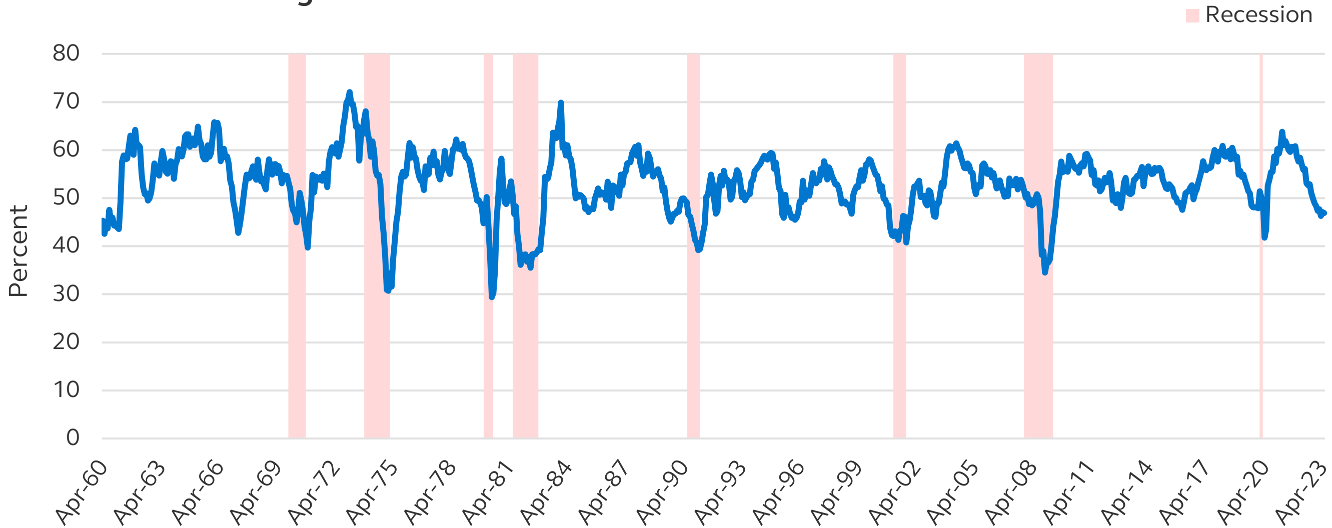
3. Since 1970, whenever the ISM Manufacturing index has declined below 45 there has been a recession (see chart below). As of May 31, 2023, the ISM Manufacturing Index is at 46.9.

**U.S. ISM Manufacturing Index**




Source: Institute for Supply Management. As of May 31, 2023.

4. Another reliable indicator is the yield curve, or the yield differential between different points on the Treasury maturity spectrum. For example, the difference between the three month and ten-year (3m X 10y) maturities has inverted, or turned negative in all six of the Fed hiking cycles which culminated in a recession since 1970. A commonality of the two soft landing cycles (1983-84 and 1994-95): 3m X 10y did not invert. The 3m X 10yr is currently as deeply inverted as at any point in the last 40 years. Additionally, the curve tends to reach maximum inversion and begin to re-steepen (as has been the case of late) when a recession is becoming more imminent.

**U.S. 3M/10Y Yield Curve**

Source: Bloomberg. As of May 31, 2023.

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## Final thoughts

The current cycle of rate hikes began with the Fed increasing its target range in March of 2022. Although it's possible the Fed will hike again, they are very near the end of the current cycle. While a soft landing is not out of the question, a confluence of leading recession indicators – Senior Loan Officer survey being restrictive; LEI starkly negative; and ISM Manufacturing contractionary – are suggesting that a recession is far more probable in the near-term than a soft-landing.

The historical data (Table 1) would indicate that a recession generally occurs -2 to 18 months after the final hike of the cycle, with an average lag time of 9 months. However, the current labor market remains strong and consumers continue to draw upon excess savings, the result of pandemic stimulus transfers and reduced spending during shutdowns. Because much of the excess savings has already been depleted, consumer spending should slow in the quarters ahead, and corporations will be forced to reduce employment. As jobless claims increase a recession will be underway, likely by late 2023 or early 2024.

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