A macro market disconnection

Historical macro relationships appear increasingly disconnected, with sizeable divergences between business cycle variables and risk assets, morphing some recession fears into mistaken hopes that "this time is different."

Leading indicators, however, almost uniformly signal elevated risk of recession:

- The pace of the Federal Reserve's (Fed) rate hiking cycle has been historic, causing a deeply inverted Treasury yield curve—a historically reliable recession indicator.
- Not only is the 2s10s curve inversion material and sustained, but other segments of the yield curve are also inverted, including the 3-month1-year curve—which is typically consistent with recession risk within a 12-month period.
- The Sahm Rule indicates that through U.S. economic history, every time there has been a 0.5% increase in the unemployment rate in a 12-month period, it has been accompanied by recession. The Fed's own projections see a 0.6% increase in the unemployment rate this year.

And yet, economic indicators have remained resolutely resilient, prompting many analysts to expect a soft landing.

The labor market is feeding those false hopes. Historically, a substantial decline in job vacancies has never occurred without a sharp increase in unemployment. Yet, the labor supply/demand imbalance has gradually loosened via a drop in job vacancies alone, permitting wage and inflation pressures to ease, unaccompanied by economic weakness.

Tightening credit conditions, however, suggest labor market strength will prove short-lived. Small banks account for 30% of all loans in the U.S. economy, so tightening lending standards by small banks will likely lead to greater job losses and, in turn, recession.

Risk asset markets have advanced this year, with performance consistent with negligible recession risk. However, markets have entered a precarious phase, now priced to perfection with mounting investor complacency. It seems that markets appear oblivious to the higher interest rate environment and the deterioration in many leading economic indicators. Equity valuations, which should compress with higher interest rates, are now approaching lofty multiples last seen before the Fed launched its rate hiking cycle.

Investors should keep in mind that Fed policy acts with "long and variable lags." Today, these lags appear to be extended even longer than usual. Current corporate finance structures reflect substantial medium-term debt issuance during the pandemic, which at the time was financed at low fixed interest rates. This meaningful "maturity funding wall" has so far helped maintain a crucial cushion against the impact of today's much higher Fed policy rates. However, this disconnect can only provide a temporary window of relief. As corporate debts mature in future quarters and require rolling-over at higher rates, companies will face the true economic impact of higher Fed policy rates and tighter credit conditions. Spreads, particularly for lower grade credits, will widen, finally precipitating the arrival of one of the most anticipated recessions in history.

Macro disconnects in charts

The disconnects fueling recession skepticism, and the factors that indicate why soft-landing hopes are likely misguided:

1. Leading indicators signal recession
2. Labor market false hopes
3. Vulnerable equity markets
4. The Fed's "long and variable" lags

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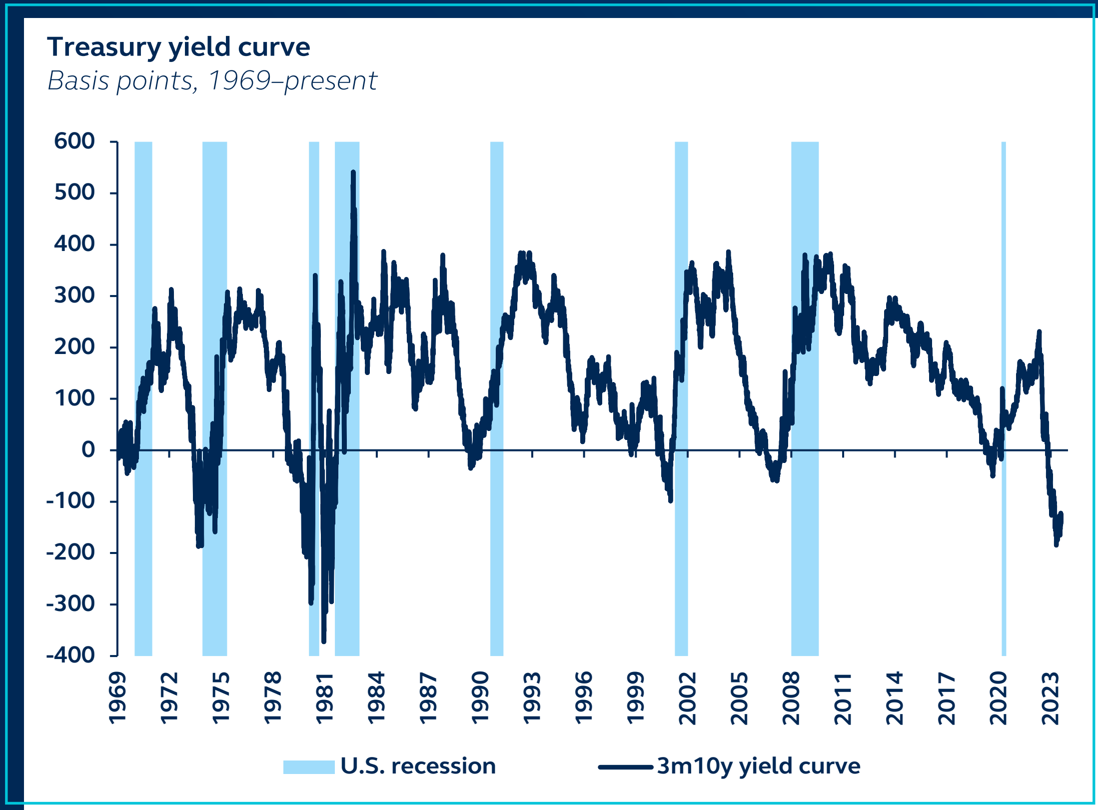
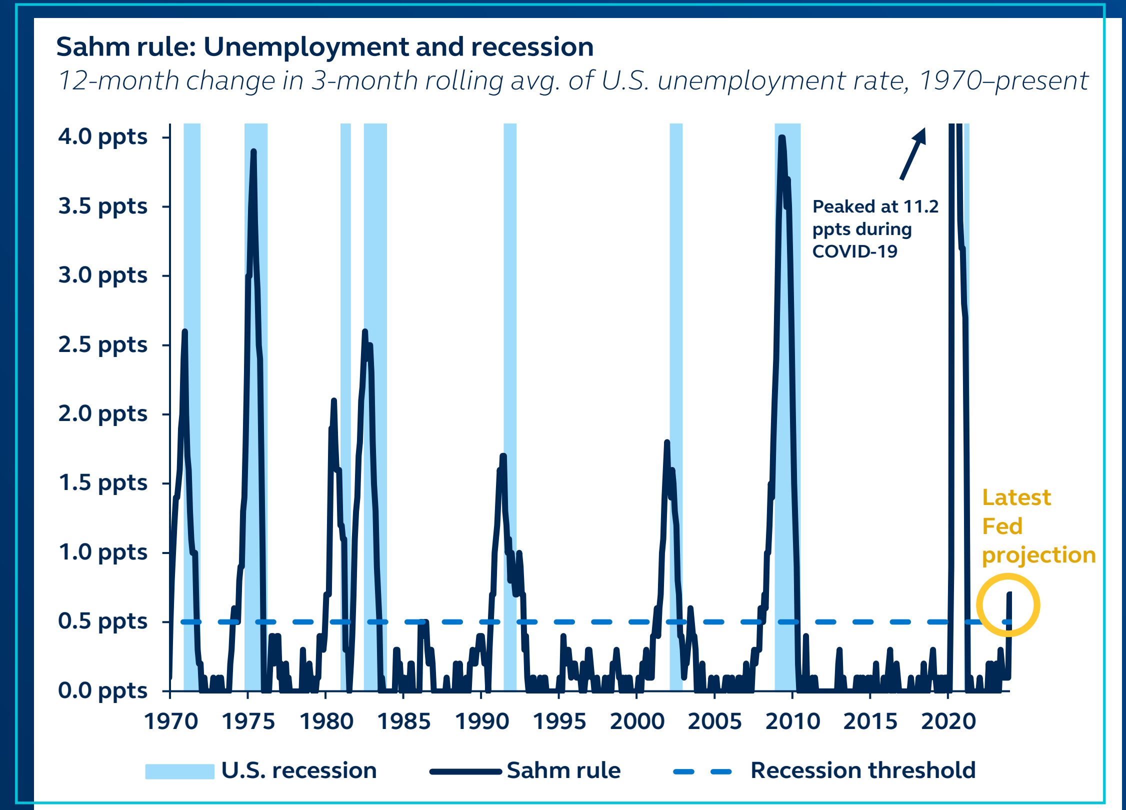
1 Leading indicators signal recession

An inverted yield curve has reliably anticipated prior economic recessions…



Source: Federal Reserve, NBER, Bloomberg, Principal Asset Management. Data as of August 14, 2023.

…and the Fed's own economic projections imply a recessionary unemployment rise.



Source: Bureau of Labor Statistics, National Bureau of Economic Research, Principal Asset Management. Data as of July 31, 2023.
Note: Created by former Fed economist Claudia Sahm, the Sahm rule stipulates that recession occurs when the unemployment rate rises by at least 0.5%.

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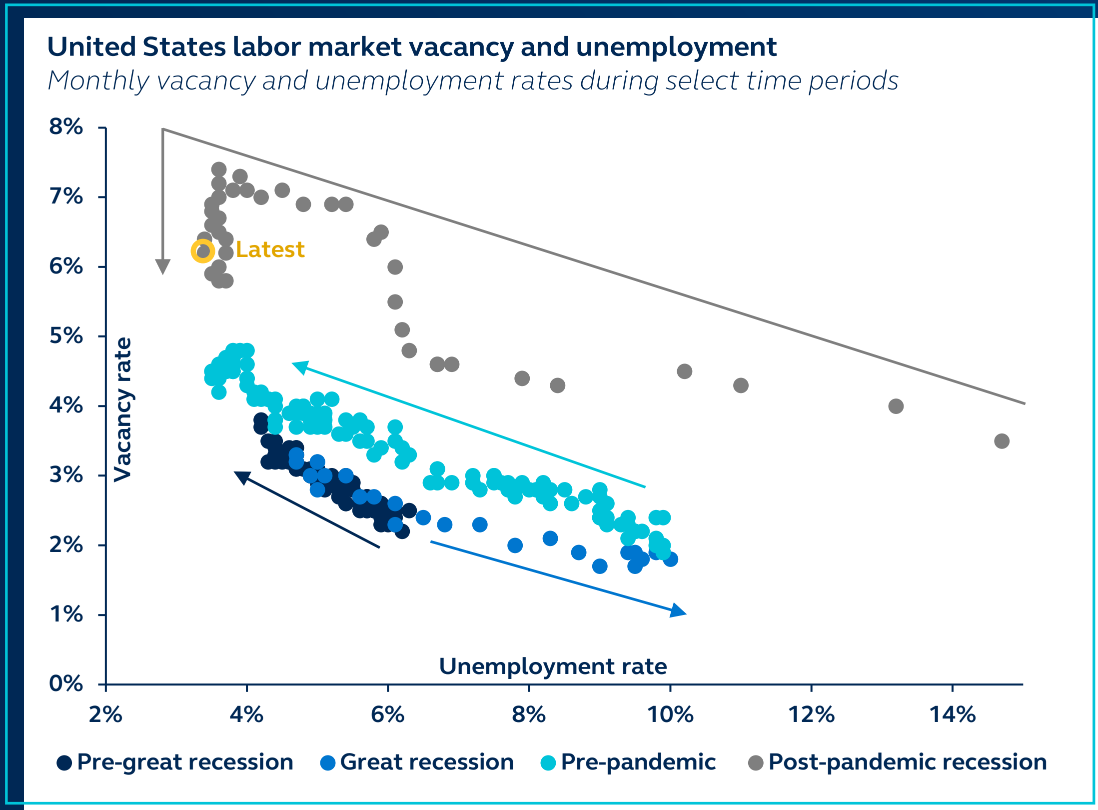
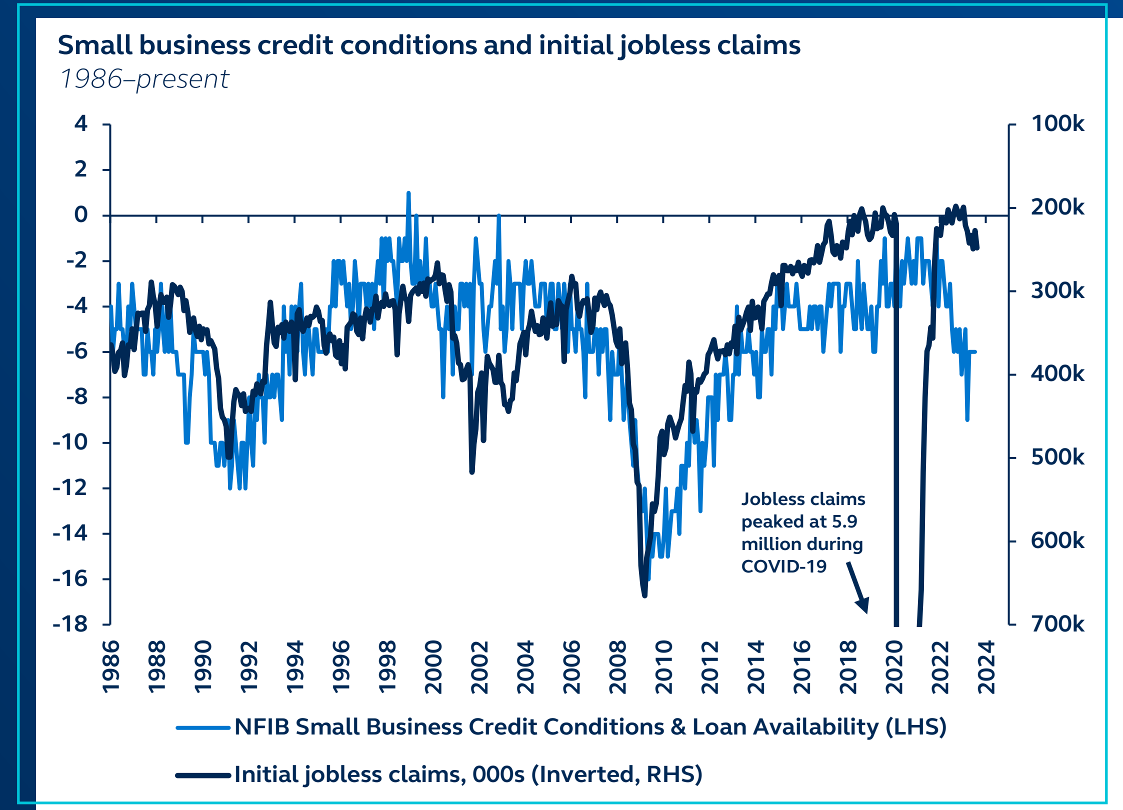
2 Labor market false hopes

Job vacancies have fallen without a rise in unemployment, raising soft landing hopes…



Source: Bureau of Labor Statistics, Federal Reserve, Bloomberg, Principal Asset Management. Data as of July 31, 2023.

…but tightening credit conditions warn of rising jobless claims in the near future.



Source: NFIB, Bureau of Labor Statistics, Bloomberg, Principal Asset Management. Data as of July 31, 2023.

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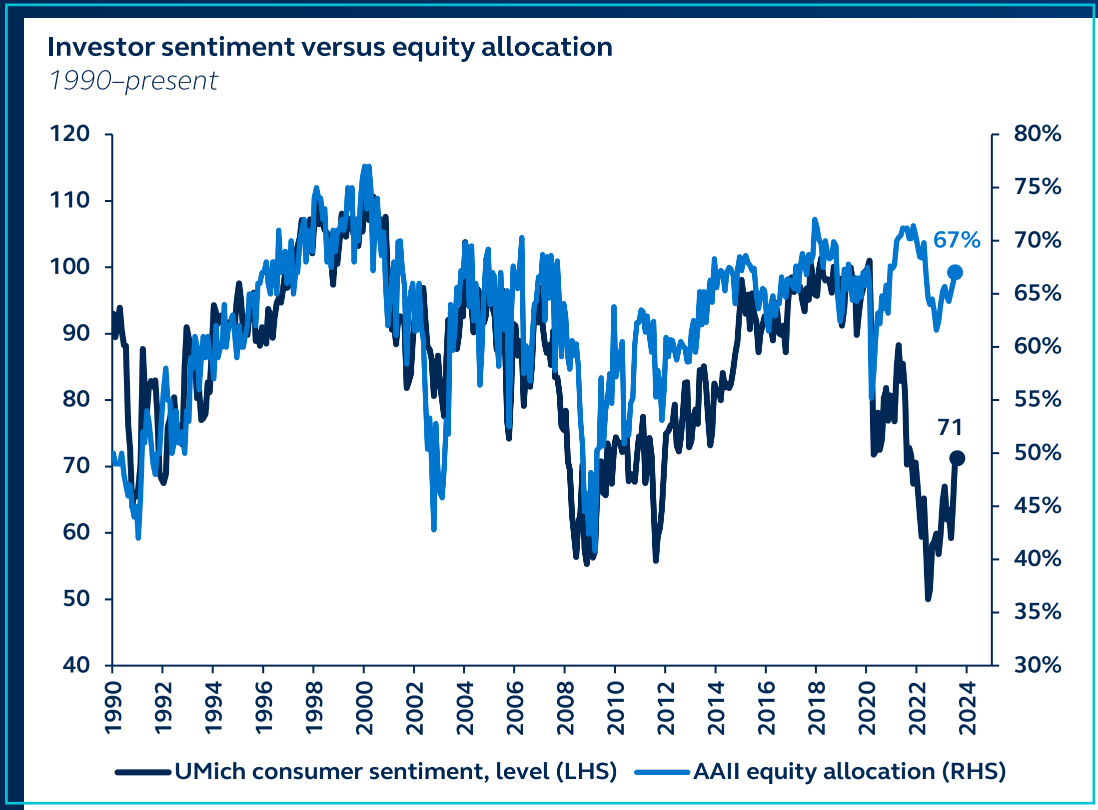
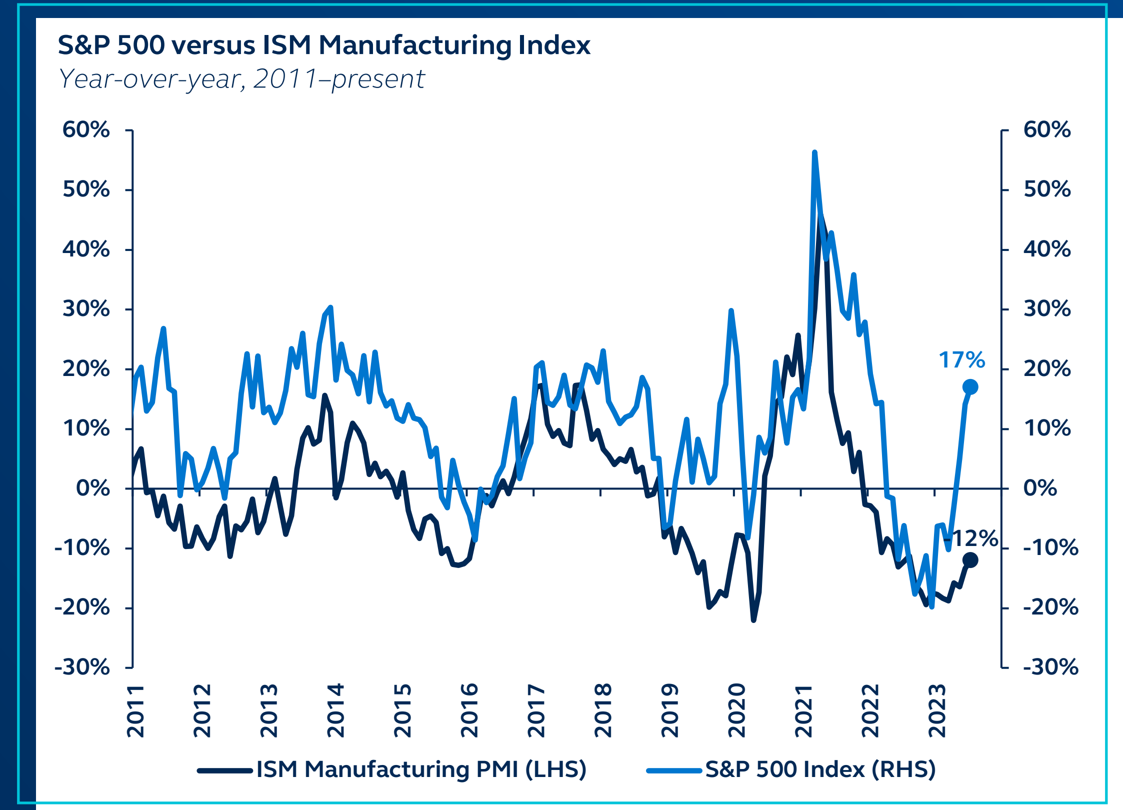
3 Vulnerable equity markets

Retail investors may feel dejected but remained optimistic on stocks…



Source: University of Michigan, American Association of Individual Investors, Principal Asset Management. Data as of July 31, 2023.

…despite equities substantially diverging from cyclical economic indicators.



Source: S&P Dow Jones, Institute of Supply Management, Principal Asset Management. Data as of July 31, 2023.

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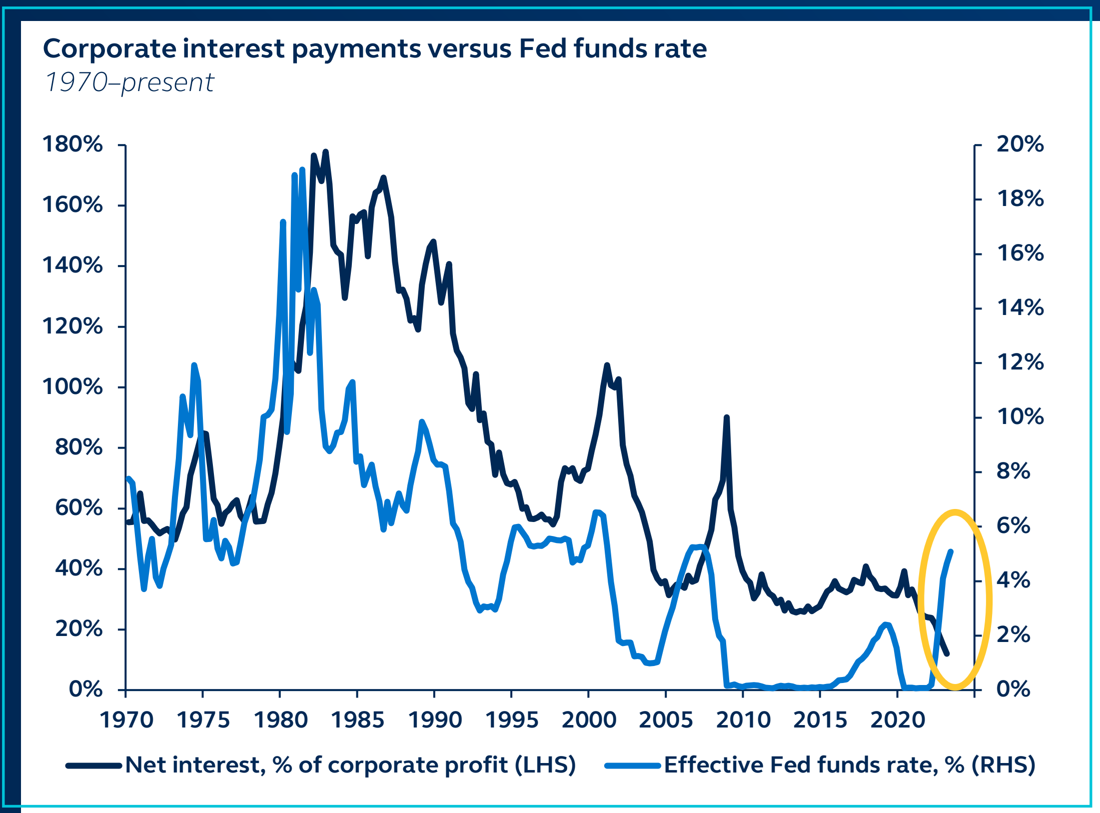
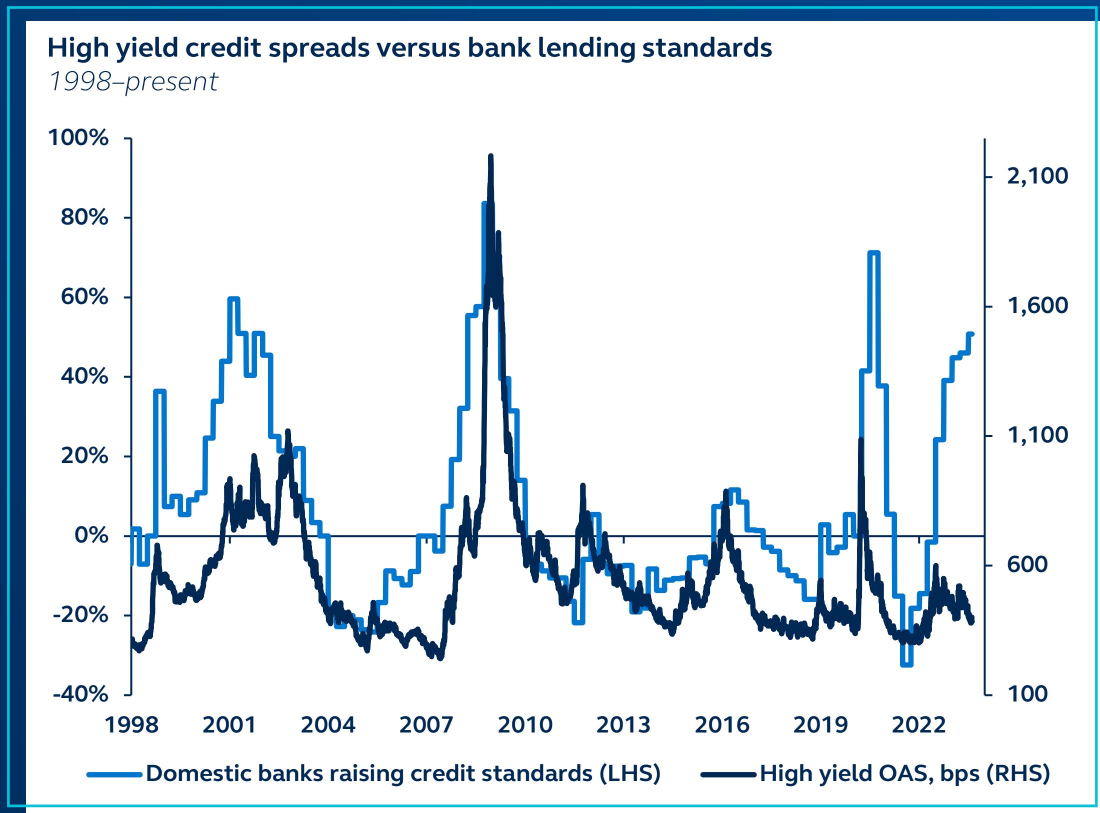
4 The Fed's "long and variable" lags

Debt maturity walls have temporarily insulated corporates from higher policy rates…



Source: Federal Reserve, Bureau of Economic Analysis, Bloomberg, Principal Asset Management. Data as of June 30, 2023.

…but as corporate debt matures, tighter bank loan standards will drive wider spreads



Source: Federal Reserve Board, Ice Data Indices, LLC, Principal Asset Management. Data as of July 31, 2023.

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