
'No Sign of Recession on the Horizon'

By Stephen Slifer Thu, Jan 10, 2019

Citing growth in the US labor force and in productivity, our guest columnist sees no likelihood of a recession in the near future despite volatility in the equity markets. He expects the Fed to act cautiously.



When the stock market experiences a down day, the market concludes that the economy could enter a recession by the end of this year and that the Fed will lower rates by year-end.

Forget it. Neither of those things is going to happen.

In mid-December the Fed suggested that it would boost the funds rate twice in 2019, from its current 2.25-2.5% target range to 2.9% by year-end. We still expect that to happen. However, in the near-term more and more Fed officials will advocate for no additional rate hikes until some of the current uncertainty comes to an end.

If that happens, which is what we expect, the Fed may well implement two additional rate hikes later this year.

The Fed continues to believe that potential GDP growth is 1.9%. GDP growth last year was 3.1% and the Fed expects 2.3% growth in 2019. Both growth rates exceed potential. Because the economy is at full employment, the Fed worries that inflation could begin to climb.

Potential growth measures how quickly the economy can grow over the longer-term when it is at full employment. It is interested in, say, a three-year growth rate for the labor force and productivity. We take comfort from the fact that growth for both measures has accelerated in the past year and, most likely, potential GDP growth is on the rise.

Growth in the labor force has picked up considerably. At the end of 2017 the three-year growth rate for the labor force was 0.9%. But the labor force increased 1.6% this year as rapid GDP growth lured some previously unemployed workers back into to work. The three-year growth rate in the labor force has climbed to 1.1%. If it climbs as rapidly this year as in 2018, the three-year growth rate will continue to climb.

Productivity growth has quickened. The three-year growth rate remains sluggish at 0.9% because of slow growth in earlier years. But growth this past year picked up to 1.5% and surpassed the 2.0% mark in the two most recent quarters. Like growth in the labor force, growth in productivity seems to be gathering momentum.

This suggests that potential GDP growth is on the rise. The Fed's 1.9% estimate probably consists of 0.9% growth in the labor force and 1.0% growth in productivity. But, as described above, growth in the labor force has picked up to at least 1.1%. Productivity growth has climbed to 1.5%. Thus, potential growth is no longer 1.9%. It is probably close to the 2.5% mark.

If that is accurate, the economy can grow at a sustained 2.5% pace without generating inflation. If our forecast of GDP growth for 2018 of 2.8% is accurate, the Fed has little reason to further raise rates. That is particularly true if inflation expectations remain in check. In the past couple of months, inflation expectations have slipped from 2.1% to 1.8%.

Also, keep in mind that the yield curve has flattened considerably in the recent months. With the yield on the 10-year note currently at 2.6% and the funds rate at 2.4%, the yield curve is positive by just 0.2%. The Fed does not want the yield curve to invert. It knows that an inverted curve is a warning sign that a recession is likely within the next year.

If potential growth picks up to a pace roughly in line with projected GDP growth, inflation expectations are declining, and the yield curve is extremely flat, the Fed won't raise the funds rate any time soon.

While recession chatter has become more widespread in the past month or two, there is no recession on the horizon for the foreseeable future.