

Strong data could push U.S. recession down the road

"We're stuck in the messy middle." That's how Josh Hirt, Vanguard senior U.S. economist, described a U.S. economy that hasn't fully reacted to sharp Federal Reserve interest rate increases over the last year. It's a state that has led Vanguard to revise its views for U.S. economic growth, inflation, and how high the Fed will ultimately need to raise its interest-rate target.

"Activity has weakened in the most interest rate-sensitive sectors of the economy," Hirt said. "But core areas are still showing resilience. We are in this in-between period where the impact of rates has not fully worked through the economy."

That analysis is informed by a proprietary model, the Vanguard Leading Economic Indicators Index (VLEI), created to infer developing economic trends. VLEI incorporates a broad array of the most significant variables on housing, the consumer, manufacturing, financials, expectations surveys, price levels, interest rate spreads, and major economic indexes compiled by the Federal Reserve and other agencies. Within VLEI, each variable is assigned a weight based on its historical correlation with economic activity and its lead-time predictive power.

What VLEI is signaling now

Our index shows that the most interest-rate-sensitive indicators have reacted to the Fed's changes in policy rate and started to turn red and yellow (top right section of the dashboard shown below indicating weak and slowing activity, respectively). Notably, they include indicators on home prices, financial conditions, and the purchase of big-ticket items. What we haven't seen yet is a deterioration in indicators that respond to more restrictive policy later in a business cycle, such as consumption and the labor market. They continue to indicate strong activity.

"With the Fed expected to continue raising rates and the hikes it has already made working their way through the economy, we expect to see more red and yellow among these indicators in the months to come," said Vytas Maciulis, a Vanguard U.S. economist who works closely with the model. (See the bottom right section of the dashboard.)

For context, the left side of the chart reflects activity leading up to and during the global financial crisis. The Fed began raising rates in the second half of 2004 and we started to see significantly more red and yellow at the top of the VLEI dashboard two years later. We see a similar pattern developing in recent data.

Core of the economy is showing resilience



Notes: For a given positively correlated variable in VLEI: red indicates weak activity, yellow indicates slowing activity, and green indicates strong activity. (The relationship is reversed for negatively correlated variables, or those that move in the opposite direction from that of the activity being measured.) Data are from January 2006 through December 2009 and from January 2020 through February 2023.

Source: Vanguard.

Implications for our outlook

Given the above-trend activity in some core leading indicators, it could take longer for the business cycle to turn, and we have adjusted our outlook to reflect that.

Our base case remains that there will be a shallow recession in late 2023, but that the odds of a "later landing" have increased. The economy should nevertheless post GDP growth of

around 0.75% this year—half a percentage point higher than our previous expectation—and just shy of 2% next year.

Stronger economic activity could lead to fewer job losses and more stubborn inflation readings. We expect the unemployment rate to climb a little more modestly from its current 54-year low to around 4.5%–5% by the end of this year and to be at a similar level at the end of 2024. We expect the Personal Consumption Expenditures Price Index (the Fed's preferred inflation yardstick) to end 2023 around 3% before falling closer to the Fed's 2% target in 2024.

The Fed will need to keep raising rates given this backdrop. We now see its rate target peaking in a range of 5.5%–5.75%. "Our outlook has held that stubborn inflation would require restrictive policy well into 2024," said Hirt. "We believe the current state of the economy is providing evidence that this will indeed be necessary."

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