The *R* Word

Talk of a recession has abated recently, yet economic headwinds remain, and consumers and businesses continue to feel the pinch of rising prices and rates. But is a minor recession cause for panic?

Economists see 46% chance of a recession by September 2024.*

If you were to listen to the average American, you would think that the U.S. economy is going down the tubes. As many surveys show, most consumers view the economy as bad and getting worse. In one poll, some described it as "horrible," "chaotic," "sad," "struggling," and "scary."[1] But the numbers tell a different story. Unemployment remains below 4%, near historical lows. The latest inflation figures show the annualized CPI dropping to 3.7% for the 12 months ended in September -- well down from over 8% a year earlier and within sight of the Federal Reserve's 2% target rate. And, for now at least, the Fed has halted rate increases. What's more, real gross domestic product (GDP) increased at a robust rate of 4.9% in the third quarter, exceeding analyst expectations.[2]

So why the disconnect? Although the metrics remain strong, consumers are feeling the pinch of inflation where it hurts -- at the checkout counter and at the gas pump. They are also running out of reserves built up from COVID relief checks and taking on more debt -- at higher rates.

Challenges Ahead

Despite recent evidence of continued economic resilience, there are a number of factors that could still drag the U.S. economy into a recession.

Continued hawkish stance by the Fed. While the Federal Reserve has halted rate increases for now, it has indicated that there may be more to come. At its September policy meeting, the Fed signaled that it anticipates raising rates once more this year and expects rates to stay higher in 2024 than most analysts had expected. The high rate environment is already putting a damper on economic activity, which will only worsen until rates come down.

The resumption of student loan payments. In October, millions of borrowers resumed payments on their student loans, which had been suspended since March 2020 in response to the COVID-19 emergency. The payments will put a pinch on many households, who now face a monthly bill that is often one of the largest expenses in their household budgets. As a result, many households will likely cut back on spending.

Pandemic relief has run out, and consumers are piling on debt. The last pandemic relief checks were issued over two years ago. Since then, consumers have spent their relief savings and taken on more debt. In fact, in the second quarter of 2023, total credit card debt topped $1 trillion for the first time ever, bringing total household debt to over $17 trillion, also a record, according to the New York Federal Reserve.[3]

Unaffordable housing. The average rate on a 30-year conventional mortgage is near 8%, up from around 3% just two years ago. Despite higher rates, house prices remain stubbornly high, as supply is constrained by would-be sellers opting to remain in their current homes rather than move and take on a high-rate mortgage. The national median home price in August was $407,100, according to the National Association of Realtors, not far off from the record high of $413,800. While few foresee a housing crash along the lines of the 2008 crisis, the higher rates are taking a toll on housing activity, which has repercussions throughout the economy.

Inverted yield curve. A normal yield curve has an upward slope, where bonds with longer maturities offer higher yields than those with shorter maturities. But since mid-2022, the reverse has occurred, with yields on short-term bonds higher than those on long-term bonds. This is called an inverted yield curve, and historically, it has been a harbinger of recession. All of the recessions since the 1950s have been preceded by an inverted yield curve -- though not every inversion has resulted in a recession.

Possibility of a government shutdown in November. While a government shutdown was barely averted in October, the temporary fix runs out on November 18. Given the protracted turmoil in Congress, it is unclear whether a closure can be avoided this time. Any shutdown will weigh on the economy and douse consumer sentiment even further.

Global events. The crisis in Israel, the war in Ukraine, China's looming real estate bust -- all have a limited impact on the U.S. economy. But they create uncertainty in financial and commodity markets that can filter down to consumers and businesses. Moreover, any escalation of the war in Israel could pose a serious risk to global economic stability.

No Cause for Panic

While all these factors do increase the likelihood of a recession, those who forecast one generally expect it to be mild and short-lived. In fact, recessions are fairly common. Since World War II, there have been 13 of them -- or about one every six years. The median duration of a recession during that time was about 10 months, and the GDP dropped an average of 2.3%. The COVID-19 recession in early 2020 lasted just two months. Even the Great Recession of 2008-2009, the longest since 1945, lasted under two years.

It's also important to bear in mind what a recession is -- and what it isn't. The widely accepted definition of a recession is two or more consecutive quarters of contraction, as measured by GDP. That means that a 0.1% drop in GDP over two months technically constitutes a recession. A recession should not be confused with a depression, which is a period of sharp and sustained drop in economic activity where unemployment rates rise into the double digits and stay there for years, leading to a collapse in demand and dramatic declines in production.

Although recessions can be painful in the short run, they can be beneficial over time. They tend to purge the excesses of boom times and improve overall economic efficiency, as businesses lower prices, reduce costs, and streamline operations. People also save more during recessions. Rates come down, and housing becomes more affordable. And some businesses, such as discount stores and maintenance services, thrive in recessionary times.

So even with storm clouds in the forecast, the doom and gloom sentiment of many Americans may be overwrought. Whether the U.S. economy has a soft landing or a minor recession may not make that big of a difference in the end.

*Bankrate.com, October 10, 2023. Based on Bankrate's latest quarterly survey of top economists.

[1]*USA Today*, "If the economic statistics are good, why do Americans feel so bad?," September 15, 2023.

[2]Bureau of Economic Analysis, U.S. Department of Commerce, *News Release*, October 26, 2023. Annualized and seasonally adjusted.

[3]Federal Reserve Bank of New York, *Household Debt and Credit Report*, Second Quarter 2023.