MARKET STREETWISE

Economists Think They Can See Recession Coming—for a Change

They might be wrong again, but investors need a lot to go right

Since the S&P 500 reached its low for the year so far six weeks ago, stocks have risen 17%.

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Updated Dec. 4, 2022 5:46 am ET

If the economy shrinks next year, no one should be surprised. We’re facing the most widely forecast recession in history—and investors don’t seem to care.

Recession in Europe and the U.K. is already the average of economic predictions, while the U.S. average forecast for next year is growth of a miserly 0.2%, according to Consensus Economics, the third lowest since 1989.

The regular Wall Street Journal survey finds economists think there is a 63% chance of recession in the next year. And a survey of economists and investors by the Federal Reserve Bank of Philadelphia shows expectations that gross domestic product will fall in three or four quarters are by far the highest since it started in 1968.
Just because economists are convinced of their predictions doesn’t mean they are right, of course. Since that Philly Fed survey started, not a single recession was spotted a year in advance. Economists missed the 1990, 2001 and 2008 recessions completely.

Are economists more likely to be right this time? And, if they are, does that mean stock prices and bond yields should be higher or lower?

The cynics among us (yes, me included) will be tempted to answer with a “duh” to both. Obviously economists still have no crystal ball, and obviously recession would mean lower stocks, and probably lower bond yields, as it always has.

There are reasons to be doubtful, though.

Start with the economists. Like generals, economists are really good at fighting the last war. They build models that incorporate previous problems, and are constantly blindsided by new issues. This time, they think they understand because the problem for the economy is well understood: a central bank raising rates aggressively to fight inflation.

“People think they’ve seen this movie a few times now, and they’ve appreciated the significance of central banks being late [to tighten] and making a soft landing more difficult,” says Sushil Wadhwani, a former Bank of England policy maker and now chief investment officer of hedge fund QMA Wadhwani.

The Fed hasn’t raised rates so far, so fast since Chairman Paul Volcker’s assault on inflation at the end of the 1970s. Back then, not just one but two recessions followed in short order.

Economists and investors alike have also learned to appreciate a market indicator that has in the past preceded recession, the inverted yield curve, when long-dated bond yields are lower than those maturing soon. The 10-year Treasury yield is now 0.8 percentage point below the three-month yield, the biggest gap since December 2000 in what is, according to Campbell Harvey of Duke University, the most reliable indicator of recession.

“Especially after the global financial crisis [of 2008-09] people said we just can’t ignore this any more,” Prof. Harvey says. “So this [inverted curve] is impacting expectations.”

To hear the economists tell it, things are pretty dire. Bad economic news means recession of course, but so does good news. “It just means the central banks have to do more,” says Alex
Brazier, deputy head of fund giant BlackRock’s Investment Institute. “If the Fed wants to get core inflation all the way down [to its 2% target] it needs a recession.”

Economists might be wrong again. The comparison to the 1970s isn’t perfect, since the pandemic lockdown and reopening caused rapid shifts in the economy. Equally, the yield curve isn’t magic, with the inversion reflecting investor expectations that the Fed will move to cut rates again starting next year, as inflation pressures wane. And not every economist agrees that recession is inevitable.

“The most important data, especially market data, look nowhere near recessionary,” says Jan Hatzius, chief economist at Goldman Sachs. He points to the strong jobs market supporting household incomes, especially as headline inflation is likely to fall next year. Goldman puts the risk of recession at 35%, far below the consensus.

If there is a recession, should investors be worried? Historically, recessions have been accompanied by sharp falls in stock prices and bond yields. But since the S&P 500 reached its low for the year so far six weeks ago, stocks have risen 17%, even as Wall Street analysts pared their forecasts for earnings over the next year by about 3%.

Stocks move inversely to bond yields at the moment, a sign that investors care far more about the outlook for interest rates than for profits. In part that’s because the fall in forecast earnings remains contained. (Analysts are as bad as economists at predicting recessions.) The rally has been driven by an optimistic scenario in which inflation comes down without the Fed squeezing the life out of the economy, allowing interest rates to be cut late next year.

Such a soft landing is possible. But even in that scenario, optimistic investors also need to believe that Fed policy makers will rapidly lose their fear of inflation and recognize at some point next year that rates can be cut.

Investors trying to decide whether to buy the stock and bond rally need three things to go right. First, inflation comes down on its own, not because demand collapses. Second, the Fed recognizes in time that it doesn’t need to crush demand to get inflation back to target. Third, the sharp rise in interest rates that’s already happened doesn’t cause a recession, or a recession is so shallow that earnings are basically fine.

I put little faith in economic models that have missed so many recessions in the past. But it’s hard to have faith that stocks are having anything other than a bear-market rally, either.