Tell-Tale Signs Of A Possible US Recession; Its Ability To Impact Indian Shores

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George Santayana's adage "Those who cannot remember the past are condemned to repeat it" and Mark Twain's famous aphorism, "History doesn't repeat itself, but it often rhymes" hold a lot of significance with respect to past economic recessions. These statements give us an excellent framework of the importance of viewing present economic events through the lens of history.

History suggests that amidst financial and trade interlinkages, the recession does not remain restricted within the United States i.e. "When US sneezes, the world catches cold". The spill over effects are always felt across the countries through trade and financial channels which in turn percolate to marked growth slowdown in other economies. Thus, an impending growth slowdown or a recession is likely to impact Indian economy also as it has been the case during past recessions as well. However, the quantum of slowdown in India remain contingent upon the magnitude of the recession in US. Looking at the relative improvement in the past macro vulnerabilities (forex reserves, short term debt, import cover, external debt, debt service ratio) coupled with the unwavering commitment of the Indian government to foster capex, holds the ability to partially offset the bearing from US recession. With appropriate policy mix accompanied with the innate strength of macro fundamentals as economy possess, India can remain insulated. We expect Indian economy to grow on an average 6-6.5% between FY23-25. An unfavourable global backdrop in the wake of monetary tightening, geopolitical tensions, China slowdown, and elevated commodity prices is likely to weigh on domestic growth via the trade channel and through flows. Alongside, higher input prices would weigh on discretionary spending. While healthier corporate & bank balance sheets bode well for the private investment recovery that's currently at a nascent stage, weakening global demand, subdued consumer sentiments, rising rates and margin pressures are likely act as key deterrents.

Likelihood of a US recession has risen…: With inflation soaring to multidecadal highs, the US Federal Reserve Bank has been emboldened to embark on an aggressive tightening campaign by ratcheting up interest rates more rapidly and possibly by a higher quantum than previously anticipated with the clear objective of softening demand and dialling back sky-high prices. Even as the Fed's intention behind policy tightening is to slow the economy just enough to cool inflation without prompting a recession, an overheating economy, along with faster/bigger rate hikes and resultant tightening of financial conditions, has raised the likelihood of a recession in the US. A survey undertaken by the Wall Street Journal in Jun'22 indicates that the probability of a recession in the US over the next 12 months has surged to 44%. This is a level that's usually seen only on the brink of or during recessions and is much higher than 28% and 18% probabilities indicated during the surveys undertaken in April and January 2022 respectively. While substantiating the response, the news agency acknowledged that since the commencement of this survey in mid-2005, a 44% recession probability has been rarely assigned by respondents outside of an actual recession. In Dec'07, the month that the Global Financial Crisis began, survey participants assigned a 38% probability. In Feb'20, when the Great Lockdown due to COVID began, they assigned a 26% probability. Similarly, according to the latest Bloomberg survey, probability of a downturn over the next 12 months stands at 47.5%, up sharply from 30%/20% odds in June/March 2022. The dreaded R word has been hurled around a lot recently. Google search activity for the term "recession" in the U.S. is peaking. This was the case around the last two U.S. recessions. However, the timing here isn't always perfect. Search activity for recessions often rises several months before a recession hits.

…as also corroborated by several economic and financial indicators: Growing number of indicators in the US now suggest that a recession in the next year or two is imminent. Continuous rate hike and expectations of them happening at a steeper pace in future have already resulted in escalating US borrowing costs and sparked a strong selling in the corporate bond market. Alongside, a huge sell-off in the US equities in H1 2022—the worst loss seen during the first half since 1970, and the strongest dollar in two decades has led to financial conditions tightening to levels seen in early 2020. The most popular gauge of recession i.e., inverted US yield curve is showing prominent signs of a dismal economic outlook. Past trends apparently elucidate that a US recession has followed every yield curve inversion within six months to two years over the past five decades. A lot of surveys and sentiment indices are also showing noticeable signs of weakness, indicating deteriorating economic outlook conditions. Considering these indicators, a running economic forecast by the Atlanta Fed is pointing to output contracting at an annualized rate of 1.2% in the second quarter of this year, following a 1.6% annualized fall in the first quarter. This more downbeat outlook is also reflected in expectations for Fed rate rises.

Commodity prices soften as supply issues are easing with moderating demand: Worsening demand concerns are outweighing unresolved supply-side bottlenecks, thereby putting pressure on commodity prices. Industrial metal prices have dropped precipitously amid global recession jitters. Oil and food prices too seem to be coming under pressure. This has been further corroborated by the latest PMI survey results that showed companies' input costs rising at the slowest rate for four months in June. The data suggests that the global cost pressures eased in June even as they remained elevated. The Composite PMI Input Cost Index that tracks changes in costs for Manufacturing as well as Services sectors—fell from a 14-year high of 71.5 in May to a four-month low of 69.3 in June, primarily attributed to easing supply delays across a wide range of input categories. That said, supply shortages continue to remain significantly above long-term average levels for most of them, while it worsened further for semiconductors.

A look at the past Fed tightening cycles: While demystifying the tell-tale signs of a possible US recession, we have also looked at the past episodes of tightening in the US since 1955, peak of hiking cycle and the time of recession if any. Out of 13 times when Fed has tightened, the US economy has entered recession seven times since 1955. The inflationary periods of the 1970s and early 1980s saw the biggest increases in interest rates. The FOMC this year commenced the 14th tightening episode since 1955. According to the FOMC's latest dot plot, the Fed Funds Target Rate is expected to increase to 3.75% by December 2023 only to drop to 3.4% by December 2024. With signs of inflation expectations moderating, Fed is most likely to reduce the quantum of rate hikes from September onwards. A case study by the BIS institution examining soft or hard landing scenarios across 35 countries over the period 1985-2018 reveal that historically nearly half of all monetary policy tightening cycles during this period have ended in a soft landing, while the probability of hard landing escalates substantially when monetary tightening is followed by the build-up in financial vulnerabilities. The study elucidates that the faster growth in credit to GDP prior to a tightening period is associated with hard landings.