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Q&A with Matthew Luzzetti

Author
Matthew Luzzetti
+1(212)250-6161
matthew.luzzetti@db.com

www.dbresearch.com

research.db.com

In a new 'Q&A with' Matthew Luzzetti, Chief US Economist shares his insights on whether the US Economy is already in a recession, and if it isn't when one is expected and how the Fed is likely to respond to the conflicting signals from inflation and growth.

Q: Is the US economy already in a recession?

A: We just revised our forecast for the second quarter and now expect the economy to contract by -0.6% annualized. That would be the second straight negative quarter for US real GDP growth, consistent with a technical recession. However, we do not think the economy was in a recession in the first half of the year for a few reasons. First, the contraction in the first quarter was driven primarily by volatile international trade data, while consumer spending and business capex were resilient. Second, alternative measures of economic output, for example gross domestic income, grew solidly. Finally, there has been little evidence of a deterioration in the labor market – the usual tell-tale sign of a recession – with the economy adding about 450k jobs per month on average in the first half of the year.

Q: If the economy is not currently in a recession, when do you expect one?

A: Back in April we first forecasted a US recession that would begin towards the end of 2023. Since then, a more aggressive tightening from the Fed has rattled markets, and business and consumer sentiment and activity have softened at a worrying speed. While our base case has been that a still-solid labor market will allow for positive growth throughout the remainder of this year, we are becoming increasingly concerned that weakness spreading throughout the goods sectors of the economy will spill over into the labor market and services sectors this year. If that happens, a so-far unemployment-less recession would likely turn into a more traditional contraction.

Q: How is the Federal Reserve likely to respond to the conflicting signals from inflation and growth?

A: The Fed has pivoted aggressively in a hawkish direction in recent months to better position monetary policy in responding to four-decade-high inflation. Still stubbornly high and broadening price pressures, which have raised the risks that expectations of future inflation could become unhinged, should keep the Fed on a hawkish path in the near term. And with the labor market still at historically tight levels, some modest softening will not be sufficient to derail the US central bank's hawkishness. Indeed, a dovish pivot for the Fed likely requires both clear signs of inflation pressures abating and a material softening in the labor market. If the economy does fall into recession this year, we could see the latter condition met before the former, complicating the Fed's tightening plans.