QNB Economics
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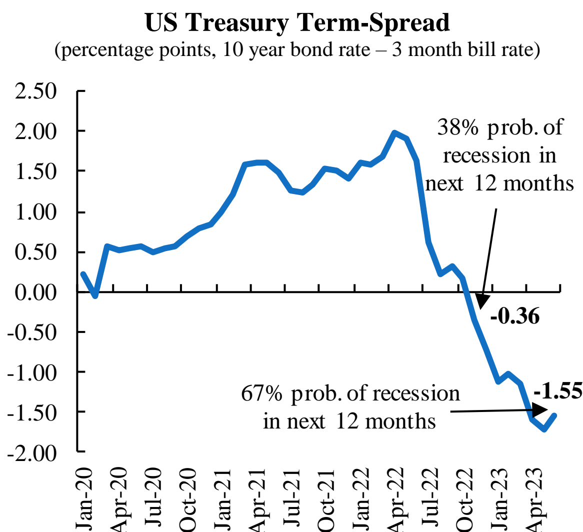
Financial markets point to a weak US economy in 2024

The US economy continues to demonstrate its resilience despite significant headwinds from high inflation, tighter financial conditions, and an uncertain global environment. Since the beginning of the year, firm conditions in labor markets, strong household consumption, and a robust services sector have beaten the initial expectations that these sectors would deteriorate. On the back of these developments, the Bloomberg growth forecast consensus for 2023 increased by a full percentage point, from 0.3% in January to 1.3% by mid-year. While economic momentum should further prevent a downturn for the US in 2023, a recession is not out of the picture yet for 2024. In our view, the question of this much anticipated recession deserves a more in-depth analysis.

In a series of articles, we carry out an analysis of indicators from three categories (production, household, and market-based) to assess the state of the US economy to understand if and how a potential downturn is evolving. In this week's article, we analyse financial markets indicators, and the evidence they provide regarding the outlook of the economy. We focus on the US yield curve, the newly created financial conditions index from the Federal Reserve Board (Fed), and the dynamics of the US equity markets.

US Treasury Term-Spread
(percentage points, 10 year bond rate – 3 month bill rate)



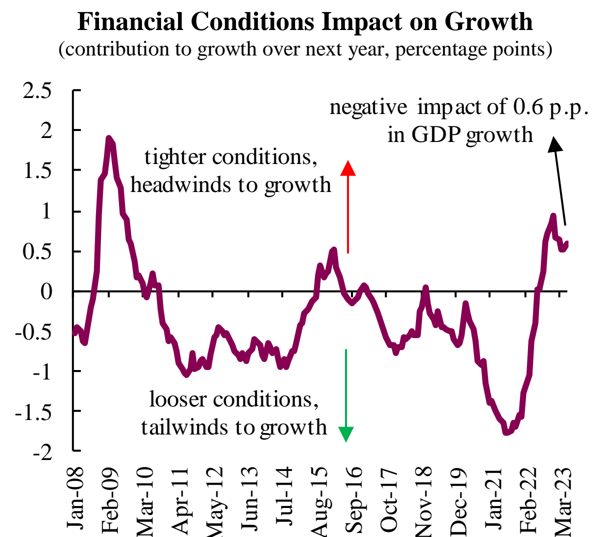
Source: Federal Reserve Bank of New York, QNB Economics

First, the inversion of the slope in the US Treasury yield curve is signalling an economic downturn with high probability over the next 12 months. This simple indicator, also named the term-spread, is constructed as the difference between long-term and short-term interest rates of treasury securities. Historically, it has provided a consistent relation with economic activity in the US: lower values of the spread predict a softening of the economy.

Yield curve inversions provide reliable signals of looming recessions. Since 1968, before each of the last eight recessions, short-term interest rates have risen above long-term-rates, generating an inversion of the yield curve. The recent monetary cycle of the Fed has accumulated 500 basis points of hikes in the central bank's policy rate since March 2022, taking the yield curve to negative territory at the end of last year. The monthly value of -1.55 percentage points (p.p.) in June implies a 67% probability of recession in the 12 months ahead, according to a statistical model developed by the New York Fed.

The intuition behind the relation between the term-spread and economic activity is straightforward: tighter monetary policy leads to higher short-term interest rates, which are expected to induce a slowdown in economic activity, as well as soften the demand for credit. In turn, this weakening induces lower inflation and interest rate cuts into the future, reducing current long-term rates, and therefore the term-spread.

Financial Conditions Impact on Growth
(contribution to growth over next year, percentage points)



Source: Federal Reserve Board, QNB Economics

Second, financial conditions are at the tightest levels in years, and imply a drag on growth going forward. A useful description of markets is provided by the financial conditions index (FCI), newly created by the Fed. This index aggregates financial variables, such as corporate bond yields, the Dow Jones stock market index, treasury and the federal funds rates, 30-year mortgage rates, and the nominal exchange rate dollar index. A convenient feature of this index is that it is expressed in terms of its impact on economic growth over the next year. The recent readings of the FCI are at their tightest levels since the Global Financial Crisis, and these conditions are estimated to be a drag on GDP growth of roughly 0.60 percentage points over the next year.

In our view, tight financial market conditions will persist going forward. In addition to the interest rate tightening cycle, the Fed continues to revert the balance sheet expansion that was put in place during the Covid-pandemic as an extraordinary and temporary measure. Higher costs of credit and tighter lending standards by banks will restrain the availability of credit for households and firms.

Third, although stock markets have beaten the overall pessimistic expectations of the end of last year, this has been to a large extent due to the surge in specific sectors fuelled by new technological trends, such as the artificial intelligence boom (e.g., ChatGPT and associated technologies). Stock markets provide valuable information regarding expectations of corporate performance and the economic outlook in general. In the first half of the year, the S&P 500 was roughly up 16%, while the Nasdaq 100, which heavily weighs technological stocks, climbed close to 40%. However, this performance has been driven by technological companies such as Apple, Microsoft, Google, and Meta. Excluding firms more directly affected by AI, the S&P was almost unchanged, showing that there is actually a high degree of caution embedded in equity markets regarding the overall economy.

Furthermore, going forward analysts' expectations express a high degree of uncertainty in addition to pessimism. According to a survey conducted by Bloomberg, analysts expect the S&P 500 to fall 8% in the second half of the year. More striking is the 50% difference between the most optimistic and the most pessimistic forecasts, showing discrepancies in expectations that have not been recorded in two decades, and reflecting the high level of uncertainty with respect to the economic outlook.

All in all, market-based indicators point to a drag on economic growth from tight financial markets, and a high likelihood of an economic downturn. This complements our previous analysis of the main production sectors and household consumption foreseeing a soft-landing of the US economy.

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