TS Lombard

Daily Note

A BETTER RECESSION SIGNAL THAN BONDS!

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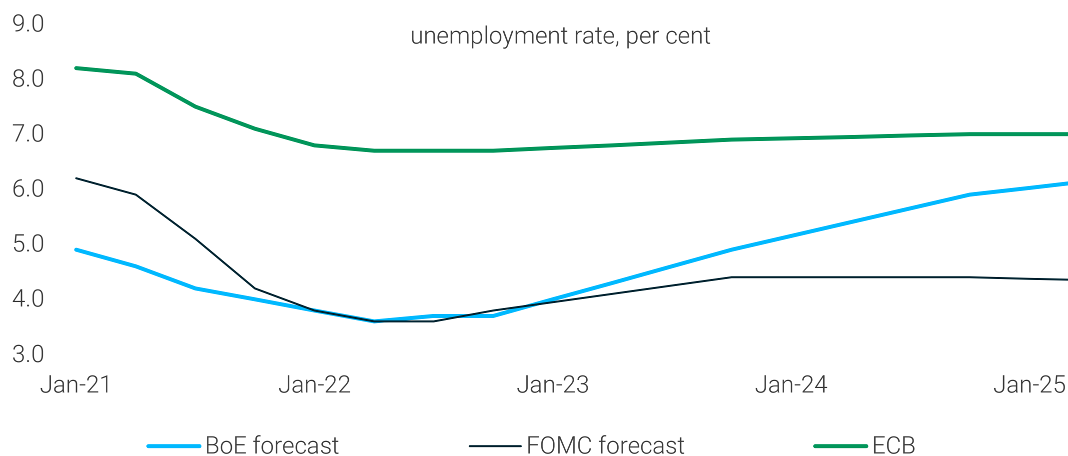
- **Central banks are doing something they never do – warning of recessions**
- **The bad news: they have a decent record at spotting cyclical peaks**
- **The worse news: central banks always underestimate recession severity**

We find ourselves in a weird situation. Not only is the consensus predicting a global recession next year – which is unheard of – but central banks, once the cheerleaders of the world economy, are equally pessimistic. Both the Federal Reserve and the Bank of England are projecting higher unemployment in 2023 – which only happens during recessions – and though the ECB is still in resolute denial about the state of the euro-area economy, it is rare to see major central banks putting out forecasts of this nature. What should we make of it? If you are a contrarian investor, you probably feel this is a bullish signal. Central bankers' recent forecasting record is so laughably bad, there must be a decent chance they are making another massive error today. But there is also another, more unnerving, possibility. Perhaps the recession is now so blindingly obvious that even economists have figured it out. And we shouldn't forget there may even be a degree of wishful thinking behind these official forecasts. Central banks actually seem to want a recession in 2023 to end their current inflation nightmare. If so, they certainly have the tools to deliver one.

Chart 1: Central banks are forecasting recessions in 2023 (except the ECB)



Sources: Staff forecasts, FOMC, ECB, Bank of England

20 years ago it would have been unimaginable for central banks to publish a forecast that included rising unemployment, let alone use the "r" word in public. The monetary authorities would never deliberately talk down their economies, because they needed to support public confidence. Even if they expected a downturn, they would have kept it quiet. Or lied about it. And that's the first important point investors should bear in mind today. Excluding the fake Covid

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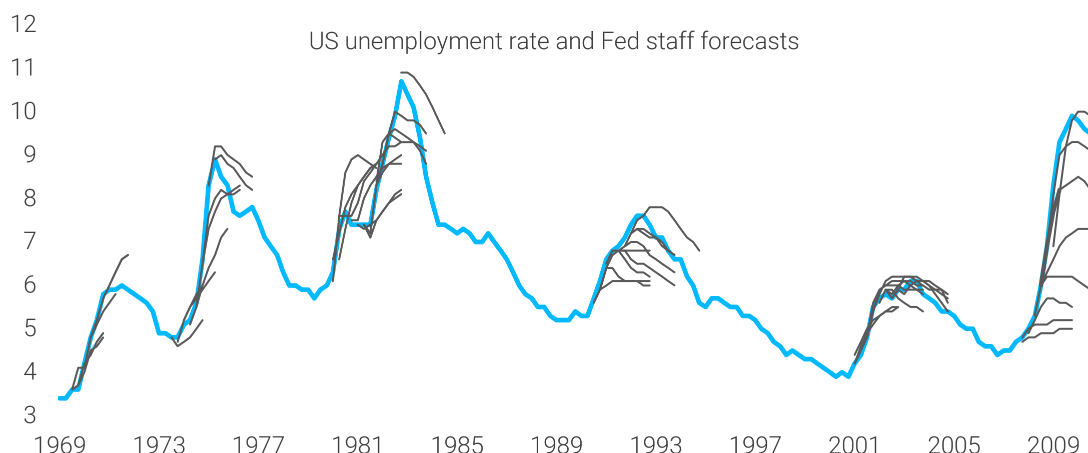
recession, this is the first time we have faced genuine recession risk in this new era of central-bank transparency. There are good reasons why most investors cant remember the last time the authorities predicted a recession, because they were actually under no obligation to reveal those forecasts to the public. Publishing a chart of rising unemployment was a central banker taboo.

Chart 2: The Fed forecasts recessions, but gets the magnitude wrong



Sources: Philadelphia Fed Tealbook database, TS Lombard

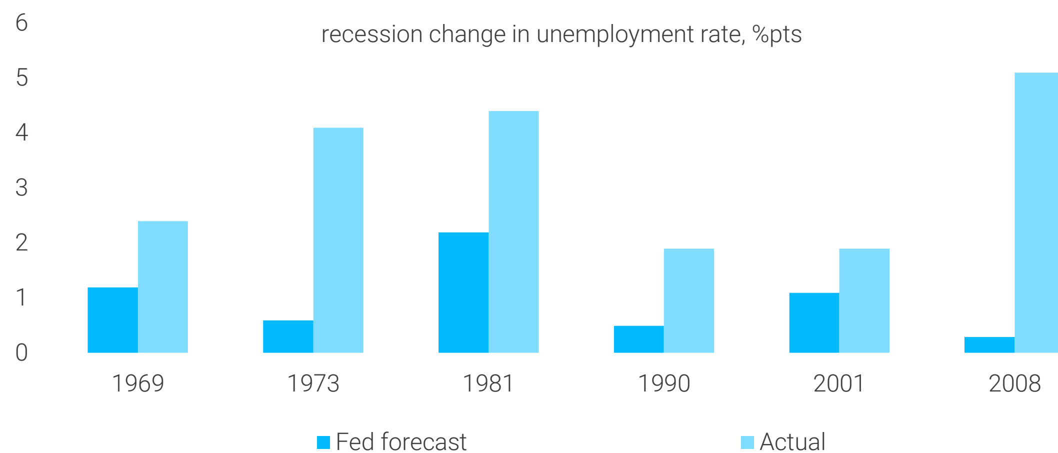
In this new world of full transparency, central banks' incentives have shifted. They are deliberately more open. But they are not necessarily more honest. When the authorities started publishing detailed forecasts they discovered they had a new policy tool – forward guidance. When they wanted to stimulate the economy they would predict long periods of zero rates and continuous disinflation. But today's environment calls for a different form of forward guidance. With inflation at dangerous levels and central banks obsessed with the threat of expectations becoming "unanchored", they actually have an incentive to exaggetate the downside risks and re-emphasize their determination to raise interest rates anyway. So they start channeling their inner Paul Volcker, or bore us endlessly with "the lessons of the 1970s". Forecasting higher unemployment is a good way to signal their "toughness". They will "keep at it", regardless. And in an ironic twist, this communication may even help to prevent a recession. By injecting extra uncertainty into the outlook, central banks might be hoping that their hard message can discourage hiring, reduce spending and prevent big wage demands. Perhaps this is just another of their Jedi-mind tricks…

We need to know whether central banks made similar forecasts even when they kept their projections secret, locked up in their vaults with their gold and the details of their personal trading activities. And this is where the news gets rather worrying. While most central banks have never published their internal forecasts, even with a lag, the Federal Reserve is a crucial exception. The FOMC publishes its staff projections – and all the underlying analysis and documents on which those forecasts are based – with a five-year delay. The Philadelphia Fed collates them all into a neat online database. The first thing I have discovered – which frankly surprised me – is that the Federal Reserve has a pretty good track record when it comes to spotting turning points. Since the 1960s, the Fed has forecast rising unemployment ahead of every US downturn – typically up to six months in advance. This makes its staff forecasts even more useful than the signal we get from an inverted yield curve. Yes, contrary to conventional wisdom, Fed officials are just as good as the bond market – perhaps better, given the occasional false positive from yield inversion!

Ok, sure, I'm exaggerating. To really understand those forecasts for rising unemployment we need to consult the documents and transcripts associated with their predictions. When we do this, we find that Fed officials were usually predicting relatively "soft landings" rather than large

declines in employment and output. With a few exceptions, the Fed realized the cycle had peaked but assumed the downturn would be fairly mild, with a period of "subpar" activity sufficient to resolve whatever imbalances had arisen. Unemployment rose on those forecasts, not because of widespread job losses, but because employment would be growing more slowly than its long-run trend. Naturally, this meant the central bank always underestimated the pain the economy was facing. As the outlook deteriorated, Fed staff had to make a rapid succession of upward revisions to their unemployment projections. And if you think about it, the pattern makes a lot of sense. Recessions can be highly reflexive and non-linear. Once people start losing their jobs, confidence plunges, spending stops, corporate revenues decline, and you get further rounds of job cuts. The whole process feeds on itself, especially as financial conditions tighten, and asset prices plunge.

Chart 3: The Fed always underestimates the eventual pain in labour markets



Sources: Philadelphia Fed Tealbook database, forecast at NBER cyclical peaks

It is difficult to read those past transcripts, or study those previous forecasts, without feeling slightly humbled about the current environment – especially when every central banker, and 90% of private-sector forecasters, are keen to assure us that the next economic downturn will be "mild". We can only hope that in publishing their projections for the first time, central banks have made themselves victims of a sort of Goodhart's law, where the forecasts themselves alter private behaviour and make a soft landing more likely. Perhaps the Jedi-mind tricks will work. Because if that is not the case, and the major economies genuinely contract and unemployment begins to rise, there is a real risk that everyone is underestimating the severity of the situation. This week's macro picture – out on Thursday – will look at the risks to the consensus in detail. For a big surprise in 2023, the major economies must perform much worse than the soft landing everyone is predicting, or there has no to be no landing whatsoever. But which is more likely?