EMPOWER INVESTMENTS | Thomas Nun, CFA® | Portfolio Strategist

Quarterly economic review: Standing at the crossroads

Inflation is probably under control. Now what?

The Federal Reserve has probably finally achieved what it set out to do a little more than two years ago: It has nearly beaten inflation.

And that's good news, right? Well, sort of. It's undeniably a good thing that the Fed is finally feeling confident enough to begin easing interest rates, which Fed Chair Jerome Powell has announced will happen in September. But here's the thing about tightening cycles: By the time the Fed is finally in a position to begin cutting rates, the economy has usually already slowed enough to place both economic growth and the labor market at serious risk of contraction. And that's where we stand today — at a crossroads between recession and recovery.

We'll discuss which road the U.S. economy seems most likely to choose in the commentary below, but first, let's remind ourselves how we got here in the first place.

- The Federal Reserve is probably finally satisfied that inflation is under control, but by the time the Fed is in a position to begin cutting rates, the economy has usually slowed enough to place the economy at serious risk of contraction.
- COVID-era inflation was "double barreled" and notoriously hard to defeat, but the popping of the travel bubble provides a great case study on how the Fed won.
- The defeat of inflation has left the U.S. economy at a crossroads, with "soft landing" on one side and recession on the other.
- Both are plausible outcomes, but the road to recession seems shorter to me — especially with so many classical signals already flashing red.
- The U.S. labor market will tip the balance and solve the puzzle — and labor appears to be weakening across multiple dimensions.
- But, even if the U.S. economy does tip into recession, it wouldn't be unreasonable to expect a constructive market environment after an initial period of volatility.

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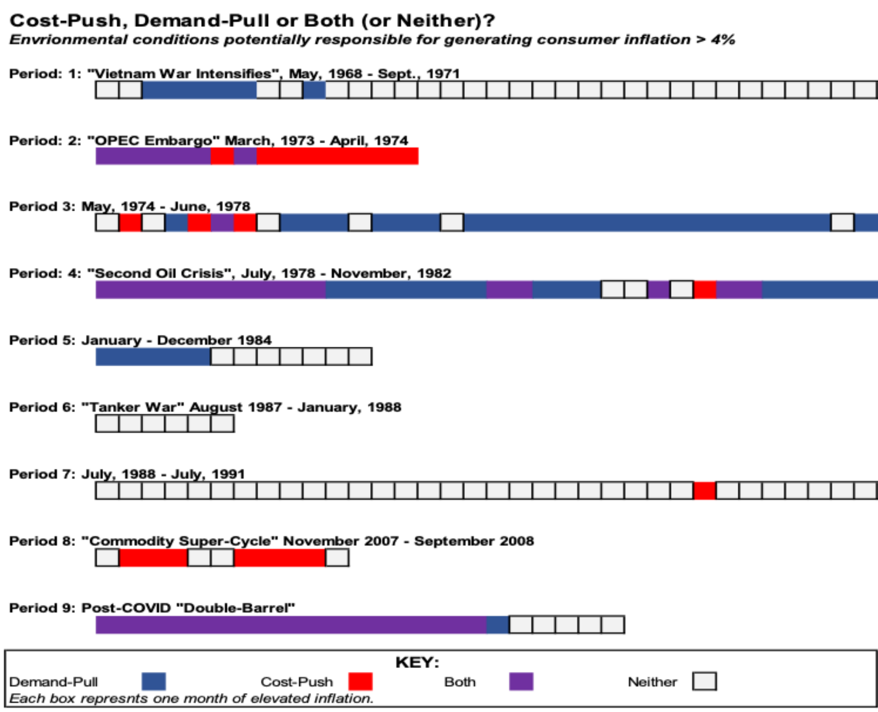
Where did all this inflation come from, anyway?

Economists generally believe there are two types of inflation: cost-push (which occurs when capacity-constrained producers suddenly face rapidly rising costs and push some of that burden through to their customers in a bid to stay afloat) and demand-pull (which occurs when consumers suddenly engage in frenzied buying, pitting themselves against one another in a bidding war for scarce goods and services that ultimately forces prices to rise).

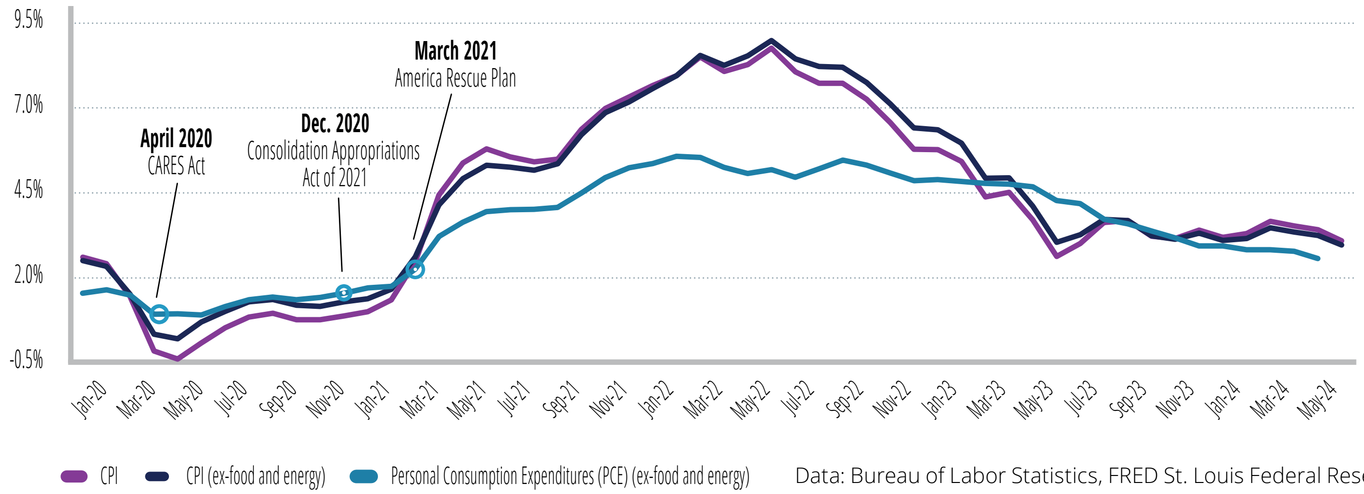
Both kinds of inflation can and do create the kind of pressure on prices that compels the Fed to act. But occasionally, they combine forces to create a double-barreled blast of inflation that is devilishly hard to fix. That was arguably the case during the inflationary episode of 1973-74 (which corresponded to the first OPEC oil embargo), and then repeated itself a few years later. The inflation wrought by these episodes eventually required a very aggressive rate-tightening campaign by the Central Banking GOAT, Paul Volcker, before prices were finally brought to heel.



Source: Empower Investments, Bureau of Labor Statistics, FRED St. Louis Federal Reserve, 2024.

But the COVID pandemic was perhaps an even better example of cost-push and demand-pull inflation ganging up to bruise the U.S. consumer. The cost-push side of the equation was obvious and pervasive: Never before in modern economic history had a global event so thoroughly shut down productive capacity than the COVID pandemic, with its near-total closure of factory floors, transportation networks, supply chains, and commercial activities of nearly every sort.

June's -0.1% month-over-month decrease in the Consumer Price Index (CPI) was the tamest of the post-COVID era



Data: Bureau of Labor Statistics, FRED St. Louis Federal Reserve.

The demand-side expansion was perhaps less pervasive but equally obvious: Governments worldwide replaced as much as one-third to one-half of global gross domestic product (GDP) with various forms of stimulus. Here in the U.S., three distinct direct-to-taxpayer stimulus programs served to juice liquidity: the Coronavirus Aid, Relief, and Economic Security (CARES) Act in April 2020; the Consolidated Appropriations Act in late December of that year; and the American Rescue Plan roughly three months later.

Initially, those stimulus checks did little to generate inflation. Even if our bank accounts were suddenly flush with cash, we had precious few places to spend the windfall as the lockdowns continued. But something important happened between the last two of these stimulus programs: the Pfizer/BioNTech vaccine came along and supercharged "The Great Reopening." Suddenly, it was possible to spend that stimulus cash, and prices responded quickly.

Inflation at the consumer level would eventually peak in mid-2022 at 9.1%[1] — higher than at any point since the 1970s-and-'80s era that made Paul Volcker famous. Since then, a natural healing of supply chains as the COVID shut-ins ended, combined with a very aggressive tightening campaign by Jerome Powell's Fed (who has emerged as the Patrick Mahomes of Fed fame to Paul Volcker's Tom Brady), has pushed inflation back toward levels with which the Fed (and the rest of us) can finally live.

1 Bureau of Labor Statistics, FRED St. Louis Federal Reserve.

The travel-bubble daisy chain: How the Fed won the war

Once the Great Reopening gained pace, supply chains largely began to heal on their own. That turned the job of controlling inflation into mostly an exercise in controlling demand — something the Fed is pretty good at. And the post-pandemic travel bubble — one of the most visible features of the post-COVID recovery — provides an excellent case study in how this daisy chain actually works.

Demand-pull inflation typically begins when demand enters a manic phase — something three rounds of COVID stimulus (and a sense of wanderlust stoked by months of being shut in our homes) accomplished by generating a wave of "revenge travel" that sent many of us packing our bags for a trip to Disneyland or hopping a long flight to Tokyo. In short order, this quick burst of demand caused inflation to spike as buyers competed for scarce capacity: During the six-month period between January and June 2022, lodging away from home jumped 18.7% while airfares spiked 42.6% as we all competed for that economy-class seat.[2]

But in the background, the Fed had already begun jacking up interest rates as a way to soak up some of the excess liquidity that was still sloshing around the economy as a result of aggressive COVID stimulus. While the Fed wasn't targeting travel demand specifically, the effect was the same: By hiking rates, demand for discretionary purchases like travel eventually began to fall as budgets for non-discretionary purchases like mortgages, gas, and groceries became stretched thin by higher rates. That was particularly true for anyone financing large expenditures like a three-week European vacation on a credit card that was suddenly carrying an annual percentage rate (APR) in excess of 20%.

Eventually, the travel bubble started to deflate and demand began to slow. Prices fell, too, with lodging and airfares becoming notable standouts in June's happily benign Consumer Price Index (CPI) release — the closest one so far to the Fed's infamous 2% target. But eventually,

The Fed's good work: The travel bubble is a great example of how "demand-pull" inflation spikes (and then recedes)

1. Demand enters a "manic" phase	TSA throughput: +97% (2021-22)
2. Inflation spikes as buyers compete for scarce capacity	Lodging: +18.7% Airfare: +42.6%
3. The Fed raises rates to quash demand	Fed funds: +5.25%
4. Demand falls and producers face excess capacity	TSA throughput: -1% (June 23-June 24)
5. Producers cut prices to compete and reduce excess capacity to survive	June CPI (month-over-month): Lodging: -2.5% Airfare: -5.0%
6. The economy cools, inflation reverses, and the Fed cuts rates	-0.25 to -0.50% expected in September

Source: Bureau of Labor Statistics (CPI).

price cuts and promotional activity may not be enough — one consistent feature of second-quarter earnings among premier and budget airlines alike has been a near-universal call to cut excess capacity in response to this ongoing reset of consumer demand. When macro data and company data align like this, there's probably something going on.[2]

It would be easy to overplay this. After all, airfares and hotel stays collectively account for only around 2% of the basket of goods used to calculate CPI and are therefore only a small portion of the inflation equation. But as a stand-in for how inflation, Fed rate hikes, and the overall economy interact with each other, it'll do just fine. And through this lens, demand is clearly cooling — enough that the Fed is finally in a position to begin cutting rates.[2]

But here's the problem: "Reduce excess capacity" is often just a euphemism for "layoffs," a phrase that is now showing up with increasing frequency across the economy, not just in travel-related sectors. So the question now becomes can the economy cool "just enough" to wring out the excesses wrought by the post-COVID recovery without cutting so deeply as to tip the economy into recession?

2 Sources: Bureau of Labor Statistics (CPI), Transportation Security Administration Passenger Volumes, Federal Reserve Board of Governors, and Bloomberg.

Standing at the crossroads

Almost immediately after the Federal Reserve began hiking rates in March 2022, economists and market-watchers began debating whether the Fed would accomplish the nearly impossible feat of engineering a "soft landing" — that is, raising interest rates just enough to rein in inflation but not so much to tip the U.S. economy into recession.

That debate was premature. Recessions typically develop about two years after the Fed starts raising rates and often occur only after it stops hiking. (On average, recessions have occurred about five months after the last Fed-sponsored rate increase.) For those keeping score, we're now about 28 months beyond the first hike of this cycle and nearly a year past the first pause. So by that standard, we've only recently stepped into the window during which history tells us the economy often starts to run into serious trouble. As exceptional as the COVID experience has been, at least that aspect has been mostly true to script.

And because unemployment typically begins rising only in the early innings of a recession, joblessness usually peaks long after the Fed finishes its work. Historically, it takes nearly four years from the time of the first Fed hike for unemployment to peak. That suggests that even if the U.S. economy tips over in the very near future, the unemployment rate could continue to rise into mid or even late 2025.

It takes time: Recessions typically start only after the Fed quits raising rates

Start of tightening cycle*	End of tightening cycle	Arrival of recession	Months from: Start of cycle	End of cycle
Jan. 1973	Aug. 1973	Nov. 1973	10	3
Oct. 1976	Nov. 1979	Jan. 1980	40	2
Sept. 1980	May 1981	July 1981	11	2
April 1987	June 1989	July 1990	40	14
Feb. 1994	June 1995	NA	NA	NA
July 1999	Dec. 2000	Mar. 2001	21	3
July 2004	Sept. 2007	Dec. 2007	42	3
Dec. 2015	July 2019	Feb. 2020**	51	7
Mar. 2022	Sept. 2023	NA	NA	NA
Average (ex. COVID recession)			27	5

Source: Empower Investments, "False Labor," April 2024.

* Tightening cycles are defined here are periods of sustained, uninterrupted increases in the Federal Funds rate, followed by a sustained series of cuts and/or stable rates. As such, the exact timing of these cycles is, to some extent, subjective.

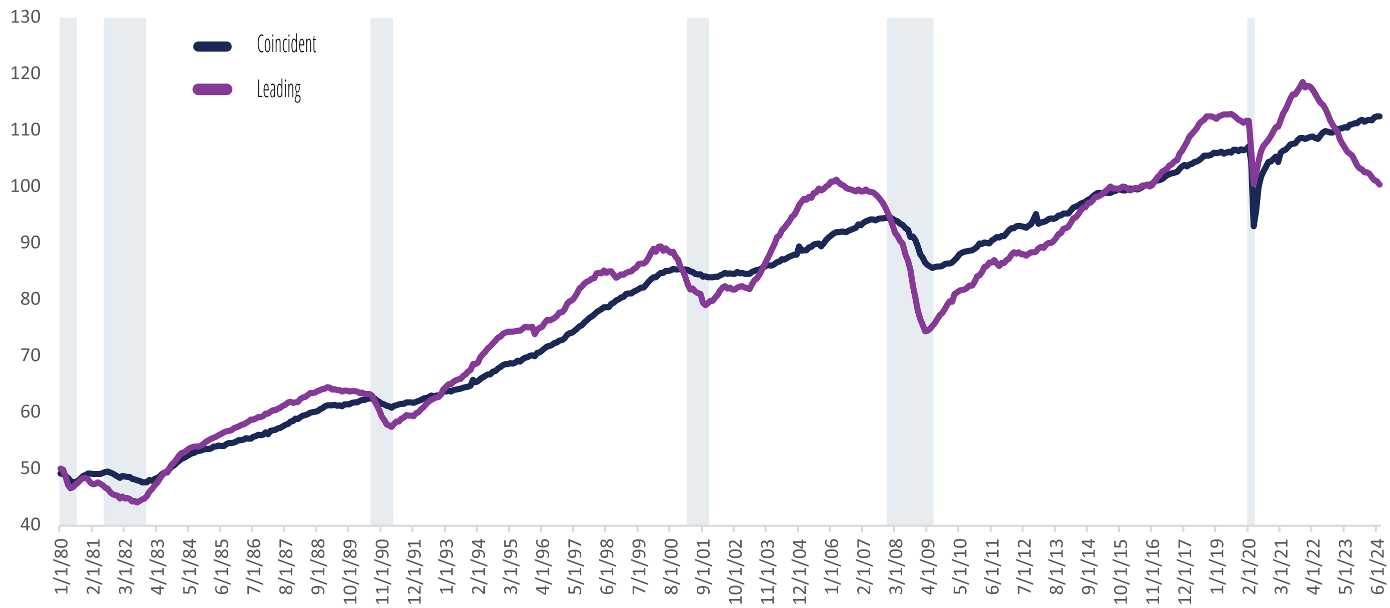
**The 2020 recession was directly related to the COVID-19 pandemic and cannot be credibly attributed to FED tightening.

Postponing the inevitable

End of tightening cycle	Unemployment rate: Surpasses pre-tightening rate	Unemployment rate: Hits cycle peak	Peak months from: Start of cycle	Peak months from: End of cycle
Aug. 1973	June 1974	May 1975	29	21
Nov. 1979	July 1980	July 1980	46	8
May 1981	Oct. 1981	Nov. 1982	27	18
June 1989	March 1991	June 1992	63	37
June 1995	NA	NA	NA	NA
Dec. 2000	Apr. 2001	June 2003	49	30
Sept. 2007	Dec. 2007	July 2008	65	26
July 2019	Apr. 2020	Apr. 2020	NA	NA
Sept. 2023	NA	NA	NA	NA
Average (ex. COVID recession)			47	24

Source: Empower Investments, "False Labor," April 2024.

You said don't cross the streams:
When leading indicators fall below coincident indicators, recession usually follows



Source: Bureau of Labor Statistics.

Let me count the ways

So even though the soft-landing debate has set the tone for markets for roughly two years, we've only just now reached the crossroads at which the economy must decide which direction will it take. Of course there's no way to know for sure, but it seems relevant that a number of classic recession signals have been flashing red for months. First and most obvious, the U.S. yield curve inverted in July 2022. While curve inversions are imperfect predictors of recession, the recent inversion has earned the unfortunate distinction of being the longest and deepest curve inversion since the era that made Paul Volcker a star. Moreover, it's typically true that the economy enters recession only after the curve rights itself. Ominously, that appears to be exactly what's happening now as a Fed cut has been announced: As I write this, the gap between two- and 10-year Treasury yields has narrowed to just a short hop to "normal" and the recessionary signal that might send.

Meanwhile, the Leading Economic Index (LEI) and its close cousin, the Coincident Economic Index (CEI), crossed paths last year, with the LEI uncharacteristically dipping below the CEI in early 2023. This "crossing of the streams" was closely associated with the recessions of 1991, 2001, and 2008, and is somewhat more ambiguously connected to the 2020s COVID recession as well as the twin recessions in the early 1980s. Its track record at signaling recession is empirically better than the inverted yield curve, and yet the U.S. economy has resisted its signal so far this cycle by remaining in expansionary mode.

Notably, the organization that compiles the LEI and the CEI is The Conference Board (a century-old, nonpartisan think tank) that also uses its macroeconomic database to compile a more explicit recession signal. That model, too, has been issuing on-again/off-again warnings about recession since mid-2022 — as have other time-tested signals from the Chicago Purchasing Managers' Association/Market News International, the National Federation of Independent Business, and others.

And yet still no recession. That could be a testament to the consumption-juicing impacts of the powerful stimulus and very loose monetary stance adopted during the COVID pandemic … or it could simply reflect the tendency of the National Bureau of Economic Research's (NBER's) official business cycle-dating committee (which essentially acts as the referee of business cycles by officially declaring when recessions begin and end) to post-date the economy's official peaks and troughs by several months. Put another way, when all is said and done, we might find that the U.S. economy tipped into recession months ago, but the official call has yet to catch up with it.

Either way, the list of indicators flashing warning signs is long and growing. Recently, the Bureau of Labor Statistics reported that unemployment ticked up to 4.3% in July, enough to trigger the so-called "Sahm Rule" that has an even better track record at forecasting recessions than the inverted yield curve, the gap between the LEI and CEI, or any other indicator discussed so far.

What's missing?

For now, we'll take it on faith that the U.S. economy remains in expansion mode despite all the red flags. That conclusion is certainly supported by recent GDP figures, which suggest that the U.S. economy grew by a surprisingly robust 2.8% during the second quarter. But the debate is far from closed, and it's almost as if the two competing narratives — soft landing on one side, recession on the other — are completing a puzzle to see who wins.

To me, it seems as if the side assembling the "recession" puzzle has far fewer missing pieces than those on the more optimistic "soft landing" side of the debate. For a recession to finally (and credibly) appear, only the labor market has to weaken. Meanwhile, the soft-landing/no-landing thesis needs a much larger set of pieces to come together, namely a reacceleration of consumer spending, a significant healing of the housing market, a recovery in small-business profitability, a normalizing and strengthening LEI and CEI, and an alignment of the manufacturing and services sectors as viewed through the lens of the Purchasing Managers' Index (PMI) and Institute for Supply Management (ISM) reports.

Put even more simply, the path from here to recession is much shorter than the path to reacceleration, at least in my view.

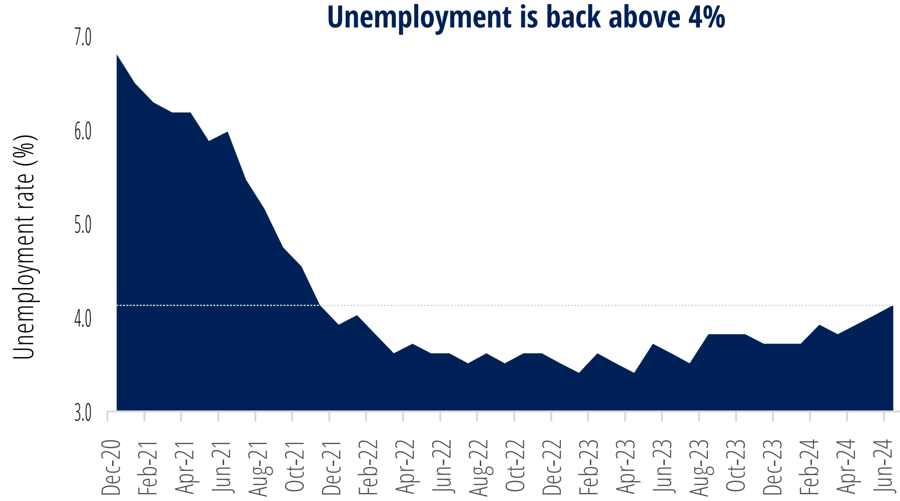
Two competing narratives

Labor under pressure

That places a lot of pressure on the labor market to prevent the U.S. economy from dipping into recession. And recent data suggests it may be buckling under the weight of that obligation.

After spending years below 4% — exceptional by historical standards — the U.S. unemployment rate broke through the 4% barrier in May. Since then, it has continued higher and now stands at 4.3% — high enough to trigger the Sahm Rule and reignite fears that the economy is truly sliding toward contraction.

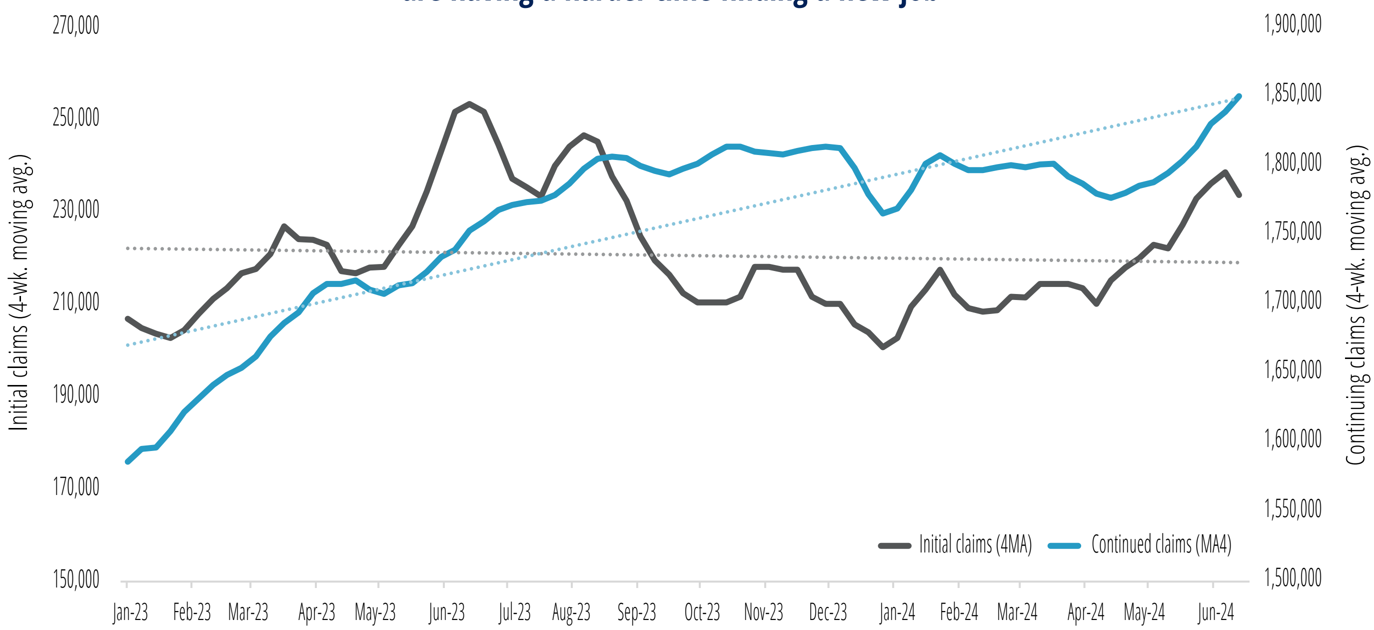
Unemployment is back above 4%



Source: Empower Investments, Bureau of Labor Statistics, FRED St. Louis Federal Reserve.

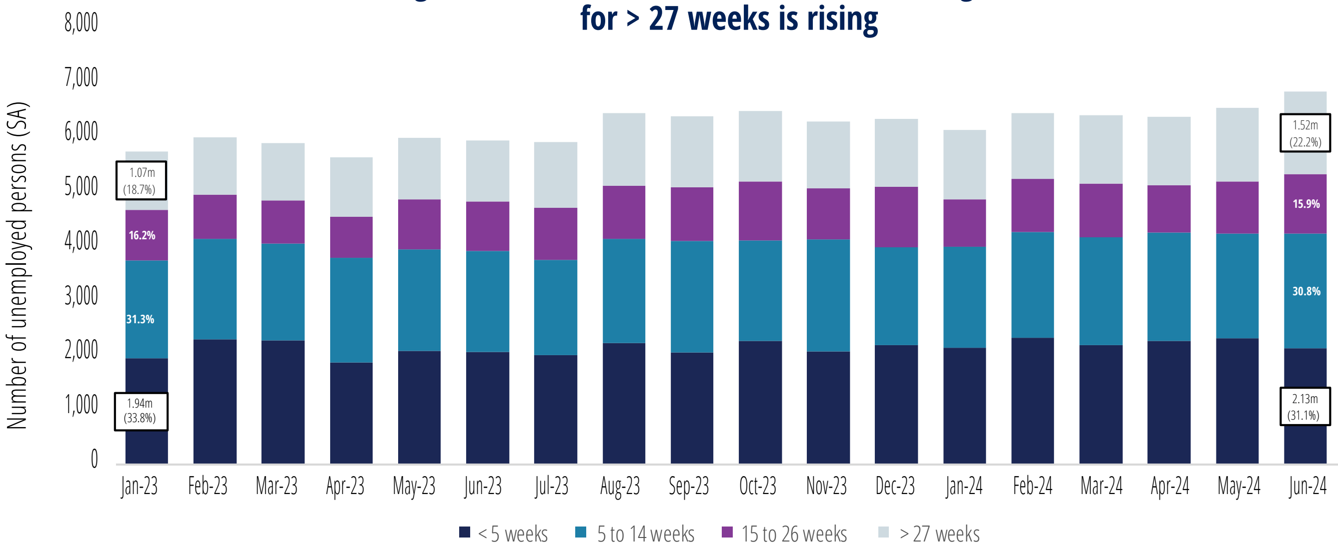
But other, more subtle signs support the point that the labor market is deteriorating, too. For example, continuing claims — the number of unemployed people who have received benefits for two consecutive weeks or more — have been rising faster than the number of recently unemployed for months. Long-term unemployed — those who have been receiving benefits for 27 weeks or more — stood at 1.07 million at the beginning of last year, or 18.7 % of all claimants receiving unemployment benefits. As of June, roughly 1.52 million people had been receiving a check for that length of time, accounting for more than 22% of total unemployment roles. This evidence that the labor market is having a harder time digesting those who find themselves out of work is also classic late-cycle behavior that suggests more weakness could be coming.

Lingering longer: New claims haven't spiked yet, but those who are out of work are having a harder time finding a new job



Sources: Bureau of Labor Statistics, Empower Investments.

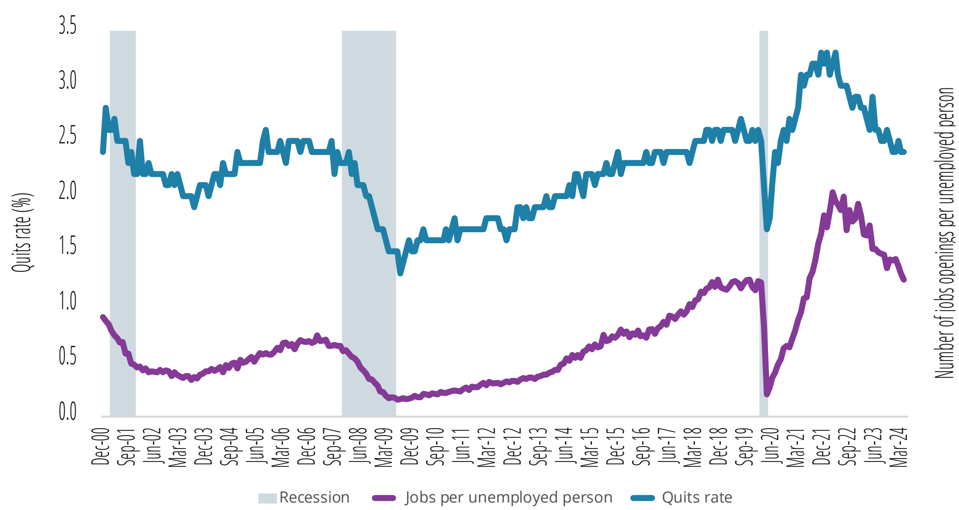
Indigestion: The number of claimants receiving benefits for > 27 weeks is rising



Source: Bureau of Labor Statistics, Empower Investments.

Other indicators also suggest the U.S. labor market is weakening from its extremely strong post-COVID recovery. According to the Bureau of Labor Statistics Job Openings and Labor Turnover Survey (JOLTS), the number of job openings in the U.S. has declined significantly from its post-pandemic high of more than 12 million and now stands at just above 8 million. That's still high relative to historical norms, and it's also still enough to represent more than one job for every would-be job seeker — a rare condition for any economy, including ours. But an interesting disconnect appears to be developing between the JOLTS data and other, somewhat more anecdotal, data like that issued by search and outplacement firm Challenge, Gray & Christmas.

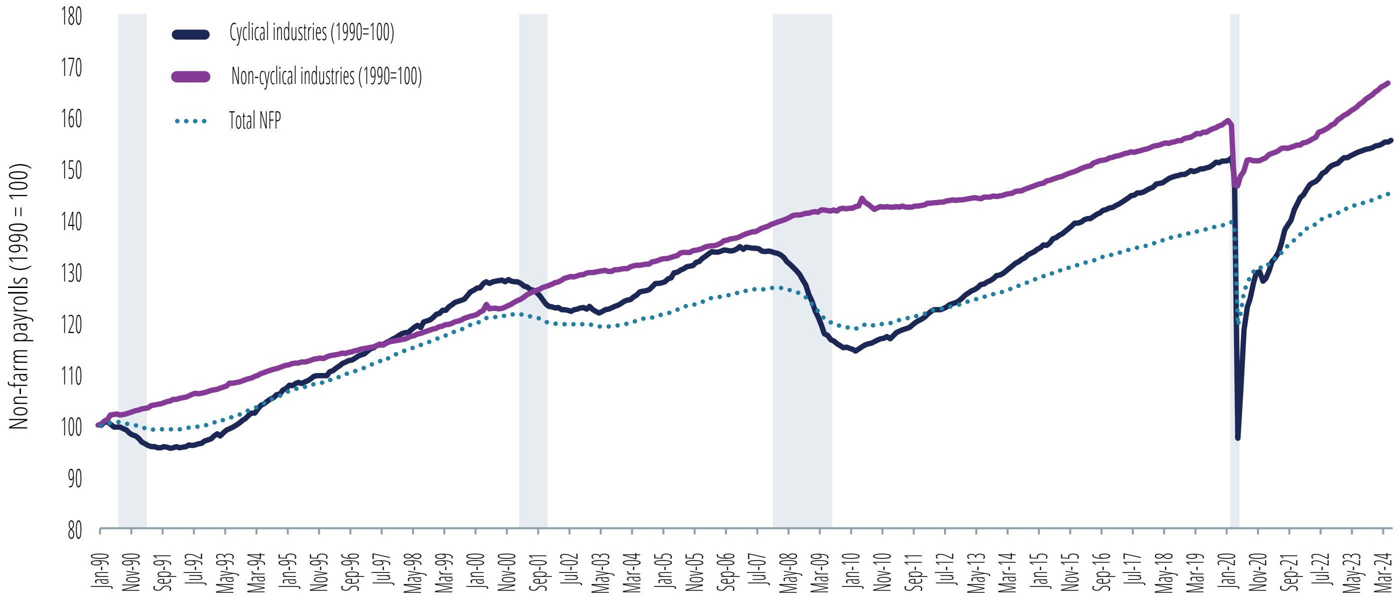
Welcome relief (but don't overdo it ...) The job market is coming off the boil



Data: Bureau of Labor Statistics; Job Openings and Labor Turnover Survey (JOLTS); FRED St. Louis Federal Reserve; Empower Investments; Challenger, Gray & Christmas, Inc.

According to Challenger, Gray & Christmas year-to-date data, hiring plans are the lowest they've been in more than a decade; fewer hiring announcements were made last month than in any July since at least 2009, when the U.S. economy was in the throes of financial crisis and "The Great Recession."

Stall speed: Cyclical employment is tipping over while non-cyclical grinds higher



Data: Bureau of Labor Statistics, FRED St. Louis Federal Reserve, Empower Investments.

This disconnect is consistent with a phenomenon that might be described as "unicorn hunting." Employers, who were caught short-handed and faced an acute shortage of candidates with applicable skills as the post-pandemic recovery took off, are incentivized to leave job postings open even if they aren't truly committed to hiring anything less than the perfect candidate. If that's truly what's happening, then "unicorn hunting" and its close cousin, "panic hiring," may be post-COVID phenomena that prove to be as durable as the work-from-home revolution seems to be.

At the same time, the so-called "quits rate" has also declined significantly. That's relevant because it speaks to the supply side of the labor equation — specifically, how confident workers are in their ability to find a new job if they quit the one they already have. Recognizing that the tables are slowly turning in favor of their employers, employees are hunkering down and staying put far more frequently than they were when labor seemed to hold all the cards. Like other labor market indicators, the quits rate is still relatively high compared to its own history. But it always declines in economic downturns, and the consistent move lower from its early 2022 peak certainly has a contractionary feel.

Cyclical

- Motor vehicles and parts
- Construction
- Semiconductor manufacturing
- Primary metal manufacturing
- Air transportation
- Leisure and hospitality (total)
- Apparel manufacturing
- Temporary help services

Non-cyclical

- Food manufacturing
- Utilities
- Education and health services
- Government (incl. education)

Finally, the composition of hiring seems to be throwing off slightly negative vibes as well. While total payroll growth has remained positive for more than three years, not all hiring is created equal: Some sectors like government, education, healthcare, and utilities tend to keep hiring activity relatively stable regardless of how the overall economy is performing while others tend to expand and contract alongside it. These so-called "cyclical" sectors include construction, temporary help services, leisure and hospitality, manufacturing, and a handful of others, and hiring in these sectors typically declines during recessions. It's plateauing now.

What's next?

Of course, it's entirely possible that the U.S. could continue to sidestep recession altogether as the Fed redirects its focus from inflation to jobs. But even if it doesn't, there's reason to hope that markets could remain durable even in the face of a significant contraction in the economy. Said a little differently, it would be reasonable to expect heightened volatility in the months ahead if the U.S. slips into recession, but "recession" doesn't have to equal "dismal market performance."

During past cycles, stocks have tended to sell off before (and recover during) economic recessions. That's because investors try to anticipate — not react to — economic trends. In fact, based on our research, stocks often finish an economic recession higher than when it began. While every cycle is unique (and the post-COVID economic cycle is perhaps the most unique of all), it wouldn't be out of character for markets to become increasingly volatile as the economy slows toward recession. If and when a recession arrives, though, you might be surprised to find that markets may have already "paid forward" a significant portion of the check.

Anticipation or reflection?

Markets have anticipated big changes in economic growth, not just reflected them.

			Market peak pre-recession time frame	Market trough after pre-recession peak	Market trough once recession hits	Peak-to-trough return	Return during recession
Post-war era (1945 - today)	12	Average	8.4 months	14.2 months	5.7 months	-27.4%	+2.4%
		Median	8.1 months	16.3 months	5.3 months	-22.6%	+3.5%
All periods (1858 - today)	24	Average	7.1 months	16.4 months	5.9 months	-30.1%	-3.0%
		Median	3.8 months	17.4 months	5.7 months	-27.4%	+0.5%

Equity market returns represented by the price return of the Dow Jones Industrial Average, the only equity index with consistent history throughout the analysis period. Data: Bloomberg, National Bureau of Economic Research, Bureau of Labor Statistics, and Empower asset management analysis.

Source: Empower Investments, "Splitting the Tab," September 2022. This analysis focused on the period beginning two years before the onset of each recession and extended two years after each recession's official end. Accordingly, there is occasional overlap in the period of market returns analyzed, and our dataset naturally expanded during more recent periods as the increasing reach and sophistication of domestic capital markets were reflected in a broader and more diverse set of benchmark indices.

Past performance is not a guarantee of future results. An index is not actively managed, does not have a defined investment objective, and does not incur fees or expenses. You cannot invest directly in an index.

"Peak-to-trough return" refers to the price return of the Dow Jones Industrial Average (DJIA) from its highest point prior to the onset of each of the 24 economic recessions that occurred between 1858 and 2024, as defined by the business cycle dating committee of the National Bureau of Economic Research (NBER), and extending to the index's lowest point associated with each recession. "Return during recession" refers to the intra-recession price return of the DJIA beginning on month of the peak in economic activity as determined by the NBER and extending to the trough in economic activity as determined by the NBER.