April 9, 2025

Dutta's Economic Daily

Fine. I'll Say It.

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Warning signs point to imminent recession

We are going into a recession. I don't think it is especially controversial to say so.

I suspect it will be relatively brief, but that the recovery off the lows will be pretty sluggish. Think 2001 to early 2003.

Five points I want to make ...

- Financial conditions have tightened considerably. I simply plot the Fed's FCI-G against the 12-month change in the US equity market. You are looking at a 0.75 basis point drag to GDP growth.

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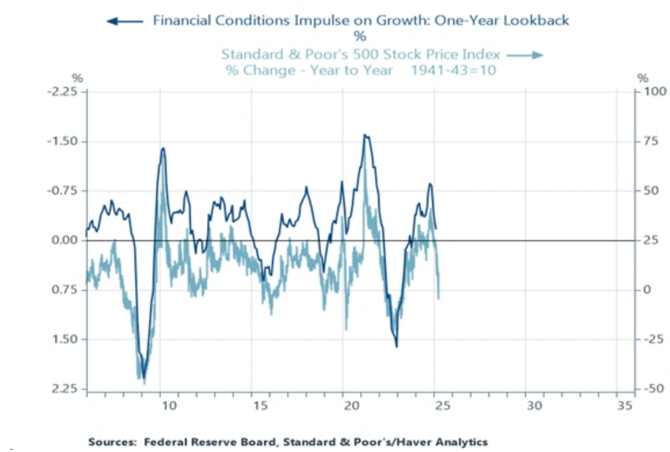
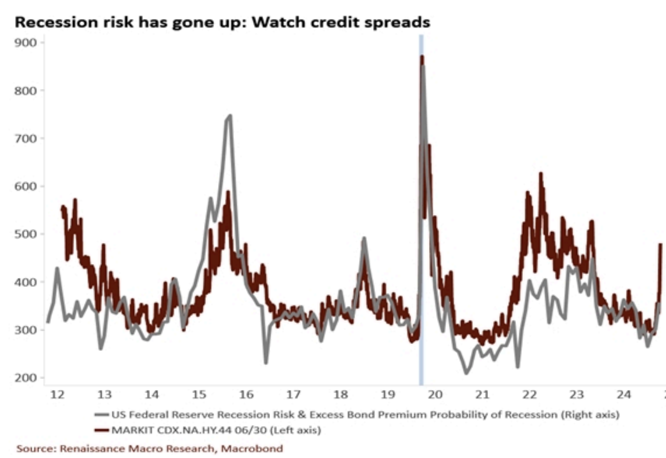
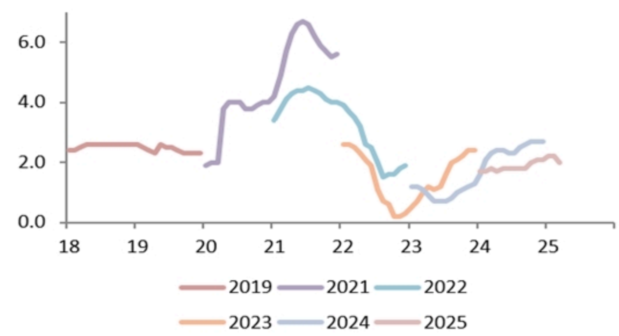


- In terms of the markets, I am watching two things closely. One, **credit spreads continue to rise**. Even though stocks are up as of this writing, I see that high-yield spreads have widened. Two, homebuilding stocks continue to drop. If residential investment does not really get off the ground with the market pricing in cuts, we have problems.



- **State and local governments will be a drag on growth**. In 2024, state and locals added 0.3ppt on average per quarter. That is downshifting to zero. I focus on state and locals because my assumption is they are somewhat less prone to swings in financial market conditions compared to household consumption and investment.

Consensus went into year with high hopes!
BlueChip Consensus GDP Forecast (Yr/Yr % Change)



Source: Renaissance Macro Research, Haver Analytics

- **<u>We are still in the escalation phase of the trade war</u>**. From Bloomberg News: "China Raises Tariffs on US Goods to 84% as Trade Rift Worsens" and "EU Adopts Tariffs on €21 Billion of US Goods in Metals Dispute." This is the tit-for-tat part of the Prisoner's Dilemma Game. I don't think Trump has much reason to back-down yet. He continues to hold the whip-hand in this game.

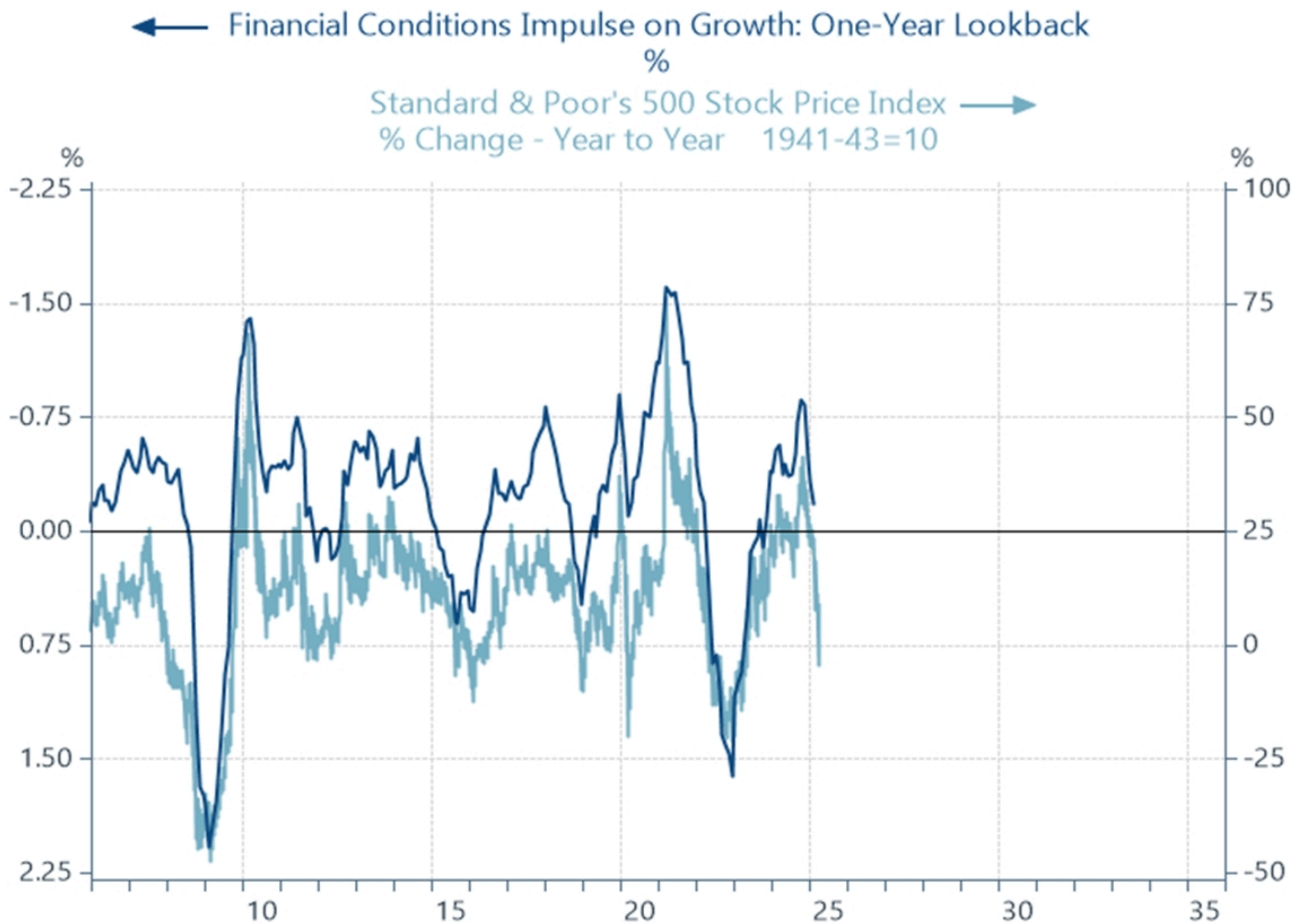
- **<u>The consensus still has a ways to go in slashing their estimates</u>**. According to the latest BlueChip forecast, the median estimate for real GDP in 2025 is 2.0 percent. There is still room for the consensus to capitulate. What is interesting is that sell-side (business) economists appear to be largely revising up their recession probabilities. By contrast, it is the academics that have basically called it. Tells you a little bit about the incentive structure of the two types of economists!

Three points before the open

- The rise in bond yields is not really about foreign selling. If the Chinese want to avoid the "embarrassment" of devaluation, they need to hold onto their reserves.

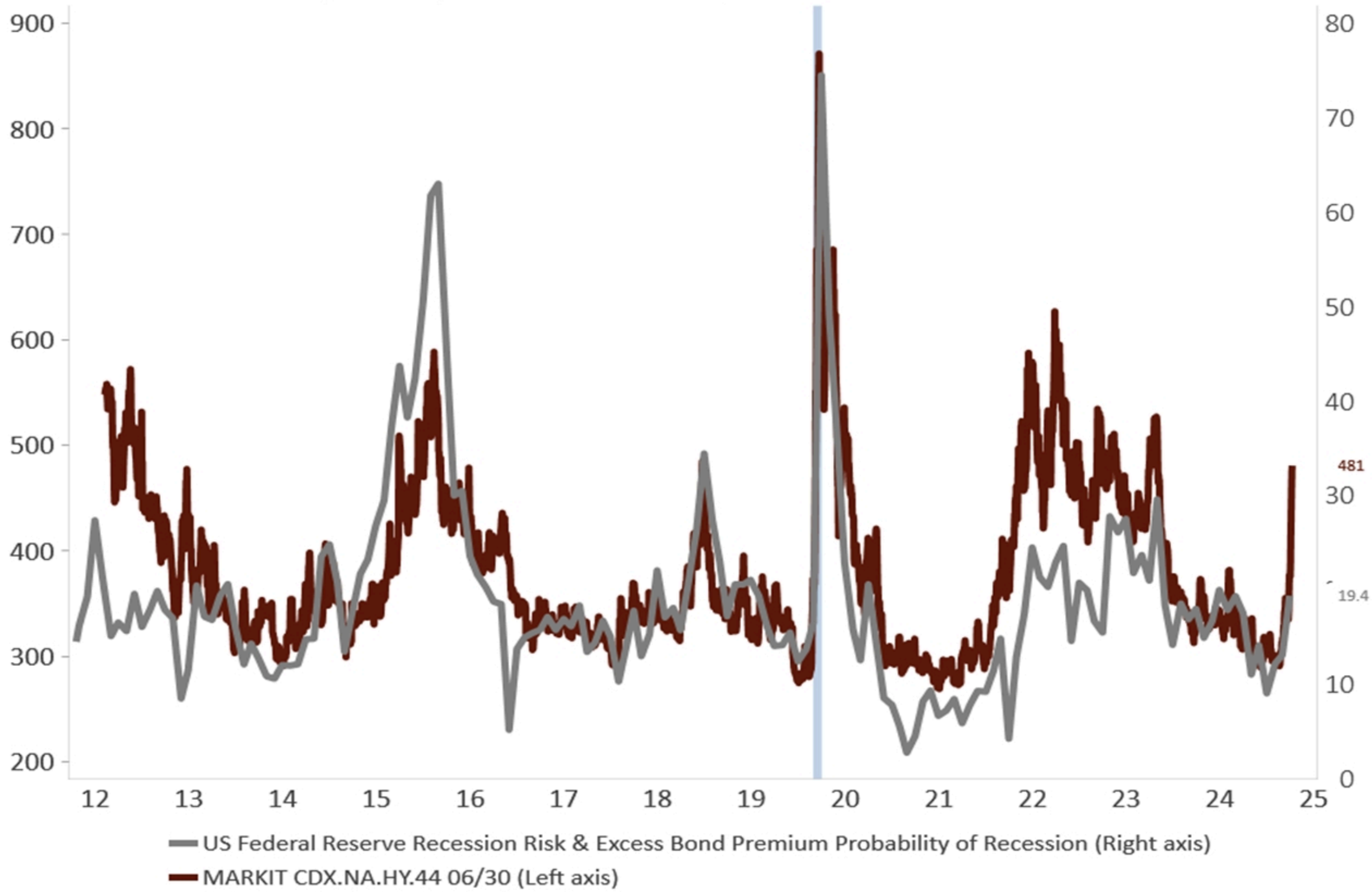
- The rise in bond yields seems to be mostly about investors facing margin calls, looking to sell high-quality assets to raise cash. This is the conclusion of the BoE.

- In the US, the drop in rates last week helped push up mortgage purchase applications, up 6 consecutive weeks to its best level since early 2024. Mortgage rates likely have jumped sharply this week, which likely means some of the progress in purchase applications is undone.



Sources: Federal Reserve Board, Standard & Poor's/Haver Analytics

Recession risk has gone up: Watch credit spreads



Source: Renaissance Macro Research, Macrobond

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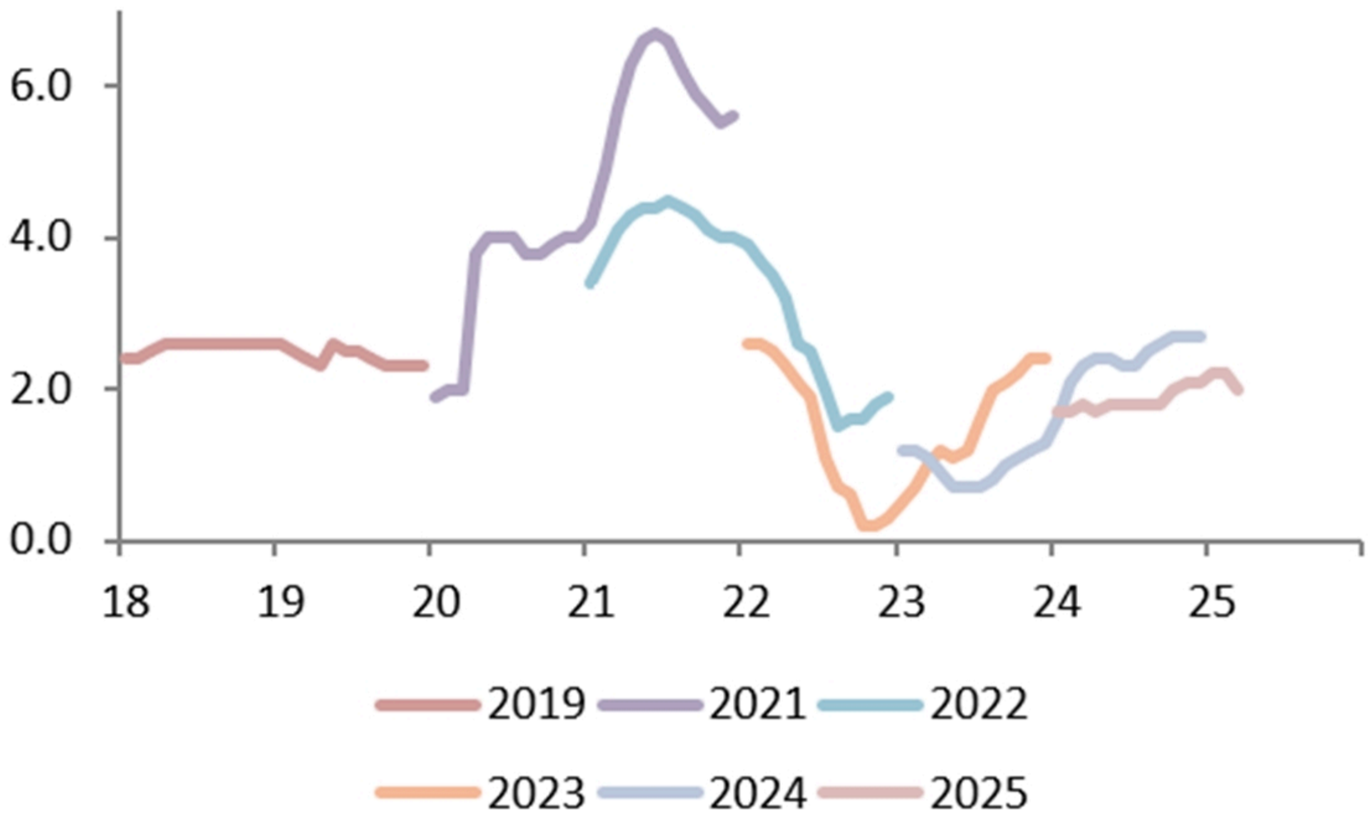

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