What will cause the next US recession?

By J. Bradford DeLong
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Three of the last four US recessions stemmed from unforeseen shocks in financial markets. Most likely, the next downturn will be no different: the revelation of some underlying weakness will trigger a retrenchment of investment, and the government will fail to pursue counter-cyclical fiscal policy.

Over the past 40 years, the US economy has experienced four recessions. Among the four, only the extended downturn of 1979-1982 had a conventional cause. The US Federal Reserve thought that inflation was too high, so it hit the economy on the head with the brick of interest-rate hikes. As a result, workers moderated their demands for wage increases, and firms cut back on planned price increases.

The other three recessions were each caused by derangements in financial markets. After the savings-and-loan crisis of 1991-1992 came the bursting of the dot-com bubble in 2000-2002, followed by the collapse of the subprime mortgage market in 2007, which triggered the global financial crisis the following year.

As of early January 2019, inflation expectations appear to be well anchored at 2% per year, and the Phillips curve – reflecting the relationship between unemployment and inflation – remains unusually flat. Production and employment excesses or deficiencies from potential-output or natural-rate trends have not had a significant effect on prices and wages.

At the same time, the gap between short and long-term interest rates on safe assets, represented by the so-called yield curve, is unusually small, and short-term nominal interest rates are unusually low. As a general rule of thumb, an inverted yield curve – when the yields on long-term bonds are lower than those on short-term bonds – is considered a strong predictor of a recession. Moreover, after the recent stock-market turmoil, forecasts based on John Campbell and Robert J. Shiller's cyclically adjusted price-earnings (CAPE) ratio put long-run real (inflation-adjusted) buy-and-hold stock returns at around 4% per year, which is still higher than the average over the past four decades.

These background indicators are now at the forefront of investors' minds as they decide whether and when to hedge against the next recession. And one can infer from today's macroeconomic big picture that the next recession most likely will not be due to a sudden shift by the Fed from a growth-nurturing to an inflation-fighting policy. Given that visible inflationary pressures probably will not build up by much over the next half-decade, it is more likely that something else will trigger the next downturn.

Specifically, the culprit will probably be a sudden, sharp "flight to safety" following the revelation of a fundamental weakness in financial markets. That, after all, is the pattern that has been generating downturns since at least 1825, when England's canal-stock boom collapsed.

Needless to say, the particular nature and form of the next financial shock will be unanticipated. Investors, speculators, and financial institutions are generally hedged against the foreseeable shocks, but there will always be other contingencies that have been missed. For example, the death blow to the global economy in 2008-2009 came not from the collapse of the mid-2000s housing bubble, but from the concentration of ownership of mortgage-backed securities.

Likewise, the stubbornly long downturn of the early 1990s was not directly due to the deflation

of the late-1980s commercial real-estate bubble. Rather, it was the result of failed regulatory oversight, which allowed insolvent savings and loan associations to continue speculating in financial markets. Similarly, it was not the deflation of the dot-com bubble, but rather the magnitude of overstated earnings in the tech and communications sector that triggered the recession in the early 2000s.

At any rate, today's near-inverted yield curve, low nominal and real bond yields, and equity values all suggest that US financial markets have begun to price in the likelihood of a recession. Assuming that business investment committees are thinking like investors and speculators, all it will take now to bring on a recession is an event that triggers a retrenchment of investment spending.

If a recession comes anytime soon, the US government will not have the tools to fight it. The White House and Congress will once again prove inept at deploying fiscal policy as a counter-cyclical stabilizer; and the Fed will not have enough room to provide adequate stimulus through interest-rate cuts. As for more unconventional policies, the Fed most likely will not have the nerve, let alone the power, to pursue such measures.

As a result, for the first time in a decade, Americans and investors cannot rule out a downturn. At a minimum, they must prepare for the possibility of a deep and prolonged recession, which could arrive whenever the next financial shock comes.

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