Should investors price in a US recession?

Given recent market gyrations, exacerbated by a weaker US payrolls number in July, it is worth asking whether the repricing of Fed futures markets for aggressive near-term rate cuts is warranted. Currently, markets are pricing in nearly 100 bps of cuts by the Fed by end-2024, pulling back from the near 125bps of cuts priced in on Monday 5th August following the equity market rout. However, while the US economy is slowing, there are, as yet, few signs that a recession is imminent.

The US economy has been slowing of late following the rapid consumer-led boom in 2022-23. This was inevitable as US households ran down Covid-era savings, and a wage-price spiral failed to materialise on the back of high inflation, which might have sustained spending. Indeed, US household savings are now below where they were in 2019, meaning future consumer spending growth will be firmly tied to household earnings. In the labour market, jobs growth has clearly slowed in recent months, with downward revisions to payrolls growth in Q2 2024 and the below-consensus out-turn for July which spooked investors last week.

Digging into the payrolls data shows a general slowdown in private sector hiring, particularly in the retail and hospitality sectors, on top of some weather-related effects in July. However, an underappreciated driver of the recent slowdown in jobs growth has also been the pullback in hiring by the public sector in the US. In 2023, new Government payrolls averaged nearly 60k per month. This rapid growth was sustained into Q1 2024, but since April Government hiring has eased considerably, averaging just 17.5k per month. Therefore, the US labour market might now be feeling the effects of the fading fiscal stimulus enacted by President Biden in 2022, alongside the lagged effects of monetary tightening by the Fed on private sector hiring and investment.

As indicated by US Federal Reserve Chair Powell last week, the monetary policy-setting committee is now placing greater store on a weakening labour market as its dual mandate (stable inflation and maximum employment) "continues to move into better balance" and is set to cut at its next meeting. However, a 50bps cut is unlikely in September, unless a further sharp deterioration in payrolls comes through in August.

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