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If Recession Lurks, Here Are the Signs

Rising Debt Costs, Slowing Housing Market Bear Watching

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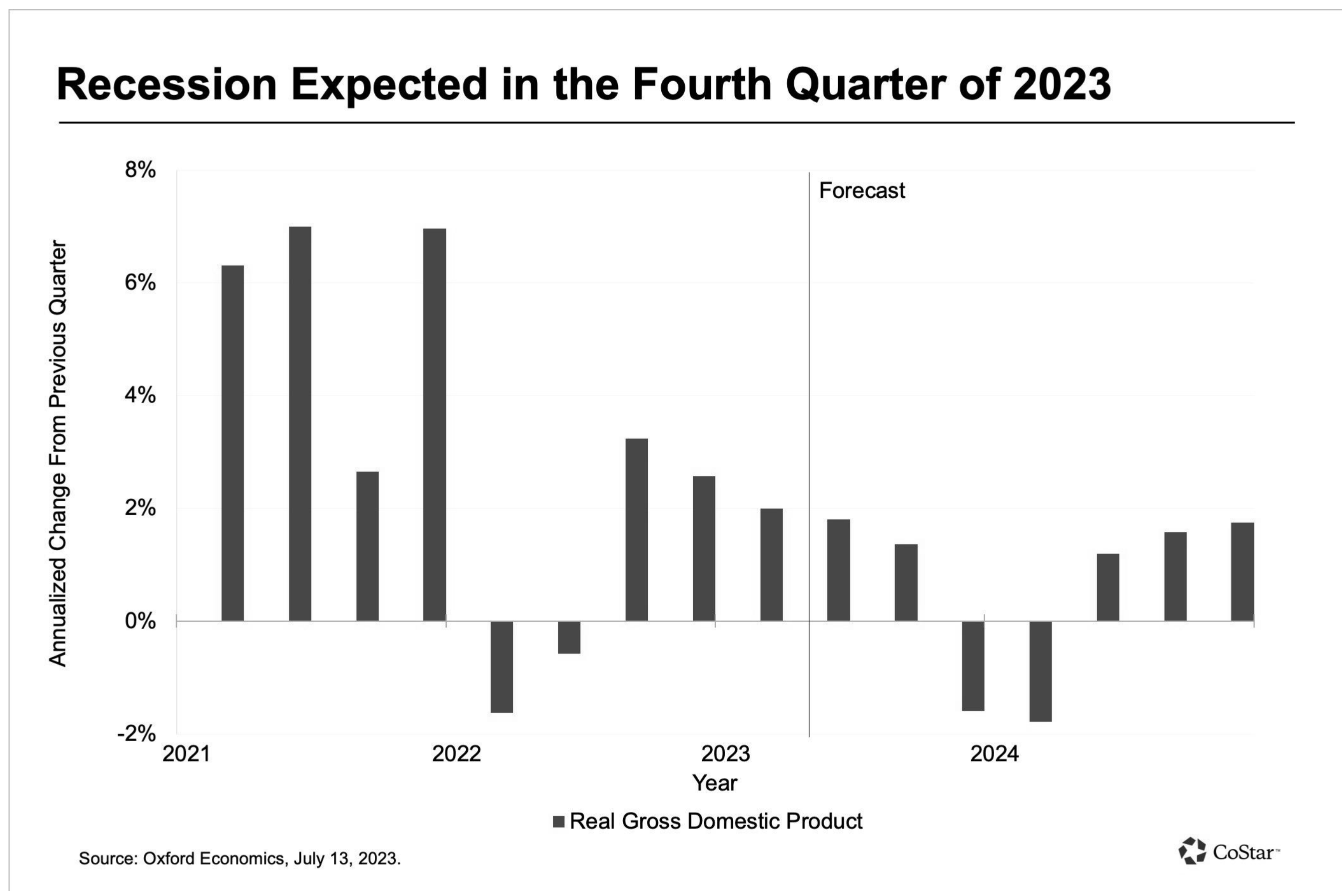
The economists who have been calling for a recession ever since the Federal Reserve started raising interest rates are starting to feel more optimistic. Instead of seeing a contractionary economic environment, the nation continues to expand, albeit slowly. At the same time, inflation is subsiding, and the Fed is nearing the end of its historic rate-hiking cycle.

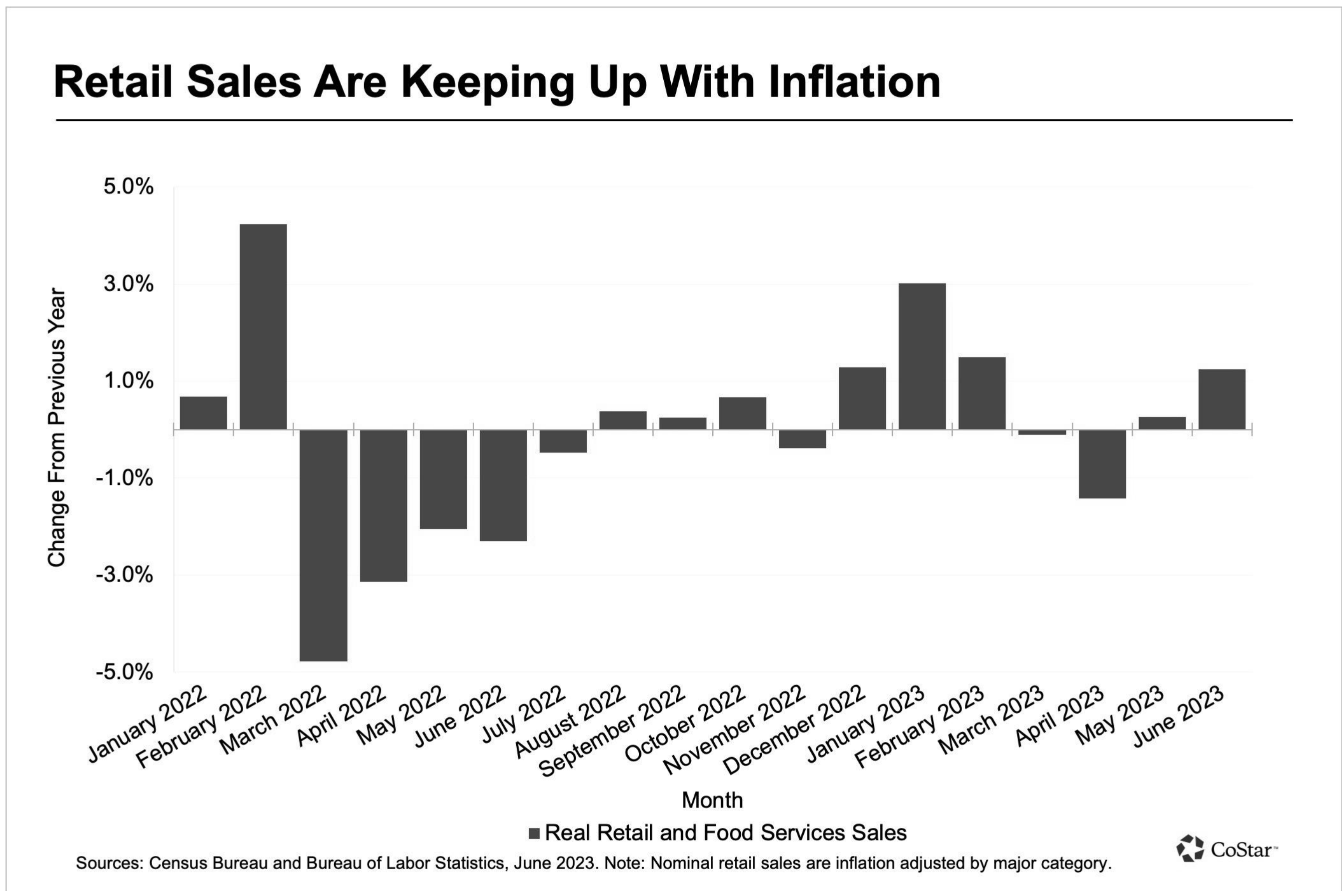
Some forecasters are now suggesting that we could altogether avoid a recession this year. Others are calling for a mild one. For example, in its latest release, Oxford Economics forecasts real gross domestic product to decline by about 1% from a peak in the third quarter of 2023 to a trough in the first quarter of 2024.

Economists like to determine the primary cause of each recession to better understand how the economy functions and to help forestall similar downturns in the future with possible policy actions. Consider the Great Financial Crisis of 2008. The loose mortgage lending practices and risky financial system that led to that collapse prompted changes to the banking sector aimed at preventing something similar from occurring again.

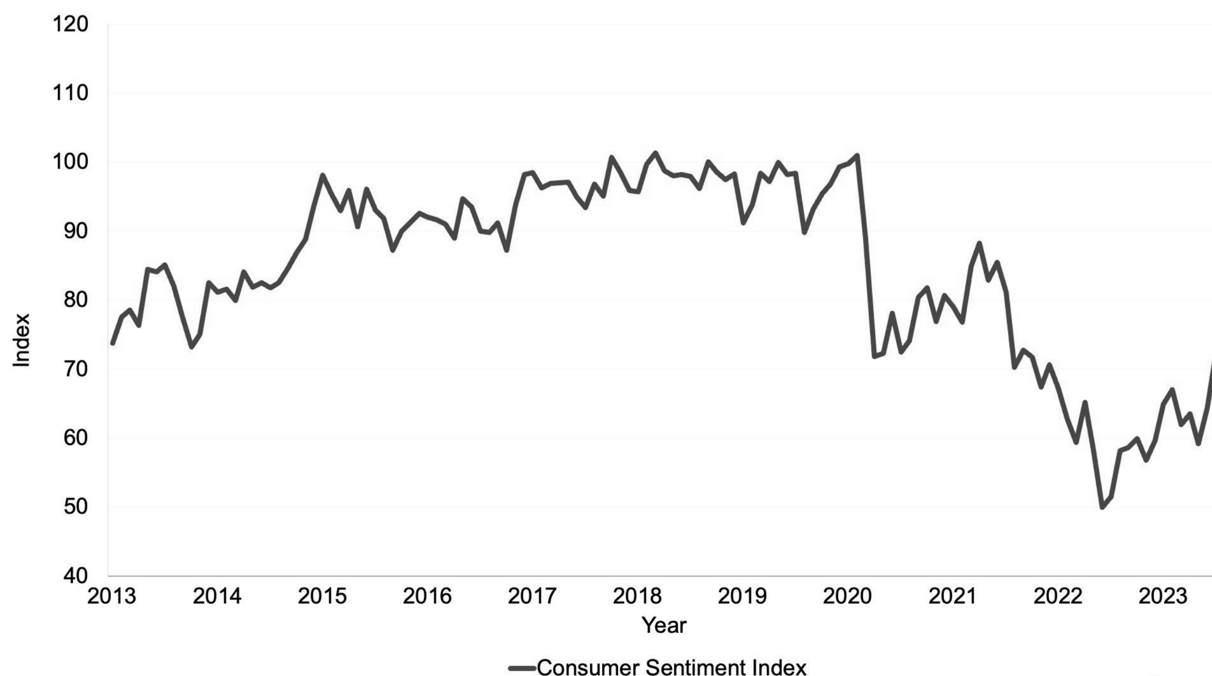
In 2020, it was the global health crisis that put millions out of work and caused the economies around the world to plummet. In the aftermath, if efforts to tame inflation spark a recession later in 2023 or early next year, we could point to early signs of it materializing in a number of areas.



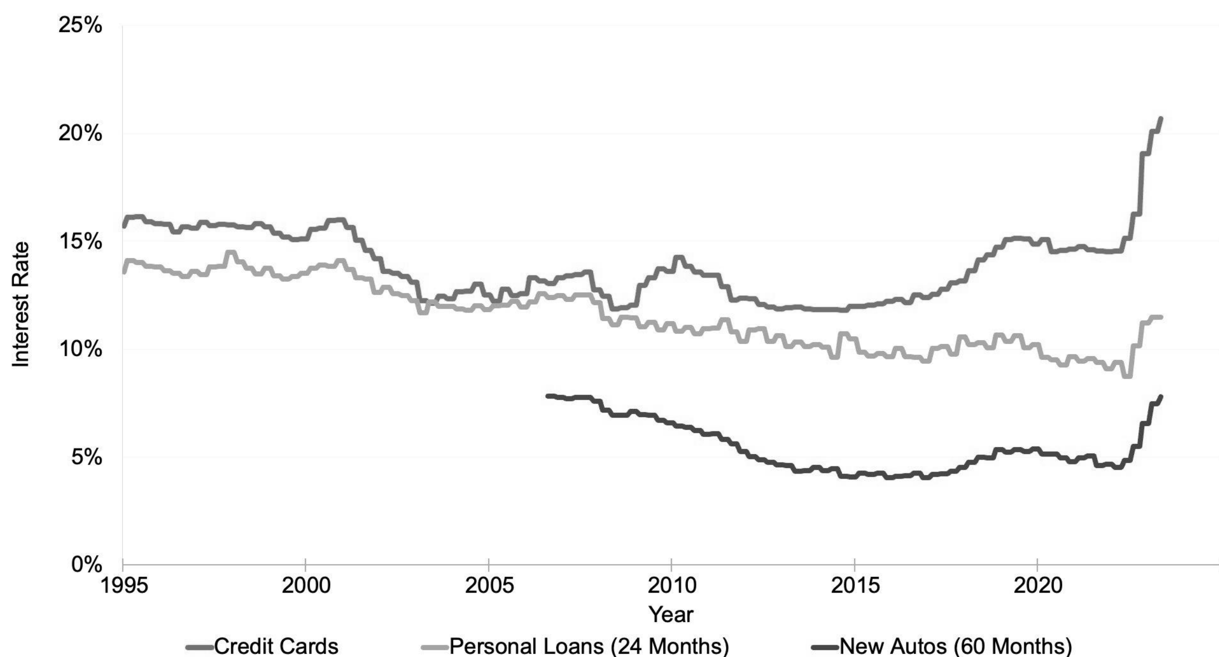
With consumer spending front and center in the economy, how households are managing inflation and higher interest rates is key. So far, the consumer has been resilient. We would have expected spending to slow after inflation rose by 18% over the past three years, as measured by the consumer price index. But retail and food services sales managed to grow by 0.2% in June and were 1.5% higher than a year ago, all while prices for non-shelter goods and services were subsiding. June's inflation adjusted retail and food service sales were 1.3% higher than a year ago.



Optimism about the future path of the economy appears to be contagious, according to the University of Michigan Consumer Sentiment Survey. In June, the index spiked to 72.6 from the previous month's reading of 64.4 and marked the highest figure since September 2021. The decision to raise the debt ceiling and the perception that inflation has slowed appear to have helped alleviate some consumer concerns, and the solid labor market is helping keep incomes afloat.



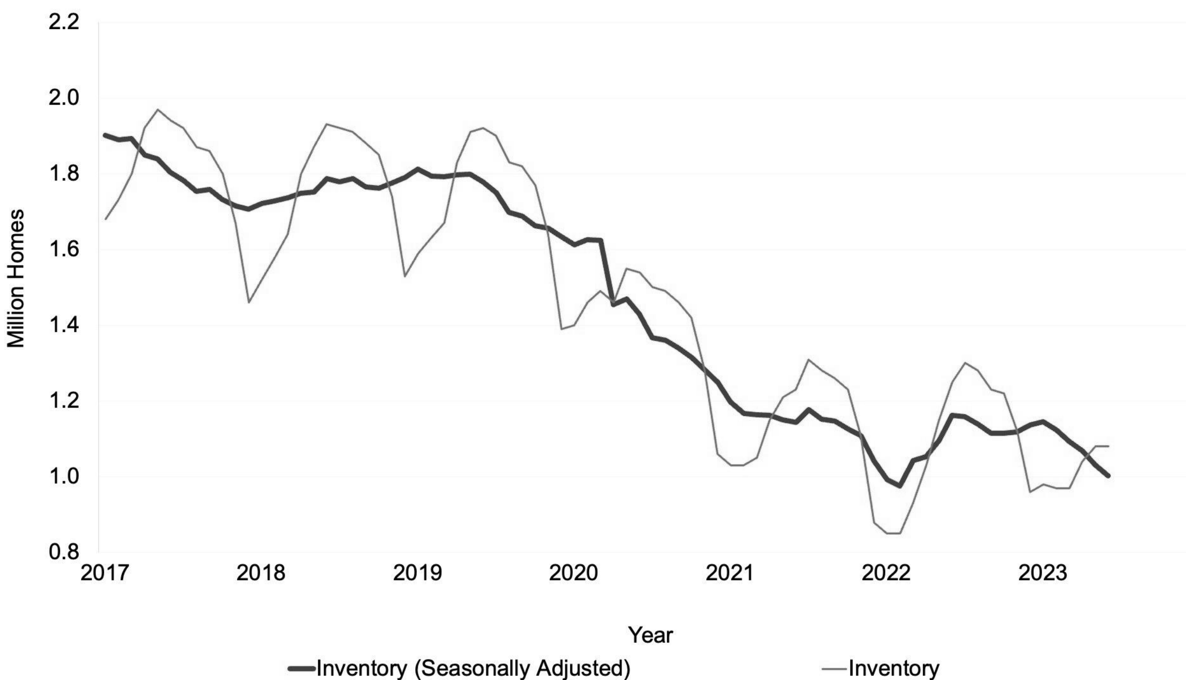
However, consumers will be tested for the remainder of the year as debt costs have skyrocketed. Credit cards held by commercial banks are now charging an annual rate of more than 20% in interest on average, approximately 11.5% on personal loans, and 7.8% on new car loans with five-year terms, according to the Federal Reserve. Moreover, for the more than 20 million borrowers with student debt backed by the federal government, interest will begin to accrue on Sept. 1 and payments will be due the following month. Both higher credit costs and the return of monthly loan repayments are likely to be a drag on consumer spending and presumably up the risk of recession.



The cooldown of the housing market poses a potential threat to the economy as well, as the peak selling season winds down. According to some estimates, housing accounts for more than 15% of the economy, so a slowdown here can have a significant impact.

Mortgage rates are back near or above 7%, leaving most current homeowners locked in their existing homes with rock-bottom mortgage rates secured during the pandemic, and eroding affordability for potential buyers who are unable to qualify for a home loan at these higher rates. Existing home sales fell by 3.3% in June and were 18.9% lower than a year ago.

The number of existing homes for sale at the end of June was 13.6% lower than a year ago. After accounting for seasonal factors, existing inventory has declined for five consecutive months, suggesting that home sales will remain sparse.



Looking into other areas of real estate, troubles in the commercial real estate market also pose a threat to the economy across property types. The office sector has struggled with lower workplace utilization rates, and the resilient industrial market is starting to show resistance as construction starts have plummeted. More risk emanates from the rapid rise in interest rates and how that has impacted debt. Three-quarters of a trillion dollars in loans are scheduled to come due this year and next.

Ultimately, this recession, should it arrive, will be brought on by tightening financial conditions as the Federal Reserve continues raising its policy rate. Consumers, businesses, builders, home buyers and lenders cannot escape higher borrowing costs, higher costs of capital, and the mark-up of credit conditions from pre-2022 to today's rates.

What We're Watching ….

Another round of data this week should shed light on the Federal Reserve's preferred measure of inflation, the personal consumption expenditures price index. This will be a

look back all the way to June. With the consumer price index falling, we would expect to see this index cooling as well, but not to the Fed's desired 2% target yet.

Data for personal income for June is to be released at the same time. At some point, a cooling economy is sure to hit personal income (and consequently spending), but the labor market is still supportive of higher incomes, so we'll wait for a few months to see things deteriorate here.

CoStar Economy is produced weekly by Christine Cooper, managing director and chief U.S. economist, and Rafael De Anda, associate director of CoStar Market Analytics in Los Angeles.