Perspective

Daniel L. Bain
Chief Investment Officer
and CEO

Navigating Post-Pandemic Economics - The Unemployment Rate as a Recession Indicator

In the ever-evolving landscape of the post-pandemic economy, the behaviour of the unemployment rate garners significant attention. Traditionally, a rise in this rate has been a reliable precursor to economic recessions. But today's unique economic conditions prompt a critical question: does this historical pattern still apply?

NONLINEAR ECONOMIC PATTERNS

The pattern of unemployment since World War II has been a subject of intense studies. During business cycles, the unemployment rate has shown a nonlinear trend, where it either rises marginally or escalates significantly, often coinciding with periods of economic downturn. Economists suggest this may be linked to a deteriorating labour market which affects consumer spending and investment, thereby further weakening the labour market.

For example, following the 2008 financial crisis, unemployment peaked at 10% in October 2009, up from 4.7% in November 2007. The recent low in unemployment was 3.4%, and historically, even a small increase from such a low point could signal a substantial rise. However, few analysts predict it will reach the highs of previous recessions, such as 5% or more.

ECONOMIC SCENARIO UNIQUELY CHALLENGING

The present economic situation, shaped by the pandemic, introduces unique factors that might alter the traditional unemployment-recession relationship. There are two key reasons why the unemployment rate might not increase as dramatically as in previous recessions:

1. **Reduced Labour Supply**: The labour market is experiencing a rise in supply, partly due to people returning to work post-pandemic. This influx should moderate as the labour participation rate normalizes.
2. **Strong Financial Foundations**: Many households and corporations have fortified their balance sheets, partly thanks to stimulus measures and a shift in spending patterns during the pandemic. This financial strength might buffer the economy against a deep recession.

Despite these mitigating factors, a shallow recession seems likely. This prognosis stems from the unique nature of the current business cycle, marked by the Federal Reserve's aggressive measures to control inflation, which could potentially slow down economic growth.

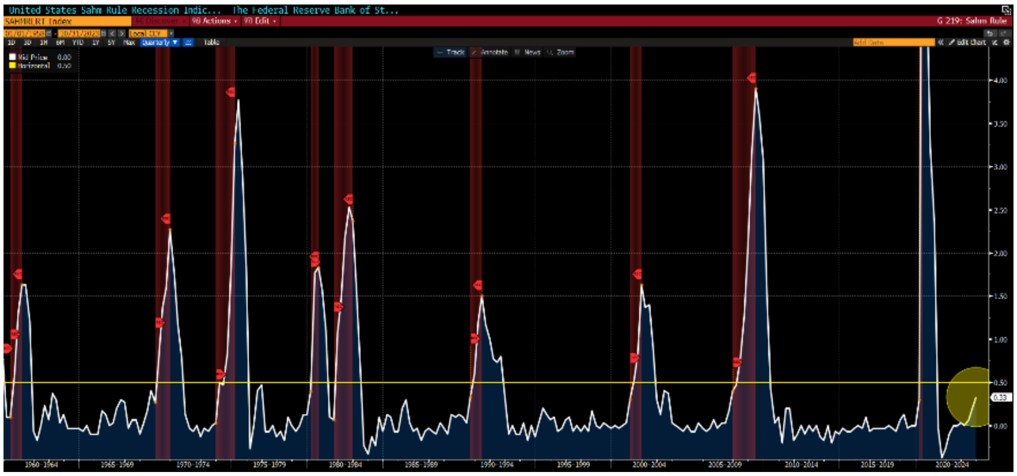
UNEMPLOYMENT AS A RECESSION INDICATOR

Various recession indicators, such as the Sahm Rule – which flags a recession when the three-month moving average of the national unemployment rate rises by 0.5 percentage points or more above its low during the previous 12 months – suggest a recession might be near. As shown in the chart on the next page, the Sahm Rule successfully indicated the previous US recessions, sometimes months before the official declaration.

Historically, the pattern of unemployment increases has been bimodal (two clusters of historical outcomes), suggesting a critical tipping point beyond which unemployment rises sharply. This pattern suggests that once the economy starts shedding jobs, a self-reinforcing cycle of reduced spending and further job losses can quickly escalate the situation. As indicated by the yellow circle in the lower right corner of the chart, unemployment is trending higher consistent with a pending breach of the Sahm Rule.

"ANIMAL SPIRITS" AND MARKET DYNAMICS

A sudden jump in unemployment rates can be partially explained by the concept of Keynes' "animal spirits". This term refers to the psychological and emotional factors that drive consumer and corporate behaviour, often leading to reduced investment and spending during uncertain times. The dynamics of labour market inflows and outflows are also vital. For example, during recessions, layoffs typically increase while the rate at which people are hired decreases, exacerbating the unemployment situation.



COMPARING PAST RECESSIONS

To understand the potential trajectory of the current cycle, it's instructive to look at past recessions. Each recession has its unique causes and characteristics, but the role of unemployment as a leading indicator has been consistent. For example, the 2001 recession, triggered by the burst of the dot-com bubble and exacerbated by the September 11 attacks, saw a relatively modest increase in unemployment compared to the 2008 financial crisis. This suggests that the magnitude and speed of unemployment increases can vary significantly depending on the underlying economic conditions.

THE CURRENT CYCLE: DEVIATIONS AND EXPECTATIONS

The current economic cycle might deviate from historical norms due to several factors, including an increased labour supply and strong financial situations. However, the consensus among economists seems that while this cycle might be different, it's unlikely to avoid a recession completely. A mild downturn seems probable, supported by various labour market indicators, such as rising initial jobless claims and slowing job growth.

It's also important to consider the global economic context. The pandemic disrupted supply chains and altered trade dynamics, potentially affecting the US labour market. Furthermore, geopolitical tensions and international policy decisions can have ripple effects, often unintended, on domestic employment.

VIGILANCE DURING UNPRECEDENTED TIMES

While the post-pandemic economy presents new variables, the unemployment rate remains a crucial barometer of economic health. Its future trajectory will be instrumental in shaping economic strategies and responses in these unprecedented times. We remain vigilant and adaptable, ready to navigate the challenges and opportunities that lie ahead.

In conclusion, understanding the nuances of the unemployment rate and its relationship with the business cycle is more critical than ever. As we forge ahead, the lessons from the past, combined with a keen eye on current trends, will be vital in anticipating and preparing for what the future holds in these dynamic economic times. For now, we are maintaining a defensive portfolio position.

David Baier