22 August 2024

Global Markets Research

Research Alert

Uptick in US unemployment rate triggered Sahm rule

Sahm rule uses unemployment rate to detect recession; has been historically accurate

Low probability of recession despite slowdown in labour and manufacturing prints

No change in house view of a 25bps rate cut in the September FOMC meeting

Sahm rule triggered the global financial markets rout early August

The global financial markets took a severe beating early August after a much weaker-than-anticipated unemployment rate for July (4.3% vs 4.1%), and sent the 3-month moving average (3MMA) unemployment rate higher by 0.5ppts to 4.1% for the 3-months ended July 2024 vs 3.6% one year ago, and triggered the Sahm rule recession indicator. This caused investors to turn risk averse on recession concern and drove a broad-based sell-off in the global equity markets. Traders pencilled in as much as 50bps rate cut in the September FOMC meeting after the data and a total of 100bps by year end, but has since scaled back their expectations to only 25bps rate cut in the September meeting after the strong retail sales data and amid still low jobless claims. Traders maintained their expectations of 100bps rate cut by end-2024.

What is the SAHM rule recession indicator?

The Sahm rule recession indicator was first created in 2019 by the-then Federal Reserve economist Claudia Sahm, to use the unemployment rate to detect upcoming and current recessions. The Sahm Recession Indicator signals the start of a recession when the 3MMA of the national unemployment rate rises by 0.5ppts or more relative to the minimum of the three-month averages from the previous 12 months.

Sahm rule has been historically accurate

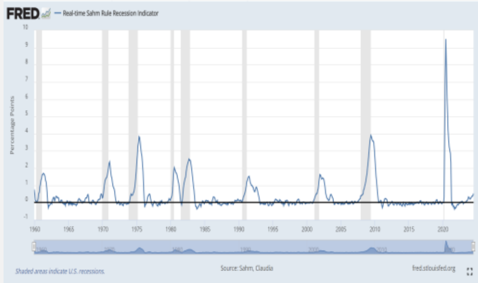
The National Bureau of Economic Research defines a recession involves a significant decline in economic activity that is spread across the economy and lasts more than a few months. Most of the recessions identified by NBER consist of two or more consecutive quarters of declining real GDP, but not all of them.

So, from an historical perspective, data suggests that even within the narrow definition of 2 quarters of contraction, the Sahm rule has been helpful and has a good track record of predicting at least 6 out of 8 times every recession in the past 50 years.

Start date	End date	Start (ppts)	End (ppts)	Quarterly contractions in GDP
Jul-24	-	0.5	-	-
Apr-20	Feb-21	3.9	2.6	1Q & 2Q of 2020
Feb-08	May-10	0.5	0.5	1Q 2008 - 2Q 2009
Aug-03	Aug-03	0.5	0.5	Nil
Aug-01	Sep-01	0.7	0.7	3Q of 2001
Oct-90	Oct-92	0.5	0.5	4Q of 1990 - 1Q of 1991
Nov-81	Jun-83	0.5	0.5	4Q of 1981 - 3Q of 1982
Mar-80	Feb-81	0.5	1.1	2Q & 3Q of 1980
Jul-74	Dec-75	0.5	1.0	3Q 1974 - 1Q of 1975

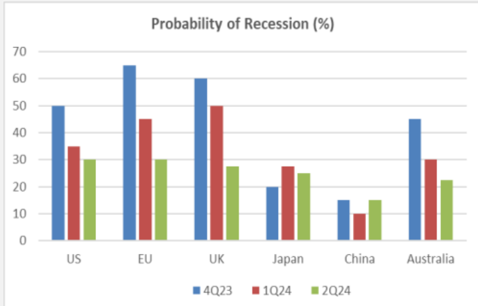
Source: Bloomberg; HLBB Global Markets Research

Figure 1: Unemployment rate averaged 0.5ppt higher at 4.1% for the 3-months ended July 2024 vs 3.6% one year ago



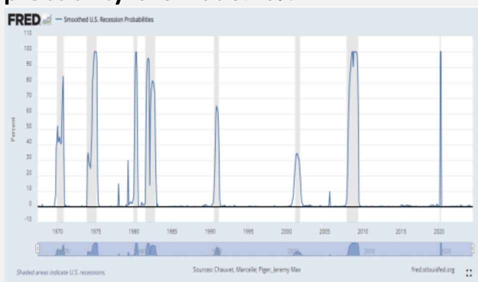
Source: Federal Reserve Bank of St. Louis

Figure 2: Market is pencilling in only 30% chance of a recession for the US



Source: Bloomberg, HLBB Global Markets Research

Figure 3: Fed's smoothed US recession probability is low at 0.16%



Source: Federal Reserve Bank of St. Louis
**Smoothed recession probabilities are obtained from a dynamic-factor markov-switching model applied to four monthly coincident variables: NFP, IPI, real personal income excluding transfer payments, and real manufacturing and trade sales.*

But 2024 could be an exception

As such, it is only pertinent that traders monitor August's NFP data for any extension to this 0.5ppts increase in the 3MMA in the unemployment rate for any signs of impending recession or even potentially disruption to sentiment and risk appetite in the global financial markets.

At this juncture, July's data could just be a blip (similar to August 2023) and the rule's inventor herself reiterated that US is not in a recession. **Labour data, consumer spending, IPI and household income, all point to a slowdown but not a recession** and the Fed has substantial scope to pull the trigger to start cutting rates (latest consensus and house view: -25bps in the September FOMC meeting). Market is also pencilling in only 30% chance of recession for 2024 and the Fed, 0.16%.

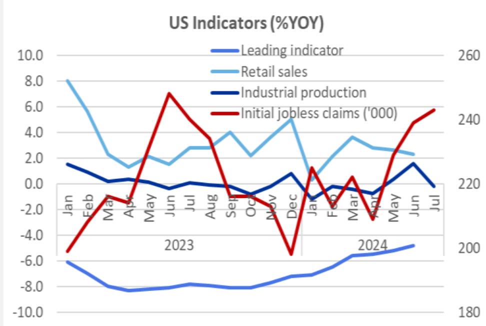
- The labor market is indeed cooling – but the higher unemployment rate in July was partially driven by more labour supply (labor participation rate: 62.7% vs 62.6%), increase in workers who haven't found jobs and not a collapse in labour demand nor due to layoffs, typically fanning recessionary flames.

  Continuous claims, a good approximation of the current number of insured unemployed workers filing benefits, stood at 1864k for the week ended August 3rd, slightly higher than an average of 1718k in 2018-19 (pre-pandemic) but was significant below 10440k in 1H of 2020 (pandemic). According to the JOLTS job openings report, there were 8.2m job openings in June, outpacing 6.1m during the pandemic and 7.1m pre-pandemic. Jobless claims remained low at 227K for the week ended Aug 10th, only a shade higher than 219k pre-pandemic but also sharply lower than 1797k in 1H of 2020.

- Prospects for the manufacturing sector remained weak – IPI fell m/m in July (prior: +0.3% m/m), the most since January but this was partially due to disrupted output of motor vehicles due to Hurricane Beryl. Forward looking indicators nonetheless was mixed. The ISM-Manufacturing was contractionary at 46.8 in July, softer than 48.1 in 1H of 2020 and 55.0 in 2018-19, but non-defense capital goods excluding aircraft, seen as a proxy of business spending plans, remained solid and increased 0.9% m/m in June after gaining 1.0% m/m previously.

- Latest retail sales came in firmer than expected at +1.0% July (prior: -0.2% m/m) while sales within the control group (which excludes vehicles, gas, food services and building materials) slowed but also out-beat forecasts at +0.3% m/m (prior: +0.9% m/m). A 3.6% m/m jump in sales motor vehicles accounted for the bulk of the increase for headline, further supported by food & beverages as well health & personal care. Spending on food services, a proxy for services demand, also posted a modest gain 0.3% m/m.

Figure 4: Labour indicators, retail sales and IPI all point to weaker growth, but not a recession



Source: Bloomberg

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