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No recession yet, but risks are rising. Are you prepared?

Where has the continued economic strength come from?

The recession that many have been talking about, including me and my colleagues at Allspring, has yet to arrive. With the strength of the economy and jobs market, will we ultimately face one? Historically, recessions typically have begun 12 to 18 months following the beginning of the Federal Reserve's (Fed's) tightening cycle. The ongoing resiliency nearly 16 months into the Fed's aggressive rate-hiking cycle has puzzled some observers. I can point to three reasons why the long-awaited slowdown has yet to set in:

Companies and individuals accumulated low coupon debt since the Global Financial Crisis. Further, many used the COVID era to extend maturities at even lower rates. This has muted some of the effects of rate increases since early 2022. Moreover, the nonbank, unregulated financials sector—also known as the "shadow banking" system—is substantial in size and has been less directly influenced by the Fed's actions to date.

Fiscal stimulus from COVID-related packages persists in the economy. Specifically, excess savings of companies and consumers have lasted longer than expected. Additional stimulus was provided via student loan payment deferrals, which increased consumers' spending capacity.

The work-from-home, or hybrid-work, movement continues to be influential. However, the effects are more balanced between the winners and losers. Workers are saving money on transportation and meals. However, as employers reassess their needs, with some reducing their office footprints, restaurants, retailers, and building owners that supported traditional work arrangements are losing out from this shift.

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Is a recession on the horizon?

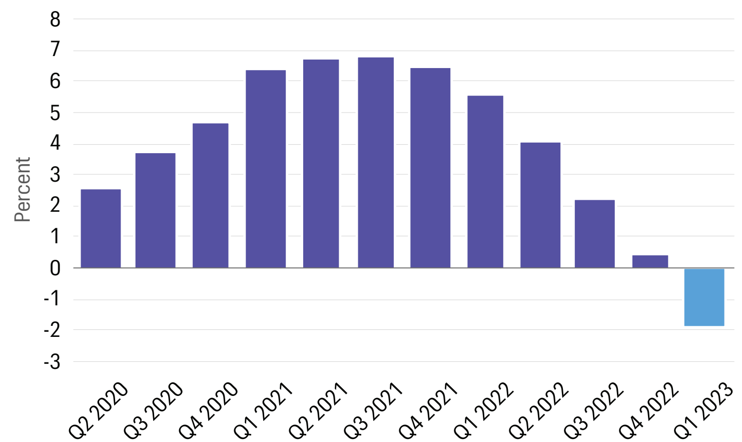
While these factors have temporarily extended the business cycle, in the end, I don't think we will escape a recession. To be clear, I don't expect a hard landing, and there will likely be sectors and regions that will suffer less in a recession than others. Still, I expect we may enter a recession in late 2023 or early 2024 for several reasons:

01 **Excess savings are running off.** We are seeing cracks appear in consumer-focused lending. For example, credit cards, auto, and consumer loans are seeing delinquency rates push higher. Further, student loan deferrals are finally set to end after the Supreme Court announcement, and payments should restart for many borrowers this fall.

02 **Interest rates are starting to bite.** Companies that rely more heavily on short-term debt and/or variable-rate debt are feeling the pain. We see this particularly with lower-quality debt, as companies are struggling to absorb increasing interest costs, driving more into default and/or bankruptcy.

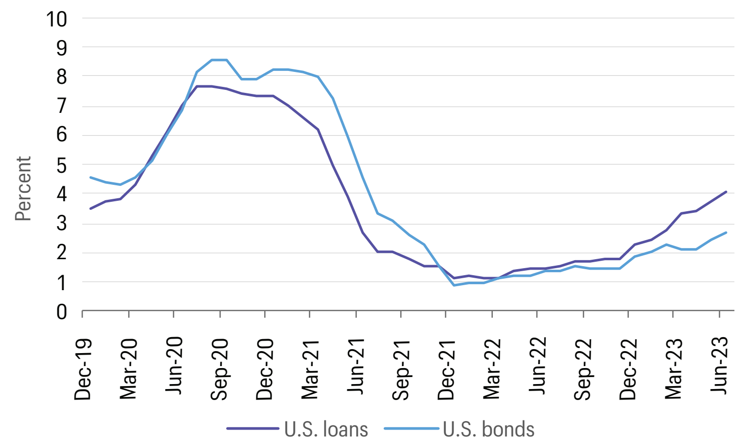
03 **Higher rates hurt as companies roll their debt.** About U.S. $900 billion in corporate bonds and leveraged loans—which represents just over 8% of the market—must be paid down or refinanced in 2024 at higher rates. In 2025, maturities are expected to jump to $1.2 trillion, and 2026 should see similar levels. In total, nearly 30% of the corporate market matures within the next three years.

FIGURE 1: EXCESS SAVINGS RATES ARE STEADILY DECLINING



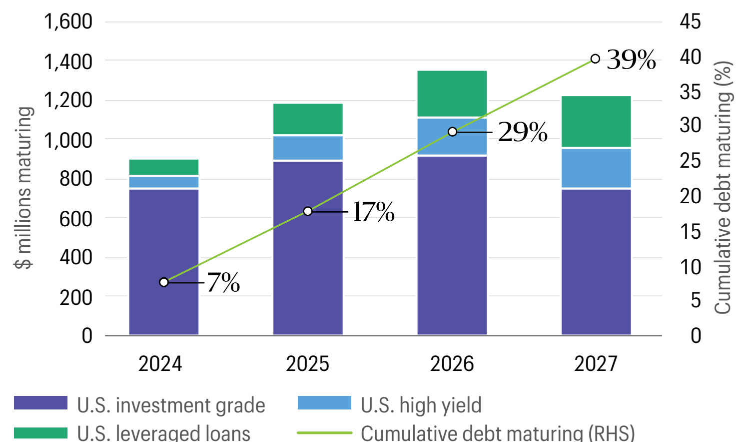
Sources: Fed and Haver Analytics. Presents U.S. excess savings as a percentage of GDP. Data presented from June 2020 through March 2023.

FIGURE 2: SPECULATIVE-GRADE DEFAULT RATES ARE TICKING UP



Source: Moody's Investors Service. Issuer-weighted speculative-grade default rates. The senior unsecured bond rating is included in the bond series and the most senior loan rating is included in the loan series. Data presented from December 2019 through June 2023.

FIGURE 3: MATURING DEBT WILL REFINANCE AT HIGHER RATES

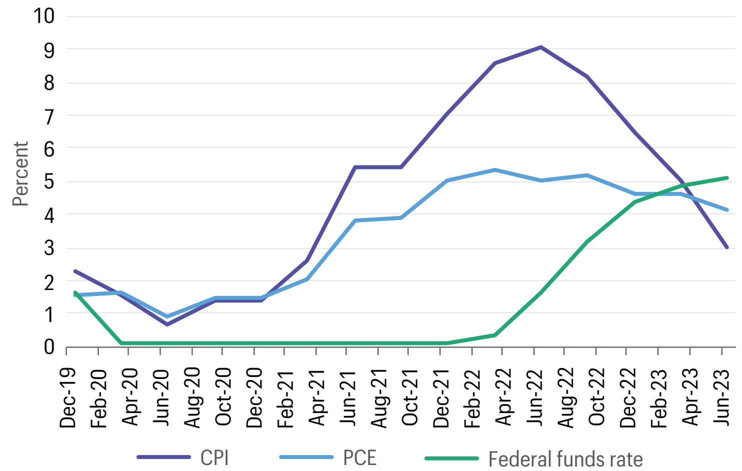


Sources: Allspring, Bloomberg, and J.P. Morgan. Dollar amount of maturing debt is shown on the left axis and cumulative percentage of outstanding debt maturing is shown on the right axis. The year 2024 uses 2022 year-end data and the remainder of periods and total outstanding debt use data as of June 2023.

04 **Rate hikes may not be over.** The Fed raised rates again in July, and future moves will be data dependent. However, the jobs market remains strong and personal consumption expenditure (PCE) inflation readings persist at elevated levels, while CPI is well off its peak. This means new economic information will be heavily scrutinized.

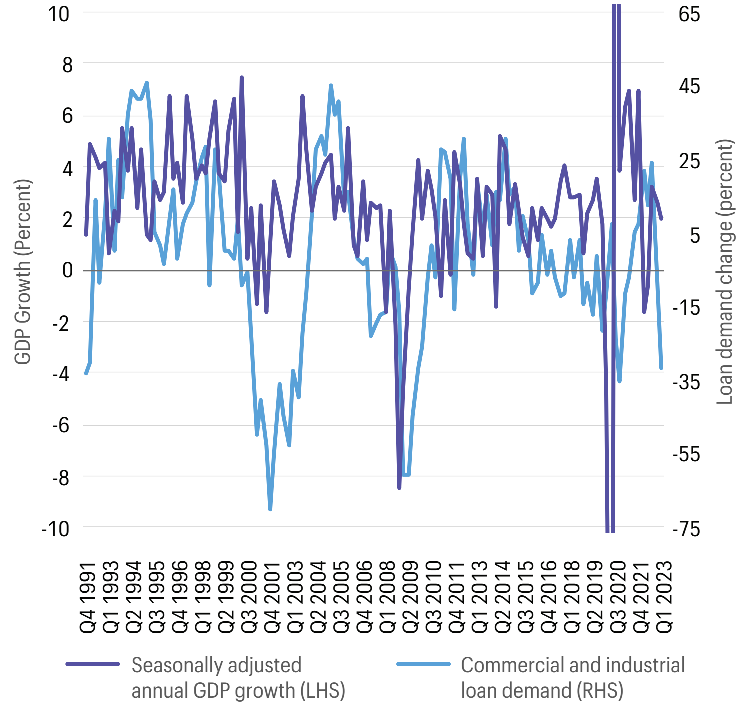
05 **Banks are tightening lending standards and reducing exposures.** As a result, access to debt and capital is deteriorating for some borrowers in the wake of the banking turmoil earlier in 2023 and will likely weigh on growth.

FIGURE 4: PCE REMAINS STUBBORNLY HIGH IN SPITE OF FED TIGHTENING

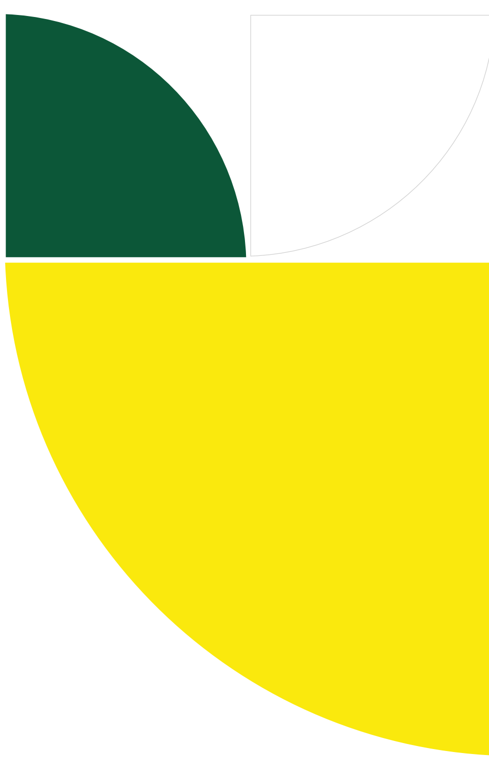


Source: Fed. Year-over-year CPI and PCE growth versus federal funds rate. Data presented from December 2019 through June 2023.

FIGURE 5: GDP GROWTH AND LOAN DEMAND ARE CORRELATED



Source: Fed. Readings for seasonally adjusted annual GDP growth for Q2 2020 (-29.9%) and Q3 2020 (+35.3%) are outside the scale of the chart in order to highlight the positive historical correlation between the two series. Data for seasonally adjusted annual GDP growth is presented through March 2023. Data for commercial and industrial loan demand is presented through June 2023.



06 **Commercial real estate (CRE) faces tighter access to bank lending, reduced rents, and lower occupancies.** However, not all CRE sectors are the same—office, industrial, health care, and multifamily face different dynamics. Idiosyncrasies are important, as location, lease terms, and financing structure will influence which assets become stressed. This complexity creates fertile ground for selection.

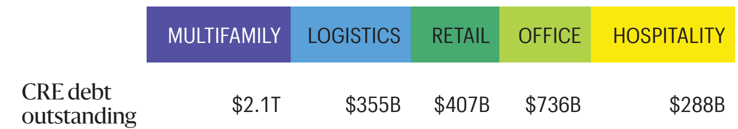
07 **Manufacturing, by many accounts, is already in recession.** Manufacturing Purchasing Managers' Index (PMI) readings have weakened around the globe and U.S. manufacturing is no exception to this trend.

What can investors do about it?

Investors can ignore these warning signs, but we have concerns and believe that clients can protect themselves by taking the following actions:

- **Don't get caught in the cash trap.** Short-term rates are currently very attractive, but this could change quickly in front of Fed rate cuts around a recession. The market will likely reprice interest rates further out on the yield curve as well. Investors have an opportunity to extend their duration over the next several months, lock in higher yields for longer, and position to benefit from lower yields.
- **Stay diversified.** The market is broad, disparate, and dynamic. The effects of any recession are likely to be felt unevenly across fixed income markets and present an attractive opportunity for sector and issue selection. Broadly speaking, your equity and fixed income exposures should be proactively deployed.
- **Bias toward quality.** At current valuations, and in the context of the concerns noted above, there appears to be little reward for reaching down in quality. A focus on fundamentals—especially leverage, interest coverage, and margins—should be as important as ever in security selection as markets and valuation evolve.

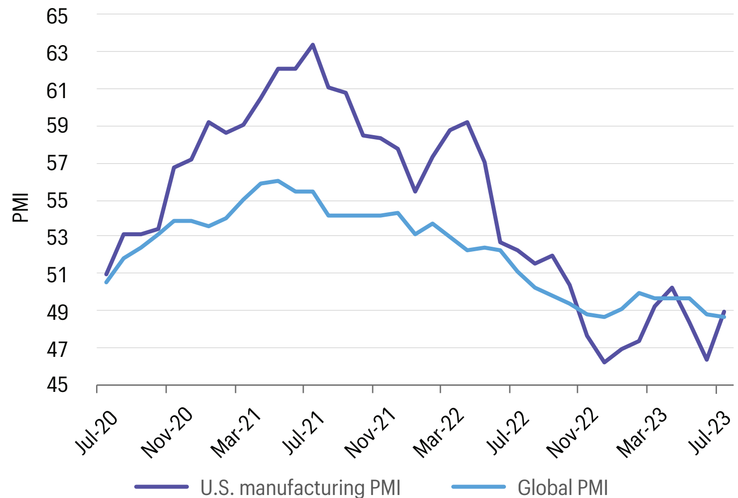
FIGURE 6: CRE LOAN MARKET HAS SIGNIFICANT BREADTH, OFFERING AMPLE SELECTION OPPORTUNITIES



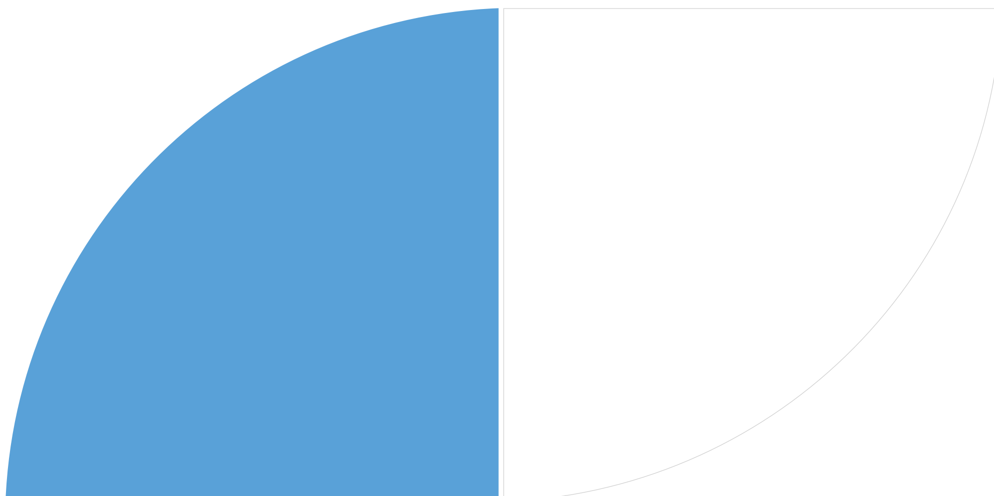
	MULTIFAMILY	LOGISTICS	RETAIL	OFFICE	HOSPITALITY
CRE debt outstanding	$2.1T	$355B	$407B	$736B	$288B

Source: Fed, as of June 2023

FIGURE 7: PMIs ARE IN CONTRACTIONARY TERRITORY



Source: Moody's Investors Service. A reading above 50 indicates expansion and below 50 indicates contraction. Data presented from July 2020 through July 2023.



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