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Recession Risk Rising As Economy Loses Momentum

Will the Economy Fall Back Into Recession In the Next Six Months?

May 19, 2012 By William L. Pittenger, MAI, SRA

Questions many business people and professionals have about the probability of recession are first, whether it will happen and second, how does one estimate the probability before it occurs. They wonder too if a forecast is just a wild guess, an educated guess or whether there is actually some science behind it. The answer is the latter. While we never know precisely and we always face the possibility of unforeseen economic shock, there is a little science underlying the opinion. The following is a brief, but high level, explanation of both recession risk and forecasting methodology as well as how the Business Cycle Dating Committee (BCDC), the official arbiter of the nation's business cycle, works.

By definition, a forecast is a judgment about the probability of a future event happening or not happening based on currently known or reasonably knowable information. It is not an exercise in crystal ball gazing nor is it an absolute guarantee that the forecast will materialize. That is why most forecasts, including this one, are expressed in probabilities.

The nation's business cycle (contraction versus expansion) is dated by the Business Cycle Dating Committee (BCDC) of the National Bureau of Economic Research (NBER). The committee is comprised of a group of academic economists at Princeton University. When dating the business cycle, the committee considers a wide variety of economic indicators over a reasonable period of time and from a broad geographical area. It is not as simple as often depicted such as a recession is measured by two quarters of negative GDP (Gross Domestic Product) or expansion by two quarters of growing GDP. While GDP is considered, so are financial market indicators, labor market conditions, housing, manufacturing, imports v. exports, confidence and much more. When the BCDC declared *The Great Recession* had ended in June 2009, they relied heavily on GDP and GDI (Gross Domestic Income). At that time, the average of GDP and GDI was 3.1% above its low in the second quarter of 2009 but 1.3% below its previous peak in December 2007 when the recession officially began.

Note too that the announcements were made a year or more after the recession began or ended. The beginning of *The Great Recession* was determined to be December 2007, however, the announcement came a full year later in December 2008. Similarly, the recession technically ended in June 2009 but the announcement was not made until September 2010. The committee is not in the business of forecasting. Rather its sole responsibility is dating the business cycle and it would rather be right than fast. Economic data are also revised frequently and the committee will usually wait for revisions as it did before declaring the recession had ended in mid-2009.

In forecasting a change of direction in the business cycle before the BCDC acts, we too consider a wide variety of indicators and evaluate them individually and collectively. We attempt to mimic what the BCDC is most likely to do. We also weigh each factor's relevance and potential impact. We then assign a probability weight to each indicator. Since a wide variety of indicators are considered, some tend to wash out others. We understand that any forecast can be rendered moot if unexpected economic shock occurs. We saw that with the 9-11 terrorist attacks, the Japanese earthquake and tsunami last year as well as other catastrophic events over the years. Sans unknown or unknowable events, however, it is possible to get reasonably close to a supportable and defensible forecast of change of direction in the business cycle including the probability of a short term dip into a new recession.

Economic recovery has lost the momentum it had only a few short months ago. Financial markets are not conducive to robust growth and all told, employment is weak, adding only 115,000 payroll jobs in April. Both business and consumer confidence are low, GDP is weak at 2.2% annualized and housing continues to struggle. Weaknesses could grow as European economies and U.S. trading partners slip into recession. Combined, we estimate the probability of recession within six months to be about 30%.

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