Economic commentary

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Balancing act: Why old recession signals aren't enough

Overview

- **Traditional recession indicators still matter, but this cycle showed they are no longer enough on their own.**
- **The old signals flashed recession warnings in 2022–2023, yet recession did not arrive because aggressive Fed tightening transmitted only partially into the real economy.**
- **Households and businesses were cushioned by low fixed-rate debt, savings buffers, and resilient labor income, allowing spending to continue despite higher rates and inflation.**
- **Those cushions are weakening as real purchasing power falls, credit-card rates remain high, gasoline costs rise, and refinancing needs move closer.**
- **AI investment is now a cycle-specific risk because data-center financing, private credit, equity-market wealth, and GDP growth are increasingly connected.**
- **U.S. Bank Economics Group recommends a broader dashboard focused on real private sector finances and borrowing conditions, inflation measures, and AI financing conditions, in addition to the traditional signals.**

From clearer skies to sticky prices

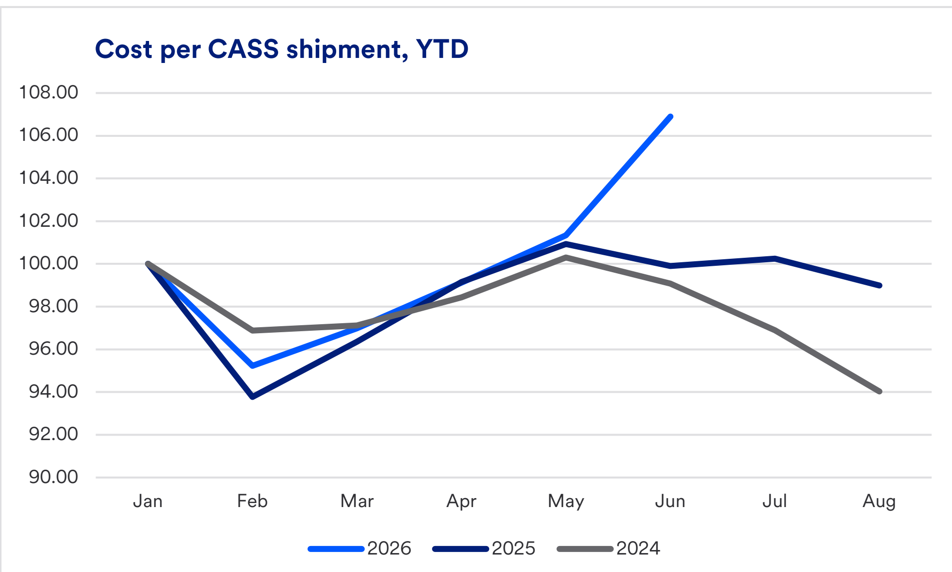
Only seven months ago, the Fed's balancing act looked manageable. The U.S. economy entered the year with enough momentum to support an expected 2.5% annual growth rate in 2026. The Fed's challenge was to slow demand just enough to cool "sticky" post-COVID inflation without choking off the expansion.

At the start of the year, that looked like a controllable task. Inflation appeared more likely to cool with time than to require another round of tightening. My team expected two rate cuts in 2026, with the first in June, giving the Fed time to confirm that price pressures were easing before gradually moving policy toward its expected exit rate of 3.0% to 3.25%.

That benign setup did not last. Overall inflation in May ran at its highest rate in more than three years – and not just because of energy. Core consumer services inflation, excluding housing, is roughly twice its pre-COVID norm. Health care and energy-driven transportation prices explain a large share of recent gains, while firm core inflation and rising producer costs point to potential pipeline risks ahead. The expected Fed cuts disappeared.

Energy risk has complicated that picture further. Promising signs of an interim pact between the U.S. and Iran to reopen the Strait of Hormuz offered some hope that the economy and gasoline prices could move back toward a pre-war footing, which showed up in the softer-than-expected June CPI and PCE readings. But it proved to be short-lived. As July has made clear, tensions have risen and energy prices have climbed higher.

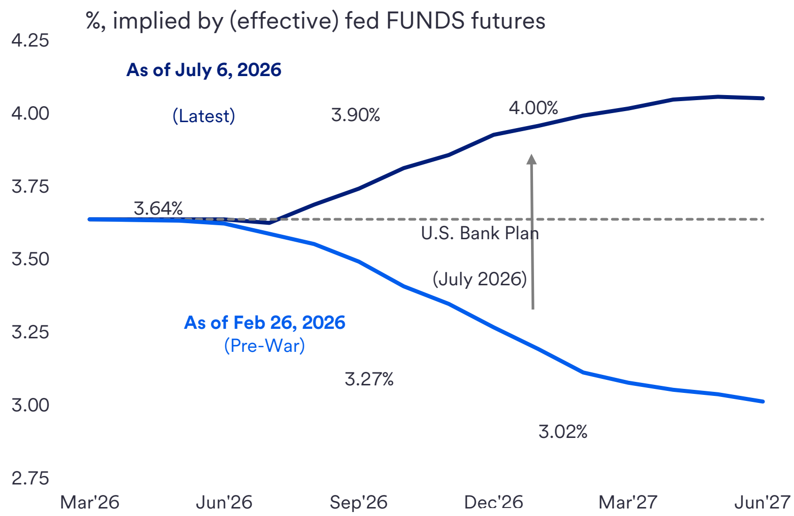
The good news is the soft price reading for core goods, which signals that the tariff-related inflation push is nearly over. But with Americans in the summer travel season, gasoline prices – a key pressure point – are increasing. CASS freight costs are also up by 6.9% year-to-date through June, much higher than the past two years, and a business cost that will get passed to consumers.



Source: U.S. Bank Economics, Bloomberg

For the Fed, the policy implication is straightforward: there is little reason to cut rates soon. Strong personal income data and a low unemployment rate reinforce that caution. Still-firm inflation has eaten over 24 percentage points of nominal income since May 2021. Inflation remains sticky and together with resilient private sector demand and the July FOMC's 'hawkish pause,' my team expects a rate hike from the Fed in the second half of the year to 4.00% to 4.25%, nearing their exit rate.

U.S. monetary policy expectations



Source: U.S. Bank Economics, Bloomberg

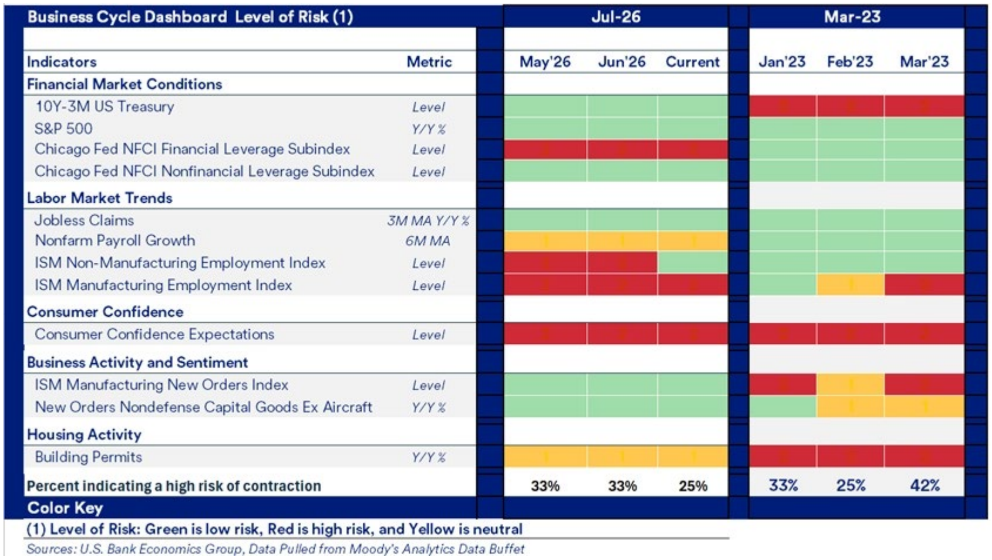
I still expect the Fed to keep the balance, but the margin for error has narrowed since January – and the Fed will need more than the old dashboard to stay upright.

Why the old signals failed

Measuring economic conditions has become more complicated.

Historically, recessions were often precipitated by financial tightening, which led to credit contraction and, eventually, recession. That pattern became so common it inspired the adage: "U.S. expansions don't die of old age; they're killed. The prime suspect is the Federal Reserve."

Heading into 2023, I trusted the old rules. The Russia-Ukraine war drove energy prices higher, while post-COVID demand surged faster than producers could supply. To combat inflation from the pandemic and supply-chain disruptions, the Fed raised rates seven times that year – the largest number of increases in a single year since 2005. Check. The cumulative increase, at 425 basis points, was also the fastest in 42 years (1980 saw 550 basis points). Check. Equity markets fell into a bear market in 2022. Check. And the 10-year/1-year yield curve, for example, measured by monthly averages, inverted for 28 months – while the 10-year/3-month curve inverted for 26 months. Historically, an average two-month inversion was a recession signal. Check.



Business Cycle Dashboard Level of Risk (1)		Jul-26			Mar-23		
Indicators	Metric	May'26	Jun'26	Current	Jan'23	Feb'23	Mar'23
Financial Market Conditions							
10Y-3M US Treasury	*Level*						
S&P 500	*Y/Y %*						
Chicago Fed NFCI Financial Leverage Subindex	*Level*						
Chicago Fed NFCI Nonfinancial Leverage Subindex	*Level*						
Labor Market Trends							
Jobless Claims	*3M MA Y/Y %*						
Nonfarm Payroll Growth	*6M MA*						
ISM Non-Manufacturing Employment Index	*Level*						
ISM Manufacturing Employment Index	*Level*						
Consumer Confidence							
Consumer Confidence Expectations	*Level*						
Business Activity and Sentiment							
ISM Manufacturing New Orders Index	*Level*						
New Orders Nondefense Capital Goods Ex Aircraft	*Y/Y %*						
Housing Activity							
Building Permits	*Y/Y %*						
Percent indicating a high risk of contraction		33%	33%	25%	33%	25%	42%

Color Key

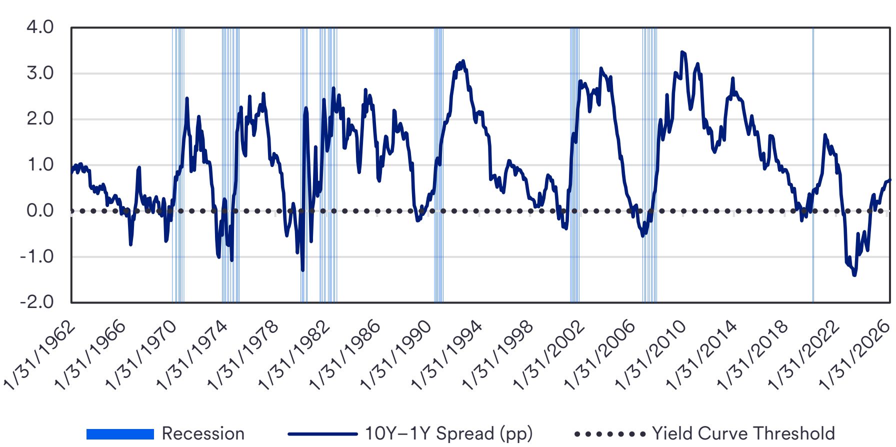
(1) Level of Risk: Green is low risk, Red is high risk, and Yellow is neutral

Sources: U.S. Bank Economics Group, Data Pulled from Moody's Analytics Data Buffet

The inverted yield curve had a very strong track record. The 10-year/1-year curve, for example, correctly signaled every recession back to 1962. The 10-year/3-month (listed in our dashboard) correctly signaled recessions back to 1959.

10-year/1-year yield curve, 1962 to present

Yield curve signal strong until this cycle



Source: U.S. Bank Economics, Bloomberg

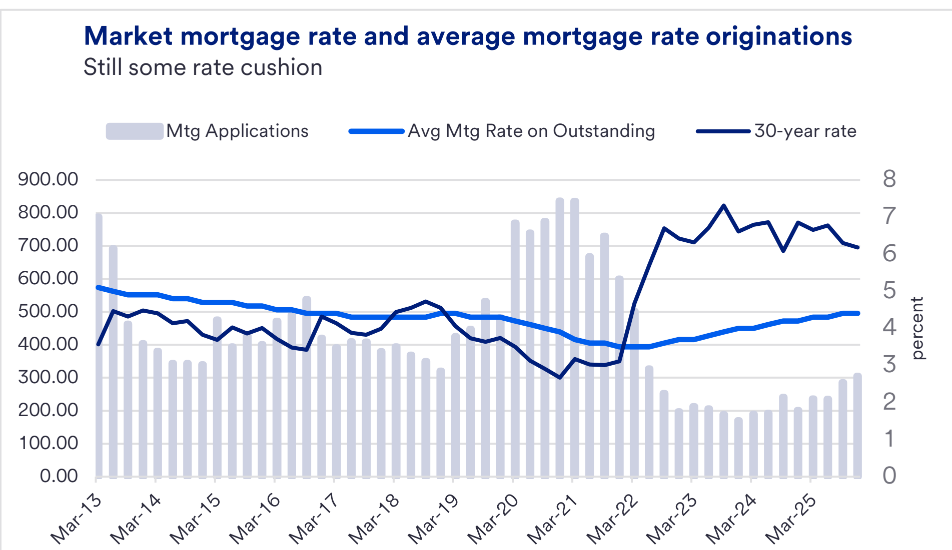
In March 2023, many signals in our dashboard measuring economic momentum were flashing warning signs, with the 'Percent indicating high risk of contraction' metric over 40 percent. The economy slowed. But recession never arrived.

The 10-year/1-year yield curve delivered its first false positive since 1962. The 10-year/3-month delivered its first since 1959. The Conference Board Leading Economic Index also incorrectly signaled recession. Even the Sahm Rule failed for the first time on record. Financial indicators that had correctly measured recession risk did not work this time.

The economy defied historical patterns because a sequence of post-pandemic conditions disrupted the usual transmission channels. In this new paradigm, traditional signals still matter – but they are not as reliable on their own.

Period	Initial signal	Transmission	Outcome
Pre-2020	Financial tightening →	Credit contraction →	Recession
Post-2020	Financial tightening →	Partial transmission →	Slower growth, not recession

In 2022, much household debt – especially mortgages – was locked in at low long-term fixed rates. With monthly debt payments cushioned from rate changes, the Fed's transmission into the real economy was much weaker than usual. Households also had larger savings buffers from fiscal stimulus, low monthly mortgage debt payments and an extremely tight labor market heading into 2022. But while wage gains climbed to almost 5.4% in 2022, with CPI inflation averaging 8.0% that year, real wages were down by 2.6% on average for 2022. The large stimulus-driven savings buffer, built through March 2021, and a low household debt burden forestalled a much worse outcome as households dipped into savings to smooth consumption. Many businesses also financed debt with long-term fixed rates. Those cushions allowed the private sector to keep spending despite higher inflation (the disease) and higher rates (the cure). As a result, the Fed's rate hikes slowed growth but did not trigger a recession. The transmission was too weak.



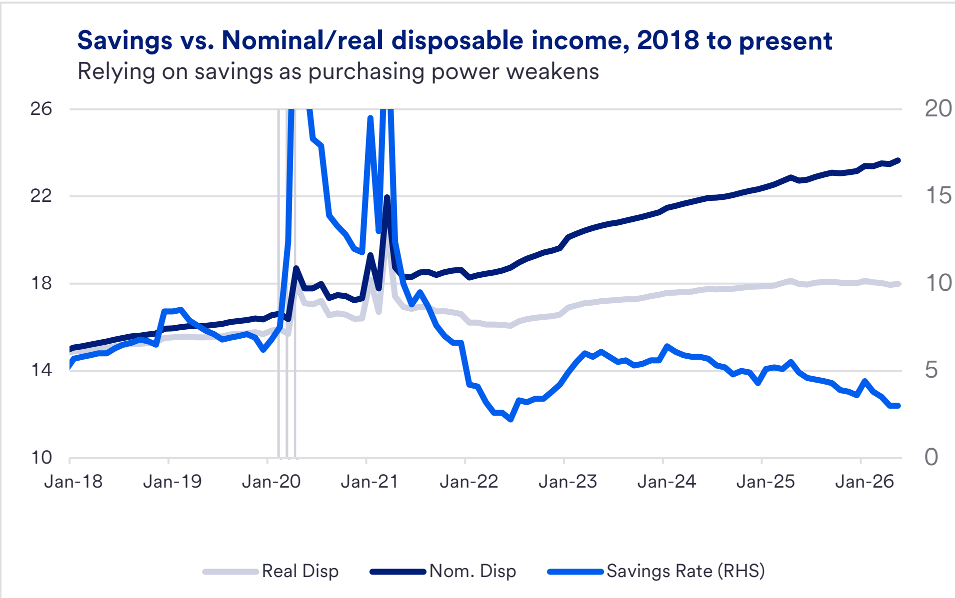
Source: U.S. Bank Economics, Freddie Mac Primary Mortgage Market Survey (PMMS), FHFA National Mortgage Database, Mortgage Bankers Association (MBA)

Back to the future

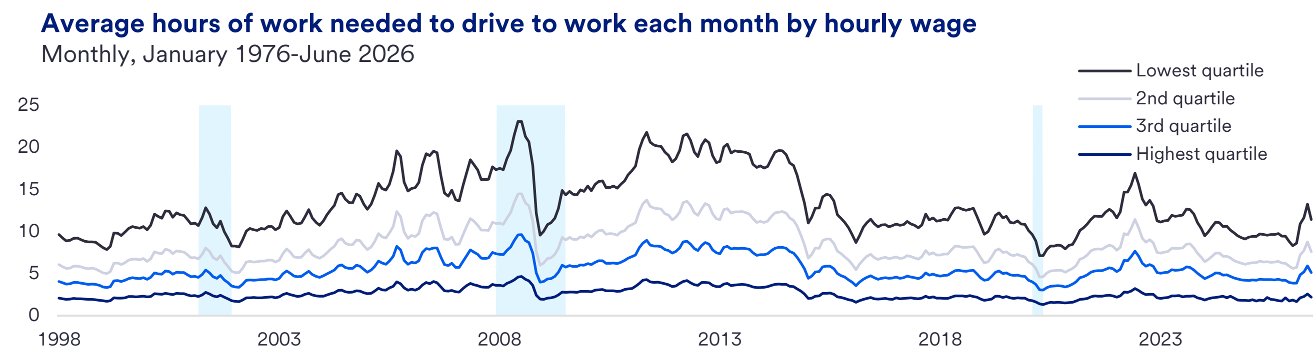
Today, how many of those cushions remain? A large share of debt is still priced at low long-term fixed rates, continuing to cushion the real economy from Fed tightening. The average outstanding mortgage rate has climbed to 4.4% today, up from 3.8% in the first quarter of 2022, but 2 percentage points below today's market rate of roughly 6.5%. That gap has kept the average debt service ratio below its historical average. The low-rate cushion is weakening, but slowly. The U.S. corporate debt maturity wall (IG vs. HY) indicates peak refinancing years are in 2028 through 2031 for both buckets, indicating the debt cushion will hold for many businesses despite increased chances the Fed will tighten policy this year and the next.

This also doesn't mean that the private sector is experiencing no pain. Floating rate borrowers, like leveraged loan issuers, are directly exposed to rising rates and those who need to refinance this year could face a dramatically more expensive market. Higher inflation from tariffs and the Iran conflict and higher borrowing costs have weakened household purchasing power, with real household income growth falling below zero for the first time in four years.

After conditions started to stabilize in 2025, the Iran war pushed inflation higher in 2026. While wage gains were over 3.4% year-over-year through June 2026, they have been negative in real terms since April. With inflation eating into household purchasing power, the average household ate into savings with less cushion in 2026. And lower-income households or middle-income households with little savings borrow with credit cards with much higher rates. According to Fed data, credit card annualized interest rates reached an average of 19.1% in late-2022 from 14.6% at the start of the year, as the Fed aggressively raised rates (most voluntary credit card forbearance measures ended by mid-2021). The averages are even higher today, at 20.9% in May. Higher energy prices also tax lower-paid workers harder than those with larger salaries. Before the war, lower-paid workers had to work 7 ¼ hours to pay for the gas they needed to drive to work for a month. They now must work almost twice as many hours to pay for that commute. The highest-paid workers had to work an extra 30 minutes. Households that borrowed later – sometimes tempted by incentives such as one-year locked-in rates and expecting to refinance once rates fell – are less insulated.



Source: U.S. Bank Economics, Bloomberg



Source: U.S. Bank Economics, Bloomberg

What to watch now: Ring in both the new and the old

So, in this new paradigm, which indicators should we watch? We should not throw out the old signals and start from scratch. Instead, the old indicators are better used as confirmation tools, while private sector financial conditions, labor market, and inflation measures become the primary cockpit gauges.

The AI-driven boom in this cycle is a key factor in which way the expansion turns. Given the huge business investment in AI and household wealth dependence in AI equity, the emerging sector is now closely tied to the stock market and GDP growth. A sharp retreat would worsen the business outlook and consumer spending. We plan to watch private infrastructure fundraising, private credit spreads, and data-center financing volumes for signs of expansion risk.

Like the Phillips Curve, the old signals may eventually start working again. Our Business Cycle Dashboard still includes several leading financial indicators with strong historical track records, but this cycle calls for placing less weight on financial market conditions and more weight on the indicators that show whether the real economy is absorbing – or ignoring – policy tightening.

New indicators in this cycle

- **Real disposable personal income:** A direct measure of household spending capacity after inflation.
- **Real versus nominal control-group retail sales:** The best proxy for core goods consumption in GDP and a useful measure of inflation's impact.
- **Mortgage applications and the average outstanding mortgage rate:** Measures the rate cushion and the effect of tighter policy on affordability.
- **Wholesale prices:** Input costs that often appear in production before passing through to core consumer prices.
- **Market-based long-term inflation expectations:** A key signal for whether inflation expectations are becoming de-anchored – a potential trigger for the Fed.
- **Artificial intelligence investment activity metrics:** Proxies for data center financing activity and ABS data center relative spreads.

Less useful in this cycle

- **Financial market indicators:** Less effective measures of business-cycle strength in this cycle, though still useful for confirmation.
- **Consumer sentiment: C**onsumer sentiment failed as a signal in 2022 and appears to be failing again in 2026, so deserves less weight.
- **New orders sentiment and capital goods orders:** Still useful as signals of business momentum and near-term activity.

Both old and new

- **Initial jobless claims:** The first real-time signal of flows into unemployment.
- **Quit rates, temporary hires, hours worked.**
- **Business sentiment:** Business industry sentiment sub-index readings for hiring and investment indicative of business appetite to invest and hire.
- **Chicago Fed Nonfinancial Leverage Subindex:** A financial vulnerability indicator with a long lead time, measures how restrictive leverage is for households and businesses and a good measure of the impact of Fed policy on credit.
- **Shipping estimates (CASS)**: Gauges business demand activity and supply pricing pressure to help measure business production costs and their impact on demand and inflation passthrough.

Now that we have them, what do they mean?

Decades of positive signals from traditional recession indicators helped confirm their usefulness as tools to watch. Before the pandemic, the yield curve's blueprint was widely accepted: if the yield curve inverted, on average, for two straight months, a recession over the next 12 to 18 months was likely. Consumer confidence readings, though perhaps not as strong a signal as the yield curve, also had documented thresholds that indicated recession territory.

New indicators to measure expansion risk are not as cut-and-dried. With that said, I believe we need a new dashboard of indicators with triggers, or thresholds, that indicate different degrees of risk. The U.S. Bank Economics Group Business Cycle Dashboard (see page 3) is one such measure. But now, the focus has shifted away from financial indicators to financial health and job readings. Our traditional Business Cycle Dashboard is useful, but still not complete. The team has expanded the dashboard's indicators to gauge financial market health to avoid the mistake we made in 2023.

Households: The cushion to watch

The household sector's financial health – the cushion that helped save the U.S. economy from recession in 2022 – is still the headliner. The key question is whether the household buffers that weakened monetary policy's impact then are still in place today. Real disposable income (page 6) highlights the pressure consumers are feeling at the checkout line. Purchasing power is now 14% lower than at the start of 2022, meaning every dollar buys roughly 14 cents less in goods and services than it did then. An overall measure of credit stress is the Chicago Fed Nonfinancial Leverage Subindex: a financial vulnerability indicator with a long lead time. It's a good measure of how restrictive leverage is for households and businesses and of the impact of Fed policy on credit. (This was a valuable item pre-Great Recession!)

Business: Making room for AI monitoring

The business sector's financial health – record volumes of long-dated fixed-rate corporate bonds at historically low coupons through 2021, helping businesses reduce exposure to Fed hikes in 2022. Given the Fed is signaling tighter policy on the horizon, we're keeping an eye on the maturation calendar of business debt across sectors. AI-related business investment financing is particularly significant in this cycle, with data center construction and other AI-related spending dominating investment activity. Data center ABS spreads are trading at the widest average spread among structured finance sectors. And AI-related stock market gains also dominate household wealth strength. A correction would mean that many dominoes could fall.

Labor: Same as it ever was (still the soft-landing backbone)

Labor market health will always matter in offsetting the effects of higher prices and borrowing costs. The leading indicators we watch include initial jobless claims, a real-time tracker of stress among workers, and the quit rate, which measures worker bargaining power. The strength of workers in 2022 was clear in the quit rate data, but that leverage has since faded as workers who were once "job hoppers" have become "job huggers." Even so, improving payrolls, still-low jobless claims, and a low unemployment rate support our expectation that the U.S. economy can weather these storms and land softly.

Inflation: The Fed's crosswind

Finally, the game today is inflation – the Fed's other mandate. I do not ignore traditional consumer price readings, but I am watching wholesale prices more closely to gauge pressure from tariff- and energy-related costs. An even more leading indicator is shipments, in nominal and real terms. We watch the CASS indicator for supply inflation pressure and also signs of reduced demand. What the Fed watches closely, however, is inflation expectations. Consumer inflation expectations are monitored but given less weight because of their limited relationship with future price changes. Market-based long-term inflation expectations are more important as a signal of possible deanchoring. So far, long-term expectations remain near the Fed's target, giving policymakers reason to stay on the sidelines rather than raise rates – at least for now.

Bottom line

The old recession signals still matter, but this cycle has shown they are no longer enough on their own. Policy transmission has been delayed, muted, or rerouted by household balance sheets, low fixed-rate debt, and still-resilient labor income – forces that helped the economy absorb rate hikes without tipping into recession. That means the Fed's dashboard needs to give more weight to the gauges that show how the real economy is handling pressure now: real disposable income, jobless claims, debt cushions, wholesale prices, and market-based inflation expectations. The economy can keep its balance, but the Fed will need to watch more than just the old warning lights to keep the economy on track.

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