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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: March 4, 2016

To: Federal Open Market Committee

From: Thomas Laubach and David W. Wilcox

Subject: Background Memos on the Probabilities of a U.S. Recession in the Next Year

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Board staff have prepared two complementary background memos presenting analyses pertaining to the probability that the U.S. economy could transition to a recessionary state in coming months. The first memo, "Probabilities of the U.S. Economy Entering a Recession in the Coming Year," prepared by Travis Berge, Nitish Sinha, and Michael Smolyansky, takes a purely statistical approach to discerning which macroeconomic and financial market indicators are most useful for predicting recessions. The memo concludes that nonfinancial indicators of real activity are most informative at near-term horizons (three and six months ahead) while financial variables gain the upper hand at a twelve-month horizon. The memo reports that data through February result in estimated recession probabilities for the near and medium term that are close to the unconditional average risk of recession. Nonetheless, the estimated probabilities of recession 12 months hence have drifted up, on net, in recent months, primarily reflecting a somewhat flatter term structure of Treasury yields and a material rise in corporate credit spreads.

The second memo, "Probability of Recession Implied by Credit Market Sentiment," prepared by Giovanni Favara, Kurt Lewis, and Gustavo Suarez, focuses on the U.S. corporate bond market, where some prior research and external analysis has documented that spreads have predictive power for downturns in U.S. economic

activity. Specifically, the authors analyze credit spreads on corporate debt net of expected defaults—which they refer to as the "excess bond premium"—an indicator capturing shifts in investor risk appetite or credit market sentiment. They show that the predictive capability of credit spreads for U.S. recessions is due entirely to the excess bond premium and not to the component of credit spreads that can empirically be attributed to expected corporate default risk. According to this measure, credit market sentiment has deteriorated appreciably since last summer, and the February level of the excess bond premium indicates the possibility of higher-than-average odds of a U.S. recession being called at some point in the next year. This memo also discusses the potential economic mechanism linking swings in credit market sentiment to fluctuations in real activity.