Understanding the Economic Signals: Are We Headed for a Recession?

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Concerns about the economy have intensified recently after a softer-than-expected national July jobs report triggered the "Sahm rule," a rule of thumb created by economist Claudia Sahm to diagnose recessions early. The Sahm rule indicates the U.S. is already in a recession when the three-month moving average of the national unemployment rate rises by 0.50 percentage points or more above the minimum of the three-month moving averages from the previous 12 months. With the unemployment rate climbing to 4.3% in July, this indicator has now crossed that critical threshold (see Figure 1).

But what exactly is a recession, and how do we recognize one? Economists, policymakers, and analysts rely on a range of indicators to assess the health of the economy, and while some of these alarm signals have flashed red, no big downturn has yet materialized. Are the indicators correct this time? This article explores what a recession is, the factors that could signal its onset, and whether we are on the brink of an economic downturn or merely slowing down.

Figure 1

	Aug 2023	Sep 2023	Oct 2023	Nov 2023	Dec 2023	Jan 2024	Feb 2024	Mar 2024	Apr 2024	May 2024	Jun 2024	Jul 2024
U.S. Unemployment Rate	3.8	3.8	3.9	3.7	3.7	3.7	3.9	3.8	3.9	4.0	4.1	4.3
Three-Month Moving Average	3.6	3.7	3.8	3.8	3.8	3.7	3.8	3.8	3.9	3.9	4.0	4.1

Source: Bureau of Labor Statistics, seasonally adjusted

What is a recession?

A recession is defined as a significant decline in economic activity that lasts for more than a few months, usually tangible across the entire economy. It is characterized by a drop in Gross Domestic Product (GDP), rising unemployment, falling income, reduced consumer spending, and a slowdown in industrial production. The National Bureau of Economic Research (NBER) is the official arbiter of U.S. recessions, with its business cycle dating committee examining several key indicators to decide if the economy has entered a recession, with a particular focus on payroll employment and real personal income growth excluding transfers.

Nonfarm payroll employment refers to the number of jobs added or lost in the economy. Reported monthly by the Bureau of Labor Statistics' Current Employment Statistics (CES) Program, it represents the total number of paid employees working for businesses and government agencies in the U.S., excluding farm workers, private household employees, and nonprofit organization employees. Payroll employment is a key indicator because it reflects the demand for labor and, by extension, overall economic activity.

The BLS reported that national total nonfarm payroll employment edged up by 114,000 during the month of July, an increase which fell short of the average monthly gain of 215,000 over the previous 12 months. Although this growth was slower than anticipated, it still indicates a positive trend and does not necessarily signal an imminent recession, though the pace of growth is slowing.

Real personal income growth excluding transfers measures the increase in total income adjusted for inflation, excluding income from government programs like Social Security and unemployment benefits. The adjustment for inflation is crucial because it reflects the true purchasing power of the income, as opposed to just the nominal (or face value) growth, which gives a clearer picture of how much more goods and services people can buy with their income over time. Real personal income growth is an important economic indicator because it reflects the financial well-being of households and their ability to spend, which in turn drives economic activity.

According to data from the Bureau of Economic Analysis, this measure of real income growth has been positive in six of the last eight months, with 0.4% growth in May and 0.1% in June. Over-the-year growth measures look good as well, with real personal income excluding transfers jumping 1.78% from June 2023 to June 2024.

The most heavily weighted data by NBER, nonfarm payroll employment and real personal income growth excluding transfers, both seem to indicate an economy that may be slowing down, but one that it is still healthy. So, what does this mean for the Sahm rule?

Breaking Down the Sahm Rule

The Sahm rule was designed to provide an early warning system for recessions by focusing on unemployment data. Because U.S. recessions from 1947 to 2008 have typically involved a gradual rise in the unemployment rate followed by a significant spike, the Sahm rule was anchored solely on unemployment data and was designed to set a threshold at which policymakers should begin responding to an economic downturn. Though simple, the rule is historically highly accurate. Introduced in 2019, the rule has correctly indicated every recession as far back as 1970.

However, the Sahm rule doesn't distinguish between the two stories that may underly an increasing unemployment rate (the percentage of the civilian labor force that is unemployed and actively seeking employment). Typically, a recession begins with an increase in the unemployment rate due to a decline in demand, leading to job losses and a subsequent feedback loop where rising unemployment further weakens the economy. However, the unemployment rate can also increase when more people enter the labor market and don't immediately find employment, raising the unemployment rate even if layoffs are not widespread.

In July, for instance, the U.S. civilian labor force grew by 420,000 people, resulting in 67,000 more employed persons and 352,000 more unemployed persons. This influx caused the unemployment rate to rise—not due to widespread layoffs, but because a larger number of job seekers had yet to find employment.

Given this context, the Sahm rule may be overstating the risk of recession this time, though slowing job growth does reinforce a slowing economy, and we are not entirely out of the woods. A report by J.P. Morgan suggests that the labor market data may be indicating an economy closer to full employment—with increasing labor force participation, minimal layoffs, and stable aggregate demand—rather than a recession characterized by rising layoffs and collapsing demand.

Spotlight on Virginia

Are these same trends happening here in the Commonwealth of Virginia? Overall, Virginia's data tells a similar story of a slowdown rather than a recession. While July saw an increase in the number of unemployed persons and a decrease in employment and civilian labor force, the unemployment rate has stayed consistently low at 3.1% or below since October 2021, unlike the national trend of rising unemployment. In fact, the unemployment rate is trending downward, reaching 2.7% in May and continuing at that rate through July, far from triggering the Sahm rule (see Figure 2).

Virginia's total nonfarm payroll employment mirrors the national trend, with an increase of 4,800, a figure that is solid but that also falls below its average monthly gain of 7,000 over the previous 12 months.

Figure 2

	VA Civilian Labor Force	VA Employment	VA Unemployment	VA Unemployment Rate	Three-Month Moving Average UR	VA Labor Force Participation Rate
Aug 2023	4,557,001	4,431,976	125,025	2.7	2.6	66.3
Sep 2023	4,565,476	4,432,525	132,951	2.9	2.7	66.4
Oct 2023	4,573,605	4,434,396	139,209	3.0	2.9	66.5
Nov 2023	4,577,183	4,436,953	140,230	3.1	3.0	66.5
Dec 2023	4,579,693	4,440,308	139,385	3.0	3.0	66.5
Jan 2024	4,588,384	4,448,607	139,777	3.0	3.0	66.6
Feb 2024	4,591,517	4,451,772	139,745	3.0	3.0	66.6
Mar 2024	4,588,725	4,454,564	134,161	2.9	3.0	66.5
Apr 2024	4,584,484	4,455,133	129,351	2.8	2.9	66.4
May 2024	4,578,976	4,454,212	124,764	2.7	2.8	66.3
Jun 2024	4,574,713	4,452,230	122,483	2.7	2.7	66.2
Jul 2024	4,570,647	4,446,004	124,643	2.7	2.7	66.1

Source: Local Area Unemployment Statistics, seasonally adjusted

Conclusion

Overall, while recession indicators suggest that a downturn is possible, the economy appears to be experiencing a slowdown rather than a full-fledged recession. However, the triggering of the Sahm rule remains significant and may be a key factor for policymakers as they navigate the uncertain economic landscape ahead.