Persistent high inflation + “super” determined Fed = recession

…but recent improvement of financial conditions lower odds of recession, make it milder and later

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Chris Varvares, Co-head US Economics, chris.varvares@ihsmarkit.com

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Hallmarks of the US forecast – it all depends on the stickiness of inflation

- **Inflation** unacceptably high, elicited aggressive Fed response; inflation falls as overshoots reverse and slack expands, commodity prices reverse, and supply issues resolve

- Unsustainably **tight labor markets**, boosted wage growth; rise in the unemployment rate will help to slow wage gains

- Fed aims to **tighten financial conditions** in effort to end unacceptably high inflation
  - Fed funds rate rising sharply – to reach **5% - 5¼%**; + 25 bps in March; another 25 bps in May, again in June
  - Term Treasury yields, corporate yields, mortgage rates, consumer loan rates need to turn up
  - Weakening equities will lessen support to consumer spending via wealth effect
  - Dollar strength has ebbed, but still in the pipeline will weaken exports, divert domestic demand to imports

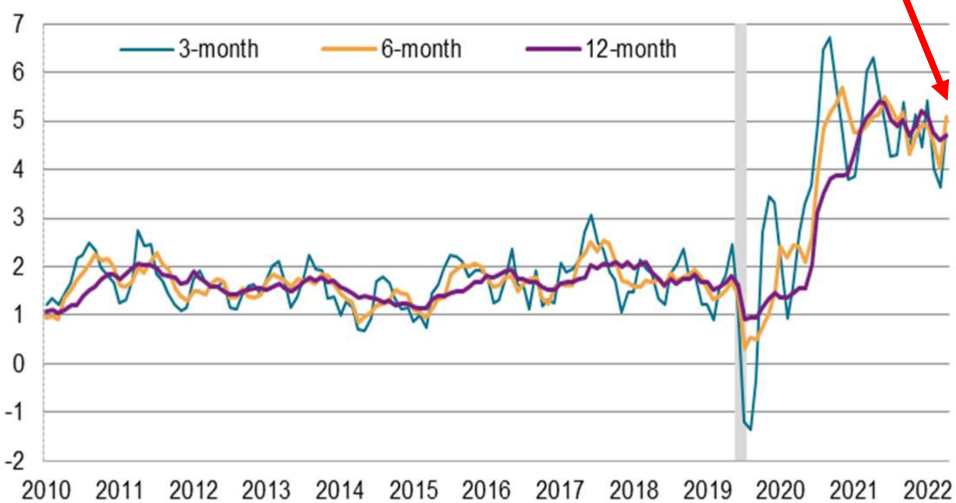
- US enters mild **recession** as: 1) fiscal support wanes 2) pent-up demand wanes, 3) financial conditions worsen, 4) surging prices erode real income and wealth, and 5) foreign growth sags

- Key risks: Policy **im**perfection, conflict in Ukraine intensifies, new COVID variants emerge

Unacceptably high inflation and unsustainably tight labor market

Core PCE inflation: alternative horizons

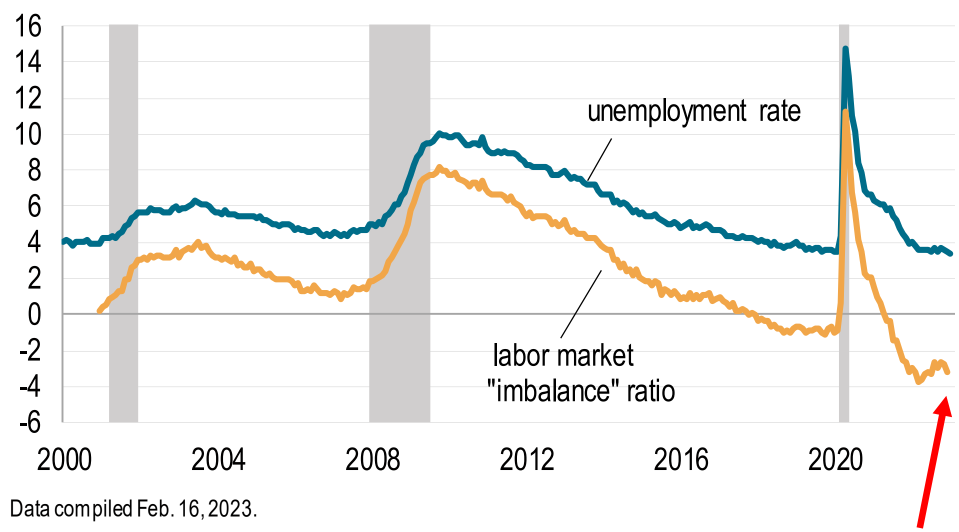
Annualized % chg.



Data accessed on February 27, 2023.
Source: BEA, Last data plotted for Jan-23

Labor market "imbalance" and the unemployment rate

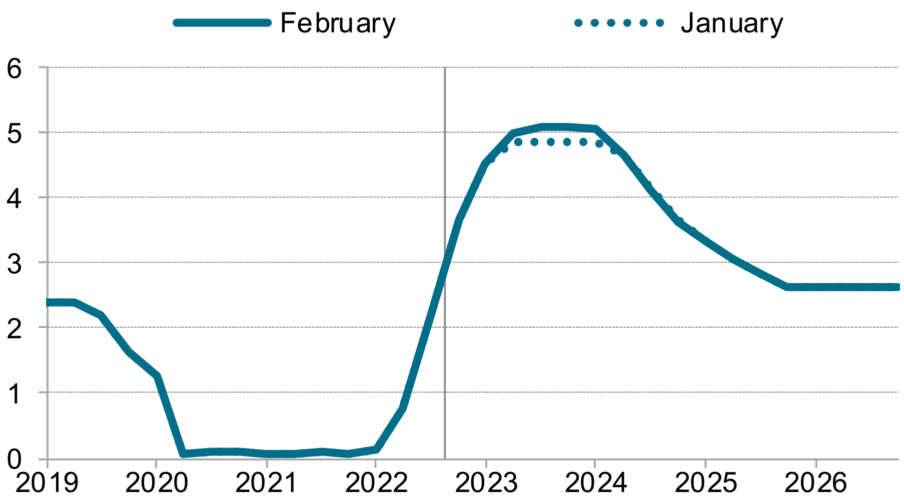
Percent of labor force



Data compiled Feb. 16, 2023.
Sources: Bureau of Labor Statistics, S&P Global Market Intelligence.

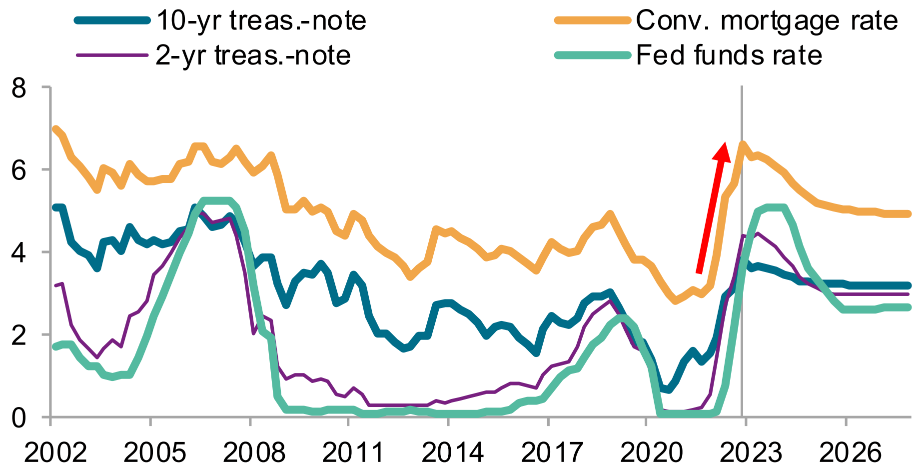
…elicits aggressive Fed policy response; market yields respond…enough?

Federal funds rate
Percent



As of February 6, 2023
Source: S&P Global Market Intelligence

Fed increases the funds rate to 5¼% by May 2023, term yields flatten after rapid rise
Percent

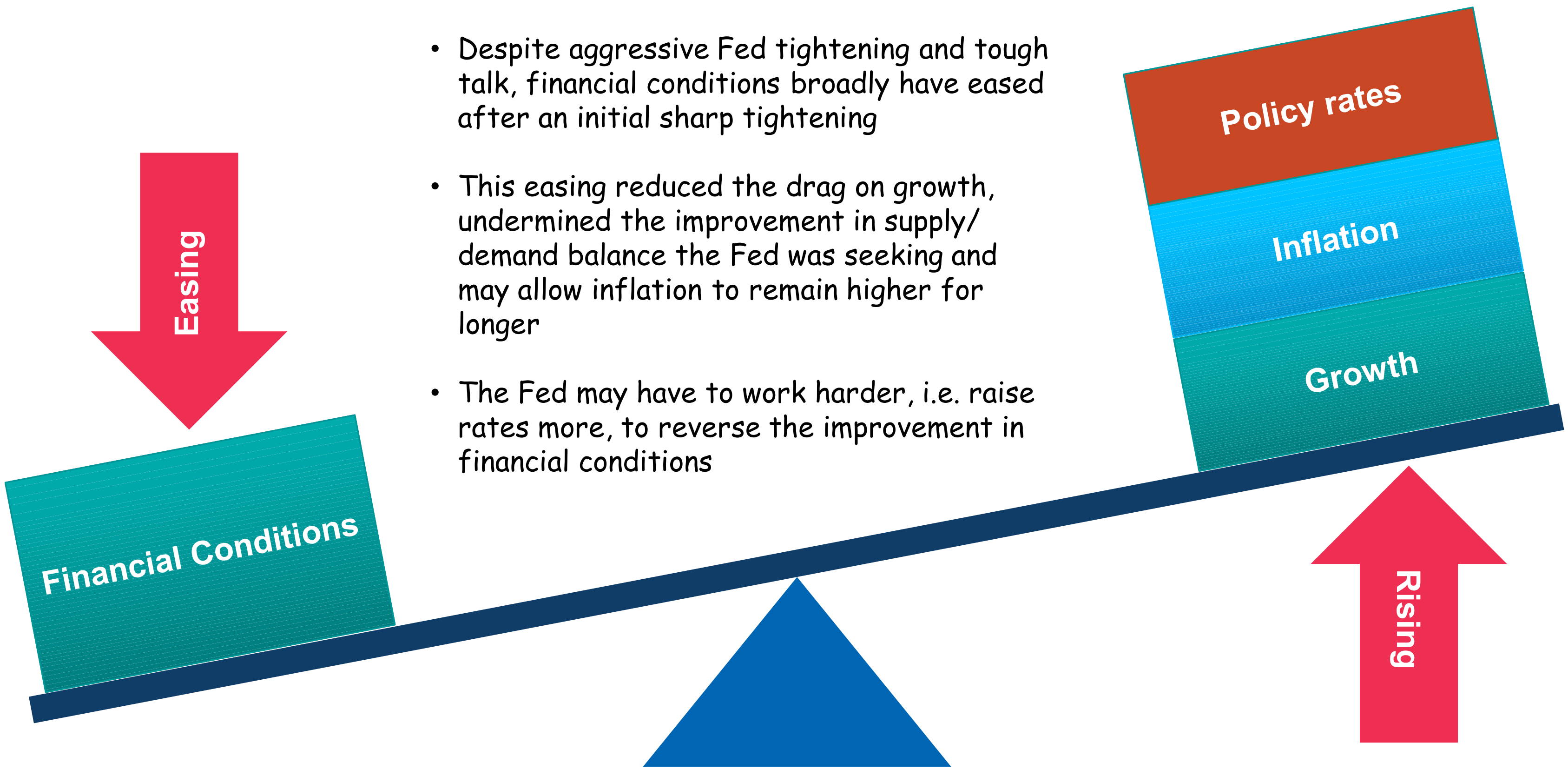


As of February 6, 2023.
Source: S&P Global Market Intelligence, FRB

Now expecting Fed to raise the target range all the way to 5¼% to 5½%

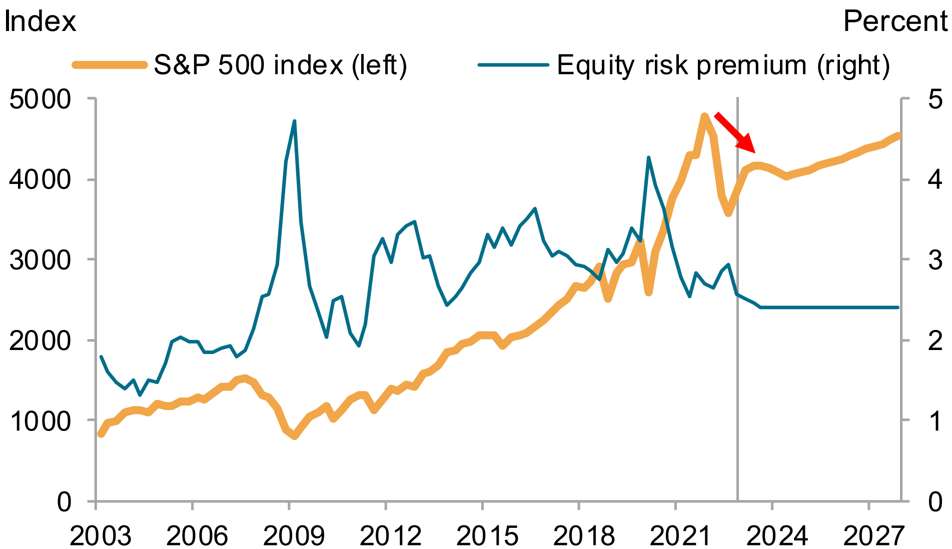
Ride my seesaw: financial conditions vs growth, inflation and rates

- Despite aggressive Fed tightening and tough talk, financial conditions broadly have eased after an initial sharp tightening
- This easing reduced the drag on growth, undermined the improvement in supply/ demand balance the Fed was seeking and may allow inflation to remain higher for longer
- The Fed may have to work harder, i.e. raise rates more, to reverse the improvement in financial conditions



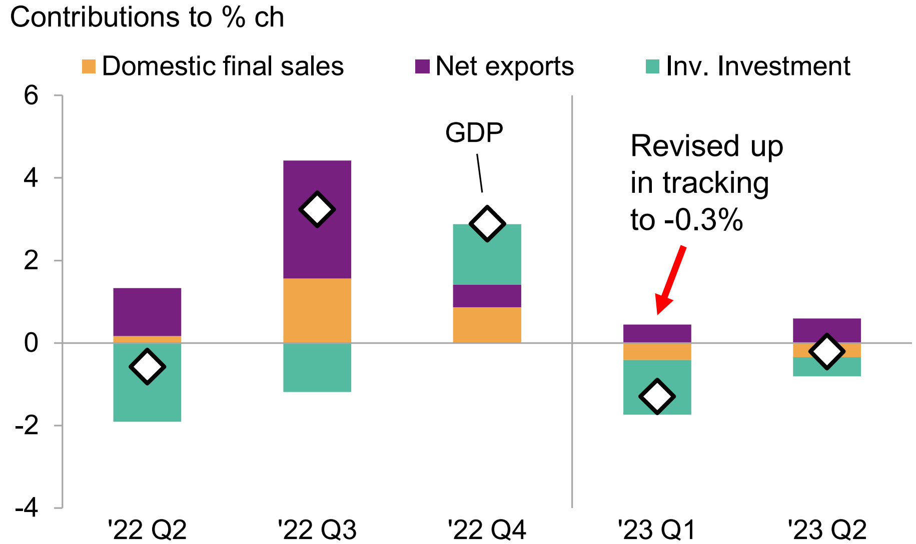
Worsened financial conditions to tip US into recession in early 2023

Equities rise unevenly through 2027



As of February6, 2023.
Source: S&P Global Market Intelligence, S&P

GDP growth and contributions

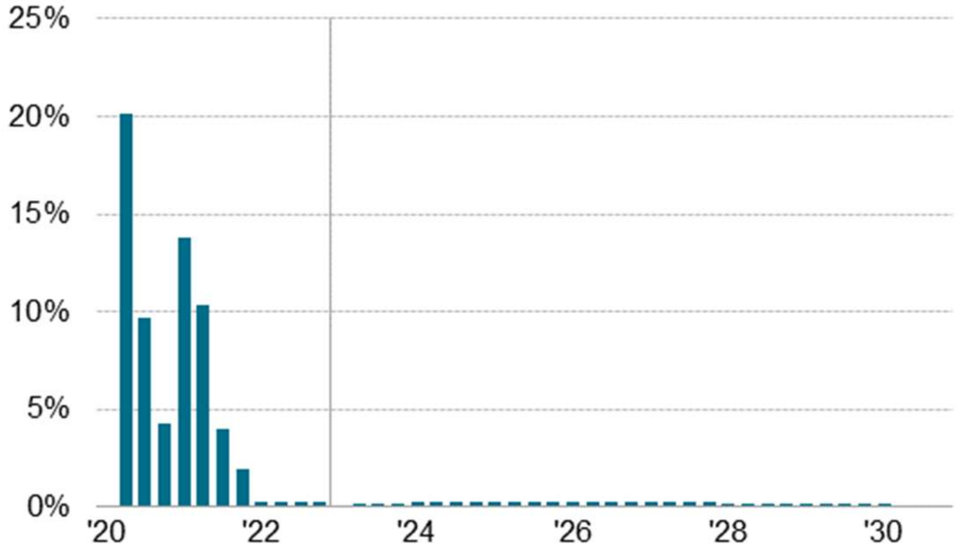


As of February 6, 2023
Source: S&P Global Market Intelligence, BEA

Waning fiscal stimulus; IRA is not a macro event

Federal outlays for COVID relief and IIJA

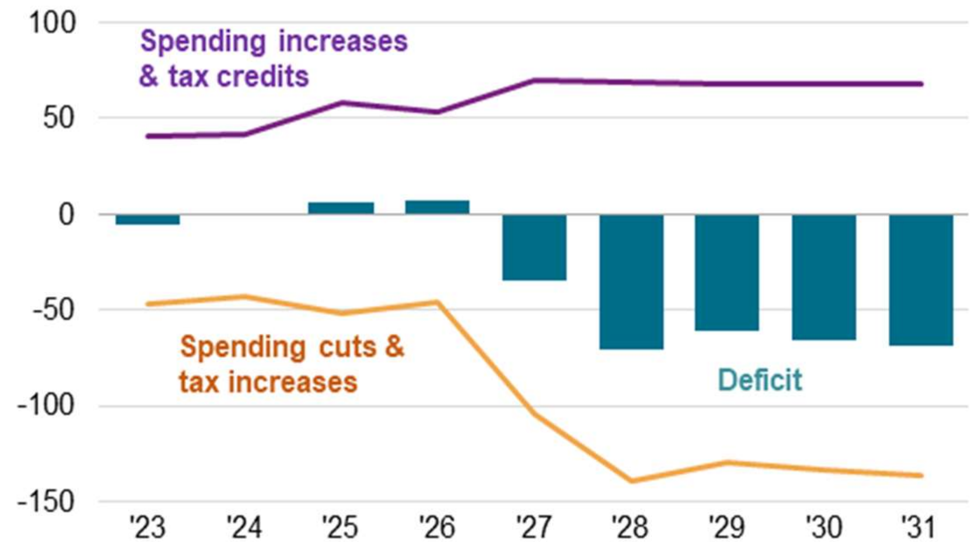
Percent of GDP



Data compiled Feb. 27, 2023.
Sources: S&P Global Market Intelligence; Congressional Budget Office.

Budget effects of the Inflation Reduction Act

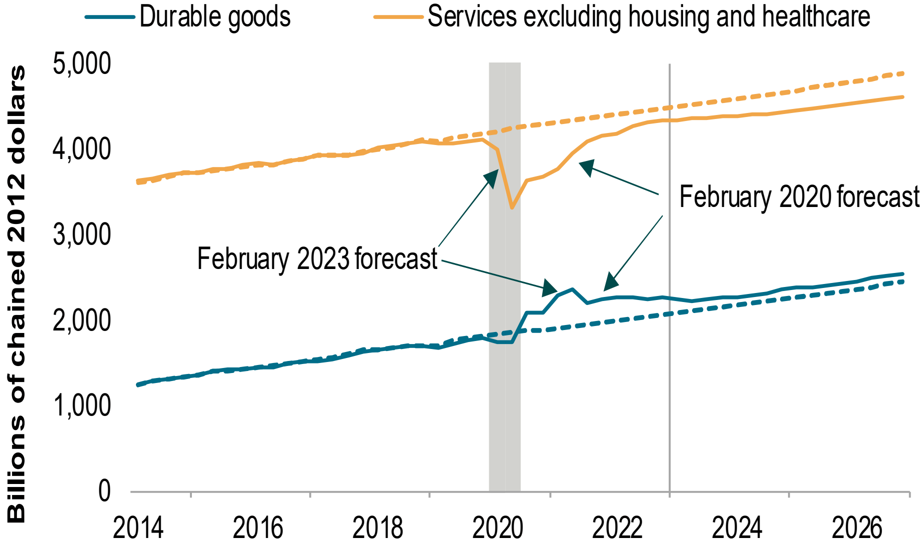
Billions of dollars, fiscal years



Data compiled Feb. 27, 2023.
Sources: S&P Global Market Intelligence; Congressional Busdget Office.

Exhausted pent-up demand and rotation away from expenditures on goods

Personal consumption expenditures

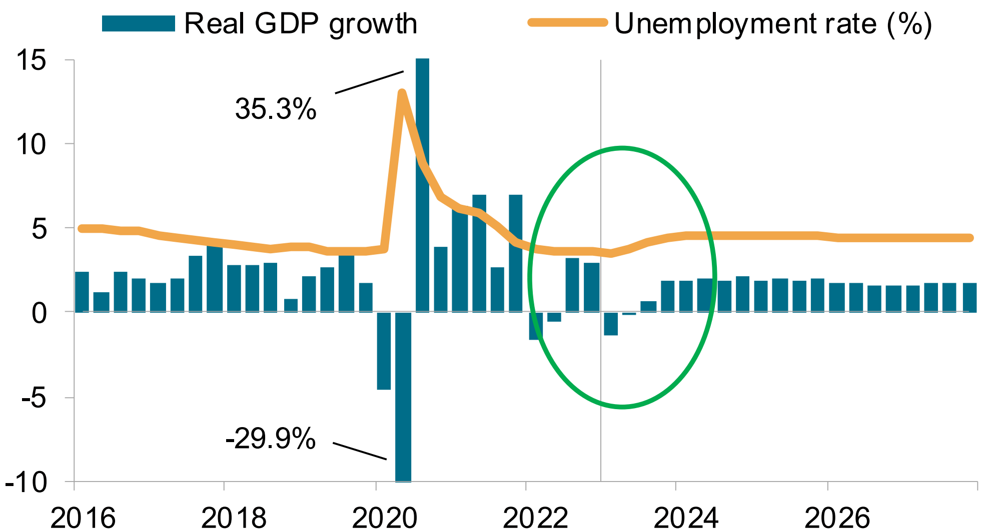


Forecast published on Feb. 6, 2023.
Sources: Bureau of Economic Analysis; S&P Global Market Intelligence.

- **Ongoing transition** from spending on non-auto durable goods toward services;
- Pent-up **demand** for services nearly **exhausted**, and spending growth expected to slow
- Excess **saving** (roughly) $2½ trillion will not be suddenly exhausted and lead to a collapse in consumer spending; it does not work that way
- Recent **weakness** in equities will restrain spending on both
- Going forward, **employment** declines and weak **income** growth will also restrain spending

GDP growth rebounded in H2, then US enters mild recession in Q1 2023

Recession begins in 2023 Q1, runs thru 2023 Q2
Percent change, annual rate

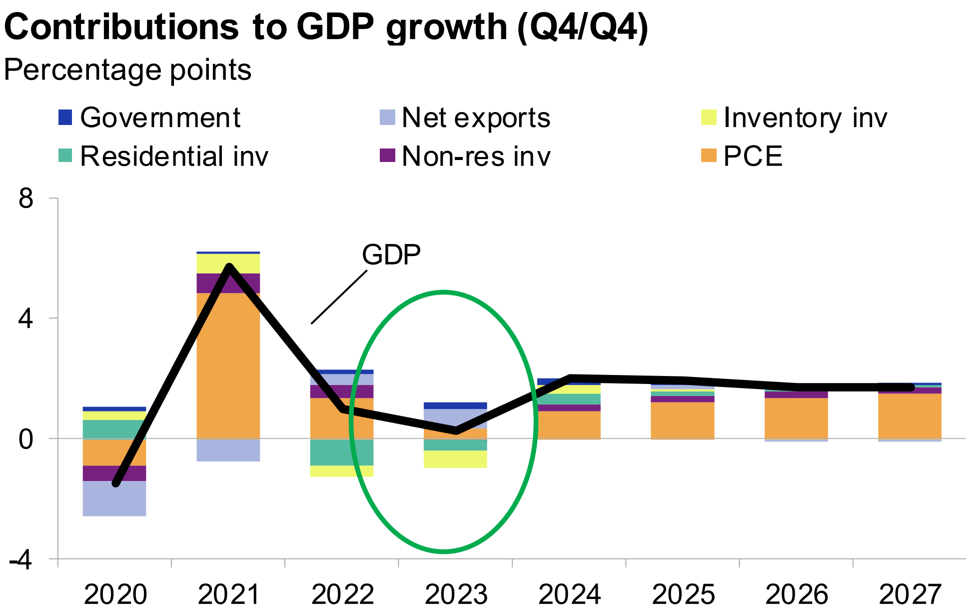


As of February6, 2023.
Source: S&P Global Market Intelligence, BEA, BLS

"Change" in our recession call

- Reversing fiscal **stimulus** restraining growth of both **income** and profits
- Surging **prices** are eroding real income
- Tightening **financial conditions** restraining (more or less) growth of demand
- **Foreign growth** is slowing, restrained by similar forces as in the US
- **GDP declines** peak-to-trough by ½%; pulls establishment employment lower by 1.4 million
- **Unemployment** rises roughly 1¼ percentage points to roughly 4.6%

Weakness widespread, but housing, non-res and inventory inv. decline



As of February 6, 2023.
Source: S&P Global Market Intelligence, BEA
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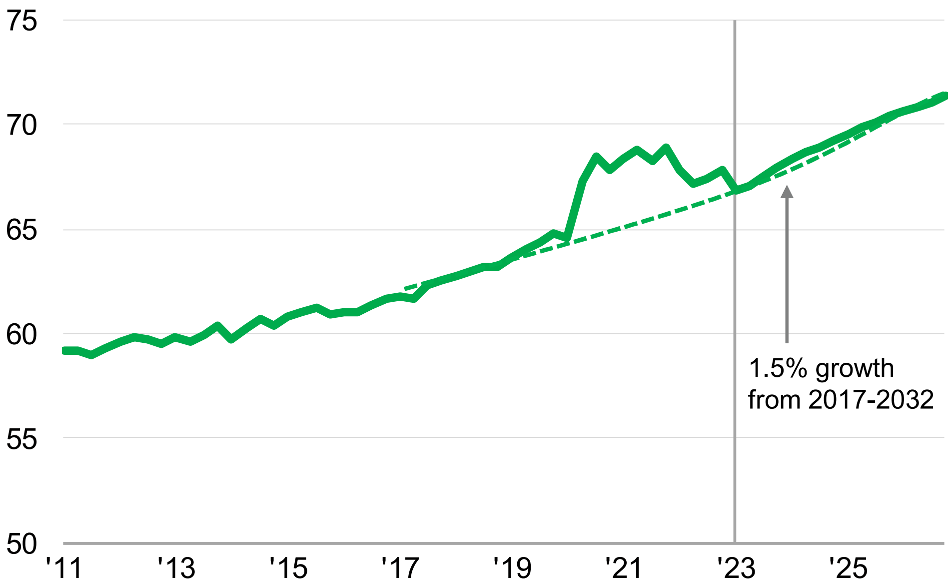
Interest rate sensitive sectors do the worst

- **Housing investment** did “surprisingly” well in 2020-2021; falling fast in 2022; expected to subtract 0.3 ppt from GDP growth this year
- But **business fixed investment** slumps beginning in Q4; and will be weakest in H1 2023; subtracts 0.1 ppt
- **Inventory investment** decline more than accounts for the peak to trough decline in GDP; vehicles a counter-weight
- **PCE outperforms**…barely as strong **HH** balance sheets help, wage catch-up and only modest employment losses should keep income growth positive; adds 0.3 ppt
- **Gov’t sector** bucks the cycle as COVID funds support S&L spending

Wage inflation expected toconverge to rate consistent with 2% price inflation

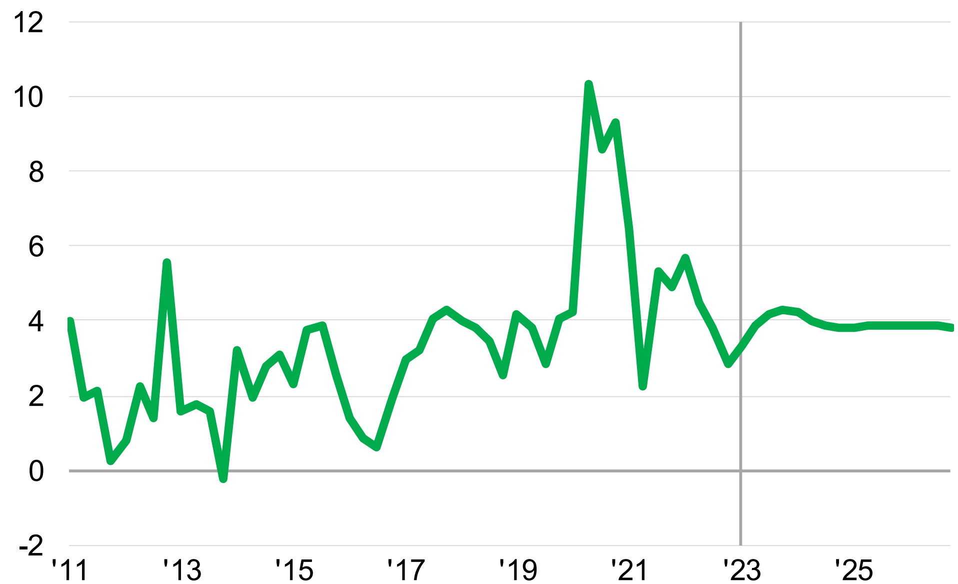
1½% productivity growth + 2% price inflation = 3.5% growth in nominal labor costs…eventually

Output/hour, pvt. nonfarm business, 2009 $ per hour



Source: S&P Global Market Intelligence; BEA

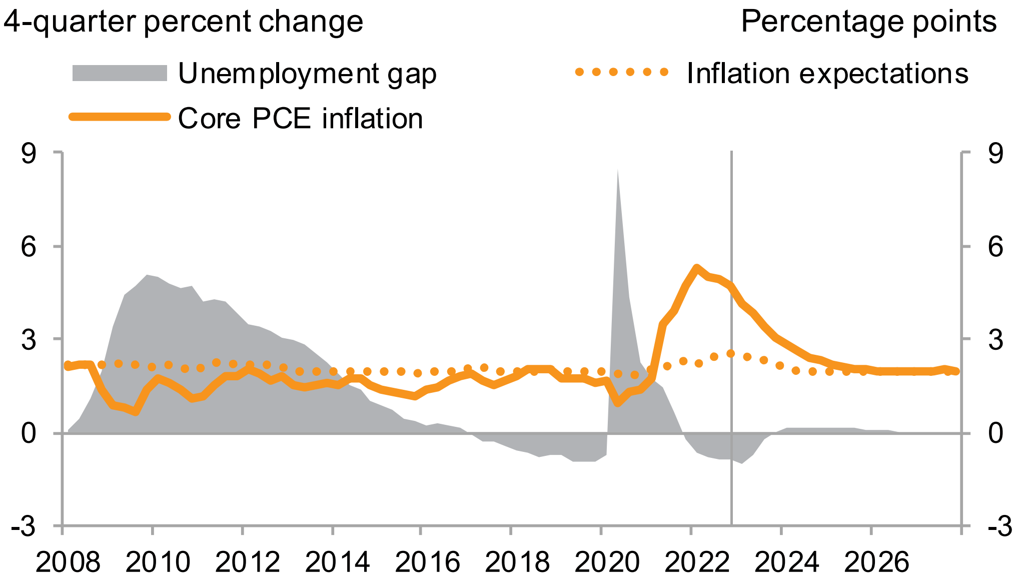
Comp/hour, pvt. nonfarm business, 4-qtr % ch



Source: S&P Global Market Intelligence; BEA

After surge, core PCE inflation is past its peak; multi-year process to get back to 2%

Core PCE inflation declines to 2% after surge



As of February 6, 2023.
Source: S&P Global Market Intelligence, Philly Fed, BEA, BLS

Inflation falling but remains stubbornly high

- Signs of global sustained **excess** of aggregate demand over aggregate supply remain, but easing
- Idiosyncratic, COVID-related, price jumps due to **mis-match** of recovery in demand versus supply are ending
- **Supply-chain** issues resolving as demand for goods softens, and logistics get sorted
- Long-term **inflation expectations** drifted up a bit
- Going forward, labor market **mismatches** resolve only after **relative wages** have time to adjust, and as demand for labor softens

Key summary variables and differences from previous forecast - annual values

	% ch from prior year, or annual average						% ch from Q4 of prior year, or Q4 level					
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**2022.4**	**2023.4**	**2024.4**	**2025.4**	**2026.4**	**2027.4**
Real Gross Domestic Product*	2.1	0.7	1.6	2.0	1.8	1.6	1.0	0.2	2.0	1.9	1.7	1.7
	0.1	*0.2*	*-0.2*		*0.2*		*0.2*		*-0.1*	*0.1*	*0.1*	*0.1*
Dom. Final Sales Contribution	1.7	0.3	1.2	1.8	1.7	1.7	1.0	0.2	1.7	1.7	1.7	1.8
	-0.1	*-0.2*	*-0.1*		*0.1*		*-0.1*	*-0.1*	*-0.1*		*0.2*	*0.1*
Net Exports Contribution	-0.4	0.9	0.3	0.1	0.1	-0.1	0.3	0.6	0.0	0.1	0.0	-0.1
	0.1	*0.4*	*0.1*	*0.1*		*-0.1*	*0.2*	*0.3*			*-0.1*	
Inventory Invest. Contribution	0.7	-0.5	0.1	0.1	0.0	0.0	-0.3	-0.6	0.3	0.1	0.0	0.0
			-0.1				*0.2*	*-0.1*		*0.1*		
Real PCE*	2.8	1.0	1.1	1.7	1.9	2.1	1.9	0.5	1.4	1.7	2.0	2.2
	-0.1	*-0.5*	*-0.1*		*0.2*	*0.1*	*-0.3*	*-0.3*	*-0.1*		*0.2*	*0.1*
Unemployment Rate**	3.6	3.9	4.6	4.5	4.4	4.4	3.6	4.4	4.6	4.5	4.4	4.4
	-0.1	*-0.7*	*-0.2*				*-0.1*	*-0.7*		*0.1*		
Core PCE Inflation*	5.0	3.6	2.6	2.1	2.0	2.0	4.7	3.1	2.3	2.0	2.0	2.0
			0.2	*0.1*					*0.1*			
Federal Funds Rate**	1.68	4.92	4.37	2.96	2.63	2.63	3.65	5.09	3.63	2.62	2.63	2.63
		0.10	*0.10*					*0.23*	*-0.02*	*-0.01*		*0.01*
10-year T-Note Yield**	2.95	3.59	3.35	3.22	3.20	3.19	3.83	3.54	3.26	3.22	3.19	3.19
	0.10	*-0.10*					*0.02*	*-0.04*	*-0.04*	*-0.02*		*0.02*
S&P 500 (period end)***	-9.2	5.3	-2.1	2.7	3.4	3.7	-19.4	7.7	-1.3	3.0	3.7	3.8
	0.4	*8.1*	*-3.8*	*-0.2*	*0.5*		*1.2*	*6.7*	*-4.2*	*0.7*	*0.2*	*-0.1*

Notes: Positive differences from previous forecast shown in teal font, negative differences shown in red font.
* % ch; ** annual average level or level at Q4; ***level at Q4 is last trading day of the year.
Source: S&P Global Market Intelligence

Customer Care

CustomerCare@ihsmarkit.com

Asia and the Pacific Rim

Japan: +81 3 6262 1887

Asia Pacific: +604 291 3600

Europe, Middle East, and Africa: +44 1344 328 300

Americas: +1 800 447 2273

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