

# 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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28 February 2023

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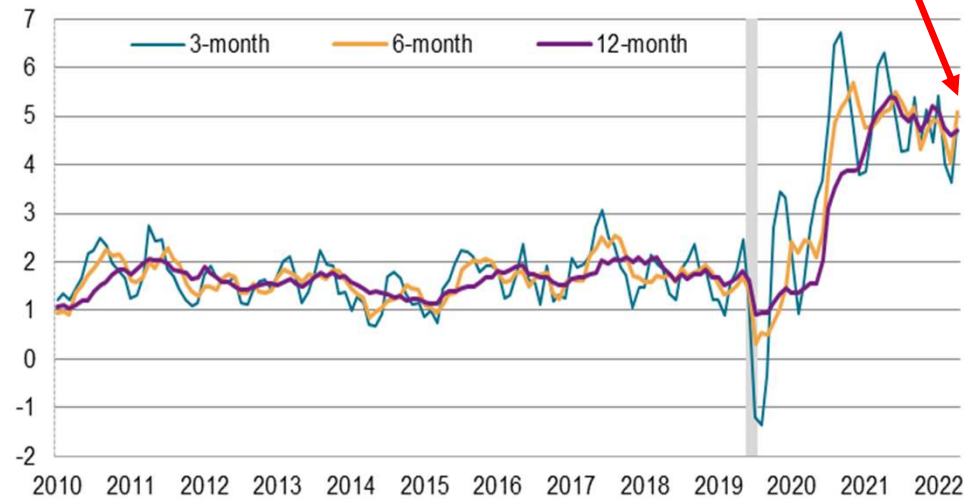
## Hallmarks of the US forecast – it all depends on the stickiness of inflation

- **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 **imperfection**, conflict in Ukraine intensifies, new COVID variants emerge

# Unacceptably high inflation and unsustainably tight labor market

## Core PCE inflation: alternative horizons

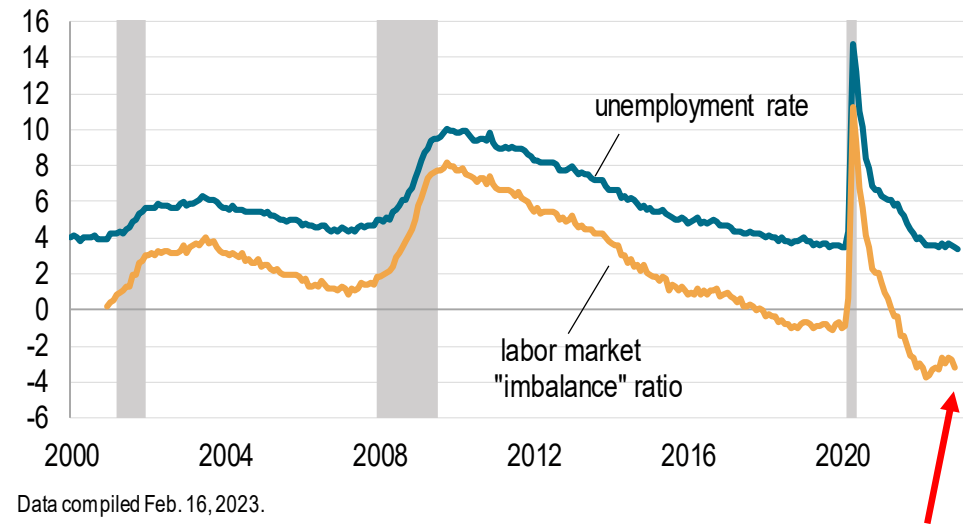
Annualized % chg.



Data accessed on February 27, 2023.  
 Source: BEA, Last data plotted for Jan-23  
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## Labor market "imbalance" and the unemployment rate

Percent of labor force

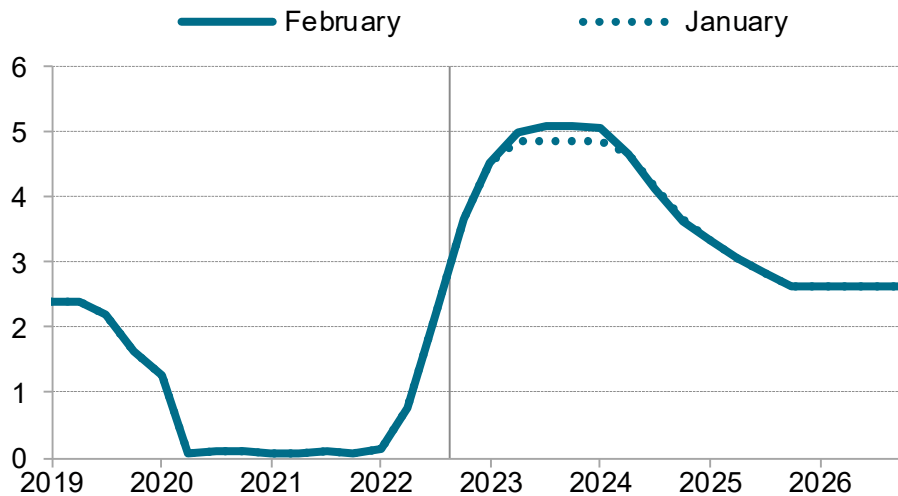


Data compiled Feb. 16, 2023.  
 Sources: Bureau of Labor Statistics, S&P Global Market Intelligence.  
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# ...elicits aggressive Fed policy response; market yields respond...enough?

## Federal funds rate

Percent



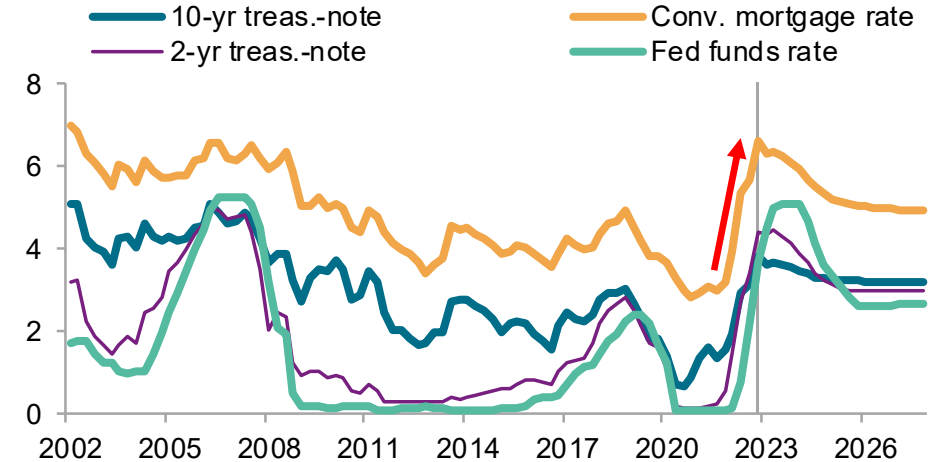
As of February 6, 2023

Source: S&P Global Market Intelligence

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

Percent



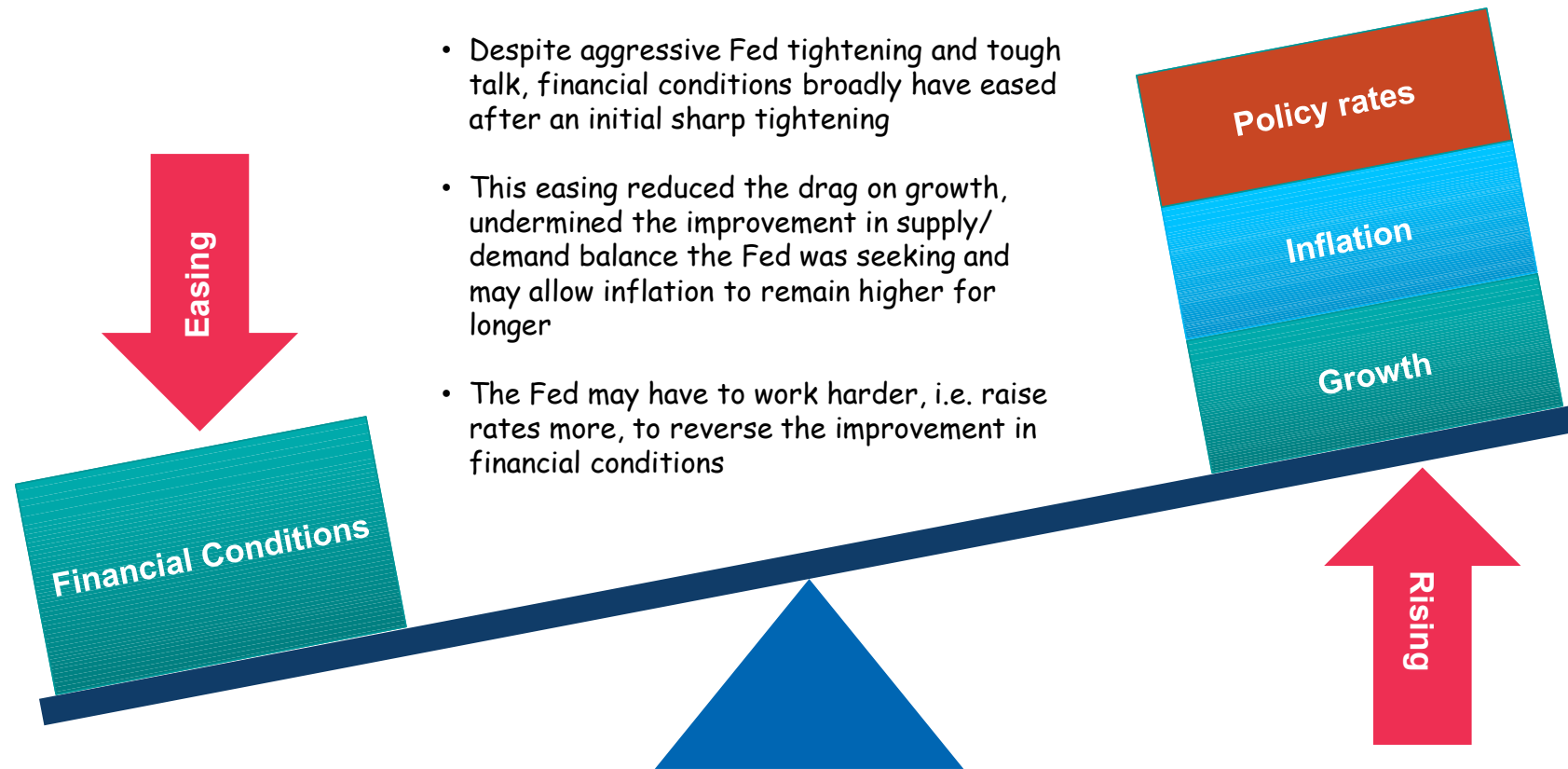
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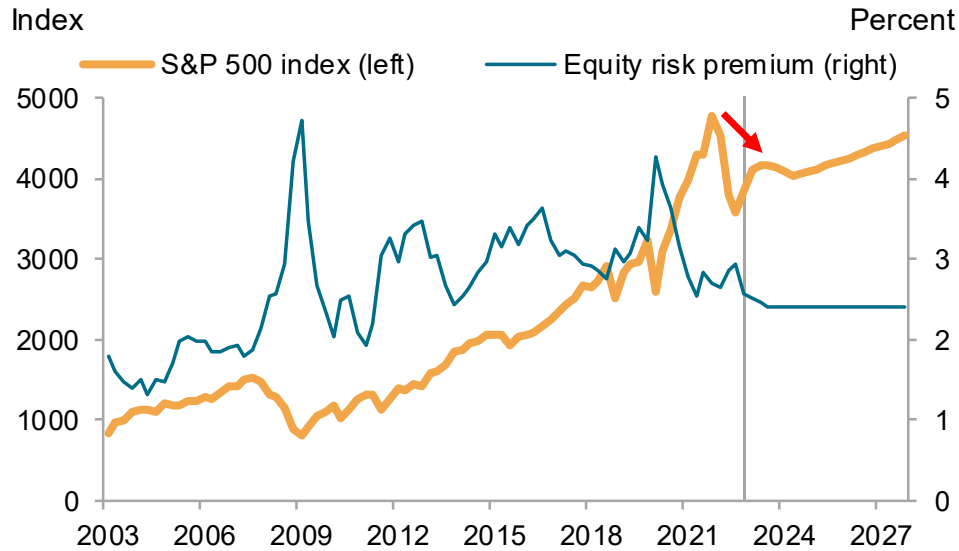
Now expecting Fed to raise the target range all the way to 5¼% to 5½%

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



# Worsened financial conditions to tip US into recession in early 2023

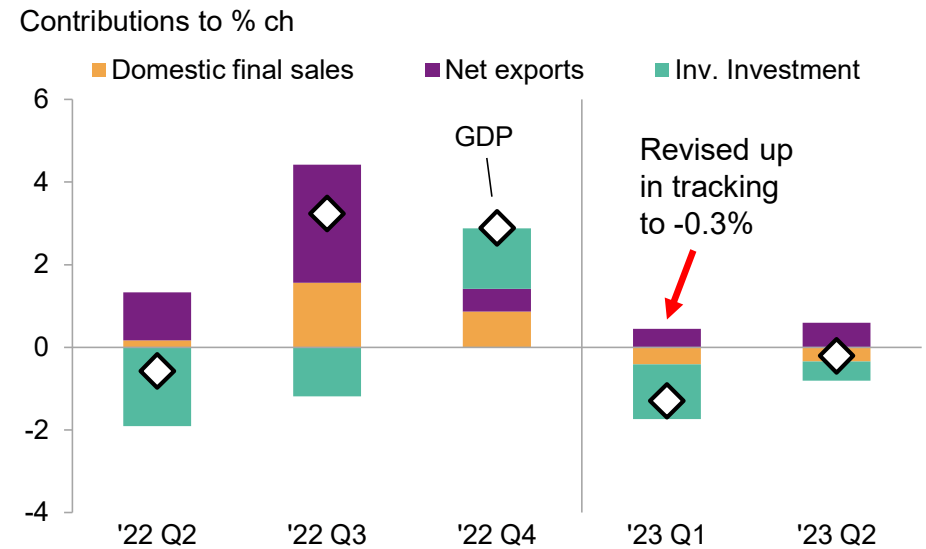
## Equities rise unevenly through 2027



As of February 6, 2023.

Source: S&P Global Market Intelligence, S&P  
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## GDP growth and contributions



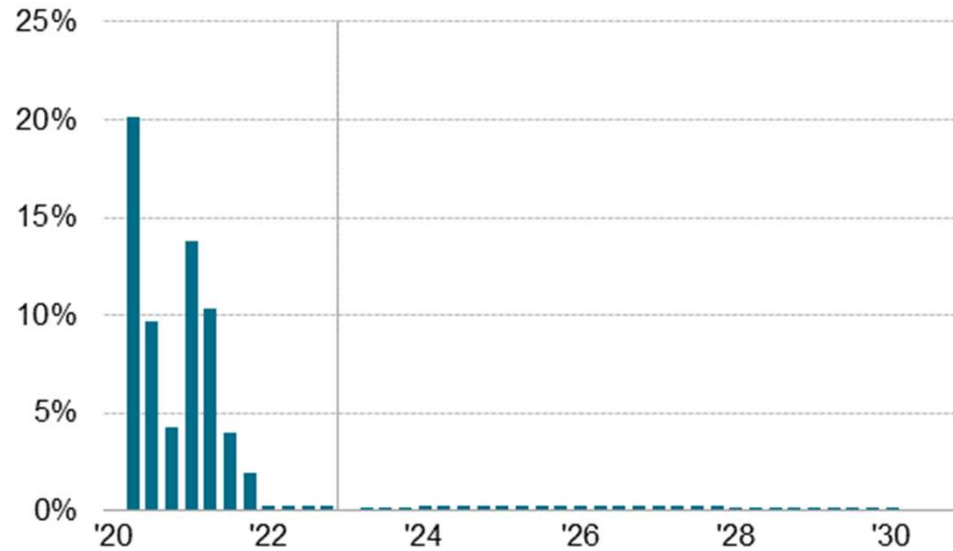
As of February 6, 2023

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# Waning fiscal stimulus; IRA is not a macro event

## Federal outlays for COVID relief and IJA

Percent of GDP



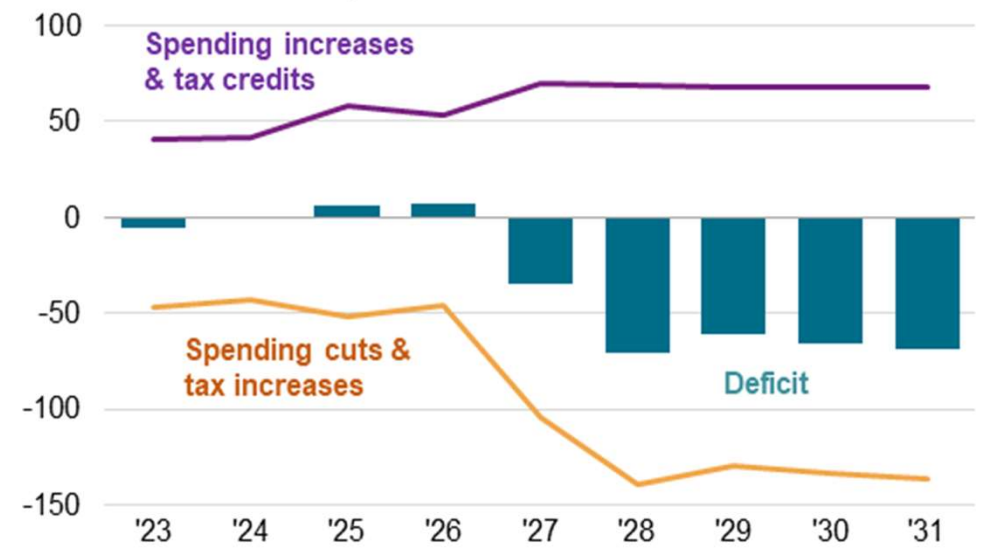
Data compiled Feb. 27, 2023.

Sources: S&P Global Market Intelligence; Congressional Budget Office.

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## Budget effects of the Inflation Reduction Act

Billions of dollars, fiscal years



Data compiled Feb. 27, 2023.

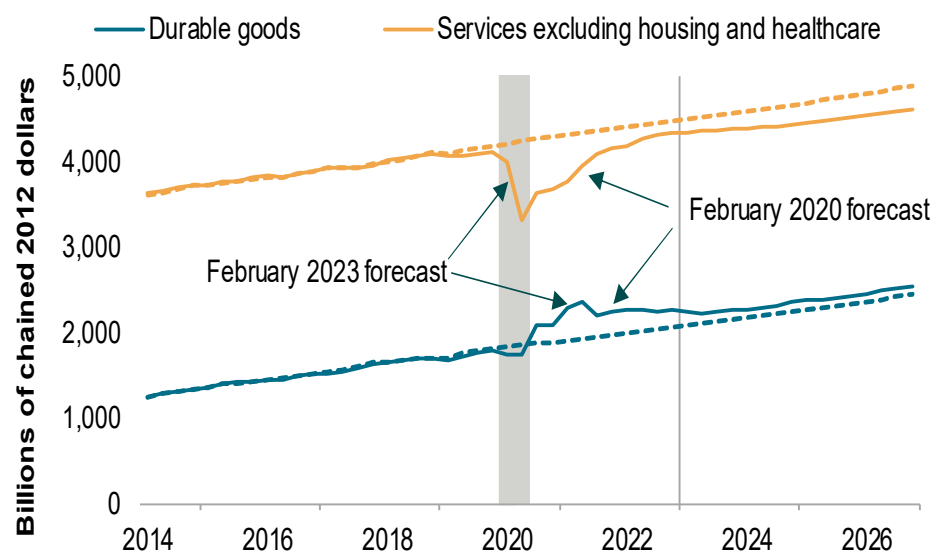
Sources: S&P Global Market Intelligence; Congressional Budget Office.

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# 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.

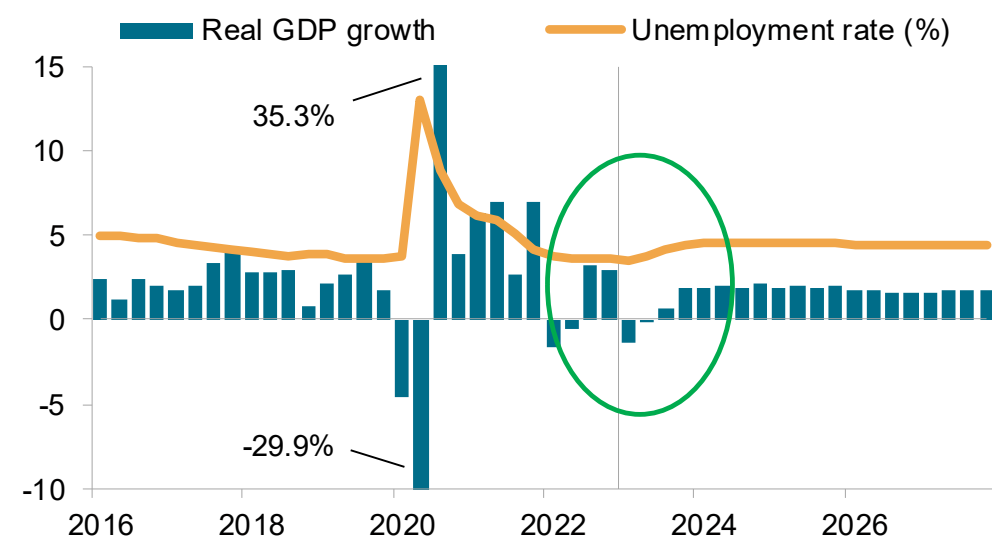
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- **Ongoing transition** from spending on non-auto durable goods toward services;
- Pent-up **demand** for services nearly **exhausted**, and spending growth expected to slow
- Excess **saving** (roughly) \$2½ trillion will not be suddenly exhausted 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 February 6, 2023.

Source: S&P Global Market Intelligence, BEA, BLS

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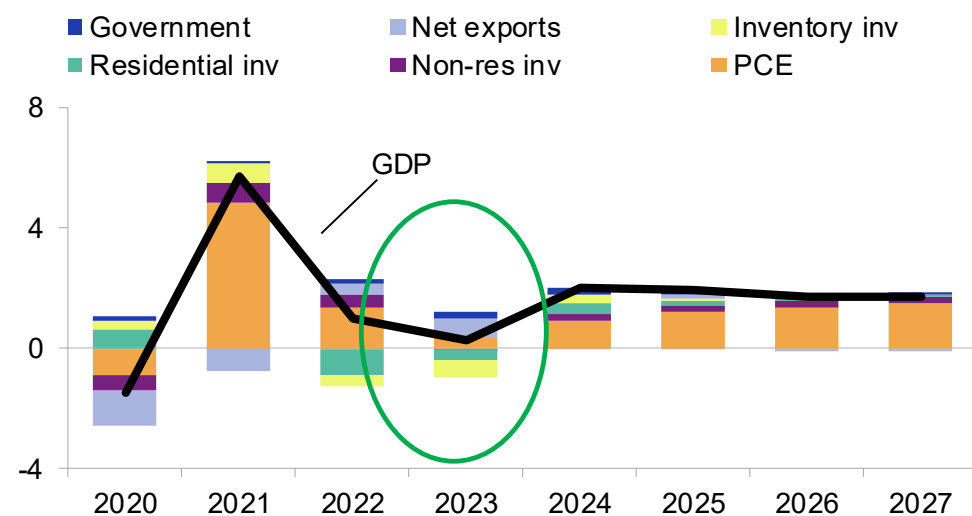
## “Change” in our recession call

- 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

### Contributions to GDP growth (Q4/Q4)

Percentage points



As of February 6, 2023.

Source: S&P Global Market Intelligence, BEA

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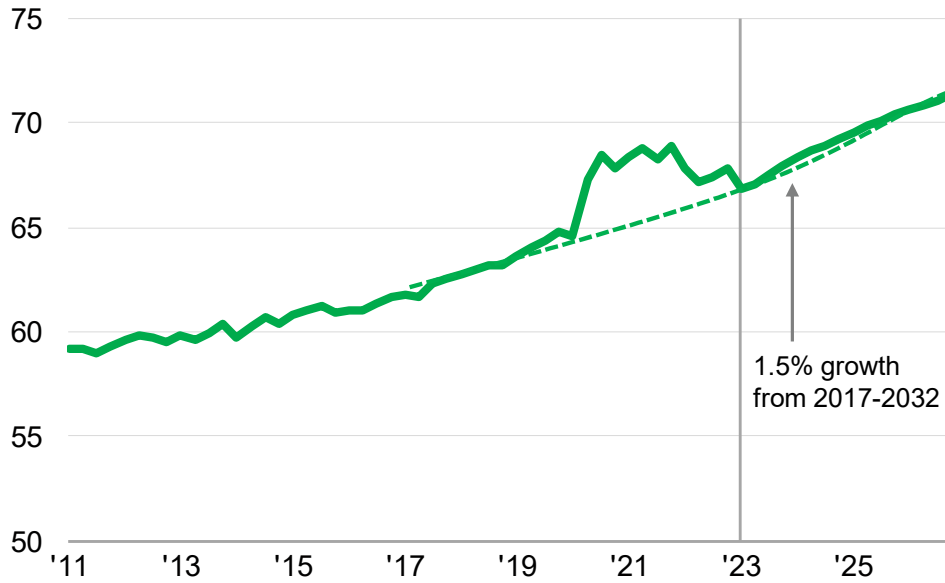
### Interest rate sensitive sectors do the worst

- **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 to converge to rate consistent with 2% price inflation

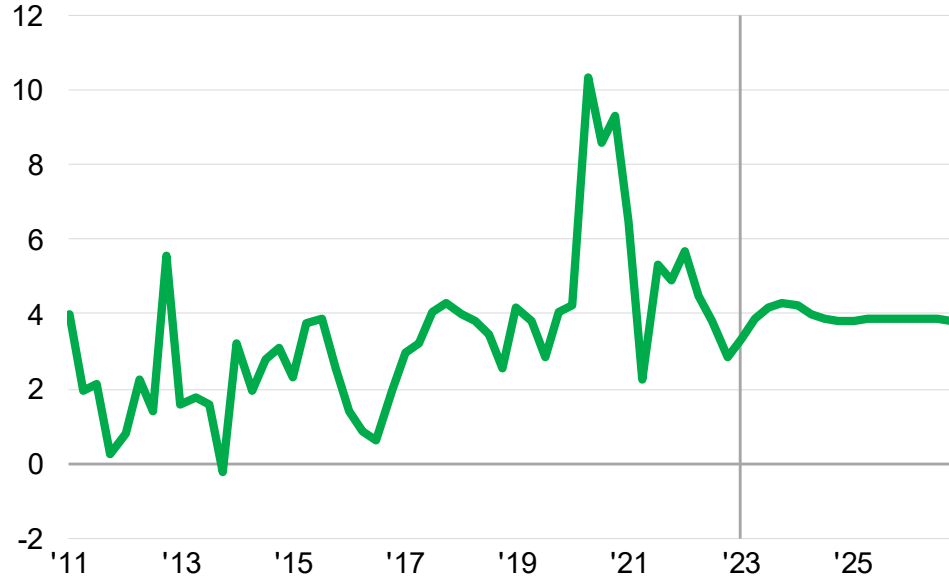
1½% productivity growth + 2% price inflation = 3.5% growth in nominal labor costs...eventually

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



Source: S&P Global Market Intelligence; BEA  
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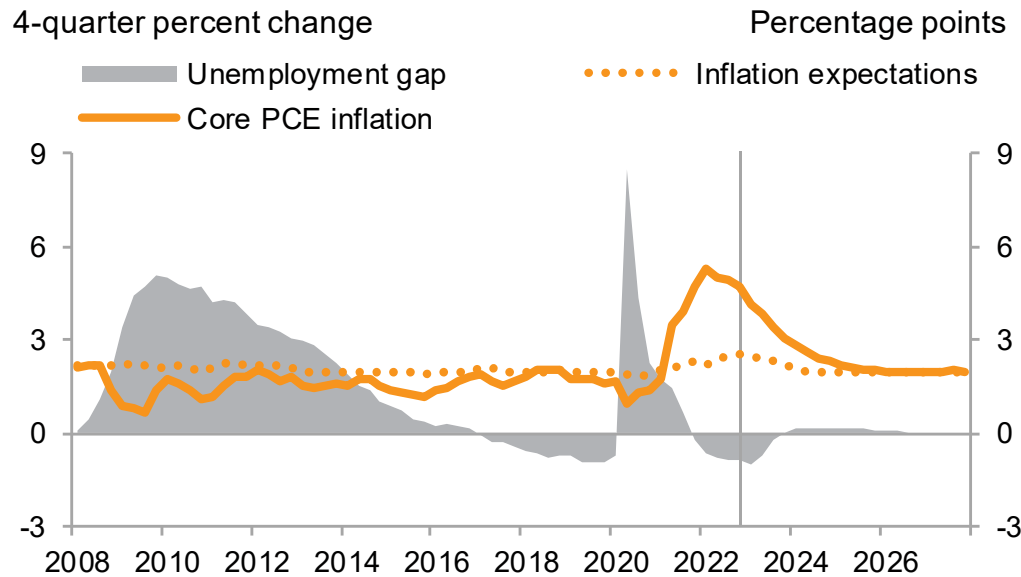
**Comp/hour, pvt. nonfarm business, 4-qtr % ch**



Source: S&P Global Market Intelligence; BEA  
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# 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, PhillyFed, BEA, BLS

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## 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

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