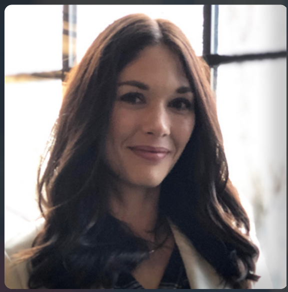

Michelle Green

Prevedere Principal Economist
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provides a personal view on
topical economic issues

U.S. Economic Outlook: economic hurricane or clear skies?

New and existing factors are sending economic uncertainty to a peak in June, with discussions of a potential recession adding further fuel to the fire. In this economic outlook report, Prevedere's Michelle Green, Principal Economist, analyzes the latest economic data to separate fact from fiction as headlines warn of a looming recession.

> "Chances of recession in the U.S. over the next 24 months are slim, but risks to the outlook are growing. Major slowdown is expected, with some industries showing signs of increased vulnerability".

Recession watch - fact or fiction?

There have been a lot of alarming headlines these last few weeks with the fear of a recession growing across the business community. Several risk factors contribute to concerns that a global economic slowdown is inevitable, including continued supply chain constraints, persistently high inflation, the ongoing war in Ukraine, and COVID lockdowns in China. Add to that tightening credit conditions and historically low consumer confidence, and the U.S. has the perfect climate for a downturn.

There have been multiple warnings that consumers will have to pull back on spending, mainly as inflation eats into purchasing power and consumer confidence continues to tumble. Although consumers still have considerable savings to help them mitigate these higher prices at the pump and grocery store, this excess cash has a shelf life and cannot support the level of spending we've seen for much longer. Earlier this month, Jamie Dimon, the CEO of JPMorgan, warned of an economic hurricane approaching as quantitative tightening by the Fed and the war in Ukraine create a scenario where the consumer can't cope with an increasingly high level of costs and dissipating savings.

Current risk of recession remains mitigated by positive signals

It's somewhat difficult to tease out fact from fiction in this narrative, and it's easy to get caught up in the fear and uncertainty. Fortunately, there have been a series of positive signals this month that suggests a recession is very unlikely, at least through the end of this year.

Domestic supply chain constraints continue to ease as increased availability of transportation and warehouse workers and sustained recovery in domestic manufacturing allows for increased mobility of goods. Inflation-adjusted consumer spending rose 2.8% in April compared with the previous year, with durable goods spending showing continued growth even as services spending has completely recovered to pre-pandemic levels.

Price pressures are expected to continue as rising energy and food prices and continued labor shortages in key sectors trickle through. This is perhaps the most significant risk to the recovery this year. It is still largely dependent upon the duration of the Russia-Ukraine war and how aggressive the Fed is in its resolve to tame inflation. However, labor market conditions are favorable to the Fed's ambitions and are expected to help offset the negative impact of rising prices on consumers. As a result, wage growth continued at a robust pace last month, with seasonally adjusted average hourly earnings of production and nonsupervisory employees increasing 6.5% in May compared to last year.

Recession may not be imminent, but an economic storm is certainly brewing

Despite the growing risk factors, Prevedere estimates that the probability of a recession occurring over the next 12 to 24 months is around 10%. That said, Jamie Dimon's comparison to a hurricane brewing resonates well. No one can predict the direct path or magnitude of a hurricane, even with evidence that one is approaching. Nevertheless, people in the possible path of the storm must start preparing for a range of outcomes. If one over-prepares, they are left with a hefty bill that might take some time to recover from financially, but if they under-prepare, the consequences can be dire. The same is true for businesses and consumers who must prepare themselves for potential economic challenges in the future.

If the U.S. overreacts to recessionary risks, it could result in a self-fulfilling prophecy as businesses seek to protect themselves from decreasing revenues and consumers cut spending in anticipation of less financial stability. Conversely, if the country underreacts, it can also leave consumers in financial crisis and businesses at grave risk.

Prevedere's economic scenarios for 2022

Given the heightened level of uncertainty, it's important to quantify all the looming risks in a range of potential economic scenarios. Prevedere's baseline scenario – which we believe is the most likely outcome through the end of this year – indicates that the recovery is still moving along at a modest pace. Inflation is limiting growth potential, but strong consumer spending, increased investment, and inventory rebuilding are keeping Real GDP growing, even if at a much slower rate than last year.

On the upside, rising wages and excess savings keep the recovery moving forward slightly faster than in the base case scenario. Even as consumer spending does slow, consumer inflation is expected to soften, and households will maintain relatively healthy balance sheets compared to pre-pandemic norms on those rising wages.

On the downside, continuously rising food and energy prices take a more meaningful bite out of consumer wallets, leading to a more severe slowdown in spending toward the back half of this year. In this pessimistic case, recessionary conditions emerge, starting in the fourth quarter of 2022 and into 2023.

Prevedere's baseline scenario is a traditional stagflationary scenario, where inflation is high, and growth is low. The optimistic scenario is a growth scenario, with pockets of weakness in industries that have overcorrected. In other words – a soft landing for the Fed. There will likely be a more pronounced slowdown in manufacturing and retail as the supply of goods and consumer demand normalize at a lower level. The pessimistic scenario calls for a light recession emerging at the end of this year, where spending on goods decelerates meaningfully. Still, services spending recovers at a level that avoids a deep recession.

Conclusion

Overall, there is very little evidence in the data that would suggest a significant downturn will occur in the next 24 months. Moreover, even with aggressive quantitative tightening and rising interest rates, considerable labor market slack is likely to protect the economy from a significant downturn, with current conditions likely to protect against a major labor market disruption thanks to an abundance of unfilled vacancies. This means households will be less vulnerable to a loss in income, which would result in a meaningful decline in spending

The post-pandemic economic recovery is fragile, and additional shocks are possible. Ongoing war, COVID variants, an energy crisis, and growing uncertainty, are risks that cannot be ignored. If this "Hurricane" makes landfall, the U.S. would likely see a more negative downturn emerge comparable to the Great Financial Crisis. Although very unlikely, this could occur if a rapid increase in interest rates causes a severe tightening of credit conditions just as household finances enter their weakest period.

In the unlikely event that a large number of workers return to the labor force due to high inflation at the same moment that employers are seeking to cut workers in response to slowing demand, it could have a ripple effect on economic activity similar to previous downturns.

Currently, there is no evidence that this is likely to occur over the next 12-24 months, as labor force dynamics remain exceptionally tight, with no signs of cooling just yet. Instead, it is far more likely that slowing demand will lead to a reduction in job openings in some sectors while remaining strong in others, leading to solid labor market dynamics and higher overall levels of wages through the end of this year and next. This all bodes well for consumer spending and overall economic activity in the next 18 months and gives little cause for alarm despite some of these worrisome headlines this month.

Thank you

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