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provides a personal view on
topical economic issues

December Economic Update: 2023 Recession Likely, but Not Certain

Key takeaways:

- Probability of recession in 2023 is high, as persistent inflation decreases the possibility of a Fed induced 'soft landing'
- Consumer spending remains robust, but risks to household finances indicate a more precarious position for the average consumer in 2023
- Given the volatility the market is presenting, predictive planning is a necessary and relevant strategy for businesses in 2023

We started the year with the expectation that 2022 would be the year of 'normalization', with the full understanding that the war in Ukraine, COVID lockdowns in China, and further price shocks could derail the recovery. Fortunately, and despite the many risks we faced, the economy maintained a solid footing throughout the year. We have seen a lot of the pandemic noise dissipate, with global supply chains opening up, mobility improving, and many economic relationships returning to a more familiar state.

That is not to say that things are now back to normal. The risks today are largely the same as those we faced at the start of the year. Consumer and business sentiment are at historic lows, inflation remains a pressing problem, the war in Ukraine continues, and on top of that, the Fed's resolve to cool pricing pressures increases the risk of recession as financial conditions continue to tighten and consumer finances deteriorate.

However, not all the news is bad. The U.S. economy continued to expand in 2022 as excess savings and strong wage growth allowed consumers to absorb historically high prices, and a still strong labor market protected households from substantive income loss. Production activity also remained robust as capacity rebounded and manufacturers worked through elevated backlogs.

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Economic outlook for 2023

If 2022 was a year of normalization, 2023 looks to be a year of moderation, as both production and consumption find balance in a slowing economy.

Despite some positive signals, our outlook remains tilted to the downside, as the current expansion is vulnerable to both continued shocks and structural risks. Probability of recession is high in 2023, as the Fed continues to battle historically high inflation.

Specifically, we expect to see a mild recession begin in the first half of 2023 and continue through much of the year into 2024. A number of factors are driving this scenario:

- The Fed's continued policy of quantitative tightening to curb inflation
- Moderation in household incomes due to potential disruptions in labor market activity
- Stretching of household finances in response to tightening economic conditions

That said, a recession is not a certainty. It is entirely possible that the tight labor market will keep consumers resilient enough to avoid a prolonged contraction. If the timing is right, this could be enough to give the Fed a chance to get inflation under control, allowing them to ease up on their tightening policy before the contraction impacts both consumer finances and business investments too heavily.

One thing that is certain: the current business cycle remains extremely volatile and is vulnerable to external shocks from war, the pandemic, and resource constraints. This makes the need for scenario planning incredibly relevant. The best thing that businesses can do to prepare for the coming year is to consider a wide range of potential outcomes and pay attention to the economic factors that impact their core consumer group.

How should businesses respond to these conditions?

As businesses engage in their predictive planning for 2023, there are several important factors to monitor, especially in the first half of the year.

First, inflation. This is important not only because of the impact on consumers, but it will also drive Fed policy in the coming year. The duration and magnitude of the next recession will depend largely on whether the Fed will continue their path of quantitative tightening, or if they will moderate their policies to encourage long-term growth and price stability.

Second, the labor market, and in particular, wages. The strength of the consumer is dependent on income growth. Businesses should look for broad-based balance in the labor market which would foster continued wage growth at a moderating pace. There is some evidence of this in certain industries, but others are still experiencing considerable labor shortages—notably in construction, transportation, warehousing, and retail—which continue to put pressure on wage growth to accelerate.

Third, spending levels. Businesses should look for moderation in goods spending as an indicator of long-term price stability, especially on durable goods. Currently, demand is too strong, even with supply chains easing. This makes it difficult for the Fed to ease tightening as inflationary pressures remain acute.

That said, the specific economic factors that a particular business needs to track can vary widely. As such, custom predictive models that account for specific economic factors are critical to making more accurate forecasts in 2023.

Learn more about how Prevedere helps enterprises discover leading indicators, predict likely outcomes, model various scenarios, and protect your business.

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