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provides a personal view on topical economic issues

January 2023 Economic Update: Tracking Economic Downturn

Key takeaways:

- The economic slowdown will continue throughout the first half of 2023 with the potential for a technical recession to take hold in the second half of the year.
- Regardless of whether we enter a recession, growth and activity will slow significantly from 2022.
- No recession is created equally nor impacts activity uniformly so business leaders must be mindful of timing, magnitude, and drivers. Some sectors, geographies, and individuals may exit the recession unscathed.

While economic conditions in the fourth quarter improved, that departure from the growth slowdown will prove to be short-lived. Interest rates have risen at a historic rate and the bite from higher borrowing costs for households and businesses is beginning to filter through to the real economy.

As a result, Prevedere's economist team is setting expectations for recessionary conditions to build during the first half of this year with the potential for a greater economic downturn to take hold in Q3. This would lead to increased job losses, rising unemployment, and a reduction in consumer spending.

The good news is that notwithstanding more supply-side events that were widespread in 2022, inflationary pressures should begin to recede bringing the U.S. economy to a more sustainable path.

The Impact of Inflation on Economic Conditions in 2023

Inflation will remain high through the first half of 2023 but will decline rapidly in the second half of the year.

In January, the rate of inflation dropped month-over-month from 7.1% to 6.5%. Yet, despite raising interest rates at an unprecedented pace, the Federal Reserve is only just beginning its fight to lower inflation to a healthy level. As such, inflation will continue to be an important indicator for business leaders to track in 2023 and keep top-of-mind. Albeit less so than in 2022.

Despite the current high rate of inflation, headline and consumer prices excluding food and energy are beginning to slow down. This trend should continue

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to progress throughout the year. **In fact, Prevedere's economist team currently forecasts that inflation will return to within a comfortable range for the Federal Reserve by the end of the year.**

In terms of tracking inflation, the most important thing for business leaders to watch will be the movement or co-movement of flexible and sticky prices. Products that have flexible prices, such as gasoline, can fluctuate quickly, which exerts downward or upward pressure on prices in a short period of time. This won't be true for services like haircuts and housing costs, which tend to be sticky and slow to change.

The rate of inflation for slow-moving consumer prices has leveled off but remains at 6%, which is still three times the level prior to the pandemic. On the other hand, flexible prices are falling fast, down approximately 10% from this past summer. If wage pressures ease and housing costs adjust to the demand headwinds it is possible that inflationary pressures could unwind rapidly.

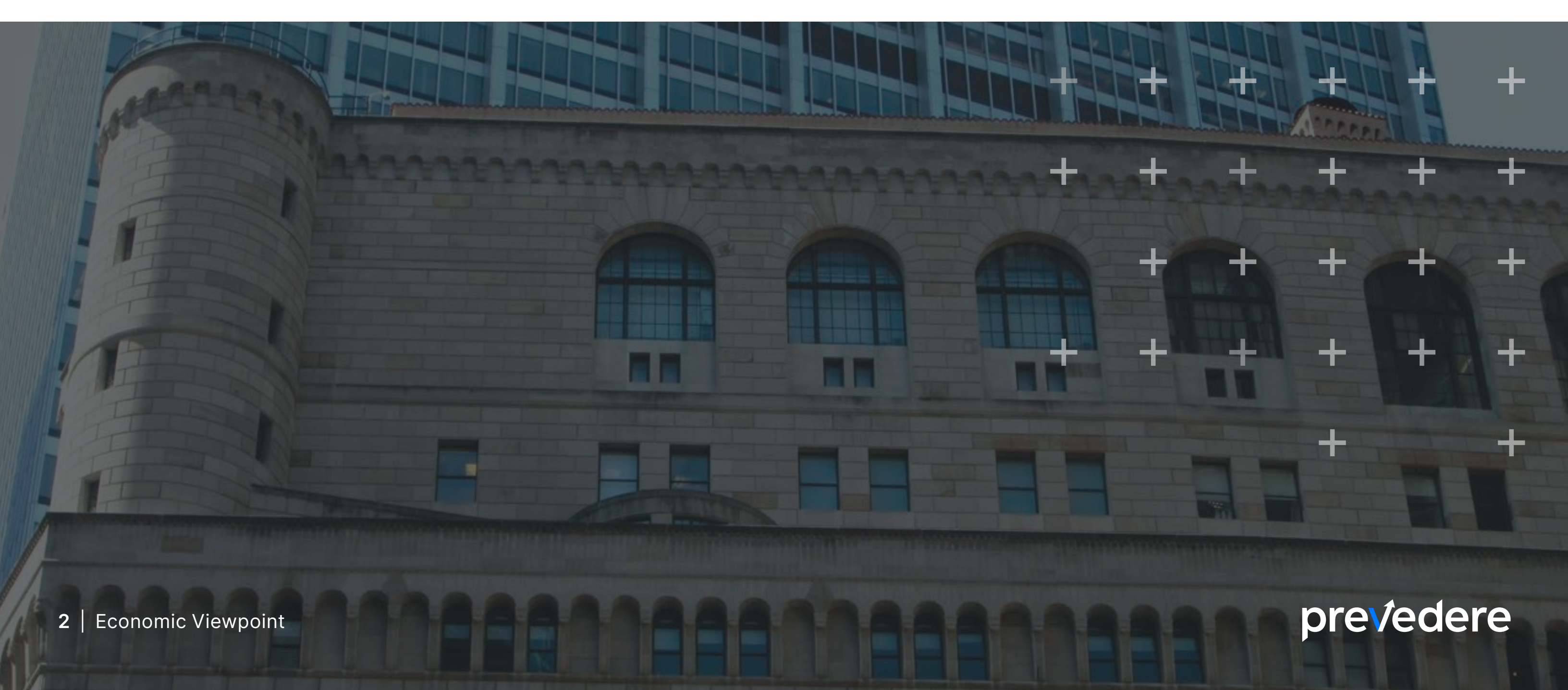
The Federal Reserve Will Continue Waging an Aggressive Fight on Inflation

Despite signs that the rate of inflation will drop throughout the year, the Fed will continue to raise interest rates. It will be important for business executives to be mindful of lags in monetary policy and the impact it will have on economic activity.

The Fed already raised rates in December and it seems like another hike is all but guaranteed at their January meeting. The Fed's job will not be done as inflation is still running hot and wage pressures are persisting. Prevedere's economic team expects the Fed will raise interest rates two more times before pausing at their May 2023 meeting. This would bring the Federal Funds Rate to just above 5.0%.

More importantly, after adjusting for inflation, real short-term rates will be at its highest level since early 2000, meaning financial conditions will be the tightest in decades once the Fed is done hiking.

The continued drawdown in the Federal Reserve's balance sheet, otherwise known as quantitative tightening, will also increase the restrictiveness of financial conditions, limiting banks' ability to lend while increasing the interest cost for mortgages.



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Impact on the Consumer

The American consumer proved resilient in the face of high inflation. The fear that inflation trends would dissuade consumers from spending in 2022 proved to be untrue. While spending on "goods" things like clothing, cars, and recreational equipment fell from pandemic highs, this was an expected outcome given how excessive spending in these categories was during lockdowns at a time when travel and mobility were still limited. Spending on travel and hospitality also ramped back up after languishing in prior years.

Despite the pullback in spending on goods, the share of wallet going to physical goods is still well above the pre-pandemic level, which is a sign that consumer behavior is still adjusting to the post-pandemic economy.

That being said, with excess savings depleted and the cost of credit increasing there is a high likelihood that American consumers will have to be more budget conscious. Unlike the situations in the last few years, there will not be another jolt from more direct federal stimulus or payments.

Planning For Recession

No recession is created equally nor impacts activity uniformly so be mindful of timing, magnitude, and drivers. *The magnitude of the downturn will depend on the presence of economic imbalances.*

During the Global Financial Crisis, financial sector leverage and systemic links between banks and nonbank financial institutions amplified what could have been a garden-variety downturn similar to the recession in 2001. It does not appear that the economy is headed toward a similar scenario. Instead, the expectation is that there will be a material slowdown but not an economic fallout. Banks are well capitalized and there does not appear to be any materially important sectors on the verge of collapse.

As such, 2001 and the early 90s should serve as a good guidepost for what to expect in this downturn. Common themes were a modest rise in unemployment, but prolonged recovery, depressed equity valuations, and a modest decline in GDP growth. That said, there will be industries, geographic regions and market segments that may exit the recession effectively unscathed.

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Thank you

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