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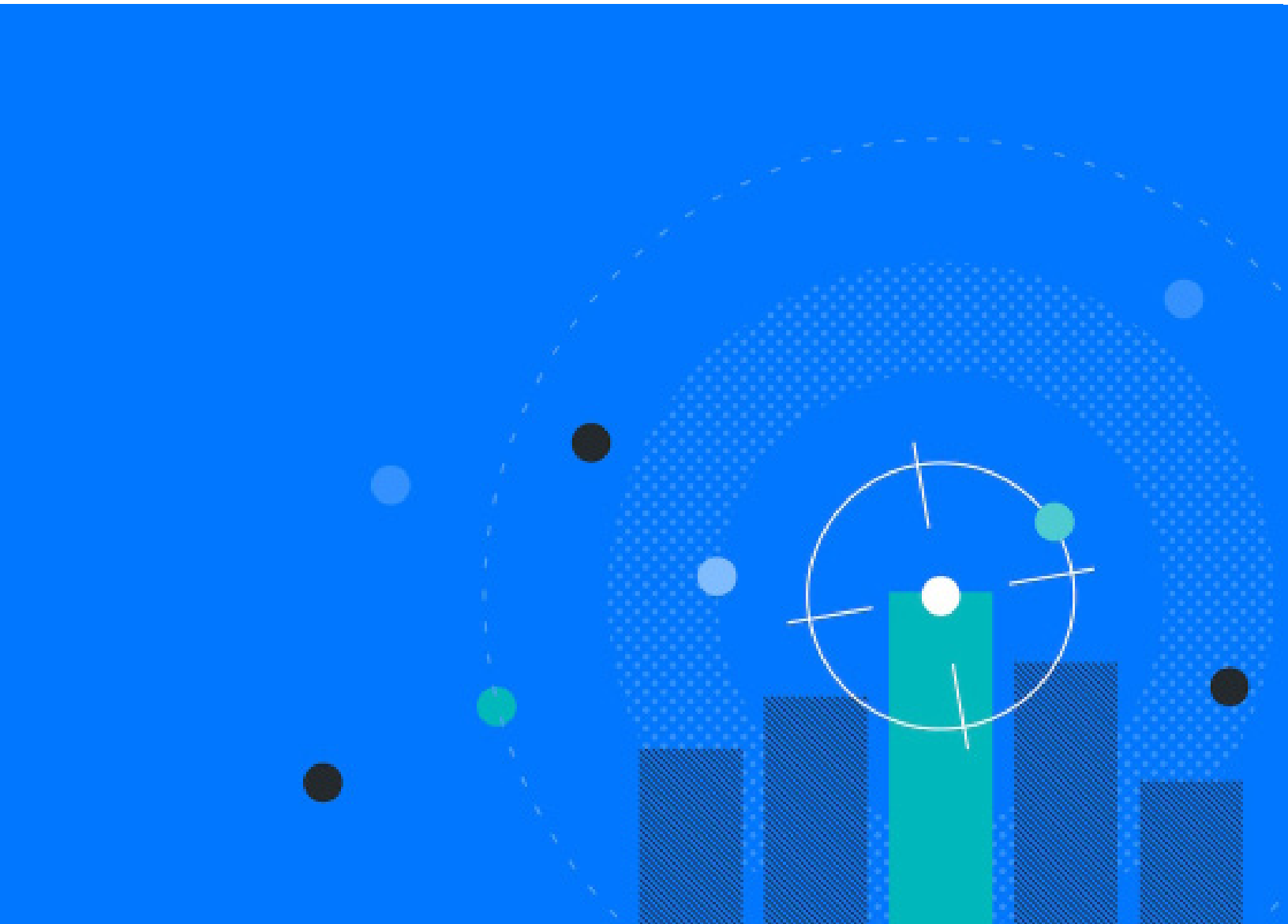
The Impact of Financial Conditions on the U.S. Economy in 2023



Introduction

There has been optimism heading into 2023. Improved economic conditions in the fourth quarter of 2022 gave some hope that a soft landing was still possible, but the improvement during that time period is expected to be short-lived, and an economic slowdown is on the horizon. At the same time, there has been a growing sentiment that a recession is inevitable in 2023. At Prevedere, our economist team is forecasting that the probability of a recession happening this year is essentially 50% or a coin flip. Regardless of whether a true recession occurs during the coming year, it is nearly certain that the business community will face challenging conditions.

As a result, the true unknown is, not whether there will be a recession, but rather the severity of the downturn. It will be important for business leaders to monitor these conditions and accurately forecast the true impact of the coming economic conditions.

There will be many factors that will impact the timing, depth, and severity of the growth slowdown, but the greatest factors will be the broader financial conditions in the U.S. Our economist team shared the following four indicators that should be watched to determine the health of financial conditions.

The Federal Reserve's Monetary Policy

The Federal Reserve ended 2022 by raising its benchmark interest rate to the highest level in 15 years. While the rate hikes may not be as aggressive in 2023, the expectation is that smaller increases will continue through the first quarter of the year until the benchmark interest rate breaches around 5%.

As a result of these actions, real short-term interest rates will reach their highest level (after adjusting for inflation) in more than 20 years. This means that when all is said and done, financial conditions will be the tightest in decades.

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

The Consumer's Ability to Borrow Money

Personal savings rates have reached their highest level ever during the pandemic but have receded to the point well below pre-pandemic levels. This trend has been largely driven by rising consumer prices and slowing wage growth. As a result, interest payments as a share of disposable income, which often serves as a reliable household proxy for carrying costs, have risen dramatically. This indicates that Americans are unable to absorb the impact of the Fed's interest rate hikes, which is making it difficult for them to manage their increasing debt loads and financial obligations.

Additionally, the willingness of banks and nonbank lenders to offer new credit cards and other forms of consumer loans like personal loans and auto loans has been declining, which is making it harder for consumers to find reasonable options for credit. These conditions are significantly weakening consumer purchasing power at a time when sentiment has already been dipping and major companies across the United States have started announcing layoffs to their workforces. Ultimately, the rise in credit standards will disproportionately impact low-income households at a time when many households are struggling to keep up with the rising costs of living.

Corporate Debt

In evaluating the state of corporate debt and its impact on the economy, it makes sense to examine two key areas: the bond market and credit availability for small-to-medium-sized businesses.

For corporate bonds, tighter financial conditions and risk-off sentiment among investors have elevated nominal corporate borrowing costs to their highest levels since the financial crisis. But, relative to risk-free bonds such as the U.S. Treasury securities, corporate bond spreads are only modestly elevated and remain well below levels seen during the financial crisis in 2008 for both high-quality and high-yield bonds.

Leveraged loans have seen similar rises in borrowing costs relative to risk-free rates, but are not dislocated from higher-quality debt, meaning there are no acute pressures building in the riskiest segments. It will be important to keep an eye on how declining asset valuations and rising debt servicing costs impact corporate bond markets in 2023.

In terms of credit availability to small-to-medium-sized businesses, lending standards have tightened across the board as many banks and lenders have been increasing the standards for providing loans. In a sign that there is not excessive market exuberance, the demand for loans has also fallen, which signals that firms and small businesses are responding to these tighter financial conditions.

Strength of the U.S. Dollar

As the Federal Reserve begins to ease off the accelerator and slow down its pace of rate hikes and possibly end its current cycle of tightening, the strength of the U.S. dollar should continue to ease in both real and nominal terms.

This should benefit multinational corporations in terms of foreign profits and increase the relative attractiveness of U.S. exports. However, there are indications that increased relative competitiveness for these products may not be enough to offset any potential drop in foreign demand building as the developed world edges closer to recession.

Conclusion

In evaluating the status and forecasts of these indicators, there is a mix of positive and negative trends, which indicates a potentially bumpy road for financial conditions this year. But the bottom line for business executives is that in terms of financial conditions, 2023 is going to be one of the most restrictive years for businesses in more than a decade.

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The right forecasting and planning platform will be key for successfully navigating recession and economic recovery in 2023.

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