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provides a personal view on topical economic issues

February 2023 Economic Outlook: 50% Chance of Recession in 2023-2024

Key takeaways:

- **Sticky prices are driving inflation, with numbers as high as 3.5 times pre-pandemic levels**
- **Job growth remains high, but will be begin normalizing this year, we expect a rate of 100,000 jobs added per month by year's end**
- **The easing of wage pressures has resulted in a lower chance of recession—15% lower than previous predictions—within the next 24 months**
- **Persistent sticky price pressures will ensure the Fed maintain its aggressive monetary policy to achieve its mandate**

Looking at the economic outlook for the rest of the month and quarter, there's good news and bad news.

The good news: the odds of a recession have actually decreased 15% since our last report.

The bad news: the odds of recession are still at 50%.

So what's changed over the last several months? What factors should businesses watch when making their strategic plans? And if a recession hits, what exactly should we be expecting?

What is the Federal Reserve's likely response to current inflationary pressures?

With regards to inflation, the U.S. is in a sticky situation right now.

Economists break down broad inflation numbers into two categories: flexible or fast-moving inflation and sticky inflation, which are categories that tend to move more slowly. Sticky prices are those services or goods that tend to remain high while others stagnate.

In terms of gauging overall economic conditions, sticky tends to be the most important. That's because while flexible prices have been unwinding due to easing pressures on production, supply chain, and transportation bottlenecks, sticky inflation has climbed.

There are a number of factors at play here, broadly divided into two categories:

- **Structural pressures**, like aging generations of workers (particularly Baby Boomers) leaving the labor force
- **Sector-specific pressures** on the re-engaging of the economy, particularly in the service sector

Persistent price increase will require the Fed to respond aggressively to achieve their mandate of cooling inflation and anchoring inflation expectations. As such, it will have major implications on the chances of economic recovery.

Additionally, there's been a lot of recent talk about the dislocation between unemployment and job openings. Although this is beginning to normalize, there's still a large gap between the number of job openings and the number of willing labor market participants.

Despite these pressures, Prevedere expects a continued trend of normalization. Over the past two years, we have seen anomalous job growth. This trend started to ease last quarter, and we expect this to return to normal levels —about 100,000 jobs added per month—by the end of the year.

Historically, the Fed is 3.5 times more likely to respond to sticky price pressures than flexible ones, particularly in the housing sector and wages in the service sector.

The current monetary policy tightening cycle has been aggressive in terms of its speed and magnitude, due to the Fed's concerns for the persistent inflationary pressures. We expect the Fed will have to raise interest rates in response to the inflation trends, with two hikes of 25 basis points each.

What's the likelihood of a recession?

Given the continued aggressive action on the part of the Fed, we should ask: what's the likelihood of a recession in the near future? Currently there's still a strong chance that a recession will occur.

We have identified three factors—in addition to financial market conditions—that are good predictors of a potential recession:

- **Interest expense as a share of disposable income.** This proxies for the carry cost of debt for households. After reaching historic lows during the pandemic, this figure has risen rapidly.
- **Year-over-year increase in average hourly earnings.** Wage increases have eased somewhat, lowering the probability of recession.
- **Cyclically adjusted price-to-earnings (CAPE) ratio.** This is a good proxy indicator for household net worth. Rapid deterioration in overall equity prices negatively impacts consumer behavior. As this figure lowers, it contributes to an increased probability of recession.

Considering these factors together, Prevedere predicts a 50% probability of recession over the next 24 months. Most of that risk is concentrated within the next 12 months.

While that seems high, keep in mind that that figure has lowered in recent weeks. This is because of the reduction in wage pressures, which may allow the Fed to ease up on its policy tightening cycle sooner rather than later. That said, it's only 15% lower than before, and is still a coin flip.

This should be enough for businesses to start making plans for both scenarios, both in terms of preventing mitigating losses and seizing potential opportunities.

What type of recession could we start to see?

If businesses are going to plan for the oncoming recession, it's important to know what kind of recession it's going to be. So beyond simply looking at the probability, we should take a look at what businesses should expect from a qualitative standpoint.

Historically, recessions have lasted for four and a half quarters, usually from peak to trough there's been a 1.4 percentage point decline. For context, during the largest impact of the pandemic, we saw a 10 percentage point decline. The 2008 global financial crisis saw a 4-5 percentage point decline.

Prevedere doesn't expect more severe scenarios to play out in this case, or for the bottom to fall out of the economy as a result. The closest comparison would be the recessions in the 1990s or 2001.

However, we also don't expect the oft-quoted "V-shaped recovery," as historical precedents suggest against this type of recovery. Additionally, the appetite for fiscal stabilizers has lessened given how much debt was accumulated through the pandemic-era fiscal programs. All of these factors will lend to a slower recovery.

When considering the impact of recession on your business, keep in mind that all recessions aren't created equal. Nor do they impact every market segment, sector, or industry at the same level.

Although in most cases recessions negatively impact stated personal income. However, there is a wide distribution of outcomes.

A potential recession presents an opportunity to think deeply about your business. Consider how it will impact not only your own market segments, but the incomes of your consumers. A broad, one-size-fits-all approach just isn't going to work.

Thank you

Learn more about how Prevedere provides the data, AI and machine learning predictive analytics, and world-class economic expertise to create a predictive model unique to your business here.

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