U.S. Economic Outlook
March 2023

Key takeaways:

- **Wages in the U.S. have continued to decelerate, and equity price declines have slowed, outside of financials. These factors have contributed to a slight rise in the recession probability from 50% in February to 52% in March.**
- **Labor force participation is on pace toward full employment and recovery.**
- **Demand is softening as consumers anticipate prices to exceed 4% for the following year. As a result, firms will likely respond with pricing action, and consumers will carry the weight of inflationary price changes.**
- **Given the current economic environment, the Federal Reserve is expected to maintain a tight monetary policy for the coming months.**
- **Despite the failure of a few regional banks, the current banking turmoil is not expected to spread throughout the sector.**

Prior to the unrest in the banking sector, there was no doubt that interest in the recession's timing, magnitude, and duration had peaked. The respite from inflationary pressures in the U.S. produced widespread market optimism, believing tightening would be shorter and less aggressive on the monetary policy. At Prevedere, monetary policy transmission to the real economy is ongoing, with sectors less sensitive to interest rates buoyed by improving sentiment, warmer weather, and excess savings from the pandemic.

2023 began with optimism. Improved economic conditions in the fourth quarter of 2022 gave some hope that a soft landing was still possible. Yet, the improvement during that time is expected to be short-lived, and an economic slowdown is on the horizon. Concurrently, there has been a growing sentiment that a recession will be inevitable in 2023, especially as smaller regional banks tighten lending requirements in the wake of the bank failures.

Prevedere's team is forecasting that the probability of a recession happening this year or next is 54%. Regardless of whether a true recession occurs during the coming year, it is nearly certain that the business community will face challenging conditions. 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.

How are wages and demand impacting the labor market?

Entering March, the demand from abroad in both developed and emerging markets has slowed. The Ukraine and Russia conflict has kept inflation pressure stubbornly high in Europe. Demand and output have also sagged as higher energy costs and downtrodden sentiment pushed the European Union towards recession. In emerging markets, the tightening of global financial conditions has forced many countries to rein in fiscal and monetary policy.

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Since February, wages in the U.S. have continued to decelerate. In addition, equity price declines have slowed, which lowers the probability of recession and therefore offsets a steepening of the yield curve and a slight increase in household interest expense. On net, this has contributed to a slight rise in the probability of a recession from 50% in February to 52% in March. From a historical context, at turning points in the past, the economy was closer to 80% in terms of the probability of recession for the next two years. While the likelihood of a recession has increased from last month, the economy is not there yet.

The sideways movement in the recession probability likely reflects the U.S. economy's broad-based strength in January. Non-farm payroll employment increased by 517,000, and the unemployment rate edged down to 3.4%. Now, the unemployment rate stands at its lowest level since 1969, while the pace of job creation also remains significantly above the rates that would be expected given the current structural-demographic trends and points in the business cycle. Given these factors, the labor market will likely cool, albeit less so than in previous downturns, given the labor supply issues that have persisted since the pandemic.

How could the labor market be signaling a potential turning point in a recession?

Despite the strength of the payrolls and level of unemployment, broader labor market indicators are showing signs of nearing turning points in the business cycle. For example, two prime age labor force indicators, prime age employment to the population and prime age labor force, are nearing levels seen in past turning points for past recessions. The outlier in employment to population was the 1990s, which saw a very prolonged and robust business cycle. However, concerning business cycles outside of the 1990s, the current economic situation is nearing turning points concerning the employment-to-population ratio.

Labor force participation is on pace toward full employment. Looking at the prime age perspective eliminates the impact that retirees, particularly the Boomers, have on labor force measurements.

Currently, labor force participation for prime-age individuals, those ages 25 to 54, is very close to pre-pandemic levels, which was also consistent with the decades prior. This indicates labor force participation is nearing turning point levels of recovery.

Finally, job openings in the labor market can indicate a recession turning point. While much attention has been given to the job openings rate from a levels perspective, detrending this data indicates turning points in the labor market. In March, the U.S. peaked in the job opening cycle across many economic sectors.

Who will bear the brunt of inflation?

Inflation remains entrenched in segments that take time to adjust. For example, in the housing market, higher interest rates will cool activity within the sector. In contrast, non-housing-related service costs are high, driven in large part by high wage growth.

Wages are currently oscillating but showing signs of potential easing in the future. Despite the market expectations that foresaw a wage slowdown to occur sooner, wages are expected to ease over the next three to six months. Yet, today wages are still well above levels that prevailed before the pandemic and levels that the Federal Reserve will be comfortable with going forward.

Consumers expect the effects of inflation to linger. Demand is softening as consumers anticipate prices to exceed 4% for the following year. In the short run, this will allow firms to pass on persistently high labor and non-labor costs that are not offset by productivity gains.

As a result, firms will likely first respond with pricing action before implementing layoffs or pullbacks in investment. These trends would lead to high inflation through the end of the year, particularly with core and sticky prices.

At Prevedere, we anticipate inflation to rise slightly before decreasing by the end of the year. Specifically, we expect inflation to be at 3.1% in the third quarter before dipping to 2.8% by the end of the year. However, in terms of core inflation, which excludes food and energy and is a better reflection of these non-service-related price pressures, levels will remain elevated at 3.6% in the third quarter and 3% in the fourth quarter, respectively.

What does this mean for monetary policy?

Given today's entrenched inflationary environment, the Federal Reserve will have no choice but to prolong its tightening cycle. Currently, markets are leading toward a 25 basis point increase in the federal funds rate during the upcoming March meeting. Uncertainty now rests largely on what actions the Fed will deem necessary in response to the regional banking crisis. While possible, it is unlikely that the Fed will pause rate increases in March, relying on their emergency lending powers instead to stabilize smaller banks. The Federal Reserve will continue with incremental increases of 25 basis points until the federal funds rate reaches 5.5% to 5.75% before pausing.

Even at this level, interest rates would remain below classic Taylor-type rule projections when considering how tight the labor market is and how far above inflation is to the long-run target.

Nevertheless, hot prints on inflation and a tightening labor market would likely mean an abrupt pivot back to 50 basis point increases in May that could last for the rest of the year, bringing that hard landing into focus.

Thank you

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