Danielle Marceau
Principal Economist & Director of Analytics
provides a personal view on topical economic issues

April 2023 Economic Outlook: Impacts of the Labor Market and Bank Failures on the Recession

Key takeaways:

- **Federal Reserve tightening policy to battle inflation is expected to continue despite recent banking failures.**
- **The labor market is cooling, and layoffs and quits are normalizing.**
- **Fallout in the banking sector will lead to a credit crunch and more difficulty for businesses and consumers to borrow.**
- **High levels of consumer spending post-pandemic are challenged by dwindling savings and decreased access to credit.**

This April Economic Outlook report dives into the future trajectory of the U.S. economy and the impact of the recent turmoil in the banking sector.

Overall, Prevedere expects the second half of this year to likely be met with recessionary conditions as the Federal Reserve continues its battle against inflationary pressures. This has been Prevedere's baseline expectation since around October / November of 2022 and likely will continue in light of the collapse of Silicon Valley Bank and ongoing uncertainty around the banking sector. These recent events solidify expectations of an economic contraction later this year that extends into 2024.

Monetary policy, tighter lending standards, dwindling savings, and negative consumer sentiment are expected to be the main drivers of the economic downturn beginning around mid-year. As a result, a U shape recession, with a prolonged and extended recovery, is expected.

Inflation and the Federal Reserve

The Federal Reserve has been persistent in its policies aimed at curbing inflation. Yet, the sticky consumer price index's rate of increase remains elevated near it's peak.

Currently, demand-side pressures are the primary driver of inflation and the supply-side pressures that dictated inflation in 2021 and 2022 are not likely to resurge in 2023. This is because easing supply chain constraints and falling producer prices have mitigated supply pressures. In contrast, the demand pressures of strong consumer spending and a robust labor market have been fueling inflation.

The Federal Reserve's aggressive monetary policy will continue to ease these demand-side pressures during the year, and it will drive a slowdown in overall consumption. But by the end of the year, headline inflation is expected to remain higher than the Fed's benchmark rate at around 3.3%, but this is significantly lower than in 2022.

prevedere

Core inflation will be even higher because of the persistence of some sticky prices and wage pressure. While there will be some slowdown in pricing pressures this year, it will unlikely be at an acceptable pace for the Federal Reserve to reverse their course.

The Federal Reserve is interested in rapidly returning inflation towards its goal and target rate. While the PCE price index release showed signs of easing pricing pressures, the Fed will likely increase rates at least one more time this cycle before pausing to see the level of impact their policy has had thus far.

Labor market normalizing

While the labor market is tight, and it has been tight for a while now, it is starting to show some signs of cooling. This is due to labor flows normalizing and the supply and demand for workers returning to a more balanced state with job openings and quits declining year-over-year and layoffs/discharges increasing year-over-year. The early signs of pressure easing in 2023 are present.

In contrast, 2021 and 2022 saw historically low levels of laying off workers. At the same time, job openings and quits, or voluntarily leaving a job with the confidence of finding another job or exiting the labor market entirely, were rising in that timeframe. The labor market is normalizing entering 2023. The labor market is balancing. The number of new people hired each month and monthly quits are declining. Yet layoffs and discharges are higher than they were last year. These combined factors illustrate initial corrections to the imbalances in the labor market in 2021 and 2022. A fully normalized labor market would have new hires, quits, layoffs, and discharges in lockstep.

Overall, the excess worker supply is concentrated in a handful of industries. The tech sector has had the most substantial layoffs in the past few months as a result of significantly over-hiring relative to other industries in the post-pandemic recovery. On the other end of the spectrum, labor intensive service industries such as leisure and hospitality have struggled to fill the jobs lost during the pandemic and have not over-hired to the same extent as the tech and other professional business services industries. As a result, these industries are likely to see a lower quantity of layoffs during this downturn to their labor hoarding counterparts.

While the unemployment rate is likely to increase as the economy traverses through a recession later this year, it will not climb at the same rate as in past recessions. As a result of the impending recession, we expect the unemployment rate to move from its historical lows closer to 4% this year and then even higher in 2024. Since these numbers are relatively mild compared to historic economic downturns, it will mean relatively fewer people are likely to lose their jobs during this downturn as in past economic downturns and help the recovery take shape by early onset 2024.

Consumer finances

Curbing consumer spending is an integral part of battling inflation. In fact, consumer spending is nearly two-thirds of overall economic output and drives the US economy more than any other sector. Over the last year, the consumer has remained resilient and continued spending month-after-month and fueling demand-side inflation, but there emerging signs of softness overall.

Consumers have been able to propel the economy forward even as inflation-adjusted income has decline through spending their excess savings. During the pandemic, consumers received many different kinds of government support to supplement their income such as stimulus checks, child tax care credit, and increased unemployment insurance benefits as well as seeing many loan payments such as student loans being deferred. Simultaneously, lockdowns prevented spending in traditional categories and led to a considerable increase in cumulative savings. For the last year, consumers have been drawing down this accumulated post-pandemic savings to maintain the current level of spend in spite of the decades high inflationary pressures.

Many consumers are also utilizing credit to continue their spending habits. Credit card debt has returned to record-high levels after being paid off significantly during the pandemic. Many of the those consumers who might not have these excess savings left to draw down have been spending on credit to maintain the level of spend they have so recently become accustomed to. However, that credit card debt is becoming harder to qualify for as banks increase lending standards and more expensive to pay off as interest rates rise.

Dwindling post-pandemic savings creates economic challenges. Consumers will soon deplete their savings and be unable to maintain the same level of consumer spending in the second half of this year. Coupled with higher interest payments on credit and lower credit availability consumers face difficulties maintaining their strong level of demand.

Banking sector turmoil

As a result of the Silicon Valley Banking collapse, small regional banks are at risk. These banks must firm up their balance sheets and be cognizant to not take on as much risk.

This is already resulting in tighter credit conditions and making obtaining loans harder for consumers and businesses. This credit crunch will be widespread across many types of loans including credit cards, personal loans, mortgages, auto loans, and commercial and industrial loans. Even before the banking crisis, banks were tightening lending standards for most loan types. While obtaining those loans was already more challenging than in 2021 or 2022, the banking sector crisis is likely to accelerate this trend.

According to the Federal Reserve Bank of Dallas, this credit crunch is likely already underway with loan volume across all loan types has already reversed direction in the few short weeks since Silicon Valley Bank collapsed. This will be a significant headwind to consumer spending and economic growth in 2023.

Another way that the banking turmoil will impact the economy is through reduced consumer and business confidence. These factors resulted in a lot of uncertainty around the globe and the future state of the US economy from both businesses and consumers. That reduction in confidence is likely to impact aggregate demand. As a result, there is an expected pullback or a hesitancy to spend, which will add to the headwinds for consumer spending later this year.

Conclusion

In summary, although there are early signs of softening, the labor market is still tight, but the unemployment rate will likely increase throughout 2023. However, the unemployment rate is not expected to reach the same heights as past recessions due to labor market tightness. These factors will help keep this recession contained to 2023 and economic recovery to take hold by early 2024. Continued declines in business expenditures and waning consumer spending will be key drivers of the recession. Keep in mind that this downturn will not be like the 2008 financial crisis but more of a traditional economic downturn. Secondly, the banking sector fallout has been mostly contained. Despite adjustments to companies within the banking sector, the Silicon Valley collapse does not appear to have triggered a full-on financial crisis and therefore we have not changed our projections for early 2024 recovery.

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.

prevedere

Contact: (888) 686-7746 or inquiries@prevedere.com