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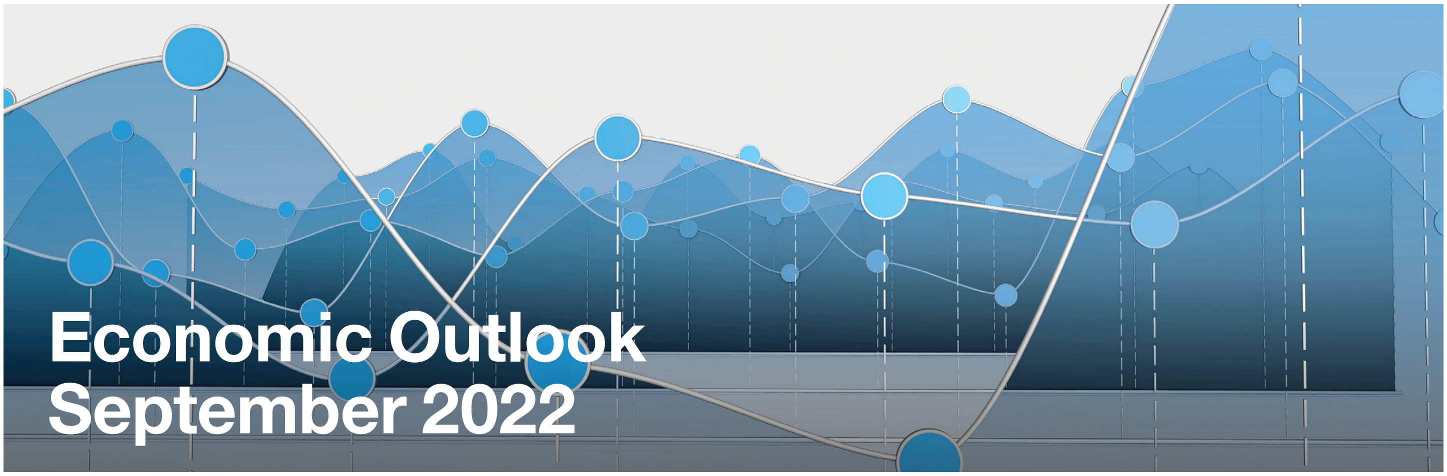

Economic Outlook September 2022

by Bruce McCain, PhD, CFA®

Overview

Officially, recessions do not occur until the National Bureau of Economic Research (NBER) declares them. Unfortunately, those declarations often come long after businesses and households need to make spending decisions where that assessment would matter. Accordingly, in an important sense, the lack of clear conceptual guidance increases the uncertainty businesses and consumers face as they assess the implications of the economy's condition and prospects for important financial decisions.

Simplistically, a recession can be defined as two successive quarters of contracting GDP spending, which the U.S. economy met with the report of a -0.6% ar (annualized return) in Q2 and a -1.6% ar for Q1. That illustrates one reason recession calls are problematic, however, since such a small decline could easily turn positive with subsequent data revisions. Unfortunately, the current weakness of the economy promises to become the subject of intense and often confusing political debate in the supercharged climate of an election. That can only intensify the concerns people feel about making substantial financial commitments.

Conceptually, economists prefer to verify recessions through the deterioration of multiple economic measures, not just the spending series that monitor GDP. Declines in the number of jobs, wage rates, retail sales and other statistics help confirm when significant recessionary contractions occur.

So far, that broad confirmation is missing. Incomes, particularly wages, have continued to expand, in part because the economy has continued to add new jobs. Certainly, there are indications that the growth of jobs and various forms of spending may be slowing, but as yet there is no strong evidence of a systemic contraction. Even within the GDP numbers, while rising interest rates took a toll on housing, GDP would not have declined in Q2 were it not for a very large 2.6% subtraction for inventory liquidation. Major inventory reductions confirm growing business caution, but they do not always signal a recession. Hence, while there are signs the economy may be slipping toward recession, the data indicate slowing more than outright contraction.

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It would be strange, in fact, not to see economic slowing given the strong policy steps the Federal Reserve (the Fed) has taken. Particularly so in light of Chairman Powell's vows to slow inflation no matter the cost. That tough Fed stance certainly should sober the public's outlook. A Conference Board survey, conducted before the Fed became more aggressive in June, found that 15% of CEOs surveyed thought the economy was already in a recession, and an additional 43% thought the economy would be in recession by year-end. In recent surveys, roughly 60% to 70% of the general public now reportedly believe a recession has begun. With so many people anticipating a recession, it would be shocking if consumers and businesses were not becoming more cautious about their spending. Bear in mind, too, that the full effect of rate hikes often lags the actual hike by as much as a year. Hence, even if the economy avoids outright recession, the hikes that have and will be implemented promise an extended period of potentially slowing growth.

At the same time, some economists think any recession that might occur now will be short and shallow. The profound labor shortage of this cycle offers one reason that may prove true. Businesses may be extremely reluctant to lay off employees they might not easily replace. That could help stabilize consumer incomes and spending both during a recession and in a subsequent recovery. Given the dominance of consumer spending within the economy, the stabilizing effects of the current labor shortage could have a significant impact on the course of any potential slowdown.

In summary, it seems premature to declare this a recession, but the odds of one are rising. The Fed's rapid deployment of aggressively restrictive policies substantially raises the risks that lagged effects will push the economy too far. While labor shortages have added to inflationary pressures, their potential stabilizing effects may also limit how damaging a downturn would ultimately be.

Consumers

Consumer spending held up nicely through July, in part because of solid wage gains as firms attempted to attract and retain employees. Bureau of Economic Analysis (BEA) data show that nominal wage income rose 8.8% year to date through July, while overall personal income rose 5.6%. Wage improvement, along with continuing strong job gains, helped support strong consumer spending growth. Beyond the strong income growth, consumers also dipped into savings to fund even more spending. Compared with the 8.8% wage growth, consumption rose 10.2% over the first seven months of 2022. The strongest spending growth, however, did occur before the Fed became more aggressive about raising rates.

Rising prices have certainly put pressure on household budgets, as average wages failed to keep pace with inflation. Perhaps that is one of the reasons the University of Michigan Consumer Sentiment survey recently recorded one of the lowest confidence readings since 1980. Fears of recession may also be suppressing confidence.

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And yet, despite their concerns, consumers have so far not significantly cut their spending. Perhaps profound labor shortages have allowed the public to feel more financially secure. Layoffs have become far less likely than they historically have been, and those who have lost jobs have transitioned quickly to others. Enhanced labor stability could make consumers more willing to spend, even when the economy struggles. Consumer spending dominates economic growth. Accordingly, a shortage of labor argues that any economic downturn could be less severe and last for a shorter time than in the past.

Bureau of Economic Analysis data through July

▲8.8%	▲5.6%	▲10.2%
Nominal wage income	Overall personal income	Consumption

Business activity

The August survey conducted by CEO Magazine showed a rise in CEO optimism, the first major improvement in sentiment recorded this year. The percentage of CEOs reporting worsening conditions decreased from 58% to 45%, while those reporting improving conditions rose from 14% to 30%. At the same time, 29% of the CEOs forecast a recession for the second half of 2022 while an additional 24% expected continued slowing. Hopes that inflation may have peaked and any downturn might be short and mild may have inspired the improved optimism. The magazine notes that "rising interest rates, and high labor, material, and energy costs remain concerns, but many of those polled see these issues beginning to abate and believe that will continue over the coming months." Looking out 12 months, 53% of CEOs expect rising profits and 63% anticipate improved sales.

The National Federation of Independent Business (NFIB) survey in July showed rising expectations for business conditions off the recent record low, but a net 52% still do not expect conditions to improve over the next six months. Respondents cited inflation as their top concern, with the availability and quality of labor also identified as problems. Almost half of the respondents report having job openings they cannot fill. And 68% of those surveyed reported moderate or severe supply chain disruptions. A net 26% do not expect profit trends to improve, and an extremely weak net 29% do not think sales will increase.

The industrial side of the economy has continued to expand. To date, the manufacturing segment of industrial production has grown 1.5% ar off the pre-pandemic peak, in line with manufacturing's 1.6% ar growth over the last cycle. Unfortunately, energy production has lagged significantly behind the improvement in manufacturing. While GDP has grown almost 15% off the pre-pandemic peak in nominal terms, in July oil and gas extraction was still 3.4% below its prior peak. That lagging production no doubt accounts for a significant part of the rise in energy costs. On the positive side, increased drilling bodes well for the future. Drilling activity stood 12% above its pre-pandemic peak in July, growing 4.8% ar off the prior peak and 55% over the last 12 months. That growth is significantly faster than the growth of drilling over the last cycle (3.4% ar). In time, that should translate to increased energy production as well.

The patterns of growth in nonresidential fixed investment are consistent with labor shortages being a principal constraint on economic growth. When it is impossible to hire enough qualified help, automation, computers, and other technology can allow existing employees to be more productive. In the investment numbers, that shows up as faster growth in the productivity-enhancing categories. Investment in computers has grown 12.3% ar off the pre-pandemic peak, whereas that area grew only 3.1% ar over the prior economic cycle. Likewise, software grew 9.2% ar off its 2019 peak, compared to 6.6% over the last cycle. And research and development spending, which can also improve efficiency, rose 10.2% ar off the prior peak, versus a 6.4% ar growth for the last cycle. In contrast, overall investment, as gauged by the growth of total nonresidential investment (5.2% ar), has remained largely in line with its historic average (5.5% ar).

The August survey conducted by CEO Magazine showed a rise in CEO optimism. Over the next 12 months:

Rising rates, of course, reduce the availability and attractiveness of business loans. The NFIB survey reports that most small businesses that wanted loans have been able to get them. Commercial and industrial lending has surged this year, increasing roughly $235 billion over the average loan volume for 2021, with the current total standing at roughly $2.7 trillion. Bear in mind, too, that privately placed loans now account for a large share of business lending. Government data show that commercial lending standards are tightening. The lending numbers provide a gauge of how much business spending might be at risk as rates rise and lenders become more cautious.

Exports and international economies

International trade added 1.4% to GDP growth in the 2nd quarter. Part of the strong improvement in trade over the 1st quarter came from much slower growth of imports, fostered perhaps partly by the shift from strong spending on consumer goods to more spending on services. Surprisingly, exports were very strong despite significant currency strength. Continued economic growth for several U.S. trading partners no doubt helped. Looking forward, however, the trends toward slowing global growth caution that the export contribution will be substantially lower in the coming quarters.

Europe has faced an ugly outlook as Russia used its energy position as an economic weapon in the battle over Ukraine. Fortunately, the European economy may have reduced current energy usage enough to avoid severe rationing this winter. Sharply rising energy prices caused industrial users to curtail production and encouraged general conservation. That has taken a toll on current economic activity but has also allowed the rebuilding of critical gas reserves that will be needed this winter. The Eurozone posted growth of 2.5% ar in the second quarter, but the region will probably be fortunate to avoid a sharp economic contraction in the coming months. Both the Eurozone's Manufacturing and Services PMIs suggest stagnation. Yet with global growth slowing and energy costs certain to be high, Europe's export and domestic sectors will face some intense pressures through the fall and winter.

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The United Kingdom faces many of the same energy problems European countries face but chose to impose price caps to slow rising energy costs. That may have cushioned energy's impact on the current economy but builds additional energy inflation into the future when the caps rise. As with the Eurozone, too, the currency weakness that normally might have stimulated exports likely cannot offset the demand lost to slowing global growth. Moreover, the U.K. continues to struggle with adjustments to Brexit. The U.K.'s economy recorded a 0.2% decline in the second quarter, but a Manufacturing PMI of 47.3 does not bode well for the industrial side of the economy and a Services PMI reading of 52.5 may be overly optimistic given the likelihood of substantially higher energy costs. Notably, the Bank of England has forecast a prolonged recession.

As Japan eased COVID restraints, a spending recovery helped their economy achieve 2.2% ar GDP growth in Q2. Forecasts for Q3 growth have also been stronger than the modest readings of 51.5 on the Manufacturing PMI and 49.2 on the Services PMI suggest. However, the escalating costs of food and energy represent major challenges for Japan and many of its export partners. A sharply rising number of COVID cases, additionally, threatens both continuing supply chain disruptions and renewed restraints on Japanese consumers.

China's economic difficulties are escalating. Their rigid COVID policies have severely restricted China's ability to export. Even worse, the unreliability of Chinese suppliers is causing customers to develop new suppliers in other countries. At the same time, the domestic economy is being rocked by the bursting property bubble. Lack of construction financing has stalled many construction projects, eliminating a strong source of economic growth and prompting consumers to retrench. Given the dominant role property has played as a store of wealth for Chinese citizens, domestic spending may remain suppressed as real estate tries to stabilize. And until the public adjusts psychologically to the collapse, consumer spending may remain under a very dark cloud for some time. Given the headwinds, Chinese officials discarded their 5.5% growth goal for this year. For the 2nd quarter, China reported year-over-year growth of only 0.4% and a quarter-over-quarter contraction of 2.6% (10.8% annualized). A neutral Manufacturing PMI score of 50.4 suggests exports will add only marginally to overall growth in the coming months. While a Services PMI reading of 55.5 suggests a better outlook for the domestic economy, it may not adequately discount the broad effects of the imploding property markets or the potential impact of additional COVID restraints.

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About Bruce McCain

Bruce McCain serves as a consultant providing perspectives on the economy and the market to both investors and business operators. He has appeared regularly on CNBC and Bloomberg providing market perspectives and has been quoted in The Wall Street Journal, Investor's Business Daily, and MarketWatch as well as published articles on Forbes.com. He retired from KeyBank in 2019 after 32 years.

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