Economic Outlook December 2022

As 2023 approaches, inflation persists and a possible downturn looms

For the past several months, the possibility and timing of a recession has been the big question on the minds of economists and market observers. The U.S. economy appears poised to avoid this pitfall before the end of 2022, but forecasts about 2023 are mixed, with many business leaders and commentators anticipating a downturn during the first half of the year. Despite an increase in GDP during the third quarter of this year, pervasive uncertainty and risk – coupled with the growing potential of an overcorrection by the Federal Reserve – continue to drive concerns.

Overview: A tight needle to thread

The U.S. economy is technically growing, but headwinds are picking up speed. Following two consecutive quarters of decline, U.S. GDP increased 2.6% during the third quarter of 2022, driven primarily by trade. But as the rising dollar drives up the trade deficit, trade could become a drag on future growth. In addition, growth in accumulation of inventories slowed and fixed investment fell, subtracting 0.7 and 0.9 percentage points, respectively, from GDP growth.

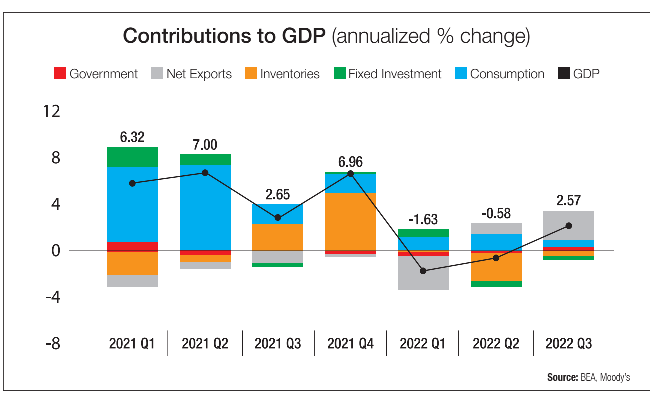

Figure 1

The labor market has proven to be resilient, which has been a stabilizing factor in recent months, though it is moderating. Job growth in October was higher than expected, especially in service industries and manufacturing. Overall, however, the labor market shows a modest slowdown from previous months.

Midterm elections, which yielded a divided federal government, also added ballast to the economic outlook. From an economic and markets standpoint, congressional gridlock can be beneficial because it reduces the likelihood of sweeping changes that could cause upheaval in the markets. During its "lame duck" session, Congress will likely be limited to passing essential legislation like government funding bills, while larger initiatives like the Build Back Better legislation and corporate tax relief will be stalled. Once the new session begins, investors can expect:

- Less fiscal support (unless a significant recession occurs)
- More oversight of China, cryptocurrencies and Big Tech
- More gridlock around the debt ceiling
- More confusion for the Fed due to parties' competing priorities

Additionally, while inflation remains elevated, signs indicate it is slowing: excluding food and energy, the Consumer Price Index rose only .3% in October, compared to .6% in September; including food and energy, the CPI rose .4%, the same as in September. As the Federal Reserve continues its efforts to control inflation without tipping the economy into recession, it will also be monitoring employment data, geopolitical risks – in particular, Russia's war in Ukraine and China's zero-COVID policies – the global supply chain, consumer sentiment and the housing market. At the time of this writing, markets are anticipating interest rate hikes of 50 basis points in December and 25 points in January, and a terminal rate of 5.14% in June 2023. For businesses, rising interest rates and other factors are contributing to uncertainty as the New Year approaches.

Businesses are wary of a possible slowdown

Despite a lift from easing supply chain pressures and a cooling labor market, businesses are wary of rising interest rates, tighter lending standards from banks and geopolitical uncertainties. The ISM Purchasing Managers' Index, which measures the breadth of growth in the manufacturing sector, fell from 50.9 in September to 50.2 in October – its lowest reading since May 2020, and one that is only barely above the 50-point threshold that designates expansion. New orders, which tend to lead growth in core capital goods orders by a few months, dropped from 51.3 in August to 47.1 in September, entering contraction territory. Several factors are conspiring to slow the pace of business investment, including:

- Lingering supply issues directly inhibiting the ability to assemble capital goods;
- Higher prices of capital goods straining corporate budgets; and
- Rising interest rates are directly and indirectly affecting the cost of borrowing and credit-sensitive spending for consumer goods and housing, respectively.

Global supply chain pressures decreased in September, marking a fifth consecutive month of easing. The Global Supply Chain Pressure Index (GSCPI)'s year-to-date movements suggest that global supply chain pressures are beginning to fall back in line with historical levels, and The Harper Petersen Charter Rates Index (HARPEX), which reflects worldwide price development on the charter market for container ships, fell sharply in the third quarter. Interestingly, recent research suggests that Americans' spending during the pandemic accounted for about 60% of inflation between 2019 and 2021 – indicating that surging consumer demand was ultimately more responsible than supply chain issues for driving up prices the past two years.

Tightening lending standards may also impact the business community as banks seek to increase precautionary capital and liquidity. Banks expect lending standards to tighten further across all loan categories in the coming months, according to the Senior Loan Officer Opinion Survey on Bank Lending Practices.

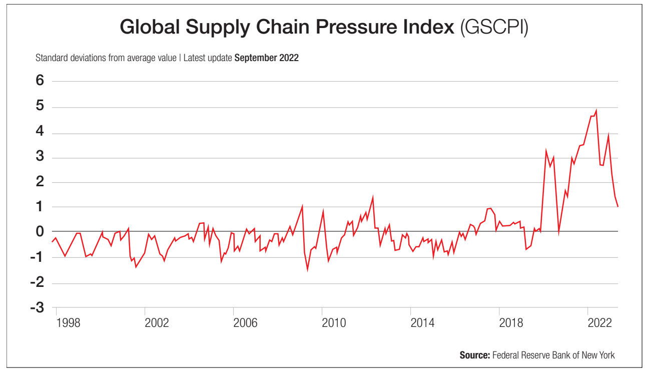

Figure 2

Survey respondents cited a less favorable or more uncertain economic outlook, the worsening of industry-specific problems and reduced tolerance for risk as reasons for the shift. At the same time, banks are experiencing heightened demand for loans due to increased customer needs to finance inventory and accounts receivable, increased precautionary demand for cash and liquidity, and a shift in customer borrowing away from nonbank sources.

Finally, geopolitical factors continue to add layers of uncertainty to the economic landscape for businesses. Moody's Risk Matrix ranks Russian aggression in Ukraine as the most immediate risk to the economy, scoring high on measures of both probability and severity. Additionally, as Chinese authorities continue to enforce the country's strict zero-COVID policy, shutdowns in critical industries could have a ripple effect across the global economy and impact demand for U.S. goods. And unfortunately for U.S. exporters, the dollar should remain strong, supported by favorable real interest rate differentials.

In an economy driven largely by consumer spending on goods and services, businesses are highly sensitive to consumer sentiment. Heading into 2023, stubbornly high gas prices, a volatile stock market and a declining housing market are testing consumer confidence.

Nervous consumers could pull back on spending

According to the final reading, the University of Michigan's Consumer Sentiment Index fell from 59.9 in October to 56.8 in November, more than reversing its gains of the prior two months and pushing it back toward its record low set in June. The Conference Board Consumer Confidence Index fell from a revised 102.2 (previously 102.5) in October to 100.2 in November, marking the second straight month of decline.

Nevertheless, the index remains 4.9 points above its most recent low, recorded in July around the time consumer price inflation was peaking.

Rising gas prices and volatility in the equity markets, as well as inflation, contributed to consumers' flagging confidence. And while continued job growth is a positive, rising interest rates and the lack of consistent declines in the price of gas present clear near-term threats. Fears of a recession and a softening labor market could soon put further downward pressure on the index. Consumer spending contributed one percentage point to GDP growth, but has slowed, likely due to weak real incomes.

Despite these concerns, consumer balance sheets remain strong, thanks largely to a resilient labor market. Retail sales grew more rapidly than expected in October, especially non-auto sales, as consumers appear willing to continue to draw down their pandemic-generated excess savings. Payroll employment rose by 261,000 in October as seasonal hiring began, while gains for September were revised higher by 52,000. The unemployment rate rose slightly to 3.7 percent. In particular, the largest service industries and manufacturing remained buoyant, but gains are moderating. This is especially true in the leisure and hospitality sector, which has driven significant payroll movements since the pandemic. While manufacturing and white-collar industries have continued to expand, consumer industries are contributing less, perhaps reflecting the bite of inflation on consumer wherewithal.

The housing market has significant implications for consumers – and is currently experiencing its worst correction since the Great Recession. CoreLogic Case-Shiller 20-City Composite Index slowed to 10.4% year-over-year in September (a nearly 3-percentage point decline from last August) and house prices declined by 1% on a monthly basis. Higher mortgage rates and declining affordability are significantly cooling housing demand and weighing on home prices. And although housing supply remains tight by historical standards, supply will increase during the coming quarters. Despite new-housing permits falling off in recent months, residential construction has skyrocketed since the pandemic. Supply-chain issues have lengthened building timelines, and an above-average number of housing units are currently under construction. Consequently, more units will come online in the short term, creating additional supply which could further depress prices.

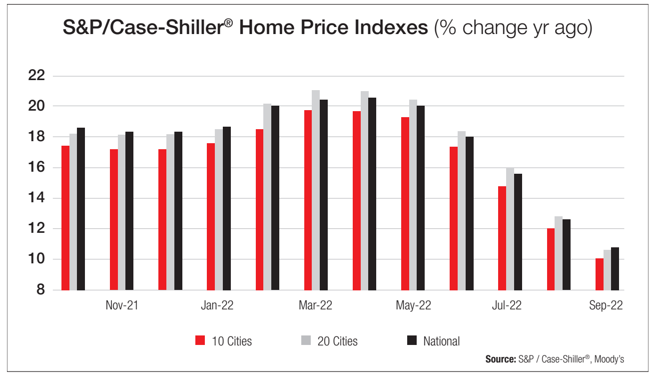

Figure 3

Mortgage rates are rising at an astonishingly fast pace. Rates have increased more than four percentage points over the last year, which is the largest one-year increase since the early 1980s. The 30-year fixed mortgage rate averaged 5.6% in August and has since added an additional 100 basis points to 6.5% in early December (although this is down from 7.1% in November). This is likely to accelerate declines in home prices, especially as the Fed continues to raise interest rates in response to inflation.

As in the business world, consumers are feeling the effects of uncertainty as 2022 draws to a close. Inflation, high prices at the gas pump, a trendless, volatile equity market and a major correction in the housing market are weighing on consumer sentiment – despite a strong labor market and low unemployment. If consumers' economic anxieties continue to grow, they may cut back spending, which could have major consequences for the broader economy.

Conclusion

In 2023, all eyes will be on inflation and the Federal Reserve. After a series of rate increases in 2022, the Fed will continue its attempts to rein in inflation without tipping the economy into recession. Geopolitical conflict, cooling job growth, tightening lending standards and nervous consumers could all complicate the Fed's efforts to achieve a soft landing next year. Whether or not a recession will occur in 2023 remains an open question, but among those forecasters and commentators who do anticipate a downturn, many expect it to be mild.

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About Benjamin E. Demko

Ben Demko manages the economic research and analytics team focused on macroeconomic, industry, and market risks that impact KeyBank's varied loan portfolios. He is responsible for proprietary, forward-looking perspectives on the economy and real estate markets which are used across the bank for stress testing, loss estimation, asset management, resource allocation, and profit planning. Ben joined KeyBank in 2005 and has nearly 20 years of business analytics, economic research, and risk management experience.

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