Focal Point

US: Shallow 2023 recession, with downside risks prevailing

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Our Focal Point series explores topical issues on macro, markets and investment

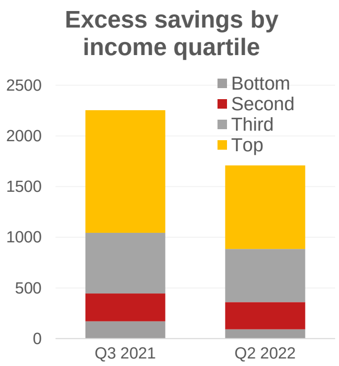
- The US will not escape a mild 2023 recession amid the Fed's fight against inflation. We expect barely positive growth (0.3%), with a contraction in activity in the middle of the year. But unemployment will exceed the Fed's 4.6% YE forecast.
- In the final months of 2022, demand has been propped up by household dissaving and increased borrowing. This is unlikely to be sustained and will add to the hit of higher rates on capex and the construction sector.
- The Fed wows to push the Fed funds rate to above 5% by Q1 2023 and keep it there for the whole year. This commitment will be hard to maintain given the economy's deterioration, and we expect a 50bps rate cut towards the end of the year. The Fed's aggressiveness is the root of the significant downside risks to our growth forecast.

With the Fed's hiking cycle slowing and approaching its end, the two key questions are how much tightening will hurt the economy in 2023 and when it will be reversed. We expect a significant impact, culminating in two quarters of contracting GDP. Annual average growth will remain (just) positive at 0.3%, but with the unemployment rate above 5%. The economy's deterioration will make it harder for the Fed to keep rates at a very restrictive level and cuts in the final meetings of next year remain our baseline. Risks to growth are titled to the downside due to a more damaging impact of the monetary squeeze and/or the possibility that the Fed may ultimately raise rates to even higher terminal rates than we expect or keep them at a contractionary level for longer.

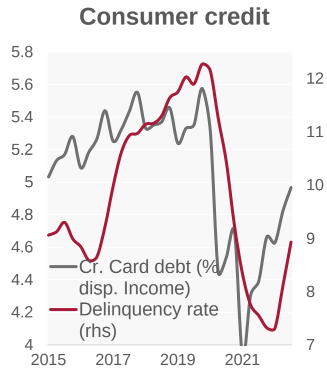
Growth: do not count too much on consumers

Inflation has eroded real incomes throughout the year. Yet households managed to support consumption by shrinking the pile of savings accumulated during the pandemic and propped up by the fiscal support measures implemented in 2021. In the three months to October, the personal saving rate has averaged 2.5%, just about one-third of the 2010-2019 average. At the current pace, the stock of excessive savings could be depleted by mid-2023. Moreover, low-income households, with a higher propensity to consume, had proportionally lower extra savings, to begin with, and have depleted it at a relatively fast pace. So, the additional contribution from wealth will be increasingly smaller. At the same time, borrowing, especially in the form of credit card debt, has increased markedly in Q3, and is back to almost the pre-pandemic average, and missed payments are on the rise. However, the wealth buffers remain higher than in the pre-pandemic period: bank deposits and money market fund holdings are around 100% of disposable income, against

75% before the pandemic. Consumption growth should moderate from nearly 3% this year to about 0.7%.

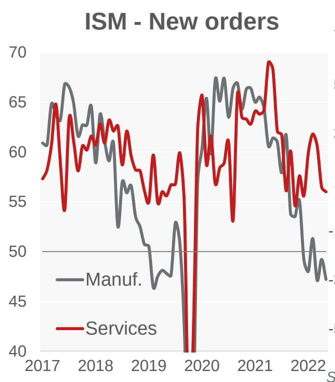


Source:Fed, GIAM

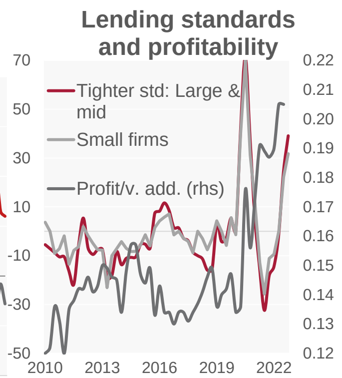


Source:NY Fed, GIAM

We expect a fast decline in the more interest rate-sensitive demand components, such as CAPEX and construction activity. Non-financial profits have likely peaked in mid-2022, and falling demand will increase the downward pressure. Moreover, the around 500 bp increase in short-term rates we project between March 2022 and Spring 2023 will add roughly US$bn 250 to nonfinancial interest expenses, (short term net debt is around US$ 5tn), corresponding to roughly 15% of nonfinancial after-tax profits. More broadly, market refinancing will be much more costly, and banks are rapidly tightening standards for corporate loans. Non-residential investment growth eased from 3.5% this year to around 1%. The prospects for construction activity are more negative; we see investment down by another 8% in 2023.



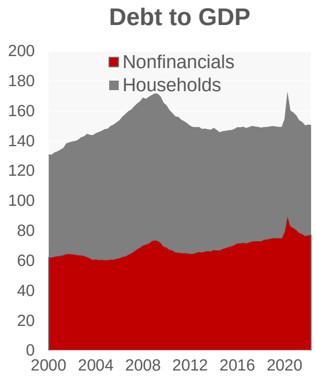
Source: ISM,



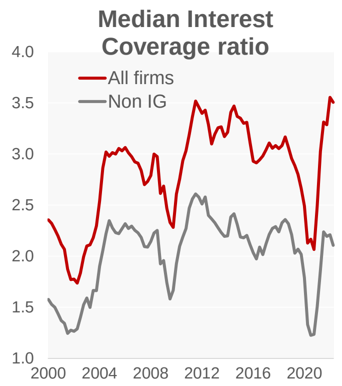
Source:Federal Reserve, BEA,

We expect a relatively muted bounce back for 2024, with GDP expanding at a rate below 1.5%. Despite the rate cuts, financing conditions will remain unfavourable, and a divided Congress will not legislate any fiscal help to the recovery. A higher for longer policy rate could clearly further depress the recovery.

Our outlook for the US economy in 2023 may look rosy, given the risks for financial stability related to the sharp increase in rates. A mitigating factor is the lack of significant vulnerabilities in the non-financial sector. Private sector debt as a share of GDP remains well below the pre-Great Financial Crisis peak due mainly to households deleveraging. And credit quality has improved: New mortgage extensions have titled heavily on prime borrowers during the recent period. Subprime loan origination is now around 25% lower than at its peak in 2006. The median non-financial firm's interest coverage ratio (earnings to interest expenses) has risen to the highest level in twenty years.

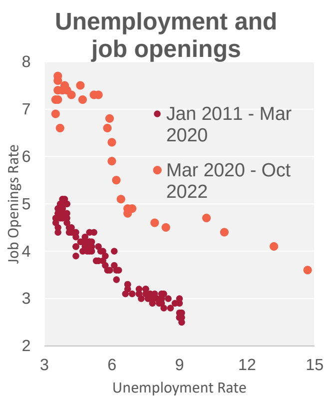


Source:Federal Reserve, GIAM

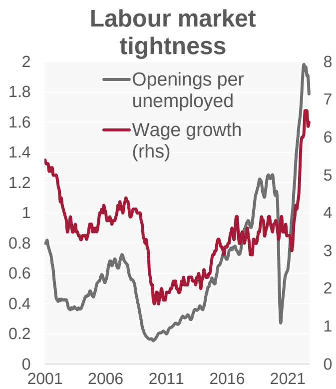


Source:Federal Reserve, GIAM

Whether the reduction in domestic demand will be enough to cool inflation hinges on the impact on the labour market and the link between wages and prices. According to the Fed, a relatively painless (or "immaculate", for the sceptics) disinflation could be achieved if the monetary squeeze reduces hiring without causing substantial layoffs. In this way, the moderation in wage growth would feed through inflation without an unwelcome second-round effect on demand due to higher unemployment. Job openings have fallen since the summer, while employment keeps growing at a robust pace (270k on average in the three months to November). But with around 1.8 openings for every unemployed person, a much more substantial drop in job availability is needed to calm wage growth, which is likely to affect unemployment.



Source:BLS, Refinitiv, GIAM



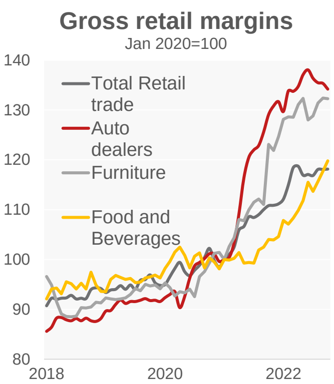
Source:Atlanta Fed , BLS, Refinitiv GIAM

Moreover, despite the strong wage increase, participation in the labour market remains more than one percentage point below the pre-2020 average. Early retirement is only part of the story. Also, the prime-age participation rate is nearly one percentage point lower. Without a meaningful increase, the labour market would remain structurally tighter, another unwelcome supply shock that would complicate monetary policy.

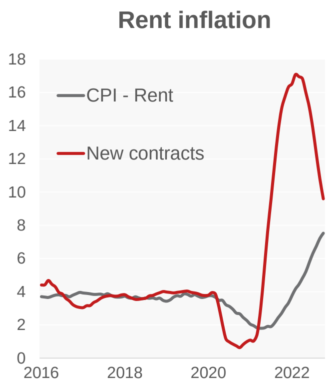
Services will slow down disinflation

It will take some time before wage growth will moderate from the current historically high. Recent research by the ECB shows that the degree of pass-through from wages to prices is nearly three times higher in periods of inflation above its long-term expectations than when it is below. Moreover, the impact is more substantial when positive demand shocks mostly drive price inflation. While idiosyncratic factors (used cars, healthcare) have contributed to inflation since 2021, underlying measures point to a strong increase across the board, which is more compatible with a demand-driven push. This is confirmed by the abnormal rise in retailers' margins.

However, the sectoral composition will be essential for its evolution, as rents and other housing costs account for nearly 40% of the core inflation basket. Data on new contracts show that annual rent inflation is contracting fast; this will be fully captured in the CPI/PCE indexes only in the first months of 2023. Core goods inflation should continue to drop, and we expect services to peak too around the turn of the year. However, prices in these sectors tend to be somewhat sticky; therefore, while the macro fundamentals will put core inflation to a steady downtrend, we see it to end in 2023 closer to 3.5% than 3%.



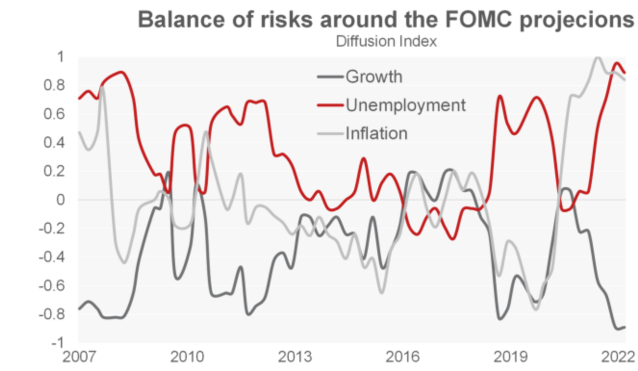
Source:BLS, Refinitiv, GIAM



Source:BLS, Zillow, GIAM

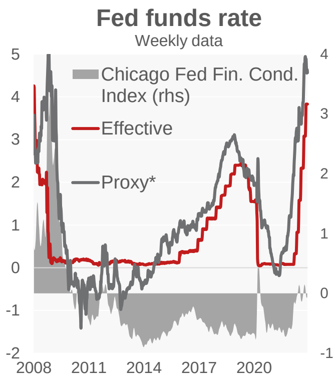
Can the Fed avoid a hard landing?

In the last meeting of the year, the pace of monetary tightening slowed as expected, but the FOMC was keen to dispel hopes of a quick turnaround. Next year's central theme will be the tension between what the Fed has committed to (a peak rate of 5% to 5.25%, maintained until early 2024) and what it can achieve without crashing the economy. FOMC members remain worried that inflation may go down at an even slower pace than they projected. At the same time, they signalled a negative tilt in the balance of risks around the growth projections This looks at odds with Chair Powell's statement about the possibility of cooling labour demand and wage growth without triggering a spike in unemployment.



Source:Federal Reserve Board

Chair Powell used most of the Dec. press conference for persuading markets that the Fed will not back down in its determination to tighten financial conditions to reduce inflation. This adds a strong upside risk to our 4.75%-5% terminal rare range forecast. However, we think, that the GDP contraction in the central part of the year will trigger rate cuts in the final meetings of 2023. Our broader measure of monetary policy tightness, based on market yields and spreads (see Appendix), shows that the overall degree of tightening peaked in October at 190 bps higher than what was implied then by the policy rate as, bond market stress rose rapidly. Conditions eased afterwards on the expectations of a less aggressive Fed, as Powell failed to convince markets of the fed's hawkishness. Therefore, monetary policy overtightening is a clear danger, which tilts the balance of risks to growth to the downside.



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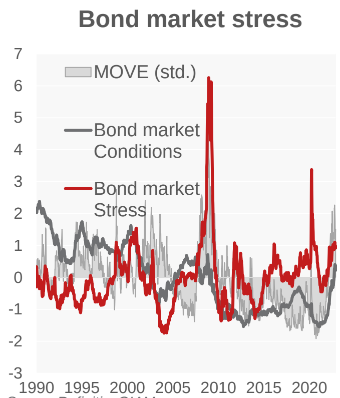

Source:Refinitiv, GIAM

Appendix

Given the important role taken by forward guidance and balance sheet policy, the Fed fund rates level alone may not fully capture the monetary policy stance. Several studies have tried to address this issue: the most popular outcome is the estimation of the shadow rate, i.e., a proxy for the whole monetary policy stance when the Fed Funds rate is at zero. Based on research by the San Francisco Fed, we developed a slightly different estimate called the proxy Fed funds rate. It aims to condense weekly information from a wider set of market yields and spreads (listed in the table below) and translate them into a Fed funds rate equivalent. We proceed as follows: first, we extract from our financial market variables the first three principal components, then map them to the level of the Fed funds rate using a regression estimated up to December 2008, when the Fed funds rate was lowered to zero, and unconventional measures were taken for the first time.

We finally use the estimated coefficients to project this rate forward. Our proxy captures the effect of the anticipation of the announcement of policy changes. The monetary policy stance, accordingly, tightens or loosens before the fed fund rates move. For example, the proxy rate started to decline in January 2019, well before the cut occurred in July (see bottom chart on prev. page). It also serves as a gauge of how effective Fed policies are. For example, after the Covid outburst, the Fed cut rates to zero and started to purchase securities. However, the proxy rate dropped into negative with some lag, as the Fed's aggressive moves did not fully offset the tightening in market conditions. Coming to the most recent period, the proxy rate turned positive as early as in the late summer of 2021 (some nine months before the actual lift-off), as the FOMC started anticipating a slowdown in asset purchases and signalled future rate increases.

We also find that the principal components can, in themselves, provide information. The first component captures the medium-term trend in rates and is a proxy of the overall conditions of the fixed-income market. The second one (generally related to the yield curve slope) captures the spreads related to inflation or other risks premia and is an indicator of stress.

<table>
<tr><th>Yields…</th><th>…and Spreads</th></tr>
<tr><td>2 yr Treasury</td><td></td></tr>
<tr><td>5 yr Treasury</td><td></td></tr>
<tr><td>7 yr Treasury</td><td></td></tr>
<tr><td>10 yr Treasury</td><td>-2 yr Treasury</td></tr>
<tr><td>30 yr Treasury</td><td rowspan="7">-10 yr Treasury</td></tr>
<tr><td>AAA corp index (BofA)</td></tr>
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<tr><td>A corp index (BofA)</td></tr>
<tr><td>BBB corp index (BofA)</td></tr>
<tr><td>MBS securities (BofA)</td></tr>
<tr><td>30 yr Fix. Rate mortgages</td></tr>
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