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Economic Edition

CRF's Annual Focus on the Economy for 2023: Projections from Leading Economists

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Oh, By the Way…Economic Outlook 2023

By: Steven C. Isberg, PhD, Senior Fellow, Credit Research Foundation and Chair, Department of Accounting, Towson University

Almost three years out from the beginning of the global COVID pandemic, we are still feeling the effects of outcomes and actions taken to keep the economy afloat through that trial. The single biggest target on the radar screen has been inflation, against which the Federal Reserve has been combatting with the largest interest rate increases in recent years. While inflation has begun to come down, the effects of the interest rate increases are being felt across the economy which, in its pandemic-weakened state, is showing recessionary signs for the coming year. And oh, by the way, the federal debt level, which stood at $23 trillion prior to the pandemic, is now $31 trillion and showing no signs of declining. Just today (15 December 2022) the Senate voted to keep the government from shutting down for at least another week while they figure out what to do about federal spending levels and raising the debt limit yet once again. Just thought you'd like to know. We will come back to this later.

Since the banking system collapsed and had to be rescued in 2008, the US economy has been able to grow only on a diet of low interest rates and trillions of dollars of fiat money. When the flow of new money has ebbed, and/or interest rates have increased, real economic growth has slowed down. There is evidence that, prior to the pandemic, contractionary monetary policy was causing real economic growth to slow despite the uptick resulting from the significant reduction in federal tax rates in 2017.

Since 2003, the Federal Reserve has engaged in two periods of monetary expansion and three of monetary contraction. Periods of monetary expansion include interest rate reductions and/or increasing monetary reserves. Contraction is characterized by interest rate increases and/or decreasing monetary reserves. Exhibit 1 shows both the reserve levels (i.e., the monetary base) and the discount rate, which is the lending rate charged by the Federal Reserve to its member banks.[1] The three periods of contraction are indicated by the red-shaded blocks, and the expansion by the green-shaded blocks. It is easy to see that the Federal Reserve's response to the banking system failure was the infusion of reserves and lowering of rates, which continued through the end of 2014. By the beginning of 2016, the Fed had begun to engage in a policy of monetary contraction characterized by both declining reserves and increasing rates. Just prior to the pandemic, the Fed began to reverse this policy and had started to add reserves to the banking system.

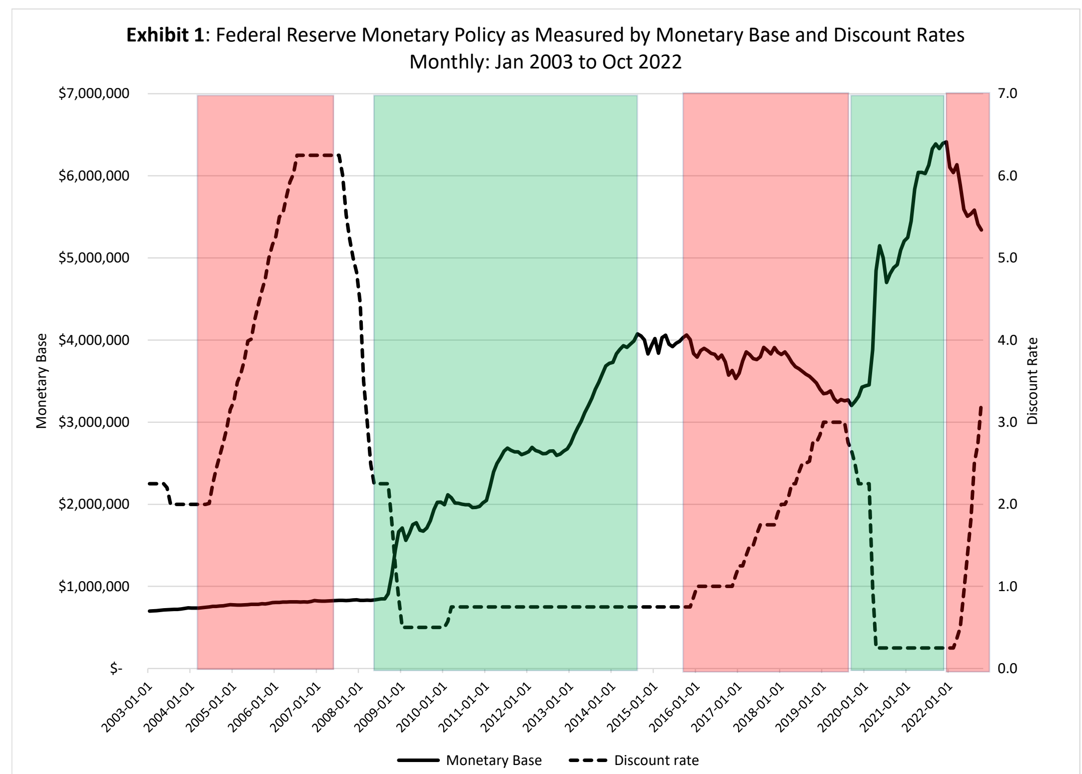

Exhibit 1: Federal Reserve Monetary Policy as Measured by Monetary Base and Discount Rates
Monthly: Jan 2003 to Oct 2022

It is also easy to see the magnitude of the Federal Reserve's response to the pandemic in 2020, as interest rates returned to near zero level and there were two huge infusions of reserves into the

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1 Data: Federal Reserve Bank of St. Louis Economic Database.

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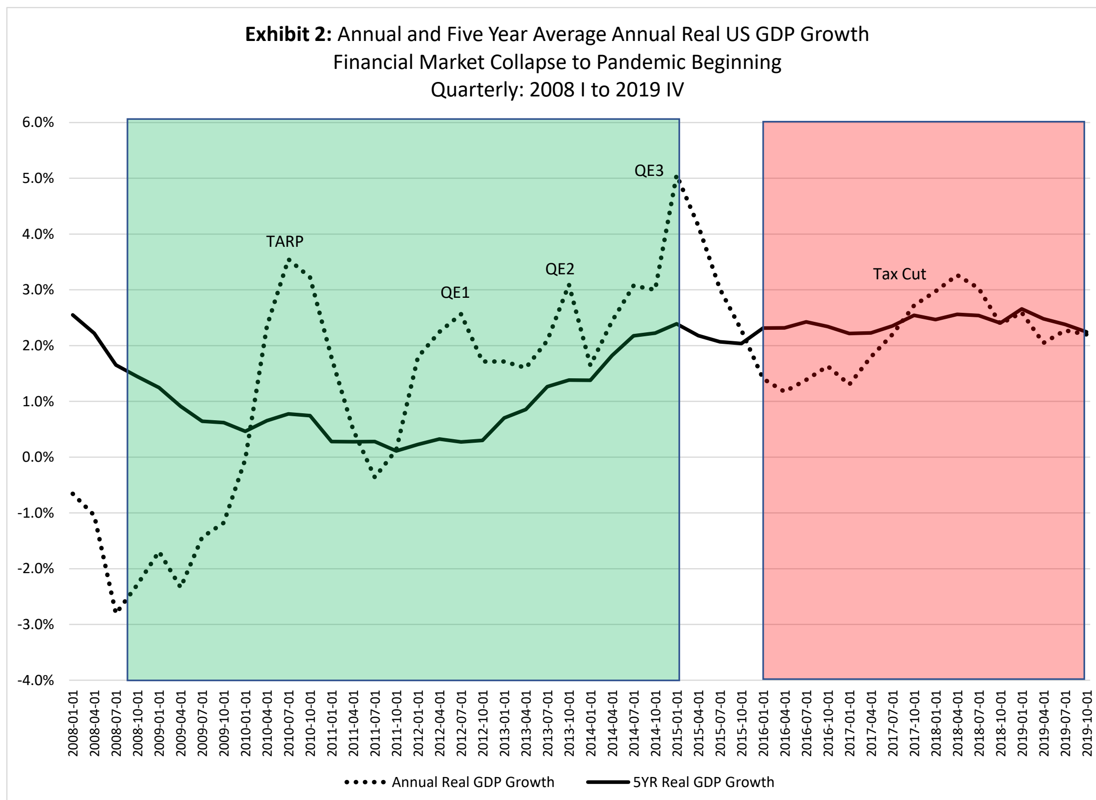
banking system. These were intended to keep the economy afloat during the pandemic shutdown, but as we have seen in the past 18 months, it was too much, resulting in the inflation that the Fed is now attempting to combat with rate increases and reductions in reserves.

Real economic growth coming out of the banking system collapse of 2008 was driven by expansionary monetary policy. This is clear in Exhibit 2, which presents the one- and five-year annualized growth rates in real US GDP.[2] As can be seen, each successive step of quantitative expansion (TARP, QE1, QE2, and QE3) led to increases in annual economic growth.[3] The cessation of quantitative expansion in 2015 led to an immediate slowdown in real growth rates. Despite the kickstart relating to the reduction in corporate and personal tax rates in 2017, rising interest rates contributed to a slowdown prior to the impact of the pandemic. Here it is important to note that, while the decreases in corporate tax rates were permanent, decreases in personal tax rates were designed to phase out over ten years, restoring them to their original levels. At the same time limitations on state and local tax deductibility increased the overall tax burdens on many individual taxpayers, more than making up for the corporate tax cuts and taking some steam out of the economy.[4]



It appears that we are now returning to a period of declining growth in which there are clear signs of recession on the horizon for the US economy. As can be seen in Exhibit 3, the pandemic shutdown resulted in real economic growth plummeting to -8.10% in 2020 QII and recovering to a real growth rate of almost 12% a year later. Since then, it has fallen below pre-pandemic levels. Annual real growth for 2022 III was 0.74%, while the five-year growth has fallen to 1.72%.[5]

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2 Data: Federal Reserve Bank of St. Louis Economic Database

3 TARP was the initial Trouble Asset Relief Program in which the Fed created reserves and used them to replace bank assets so that the banks would remain solvent; QE1, 2 and 3 were periods of Quantitative Easing in which additional reserves were infused into the banking system. The impact of these four infusions are evident in Exhibit 2.

4 Because of the way that state and local tax deductions were limited, while federal taxes may have gone down for many individuals, state taxes increased. As individual federal tax rates return to their pre-2017 levels, many are seeing reductions in take-home pay. This is a bigger problem in states with high income tax rates.

5 The real growth rate of 0.74% stands in contrast to the 2.57% rate reported for the last quarter. This difference can be explained by the time interval used to measure inflation in making the calculation. Using a quarterly annualized inflation rate results in a larger real GDP growth rate than using an annual inflation rate because the quarterly inflation rate for 2022 III was so low. The calculations reported here use a higher rate calculated for an annual time interval. This is more accurate in considering long term sustainability in economic growth.

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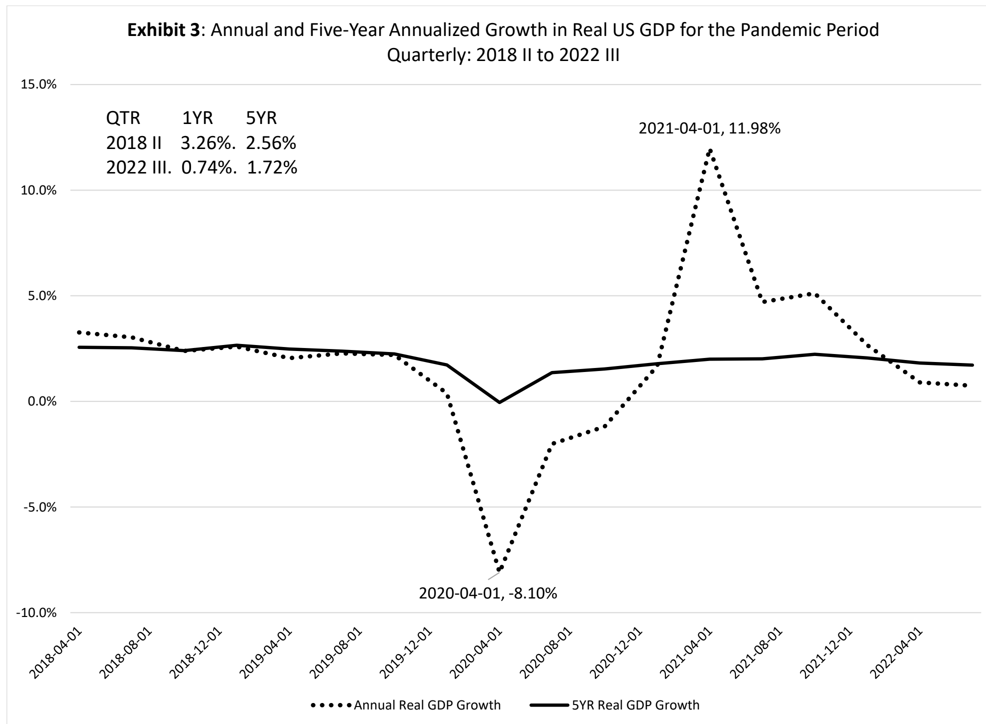
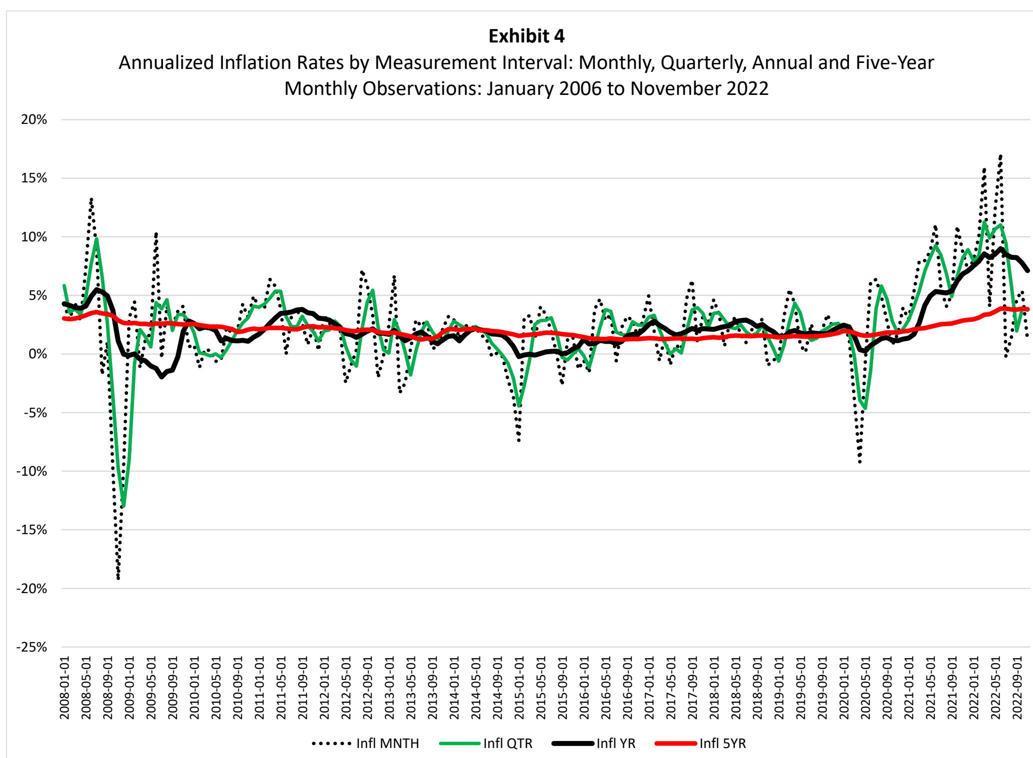


Evidence shows that the Federal Reserve's contractionary policies are having an impact on the inflation that had been created by excessive monetary expansion during the pandemic. As can be seen in Exhibit 4, inflation rates took off during the pandemic, and are now beginning to come back down, albeit slowly.[6] Here it is interesting to note that, despite the monetary expansionary and contractionary periods between 2003 and 2019, inflation was relatively stable and low. Inflation rates increased toward the end of the pandemic due to the combined effects of increasing quantities of money and disruptions in the supply chain. While increasing interest rates may be given credit for inflation retreating, prices will also fall as the supply chain catches up with demand. The impact of the interest rate increases, however, will equalize those two by suppressing demand and pushing the economy over into a recession.



6 Data: Federal Reserve Bank of St. Louis Economic Database

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The most significant lingering problems with inflation relate to rates associated with food and energy. Evidence provided in Exhibit 5 demonstrates that inflation rates are sensitive to the specific indices and time intervals used to measure them.[7] As can be seen, annual rates in the overall (all items) and core (all items less food and energy) are both decreasing when measured using the four different time intervals. Food price inflation also seems to be coming down but is much greater than overall inflation. Energy prices, however, are a lot more volatile and result in both high rates of inflation and deflation on a month-to-month basis. Food and energy price levels remain a concern because of the portion of household budgets devoted to expenditures in these two areas. Continued inflation in food and energy prices will have a negative impact on other sectors of the consumer markets and will slow growth in the overall economy, contributing to the recessionary pressure we are seeing now.

When examining real GDP growth for the third quarter, it was evident that rising interest rates are also slowing growth in the residential real estate markets. Residential real estate investment was down almost 25% (annualized) for the third quarter. Lingering high rates will continue to suppress growth in this market segment and place additional constraints on middle income consumers seeking to buy homes, as well as those who pay interest on variable rate mortgages and other loans.

Exhibit 5: Inflation Rates Measured for Different Indices Using Different Time Intervals: October and November 2022

	November 2022 Inflation Rates			
CPI Measure	**Monthly**	**Quarterly**	**Annual**	**5 Year**
Overall	1.16%	3.74%	7.12%	3.83%
Less Food and Energy	2.41%	4.26%	5.96%	3.40%
Food	6.14%	7.80%	10.66%	4.73%
Energy	-17.39%	-7.45%	13.02%	6.75%
	October 2022 Inflation Rates			
	Monthly	**Quarterly**	**Annual**	**5 Year**
Overall	5.39%	3.83%	7.76%	3.86%
Less Food and Energy	3.31%	5.81%	6.31%	3.39%
Food	7.46%	9.07%	10.94%	4.64%
Energy	23.89%	-19.73%	17.65%	7.57%

Monetary expansion is designed to stimulate economic growth at the expense of the risk of inflation. As the Federal Reserve engaged in monetary expansion from 2009 through 2014, there was always a concern that inflation would result. As can be seen by going back to Exhibit 4, it did not. The monetary expansion did, however, lead to increase in real GDP growth rates, and contraction has had the opposite effect. To fully understand the impact of monetary expansion on inflation and growth more completely, it is important to look at how bank behavior has changed since 2008, and how corporate profits have been impacted by monetary policy over the same period.

The banking industry has responded to post-2008 monetary expansion by holding a greater amount of its assets in the form of reserve deposits at the Federal Reserve. As can be seen in Exhibit 6, reserve balances as a percentage of the monetary base had been falling steadily in the time leading up to the banking system collapse. As the Federal Reserve infused funds into the monetary base, the percentage of those funds held in reserve by the banks increased to 50% almost immediately, and then gradually to almost 70% of the total base created by the Fed. As the Fed contracted the base, the reserve percentage declined. It is currently following the pattern of increases and decreases in the monetary base. Bank reserve deposits are now over 57% of the monetary base.

Infusions into the monetary base by the Federal Reserve are intended to stimulate economic growth as those funds are loaned by banks to firms for business investment purposes. These loans should lead to increases in gross private domestic investment and subsequent growth in employment and real GDP. That, however, has not been happening. One of the main reasons for this is the degree to which banks are holding onto the

7 Data: Federal Reserve Bank of St. Louis Economic Database

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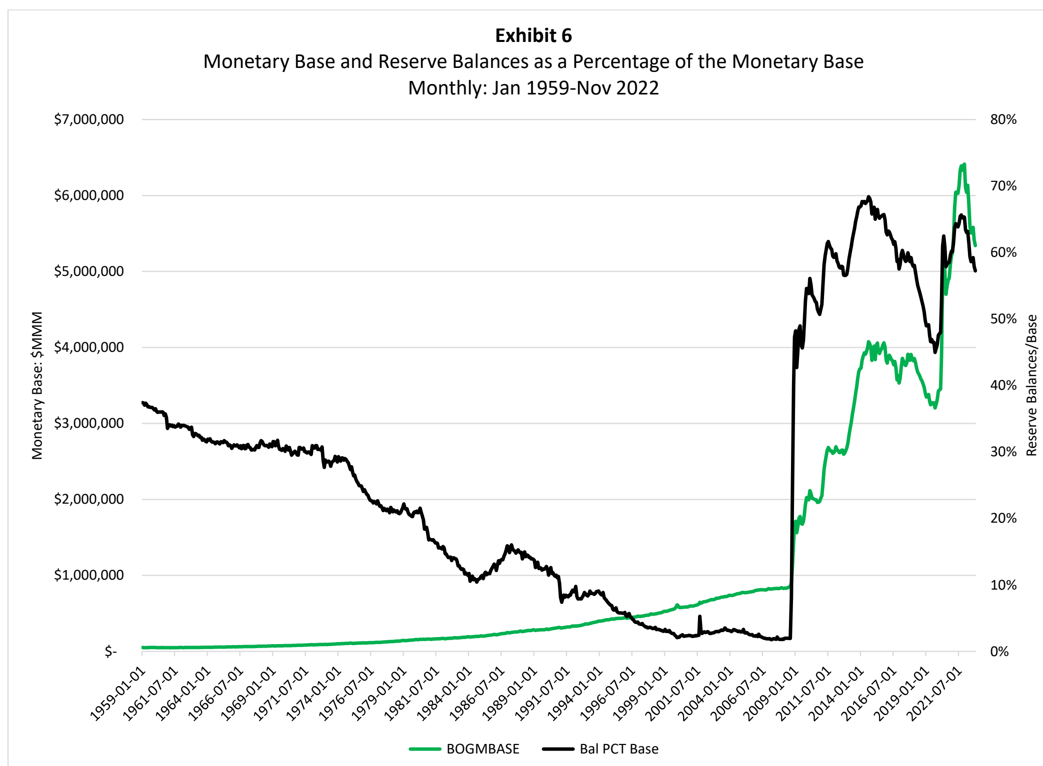
created monetary funds.



An example of this can be seen in examining balance sheet data for JP Morgan Chase Bank for the years 2019-2021. As can be seen in Exhibit 7, JP Morgan Chase's deposits in banks, which primarily consist of reserve deposits with the Fed, increased by almost half a trillion dollars between the end of 2019 and 2021, as the Federal Reserve pumped funds into the pandemic-stricken economy.[8] The ratio of bank deposits to total assets increased from 9.00% to 19.08%. At the same time, the loan portfolio shrunk from 35.71% down to 28.79% of total assets. While the pandemic period is an extreme example of this kind of behavior, it has been common across the banking system in the post-2008 economy. Banks now hold more cash and make fewer loans as a percentage of total assets than they did in the pre-2008 economy. This reduces the effectiveness of monetary expansion as a stimulus for the type of economic growth that spreads benefits more evenly across the economy.

Exhibit 7: Reserve Deposits, Loans and Total Assets for JP Morgan Chase: Year End 2019-2021 ($MM)

Item	2019	2020	2021	Change
Deposits with Banks	$ 241,927	$ 502,735	$ 714,396	$ 472,469
Loans	$ 959,769	$ 1,012,853	$ 1,077,714	$ 117,945
Assets	$ 2,687,379	$ 3,384,757	$ 3,743,567	$ 1,056,188
Reserve %	9.00%	14.85%	19.08%	10.08%
Loan %	35.71%	29.92%	28.79%	-6.93%

The reason for the high inflation that plagues us now is the combination of too much money and shortages in the supply chain. Many argue that wage and salary growth has been a major contributing factor to inflation. This is not true. While nominal wages have grown, corporate profit growth has been much greater, meaning that there is room for firms to reduce prices and still make money. As it turns out, while monetary expansion has not resulted in significant economic growth, it has resulted in significant profit growth. The average annual rate of corporate profit growth has been 10.03% since the end of 2008 and 12.75% since the end of 2019.

8 SEC Form 10-K, JP Morgan Chase, FYE 31 Dec. 2019, 2020, 2021

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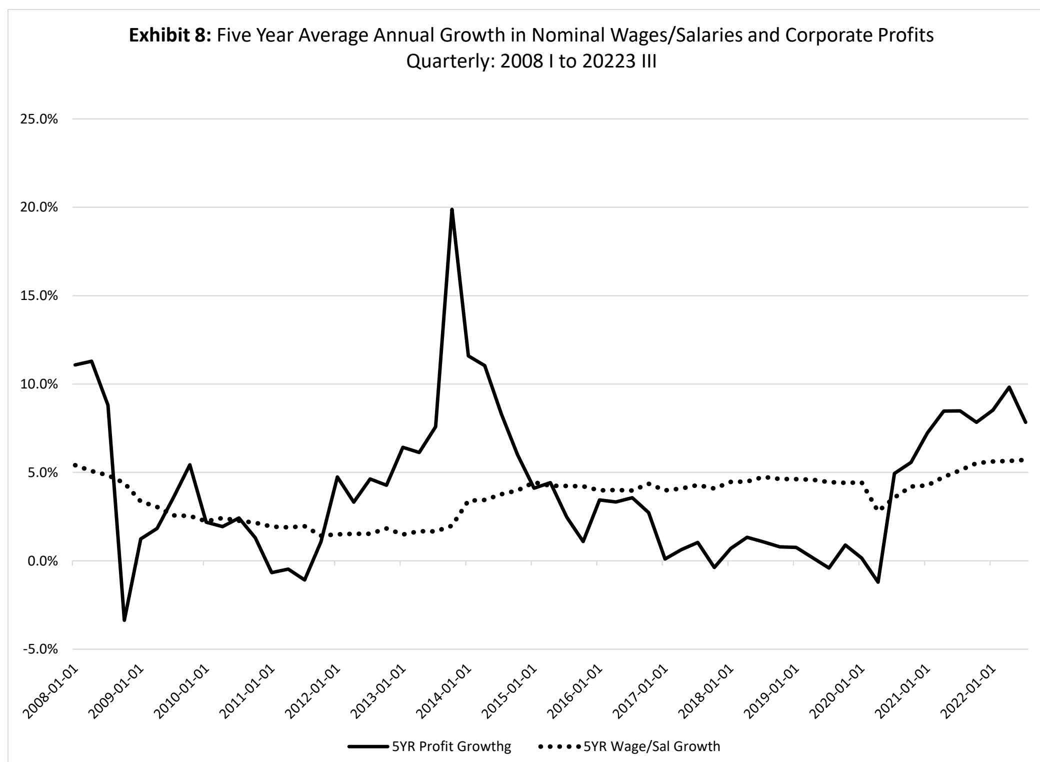
Wage and salary growth is at 4.04% and 6.43% for the same time periods respectively.[9]

To elaborate, monetary expansion has led to corporate profit growth but not necessarily wage and salary growth. As can be seen in Exhibit 8 the five-year rate of growth in corporate profits increased during both the post-2008 and pandemic periods of monetary expansion.[10] Wage growth declined through 2014 and increased slightly through the beginning of the pandemic. It has gained somewhat through the pandemic, but not nearly as much as corporate profits have gained over the same period.



As to the impact of monetary expansion on the distribution of economic benefits since the collapse of 2008, most of the gains have accrued to the highest income earners in the country. As can be seen in Exhibit 9, the percentage increase in income itself increases across income categories (quintiles).[11] As can be further seen, the overall share of income earned by the bottom 80% has decreased and has shifted to the upper 20%. Most important in this analysis is the fact that the share of income earned by the middle 60% of households has declined by 2.10%. Combined with the effects of inflation, in particular food and energy, the relative purchasing power of this group has declined. This is important because the middle 60% are in many respects driving the consumer economy with their spending. As this group has less purchasing power, certain economic sectors will feel the pressure of declining sales and profits. While it may appear that we have solid aggregate growth, the distributional characteristics of this growth are skewed in such a way as to have a negative impact on the long run sustainability of many sectors in the economy.

Exhibit 9: Changes in Income Distributional Qualities: Jan 2009 - Dec 2021

Item	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%
Change in Average Income	$ (842.00)	$ 1,603.00	$ 8,685.00	$ 19,492.00	$ 52,252.00
Percentage change in Average Income	-19.35%	9.37%	23.97%	31.28%	38.74%
Change in Share of Aggregate Income	-0.66%	-1.15%	-0.85%	-0.11%	2.76%

9 Data: Federal Reserve Banks of St. Louis Economic Database
10 Data: Federal Reserve Banks of St. Louis Economic Database
11 Data: Federal Reserve Bank of St. Louis Economic Database

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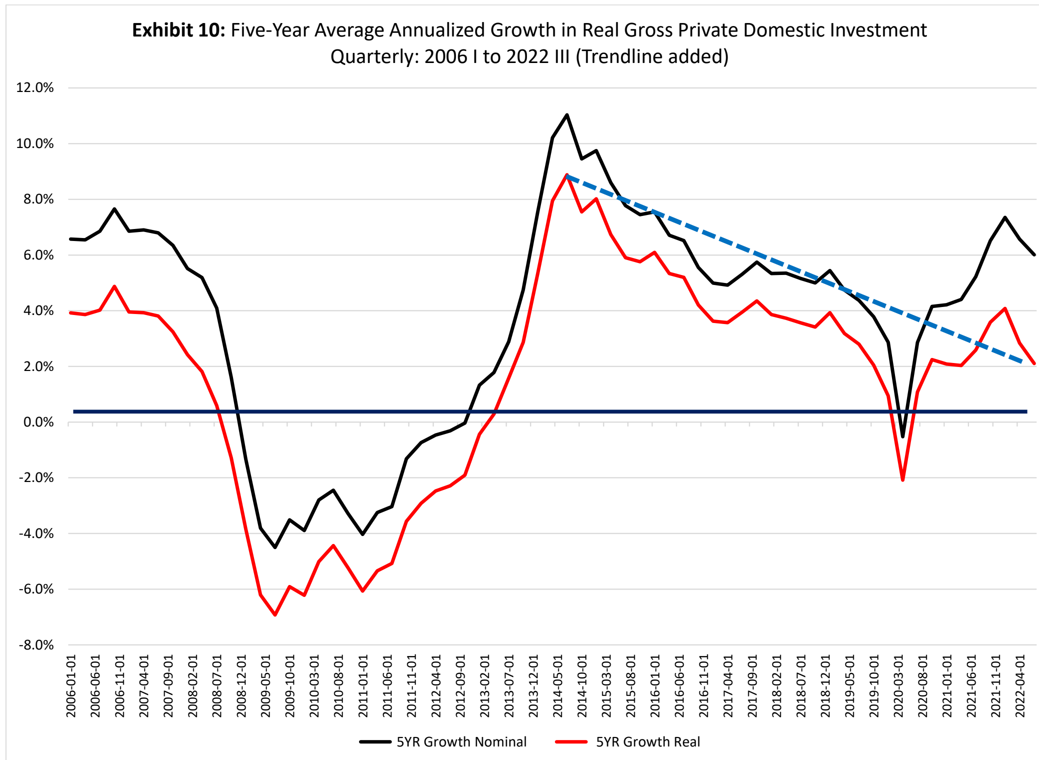
The combined effects of an economy that was slowing prior to the pandemic and the current contractionary behavior of monetary policy have had a negative impact on one of the most meaningful measures of future economic growth available: gross private domestic investment. As mentioned earlier, the residential real estate element of investment was down almost 25% in the third quarter 2022. The overall change in real gross private domestic investment for the third quarter was -7.42% annualized.



Both nominal and real gross private domestic investment growth has been in a general state of decline since the Fed ended its quantitative easing programs back in 2015. As can be seen in Exhibit 10, the growth rates plummeted and then recovered during and immediately after the pandemic shutdown, but they have returned to lower rates as the Fed has increased interest rates over the past year. In this economist's view, this is the single biggest signal of recession to come. Further, it is a sign that sustainable growth in the US economy in the longer term will be stunted and most likely remain at real rates of 2-2.5%. This, as we will see next, may not be enough to deal with the debt bomb, which continues to get larger.

As stated at the top of this analysis, US federal government debt, which stood at about $8.5 trillion in 2008, is now close to $31 trillion, picking up almost $8 trillion since the beginning of the pandemic. Given the nominal GDP of about $25 trillion, the US now ranks fourth in the G20 in terms of its government debt-to-GDP ratio. As of the end of 2021, the US was surpassed only by Japan, Singapore, and Italy in this measure. Overall indebtedness for all non-financial sectors as measured by debt liabilities has reached $57 trillion in the US.[12]

In this era of post-2008 economic monetization, the US government has established the practice of borrowing its was out of crises. As can be seen in Exhibit 11, rates of increase in federal debt levels topped 20% coming out of the 2008 financial collapse and during the COVID pandemic. The federal deficit reached a level of $3.1 trillion (annualized) during the depths of the pandemic, and currently stands at $1.375 trillion (annualized). The last time the federal government ran a budget surplus was 2000. Deficits have generally deepened since, with reductions between 2009 and 2016.

12 Data: Federal Reserve Bank of St. Louis Economic Database

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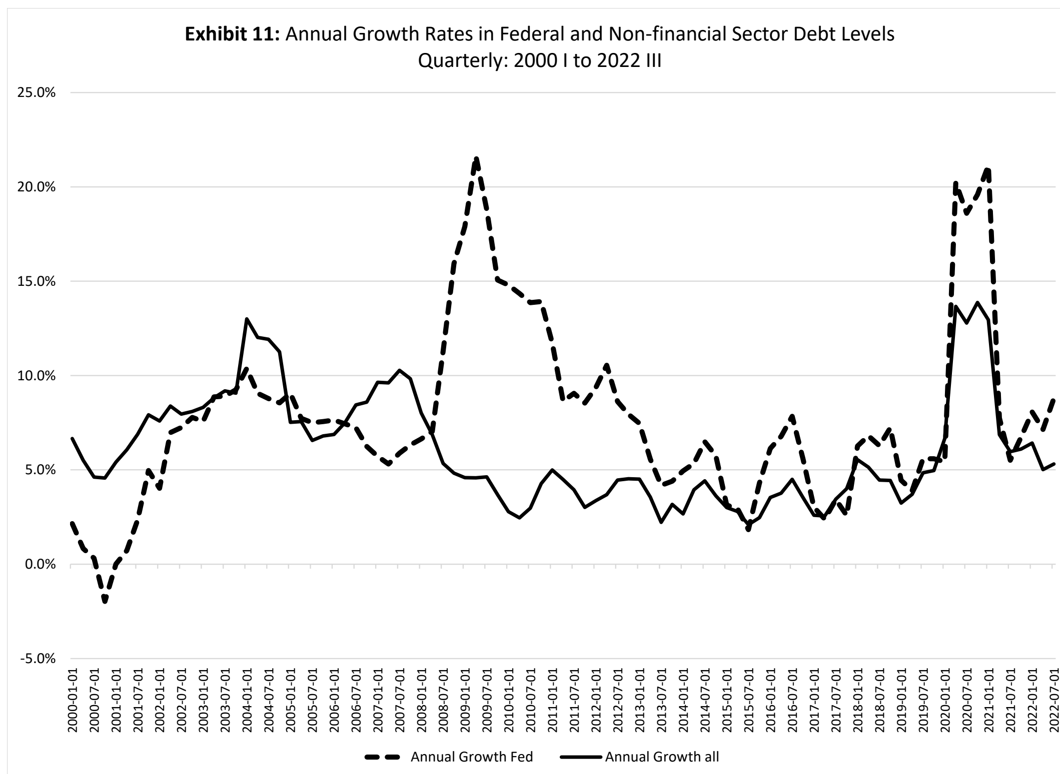

Exhibit 11: Annual Growth Rates in Federal and Non-financial Sector Debt Levels
Quarterly: 2000 I to 2022 III

Contractionary monetary policy is going to increase the difficulty in managing this debt. As the federal government funds debt payments by issuing new debt, interest costs will increase and consume greater quantities of the federal budget. Slow economic growth will reduce tax revenue growth in the absence of tax rate increases. Without decreases in federal spending levels, deficits will persist, and the debt level will deepen.

By monetizing the economy since the banking collapse of 2008, the Federal Reserve has enabled these levels of federal borrowing. During the pandemic, the Fed created almost $3.0 trillion in reserves which turned into almost $6.0 trillion in money supply (M2), virtually all of which was borrowed by the federal government. Without that monetary infusion, federal borrowing would have driven up interest rates and pushed out other investment spending. Now that the Fed is reversing that path, higher government debt levels will be increasingly difficult to maintain and will further crowd out other borrowing and investment spending. If the Fed holds course and does not decrease interest rates, the economy could spin into a deeper recession or worse. Inflation will continue to persist as long as there are gaps in supply chains. High interest rates will at the same time discourage the investments needed to grow the supply chain.

It is now more a matter of when rather than if this system of government indebtedness will collapse under its own weight. The current situation is unsustainable, and it is only a matter of time before we either encounter a very real debt crisis or enact policies to reduce the deficit – policies that will drive the economy into recession or worse.

So here is what we can look forward to for 2023:

- High interest rates will suppress investment spending and put greater recessionary pressure on the general economy.
  - This may delay the recovery of the supply chain, keeping inflation from falling.
  - Residential real estate investment growth will also slacken as housing prices fall and mortgage rates continue to remain high. This will increase the likelihood of a more severe recession.
- High prices for food and energy will put additional pressure on consumer budgets resulting in decreases in consumer spending in other consumer product and service sectors. This may result in employment market slackening in these sectors, increasing the impact of a recession.

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- Without a federal government deficit reduction program, debt will continue to accumulate and result in greater servicing costs, putting pressure on government spending in other categories. This will create additional recessionary pressure on the economy.
    - Additional taxes and/or spending reductions designed to reduce the deficit will put additional recessionary pressure on the economy.
    - It is doubtful that a split congress will be able to create and implement any meaningful strategies and programs to reduce the deficit and accumulated debt level.
    - As individual income tax rates continue to increase in the sixth year of the restoration of rates to their pre-2017 levels, paycheck values and consumer spending will both decline.
- Widening income and wealth gaps between the top five percent and everyone else will have a negative impact on the stability of the economy and many aspects of our society. Poverty and crime rates may increase; the general state of health and well-being may decline; political division may worsen.

The Federal Reserve and federal government both overreacted to the need to sustain the economy during the pandemic. The Fed created and the federal government borrowed and spent about twice as much money as was needed to sustain the economy during the pandemic shutdown.[13] The consequences have been persistent high inflation that remains stubborn despite the Fed's efforts to combat it with high interest rates and reductions in monetary growth. An economy which has come to depend upon low interest rates and steady infusions of money has stalled as a result. High interest rates and debt levels will continue to put a drag on any substantial recovery. We may need to acclimate to a higher level of inflation until the supply chain recovers. High interest rates will slow this recovery and place additional recessionary pressure on the economy in the meantime.

13 Based on comparisons of disposable income, consumer expenditures and by measuring the amount of cash in the banking system, it seems that almost $3 trillion in the money that was created was not necessary to sustain the economy through the pandemic. This is in large part the cause of the inflation we have experienced.

About the Author:

Steven C. Isberg *is the Chair of the Department of Accounting at Towson University and teaches graduate and undergraduate courses in corporate finance, financial analysis and valuation, and financial economic history. As Sr Research Fellow at the Credit Research Foundation he conducts various research studies and delivers online financial analysis courses as part of the CRF Online Classroom™ program. He has over 25 publications in academic and professional journals and has served as a professional business consultant to a variety of firms.*

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2023 – What Does the Magic Eight Ball Say?

By: Chris Kuehl, Managing Director
Armada Corporate Intelligence

So many metaphors, so little time! Is this the "perfect storm"? Is there light at the end of the tunnel and is it an oncoming train? Is the glass half empty or half full (or do you have the wrong vessel for the liquids on hand). I could go on but by now most of the readers are already fed up. All they want to know is what to expect in the coming year. It is actually pretty odd that we expect anything substantial to change as far as the economy is concerned just because there is a new calendar year, but that seems to be the expectation and who am I to buck tradition.

At the start of this year there was an expectation that recessionary conditions would dominate. The first two quarters were indeed in negative territory (down by 1.6% in Q1 and another .6% in Q2). Then there was expected to be an anemic recovery of maybe .3% in the third quarter. Instead, there was a dramatic surge of 2.9% growth in that quarter driven primarily by expanded exports. Now we are waiting to see what the fourth quarter brings with some analysts calling for another sag into negative territory and others assuming there will be a carryover from that growth in Q3. As in most years it will all come down to the actions of the consumer as they determine what kind of year the retailers will see. Initial thoughts hold that consumers are still spending. There was almost $3.5 trillion in excess savings available to spend at the start of the year and much of that is still in play. That was the assumption until the latest retail numbers came out and it was revealed that there was a 0.6% drop in retail activity between November and December. It seems the consumer is erring on the side of caution. The latest surveys of consumer mood show that most are expecting a more difficult year in 2023 – higher inflation and more risk of recession. This is worrying but we also know that consumers are notoriously volatile, and it doesn't take much to make them more upbeat or more downbeat.

The dominant driver of a potential 2023 recession will be the status of inflation. As long as the inflation issue dominates, the central banks will be pushing interest rates up in an attempt to cool the demand that has been fueling consumer and business demand. The primary drivers of inflation for much of the year have been the supply chain breakdown and the sharp hike in commodity costs. In 2021 there was also the driver created by $800 billion in stimulus cash but most of that was dissipated by the middle of the year. The supply chain and commodity drivers started to fade towards the end of the summer months and now the bulk of the inflation has been coming from the sharp wage hikes. This is what tends to worry the Fed (and the other central banks). They see these wages as part of core inflation and there has not been as much decline in the core numbers as for the non-core numbers. If these wage hikes are accompanied by higher productivity levels, the impact on the economy will be reduced but the jury is still out when it comes to the improvement in output from the workforce. The latest manufacturing sector data showed a 0.6% decline and that is the first such dip since June of this year.

In recent weeks there has been a sense that global inflation may have peaked. There are four factors that have led some analysts to this conclusion. The first is that factory gate prices have been falling for the last few months as measured by the Producer Price Index. This means that some of the inputs to the factory sector have started to calm down. The second change is that shipping costs are somewhat less than they have been – about 40% lower than at the start of the year. These are still far higher than was the case prior to the pandemic but less than they were. The third factor has been a dip in many of the commodity prices. Steel and copper are still up but oil has dropped from the $120 and $10 level to around $70 for WTI and these prices are expected to stay in the $80 to $90 range next year (with gas prices at around $3.60 and diesel coming down to around $4.00). The last factor is probably the least predictable – consumer expectations. As long as people think inflation is going to get worse, they tend to want to buy now and that feeds the excess demand that drives higher prices. There are signs that people think prices may stabilize and that makes them more patient.

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What is the good news that comes from all this? If the central banks believe they have done all they need to do, they can start reducing the interest rate pressure. That is already happening as far as the Federal Reserve is concerned as they elected to go with a half point hike in December as opposed to that ¾ jump they have favored the last four times they met. This is the same conversation taking place with the other central banks (European Central Bank, Bank of England, Reserve Bank of Australia etc.). If the patterns of the last four decades hold true, the central banks start to lower rates about seven to eight months after the inflation peak is reached and that would be summer of 2023. The expectation is that rates will hit between 4.25% and 4.50% and the view of the Fed members is that rates may top out at 5.1%. These are the highest rates since 2007 (15 years) but it is useful to remember that the last 15 years have been an anomaly when it comes to rates – they had never been that low and for that long. If one is oriented towards the half full glass, the trends would seem to point to a slow start to 2023 – perhaps a negative reading in Q1 followed by a small gain in Q2 and growth near normal by year's end (around 3.0%). The glass half empty crowd sees a steeper decline in Q1 and only anemic recovery by Q3 and Q4 (perhaps around 2.0%). There are justifications for each point of view, and much will depend on consumer mood and whether or not 2023 will be a year without another "black swan".

About the Author:

Chris Kuehl *is the co-founder (with Keith Prather) and Managing Director of Armada Corporate Intelligence, a company created in 1999 to provide strategy foundation, competitive intelligence, business analysis and economic forecasting for corporate clients.*

Armada's clients include YRC Worldwide, TranSystems, Spencer Fane Britt and Browne, KPMG, Hallmark International, Weitz Industrial among others.

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An Economic Outlook for 2023

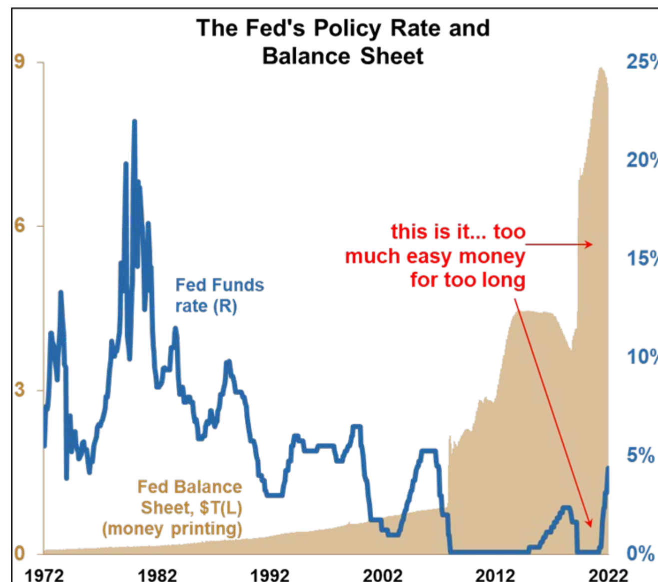
By: Dan North, Senior Economist
Allianz Trade North America

There is some good news at the end of 2022, but not much.
The consumer still has some money to spend to keep the economy going. There is work in the pipeline since according to the Institute of Supply Management's Services Survey (80% of the economy), new orders and back orders are still growing which should provide employment and economic activity for a while. And the labor market is strong. But that will all change in 2023.

The economy is quite likely to go into recession in 2023.
To understand how we reach that conclusion, we need to look all the way back to 2020, because that's when the seeds of inflation, against which we have so desperately battled, were planted.

There were several major causes. Covid shutdowns worldwide caused the global supply chain to grind to pieces, sending prices soaring everywhere. A labor shortage drove up wages. Congress launched massive fiscal stimulus programs totaling $5T, which was too much and was clearly inflationary.

However, it was three mistakes made by the Federal Reserve which really caused inflation to burst into flames. First as shown in the chart below, when the economy shut down in Q2-20, the Fed set emergency policies of enormous virtual money printing, which is the brown area, and 0% interest rates, which is the blue line. The economy then made a dramatic recovery in Q3-20, but the Fed kept those emergency policies in place for a year after they were needed. It was the classic formula for inflation – too much easy money for too long. Second, all through 2021 the Fed maintained that inflation was merely transitory. And finally, after admitting that it wasn't, inexplicably, the Fed waited four more months to do anything about it. By that time inflation was running at a forty-year high of 8.5%. The Fed was hopelessly behind, especially since it takes three to five quarters for changes in monetary policy to have full effect.



source: Federal Reserve, Allianz Trade

As a result, blistering inflation roared through 2022, forcing the Fed to be highly aggressive in raising rates. After a timid start, the Fed made four consecutive 75 bps increases, the fastest pace in 40 years. That brought the Fed Funds rate from 0.13% in February to 4.4% in December, putting the brakes on the economy.

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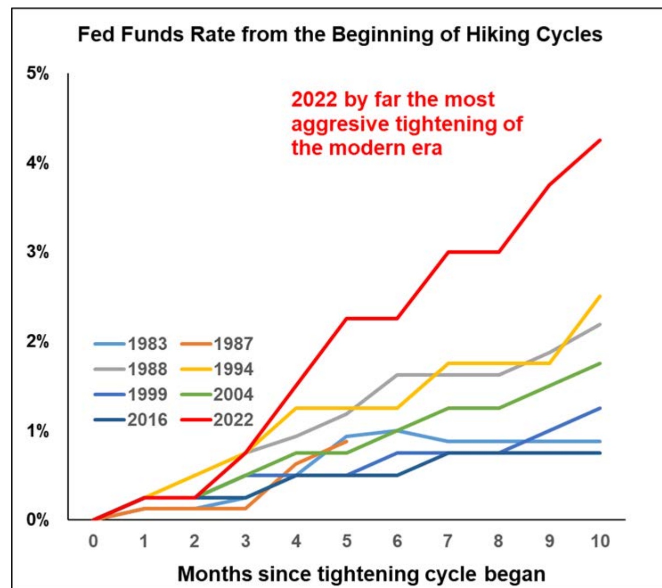

source: Federal Reserve, Allianz Trade

And that's what's going to continue in 2023, because the Fed has said it is going to continue raising the Fed Funds rate by another 100 basis points to 5.4% and leave it there until at least the end of the year, substantially higher than previously thought. It also implies that there will be no interest rate cuts in 2023 at all. That projection is very much at odds with the financial markets and with Allianz Trade, both of whom believe the Fed will have to start cutting towards the end of 2023, because by then, the economy will have been in a recession for some time. When a central bank like the Federal Reserve raises interest rates to strangle inflation, like now, it is deliberately trying to strangle the economy at the same time, and it works, often creating a recession.

The housing market will continue to crumble.
The housing market has been the first major victim (aside from the financial markets) of the Fed's war on inflation, and rising rates through 2023 will surely make things worse. When the Fed declared in December of 2021 that inflation was not transitory, the rate on the 30-year mortgage stood around 3%, and a year later, it had risen to 6.3%. As a result:

- Mortgage applications fell to 23-year lows. Purchases fell -38%, and those for refinancings fell an astonishing -85%. Since rates are likely to continue to rise, mortgage applications will remain at historic lows.
- Starts, permits, and new and existing home sales all fell -20% or more. These activities support employment and economic activity, so when they are falling, they will drag the economy along with them.
- Housing prices as measured by the S&P Case Shiller Index, which had peaked at an extraordinary 20.7% y/y, fell for three straight months to 10.7% y/y in September. That was nice since 20.7% was unsustainable, but so is 10.7%. In fact, it's still outrageously high considering the long-term growth rate is 3.8%.
- The National Association of Realtors Affordability Index combines home prices and mortgage payments to measure the cost of owning a house, and at the end of 2022, since they were both very high, affordability touched a 36-year low. That will take time to recover to more normal levels, dragging on the housing market and the economy in general.
- It's no wonder that the National Association of Homebuilders Index, which asks homebuilders about housing market conditions, plummeted from 84 to 33 after the Fed's "not transitory" admission, indicating that homebuilders are terribly pessimistic about 2023, and people on the front lines are usually right.

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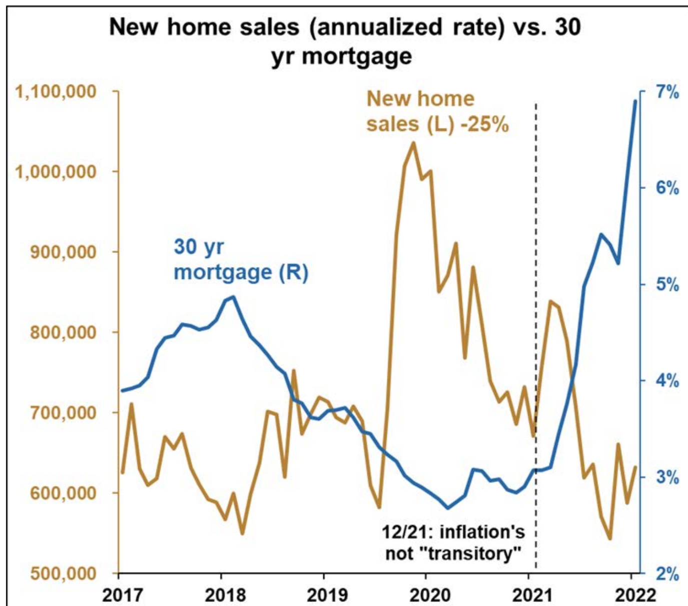
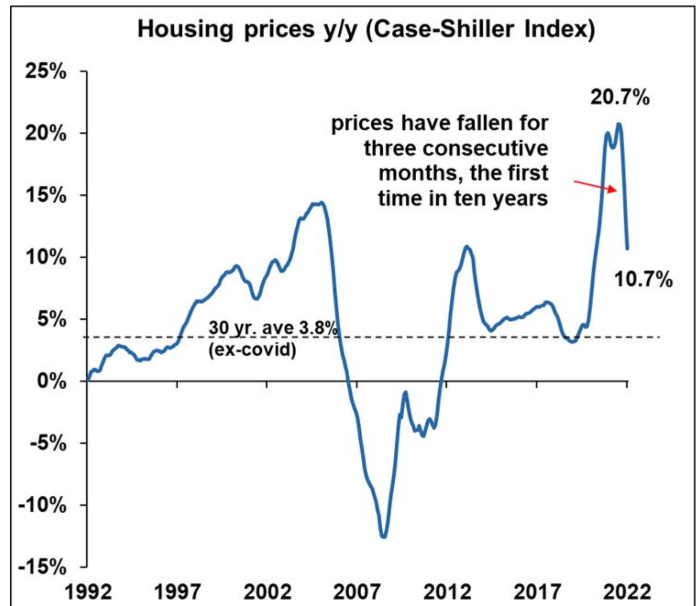
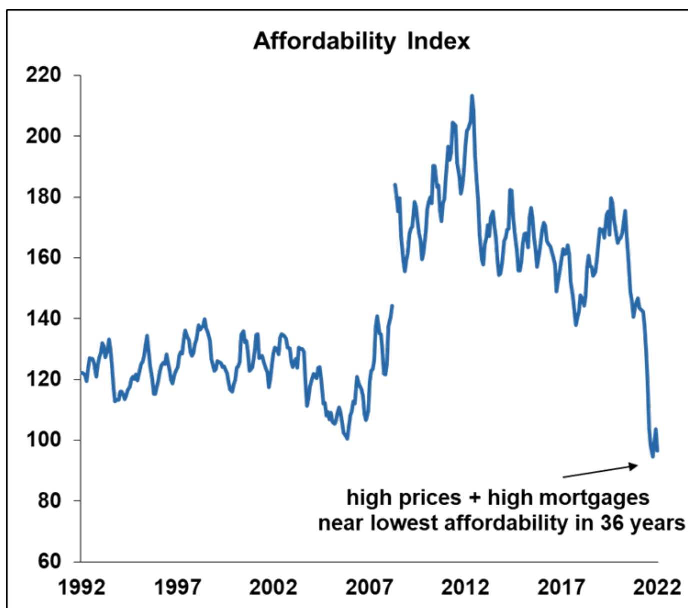
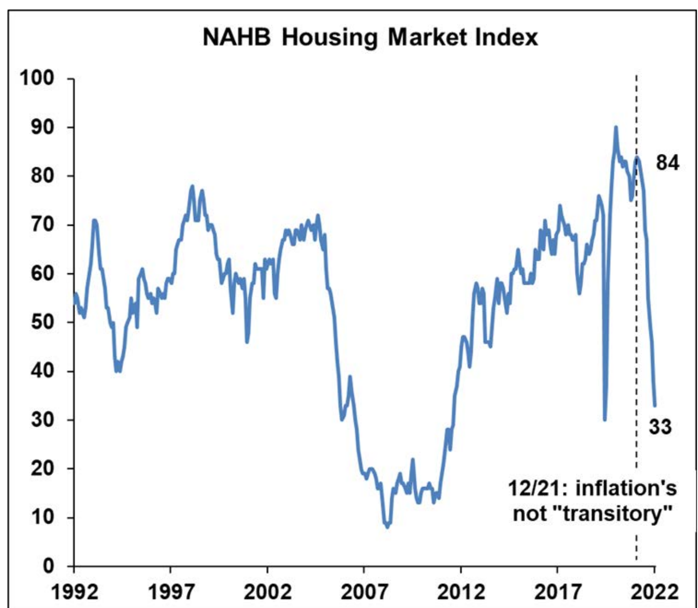




source: Census Bureau, Federal Reserve, S&P/Case-Shiller, Allianz Trade





source: National Association of Realtors, National Association of Home Builders, Allianz Trade

The labor market will continue to deteriorate.
The labor market continues to have strong headlines with low unemployment and vigorous job gains and is often described as “strong” or “tight”. That was true at the end of 2022, but there are several signs underneath those headlines that are pointing to a slowdown ahead, and a recession. And as the Fed continues to mash on the brakes, the labor market will continue to slow.

For example, almost all of the jobs that have been “created” really weren’t created at all, rather they were recovered from the massive losses of March and April 2020. The number of jobs only returned to pre-pandemic levels in June of 2022, more than two years after the losses. And now the y/y rate of job creation/recovery has peaked, slowing from 4.7% in December of 2021 to 3.3% in November of 2022. When the y/y growth rate peaks, it is often followed by a recession.

Still, many people question the idea that a recession is coming when the labor market is so strong. The answer is – “that’s what happens”. Jobs continue to grow until the recession hits, and then the job losses come. The

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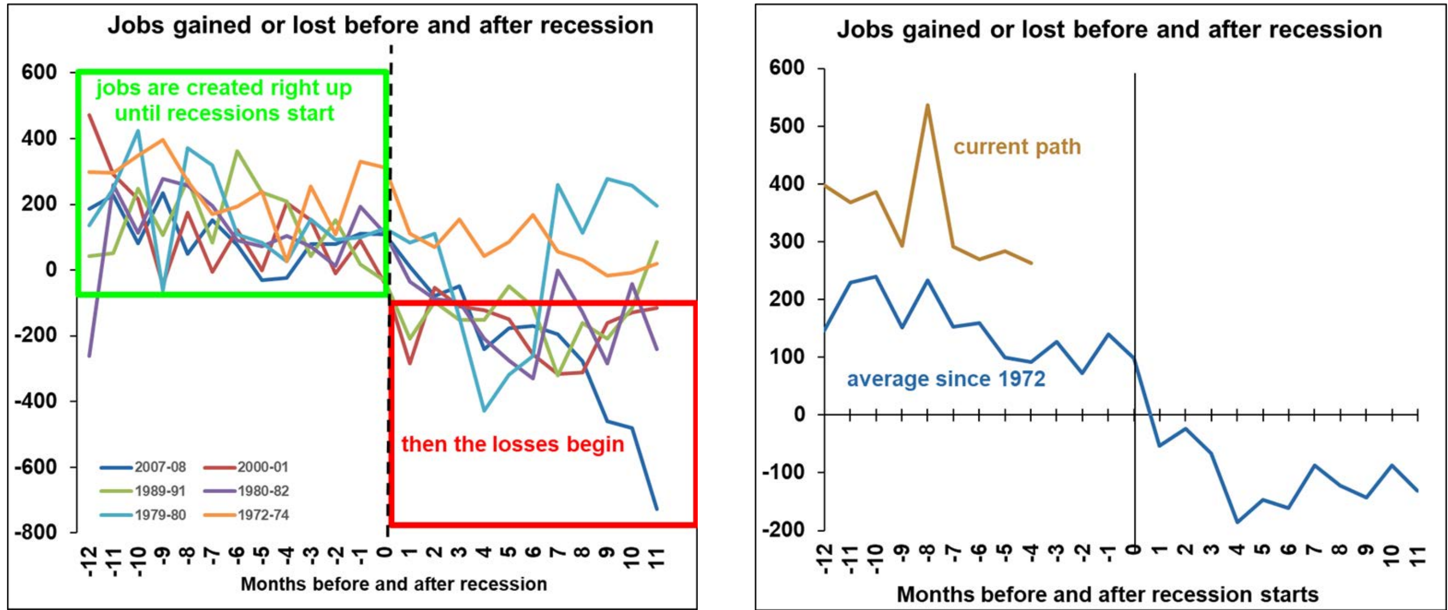
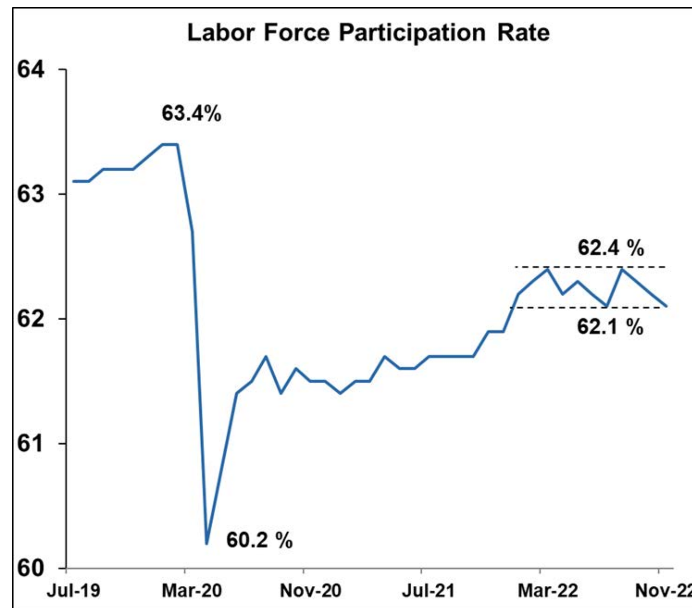
first chart below demonstrates it. Each line in the chart is a separate recession. The horizontal axis goes from 12 months before the recession to 12 months afterward, and the vertical axis is the number of jobs gained or lost. Note that jobs keep growing in the green box until the month the recession starts, represented by the vertical dotted line. Then jobs start to fall in the red box after the recession. The second chart averages all of those recessions together as represented by the blue line. The brown line is the current glide path to the coming recession, and you can see the two paths are rather similar. That means that even though the economy is still growing/recovering jobs now, it could start losing jobs very abruptly.



source: BLS, Allianz Trade

Another example of underlying weakness in the labor market is the labor force participation rate. This is a most fundamental measure of the labor market since it simply shows the percentage of the population driving the economy - those working or looking for work. Unfortunately, it has yet to recover to pre-pandemic levels, and perhaps worse, it has made no progress in 2022, hovering back and forth between 62.4% and 62.1%.



source: BLS, Allianz Trade

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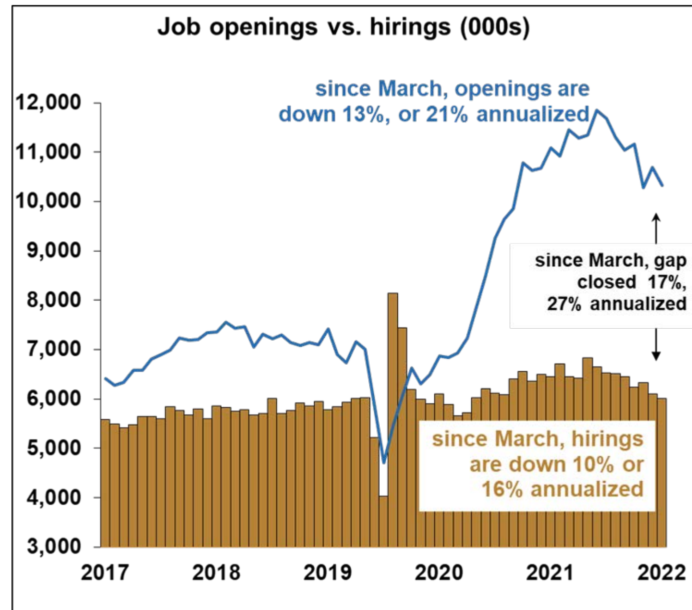
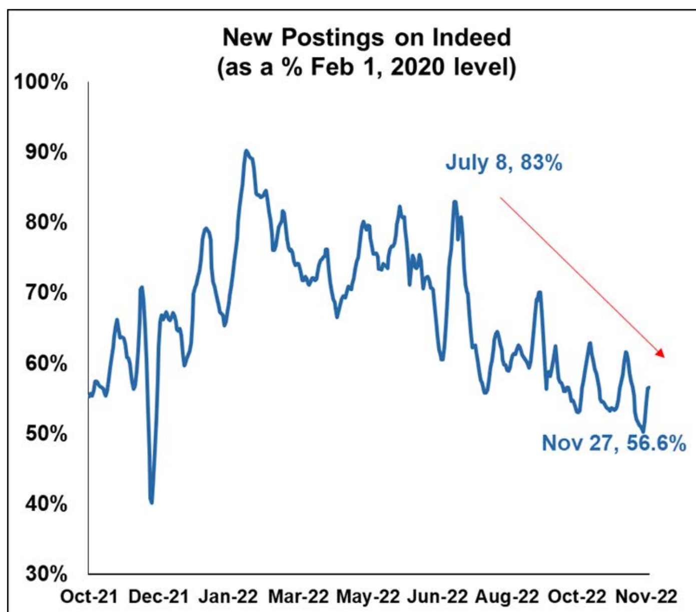
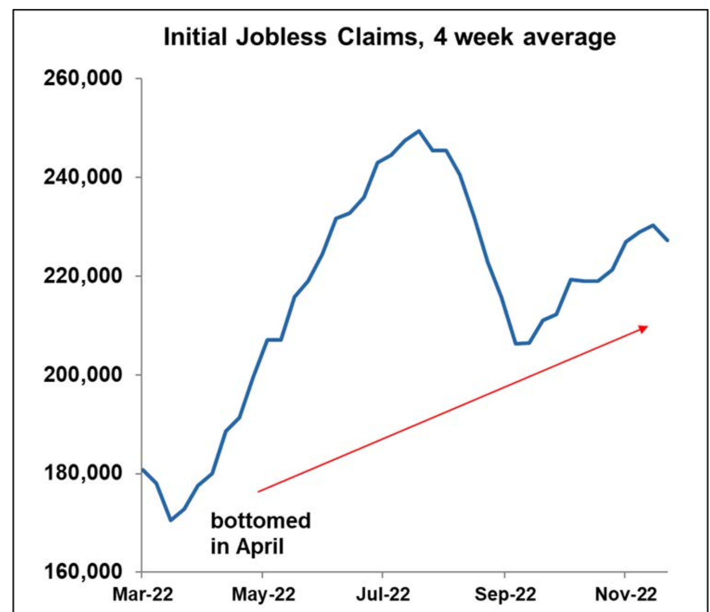
The frail labor market is also apparent in the Job Openings and Labor Turnover Survey (JOLTS). The survey shows that soon after the economy opened back up from the 2020 shutdowns, the number of job quitters rose from 2 million per month to a peak of 4.5 million per month in March 2022. Since then, however, the number of job quitters has fallen at an annualized rate of -16%; it would seem that the great resignation is not so great anymore. The same survey shows that since March, both job openings and job hirings have fallen sharply. The critical gap between the two, which is a measure of the imbalance between labor supply and demand, has fallen at a dramatic -27% annualized rate since March. While the gap itself is still large enough to drive continued wage gains, the hiring window is starting to close.



source: BLS, Allianz Trade

Similarly, new job listings on the Indeed website have plummeted from 83.0% (of the February 2020 level) to 56.6% in five months. Finally, initial jobless claims for unemployment benefits continue to rise, indicating more people are losing their jobs, and that will certainly accelerate in the new year.





source: Indeed, BLS, Allianz Trade

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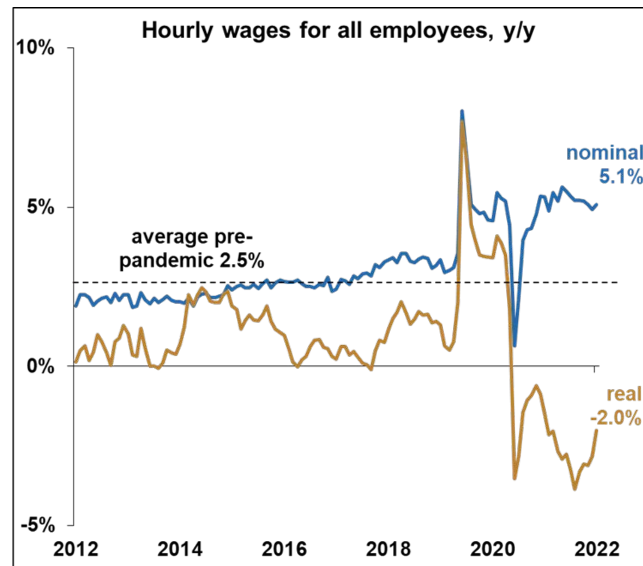
Consumers will be back on their heels.
Throughout 2022, the labor market was indeed strong enough to give a boost to wages. Average hourly earnings rose 5.1% y/y in November 2022, more than twice the pre-pandemic average of 2.5%. But blistering inflation wiped out those wage gains, grinding the real rate down to -2.0% y/y. In addition, income boosts from the $5T worth of fiscal programs have started to wane. As a result, real disposable personal income after taxes (DPI) (which in addition to wages includes items such as Social Security) in October 2022 was shrinking at a -3.0% y/y rate.

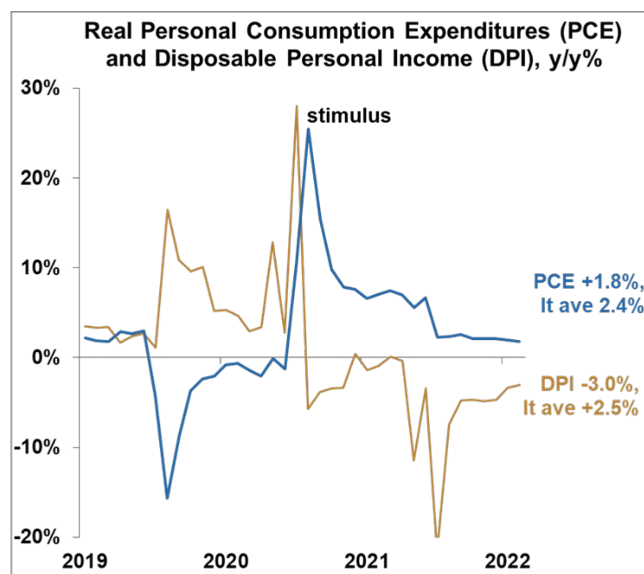


source: BLS, Allianz Trade

That real DPI is the fuel for real personal consumption expenditures (PCE), which makes up 70% of all economic activity. Therefore, shrinking real DPI is an ominous sign for the economy.

In fact, real PCE started the year growing at a 5.6% y/y rate but withered away to only 1.8% y/y in October. In addition, November real retail sales, which are about 40% of PCE, shrank at a -0.6% y/y rate. The core rate of retail sales, which strips out certain volatile components and gives a better underlying measure of sales growth, fell at a -1.7% y/y rate. The data confirmed what some major retailers were telling us – November sales were falling off of a cliff.

Consumers have been resilient, but in the New Year as income continues to slide and prices remain high, consumers might be knocked back on their heels.



source: BEA, Allianz Trade

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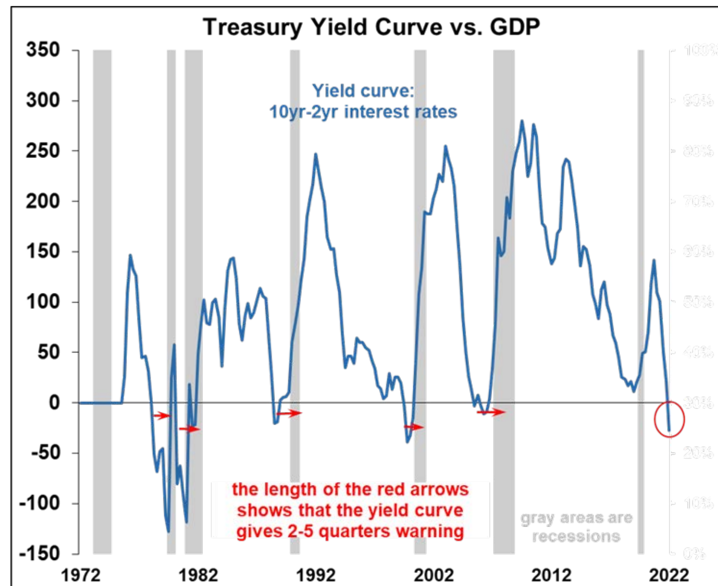
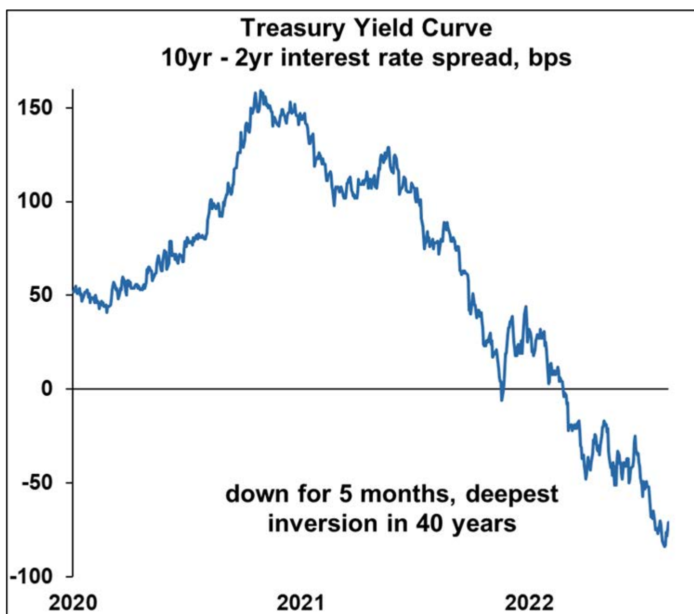
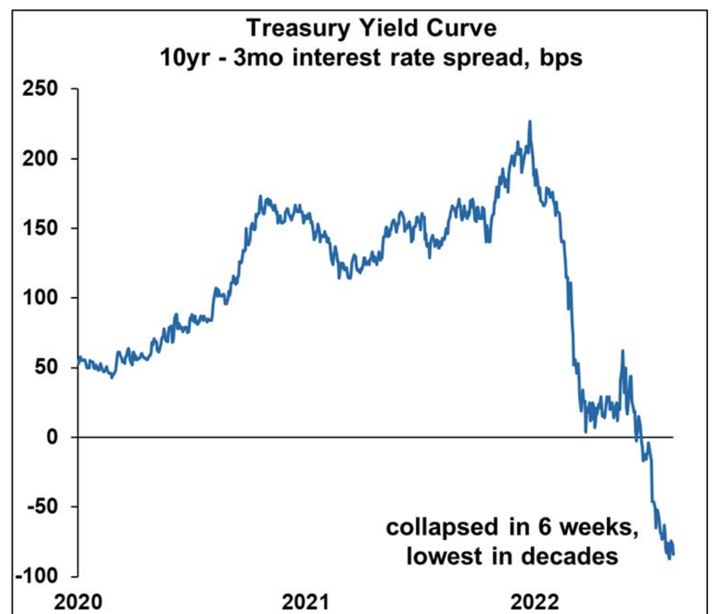
Leading indicators point to trouble.
As the Fed continues to raise rates, several leading indicators which have been highly reliable predictors of a recession, are all flashing red.

The first is the yield curve which is simply the difference between long- and short-term interest rates. In the chart below it's the difference between the 10-year Treasury yield and the 2-year Treasury yield as represented by the blue line. Usually, the line is positive since long-term rates are usually higher than short-term rates. However occasionally, like now, the Federal Reserve starts jacking up the Fed Funds rate, dragging other short-term rates with it, until they become higher than long-term rates, and the blue line goes negative. This is called an inverted yield curve, and every time it happens, it is followed by a recession (the gray columns) in three to five quarters – the length of the red arrows. The blue line is now deeply negative, clearly signaling an impending recession. That chart was plotted using quarterly data. The second and third charts are plotted using daily data which is more up-to-date. The 10-year – 2-year spread has been inverted for five months and is at the deepest inversion in 40 years. Another part of the yield curve, the 10-year – 3-month spread, collapsed at the end of October and is at the deepest inversion in decades.



source: Federal Reserve, BER, Allianz Trade





source: Federal Reserve, Allianz Trade

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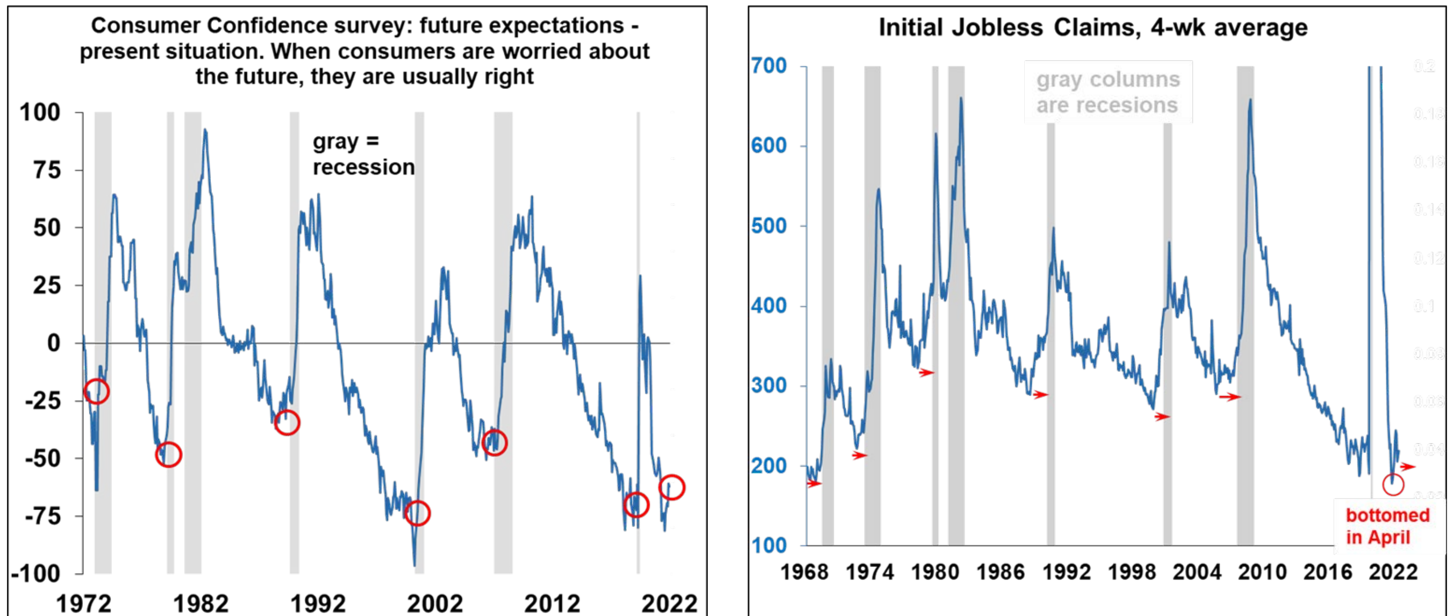
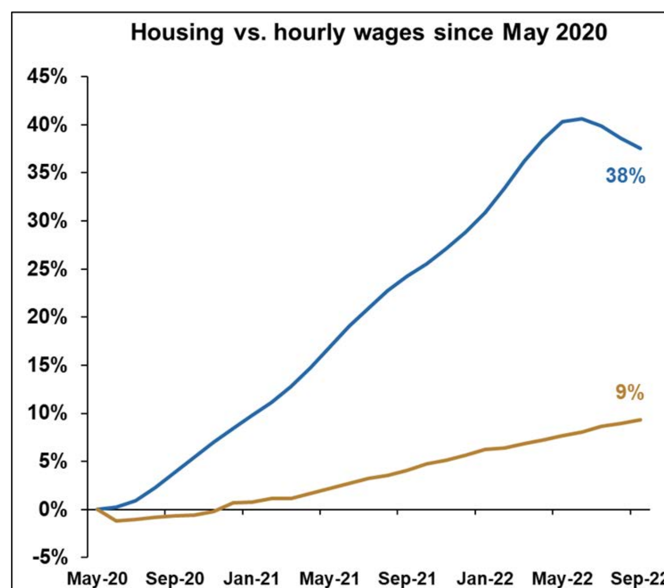
Another leading indicator of a recession is derived from The Conference Board's Consumer Confidence survey. There are several components of the survey including respondents' replies regarding how they feel about the present situation of the economy, and their expectations about the future of the economy. The difference between the two is represented by the blue line in the chart. When future expectations are much worse than the assessment of the present situation, the blue line goes negative, and once it bottoms out, it signals an imminent recession. Like the yield curve it has been a perfect indicator, and it bottomed out in June. It turns out that when consumers are worried about the future, they are right to be so. In addition, initial jobless claims also have a perfect record as shown below, and they bottomed out in April.



source: Conference Board, BER, BLS, Allianz Trade

Finally, it should be noted that a deflating asset bubble is not necessarily an indicator of a recession, but a bursting asset bubble can be part of a recession. As previously mentioned, the housing market is deflating, which is a good thing, since as shown in the chart below the rapid increase in housing prices relative to wages was clearly unsustainable.



source: S&P/Case-Shiller, BLS, Allianz Trade

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The Federal Reserve is on a mission.
There is no question that the Fed must defeat this inflation which has been so devastating, particularly to lower-income families. But the Fed started too late and as a consequence has had to become highly aggressive in the battle. Concerns about economic growth have almost been brushed aside as an afterthought. The Fed's rate increases have strangled the housing market, slowed the labor market, knocked back consumers and set the leading indicators to red alert.

The recession is likely to last around three quarters and be relatively shallow, but it is definitely coming. Unfortunately, some will suffer terrible hardship as a result. While it may be precious little comfort to know, recessions are a part of the economic cycle. We are overdue for one in the sense that before Covid, we enjoyed the longest period of economic growth in U.S. history at almost 11 years. Recessions do come along every five to ten years and enduring one can be dreadful. Then we recover.

About the Author:

Dan North *is an Economist with Euler Hermes, North America. Mr. North has been with Euler Hermes North America since 1996. He has appeared on CNBC, Fox Business News, France 24, and Bloomberg Radio and Television. He has been quoted by Barron's, Business Week, Paris Le Monde, Tokyo Nikkei, the New York Times and the Wall Street Journal. After having predicted the 2008/2009 recession and its implications accurately, he was ranked 4th on Bloomberg's list of the 65 top economic forecasters in 2010.*

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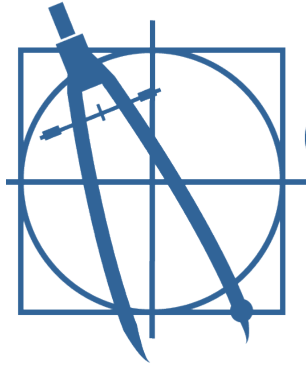

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