An Economic Update

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State of the U.S. Economy

Bottom Line in a Nutshell

- The expectations are that the US economy will fall into recession at some point in the first quarter of 2023.
- The recession is projected to end in the third quarter of 2023.
- The peak-to-trough decline in output over those three quarters is 0.7%.
- Before the “Great Recession” of 2008-2009, the average peak-to-trough decline of GDP during post-WWII recessions was 1.7%.

Bottom Line

The coming recession is characterized as mild by historical standards.

A recovery, initially anemic, begins in 2023 Q3 but gains momentum in 2024 when the Fed reverses course and begins lowering interest rates in response to declining inflation.

The previous peak of GDP will be surpassed in 2024 Q1 when the next expansion begins.

The unemployment rate rises 2.2 percentage points, peaking at 5.7% early in the recovery, before then declining gradually towards the full-employment rate of 4.3%

Rest of the Story

- Projection for real GDP growth in 2022 is 2.0% and 0.5% in 2023.
- Projected GDP growth is 1.8% in 2024.
- BEA revised up its estimate of 2002-Q3 growth of real GDP from 2.9% to 3.2%.
- The estimate for Q4 growth was raised sharply from 0.7% to 2.3%, to reflect unexpectedly strong net exports and inventory investment in November.
- Overall, in the second half of 2022, GDP grew at an above-trend 2.7% annualized rate after declining at a 1.1% rate over the first half of the year.

Rest of the Story

- Labor markets are unsustainably tight, and inflation sits intolerably above the Fed’s long-run 2% objective.
- For now, the Fed is singularly focused on preventing inflation from becoming entrenched and so, over the course of 2022, engineered a tightening of financial conditions that, <u>with a lag</u>, will tip the US economy into a mild recession this year.
- We continue to assume the Federal Open Market Committee raises the Fed’s policy rate to the range of 4.75% - 5.00% by March, reversing course in the spring of 2024.

Rest of the Story

- **The recession will be investment-driven**
- consumer spending grew modestly in 2022 and will do the same in 2023 but expect investment spending to decline in 2023.
- Within investment, the sharpest and earliest declines are in the residential component.
- Housing has been hit especially hard by the recent tightening of financial conditions, which has seen not only a sharp rise in Treasury yields, but also a widening of the spread from Treasury yields to the conventional mortgage rate.

Rest of the Story

- Single-family housing permits have been plummeting under the weight of sinking affordability.
- After reaching a peak of about 1.2 million (annual rate) in February, single-family housing permits sunk all the way to about 0.9 million in September and are forecast to fall further to 0.7 to 0.8 million during the first quarter of 2023.
- Existing home sales are exhibiting a similar pattern, having reached a peak of 6.5 million (annual rate) in January and fallen to 4.7 million by September; we assume existing home sales decline further to a pace of 4.1 million.

Rest of the Story

- **Consumer wealth**
- The personal saving rate edged up 0.2 percentage point to 2.4% in November.
- Roughly, $2.4 trillion of “excess savings” added to household wealth during the pandemic allowed consumers to maintain higher level of spending in the face of rising prices.
- Real household net worth surged 8.2% in 2021 (q4 to q4), due to large gains in home prices and surging equity markets.
- Sharply higher consumer prices and weak stock prices have resulted in an 8.9% (q4 to q4) decline in real household net worth in 2022.
- Real disposable personal income rose 1.9% in 2021 after a 6.2% stimulus-boosted jump in 2020.
- As fiscal stimulus (direct payments and emergency unemployment aid) has ended and inflation has taken off, forecast shows a 6.4% decline in real DPI in 2022.

Rest of the Story

- **Housing Market**
- House prices fell in December—the sixth consecutive monthly decline—and by more than what was anticipated.
- House prices most likely will show a peak-to-trough decline of 10% by early 2024.
- November's single-family housing numbers were harsh: Single-family permits sank 7.1%, dropping for the ninth-straight month. Existing home sales tumbled 7.7%, the 10th-straight monthly setback.
- With profit margins shrinking (or in the red), builders will continue to scale back on starting new single-family homes; and multifamily starts will also come down soon--with rents easing and nearly a million units under construction, recent levels are un- sustainable.
- Housing starts are expected to drop from 1.61 million in 2021 to 1.56 million in 2022 (previously 1.55 million), 1.19 million in 2023 (previously 1.18 million), and 1.26 million in 2024 (previously 1.24 million).
- Nominal house prices are forecasted to decline 9% from a second-quarter peak in 2022 through early 2024 — or 15% over nine quarters after accounting for CPI inflation.
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Rest of the Story

- **Inflation remains elevated, but will ease sequentially**
- In November, the CPI increased 0.1%; the 12-month change was 7.1%, down from 9.1% in June and suggesting headline inflation has peaked.
- The core CPI increased a moderate 0.2%. Its 12-month change fell from a cycle high of 6.5% in March to 6.0%.
- Inflation surged as post-pandemic demand recovered faster than could be accommodated by supplies of commodities and labor disrupted first by COVID, then by war in Ukraine.
- In addition, rents accelerated in lagged response to soaring house prices. We expect these pressures to moderate in 2023 as commodity shortages ease and unemployment rises.
- As the availability of chips improves and vehicle production rebounds, a decline in the price of motor vehicles are expected to contribute to a sequential easing of core inflation over 2023 and 2024.
- Also, a decline in energy prices, and a deceleration in food prices, will push headline inflation below core inflation in 2023 and 2024.
- Core PCE inflation is forecasted to drop sharply, from 4.8% in Q4 of 2022 to 2.6% by Q4 2023 as supplies of commodities improve, then decline more slowly to 2.0% by 2025 in response to softening labor markets conditions.
- The CPI which rose by 8.1% in 2022, will go up 4.3% next year, and 2.7% in 2024.

Rest of the Story

- **Labor market**
- Nonfarm payroll employment expanded by 223,000 in December, down from an average increase of 263,000 over the prior three months and well below the average over the prior three months of 405,000 per month in the second quarter.
- The unemployment rate has been trending sideways since last spring.
- Over the next several months, we assume that payroll employment peaks (in December) and then begins declining in the first quarter. We also assume that the unemployment rate begins trending up within the next couple of months.

Fed, the Economy and the Soft Landing

- The Fed and other central banks are raising interest rates at the fastest pace in more than four decades to beat back inflation by slowing economic growth.
- The cliché is that a central bank's job is to take away the punch bowl.
- The Fed and central banks have already lifted rates mightily in a short period— for the U.S., the midpoint of its target range will presumably be 3.875%, compared with 0.125% as recently as March of 2022.
- The Federal Reserve's main tool for managing the economy is to change the federal-funds rate, which can affect not only borrowing costs for consumers but also shape broader decisions by companies like how many people to hire.
- Why has the Fed's effort not paid off yet?

Fed & the Economy

- In 2020, the government's wartime-like response to the pandemic—generous fiscal stimulus that showered cash on households and reduced borrowing costs—interrupted the usual economic dynamics.
- It means private-sector balance sheets are in a historically strong position.
- Consumers built up unprecedented savings buffers during the Covid-19 pandemic, thanks to government stimulus and fewer opportunities to spend.
- The extra cash helped households pay down debt, buy goods like new appliances and furniture during lockdowns and take vacations once restrictions lifted.
- It gave businesses leeway to raise prices and hire more workers to meet stronger demand.

Fed & the Economy

- That buffer, combined with a strong labor market and rising wages, has helped consumers continue spending in recent months, even with inflation and <u>mortgage rates at multidecade highs</u>.
- U.S. retail sales posted their <u>strongest gain in eight months</u> in October.
- In 2019, before the pandemic hit, households saved 8.8% of their disposable income.
- That saving rate jumped to 16.8% in 2020, the highest annual saving rate on record
- In 2021 the saving rate moderated to 11.8%, and it has fallen further during 2022.
- The rate has been below 4% for seven straight months and in November it stood at 2.4%, near its lowest level since the 2008 financial crisis.

Fed & the Economy

- This suggests that consumers are spending more and saving less of their monthly income than normal, because inflation forces them to spend more on higher-priced goods and services.
- Economists’ estimates for how much consumers have left vary.
- Some estimates that at the current rate of rundown, it could last another year or so.
- JPMorgan Chase & Co. put the hoard at about $1.2 to $1.8 trillion in the third quarter and said it could be entirely spent by the second half of next year.

Fed & the Economy

- What will the Future Hold?

- Forecasters have ratcheted up their expectations for a recession because they increasingly doubt the Fed can keep raising rates to cool inflation without inducing higher unemployment and an economic downturn.
- Majority of economists said they think the Fed will raise interest rates too much and cause unnecessary economic weakness
- Soft landing will likely remain a mythical outcome that never actually comes to pass. A soft landing occurs when the Fed tightens monetary policy enough to reduce inflation, but without causing a recession.

Alabama’s Economy

- Alabama’s labor market performance is robust and strong.
- The performance of the labor market from January of 2019 to January of 2020 averaged at 40,230 additional jobs per month.
- This figure was close to the steady state growth trend.
- However, the pandemic of 2020 completely derailed the state’s labor market momentum.
- The ensuing recovery was strong yet at times uneven.
- It appears that the labor market will continue its growth in the 2022 at a rate that will be stronger than that of 2021.
- Even with weaker GDP growth in the U.S. we have yet to see a discernable and persistent weakness in the State’s labor market.

Alabama’s Economy

- Based on the recent reports released by the Alabama Department of Labor, Alabama’s unemployment rate in October 2022 is at 2.7%, which is a full percentage point below that of the U.S. rate and its job gain is at 47,000.
- Largest job gains are recorded in Education and health services, Professional Businesses Services and Manufacturing (goods Producing).
- State coffers are flush with cash and all balance sheets in every city and county are in excellent shape.
- There will be necessary adjustments to economic ills to attend as recession begins to roll in.
- We are, however, right now in the best economic shape we have been in a long while.