QUEST Economic Update | May 2022

US economic expansion continues, but with high inflation and rising interest rates

US economic growth is expected to continue but faces significant challenges. Inflation continues to surge, and the labor market remains very tight. Russia's invasion of Ukraine is further disrupting supply chains and fueling inflation. Growth in China has slowed due to COVID lockdowns. The Federal Reserve is tightening monetary policy to combat inflation. The extent and timing of the tightening raises concerns over a possible over correction. GDP fell by 1.4% in the first quarter in part due to drops in inventory-related business investment and exports. Forecasts for US economic growth have dipped to 2.5% for 2022.

The consumer price index (CPI) rose by 8.3% annually in April. Except for the 8.5% increase in March, this was the largest increase in four decades and the seventh consecutive month with above 6% inflation. While Russia's invasion of Ukraine has fueled the surge in energy, agricultural, and other commodity prices, the COVID-related lockdowns in China may reduce some pressure, particularly related to energy prices as China's economy slows. The rise in inflation may have already peaked or will in the next several months. However, the inflation rate is expected to remain elevated, possibly around 5% at year end.

The Federal Reserve increased interest rates by 50 basis points at its May 3-4 meeting and is expected to further increase interest rates by a similar magnitude at its next several meetings. Interest rates are expected to rise by 250 to 275 basis points in 2022. The Federal Reserve has also indicated that it would begin to reduce its balance sheet, which had more than doubled during the pandemic, beginning in June.

Ernst & Young LLP's Quantitative Economics and Statistics (QUEST) group's Economic Update summarizes the latest US economic trends and significant global developments.

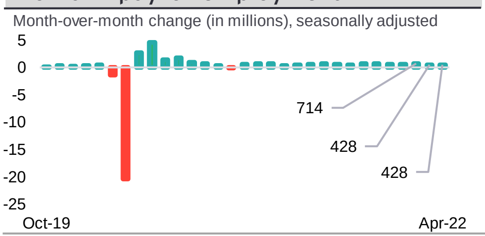
Overall US economy

The US economy continues to expand. Despite the 1.4% contraction during the first quarter, forecasters estimate that the US economy will expand by roughly 2.5% in 2022. Inflation, supply-chain disruptions, Russia's invasion of Ukraine and monetary tightening all pose risks. Recession concerns appear more pronounced in 2023 than 2022.

Labor markets

Labor markets are tight with the April unemployment rate remaining at 3.6%. The US economy added 428,000 jobs in April, the same as in March. The labor force decreased by 0.4 million in April and the labor force participation rate fell 0.2% to 62.2%, 1.2% below pre-pandemic levels. In March, job openings exceeded the number of unemployed by 5.6 million.

Nonfarm payroll employment

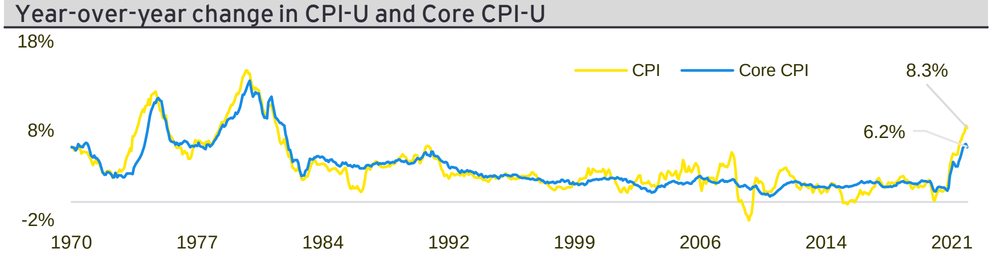


Unemployed workers per job opening

Inflation

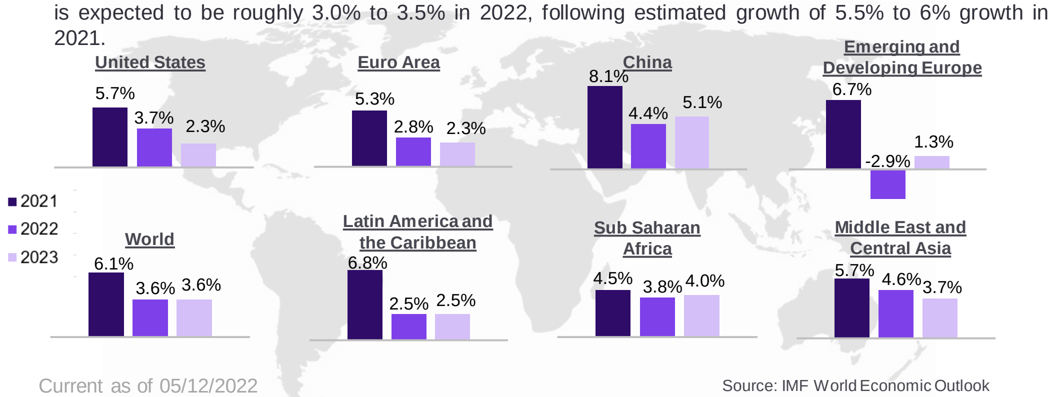
The April CPI report had consumer prices rising by 8.3% from a year ago, the largest increase in four decades, except for March's 8.5% increase. Supply-chain disruptions, rising energy and food prices, and Russia's invasion of Ukraine are all contributing factors. The rise in inflation may have peaked but is expected to remain near 5% toward the end of 2022. The Federal Reserve's target rate is about 2%.

Year-over-year change in CPI-U and Core CPI-U



Global growth

Forecasts for economic growth in the United States and China have tempered somewhat. Global growth is expected to be roughly 3.0% to 3.5% in 2022, following estimated growth of 5.5% to 6% growth in 2021.



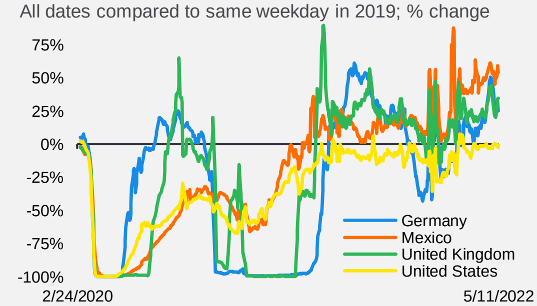
Source: IMF World Economic Outlook

Real-time indicators

Due to rapidly changing economic conditions over the past two years, traditional economic data have not fully captured the dramatic turn from growth to recession to expansion. Analysts have relied more heavily on real-time data (e.g., Google trends) to take the economy's pulse and predict economic conditions going forward. Recent data on consumer confidence suggest some flatness, likely due to Russia's invasion of Ukraine, supply-chain disruptions, and hiring difficulties. Energy prices rose markedly with Russia's invasion of Ukraine, but have more recently pulled back, possibly due to the COVID-related lockdowns in China. The increase in in-person dining and workplace visits suggests continued recovery in the hospitality sector.

Global OpenTable reservations

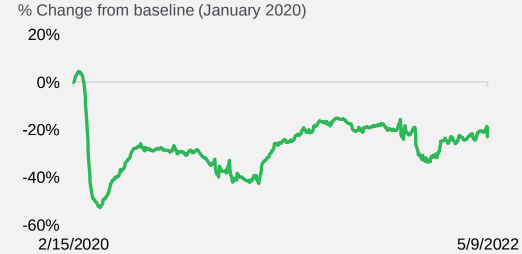
All dates compared to same weekday in 2019; % change



Note: Seven day moving average.
Source: OpenTable reservations.

US workplace visits

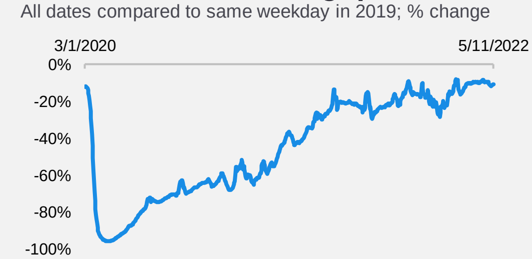
% Change from baseline (January 2020)



Note: Represents seven-day moving average.
Source: Google Mobility Reports.

US TSA traveler throughput

All dates compared to same weekday in 2019; % change



Source: TSA.

Overall US economy

The US economic expansion continues but is facing significant headwinds. Although the US economy shifted from 6.9% growth in the fourth quarter of 2021 to a contraction of 1.4% in the first quarter of 2022, the large swing was primarily related to a sharp reduction in business inventory investment and exports. Both consumer spending and business investment grew and will likely support continued growth in the near term. Many economic forecasters see growth of about 2.5% in 2022, lower than prior forecasts, but indicating continued economic expansion for the remainder of this year.

COVID has, at least for now, faded. The inflation surge has either peaked or is expected to within the next several months. Supply-chain disruptions arising from the pandemic have been exacerbated by Russia's invasion of Ukraine and, more recently, the COVID-related lockdowns in China.

The Conference Board's consumer confidence index fell to 107.3 in April from 107.6 in March. The ISM Manufacturing PMI fell to 55.4 in April from 57.1 in March. The ISM Employment Index fell sharply to 50.9 in April from 56.3 in March. Industrial production and capacity are above their pre-pandemic levels.

An April Bloomberg survey puts the likelihood of recession this year at 15% but rising to near 50% in 2023. This suggests concerns over a possible over correction by the Federal Reserve as it tightens monetary policy to combat the surge in inflation. Interest rate increases in 2022 are expected to total 250 to 275 basis points, which suggests several additional 50 basis point increases are likely over the next several Federal Open Market Committee (FOMC) meetings.

Labor market

The US labor market remains tight and is characterized by hiring difficulties. In March, job openings exceeded unemployment by 5.6 million. The US economy added 428,000 jobs in April, the same as in March. Overall, by March 2022, the US economy had recouped 95% of the 22.4 million jobs lost in March and April 2020.

Other signs of a tight labor market include the low unemployment rate. The April unemployment rate was 3.6%, the same as in March and near the 3.5% unemployment rate just before the start of the pandemic. The unemployment rate averaged 4.4% from 2015 through 2019. Many economists view the unemployment rate at which the economy's resources are fully employed to be about 4.4% to 4.5%. Hence, the low unemployment rate is seen by some economists as contributing to the overheating of the economy. The Federal Reserve expects the unemployment rate to average 3.5% during 2022.

The underemployment rate was 7.0% in April, well below the 8.7% average from 2015 through 2019. The April labor force participation rate was 1.2 percentage points below its level in February 2020. Despite some improvement in the labor force participation rate since the pandemic, the labor force participation rate is 1.2 percentage points below its level in February 2020 and is about 2.9 million jobs below trend.

Average hourly earnings have increased each month since April 2021 (up 5.5% in April from a year ago). While significant and reflecting the tightness in labor markets, these have not kept pace with the rise in consumer prices.

Inflation

By most measures, inflation remains at levels not seen in decades. The sources are varied--surging demand for goods as the economy recovered from the pandemic, excess fiscal and monetary stimulus, and collateral effects of Russia's invasion of Ukraine. Supply-chain disruptions and labor shortages are derivative of these factors but have had important feedback effects. The potential unwinding of $2.5 trillion in pandemic-related savings may further support economic growth.

Consumer prices increased by 0.3% in April and by 8.3% over the past 12 months, slightly below the 8.5% increase in March. Energy prices subsided somewhat, possibly due to the slowdown in China's economy from their COVID-related lockdowns. The core inflation rate, which excludes volatile energy and food prices, was 0.3% in April and 6.2% over the past 12 months. Producer prices and wage costs have also been surging.

If the surge in inflation has not already peaked, it is expected to within the next month or two and then begin to subside through the remainder of this year and into 2023 as supply-chain disruptions resolve and the Federal Reserve increases interest rates to quell demand. Nevertheless, many economic forecasters have the inflation rate remaining near 5% at year-end.

The Federal Reserve is tightening monetary policy. Interest rate increases of 250 to 275 basis points are expected in 2022, with 50 basis point increases possible, if not likely, over the next several FOMC meetings. The Federal Reserve will begin to reduce its balance sheet, which had been doubled in response to the pandemic.

A significant issue is whether the Federal Reserve will be able to engineer a soft landing or over correct and push the economy into recession. An April Bloomberg survey put the likelihood of recession at 15% in 2022, but near 50% in 2023.

Global growth

The global economy is expected to grow by 3% to 3.5% in 2022, following estimates of 5.5% to 6% growth in 2021. The global economy contracted by 4% in 2020. Recent forecasts for growth in the United States and China have been reduced somewhat. Forecasts in other countries depend very much on the status of COVID, vaccinations and the policy response to inflation in each country.

Various risks to the global recovery include the impact of the invasion of Ukraine, vaccine administration, COVID variants, trade tensions, potential geopolitical alignments and significant shifts in the policy agenda in the United States and elsewhere. Nevertheless, the global economic recovery is expected to continue through 2022 and into 2023.

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