

QUEST Economic Update | June 2022

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

The US economy is expected to continue to expand, but forecasts have fallen from roughly 3.5% annual growth at the start of the year to roughly 2% in June. The continuing surge in inflation and the Federal Reserve's resulting tightening of monetary policy is increasing the likelihood of recession either this year or next. A recent survey by the Wall Street Journal now puts the likelihood of recession in the next 12 months at 44%, up from 28% in April and 18% in January.

The consumer price index (CPI) rose by 8.6% in May, above the 8.3% increase in April and 8.5% increase in March. This is the largest increase in four decades and the eighth consecutive month with inflation above 6%. The rise in consumer prices is broad-based, and its persistence caused the Federal Reserve to increase the federal funds target rate by 75 basis points at its June 14-15 meeting. The Federal Reserve is expected to increase rates by another 75 basis points at its next meeting on July 26-27, and its interest rate increases are expected to total 350 basis points by year-end. The Federal Reserve also began to reduce its balance sheet in June.

The labor market remains tight with a 3.6% unemployment rate. The Federal Reserve's June forecast predicts unemployment will edge up to 3.7% for 2022, 3.9% in 2023 and 4.1% in 2024. The anticipated rising unemployment rate reflects the effects of the Federal Reserve's monetary tightening on labor markets as it attempts to slow demand.

Overall US economy

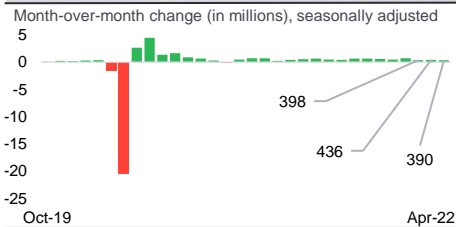
The US economy continues to expand. Forecasters estimate that the US economy will expand by roughly 2.0% in 2022, down significantly from earlier forecasts. Inflation, supply-chain disruptions, the Ukraine war, and monetary tightening all pose headwinds. Recession worries abound.



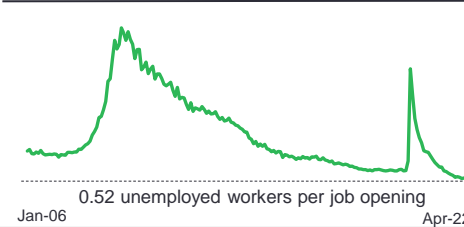
Labor markets

Labor markets are tight, with the May unemployment rate remaining at 3.6% and April job openings exceeding the number of unemployed by 5.5 million. The US economy added 390,000 jobs in May, down from 436,000 in April. The labor force increased by 0.3 million in May and the labor force participation rate increased 0.1% to 62.3%, 1.1% below pre-pandemic levels.

Nonfarm payroll employment



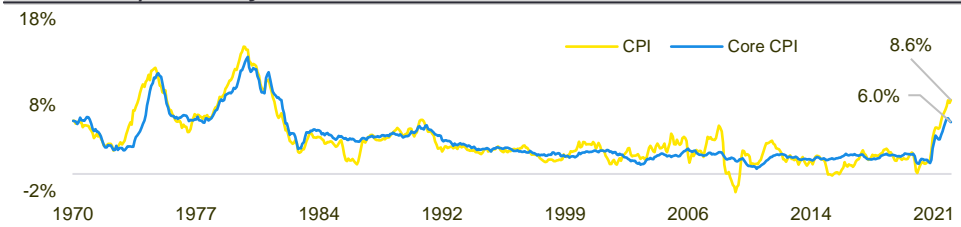
Unemployed workers per job opening



Inflation

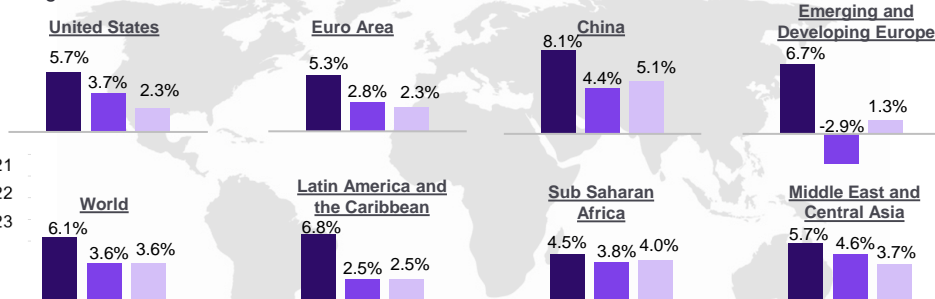
The May CPI report had consumer prices rising by 8.6% from a year ago, the largest increase in four decades. Supply-chain disruptions, rising energy and food prices, and Russia's invasion of Ukraine are all contributing factors. The surge in inflation has caused the Federal Reserve to tighten monetary policy and increase interest rates more aggressively.

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. The global economy is expected to grow by roughly 2.5% to 3.5% in 2022, following estimated growth of 5.5% to 6% growth in 2021.

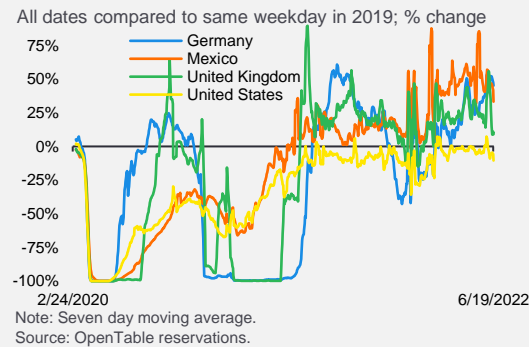


Ernst & Young LLP's Quantitative Economics and Statistics (QUEST) group's Economic Update summarizes the latest US economic trends and significant global developments.

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, workplace visits and air travel suggests continued recovery.

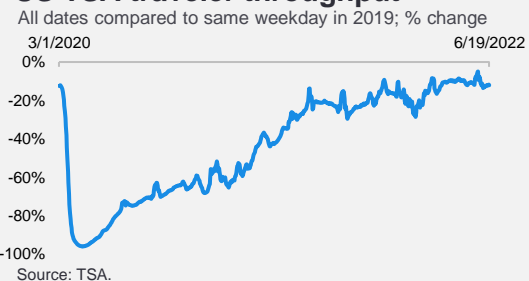
Global OpenTable reservations



US workplace visits



US TSA traveler throughput



Overall US economy

The US economic expansion continues but is facing significant headwinds. The first-quarter contraction of 1.4% was largely due to sharp reductions in business inventory investment and exports. Both consumer spending and business investment grew and likely are supporting growth in the second quarter. Other positive news is that COVID has faded as a significant factor affecting economic growth in the United States.

Inflation, however, continues to surge. Labor markets remain tight. Supply-chain disruptions continue, and growth in China has slowed due to COVID lockdowns. The war in Ukraine, with its impacts on energy, food and other commodity prices and supply chains, continues. The increasing persistence of inflation has caused the Federal Reserve to more aggressively increase interest rates.

Labor market

The US labor market remains tight. In April, job openings exceeded unemployment by 5.5 million. The US economy added 390,000 jobs in May, down from 436,000 in April. Overall, by May 2022, the US economy had recouped 96% 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 May unemployment rate remained at 3.6%, 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, at least some economists view the low unemployment rate as contributing to the overheating of the economy.

Inflation

By nearly any measure, inflation is broad-based and at levels not seen in decades. Consumer prices increased by 1.0% in May and by 8.6% over the past 12 months, above the 8.3% increase in April and 8.5% increase in March. Energy and food prices are a major factor, but the core inflation rate, which excluded food and energy prices, is also elevated, rising by 0.6% in May and 6.0% over the past 12 months. The producer price index, the GDP price deflator, the personal consumption expenditure (PCE) price index, and the employment cost index are also all elevated.

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.

Global growth

The global economy is expected to grow by 2.5% 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. Forecasts in other countries depend very much on the status of COVID, vaccinations and the policy response to inflation in each country.

The Conference Board's consumer confidence index fell to 106.4 in May from 108.6 in April. The ISM Manufacturing PMI rose to 56.1 in May from 55.4 in April. The ISM Employment Index fell sharply to 49.6 in May from 50.9 in April. Industrial production and capacity are above their pre-pandemic levels.

Growth for 2022 is now expected to be 2%, down from forecasts of 3.5% in January. There is rising concern of either an overcorrection by the Federal Reserve or that a contraction with significantly lower demand and higher unemployment will be needed to bring inflation back to the Federal Reserve's 2% target.

The Federal Reserve increased its forecast for the 2022 unemployment rate to 3.7% in June from 3.5% in March. The Federal Reserve is forecasting the unemployment rate to be 3.9% in 2023 and 4.1% in 2024 as it tightens monetary policy to combat the surge in inflation.

The May labor force participation rate was 1.1 percentage points below its February 2020 level. Despite some improvement since the pandemic, the labor force had 2.6 million fewer workers in May 2022 than it would have had it continued to grow at trend. Average hourly earnings are up 5.2% from a year ago, but at a pace well below the rise in consumer prices.

The Federal Reserve has shifted to a more aggressive monetary tightening policy stance with a 75-basis-point increase in the federal funds target rate at its June 14-15 meeting. Another 75-basis-point increase is expected at its July 26-27 meeting and rate increases totaling 350 basis points are anticipated in 2022. The Federal Reserve will begin to reduce its balance sheet, which had been doubled in response to the pandemic. The Federal Reserve forecasts inflation to be brought back to just above its 2% target in 2024.

A significant question is whether the Federal Reserve will be able to engineer a soft landing, will overcorrect, or will more aggressively stem economic growth to quell inflation. A June Wall Street Journal poll estimated the likelihood of recession at 44%, as compared to 28% in April and 18% in January.

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

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