QUEST Economic Update | December 2022

Inflation may have peaked, some additional interest rate increases expected, recession risks remain

While high inflation, interest rate hikes and recession risks continue to dominate the US economic outlook, it appears that inflation likely peaked earlier this year. The consumer price index (CPI) was 7.1% in November, down from 7.7% in October and 9.1% in June. The producer price index (PPI) was 7.4% in November, down from 8.1% in October and 11.7% in March. While the inflation rate is below levels from earlier this year, it remains elevated on a year-over-year basis and most forecasts do not expect it to reach the Federal Reserve's 2% target until sometime in 2024.

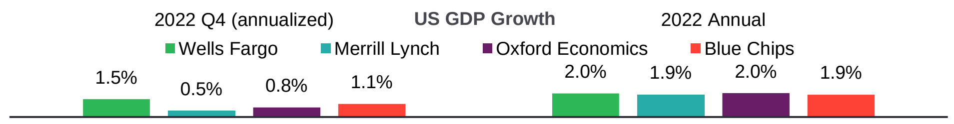
At the same time, the Federal Open Market Committee (FOMC) increased the federal funds target rate by 50 basis points at its December 13-14 meeting. The Federal Reserve forecasts that the target rate will reach 5% in 2023 and then decline to 4.1% in 2024 and 3.1% in 2025. While this forecast suggests some additional rate increases next year, it also suggests that most of the monetary tightening by the Federal Reserve has already occurred.

The trajectory of the US economy over the next year remains uncertain. Recession risk appears to remain high and possibly increasing . Nevertheless, estimates of fourth quarter GDP growth have generally been revised up and the labor market, while showing some signs of loosening, remains tight. The November unemployment rate remained at 3.7%, close to a 50-year low, and weekly UI claims remain below pre-pandemic levels. Job openings have been gradually falling and the November job gains were below those of the prior several months. Many forecasters expect a mild recession sometime in 2023.

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

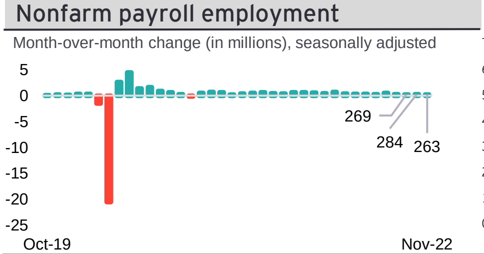
Although the US economy grew by 2.9% (real, annualized) during the third quarter, it is expected to slow during the fourth quarter and into next year as the Federal Reserve's interest rate hikes begin to take hold. The risk of recession is increasing.



Labor markets

The labor market has softened but remains historically tight. The unemployment rate remained at 3.7% in November and the US economy added fewer jobs in November than in prior months. Job openings continue to fall. However, weekly UI claims remain below pre-pandemic levels.

Nonfarm payroll employment

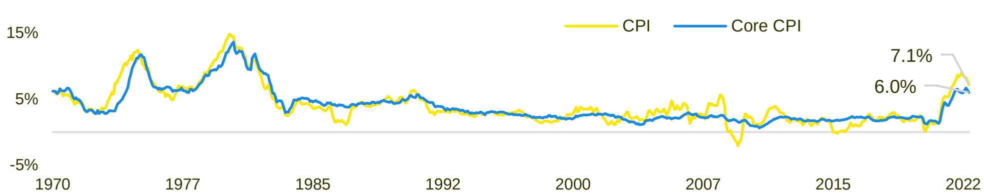


Unemployed workers per job opening

Inflation

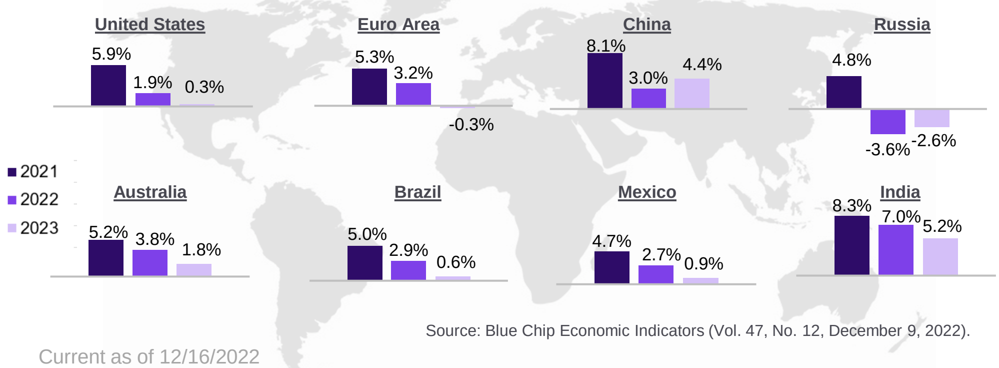
Inflation appears to have peaked earlier this year. The November CPI rose by 7.1% from a year ago, continuing its decline from the four-decade high of 9.1% reached in June. The November PPI rose by 7.4%, down from 11.7% in March. The inflation rate is not expected to reach the Federal Reserve's 2% target until 2024.

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



Global growth

Forecasts suggest slowing global economic growth in 2023, especially in the United States and the Eurozone. Economic growth is expected to increase somewhat in China in 2023, but at a relatively low level.



Source: Blue Chip Economic Indicators (Vol. 47, No. 12, December 9, 2022).

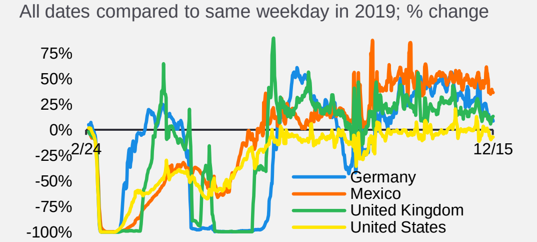
Real-time indicators

Due to rapidly changing economic conditions over the past two plus 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.

Consumer confidence has decreased, likely due to high inflation, the Federal Reserve's interest rate increases, the Ukraine war, supply-chain disruptions and hiring difficulties. Energy prices rose markedly with the Ukraine war, but have more recently declined, possibly due to the COVID-related lockdowns in China and slowing global growth. More in-person dining, workplace visits and air travel suggest resilience in the US economy.

Global OpenTable reservations

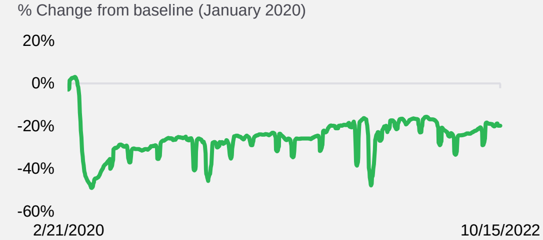
All dates compared to same weekday in 2019; % change



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

US workplace visits

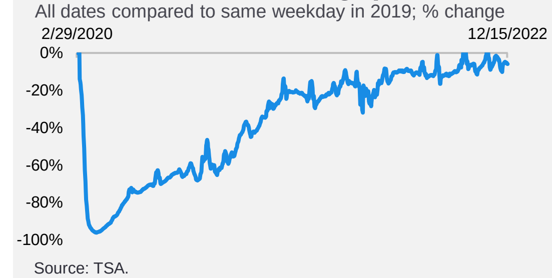
% Change from baseline (January 2020)



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.

Current as of 12/16/2022

Overall US economy

The US economy continues to face significant headwinds. Inflation remains elevated but likely peaked earlier this year. The Federal Reserve's interest rate hikes, made at a pace not seen since the early 1980s, are beginning to dampen economic growth. Forecasters have been pulling back their projections for growth in the United States and economic forecasts are starting to project recession in 2023. Nevertheless, the labor market remains tight with the unemployment rate of 3.7% just above the 50-year low reached several months ago and just before the pandemic.

Real US GDP grew by a seasonally adjusted annual rate of 2.9% in the third quarter of 2022 but is expected to slow to roughly 1% to 1.5% during the fourth quarter. The outlook for next year is less certain. Some forecasts see a recession beginning during the first half of 2023, while others see a recession beginning later in 2023.

Recent surveys of economists and recession models place a more than 60% chance of recession within the next 12 months. Worrying signs include the decline in the Conference Board's consumer confidence index to 100.2 in November from 102.2 in October, the decline in the ISM Manufacturing Employment Index to 48.4 in November from 50.0 in October, and the continuing falloff in housing starts. Industrial production also fell slightly in November.

The Federal Reserve indicated in its Summary of Economic Projections released on December 14 that most of its interest rate increases have already occurred. The projections indicate that it expects the federal funds target rate to reach 5% in 2023, suggesting several 25 basis point hikes this coming year.

Labor market

The US labor market remains tight, but with some signs of loosening. Job openings fell in October and are significantly lower than the highs reached earlier this year. The US economy added 263,000 jobs in November, below the job gains from prior months. November employment was 1 million above the pre-pandemic level.

The November unemployment rate, however, remained at 3.7% up from the 50-year low reached this past summer and just before the pandemic. The unemployment rate remains well below the 4.4% average for the US economy 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. Weekly new UI claims have oscillated up and down over the past several months but have generally remained below pre-pandemic levels.

The Federal Reserve is forecasting the unemployment rate to rise to 4.6% in 2023, remain at this level for 2024, and fall to 4.5% in 2025. Some economic forecasters see the unemployment rate rising to above 5.5% by the second quarter of 2024 and remaining above 5% for all of 2024. The November underemployment rate was 6.7%, below the average rate of 8.7% from 2015 through 2019. The November labor force participation rate was 1.3 percentage points below its February 2020 level. Average hourly earnings were up in November by 5.1% from a year ago, a pace well below the rise in consumer prices.

Inflation

The rise in consumer prices appears to have peaked earlier this year and is now falling. Consumer prices increased by 0.1% in November and by 7.1% over the past 12 months. The core inflation rate, which excludes the more volatile food and energy categories, increased by 0.2% in November and by 6.0% over the past 12 months. Most of the other measures of inflation have peaked as well. The PPI, reflecting prices paid to producers, rose by 7.4% in November from 12 months ago, down from its peak of 11.7% in March. Moreover, the GDP price deflator, the personal consumption expenditure (PCE) price index, and the employment cost index all remain elevated but are lower than their peak readings from earlier this year.

The sources of the surge in inflation have been varied -- surging demand for goods as the economy recovered from the pandemic, excess fiscal and monetary stimulus and collateral effects of the Ukraine war. Supply-chain disruptions and labor shortages are derivative of these factors but have had important feedback effects.

The Federal Reserve continued the most aggressive set of interest rate hikes, not seen since the early 1980s, with a 50 basis-point increase at its December 13-14 meeting. However, the Federal Reserve indicated that it is getting closer to the end of its tightening with about another 75 basis points of rate increases expected next year, likely over the first several FOMC meetings.

Global growth

The global economy is expected to grow by 2.2% to 3.5% in 2022, following estimates of 6.0% to 6.2% growth in 2021. The global economy contracted by 4% in 2020. Economic growth in the United States, the United Kingdom, and the Eurozone are expected to slow significantly in 2023. Recession risk is higher in the United Kingdom and Eurozone due primarily to the instability in the energy markets caused by the invasion of Ukraine. Economic growth in India is also expected to slow. Economic growth in China is expected to pick up somewhat, but at a low level. China's outlook is complicated by its COVID policies and its deleveraging. There is growing concern that global monetary tightening may create significant economic headwinds that will increase the likelihood of a global recession.

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