QUEST Economic Update | February 2023

January economic data suggests a resurgence of inflation and tightening of labor markets; Federal Reserve expected to raise interest rates higher and for longer

Even though the January Consumer Price Index (CPI) report had consumer prices rising by 6.4% as compared to January 2022, the 0.5% monthly increase from December 2022 to January 2023 was unexpectedly high and suggested some potential resurgence in inflation. This rise in inflation conforms to the strong economic performance during the last half of 2022 and a labor market that may have tightened rather than loosened in January.

The January unemployment rate fell to 3.4%, a 53-year low, and the US economy added 517,000 jobs, above the level for the prior several months and above the 401,000 average monthly gain in 2022. Weekly initial UI claims remain well below prepandemic levels and December job openings jumped by 0.6 million to 11 million.

A resurgence in inflation was also evident at the wholesale level from the 0.7% increase in the January Producer Price Index (PPI), the largest increase since June. On a 12-month basis, the PPI increased by 6%, elevated but well below its peak of 11.6% in March 2022. The Conference Board's consumer confidence index fell to 107.1 in January from 109.0 in December.

While the Federal Reserve is likely close to the end of its interest rate hikes, the January inflation and jobs numbers shifted market expectations from one additional 25-basis point increase in the federal funds target rate at the Federal Open Market Committee's March 21-22 meeting to 25-basis point increases at the next three meetings. Expectations now are for interest rates to go somewhat higher for somewhat longer, but still begin to decline towards the end of this year. The risk of recession remains but the likelihood of a soft landing may be increasing.

Building a better working world

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

Current as of 2/20/2023

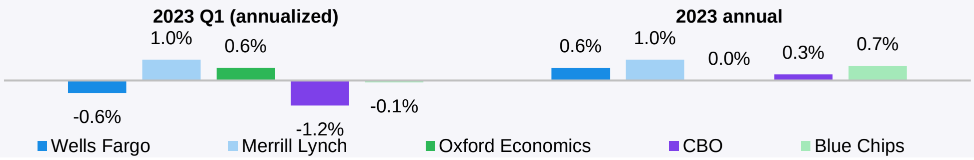
OVERALL US ECONOMY

Economic growth is expected to slow in 2023 with mixed forecasts for the first quarter and for the year as the Federal Reserve's cycle of monetary tightening begins to take hold. While there is still a risk of recession, the economy is showing surprising resilience and the likelihood of a soft landing is increasing.

-1.2% to 1.0% growth
expected for 2023 Q1 (annualized)

0.0% to 1.0% growth
expected for 2023

US GDP growth forecast



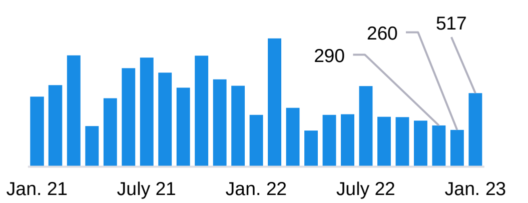
LABOR MARKETS

Labor markets likely tightened somewhat in January with the unemployment rate falling back to 3.4% and monthly job gains surging. Average hourly earnings, which rose by 4.4% in January, may indicate some upward pressure on future prices, especially in services where wages are a significant component of costs.

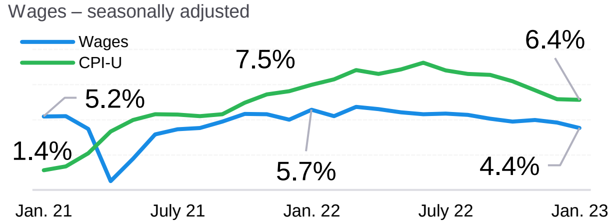
606k job gain
on average in 2021

401k job gain
on average in 2022

Nonfarm payroll employment
Month-over-month change (in thousands), seasonally adjusted



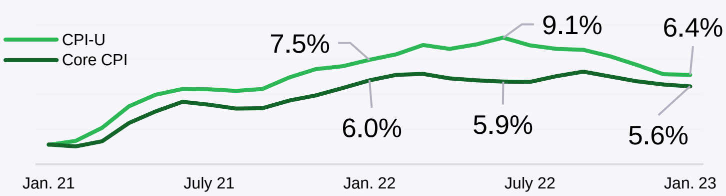
Hourly wages and CPI-U
Change from a year earlier, CPI - not seasonally adjusted, Wages – seasonally adjusted



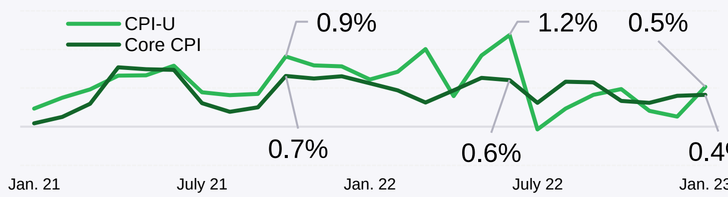
INFLATION

While inflation likely peaked at least as early as mid-2022, the January CPI report suggested some resurgence. The January CPI rose by 0.5% for the month and is up 6.4% from a year ago. The January PPI rose at its fastest pace since June. The inflation rate is not expected to reach the Federal Reserve's 2% target until 2024.

CPI-U and core CPI
Change from a year earlier, not seasonally adjusted

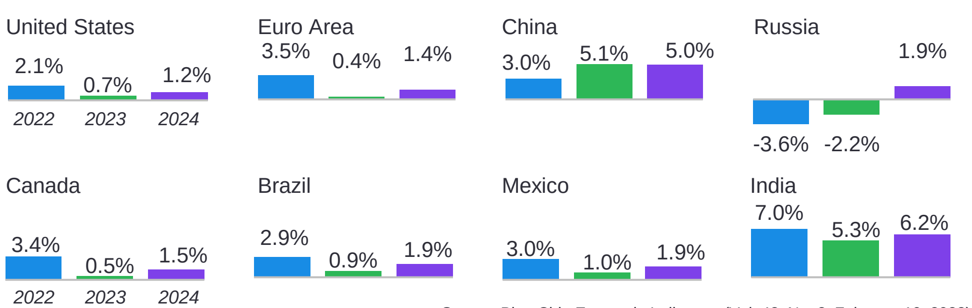


CPI-U and core CPI
Month-over-month change, seasonally adjusted



GLOBAL GROWTH

Forecasts suggest slowing global economic growth in 2023, especially in the United States and the Eurozone. China's economy appears to be picking up speed following the lifting of its COVID lockdowns and its COVID surge.



Source: Blue Chip Economic Indicators (Vol. 48, No. 2, February 10, 2023).

Upcoming economic data releases

- GDP for the fourth quarter (second estimate), February 23
- Job openings for January, March 8
- Employment situation for February, March 10
- Consumer Price Index for February, March 14
- Producer Price Index for February, March 15
- Housing starts for February, March 16
- Interest rates, Federal Open Markets Committee (FOMC) meeting, March 21-22

Overall US economy

The US economy continues to face significant headwinds. Inflation risks seem to have returned with the January CPI Report. The January Jobs Report also indicated that labor markets, rather than loosening, may have tightened. The combination of renewed inflation risks and tight labor markets has led to a stronger likelihood that the Federal Reserve will raise interest rates higher and for longer than anticipated several weeks ago. At the same time, the US economy's resilience may have increased the chances for a soft landing with weak but positive growth. That said, recession risks remain.

The January CPI rose 6.4% from a year ago, down slightly from the 6.5% increase seen from December 2021 to December 2022. However, the CPI rose 0.5% for the month of January, significantly above the monthly increases of the past several months. The January PPI, a measure of wholesale prices, rose at the fastest pace since June 2022.

The tightening of labor markets was seen by: (1) the drop in the January unemployment rate to 3.4%, a 53-year low, (2) a sharp increase in January job gains monthly to 517,000, (3) a continued low level of weekly UI claims, and (4) a significant increase in December job openings. The strength in labor markets over the past several months is consistent with the relatively fast pace of economic growth in the second half of 2022.

The inflation numbers and labor market tightness have shifted market expectations towards some additional monetary tightening by the Federal Reserve. The Federal Open Market Committee is expected to increase the federal funds target rate by 75 basis points over the next several meetings as compared to the expectation for only a 25-basis point increase at the March 21-22 meeting.

Labor market

US labor markets remain tight and may have further tightened in January. The January unemployment rate fell to 3.4%, a 53-year low and below the low of 3.5% reached just prior to the pandemic. Weekly UI claims remain near record lows. The unemployment rate is also 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, some economists view the lower unemployment rate as further contributing to the overheating of the economy.

The signs of loosening that seemed to appear several months ago now seem to have abated. Job openings, which had been broadly lower from their highs in early 2022, increased sharply in December. Although the US economy had generally been adding few additional jobs each month during the fall of 2022, in January job gains jumped to 517,000, well above the prior several months and the 401,000 average monthly gain during 2022.

The January labor force participation rate rose by 0.1 percentage point to 62.4%, 0.9% below the prepandemic level. The January underemployment rate, which averaged 8.7% from 2015 through 2019, rose to 6.6% from 6.5% in December. Average hourly earnings were up in January by 4.4% from a year ago, a pace well below the rise in consumer prices but at the same time well above the Federal Reserve's 2% target rate.

Forecasts of the peak unemployment rate, which some forecasters had reaching over 5% in early 2024, have generally been lowered to under 5%. This shift in the forecasts still suggests a slowing economy, but one where the likelihood of recession has diminished somewhat.

Inflation

January saw some resurgence in inflation. Consumer prices rose by 0.5 percent in January, following a 0.1 percent increase in December. Over the past 12 months, consumer prices increased by 6.4 percent, the lowest 12-month increase since the end of 2021 and the seventh straight month of cooling in annual inflation. The core CPI, which excludes volatile energy and food prices, rose by 0.4 percent in January, after rising by 0.4 percent in December. The core inflation rate was 5.6 percent over the past 12 months.

The index for shelter was by far the largest contributor to the monthly increase in the overall CPI, accounting for more than one-half of the monthly increase in the index. In addition to shelter, the price indexes for food, gasoline, and natural gas also contributed to the increase in the overall index. The price indexes for fuel oil, used cars and trucks, and medical care services declined.

The January inflation report adds support to the view that inflation peaked earlier this year and is cooling. Nonetheless, inflation remains elevated, particularly for the more labor-intensive services category as wages have increased in a tight labor market. The index for services (less food and energy) rose 0.5 percent in January following a 0.6 percent rise in December. Economic forecasters expect inflation to remain elevated, but gradually decline for the remainder of this year and in 2024. Most forecasts do not see inflation falling to the Federal Reserve's 2 percent target until at least 2024.

Global growth

The global economy is expected to slow in 2023 with growth in the 1.0% to 2.5% range. Economic growth is expected to slow, perhaps significantly, in the United States, the United Kingdom, and the Eurozone. 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. That said, this year's mild winter appears to have taken some pressure off European energy supplies.

China appears poised for renewed growth now that it has ended its COVID lockdowns and has worked through the ensuing COVID surge. Another factor creating uncertainty in the global economic climate is the path of inflation and the potential that associated global monetary tightening may create significant economic headwinds that will increase the likelihood of a global recession

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