# QUEST Economic Update | March 2023

**Renewed inflation worries, tight labor markets and recent bank failures create a more uncertain path forward for interest rates**

There is considerable anticipation on what action the Federal Open Market Committee (FOMC) will take when it meets next week (March 21-22) as it weighs a tight labor market, a potential renewal of inflationary pressures and the recent bank failures. Several weeks ago, it was widely anticipated that the FOMC might increase its target rate by 50 basis points at its March 21-22 meeting, continue with several more 25-basis-point increases over the next few months and keep rates at this level possibly through the end of 2023. The market now expects a 25-basis-point increase in the target rate next week, possibly followed by a holding pattern or even reductions in the target rate.

There may be some signs that the very tight labor markets are loosening. The February Jobs Report had the unemployment rate increasing to 3.6% from 3.4% in January, its 53-year low. The US economy added 311,000 jobs in February, below the 504,000 gains in January and the average gain of 401,000 in 2022. January job openings fell by 0.4 million to 10.8 million. Weekly UI claims remain well below pre-pandemic levels.

Inflationary pressures appear to have resurfaced, at least to an extent, during the first two months of this year. The overall CPI rose by 6.0% in February, following its 6.4% increase in January. While this downward trajectory suggests inflation continues to abate, the January and February CPI rose by 0.5% and 0.4%, respectively, on a monthly basis, suggesting that inflationary pressures are still significant.

Many economy forecasts continue see a several-quarter recession sometime in mid- to late-2023. The economic uncertainty created by the recent bank failures and potential shifts in the Federal Reserve's posture on interest rates makes the path forward for the economy more uncertain.

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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 3/17/2023

## OVERALL US ECONOMY

Economic growth is expected to slow in 2023, with some forecasts suggesting a possible several-quarter recession later this year. The recent bank failures and their impact on the Federal Reserve's interest rate posture are creating a more uncertain outlook.

**0.7% to 2.0%** growth
expected for 2023 Q1 (annualized)

**1.0%** growth
expected for 2023

### US GDP growth forecast


## LABOR MARKETS

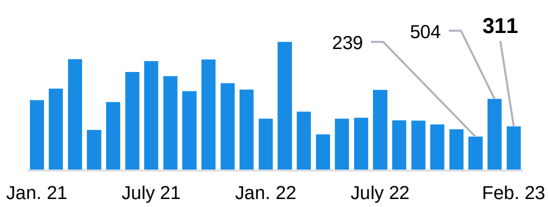
Labor markets remain tight, but the February unemployment rate ticked up to 3.6% from 3.4% in January. Some economic forecasts have the unemployment rate rising by more than one percentage point over the next year as the economy slows.

**606k**
job gain
on average in 2021

**401k**
job gain
on average in 2022

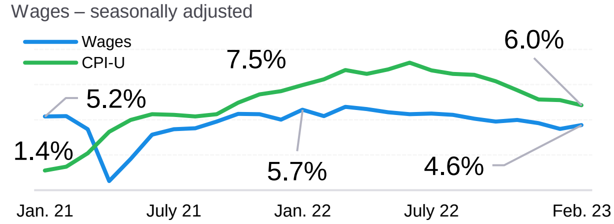
### Nonfarm payroll employment

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

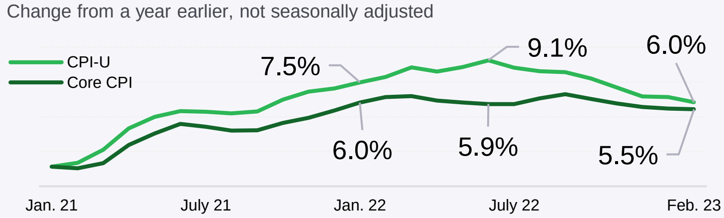



## INFLATION / INTEREST RATES

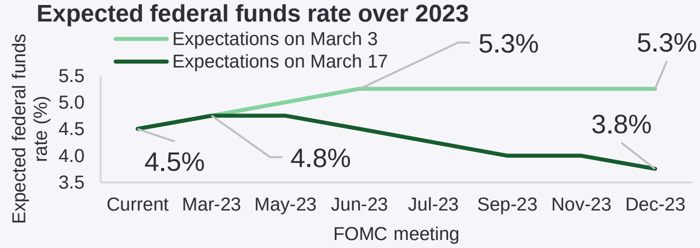
The January and February inflation numbers may have signaled a possible resurgence in inflation, with the monthly increases in core inflation suggesting an underlying inflation rate of roughly 6%. The recent bank failures appear to have shifted market expectations for the path of interest rates hikes, with the Federal Reserve expected to take a less aggressive stance.

### CPI-U and core CPI

Change from a year earlier, not seasonally adjusted

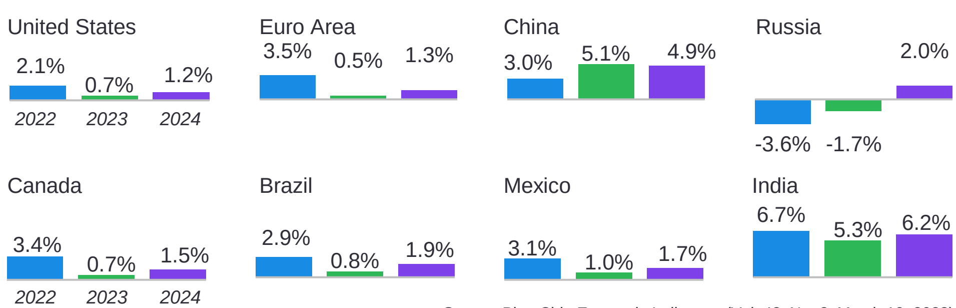



### Expected federal funds rate over 2023




## 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.




Source: Blue Chip Economic Indicators (Vol. 48, No. 3, March 10, 2023).

### Upcoming economic data releases

- Interest rates, Federal Open Markets Committee (FOMC) meeting, March 21-22
- GDP for the fourth quarter (second estimate), March 30
- Job openings for January, April 4
- Employment situation for February, April 7
- Consumer Price Index for February, April 12
- Producer Price Index for February, April 13
- Housing starts for February, April 18

## Overall US economy

The US economy continues to face significant headwinds. The recent bank failures have further complicated the outlook. A possible renewal of inflationary pressures is a significant concern, and the labor markets remain tight. Market expectations are for the FOMC to increase its target rate by 25 basis points at its upcoming March 21-22 meeting. What it does next is highly uncertain. Currently, the market, which is somewhat volatile, expects that the FOMC may begin to lower the target rate at some point over the next several months as it weighs the risks to the economy of the bank failures, stubbornness of inflationary pressures and tightness of labor markets.

Signs of a slow-down are not yet apparent. The February unemployment rate rose to 3.6% from 3.4% in January but remains well below the roughly 4.5% rate that economists view as consistent with fully employment. February job gains were 311,000, lower than the 504,000 in January, but not yet at a level that would add significantly to the unemployment rate.

Nevertheless, the Conference Board's consumer confidence index fell to 102.9 in February from 106.0 in January. Housing starts fell 4.5% in January, and the ISM Manufacturing Employment Index fell to 49.1 in February from 50.6 in January (values below 50 indicate contraction).

The Atlanta Fed's GDPNow Tracker has been estimating first quarter real GDP growth to be above 2% since the end of January and now pegs first quarter growth at 3.2%. Despite the resilience of the economy during the second half of 2022 and the beginning of 2023, some forecasters see a several-quarter recession beginning in the second or third quarter of this year.

## Labor market

US labor markets remain tight. The February unemployment rate rose to 3.6% from 3.4% January. The unemployment rate is 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 in the range of 4.4% to 4.5%. The economy added 311,000 jobs in February, below the 504,000 added in January and the average job gains of 401,000 in 2022, but job gains remain at a level that would be expected to add significantly to the unemployment rate. Weekly UI claims have been well below pre-pandemic levels.

The rate of labor force participation rose by 0.1 percentage point in February to 62.5%, 0.9% below the pre-pandemic level. The February underemployment rate, which averaged 8.7% from 2015 through 2019, rose to 6.8% from 6.6% in January. Average hourly earnings were up in February by 4.6% 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 inflation rate.

Despite the current tightness of the labor markets, many forecasters see the unemployment rate rising by roughly one percentage point over the next year. The forecasts suggest that the Federal Reserve's higher interest rates will begin to take hold and slow the economy within the next quarter or two.

## Inflation

The January and February inflation numbers appear to indicate some resurgence in inflationary pressures. The overall CPI rose by 6.0% in February following its 6.4% increase in January, down from its high of 9.1% (y/y) in June. The monthly February CPI rose 0.4%, following its 0.5% increase in January. The core CPI, which excludes energy and food prices, rose by 5.5% (y/y) in February, following its 5.6% (y/y) increase in January. The monthly core CPI rose by 0.5% in February. While the inflation rate is well below its peak of 9.1% in June 2022 when measured from the price level 12 months earlier, when measured on a monthly basis, it appears to have been trending around 6% during the first two months of 2023.

The index for shelter was by far the largest contributor to the monthly increase in the overall CPI, accounting for more 70% of the monthly increase in the index. In addition to shelter, the price indexes for food, recreation, and household furnishings and operations also contributed to the increase in the overall index. The price index for energy declined.

Following the release of the January inflation numbers and Jobs Report, the market focused on several additional interest rate hikes by the Federal Reserve over its next several meetings and a greater likelihood that the higher rates would remain in place longer. The recent bank failures have created significant uncertainty in the interest-rate outlook as the Federal Reserve weighs their impacts on the economy.

Market expectations, which are somewhat volatile, now appear to foresee to a considerably less aggressive schedule of interest rate hikes with a possibility of rate reductions within the next several months.

## Global growth

The global economy is expected to slow in 2023, with growth in the 1.5% 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. The Ukraine conflict continues to contribute to uncertainty, but the Eurozone may have benefited from this year's mild winter.

Japan's economy has been benefiting from a post-pandemic release of pent-up demand. As China comes out of the COVID lockdowns and ensuing COVID surge, its economy appears to be experiencing steady growth. 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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