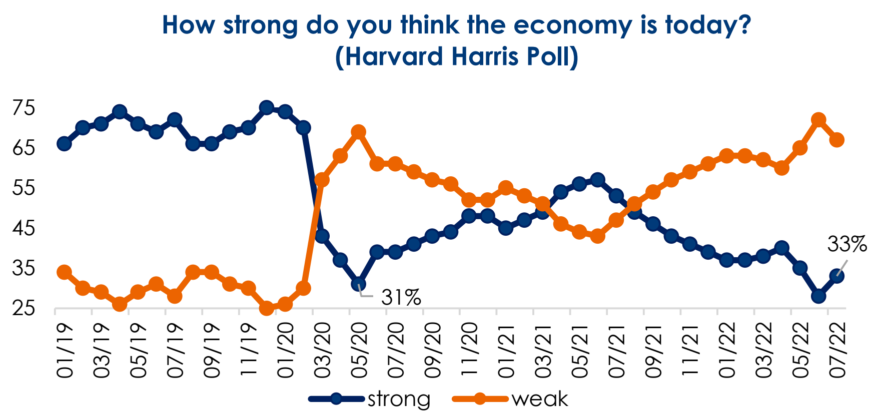
Will the Fed tip the US economy into a recession?



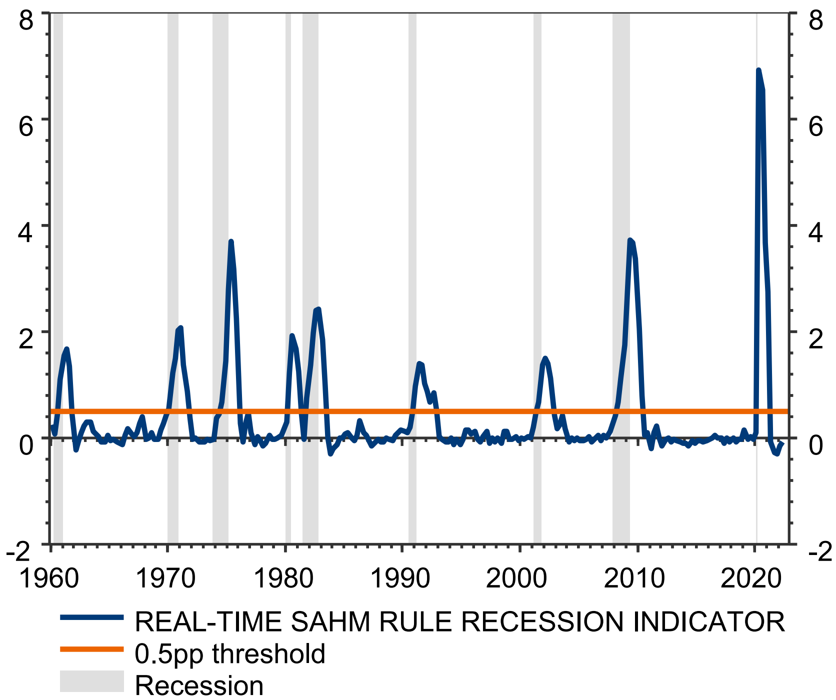
Giovanna Mossetti

Intesa Sanpaolo – Research Department

31 August 2022

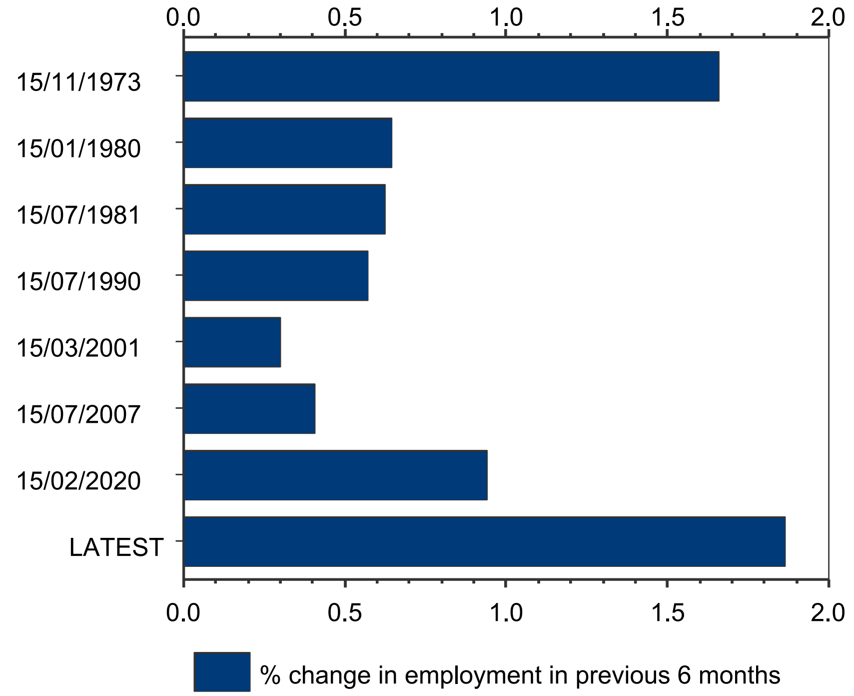
This is still NOT a recession

This is not (yet) a recession, but it could become one next year



Note: Sahm Recession Indicator signals the start of a recession when the three-month moving average of the national unemployment rate rises by 0.50 percentage points or more relative to its low during the previous 12 months. Source: St Louis Fed

It will take a lot more economic pain to turn this economy around

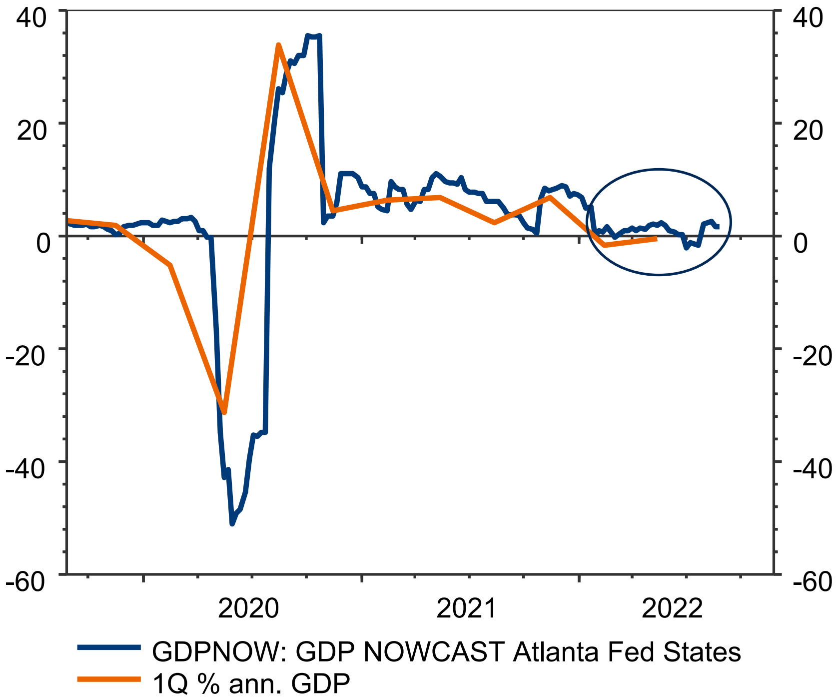


Source: BLS

INTESA SANPAOLO

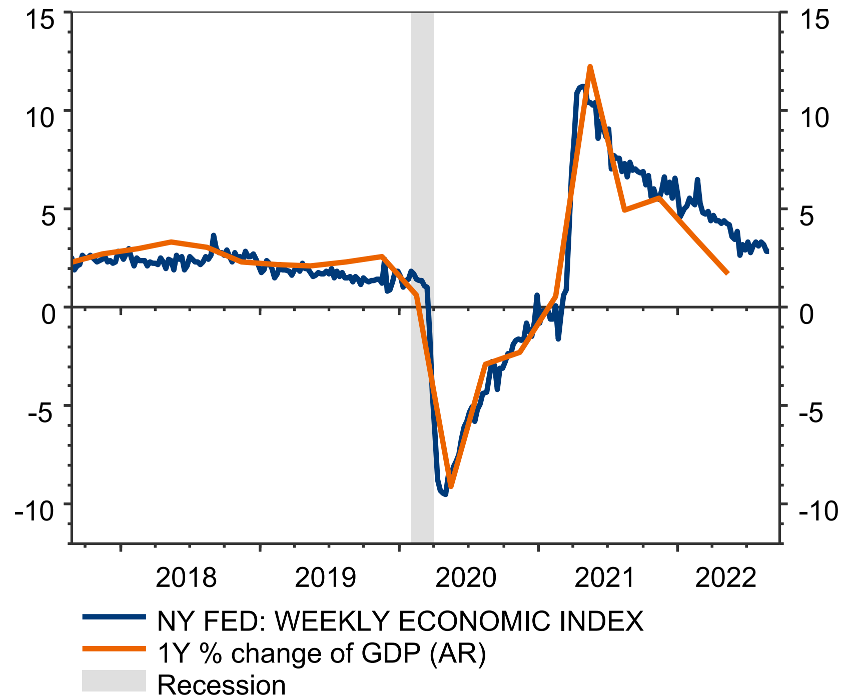
The slowdown is here, but so far it has not been painful

After two negative quarters, GDP is expected to grow again in Q3…



Source: BEA, ISM

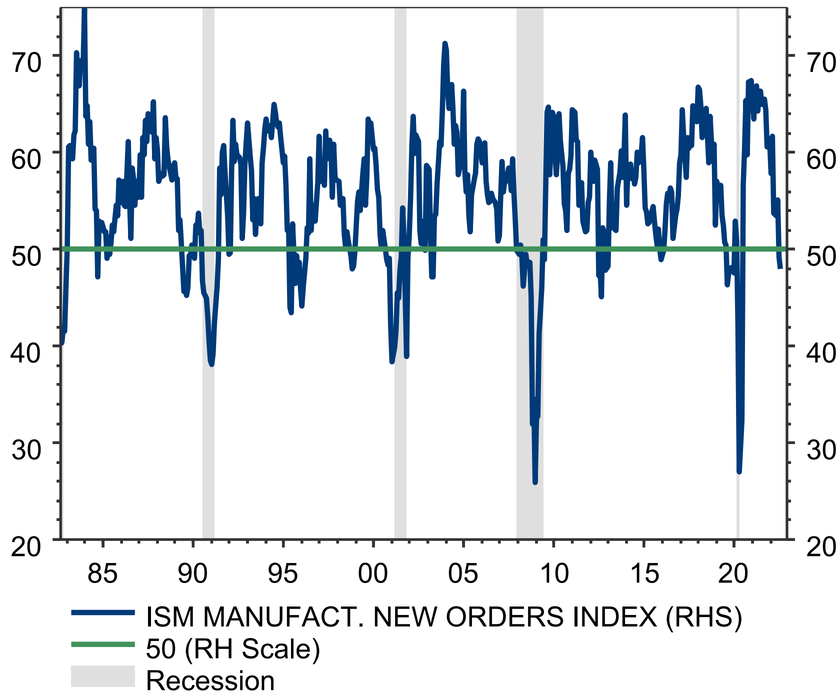
…but the trend is downwards



Source: NY Fed, BEA

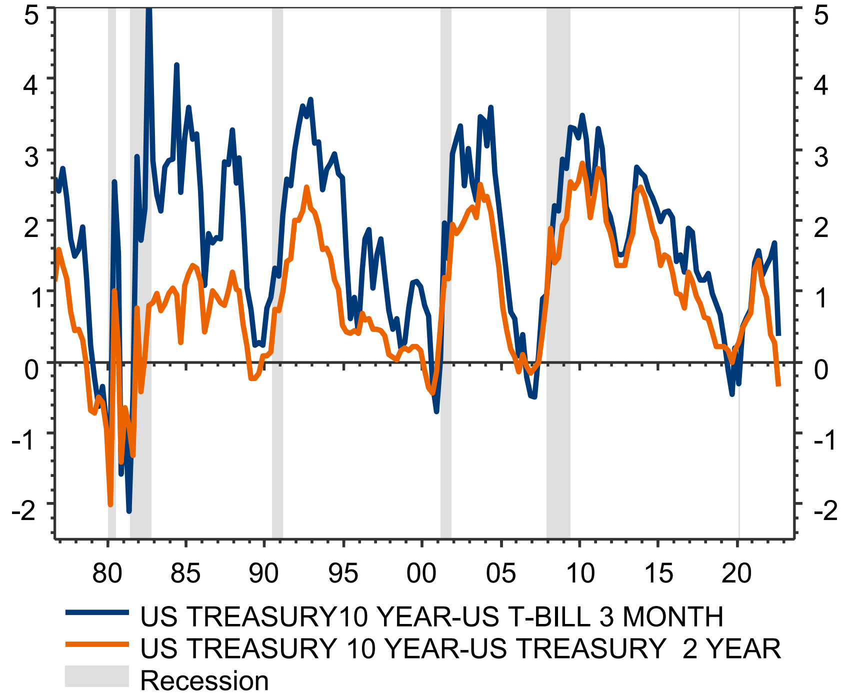
Some recession indicators are flashing yellow

ISM manufacturing orders <50 are good (not perfect!) recession predictors: July new orders at 48



Source: ISM

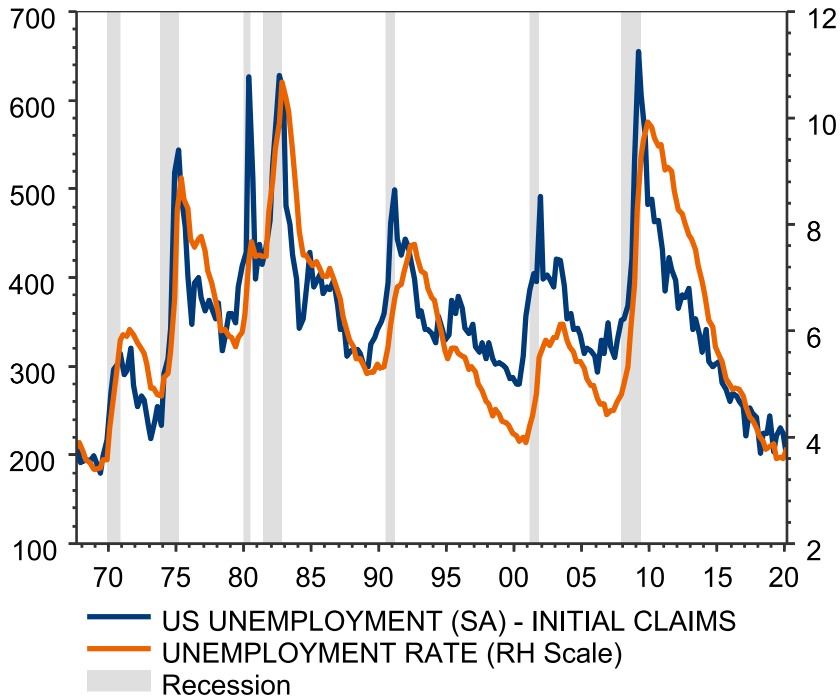
Yield curves are in dangerous territory



Source: Refinitiv-Datastream

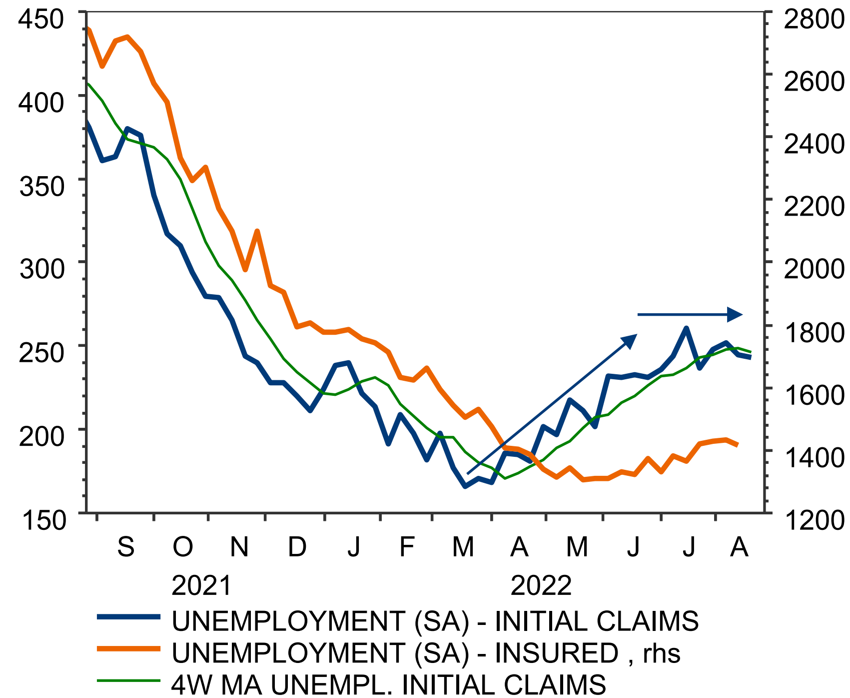
Jobless claims are the best recession predictors: here, the light is still unclear

Jobless claims and unemployment rate: 1967-2020 (pre-pandemic)



Source: BLS

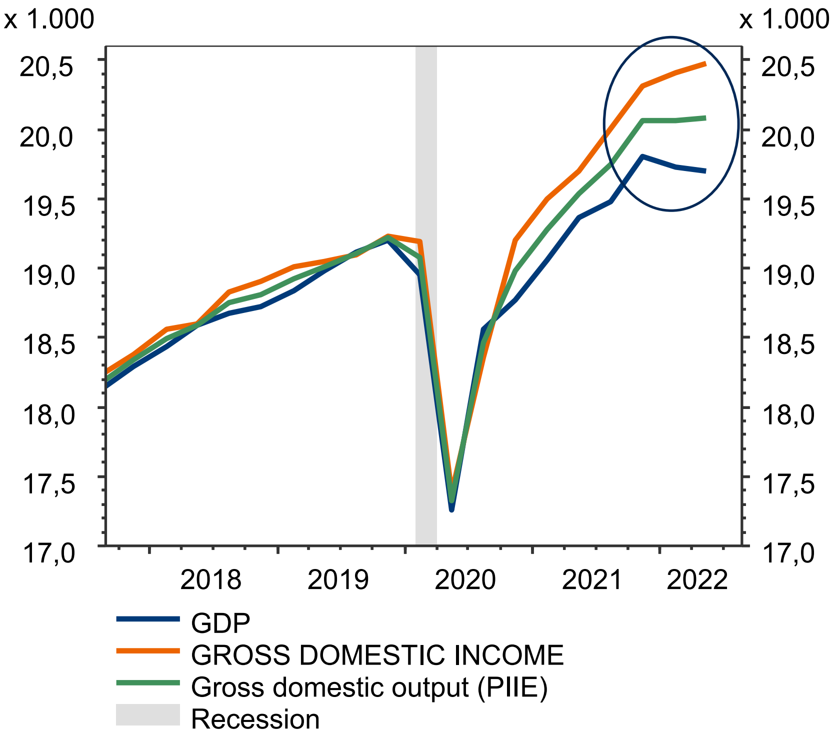
Jobless claims have turned: a problem may be on the way, but it is not here yet!



Source: BLS

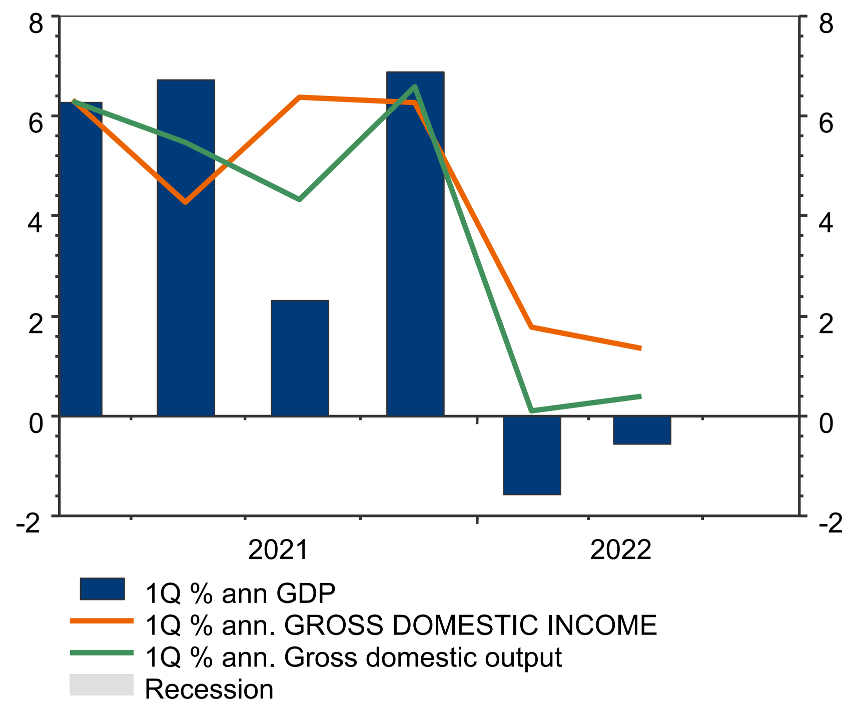
Probably the current weakness is overstated, but the slowdown is undisputable

The gap between GDP and income keeps growing: GDP is likely to be revised up



Note: Gross domestic output= average between GDP and GDI. Source: BEA, Intesa Sanpaolo calculations

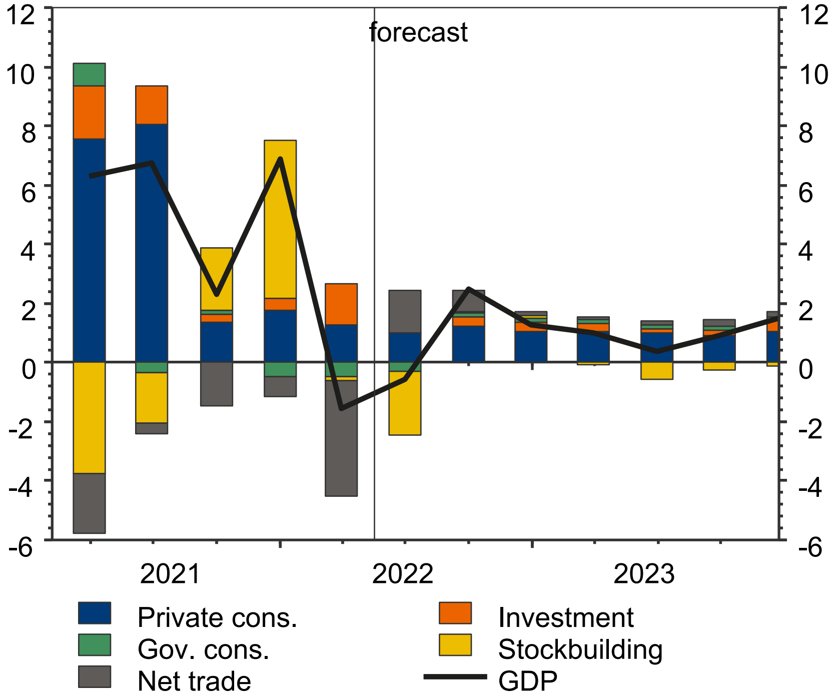
If the discrepancy between GDP and GDI closes somewhere in the middle, as has happened in the past, 1H growth would not be negative



Source: BEA, Intesa Sanpaolo calculations

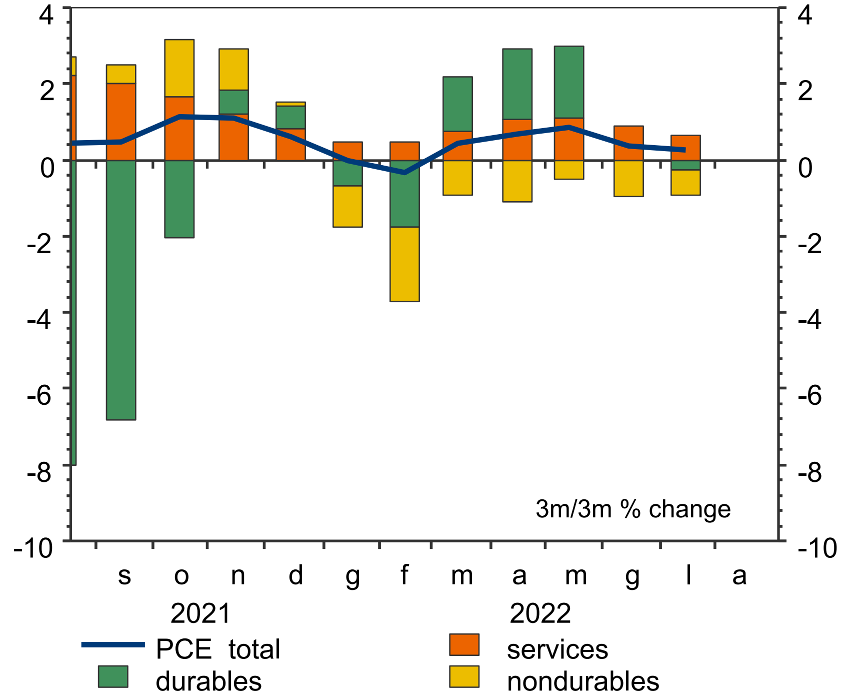
The actors in the downturn/1 – The GOOD (consumers)…

Never write off the US consumer, until the Fed's cavalry storms into the cycle



Source: BEA, Intesa Sanpaolo forecasts

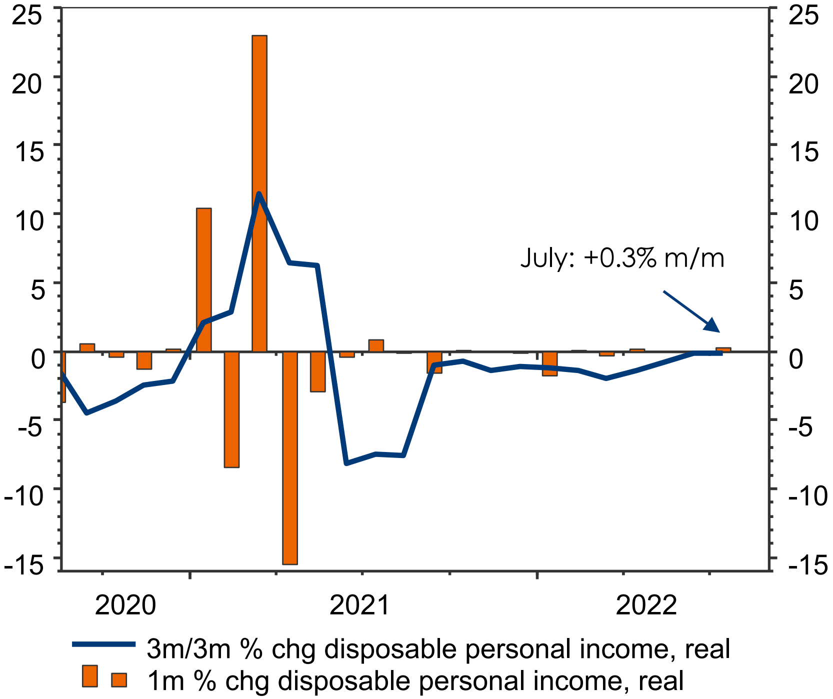
Consumers keep consuming, shifting from goods to services



Source: BEA

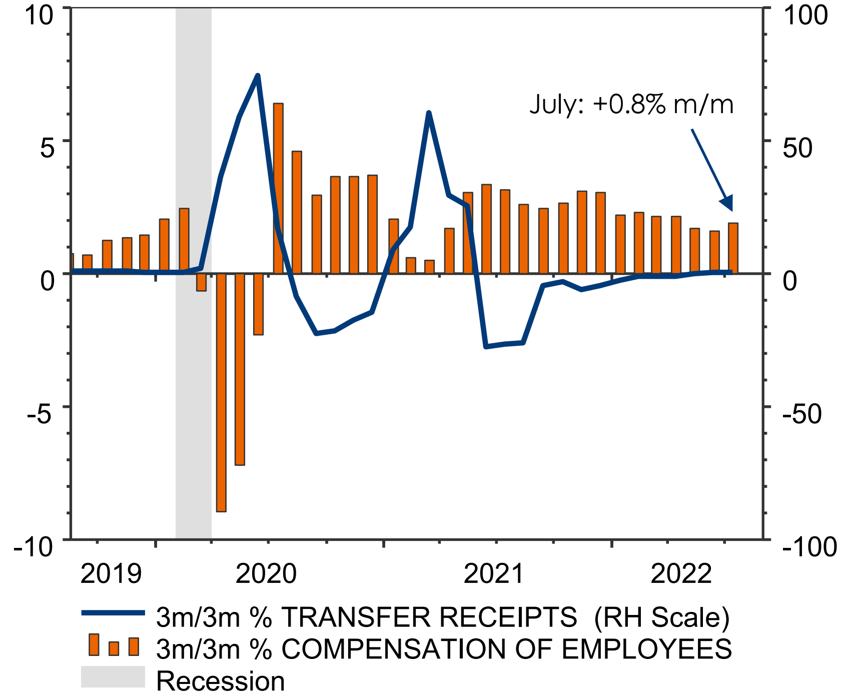
Two pillars supporting consumption: labor income…

Real disposable income turned positive again in July



Source: BEA

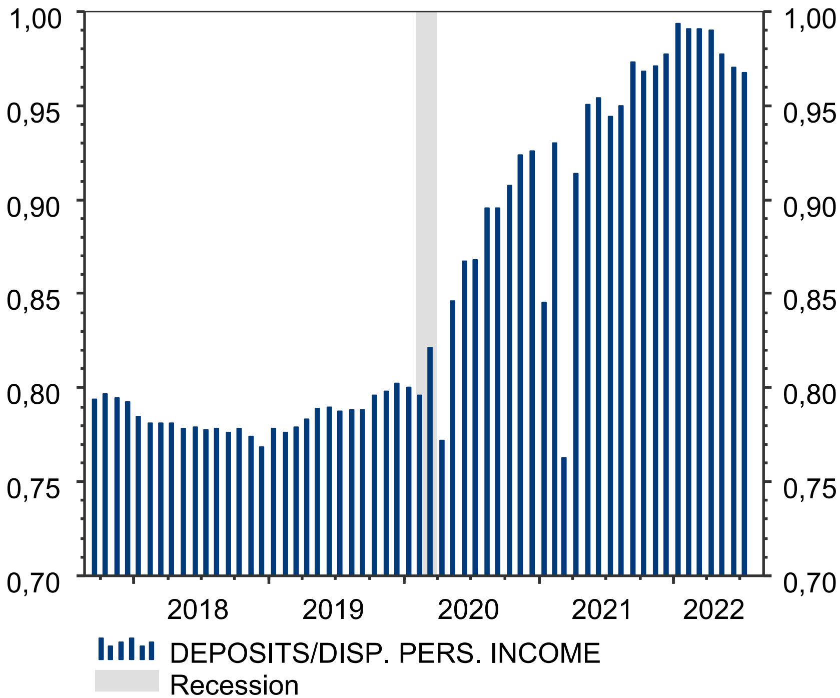
Labor income is back to its leading role in households' budgets



Source: BEA

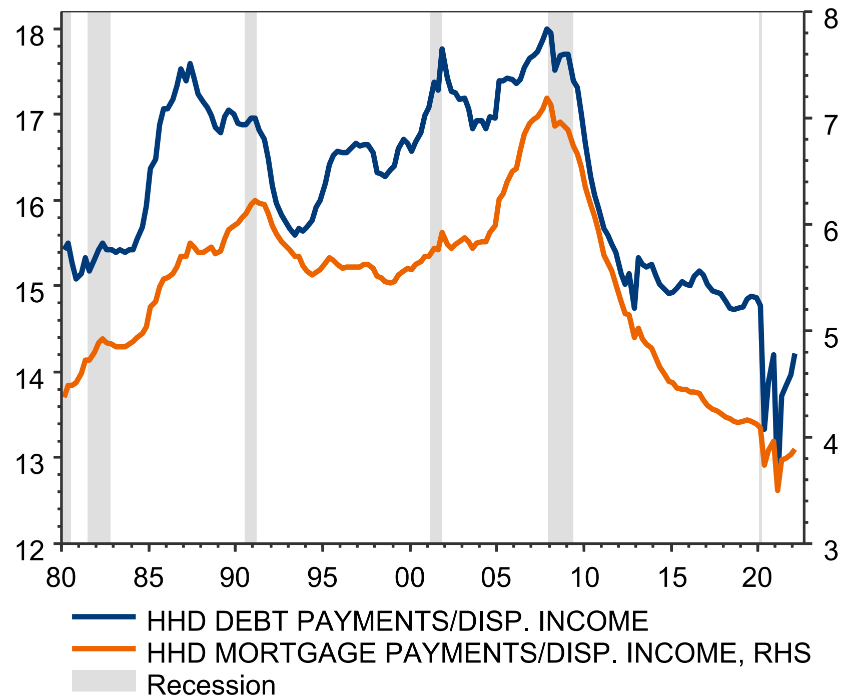
…and savings from the pandemic

Households have accumulated deposits well in excess of pre-pandemic levels



Source: Federal Reserve Board, BEA

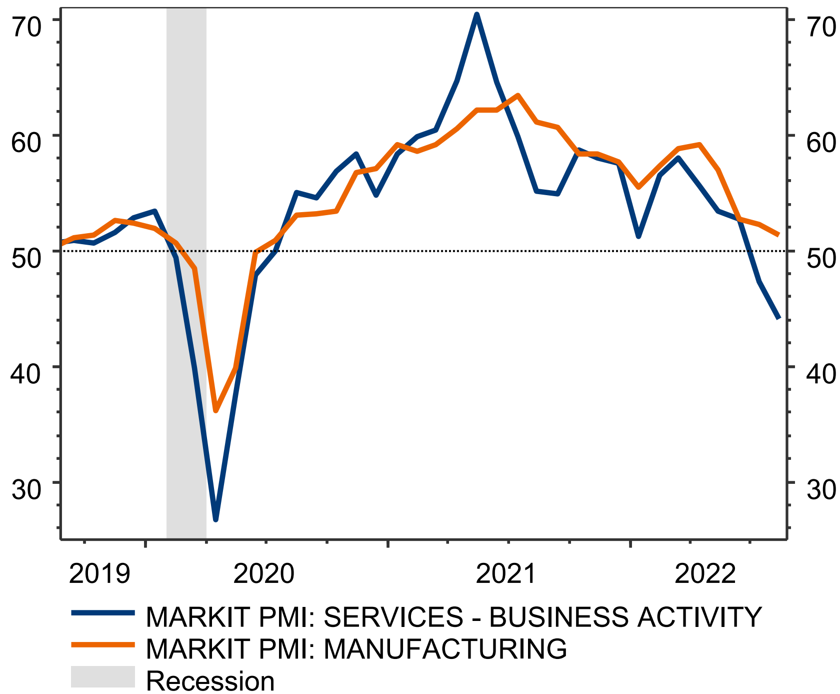
Debt service payments as a percent of disposable income are at historic lows



Source: Federal Reserve Board

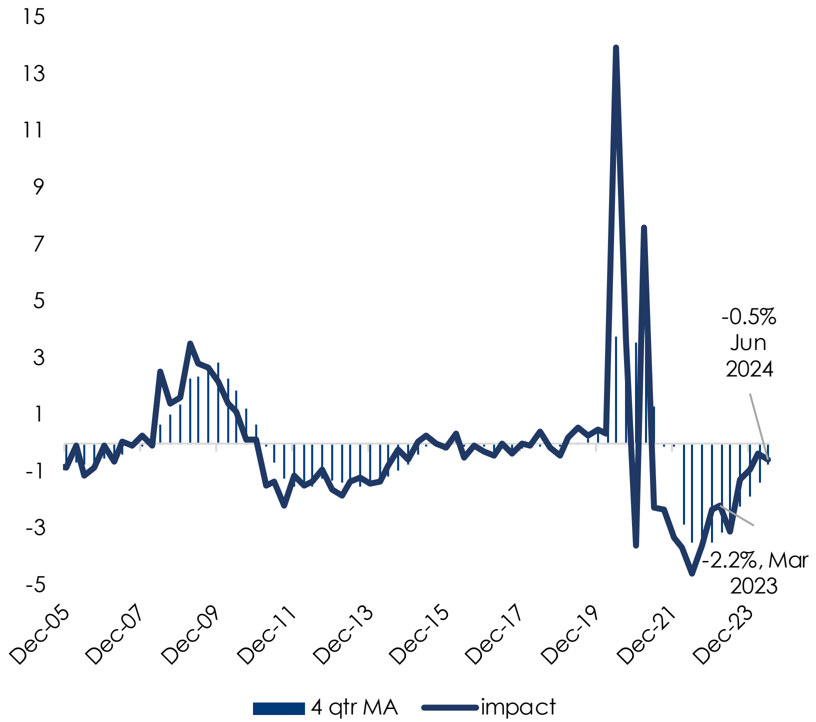
Actors in the downturn/2 – …the BAD (firms and government)…

Business surveys and data show accelerating weakness, partly still due to supply constraints but partly now due to a demand downshift



Source: Markit

The Federal government's contribution to growth will be negative until early 2024

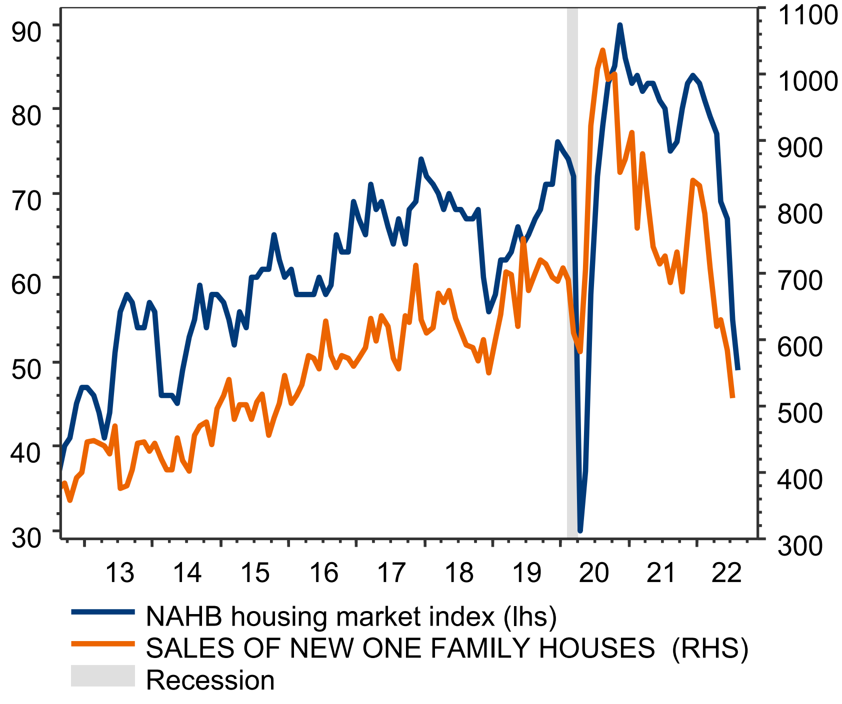


Source: Hutchins Center for Fiscal and Monetary Policy

INTESA SANPAOLO

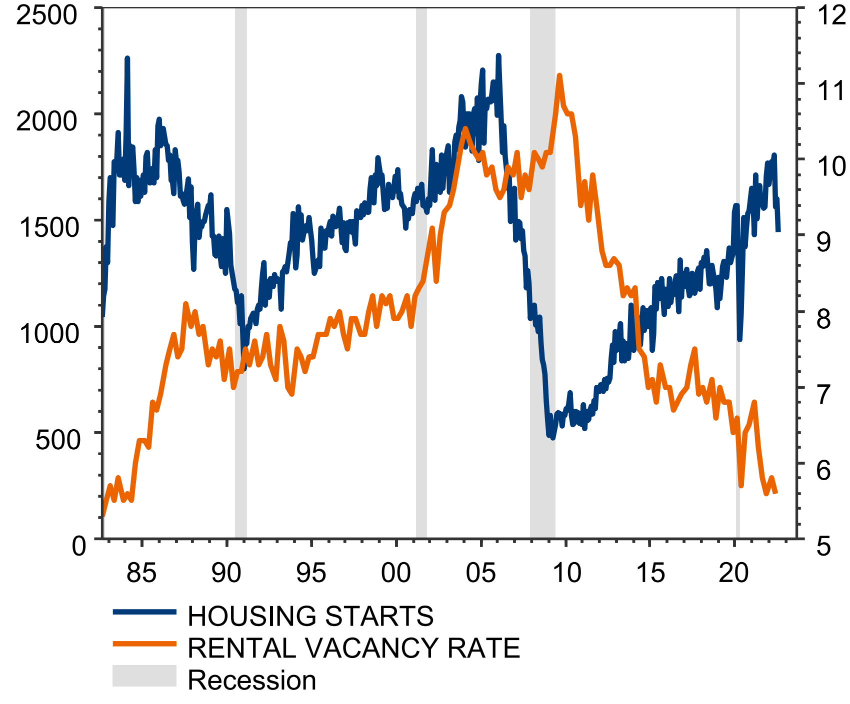
Actors in the downturn/3 – …and the UGLY (housing)

Activity in the housing sector is cratering, due to elevated home prices and higher mortgage rates



Source: Census Bureau, National Association Homebuilders

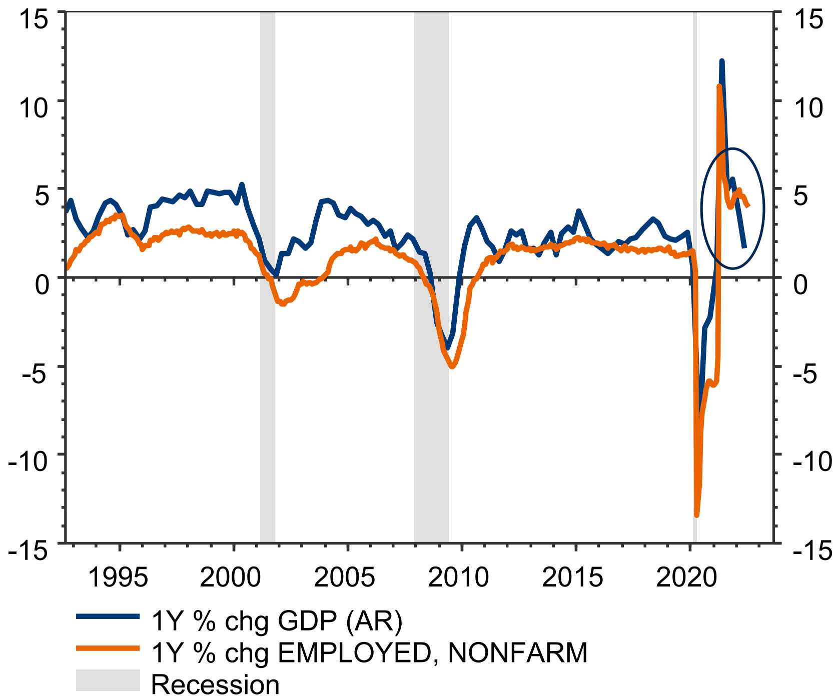
But 2022 is not 2006: there is a massive, structural excess demand for homes



Source: Census Bureau

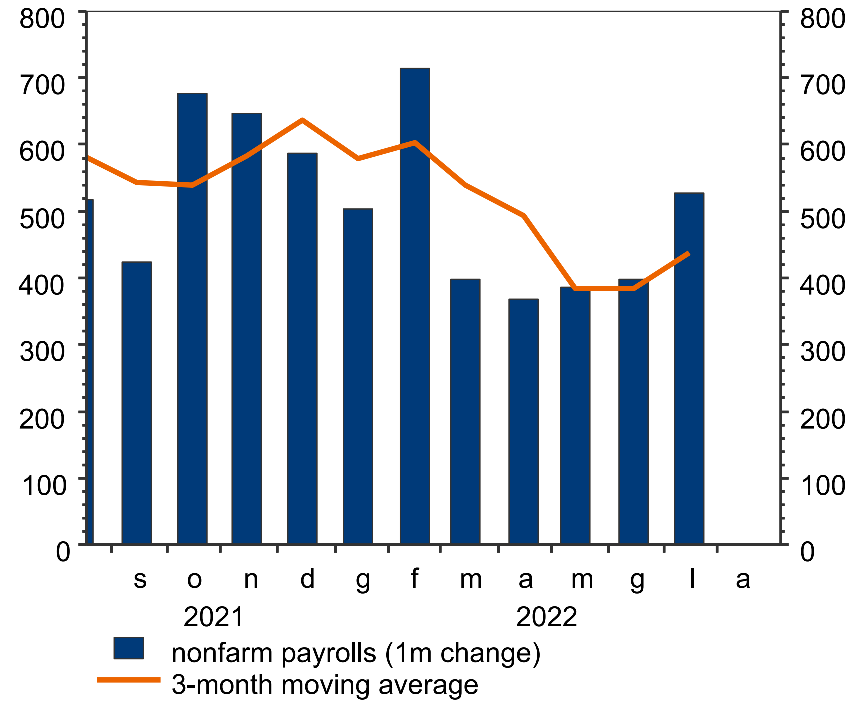
Aggregate demand may be weakening, but the labor market is still (too) hot: record demand…

Employment keeps growing much faster than GDP, productivity is plummeting



Source: BEA, BLS

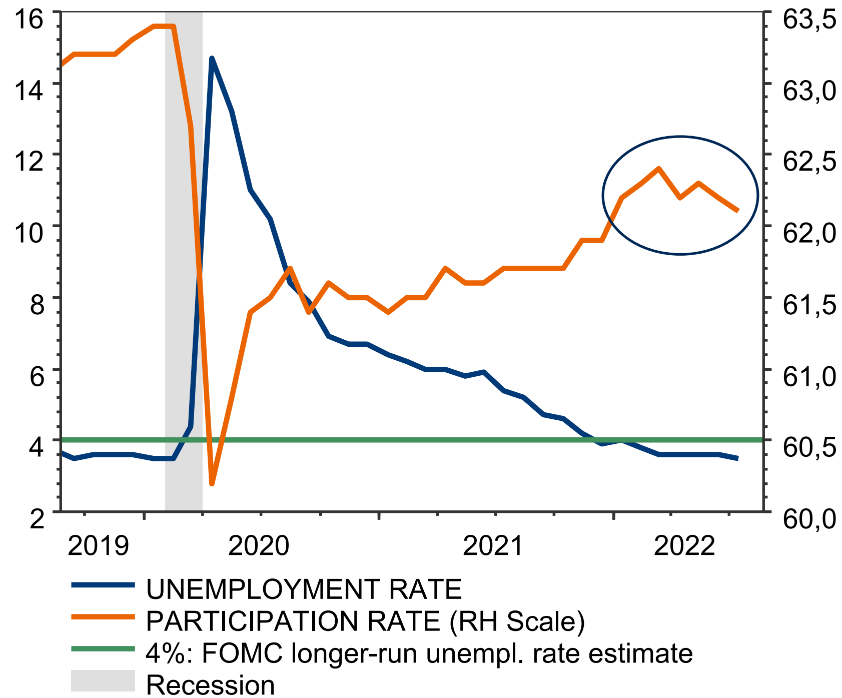
Non-farm payrolls rising at a brisk pace



Source: BLS

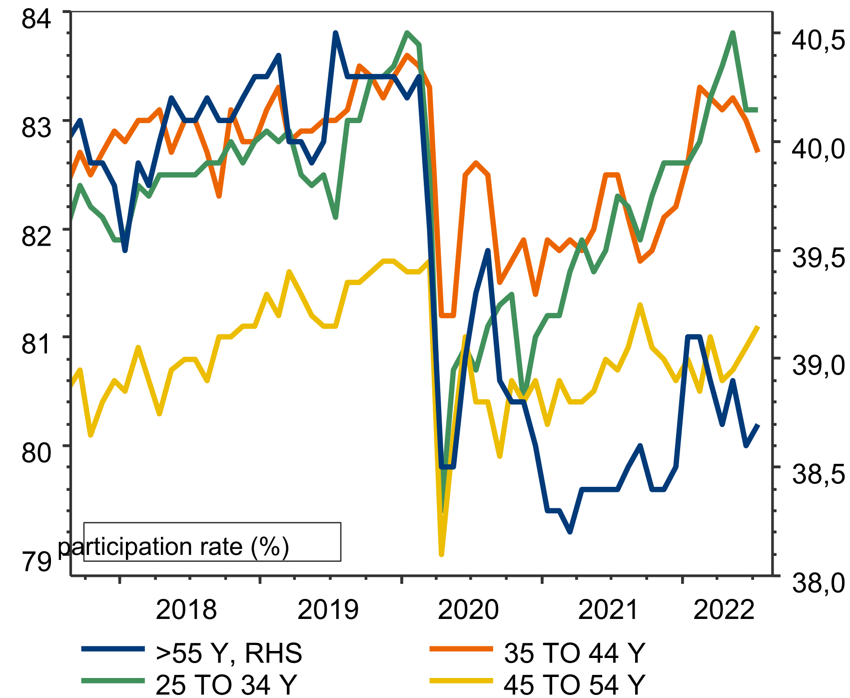
…in the face of persistently constrained supply

The unemployment rate keeps dropping, with participation 1.3pp below pre-Covid levels



Source: BLS

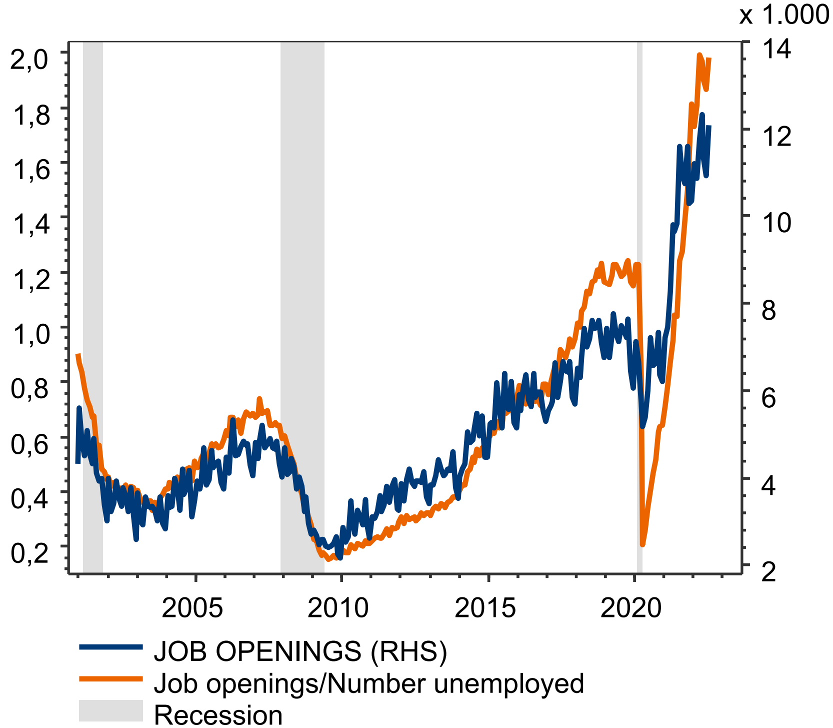
Around 10% of non-participating individuals are out of the labor force fearing Covid, app. 2M are not working due to long-Covid



Source: BLS

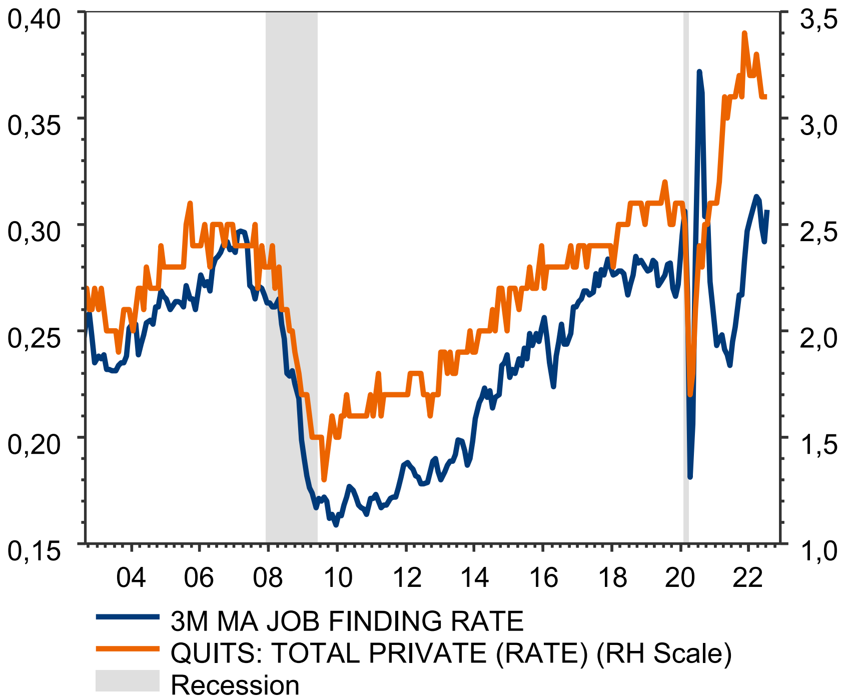
As a result, demand for labor is still outstripping supply…

Excess demand for labor remains huge: in July, 11.2 M job openings and 2 job openings/unemployed



Source: BLS

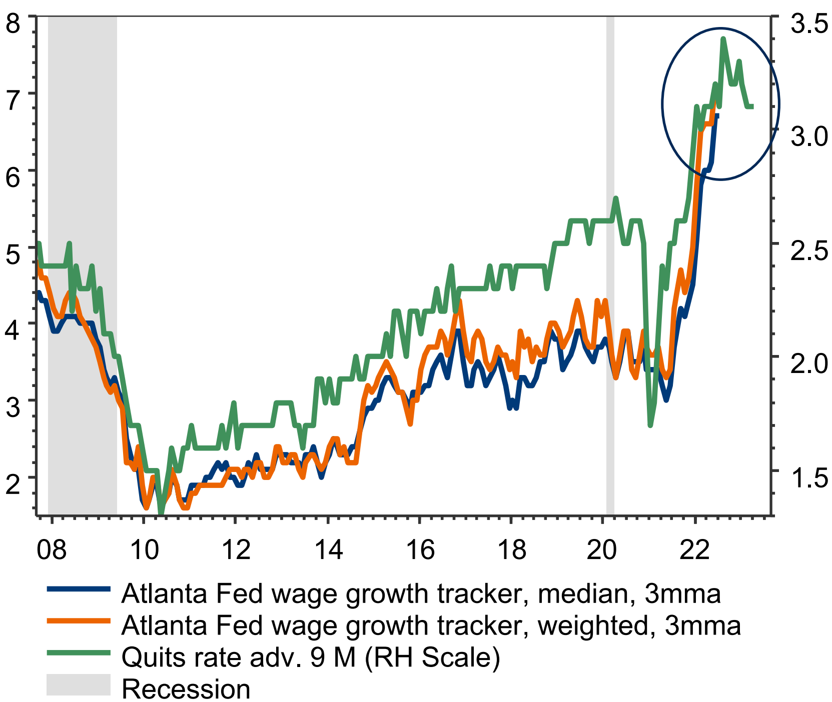
Individuals are still quitting jobs at a record rate and finding employment fast



Note: job finding rate=fraction of unemployed workers in a given month who find jobs in the consecutive month.
Source: BLS

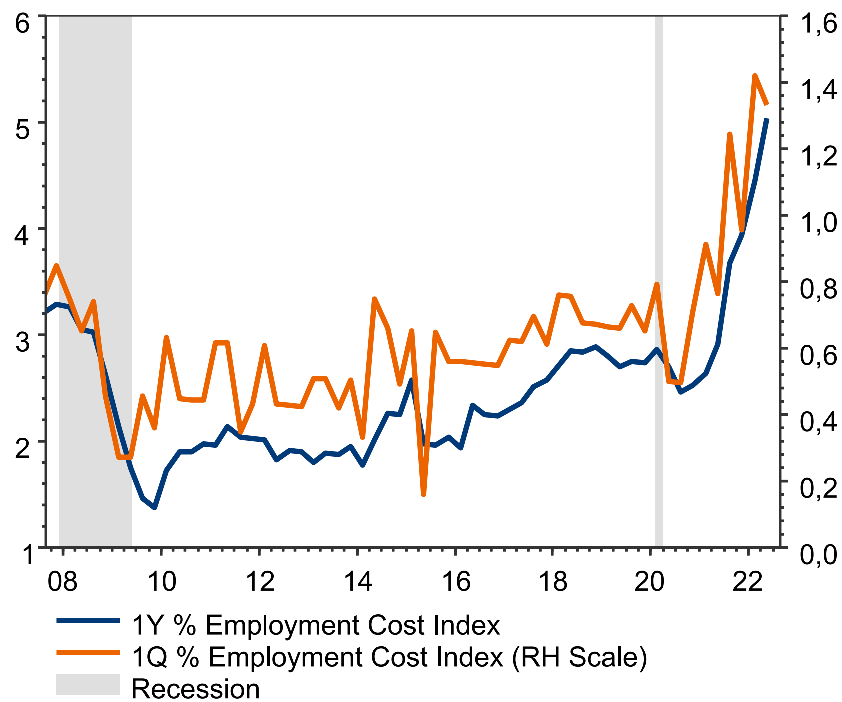
…and labor compensation keeps growing at a pace inconsistent with price stability

It will take time for wage growth to turn around



Source: BLS, Atlanta Fed

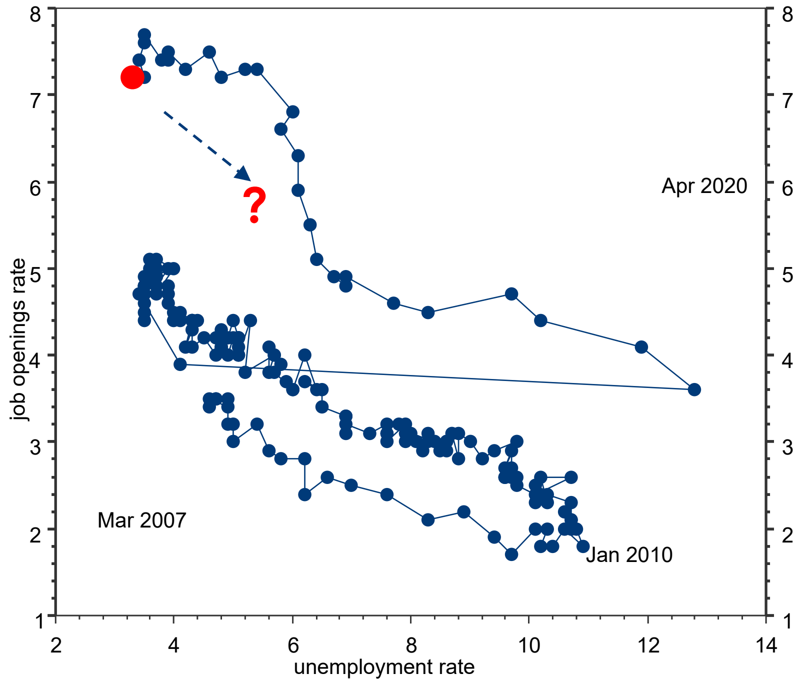
Employment costs are inconsistent with price stability



Source: BLS

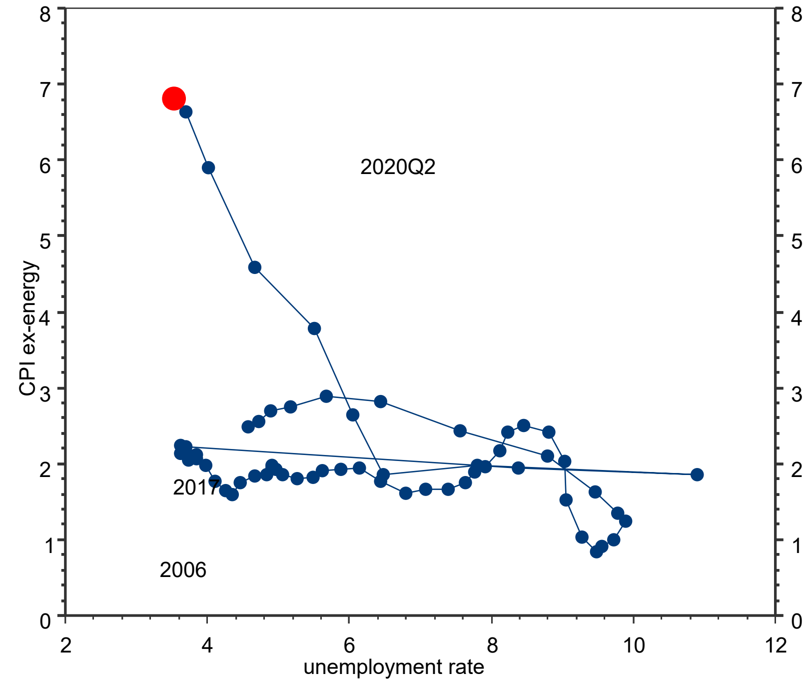
Fed-induced weaker demand=>higher unemployment

The relationship between job openings and unemployment (Beveridge curve) has shifted out: if job openings drop, the unemployment may have to move significantly up



Source: BLS

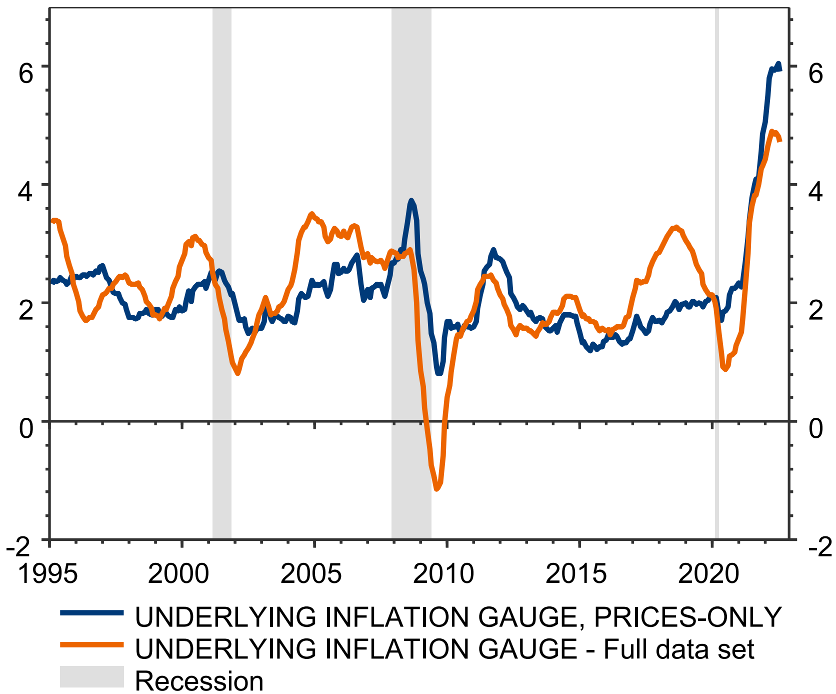
The Phillips curve gives a similar message: lower inflation=>higher unemployment



Source: BLS

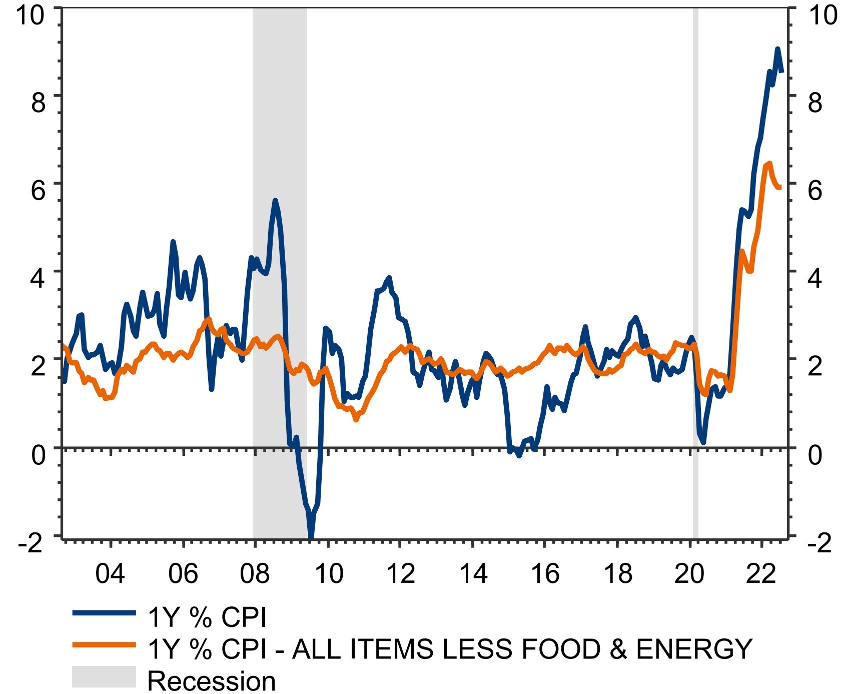
What's up with inflation?

Underlying Inflation Gauge: too early to call it a turning point



Source: NY Fed

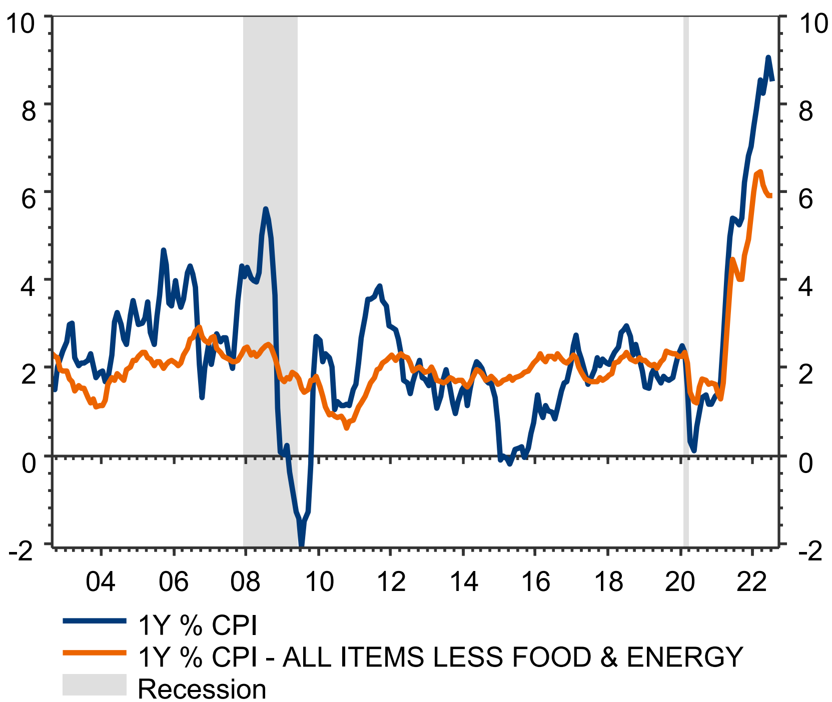
Inflation may have peaked, but it is a long way away from 2%



Source: BLS

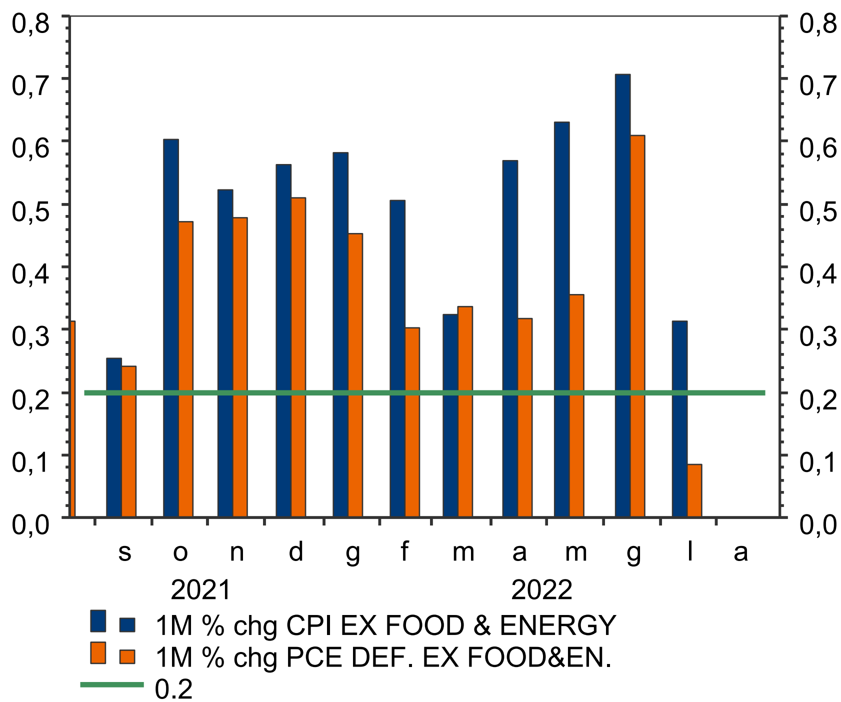
Inflation is not yet on a convincingly downward path: the Fed cannot change tack

Inflation may have peaked, but it is a long way away from 2%



Source: BLS

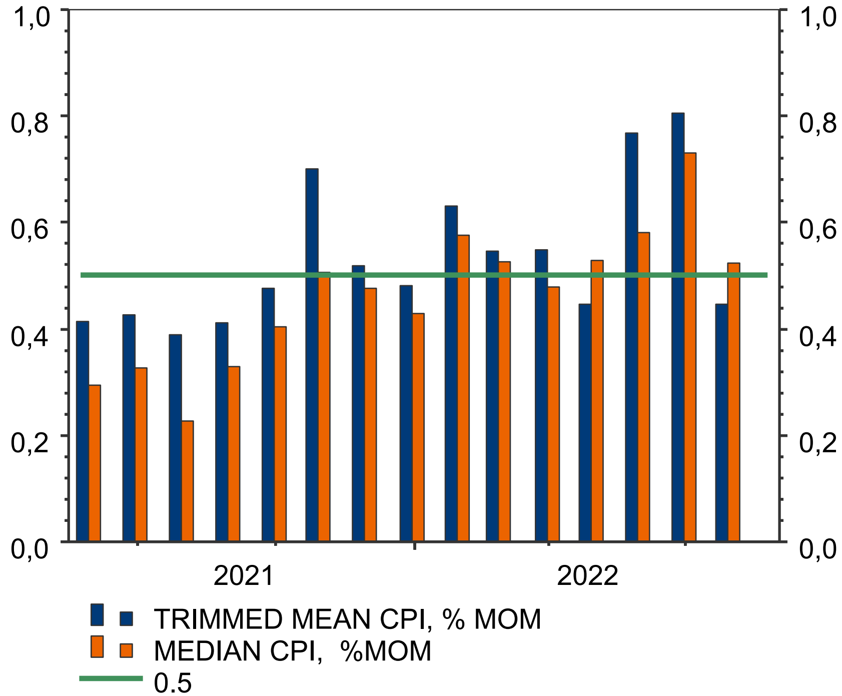
Monthly changes slower in July, but this is not the compelling evidence the Fed needs to slow rate hikes



Source: BEA, BLS

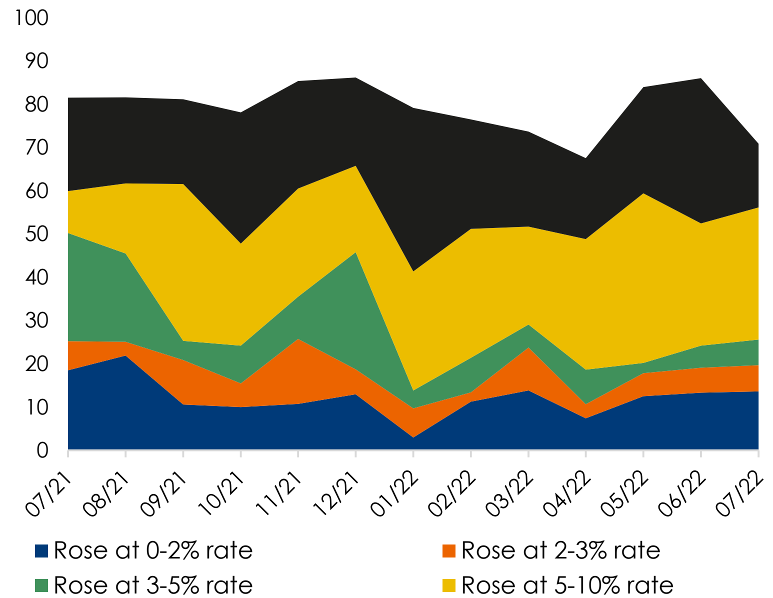
Underlying inflation measures are still flashing red

Trimmed mean and median CPI signal that large price changes are widespread



Source: Cleveland Fed

In July, 51.2% of components of the personal consumption deflator increased by more than 3% ann.

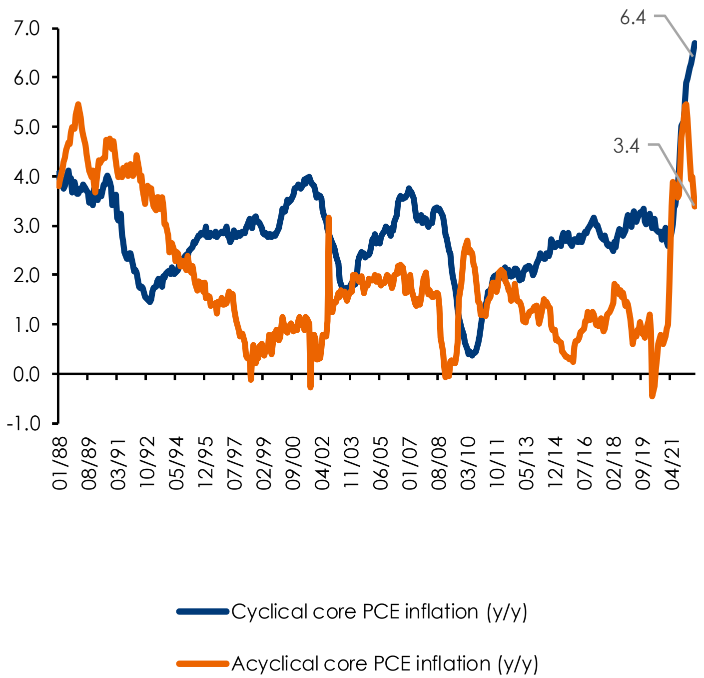


Note: Percentage of components each month, weighted by their shares in total spending, for which prices grew between 0 and 2 percent (at an annual rate); between 2 and 3 percent; between 3 and 5 percent; between 5 and 10 percent; and more than 10 percent. Source: Dallas Fed

INTESA SANPAOLO

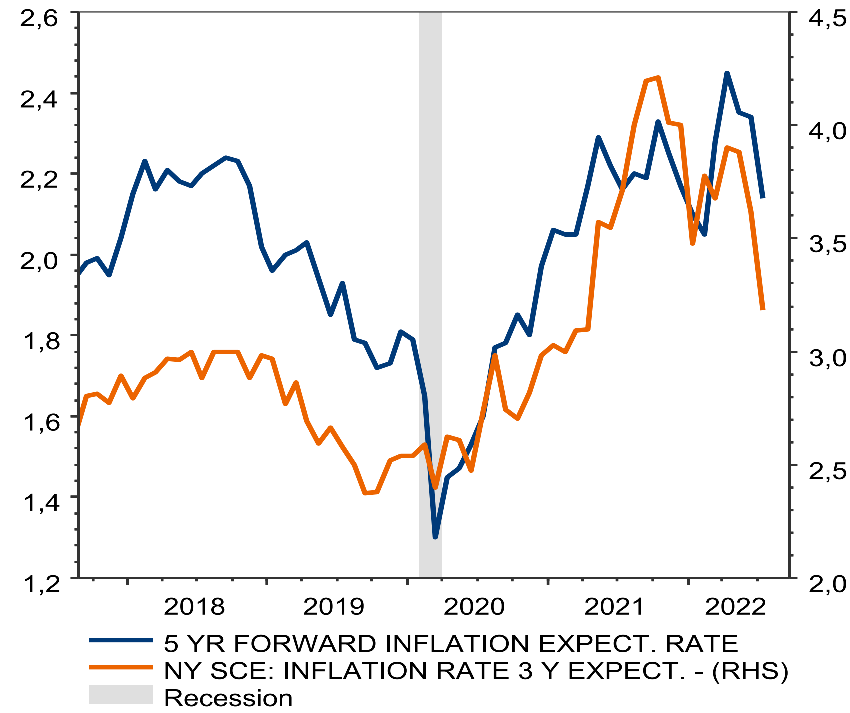
Cyclical inflation still up, but expectations have turned

Cyclical inflation is still moving up, signaling broad demand pressures



Source: San Francisco Fed

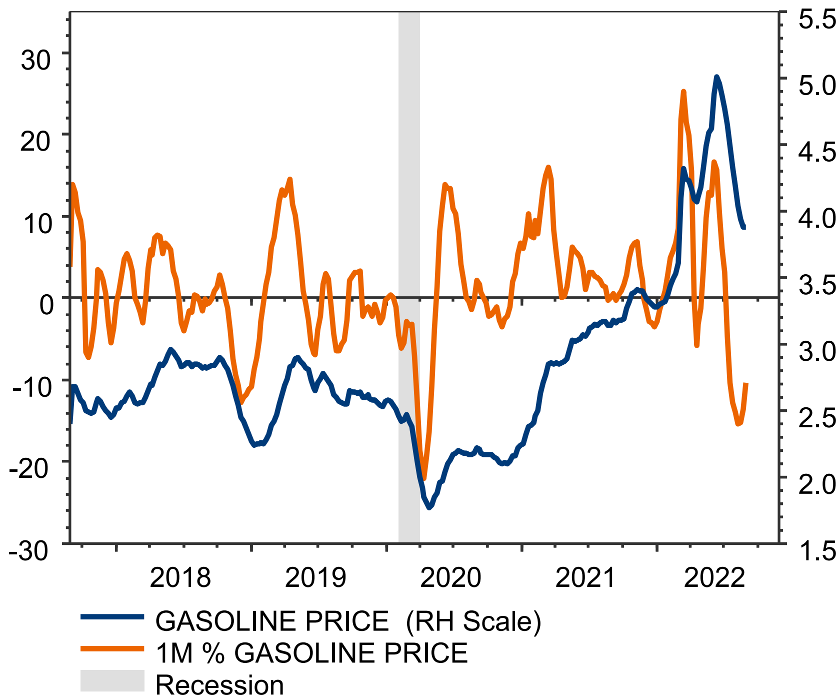
Expectations have turned



Source: NY Fed, Refinitiv Datastream

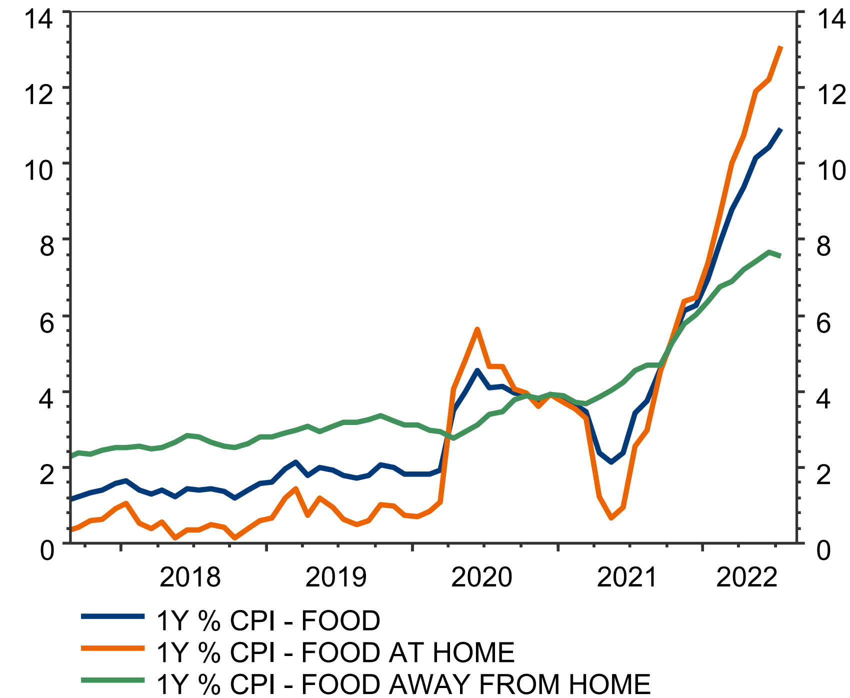
Goods: a mixed picture/1

Gasoline: the price is falling, but remains historically elevated



Source: EIA

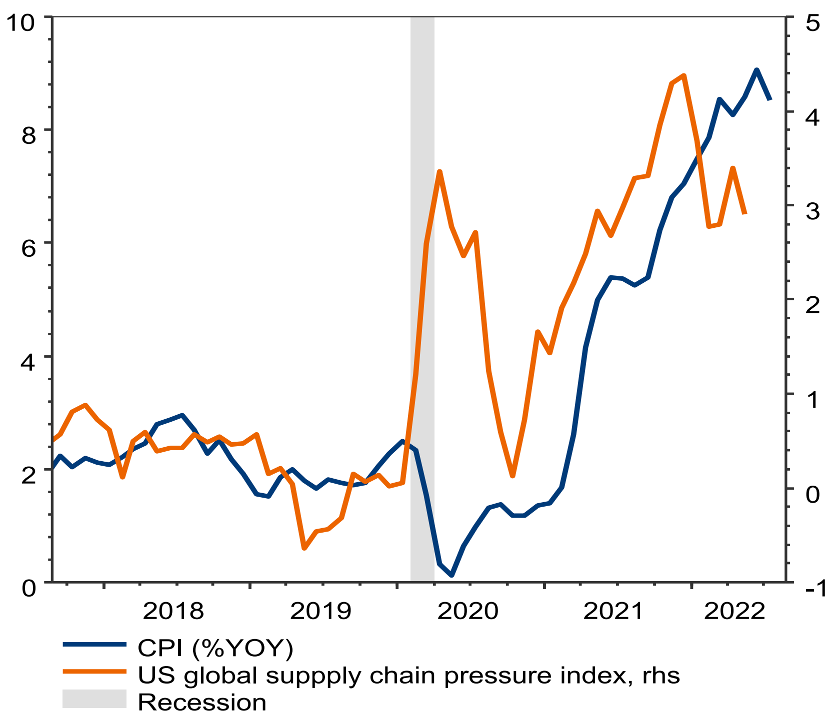
Food still flying high, no peak in sight



Source: BLS

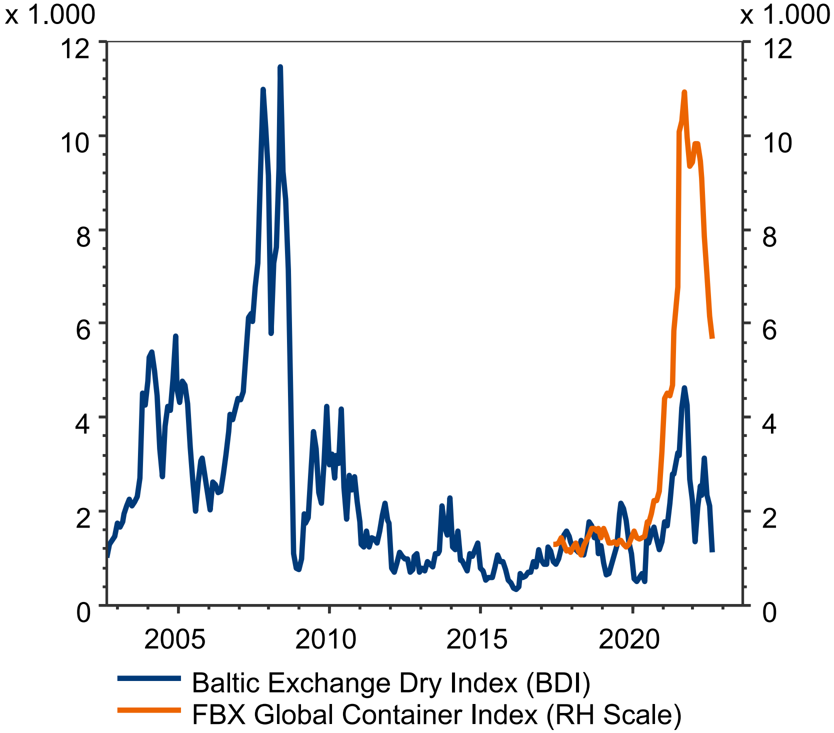
Goods: a mixed picture/2

Global supply chain pressures stabilizing, but not retreating: the NY Fed estimates that inflation would have been 30% lower without supply bottlenecks



Source: NY Fed, BLS

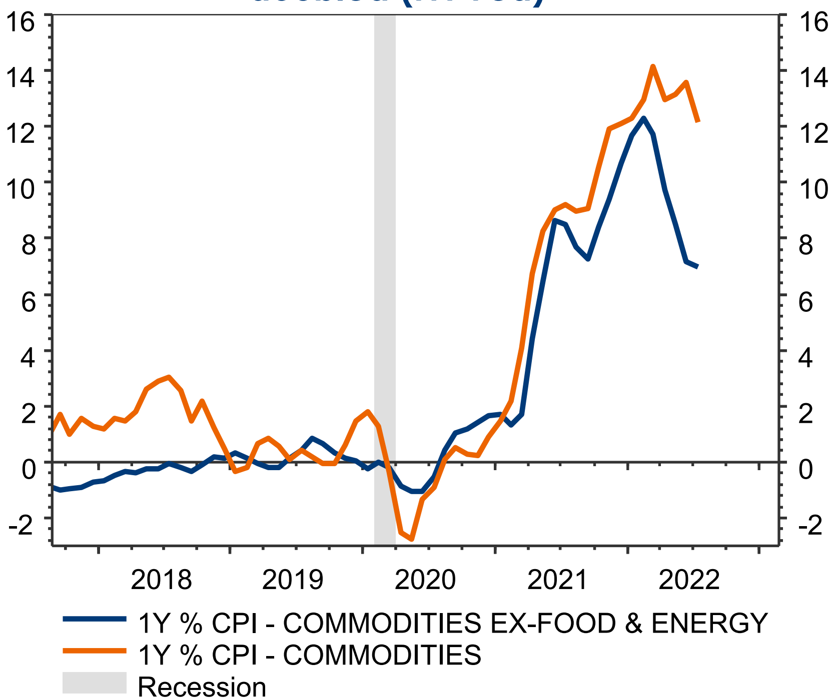
Shipping costs have turned



Source: Refinitiv-Datastream

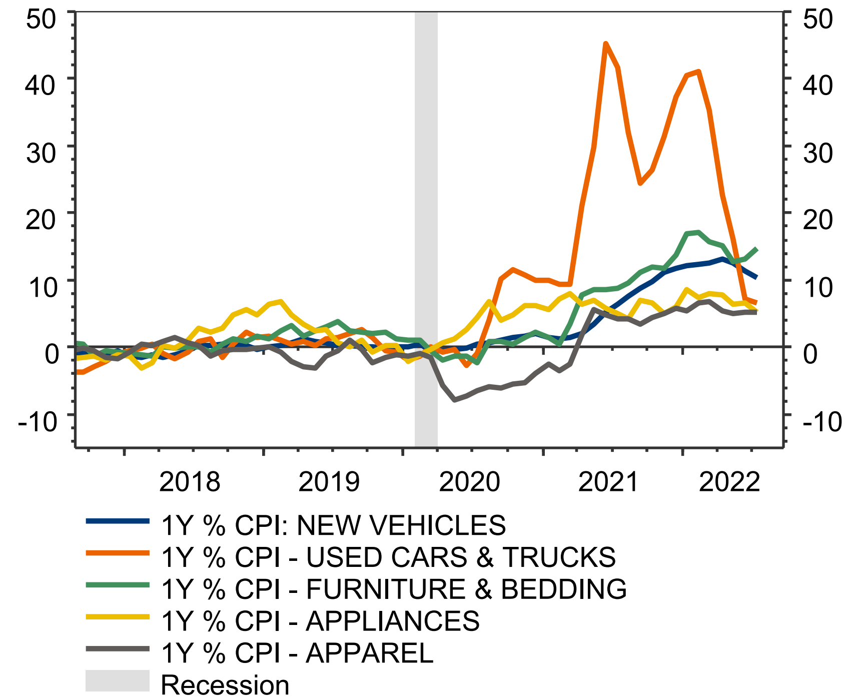
Goods: a mixed picture/3

Core commodity inflation is still far from historical norms: post-Covid, the pass-through from import prices and labor costs has almost doubled (NY Fed)



Source: BLS

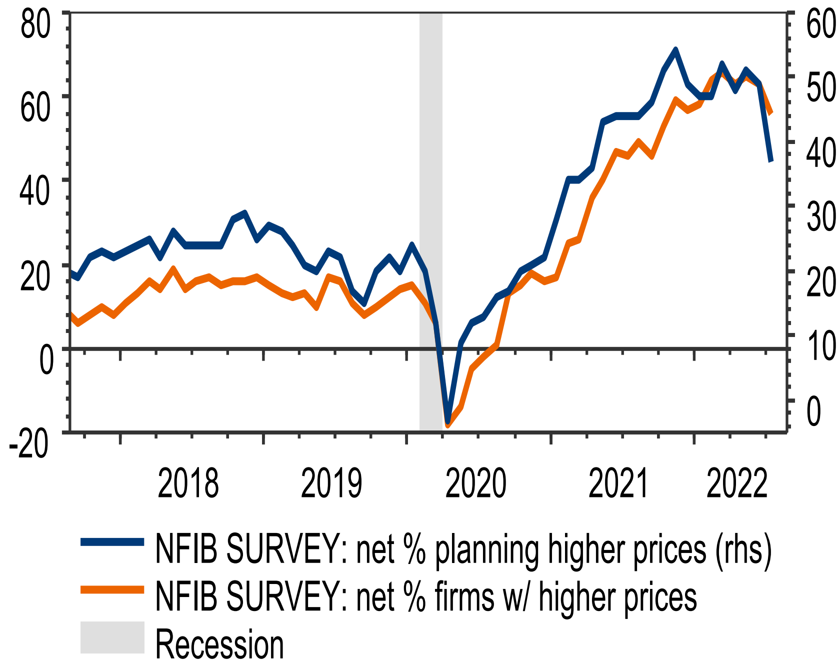
Extreme price increases are normalizing, but remain elevated



Source: BLS

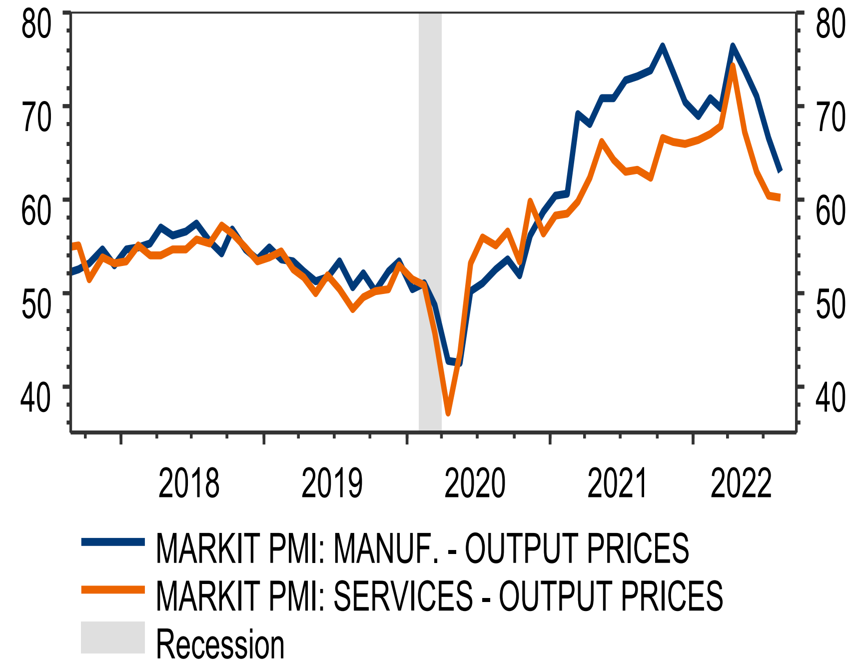
Business pricing power remains significant

NFIB: close to a net 40% of firms plan higher prices



Source: NFIB

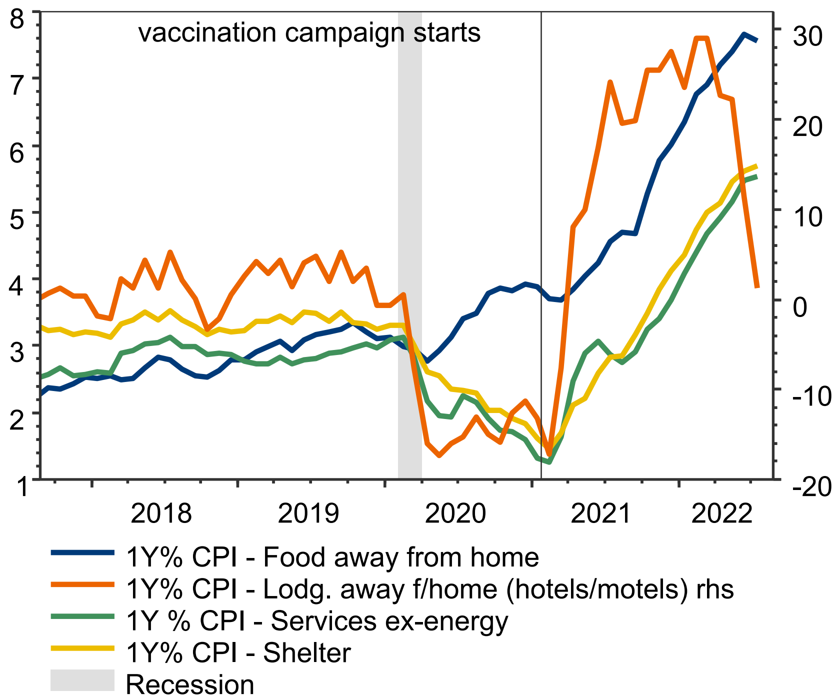
Markit PMI: selling prices still on the rise



Source: Markit

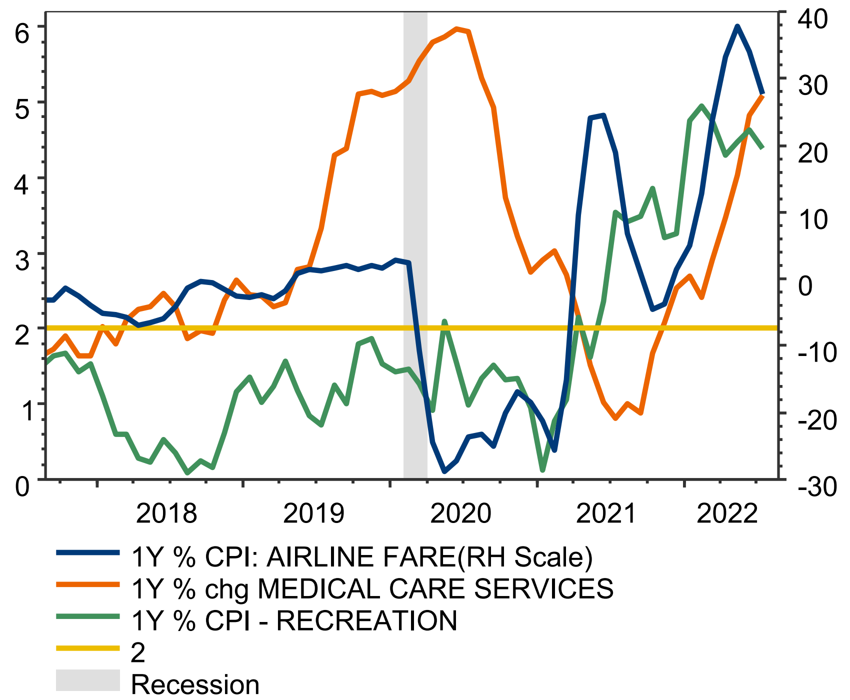
Services: a major headache for the Fed

Service prices still booming in housing…



Source: BLS

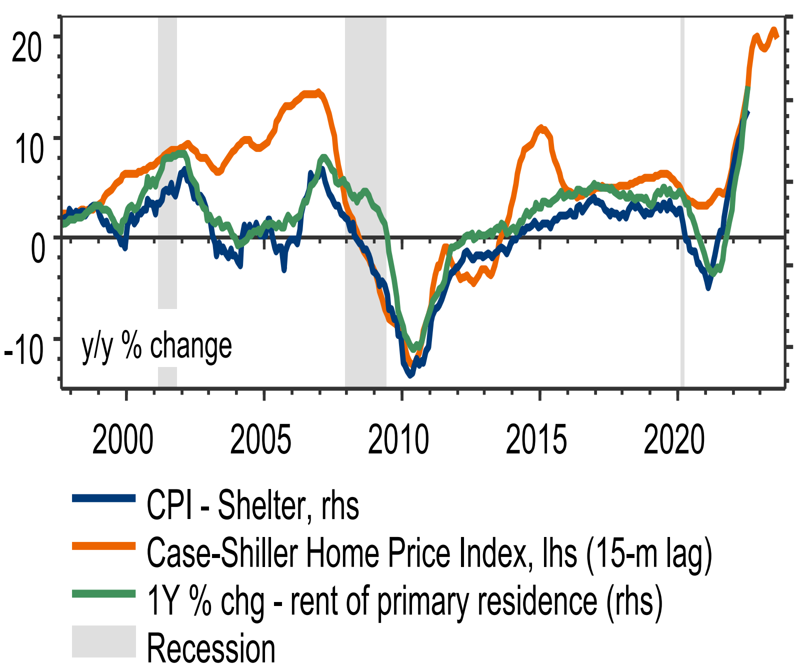
…but also in other sectors



Source: BLS

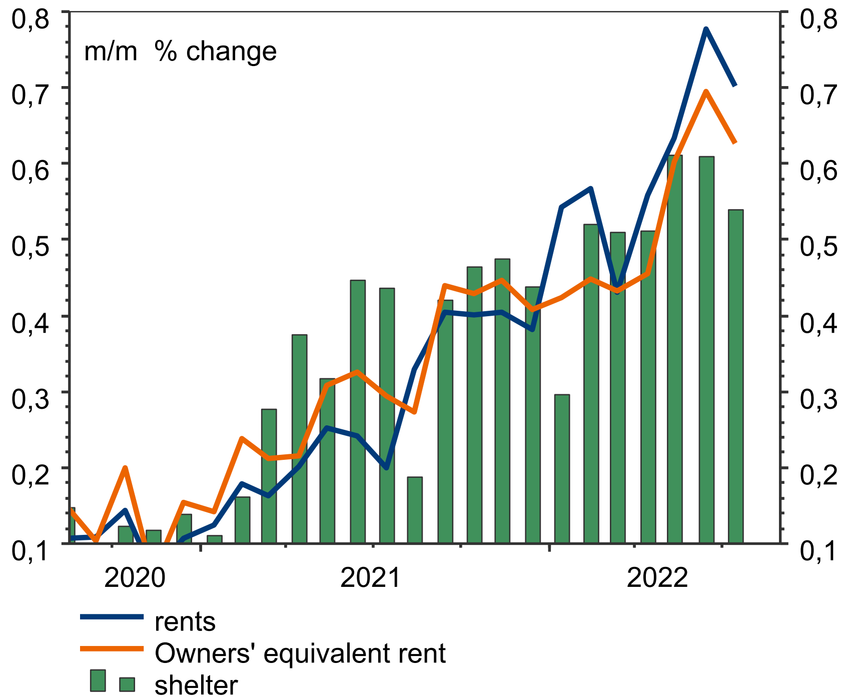
Shelter costs amplified by scarce home supply in a phase of record low affordability

Housing is the largest contributor to higher core inflation



Source: BLS, Refinitiv-Datastream

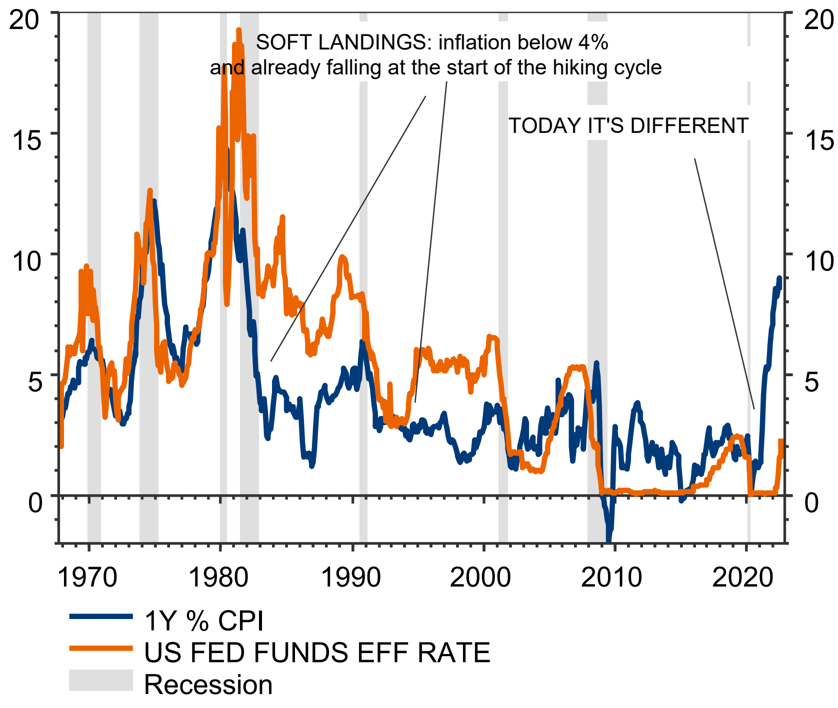
Inertia in rent-setting and record low home affordability will keep pressures elevated well into 2023



Source: BLS

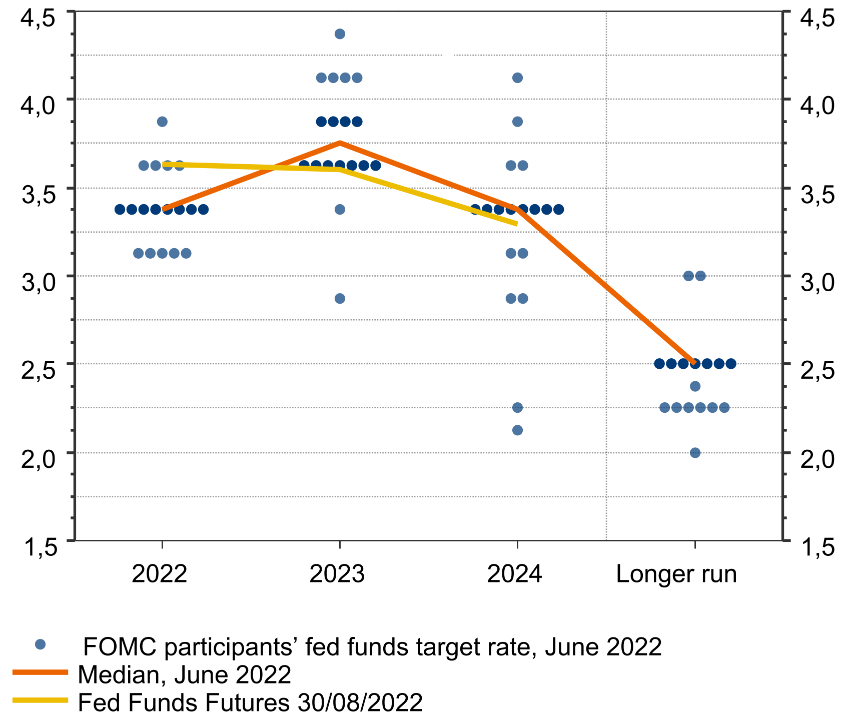
Inflation is the Fed's "overarching goal" now: not even a "softish" landing can be guaranteed

The chances of a recession are high, based on historical experience



Source: Federal Reserve Board, BLS

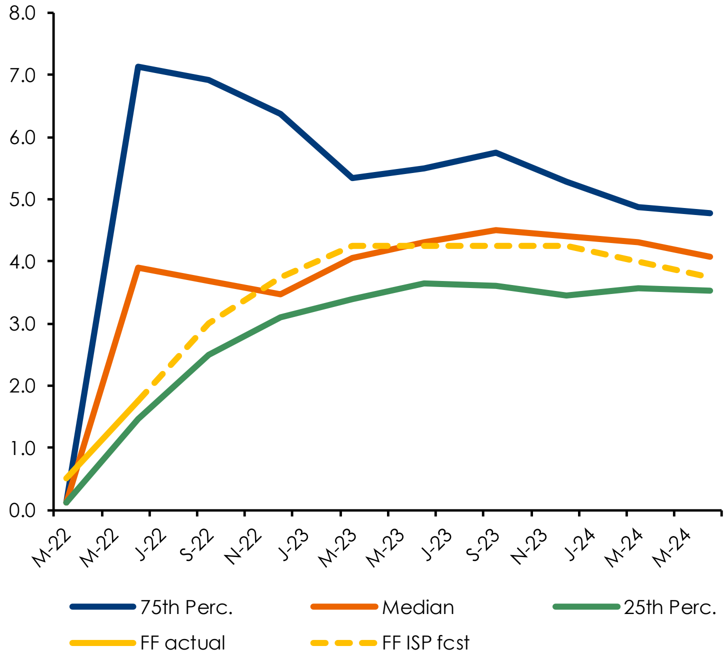
FOMC and market forecasts are again at odds with each other



Source: Refinitiv-Datastream

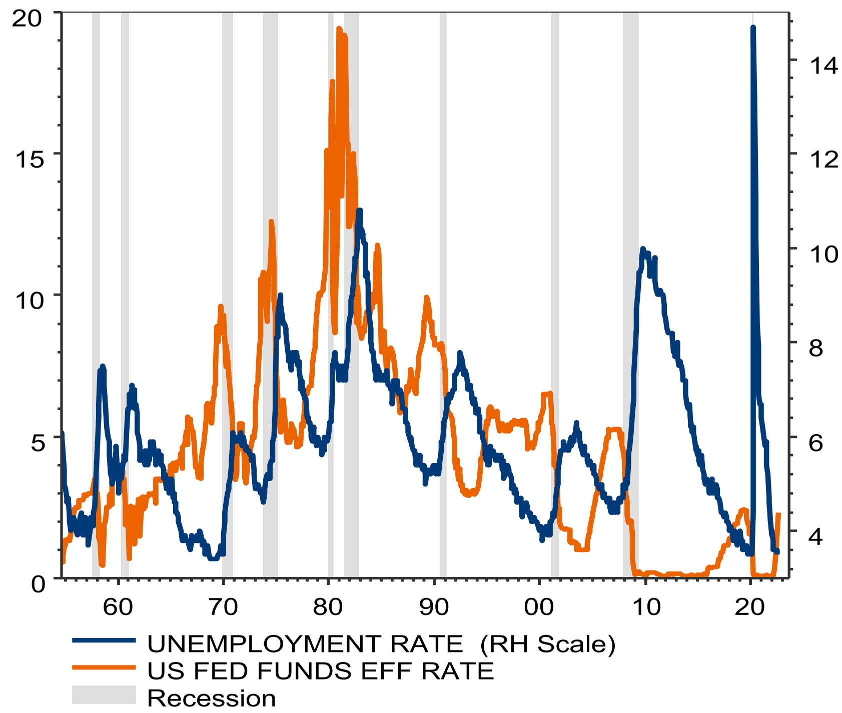
The Fed "will keep at it until we are confident the job is done", no matter what happens to the labor market

The FOMC wants to enter into restrictive monetary policy to weaken demand further



Note: Chart shows fed funds rates estimated using 7 different monetary policy rules and forecasts for macro variables from 3 different forecasters (CBO, Survey of Professional Forecasters and Cleveland Fed. Source: Cleveland Fed

Unemployment, at 3.5% now, must go up: every time the Fed pushed unemployment up by at least 0.3pp, a recession ensued



Source: Federal Reserve Board, BLS

“We must keep at it until the job is done”

Powell in his own words (26.08.2022)

- “Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. (…) These are the unfortunate costs of reducing inflation”.
- “We are moving our policy stance purposefully to a level that will be sufficiently restrictive to return inflation to 2 percent. (…) In current circumstances, with inflation running far above 2 percent and the labor market extremely tight, estimates of longer-run neutral are not a place to stop or pause.”
- “Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy. “
- ”There is clearly a job to do in moderating demand to better align with supply. We are committed to doing that job.”
- “We are taking forceful and rapid steps to moderate demand so that it comes into better alignment with supply, and to keep inflation expectations anchored. We will keep at it until we are confident the job is done.”

What rate hike in September?

Who said what

- "July's increase in the target range was the second 75 basis point increase in as many meetings, and I said then that another unusually large increase could be appropriate at our next meeting. (…) Our decision at the September meeting will depend on the totality of the incoming data and the evolving outlook." (J. Powell, 26.08.2022)
- "It's too soon to say, you know, what should we expect in September because we have some important data that's coming up" (E. George, 25.08.2022)
- "I want to see the next [inflation] reading and then decide." "We need to get inflation under control no matter what" (P. Harker, 25.08.2022)
- "At this point, I'd toss a coin between (75 and 50 bp) the two." If data remain strong and inflation doesn't clearly soften, "then it may make a case for (…) another 75 basis point move." (R. Bostic, 24.08.2022)
- "We need to err on making sure getting inflation down and only relax when we see compelling evidence that inflation is well on its way back down to 2%" (N. Kashkhari, 23.08.2022)
- "I would lean toward the 75 basis points at this point. Again, I think we've got relatively good reads on the economy, and we've got very high inflation" (J. Bullard, 18.08.2022)

We are upgrading our forecast for September from 50bps to 75bps, in light of Powell's speech and expectations for a solid August jobs report on 02.09.2022 and a still strong August core CPI (0.5% m/m) on 13.09.2022.

Conclusions: more hikes, higher recession risks

- US growth is slowing, but the economy is still expanding. Price pressures persist, in particular as a result of the tight labor market.
- **Aggregate demand must slow further to weaken labor market conditions**, as scarce supply is unlikely to turnaround soon, due to Covid, aging, headwinds to immigration.
- The Fed is committed to act until inflation is convincingly tamed. Historical experience shows that hiking rate cycles implemented with inflation above 4% and rising, and upturns in unemployment have always ended in a recession. **This time is unlikely to be different.**
- However, **not all recessions are born equal**. In the current case, some relevant features imply that **the recession may be shallow**: there are no evident financial excesses, household and firm balance sheets are in order, the Fed has turned back to a credibly anti-inflationary stance. Sources of amplified financial volatility seen in the dot-com and housing boom recessions are absent now.
- We currently **forecast rates at 4.25% at end-2022, with a peak at 4.5% in early 2023 and a turning point at end-2023.**

Appendix - What is a recession?

NBER Business Cycle Dating

- The NBER's definition emphasizes that **a recession involves a significant decline in economic activity that is spread across the economy and lasts more than a few months.** In our interpretation of this definition, we treat the three criteria—depth, diffusion, and duration—as somewhat interchangeable. That is, while each criterion needs to be met individually to some degree, extreme conditions revealed by one criterion may partially offset weaker indications from another. For example, in the case of the February 2020 peak in economic activity, the committee concluded that the subsequent drop in activity had been so great and so widely diffused throughout the economy that, even if it proved to be quite brief, the downturn should be classified as a recession.
- Because a recession must influence the economy broadly and not be confined to one sector, the (Business Cycle dating) committee emphasizes economy-wide measures of economic activity. (…) These include real personal income less transfers, nonfarm payroll employment, employment as measured by the household survey, real personal consumption expenditures, wholesale-retail sales adjusted for price changes, and industrial production.
- There is no fixed rule about what measures contribute information to the process or how they are weighted in our decisions. In recent decades, the two measures we have put the **most weight on are real personal income less transfers** and **non-farm payroll employment**.

Note: our bold. Source: NBER

Important Information

Analyst Certification and Other Important Disclosures

The analysts drafting this report state that the opinions, forecasts, and estimates contained herein are the result of independent and subjective evaluation of the data and information obtained and no part of their compensation has been, is, or will be directly or indirectly linked to the views expressed.

This research has been prepared by Intesa Sanpaolo S.p.A. and distributed by Intesa Sanpaolo SpA-London Branch (a member of the London Stock Exchange) and Intesa Sanpaolo IMI Securities Corp (a member of the NYSE and FINRA). Intesa Sanpaolo S.p.A. accepts full responsibility for the contents of this report. Please also note that Intesa Sanpaolo S.p.A. reserves the right to issue this document to its own clients. Intesa Sanpaolo S.p.A. is authorised by the Banca d'Italia and is regulated by the Financial Conduct Authority in the conduct of designated investment business in the UK and by the SEC for the conduct of US business.

Opinions and estimates in this research are as at the date of this material and are subject to change without notice to the recipient. Information and opinions have been obtained from sources believed to be reliable, but no representation or warranty is made as to their accuracy or correctness.

This report has been prepared solely for information purposes and is not intended as an offer or solicitation with respect to the purchase or sale of any financial products. It should not be regarded as a substitute for the exercise of the recipient's own judgement.

No Intesa Sanpaolo S.p.A. entity accepts any liability whatsoever for any direct, consequential or indirect loss arising from any use of material contained in this report.

This document may only be reproduced or published with the name of Intesa Sanpaolo S.p.A..

This document has been prepared and issued for, and thereof is intended for use by, Companies which have suitable knowledge of financial markets, which are exposed to the volatility of interest rates, exchange rates and commodity prices and which are capable of evaluating risks independently.

Therefore, such materials may not be suitable for all investors and recipients are urged to seek the advice of their relationship manager/independent financial advisor for any necessary explanation of the contents thereof.

Person and residents in the UK: this document is not for distribution in the United Kingdom to persons who would be defined as private customers under rules of the FCA.

US persons: this document is intended for distribution in the United States only to Major US Institutional Investors as defined in SEC Rule 15a-6. US Customers wishing to effect a transaction should do so only by contacting a representative at Intesa Sanpaolo IMI Securities Corp. in the US (see contact details below).

Intesa Sanpaolo S.p.A. issues and circulates research to Major Institutional Investors in the USA only through Intesa Sanpaolo IMI Securities Corp., 1 William Street, New York, NY 10004, USA, Tel: (1) 212 326 1199.

Inducements in relation to research

Pursuant to the provisions of Delegated Directive (EU) 2017/593, this document can be qualified as an acceptable minor non-monetary benefit as it is:

- macro-economic analysis or Fixed Income, Currencies and Commodities material made openly available to the general public on the Bank's website - Q&A on Investor Protection topics - ESMA 35-43-349, Question 8 & 9.

Method of distribution

This document is for the exclusive use of the recipient with whom it is shared by Intesa Sanpaolo and may not be reproduced, redistributed, directly or indirectly, to third parties or published, in whole or in part, for any reason, without prior consent expressed by Intesa Sanpaolo. The copyright and all other intellectual property rights on the data, information, opinions and assessments referred to in this information document are the exclusive domain of the Intesa Sanpaolo banking group, unless otherwise indicated. Such data, information, opinions and assessments cannot be the subject of further distribution or reproduction in any form and using any technique, even partially, except with express written consent by Intesa Sanpaolo.

Persons who receive this document are obliged to comply with the above indications

.

Valuation Methodology

Comments on macroeconomic data are prepared based on macroeconomic and market news and data available via information providers such as Bloomberg and Refinitiv-Datastream. Macroeconomic, exchange rates and interest rate forecasts are prepared by the Intesa Sanpaolo Research Department, using dedicated econometric models. Forecasts are obtained using analyses of historical statistical data series made available by the leading data providers and also on the basis of consensus data, taking account of appropriate connections between them.

Disclosure of potential conflicts of interest

Intesa Sanpaolo S.p.A. and the other companies belonging to the Intesa Sanpaolo Banking Group (jointly also the "Intesa Sanpaolo Banking Group") have adopted written guidelines "Organisational, management and control model" pursuant to Legislative Decree 8 June, 2001 no. 231 (available at the Intesa Sanpaolo website, webpage https://group.intesasanpaolo.com/en/governance/leg-decree-231-2001) setting forth practices and procedures, in accordance with applicable regulations by the competent Italian authorities and best international practice, including those known as Information Barriers, to restrict the flow of information, namely inside and/or confidential information, to prevent the misuse of such information and to prevent any conflicts of interest arising from the many activities of the Intesa Sanpaolo Banking Group which may adversely affect the interests of the customer in accordance with current regulations.

In particular, the description of the measures taken to manage interest and conflicts of interest – related to Articles 5 and 6 of the Commission Delegated Regulation (EU) 2016/958 of 9 March 2016 supplementing Regulation (EU) No. 596/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the technical arrangements for objective presentation of investment recommendations or other information recommending or suggesting an investment strategy and for disclosure of particular interests or indications of conflicts of interest as subsequently amended and supplemented, the FINRA Rule 2241, as well as the FCA Conduct of Business Sourcebook rules COBS 12.4 - between the Intesa Sanpaolo Banking Group and issuers of financial instruments, and their group companies, and referred to in research products produced by analysts at Intesa Sanpaolo S.p.A. is available in the "Rules for Research " and in the extract of the "Corporate model on the management of inside information and conflicts of interest" published on the website of Intesa Sanpaolo S.p.A., webpage https://group.intesasanpaolo.com/en/research/RegulatoryDisclosures. This documentation is available to the recipient of this research upon making a written request to the Compliance Department, Intesa San Paolo S.p.A., Via Hoepli, 10 – 20121 Milan – Italy.

Furthermore, in accordance with the aforesaid regulations, the disclosures of the Intesa Sanpaolo Banking Group's interests and conflicts of interest are available through webpage https://group.intesasanpaolo.com/en/research/RegulatoryDisclosures/archive-of-intesa-sanpaolo-group-s-conflicts-of-interest. The conflicts of interest published on the internet site are updated to at least the day before the publishing date of this report. We highlight that disclosures are also available to the recipient of this report upon making a written request to Intesa Sanpaolo S.p.A. – Macroeconomic Analysis, Via Romagnosi, 5 - 20121 Milan - Italy.

Intesa Sanpaolo acts as market maker in the wholesale markets for the government securities of the main European countries and also acts as Government Bond Specialist, or in comparable roles, for the government securities issued by the Republic of Italy, by the Federal Republic of Germany, by the Hellenic Republic, by the European Stability Mechanism and by the European Financial Stability Facility.

Report prepared by:
Giovanna Mossetti, Research Department, *Intesa Sanpaolo*