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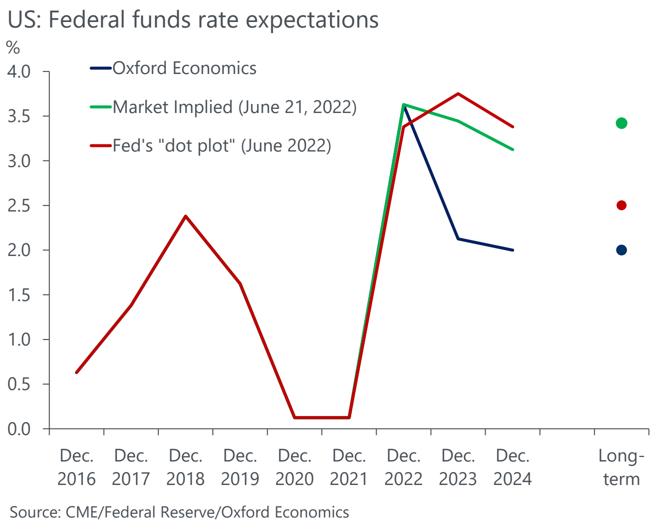
Research Briefing | US

Fed front-loading raises recession odds but it's not inevitable

- **Aggressive and front-loaded Fed rate hikes increase the odds of a hard landing, especially for 2023. Accordingly, we have revised down our GDP growth forecasts that will be included in our July baseline forecast. However, we remain in the camp that recession is not inevitable. As we wrote recently, we see still see several unique dynamics in this expansion that give the Federal Reserve a fighting chance to achieve a soft landing. These include the ability for supply to increase in the product and labor markets and the fact that household and corporate balance sheets remain in good shape.**
- **Inflation continues to concern Fed officials and now looks to be even stickier, with annual headline CPI likely to remain above 8.5% through September and only receding to 7% by year-end. Higher food, gasoline and core service prices and a more gradual cooling in core goods prices will keep upward pressure on overall prices. Looking ahead to 2023, declining gasoline prices and moderating food and core goods prices as supply chain stress eases should help lower the pace of inflation to below 3% by mid-year, before falling further to below 2% in Q4 2023.**
- **Due to the persistently elevated pace of inflation expected throughout this year, and the Fed's hardened resolved to restore price stability, we now see the Fed again raising the policy rate by 75bps at each of the July and September meetings. With the rate of inflation finally decelerating, by October and the policy rate already above the neutral level, we look for the Fed to throttle back the pace of rate hikes to 25bps at each of the November, December, and January 2023 meetings. This would lift the fed funds target range to its cycle peak of 3.75% - 4%. We then see the policy rate on hold until July 2023, at which point we look for policymakers to start cutting the policy rate as inflation falls markedly and GDP growth stalls.**
- **The more aggressive and front-loaded policy tightening will weigh heavily on economic activity. We now see real GDP growth slowing to around 2.3% (previously 2.6%) in 2022 and pulling back further to 1.3% (previously 1.8%) in 2023. The quarterly forecast profile shows economic growth falling to below stall speed growth in mid-2023. Our models continue to show recession odds are meaningfully higher but are not yet conclusively signalling recession. If we do end up tipping into recession, the lack of major imbalances indicate we will likely have just a mild downturn.**

Chart 1: Fed more aggressively front-loads rate hikes



Source: Oxford Economics

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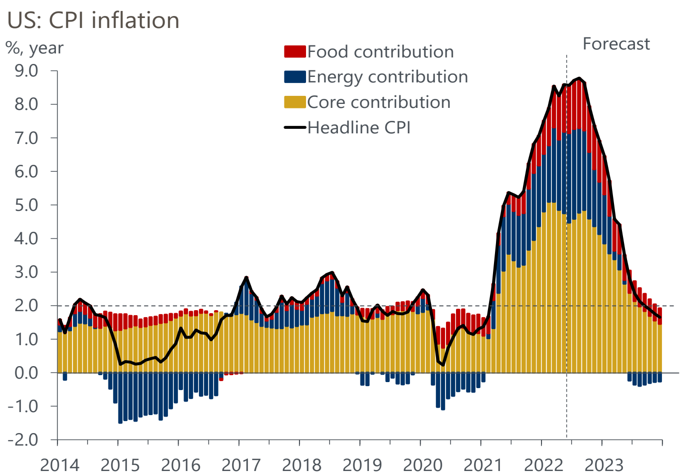
Inflation to remain stubbornly high

The Fed has a dual mandate of full employment and low and stable inflation of around 2%. Given that the employment mandate has been met but inflation continues to massively overshoot its 2% target, the Fed is hyper-focused on reducing inflation. While Chairman Powell is aware that tightening policy too quickly and too much could tip the economy into recession, he has asserted that "the worst mistake we could make would be to fail" to restore inflation to its 2% target, "which is not an option." He added that price stability is the "bedrock of the economy" and without it the economy will not operate properly in the medium to long-term.

Policymakers are also concerned that the longer inflation remains extremely high, the more it will push inflation expectations higher. And Powell pointed out that it is overall inflation, not core inflation that most influences consumers' inflation expectations since consumers look at all prices, especially of food and energy, as they form their opinions about prospective inflation. Expectations are critical since they can determine whether the rise in inflation becomes structural and harder to wring out of the economy. As such, the path of inflation and the impact on inflation expectations will determine the path for fed funds rate.

Our revised forecasts show that inflation is poised to remain stubbornly high, with overall CPI remaining above an annual 8.5% rate through September and overall PCE price inflation running at a rapid 6.5% clip **(Chart 2).** By year-end, we forecast CPI inflation remains at 7%, while PCE inflation eases to 5.3%. Higher food, gasoline and core service prices and a more gradual cooling in core goods prices will keep upward pressure on prices. Looking ahead to 2023, declining gasoline prices and moderating food and core goods prices – as supply chain stresses ease and demand slows – should lower the pace of CPI inflation to below 3% by mid-year, before falling further to below 2% in Q4 2023. PCE price inflation would follow suit, decelerating to 2.5% by mid-year and then falling below 2% by year-end.

Chart 2: Inflation remains higher and stickier



Source: Oxford Economics

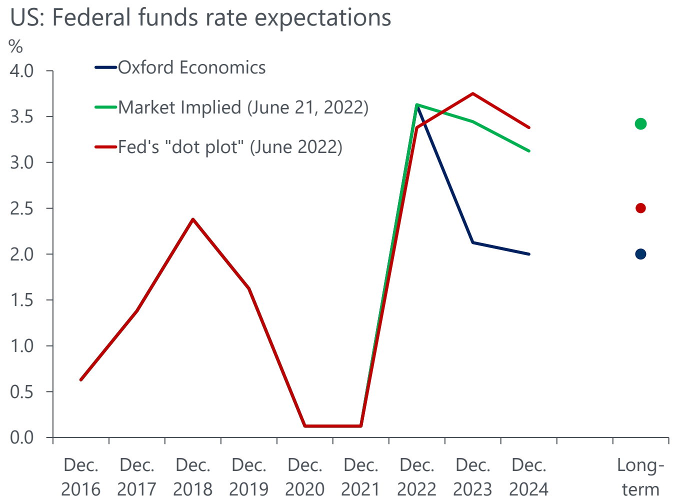
Inflation calls the shots for rates

Given the Fed's laser focus on inflation, we are explicitly tying our rate forecast - the timing and degree of rate changes - to our inflation forecast. With our view that CPI inflation remains stubbornly above 8.5% through September, we expect the Fed to again raise the policy rate by 75bps at both the July and September meetings. With the rate of inflation finally decelerating in October and the policy rate already in restrictive territory, we look for the Fed to scale back rate hikes to 25bps each at the November, December, and January 2023 meetings. This would increase the fed funds target range to a cycle high of 3.75% - 4% **(Chart 3).**

In terms of the Fed pausing its rate hikes, we have chosen an inflation rate around 5.5% as the trigger because it represents a material slowdown in inflation, and with our forecast for slower demand growth in

2023 and some easing in supply chain stress, inflation should continue to trend lower. We see the Fed keeping rates on hold from February through July next year. We project that CPI inflation slows to 2.3% by July 2023 and GDP growth stalls to below 1%, which is when we look for Fed officials to begin cutting the fed funds rate.

Chart 3: Fed front-loads rate hikes, but easing ahead in H2 2023



Source: Oxford Economics/CME/Federal Reserve

GDP growth stalls in mid-2023 and recession odds rise

The larger and front-loaded policy tightening will dampen economic activity more than we previously anticipated. We now see real GDP growth slowing to around 2.3% (previously 2.6%) in 2022 and falling more sharply to 1.3% (previously 1.8%) in 2023. On a quarterly basis, we forecast real GDP growth stalls to below 1% growth by mid-year 2023.

As such, the economy would come precariously close to tipping into a recession by mid-2023, but for now we see the labor market remaining solid enough to generate personal income gains that would underpin resilient, though sluggish consumer spending. Importantly, we only see the unemployment rate rising to around 3.8% from a low of 3.5%. Further we see the lack of major imbalances or deterioration in consumers' and businesses' balance sheets as a buffer against recession.

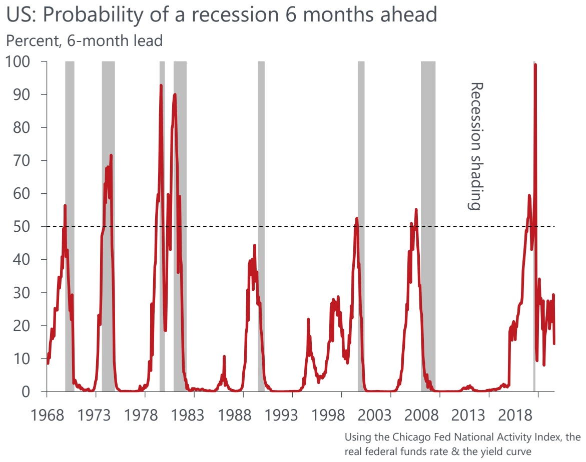
Our recession models continue to signal recession odds are meaningfully higher, but the probabilities have not breached recession threshold levels **(Charts 4 and 5)**. Specifically, our yield curve-based and activity-augmented recession model now points to a rising risk of around 22% of a recession in the next six months – historically, a breach of the 50% risk threshold has been consistent with a recession.

Our Treasury yield curve-based model using the Fed's preferred 10-year less 3-month Treasury yield spread signals a low recession risk of just 5% and previously it would need to rise to a threshold of 30% to be consistent with an unfolding recession. Using the 10-year less 2-year yield spread, the probability levels have moved closer to those associated with prior recessions, and the very flat spread along with the tightening in broader financial conditions are measures we will continue to track closely. However, as we have written previously, history shows that an inversion of the 10-year less 2-year spread would not provide clear guidance on the timing of a recession. Historically, the time between the spread inverting and the onset of recession has been long and variable. For the five recessions prior to the brief Covid-induced recession in 2020, the lead time between the inversion and the onset of the recession averaged approximately 20.5 months. Further the range of the lead time is quite wide, spanning from 9.5 months ahead of the 1981-1982 recession to 35 months ahead of the 2001 recession.

We also watch closely leading economic indicators. Specifically, The Conference Board's Leading Economic Index (LEI) is signalling slower economic momentum in the coming months. The LEI has contracted 0.4%

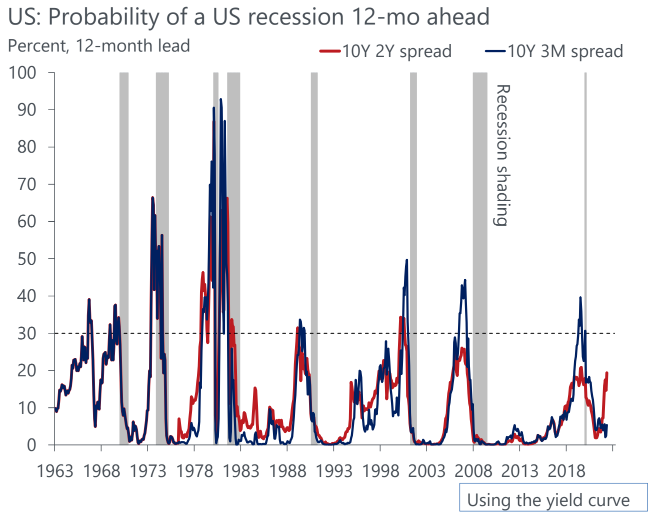
over the past six months and annual growth has slowed 1.9ppts to 3.2% y/y in May - the slowest pace since February 2021. However, the year-on-year reading remains in positive territory and not yet indicative of a pending recession **(Chart 6).**

Chart 4: Recession odds are rising, but not yet flashing red



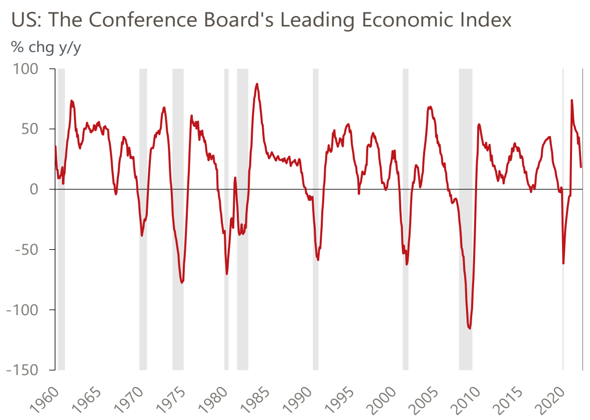
Source: Oxford Economics

Chart 5: Recession odds are rising, but not yet flashing red



Source: Oxford Economics/New York Federal Reserve

Chart 6: US Leading Economic Index signals slowing growth ahead



Source: Oxford Economics/The Conference Board

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