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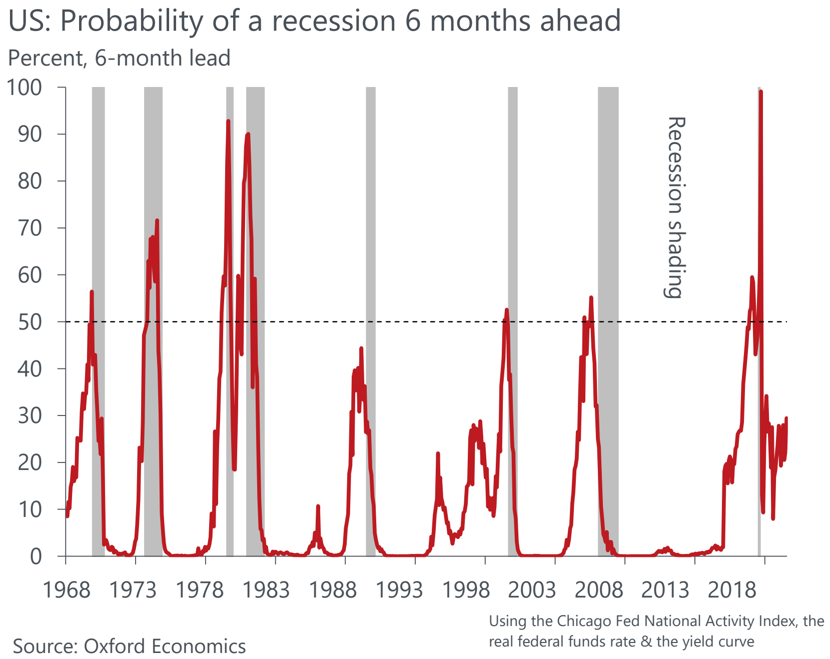
Research Briefing | US

Why a soft landing is more likely than recession

- **Risks of a US recession have increased, particularly in 2023, as strengthening headwinds buffet the economy. But in our view, several unique dynamics in this expansion give the Federal Reserve a fighting chance to achieve a soft landing.**
- **The economy is already in the late stages of the business cycle, but atypically we see potential for an increase in the supply of both labor and goods that could cool inflationary pressures and allow the expansion to continue. Our baseline forecast anticipates a continuing rebound in labor force participation, which should temper wage gains and help short-circuit a self-reinforcing price-wage spiral. This would allow the Fed to ease up on tightening.**
- **We also assume some moderate easing of supply chain stresses in 2023, although supply conditions will remain far from pre-pandemic levels. Consumers' rotation away from goods to services consumption will also help lessen inflationary pressures in the goods market.**
- **Household and corporate balance sheets overall are in good shape and lack the large imbalances that can contribute to recessionary conditions. Households and corporations are not highly leveraged and incoming personal income and corporate revenue flows remain sturdy overall, although profit margins have peaked. Households also maintain a surfeit of pandemic-related savings, having tapped only about $40 billion (1.6%) of the accumulated $2.5 trillion. This is in addition to strong gains in net worth, although the recent pullback in equity prices will dampen some of the wealth effect and consumer sentiment.**
- **Other factors boding well for avoiding a recession include inventories remaining lean relative to sales, and long-term inflation expectations remaining anchored despite the relatively long period of high inflation. If inflation slows in H2 2022, this could lead the Fed to ease up on rate hikes.**

Chart 1: Recession risks have risen, but not yet flashing red



Source: Oxford Economics

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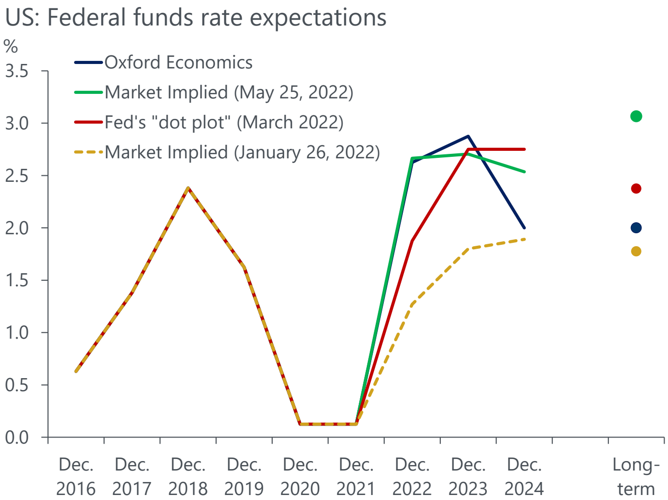
The stock market has tumbled close to a bear market, weighed down recently by the steep drop in Q1 retail corporate earnings and mounting recession concerns. But incoming economic readings show that the economy is far from falling into a recession. In fact, the April retail sales report indicates that real consumer spending looks to be running at a buoyant 4.5% annualized pace in Q2 – the fastest pace since Q2 2021.

The April data also show that while consumers are still spending on goods, they are also increasingly rotating their spending towards in-person services as we anticipated. We should get more evidence of this trend on Friday when April's consumer spending data is released. And considering the shift in consumer spending was a large contributor to the deterioration in retailers' profit margins, the overall consumer outlook does not look as bleak as headline earnings data suggests. Bolstered by the consumer, real GDP growth looks set to reach 2.8% annualized in Q2. In the second half of the year we think real GDP growth will slip, but will still average 2.3%.

However, the strong consumer and GDP performance cuts both ways, since it also incentivizes the Fed to continue to aggressively raise interest rates. Policymakers may surmise that demand is still running way too hot and aim to cool it to allow aggregate supply conditions to catch up, with the aim of reducing inflationary pressures. This is particularly crucial given that recent labor market indicators are pointing to a labor market that is still extremely tight.

Indeed, we now anticipate a total of 250bps in rate hikes by the Fed this year, lifting the mid-point of the fed funds target range to 2.63% by year-end. We think the Fed is poised to raise the fed funds rate by 50bps at each of the June and July meetings and then to scale back the pace of tightening to 25bps rate increases at the remaining meetings of the year (**Chart 2**). This reflects the latest forward guidance from Chairman Powell that Fed officials "need to see clear and convincing evidence that inflation pressures are abating and inflation is coming down." Our forecast is for inflation to slow markedly by year-end, with the headline PCE price index falling from a peak of 6.4 % in Q2 2022 to 4.6% by Q4 2022. But this could still represent too high a rate for Fed officials.

Chart 2: Fed now likely to lift rates 250bps this year

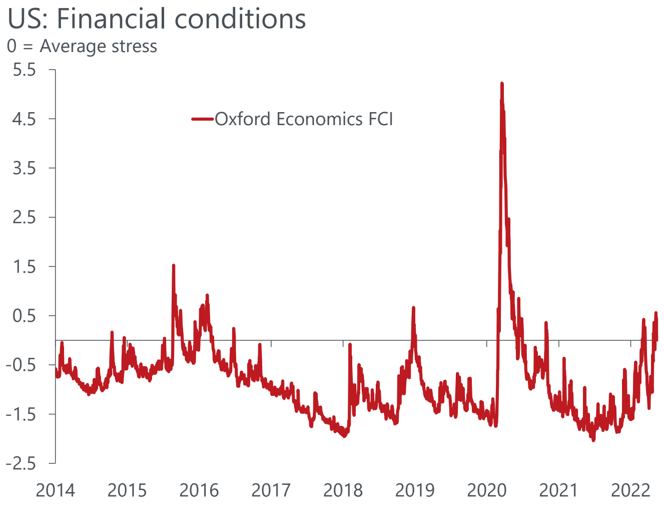


Source: CME/Federal Reserve/Oxford Economics

A steeper Fed rate path along with a tightening in overall financial conditions that includes the sharp drop in equity prices, wider corporate bonds spreads, and a stronger dollar (**Chart 3**), increases the risk of a hard landing in 2023. Higher borrowing rates in addition to still-elevated inflation erodes consumers' purchasing power, especially for mid- to low-income households. Meanwhile, corporate profit margins are experiencing downward pressure from still rising input costs and some diminished pricing power.

Our yield curve-based and activity-augmented recession model now points to a rising risk of around 30% of a recession in the next six months – historically, a breach of the 50% risk threshold has been consistent with a recession (**Chart 1**). The increase in recession risks is not surprising given the economy is in the late stages of the business cycle, inflation is running red-hot, and the Fed is looking to rapidly tighten policy to a restrictive level.

Chart 3: Broad-based tightening in financial conditions



Source: Oxford Economics

Soft landing still possible

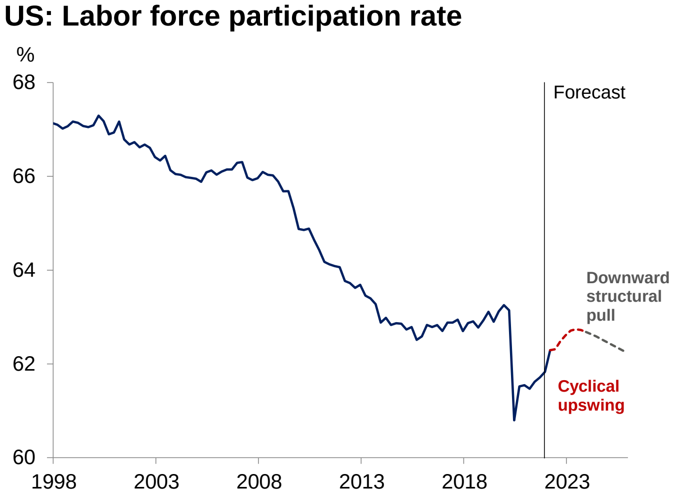
Still, we view a soft landing as the more likely outcome in 2023, despite the strengthening headwinds. We think the Covid-induced recession and the subsequent stimulus-propelled expansion have idiosyncratic dynamics that set it apart from prior cycles. Typically, when the economy reaches late-cycle it has nearly exhausted all its spare and available capacity in labor and product markets. This leaves no way to tap into additional capacity to release inflationary pressures.

But we think this economic expansion is different. Additional labor supply could be tapped as workers who left the labor force return, while the supply of goods could increase as stressed supply chains eventually ease – our baseline forecast assumes this will unfold gradually over the next 18 months. An increase in the supply side of the economy would go a long way to quell inflationary pressures. In this scenario, the Federal Reserve could slow its pace of tightening and not have to ratchet rates up to such a restrictive level. This could sharply improve the chances of achieving a soft-landing for the economy.

Labor supply has gradually recovered from the pandemic-provoked collapse, with the participation rate rising to 62.2% in April 2022 from 60.2% in April 2020 as people who left the labor forecast returned to look for jobs in this hot labor market. But it's still 1.2ppts below the pre-pandemic high of 63.4%. If the participation rate had rebounded to pre-covid levels, another 2.6 million individuals would have been in the labor force looking for a job in March. Those extra job seekers would have lowered the ratio of the number of job openings per unemployed person from the historically high 1.9 currently – described by Chairman Powell as an "unhealthy level of tightness in the labor market" – to possibly 1.3, which is more in line with the healthier pre-pandemic readings (**Chart 4**).

In our baseline forecast, we expect a further steady but moderate rise in the labor force participation rate to 62.7% by mid-year 2023, adding around 1.3 million more workers to the supply of available labor. A steady rebound in the labor force participation rate would reduce upward pressures on wage growth. Fed officials are closely watching wage growth out of concern that the long period of very elevated inflation might be leading to a price-wage spiral that would become harder to wring out of the economy – much more so than waiting for supply chains disruptions to subside.

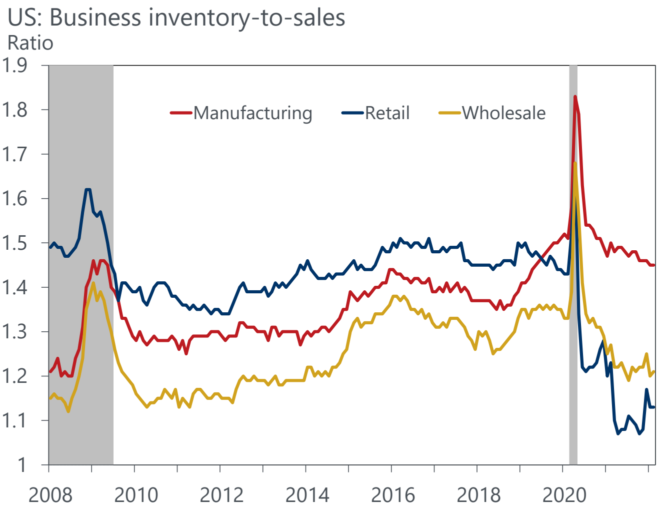
Chart 4: Labor supply should continue to rebound



Source : Oxford Economics/Haver Analytics

In the product market, we also assume some gradual easing of supply chain stresses in 2023, although conditions will remain far from pre-pandemic levels. Additionally, consumers' rotation away from goods to services consumption will help lessen inflationary pressures in the goods market. Together the lessening of demand and the rise in the supply of goods will help to boost inventories, especially for wholesale and retail, with the latter still exceptionally low relative to sales (**Chart 5**).

Chart 5: Inventory/sales ratios are very low



Source: Oxford Economics/Haver Analytics

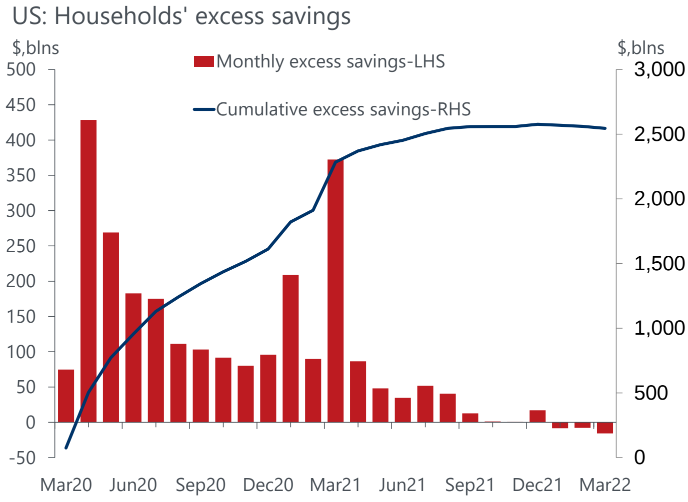
At the same time, these low inventory/sales ratios signal inventories have not built to a high level that would necessitate a large drawdown which would weigh heavily on GDP growth, as is typically associated with recessionary downturns. In fact, low inventory levels augur well for sizeable corporate investment to rebuild stock, adding to GDP.

Household and corporate balance sheets in solid shape

The sharp sell-off in retail equities last week underscored several signs of strain for some households, including rising delinquencies on consumer loans and a greater reliance on credit cards. But in our view, consumer fundamentals including household balance sheets overall are in very good shape.

The strong labor market continues to fuel robust aggregate personal income gains that underpin consumer spending. Households are also maintaining a surfeit of pandemic-related savings, having only tapped into about $40 billion of the accumulated $2.5 trillion so far, according to our estimates (**Chart 6**).

Chart 6: Consumers have just modestly begun to tap into savings

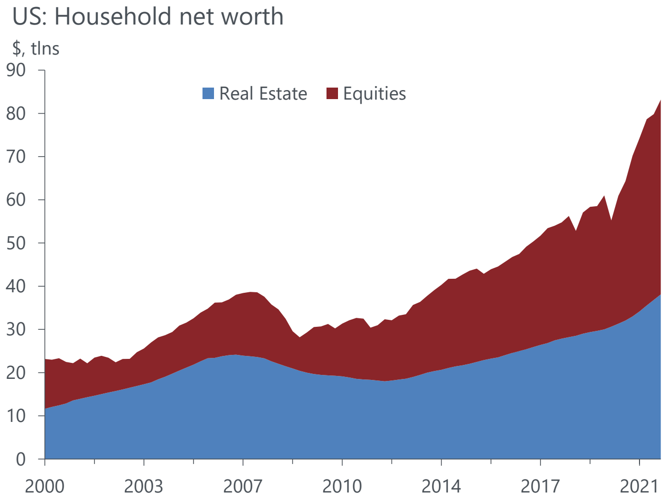


Source: Oxford Economics

Consumers are also benefitting from the strong gains in household net worth, which surged to $150.3tn at the end of last year, up 35% since early 2020. The fuel for this rise is households' equity holdings, which over 2020-2021 nearly doubled from $24.5tn to $45tn, and the surge in the value of households' real estate assets, which rose from $30.6tn to $38.1tn (**Chart 7**).

That said, the recent pullback in equity prices has dampened some of the equity wealth gains. Since the end of 2021, the S&P 500 has tumbled 18%, which translates into about $8.1tn of 'lost' wealth. Conversely, home prices have risen an estimated 3.7%% further in Q1, which equates to a $1.4tn increase in the value of households' real estate holdings. Combined, we estimate that the total negative hit to household net worth since the start of the year is roughly $6.7tn – still nearly $27tn above the pre-pandemic level of $116.7tn in Q4 2019.

Chart 7: Household net worth is high despite recent equity declines



Source: Oxford Economics/Haver Analytics

On the corporate side, aggregate balance sheets do not look highly imbalanced, as is often the case in the run up to an economic recession. Indeed, the share of net operating surplus nonfinancial debt has fallen back below its pre-pandemic level as corporate revenue flows remain sturdy overall, despite the peak in profit margins (**Chart 8**).

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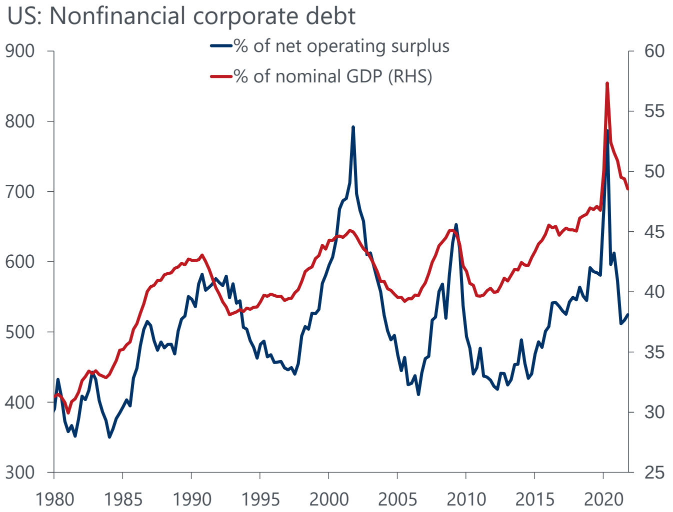
Chart 8: Corporate debt levels are healthy

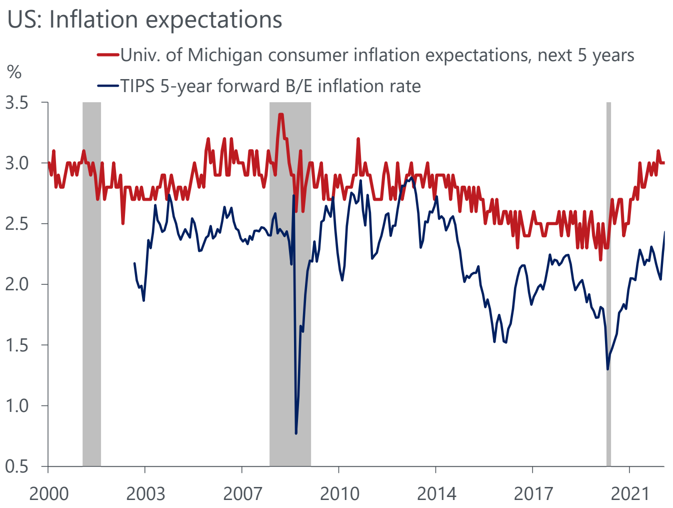


Source : Oxford Economics/Haver Analytics

Inflation expectations remain anchored

The other key factor supporting our view that a soft rather than a hard landing is more likely, is that long-term inflation expectations still seem anchored despite the extended period of high inflation (**Chart 9**). This reduces the degree of rate hikes that the Fed will need to engineer, and if inflation slows in H2 2022 as we expect, this should ease the pace of rate hikes.

Chart 9: Inflation expectations have risen but not de-anchored



Source: Oxford Economics/Haver Analytics

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