

FOCAL POINT

US: Recession looming, rate cuts at the end of the year

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May 23, 2023

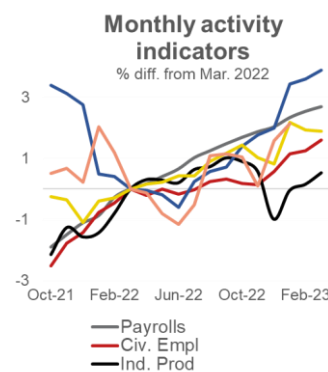
Our Focal Point series explores topical issues on macro, markets and investment

- Even if domestic demand proved rather strong in Q1, we still expect GDP to contract in H2. We push back to Q4 the worst of the recession that we anticipate.
- Excess savings and labour income resilience remain supportive to growth. But increasingly tighter credit standards and cracks in parts of the economy (such as Commercial Real Estate) could deepen the recession. We expect that a compromise on the debt ceiling results in fiscal consolidation, dampening an already weak 2024 growth outlook. The alternative would be an unprecedented period of chaos.
- The Fed is done with tightening, but sticky inflation prevents an early pivot. We expect two rate cuts in Q4 of this year, roughly in line with current market pricing despite our more bearish growth outlook.

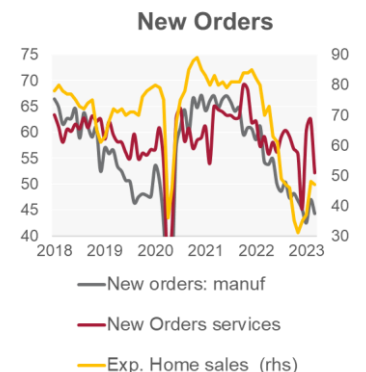
The impact of monetary tightening on the US economy is getting increasingly visible. We expect GDP to perform worse than consensus this year (0.6% versus 1.1%), Tighter credit may have an even bigger than expected impact on the economy and the compromise on the debt ceiling could come at a cost of cutting public expenditures. That said, positive surprises, coming from households, cannot be ruled out. In what follows we detail our updated view on the US economy and the main risks to the outlook in the second half of the year and the Fed, which we expect to start cutting in Q4, earlier than what it hinted at in the March meeting while roughly in line with markets, who until recently were discounting an earlier pivot.

Strong Q1 delays the slowdown

Data for the year so far have overall surprised to the upside. In January, the push to income due to tax changes has lifted consumption and the boost is only gradually fading. The post



Source: BLS, BEA, Fed,



Source: ISM, NAHB, Refinitiv, GIAM

Covid rebalancing in consumption away from goods and rising rates has hit industrial production and construction activity, but both seem to have found a bottom (at least temporarily). All this has guaranteed a strong showing in domestic demand in Q1 (2.2% annualised). Employment growth, while stronger than foreseen, is gradually

decelerating, and the participation rate has almost reached the pre-pandemic level. Despite still high inflation labour income should continue to sustain consumption in Q2. Of course, these data do not reflect in full the impact of the acceleration in credit tightening following the March banking sector woes.

We predict weaker growth than consensus...

Indeed, tighter finance will drive the cycle in the second half of the year, leading to two quarters of GDP contraction. As a result, we forecast a below average growth for this year, with financial conditions slowing down the rebound in 2024, when GDP should grow by just 0.2%. We expect a 1.3% GDP drawdown from peak to trough, not too different from what happened in the early 1990 recession, when banking turmoil played a big role. The hit to activity will be far less severe than in 2008, as the economy and especially private sector balance sheets, are in much better shape.

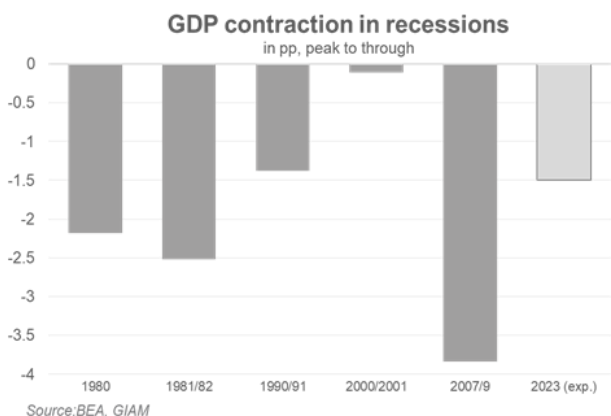
within six to nine months, and this drives our expectation of negative growth in both Q3 and Q4.

Credit and politics main downside risks

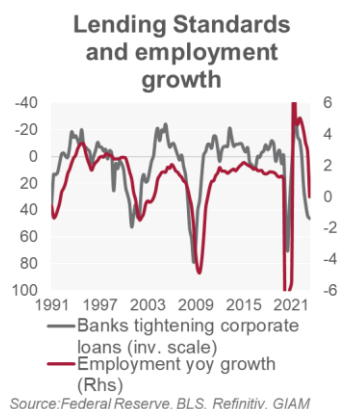
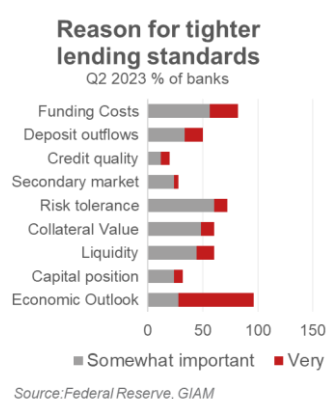
As pointed out by chair Powell, the effects of the credit squeeze on the economy are very uncertain, and this constitutes the most material downside risk to our forecast. A more severe deterioration in credit supply will affect principally the length of the duration rather than its depth. Private sector balance sheets show overall good health and worries about high corporate leverage must be weighed against the fact that very high bond issuance in 2021 and 2022 allowed firms to lock in very low borrowing rates; additionally private sector interest debt services remains within the norm. But a weaker banking sector, - subject to funding pressures due to deposit flight and higher interest rates reducing the present value of mortgages - is likely to remain risk averse for long. This will result in a persistent drought of credit hitting consumers and small firms and lead to a shallow recovery, especially in the first half of 2024.

In the very short-term politics remain the biggest downside risk. Serious discussion between the administration and the Republican majority in the House of representative has just started and must be completed by the end of the month or anyway not too much after the date at which the Treasury runs out of cash, June 1st according to Secretary Yellen. We expect the position to converge towards a deal, which however would entail a drastic reduction in government expenditure in the next fiscal year, that starts in October. This could further depress GDP in the final quarter of this year and curtail growth thereafter. The alternative, which involves the impossibility by the Federal government to fund expenditure, cannot be fully ruled out. A more polarised political landscape and the Republicans' reliance on a small group of hardliners to keep their tiny majority in the House has increased the risk of an accident compared with 2013 and especially 2011, when bickering cost the US a one notch downgrade by S&P. Financial markets are discounting such a possibility, as shown by the spike in short term CDS and especially of the yield of T-bills maturing during the early summer. Several possibilities to avoid a default have been laid out, but they are clearly untested and liable to be challenged in courts.

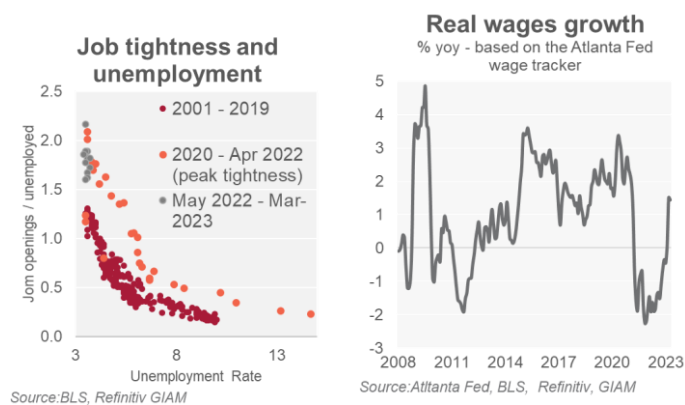
Yet positive surprises cannot be ruled out, as households may prove more capable and willing to spend. The evolution of the labour market is in this sense crucial. Labour market tightness has faded over the last few months – with the ratio of job openings to unemployed dropping fast from two to 1.6 - but the unemployment rate has not moved from near the historical low. This may mean that faced with higher search costs, firms may become more reluctant to fire workers in a downturn, in turn allowing consumption to cushion somehow



But it is hard to imagine that the economy can withstand the impact of a 500 bps rise in the policy rate and a weaker banking sector. The latest release of the Fed survey points to another tightening in lending standards in Q2, with banks increasingly negative about the economic outlook, more risk averse and worried about the fall in collateral value, which bodes ill for sectors like corporate real estate. A sharp contraction in activity and employment growth usually follows



the GDP contraction. This is the rather optimistic scenario chair Powell painted to motivate his own forecast of a deceleration rather than a recession. Shorter term, as inflation has decelerated by more than wage growth, workers' purchasing power has recovered, and this may lead to a stronger than expected consumption growth. Moreover, as pointed out by [recent research by the San Francisco Fed](#), the stock of excess saving invested in very liquid assets (like bank accounts) may last longer than expected, supporting consumption until the end of the year. However, this seems at odds with the reported rise in credit card utilisation despite the steep increase in borrowing costs.



Inflation on the right track, with no hurry

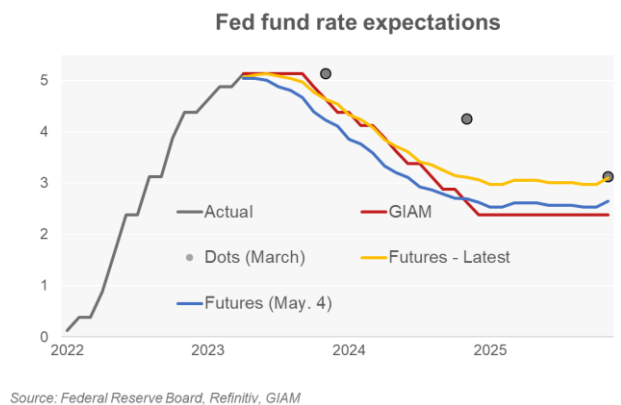
The latest batch of data brought mildly positive views on inflation: in April core CPI inflation eased a bit to 5.5% yoy but the three-month annualised rate decreased to 5.1%, from above 6% a few months ago. The pause in the slide of core good inflation was mostly due to volatility in used cars, while production and import prices point to further disinflation in the pipeline. Within services shelter inflation remains above 8% yoy but data on new rents continue to indicate a sharp deceleration in the coming months. Service excluding shelter, the measure the Fed is mostly concerned about, receded to 5.2% yoy, sharply down from the 6% yoy posted in March.

Margins are compressing and this will help drive down inflation. Yet without a collapse in demand or a significant weakening in employment pushing down labour costs it is almost impossible to expect core CPI inflation substantially below 4% by the end of the year. The corresponding PCE rate the Fed monitors should then settle at just above 3.5% by December.

Fed on hold until November, cuts will follow

The latest developments are in line with what the Fed was expecting, but disinflation is too slow. Banking sector tremors have not turned into a crisis, but nasty surprises cannot be excluded, and the still large recourse to the Fed's emergency liquidity facilities signals that the industry is not yet out of the woods. Sticky inflation means that the Fed cannot loosen anytime soon, but the large uncertainty related to financial and credit condition also implies that another round of hikes would be too risky and, in the end, counterproductive. Then the Fed is set for a long pause on rates. The still rather hawkish tone of the communication is aimed mostly at convincing markets that a U-turn on rates is not forthcoming. These efforts are paying off and a cut before Q4 is no longer priced. Whether the Fed will stick to its pledge not to reduce rates before the beginning on 2024 is another matter.

We confirm our expectation of two rate cuts in Q4 2023, and markets are converging to this view. First, despite the evidence of labour hoarding, the contraction in GDP we predict (more severe than what the Fed forecast implies) would drive the unemployment rate to above 5%. Secondly, weighting the positive evolution on the price side against the downside risks to growth should help the Fed to take a more accommodative position on inflation, even if it remains well above target. The balance of risks is tilted towards a longer period of high rates, if more resilient domestic demand and stable employment put a brake to service inflation decrease.



 **Imprint**

Issued by: **Generali Insurance Asset Management S.p.A.**
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