PICTET WEALTH MANAGEMENT

2023 US Macro Outlook

Federal Reserve risks overkill on rate tightening

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FLASH NOTE

SUMMARY

- Our central forecast is for a moderate US recession starting in early 2023, with annual US GDP dropping 0.2% after estimated growth of 1.9% in 2022. Having peaked at 9.1% year-on-year in June 2022, we forecast consumer price index (CPI) inflation to be close to 3% by end-2023 (the annual average CPI could drop from 8.1% in 2022 to 4.0% in 2023). We think the unemployment rate will edge up in the second part of the year.
- We believe the main culprit for the expected contraction in GDP and rise in unemployment will be the Federal Reserve's (Fed) sharp tightening of monetary conditions in an environment of fiscal policy prudence (even more so as Congress is now divided post the midterms elections). The full impact of 2022 tightening will really only be felt in the coming months.
- We forecast that household consumption will grow a little less than 0.5% in 2023, down from an expected 2.6% in 2022. With the household savings accumulated as a result of the pandemic largely depleted, the key to the outlook for household spending in 2023 will be consumers' ability (and willingness) to borrow. One silver lining is that slowing inflation may mean more purchasing power as wage growth will likely remain high by historical standards.
- We expect the Fed to hike the fed funds rate to a range of 5.0-5.25% (versus 3.75-4.0% currently) by March 2023, and then keep it there for the rest of the year. Fed messaging could remain hawkish due to sticky inflation expectations, still-high services inflation and resilient wage growth. Meanwhile, the central bank's balance sheet will likely continue to shrink according to pre-set plans unless there is an inordinate deterioration in liquidity conditions.
- Indeed, the risk to our central scenario for the US is that inflation proves 'stickier' than expected (especially in services) and that the Fed feels it needs to tighten more to force down demand—in which case, the recession could be deeper and longer.

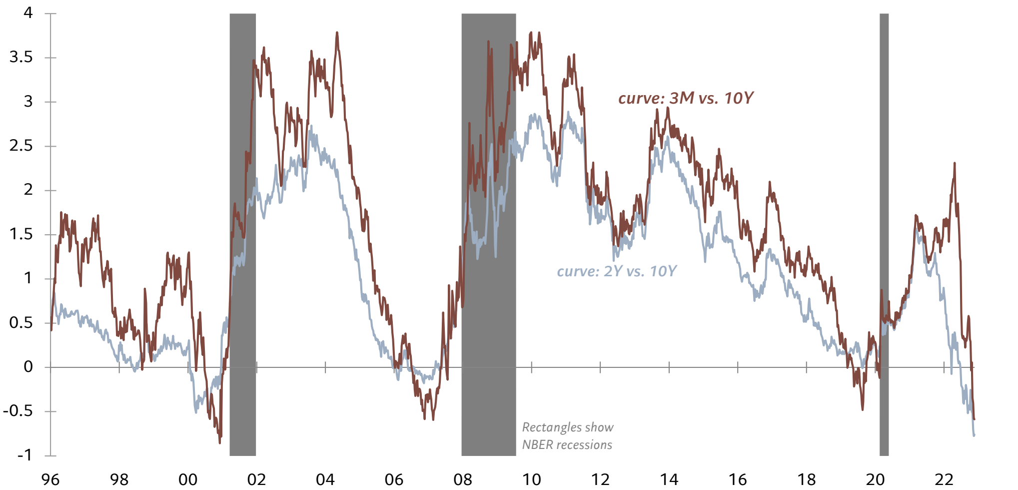
US: US CONSUMER RESILIENCE WILL DEPEND ON THE BANKS

Three major elements go into our economic forecast for the US: credit and financial conditions, leading economic indicators and cross-analysis of the main components of GDP reports (consumption, investment, government spending, net trade and inventories). On all three fronts, the news is not good for 2023.

We see the two biggest drags on 2023 GDP as being housing and business investment. Only partially offset by consumer resilience, they will likely lead to a **moderate recession next year.**

Inversion along parts of the **US yield curve is already signalling a recession,** with three-month and two-year interest rates below 10-year rates (chart 1). **A Bloomberg survey of economists shows that 63% of them believe a recession is probable within the next 12 months**.

Chart 1: The inverted yield curve is signalling a US recession in the coming months



Source: Pictet WM CIO Office & Macro Research, Bloomberg Finance LP, 30 November 2022

The US housing sector is likely to feel the most pain from the Fed's steep rate tightening via mortgage rates. While the fact that most US mortgage holders pay fixed rates should lessen the pain, they will still be hurt indirectly through **falling house prices**. House prices dropped by 1.1% per month on average in the three months to end-September, with leading indicators pointing to further weakening ahead. This could hit confidence and the 'wealth effect' that comes with rising house prices. There could also be a knock-on effect on consumer spending. At the same time, the decline in housing construction and transactions is also a drag on GDP.

Yet our central scenario is for US consumer spending to bend, but not break. On the positive side, there is still some pandemic savings left, and lower inflation may mean household disposable incomes recover on an inflation-adjusted basis. But **much will depend on banks' willingness to continue lending next year**. There is a possibility that the rapid rise in consumer loans in recent months comes up against signs of steadily tighter lending conditions.

We will pay special attention to US consumers' monthly saving rate, which averaged only 3.3% of aggregated disposable income in the three months to end-

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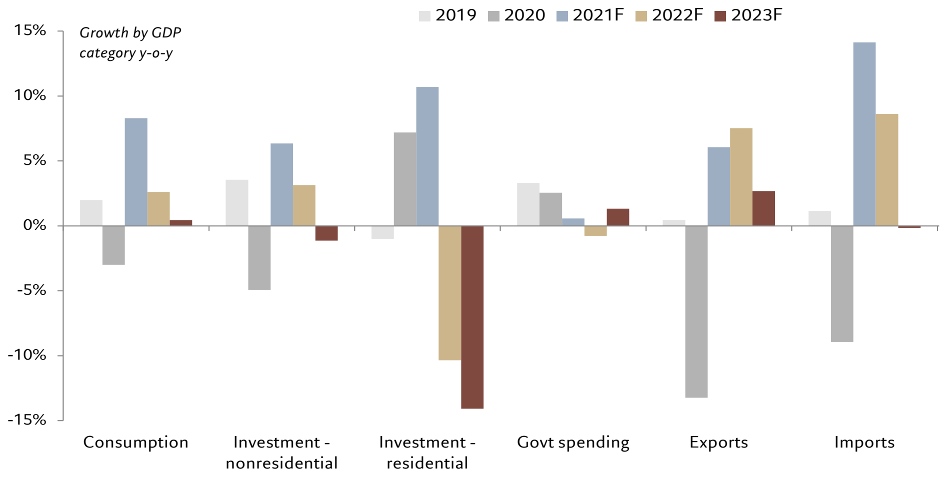
September. This compares with a 10-year average of 6.8% (and 8.8% in 2019, before the pandemic). **Such a low level of saving accumulation indicates that for some households at least finances are becoming stretched.**

We predict real (inflation-adjusted) personal consumption growth of 0.4% in 2023, down from +2.6% (estimated) in 2022 and +8.3% in 2021. Consumption could be lower should banks tighten access to credit-card debt more than we expect in our central scenario.

Regarding government spending, our expectations are low given that the last month's midterm elections produced a divided Congress. The probability of further large spending packages with bipartisan support looks low, unless a significant recession leads to cross-party agreement for fiscal stimulus. In fact, the early-2023 deadline for lifting the federal spending ceiling could be used by Republicans to to force through government spending cuts. Budget spending through the Inflation Reduction Act passed last summer (mostly focused on subsidising green energy initiatives) is mostly meant to work via tax credits, with the impact spread out over several years.

Chart 2: Our forecast is for slow personal consumption and a sharp drop in housing



Source: Pictet WM CIO Office & Macro Research, Bloomberg Finance LP, 1 December 2022

UNEMPLOYMENT RATE LIKELY TO RISE, WAGE GROWTH COULD MODERATE

The labour market is usually a *lagging* indicator. In other words, it usually ends up losing speed months after most other 'recession' indicators such as the flagship ISM manufacturing confidence index. Due to the difficulty in hiring (or re-hiring) since the pandemic, some argue that US employers could end up keeping workers even if a recession drives down demand. This could mean the labour market is even more of a lagging indicator than usual.

Nevertheless, our central scenario is that companies will end up firing workers as revenue growth stalls, with modest job losses in Q2 2022 giving way to more severe job losses in the second half of the year. We therefore **predict that the US unemployment rate will rise to 4.7% by end-2023** (from 3.7% in October 2022). This is quite close to a recent forecast by New York Fed president John Williams, who predicts an unemployment rate of between 4.5-5.0% by end-2023.

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As an aside, labour market deterioration will be the 'true' sign of a recession as it indicates a broad-based decline in economic activity, whereas a technical recession is just two quarters of negative GDP growth. In the US, the official 'arbiter' of 'true' recessions is the National Bureau of Economic Research's business-cycle dating committee.

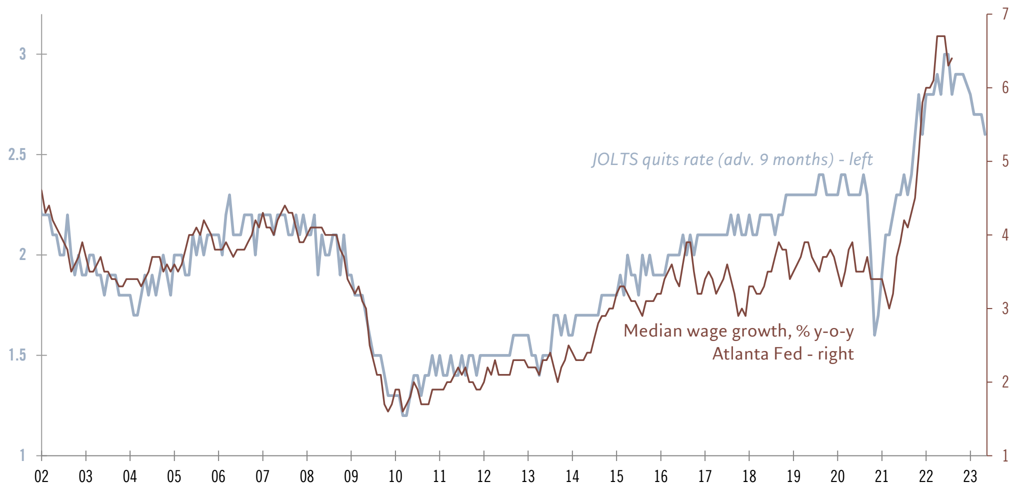
Looser labour-market conditions should eventually mean wage growth moderates, which will in turn mean **slower services inflation**.

We think CPI inflation peaked at an annual rate of 9.1% in June. Supply-chain bottlenecks (including transport costs) have been easing considerably. This, combined with falling global commodity prices, should mean merchandise/goods inflation continues to decelerate.

But the **focus in 2023 will really be on services**, where disinflation could be more gradual. It may be that the drop in new rents seen in private-sector data lately (mirroring falling house prices) has yet to turn up in official rental inflation numbers. The deceleration in services ex-rents may be gradual due to the ongoing resilience of wage growth but, ultimately, we expect wage growth to continue to moderate, probably towards 4.0% by end-2023 (from 6.4% in October 2022, according to the Atlanta Federal Reserve's widely followed 'median' wage growth measure). A rising GDP output gap (the difference between demand and potential output/production) due to weaker GDP should ultimately depress inflation, with domestically generated disinflation particularly pronounced in the second half of 2023.

We forecast core PCE (personal consumption expenditure) inflation to average 3.7% in 2023 after 5.0% in 2022 and 3.5% in 2021.

Chart 3: Wage growth should moderate as the labour market slackens



Source: Pictet WM CIO Office & Macro Research, Bloomberg Finance LP, 1 December 2022

FEDERAL RESERVE MAY PAUSE RATE HIKES, BUT COMMUNICATION MAY STAY HAWKISH

While Fed chairman Jerome Powell has signalled a slowdown in the pace of rate hikes from 75bp to 50bp as soon as this month, the Fed is not yet ready to flag a full pause. We think it will raise base rates at its February meeting by a further 50

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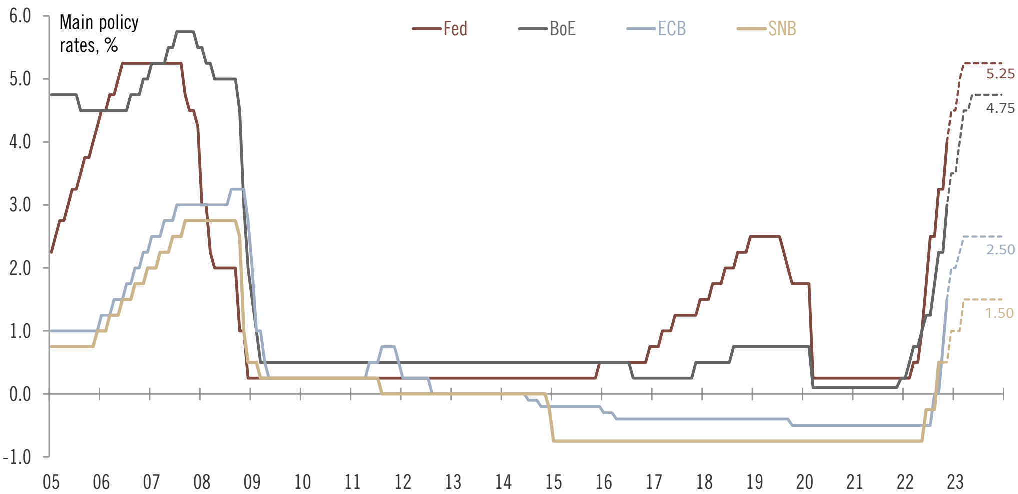
bps before we see a final 25 bps hike in March. This would bring the **top-end of the fed funds rate range to 5.25%.** We then expect base rates to be stable until the end of 2023. Keeping rates stable while the labour market deteriorates will perhaps look 'hawkish' **but can be explained by the Fed's unwillingness** to lower its **guard given how it was surprised by the inflation surge of the past year.**

The Fed may worry about robust wage growth, especially in the first half of 2023. It will also pay close attention to the **ratio of job openings to numbers unemployed**. Since this ratio has been declining only moderately, the Fed may believe the labour market remains a potential source of inflation.

The Fed will also stay focused on **consumers' inflation expectations.** These have stayed high in recent months, providing another reason for the Fed to take rate cuts off the table. In November, the University of Michigan survey of US consumers showed they expected a consumer inflation rate of 4.9% in a year's time. The measure peaked at 5.4% in March 2022, but the number is still high (the 10-year average is 3.1%). We believe the findings of the Michigan survey of expected inflation will act as an implicit floor for the fed funds rate over the coming year.

We see the first rate cut coming in early 2024, when the Fed will be more convinced that inflation has indeed been put to bed. This will give it the green-light to focus more on growth preservation. Nonetheless, we do not exclude the possibility we see earlier rate cuts—for example, if the recession is deeper than expected.

Chart 4: Fed funds rate versus other central banks' policy rates (including forecasts)



Source: Pictet WM & CIO Office, US Federal Reserve, European Central Bank, Bank of England, Swiss National Bank, 1 December 2022

STICKY INFLATION FORCING FED TO KEEP TIGHTENING IS BIGGEST RISK TO FORECAST

There are several risks to our central scenario. A prominent **downside risk is a resurgence in inflation**—for instance if the labour market stays tight for longer than we expect, or if new global supply-chain disruptions re-emerge in China or elsewhere. In that scenario, consumers' inflation expectations could rebound rather than decline as we expect, forcing the Fed to resume rate hikes after a short pause. In this alternative scenario, the Fed would prioritise inflation fighting over economic well-being, potentially leading to a deeper and longer recession.

Fed reticence to inject liquidity into the system in the case of an unexpected market event is another downside risk as tightening financial conditions reverberate throughout the economy. Shrinkage of the Fed's balance sheet through so-called 'quantitative tightening' has never really been done in the past, and could prove bumpier than expected. Pre-set plans are for shrinking of bond holdings by USD95 bn per month.

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