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Moderating Inflation Won't Forestall a Recession in 2023

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In 2022, the vast majority of developed market central banks significantly tightened policy as they sought to address broad-based inflation. With most of this adjustment in the rearview mirror, 2023 will be the year in which the full impact of global policy tightening will be felt in force, with growth slowing and inflation moderating.

In light of this view, what follows are three themes that serve as a template for this challenging outlook, with specific application to the US. Overall, we see a meaningful moderation in headline and core inflation in 2023, but it won't happen quickly enough to stave off further policy tightening through the first quarter. Inflation moderation also won't be significant enough to allow the Fed to pivot to rate cuts quickly thereafter. We continue to view a recession, beginning around the middle of 2023, as our base case. With policy remaining restrictive for some time thereafter, the subsequent recovery is likely to be sluggish.

1. Resilient Growth Only Increases the Fed's Resolve

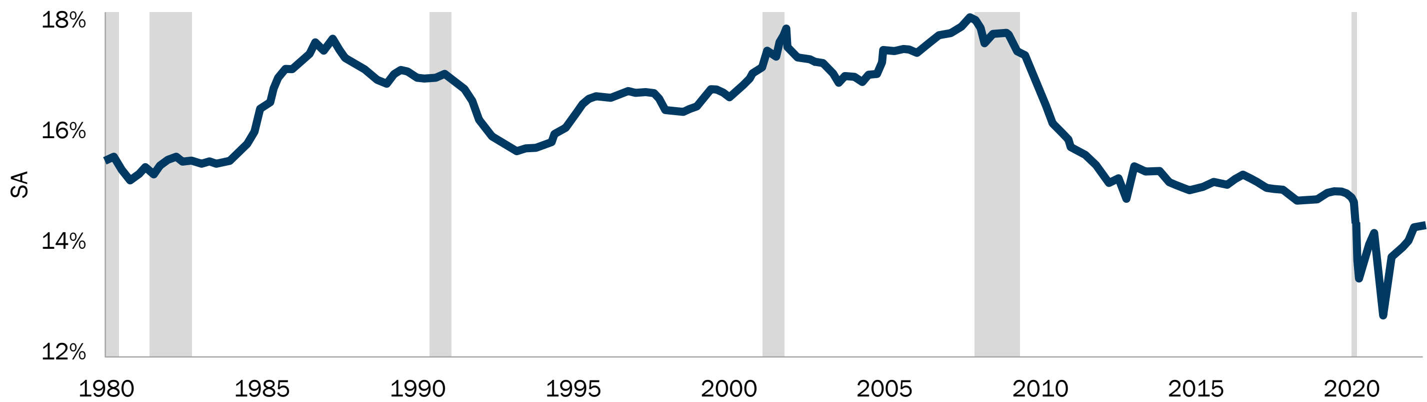
Despite meaningful tightening to date, what has clouded the outlook for many investors is the lack of obvious imbalances that would tip the economy into a recession. In markets, there are few signs of asset bubbles and associated contagion risks, especially after the decline by the S&P 500 this year. Meanwhile, household and corporate balance sheets remain healthy. Not only do leverage levels appear manageable, but two years of rock-bottom interest rates have allowed households and businesses to lock in lower financing costs. In addition, many households still have excess savings that accrued during the pandemic. Finally, increasing signs of disinflation suggest that real household income may begin to rise again after largely stagnating in 2022, a development that could further support spending in the near term.

None of the above, however, is reason for optimism. With inflation remaining above the Fed's 2 percent inflation objective throughout 2023, resilience only means that monetary policy needs to work even harder to slow the economy and bring down inflation on a sustained basis. This is why the Fed's signaling of a policy rate of at least 5 percent looks quite durable. If anything, most standard policy rules suggest that it is the bare minimum that the Fed will need to do to slow the economy.

Resilient household and corporate balance sheets and a still-strong labor market may keep the economy on a solid footing, but only for so long.

As the chart in Figure 1 shows, the past two years of low rates have made household balance sheets more resilient to Fed tightening.

FIGURE 1: HOUSEHOLD FINANCIAL OBLIGATION RATIO



Source: Federal Reserve, Macrobond. Shaded bars denote recessions.

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2. Services Inflation Holds the Key

The easing of global supply-chain bottlenecks, increasing manufacturing output, and the ongoing post-pandemic reorientation of household spending back towards services all suggest deflation for goods prices in the year ahead. But this will not be enough to return inflation to 2 percent on a sustained basis.

Ultimately, core services inflation will need to moderate significantly as well. There is some encouraging news on this front. Market rents are beginning to moderate, and this will gradually feed through to lower shelter inflation over the course of next year. The outlook for core services inflation excluding rent of shelter, however, is murkier.

Historically, overall core services inflation is closely tied to the business cycle and the labor market. The Fed is working under the assumption that it will need to meaningfully cool the labor market in order to reduce services inflation to a level consistent with its price stability objective. This is another reason why continued policy tightening and elevated recession risks remain our base case for next year.

As Figure 2 shows, history suggests that services inflation may not moderate without a higher unemployment rate.

FIGURE 2: SERVICES INFLATION MAY NOT MODERATE WITHOUT A HIGHER UNEMPLOYMENT RATE

Source: US Bureau of Labor Statistics (BLS), Macrobond

3. The Lessons of the Great Inflation

The Great Inflation of the 1970s and the Fed's policy mistakes are deeply rooted in the central bank's institutional memory. One key lesson of that era is the importance of expectations in shaping outcomes. During periods of persistently high inflation, households and businesses are likely to incorporate expectations of further significant price increases into their spending, saving and investment decisions.

Thus far, it appears the Fed's forceful policy actions this year have kept medium- and long-term inflation expectations relatively well-anchored. For this to continue, the Fed needs to ensure that inflation returns to the 2 percent objective before long. Hence, their focus on achieving a "sufficiently restrictive" policy stance over the coming months.

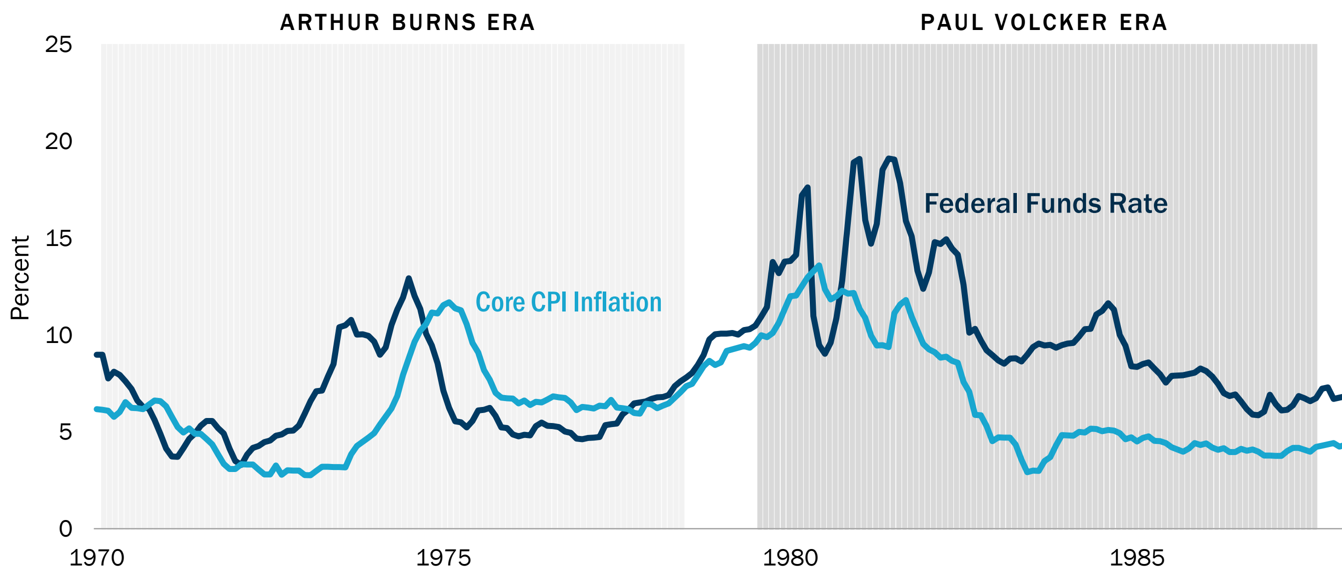
This leads to a second important lesson from the Great Inflation – namely, that when inflation is high, the Fed should avoid pivoting quickly to rate cuts when growth weakens and unemployment rises. With the benefit of hindsight, Chairman Burns' rate cuts following the 1973 recession (see Figure 3) prevented a sustainable moderation of inflation and likely contributed to an un-anchoring of inflation expectations as the decade progressed.

Chairman Volcker's brief period of rate cuts following the 1980 recession might also have been a mistake. As inflation stayed stubbornly high, the Fed was forced to resume raising rates, leading to a second recession less than a year later. To put the inflation genie back in the bottle, Volcker then kept the policy rate above the rate of core inflation for the rest of his tenure.

The implications of the Great Inflation are clear for today's policy makers. First, act forcefully to keep inflation expectations well-anchored. This has largely been accomplished. Now comes the harder part: maintaining restrictive policy even if the economy contracts and unemployment rises. Having been slow to react to inflationary pressures last year and early this year, the Fed won't compound this error with a premature exit from restrictive policy.

As such, if the economy indeed falls into a contraction next year, the Fed's hands may still be tied by elevated inflation and the lessons of the Great Inflation. If so, the contraction may be deeper than investors currently assume.

FIGURE 3: INFLATION AND THE POLICY RATE UNDER BURNS AND VOLCKER



Source: Federal Reserve, US Bureau of Labor Statistics (BLS), Macrobond. G. William Miller served briefly as Federal Reserve Chairman between Burns and Volcker.

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