

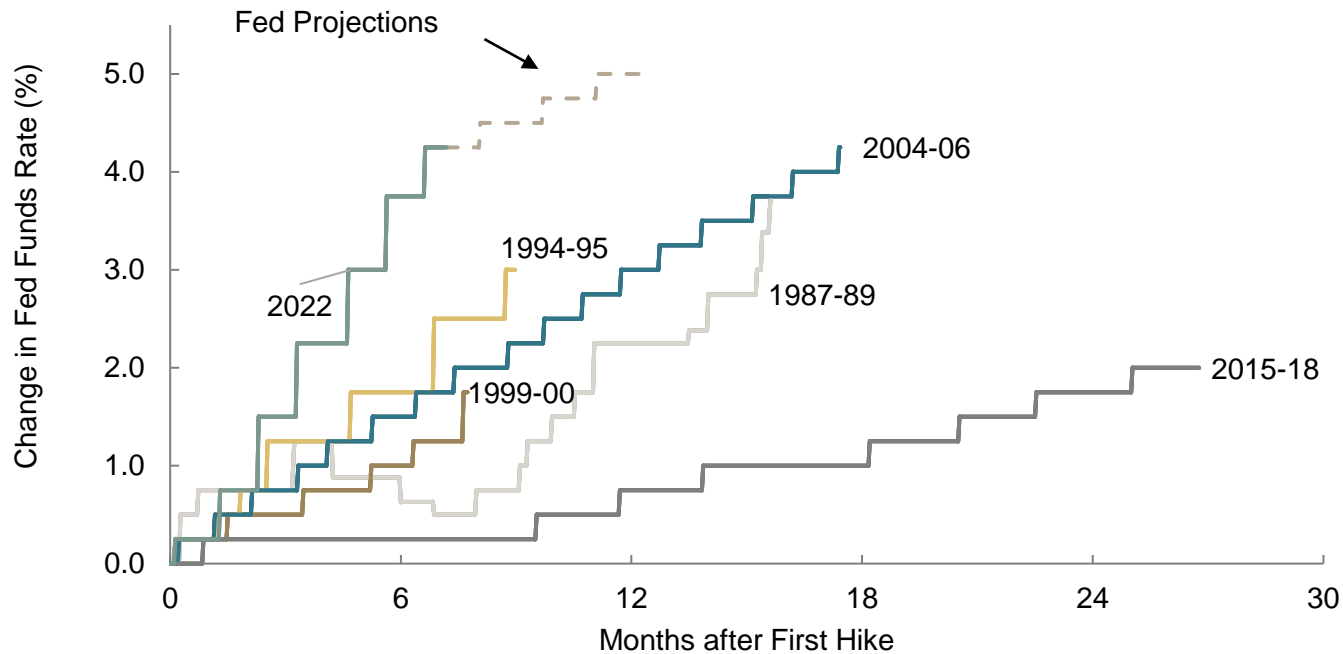
The 2023 US Economic Outlook: Hard Landing In View

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January 2023

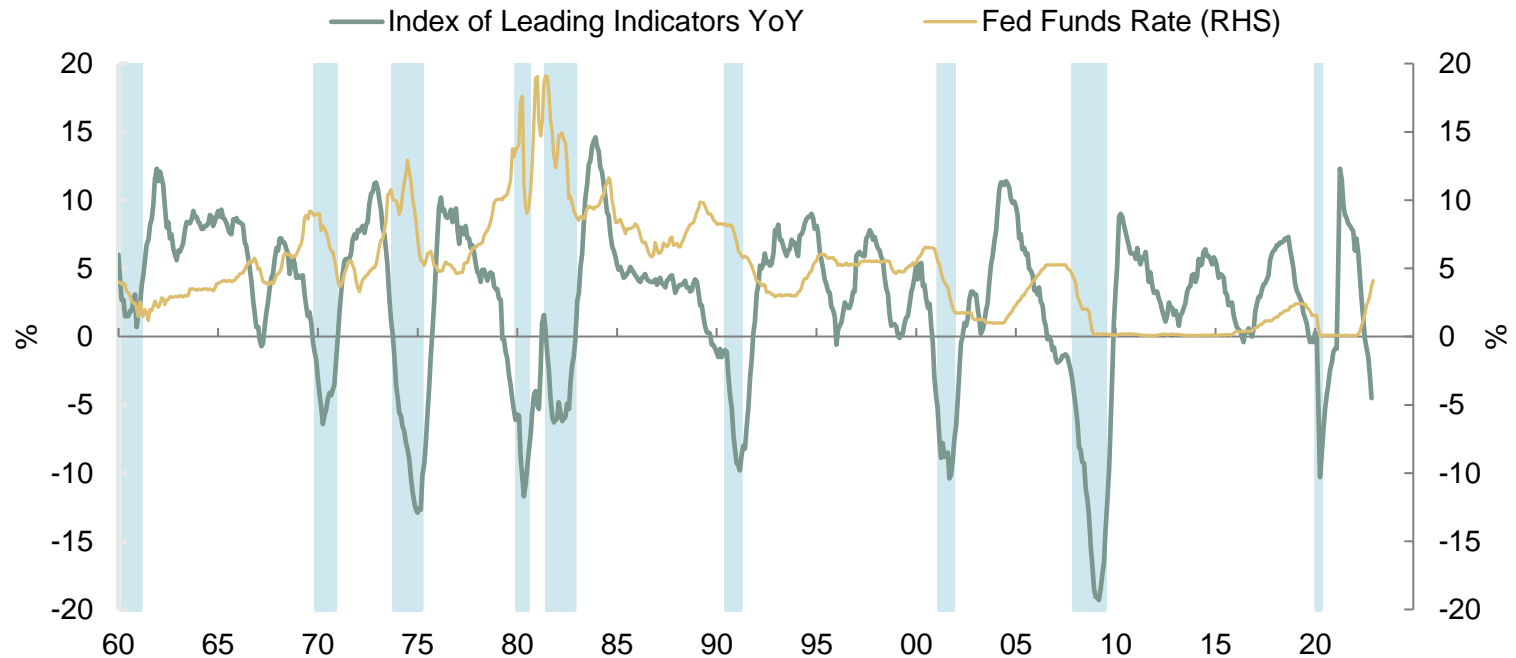
A Rapid Rise In Interest Rates

The Fed has raised rates 425 basis points in just nine months. This is the fastest tightening cycle in more than four decades.



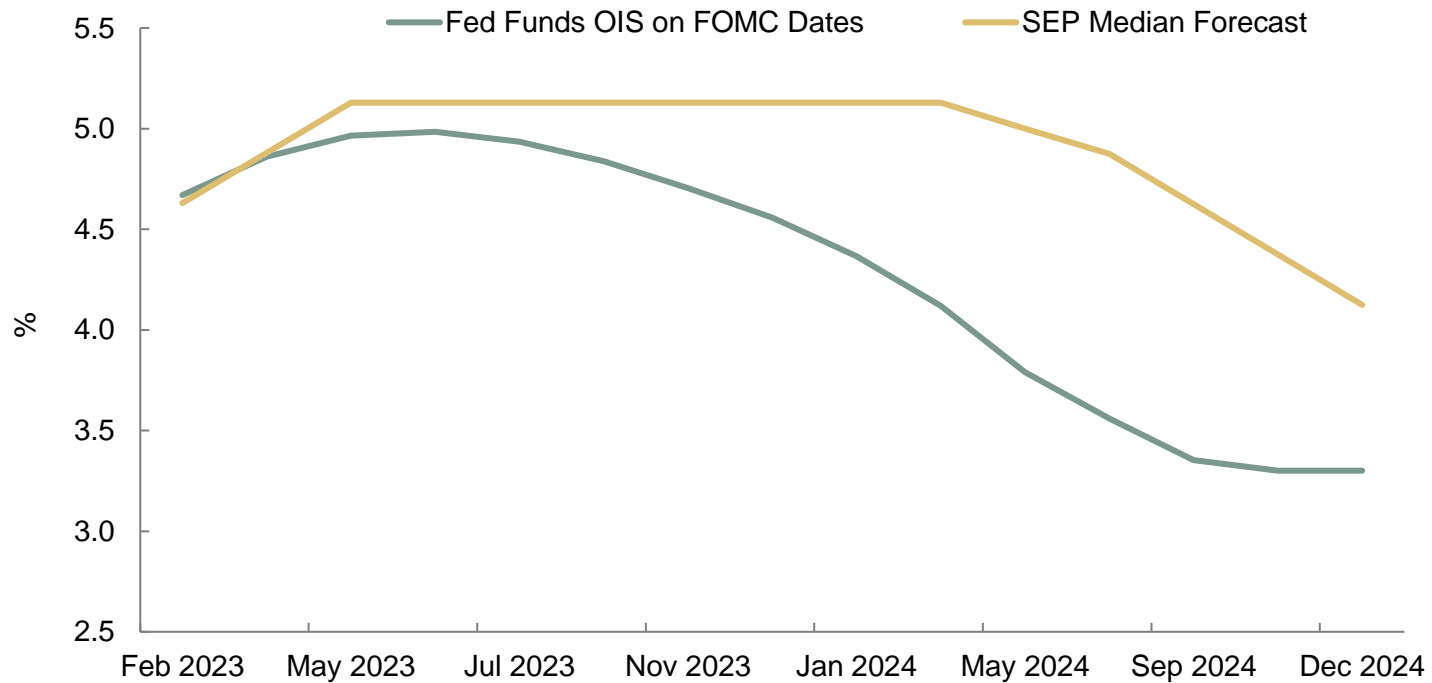
Tightening Into A Downturn

The Index of Leading Economic Indicators is declining at a near 5% year-over-year rate. In the past, the economy always entered recession when this happened.



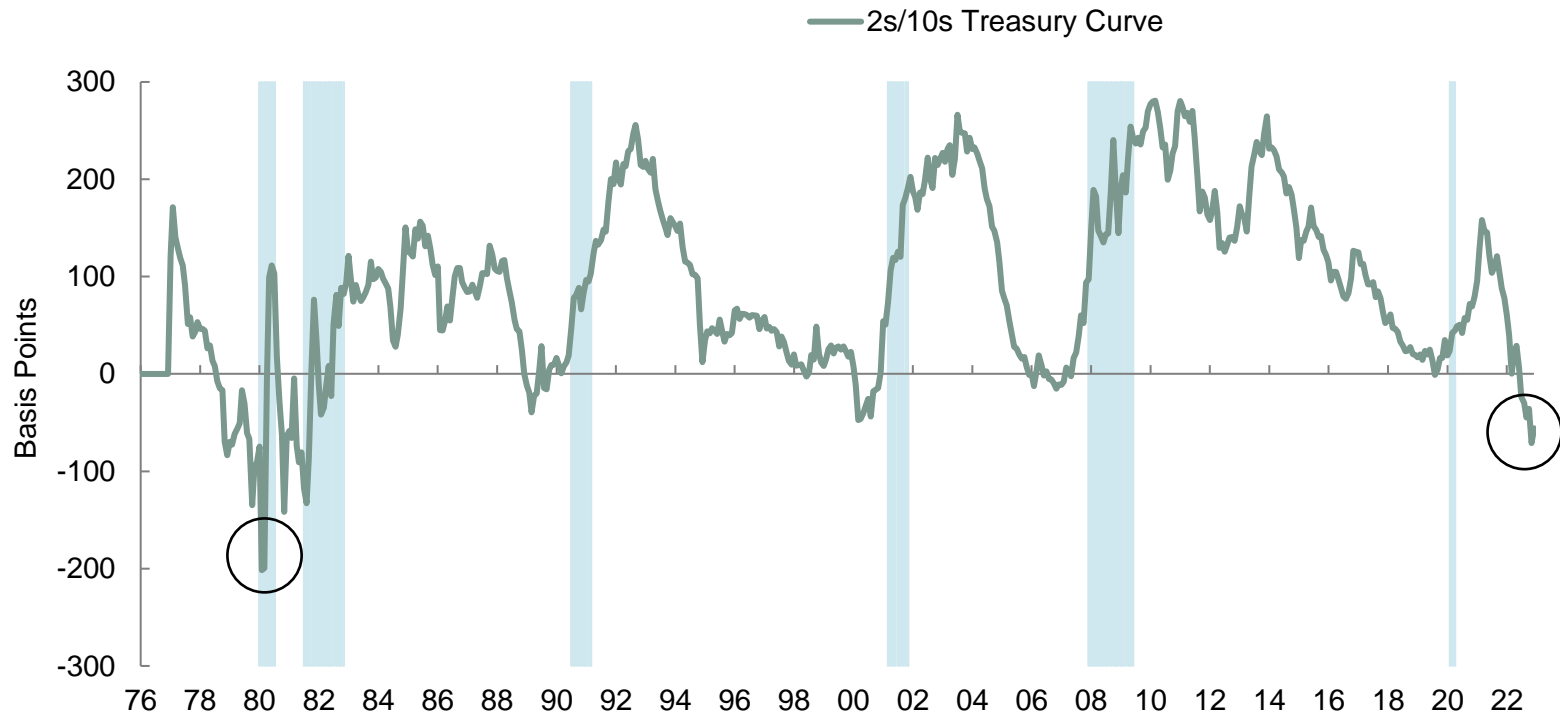
The Bond Market Vs. The Fed

The bond market expects the Fed to begin cutting rates later this year. However, the Fed is projecting “higher for longer” with rate cuts not occurring until sometime in 2024.



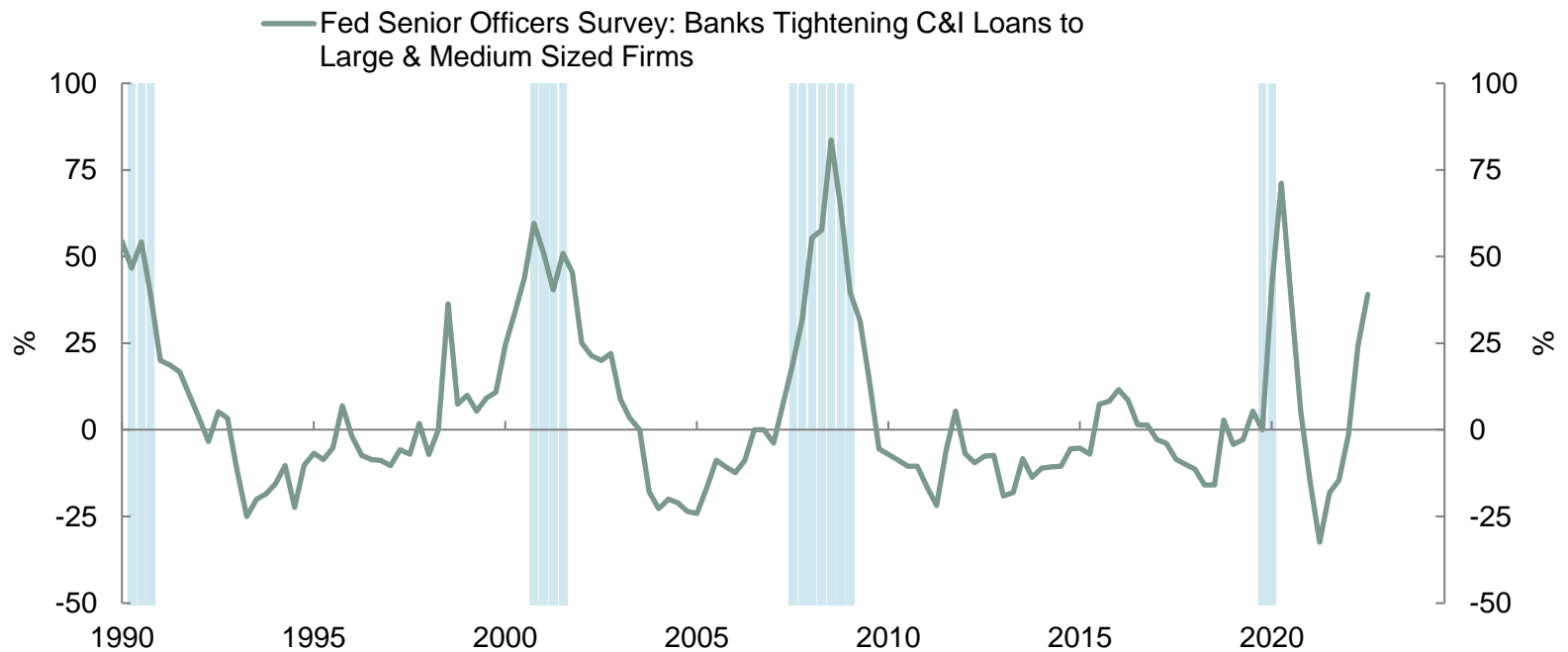
Historic Inversion

The Treasury yield curve is deeply inverted at around 70 basis points. The bond market is telling us that the Fed is too restrictive and that a deep economic downturn is possible.



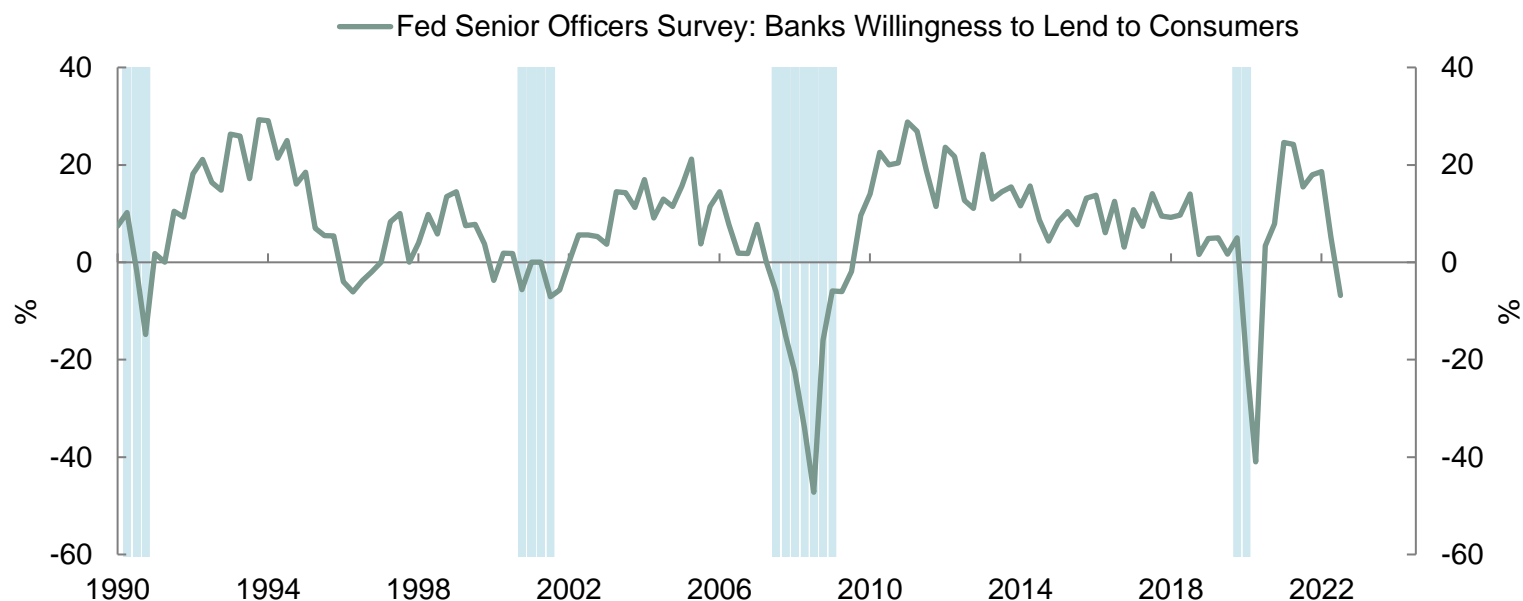
Tightening Credit Conditions

The Fed's Senior Loan Officer Survey has shown a dramatic tightening in lending standards for commercial and industrial loans. These standards have tightened to their highest non-pandemic reading since the 2008-09 financial crisis.



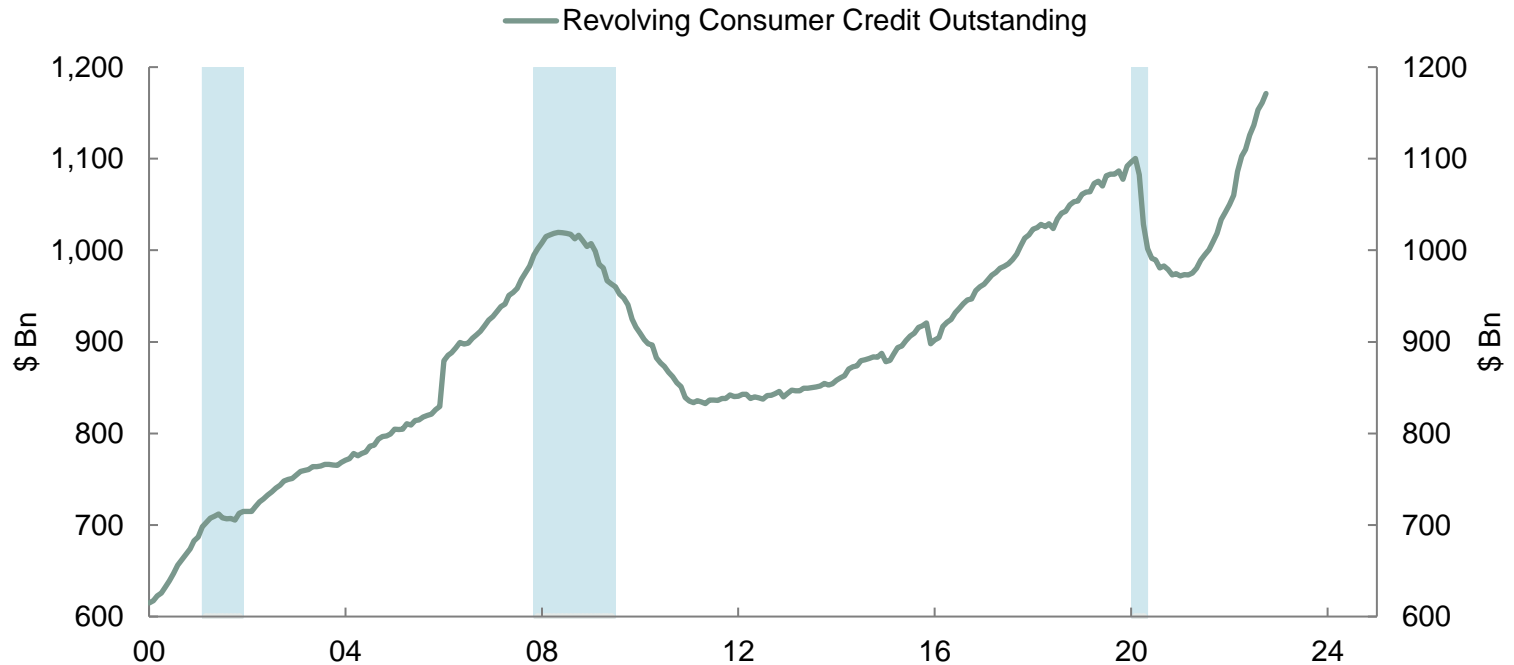
Reining In Consumer Lending

Standards are also tightening for households as commercial banks are showing less willingness to extend consumer credit. This should weigh on consumption going forward.



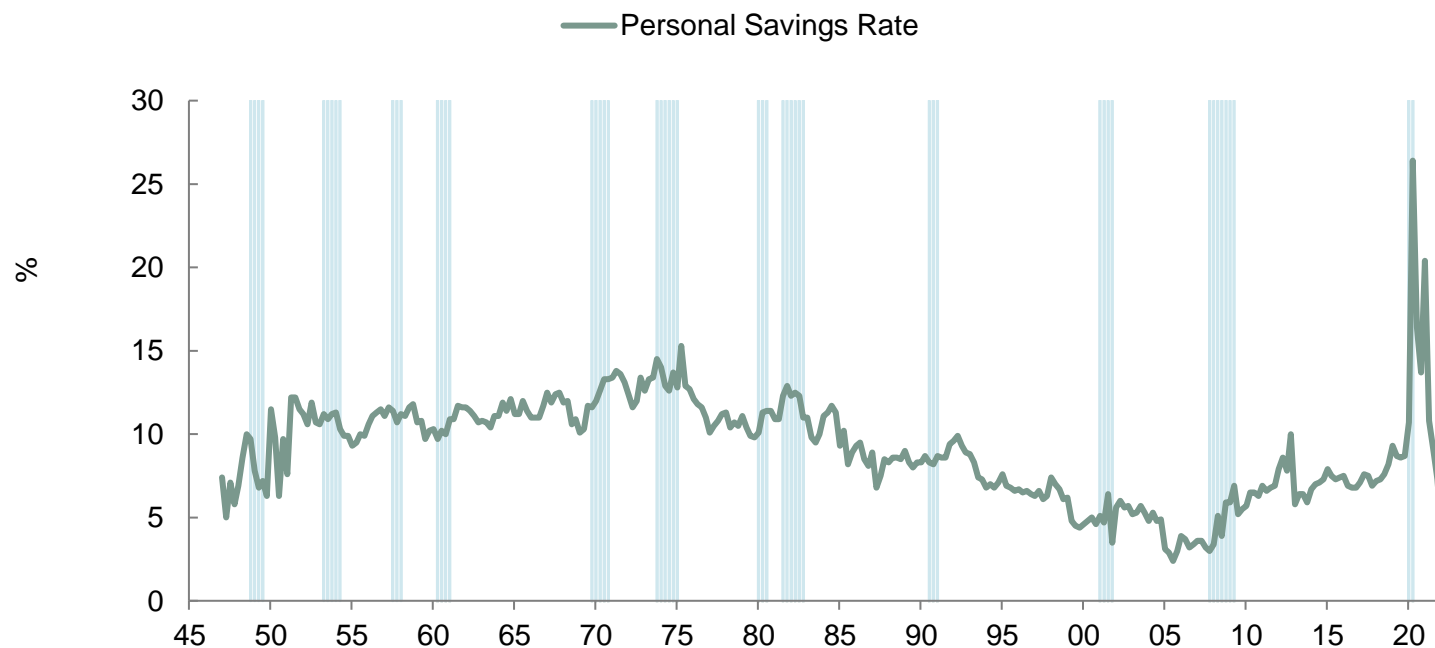
Record High Debt

Over the last 12 months, credit card debt has grown 15%, close to a three-decade high. Less credit means less spending which means less real GDP since consumption accounts for 70% of total economic output.



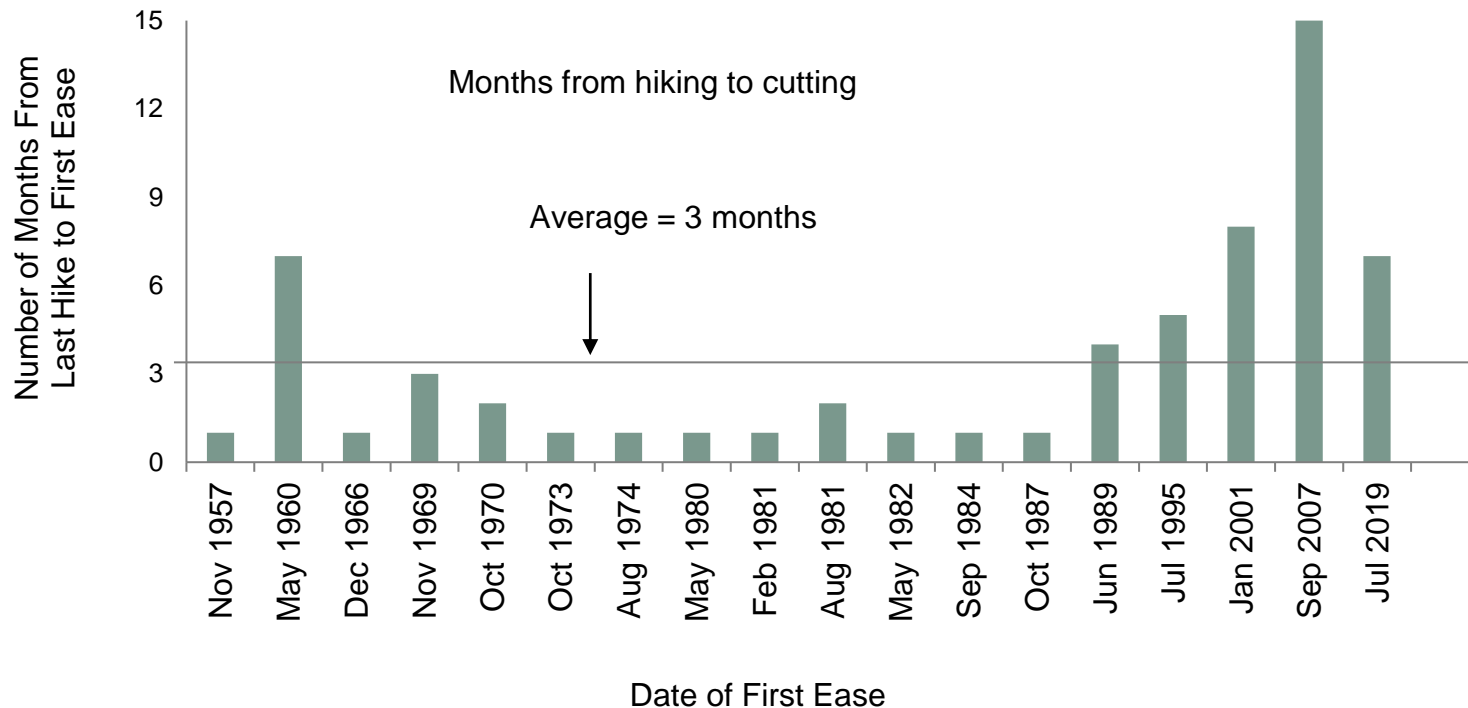
Depleted Savings

The saving rate is only 2.4%, close to a record low. A rebuilding of savings would exert significant downward pressure on consumer spending, potentially leading to a severe recession.



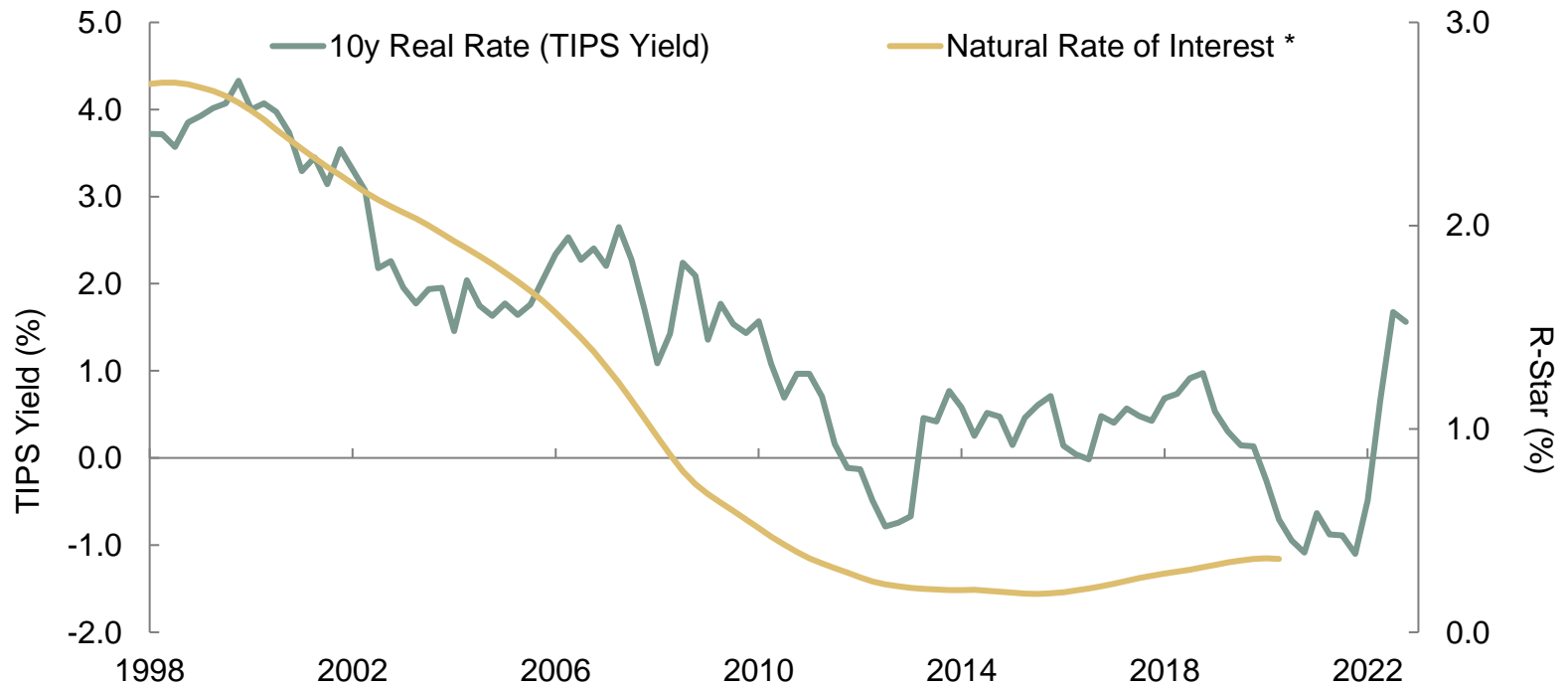
Timing the Pivot

Historically, the amount of time from the last Fed rate hike to the first Fed rate cut has been short. Given how quickly the Fed has raised rates, past may be prologue.



Estimating R-Star

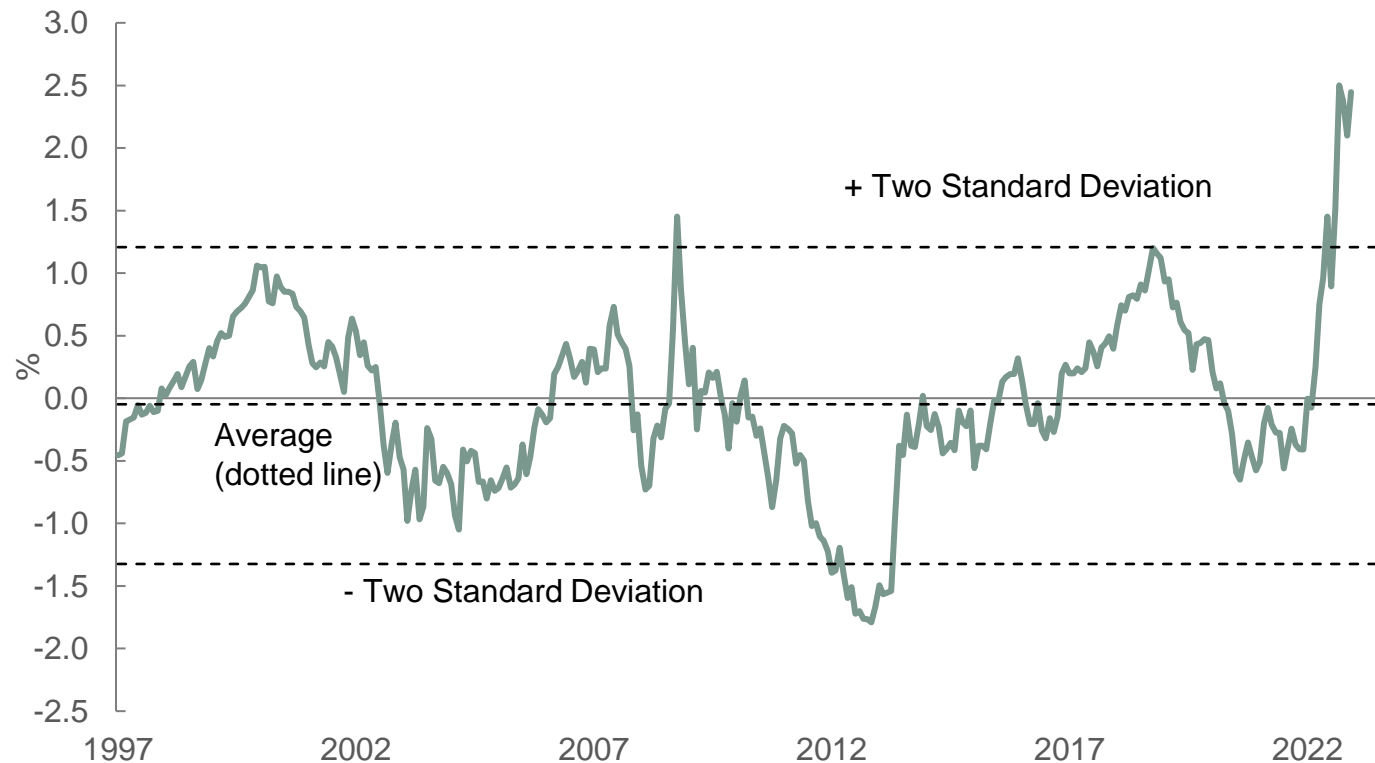
The trend in Treasury Inflation Protected Securities (i.e., TIPS) has broadly followed the downtrend in R^* . Hence, TIPS serve as a good proxy for the equilibrium real rate.



Source: FRB Estimates (Laubach and Williams); Bloomberg, SMBC Nikko

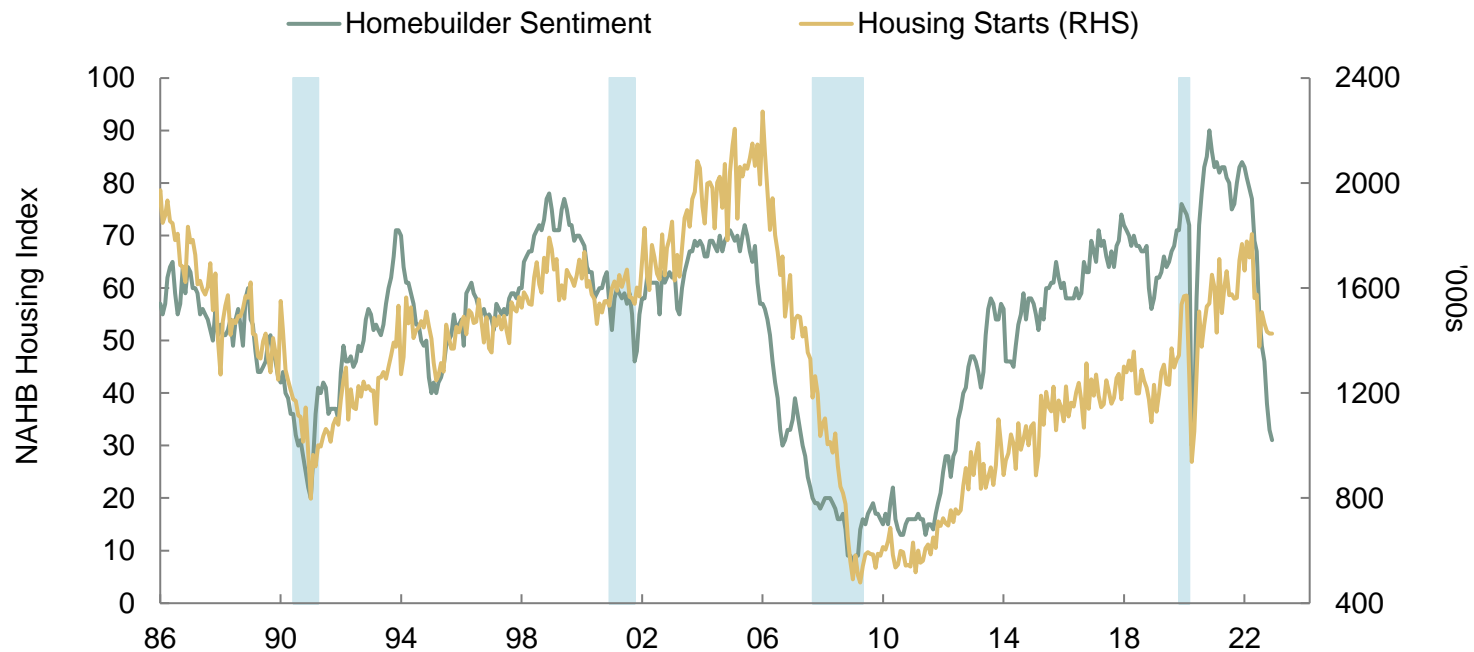
Surging Real Rates

According to our calculations, R-star recently rose to a record high reading. This surge has pushed the interest-sensitive housing into recession.



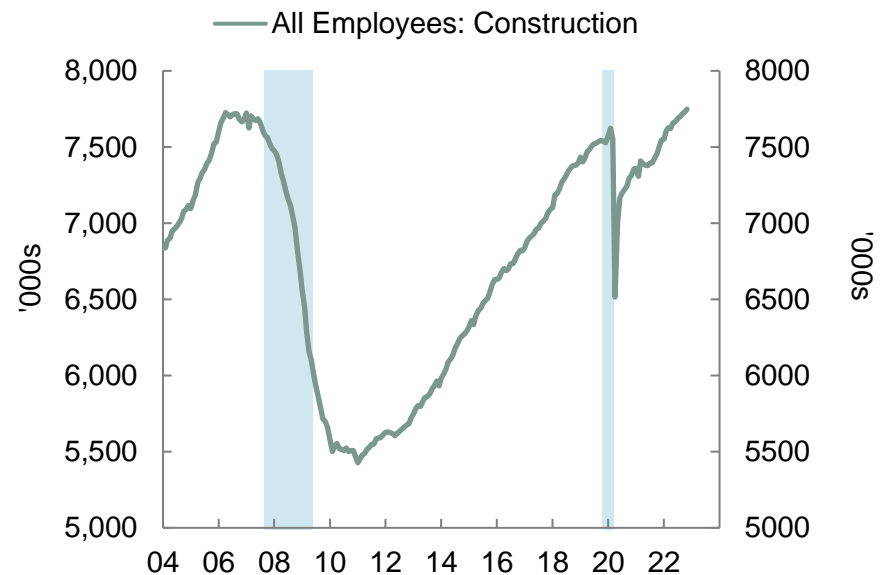
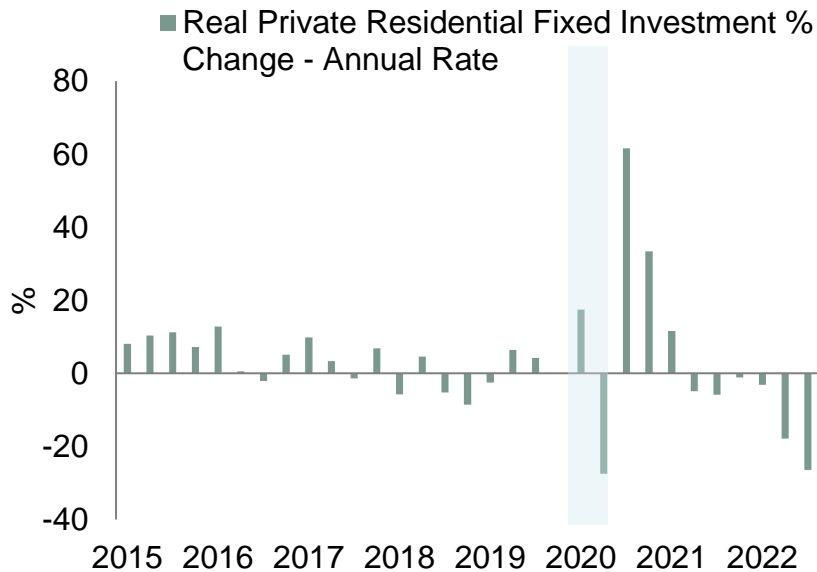
Onset Of Housing Recession

Homebuilders' sentiment has collapsed and not yet bottomed. This points to further weakness in housing starts in the months immediately ahead.



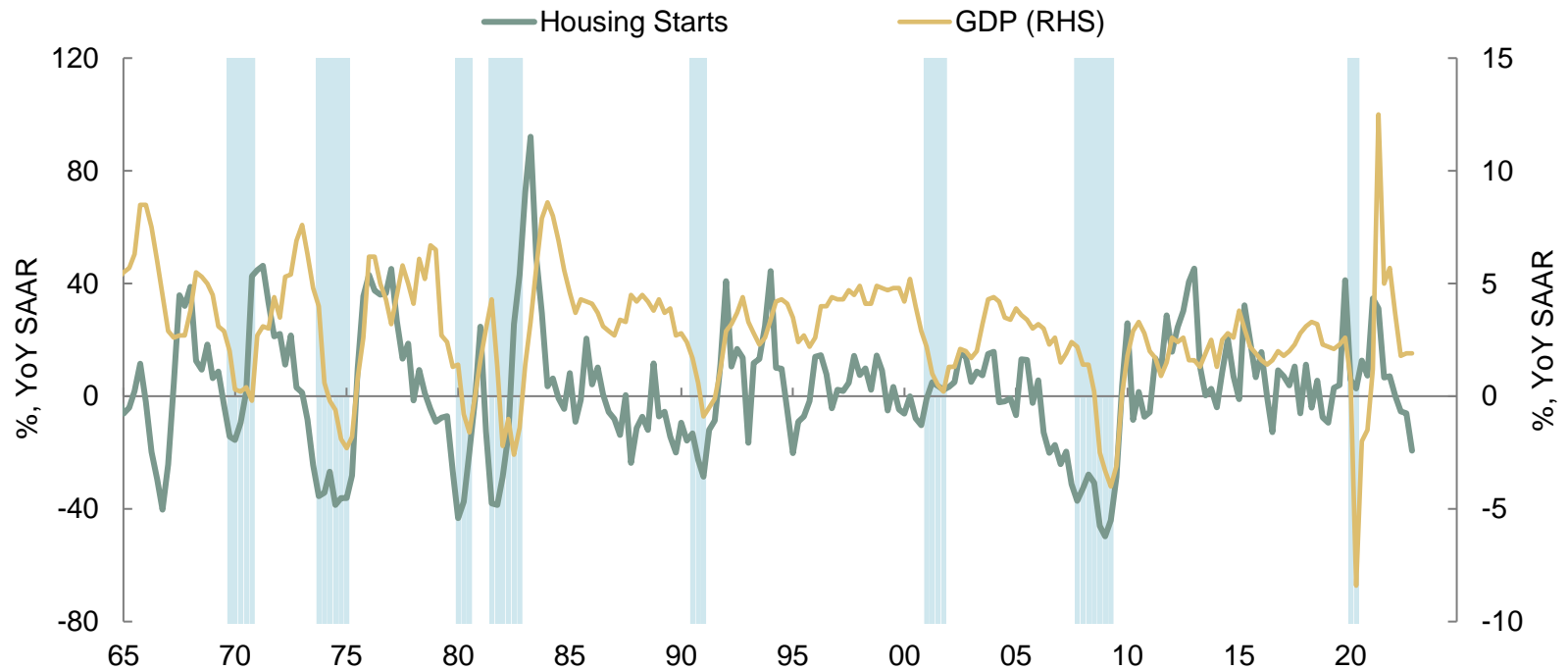
Construction Down But Employment High

Residential Construction has declined for six consecutive quarters. However, overall construction employment is close to a record high.



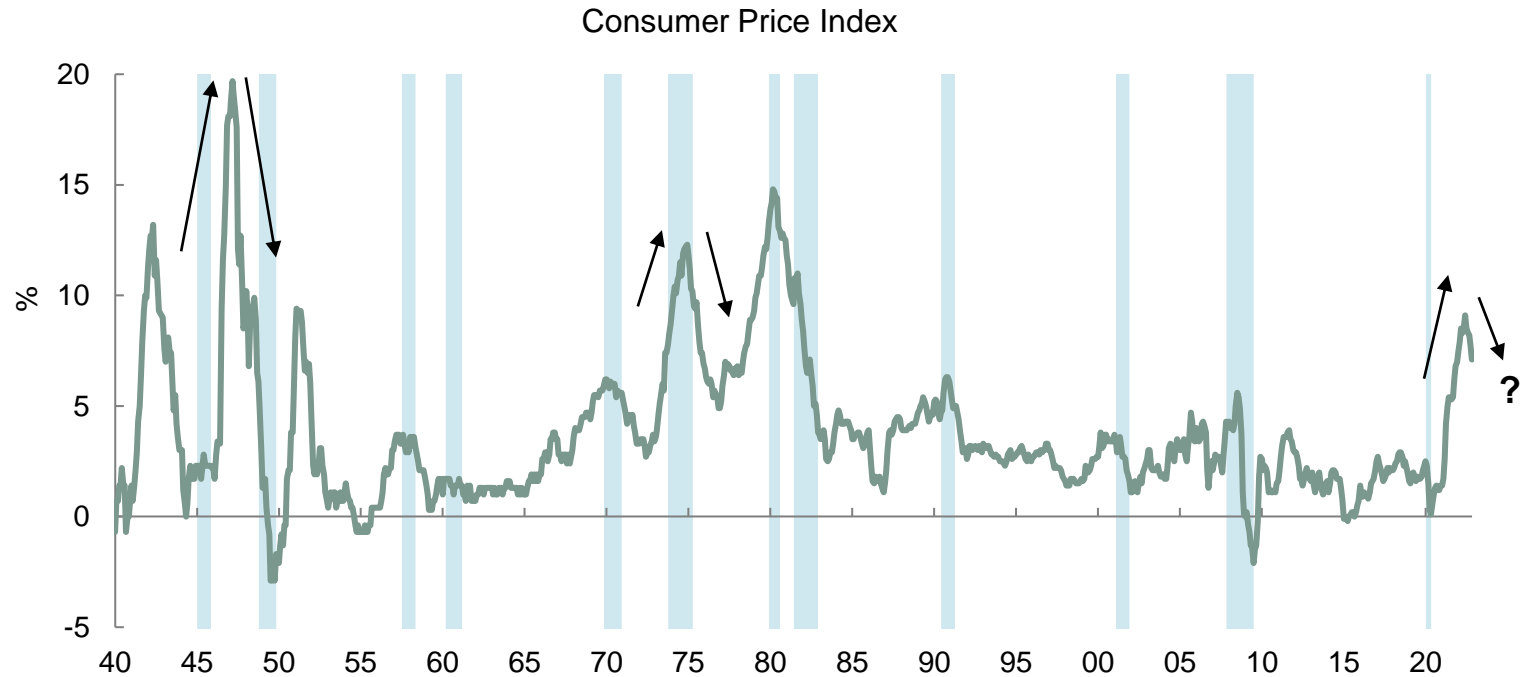
Housing Leads The Economy

Housing starts lead real GDP growth by a couple of quarters. With starts poised to fall further, overall economic activity follow.



What Goes Up Quickly, Comes Down Quickly

Historically, inflation does not plateau at an elevated reading. The latest data suggest the economy is past peak inflation.



Symmetry In Prices

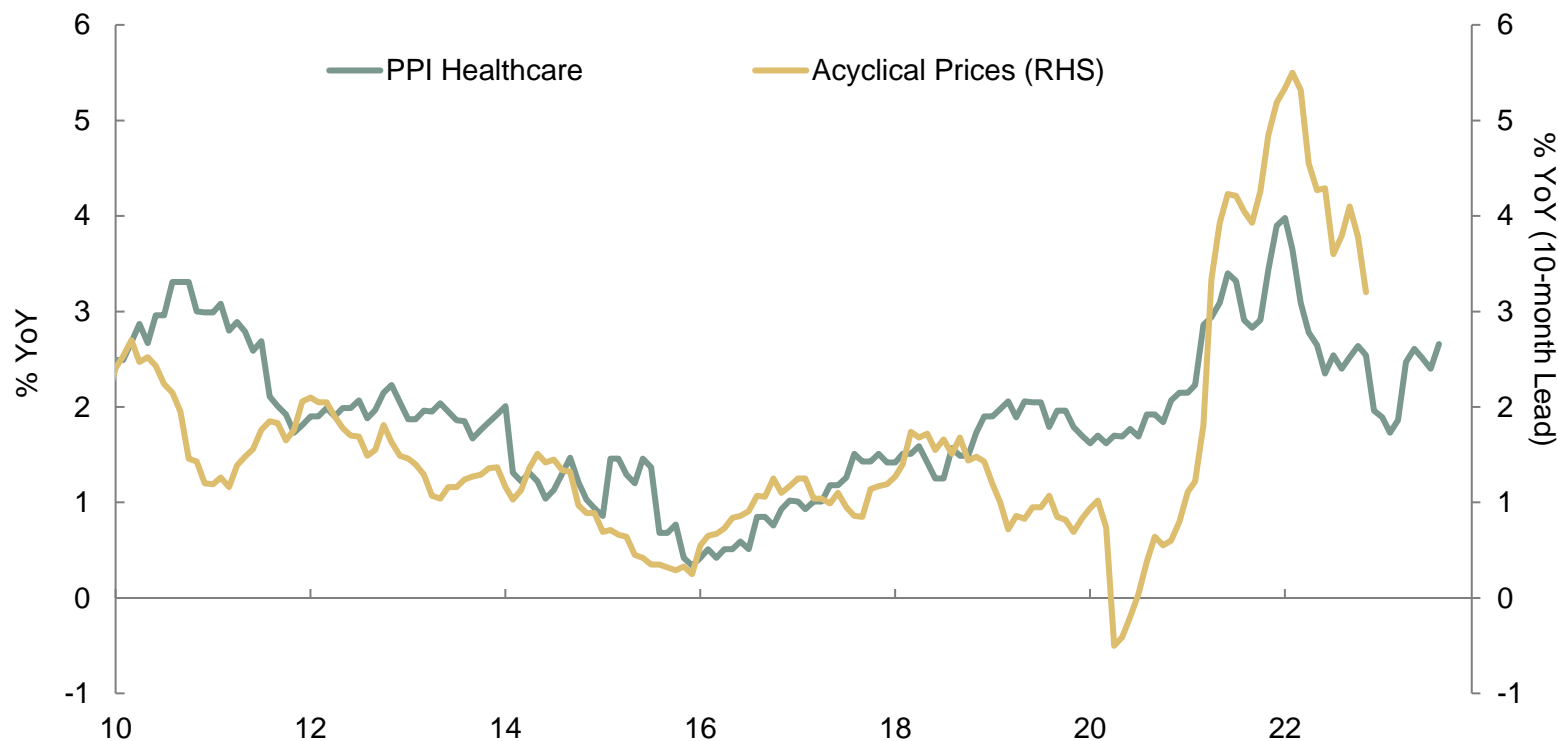
The rise in inflation is often offset by a similar pace of decline. Indeed, the average slopes are a mirror image of one another.

Consumer Price Index

Inflation Upwing	Slope	Inflation Downwing	Slope
Sep 1940 to May 1942	0.35	May 1942 to May 1944	-0.47
Feb 1946 - Mar 1947	1.61	Mar 1947 to Apr 1949	-0.66
Jul 1949 - Feb 1951	0.58	Feb 1951 to Oct 1954	-0.21
May 1967 - Dec 1969	0.12	Dec 1969 - Jun 1972	-0.12
Jun 1972 to Dec 1974	0.37	Dec 1974 to Nov 1976	-0.31
Nov 1976 to Mar 1980	0.22	Mar 1980 to Jun 1983	-0.31
Jun 1986 to Sep 1990	0.07	Sep 1990 to Jan 1992	-0.25
Aug 2007 to Jul 2008	0.22	July 2008 to Dec 2008	-1.19
May 2020 to Jun 2022	0.38	Jun 2022 to ?	
Average 1940-2008	0.44	Average 1940-2008	-0.44

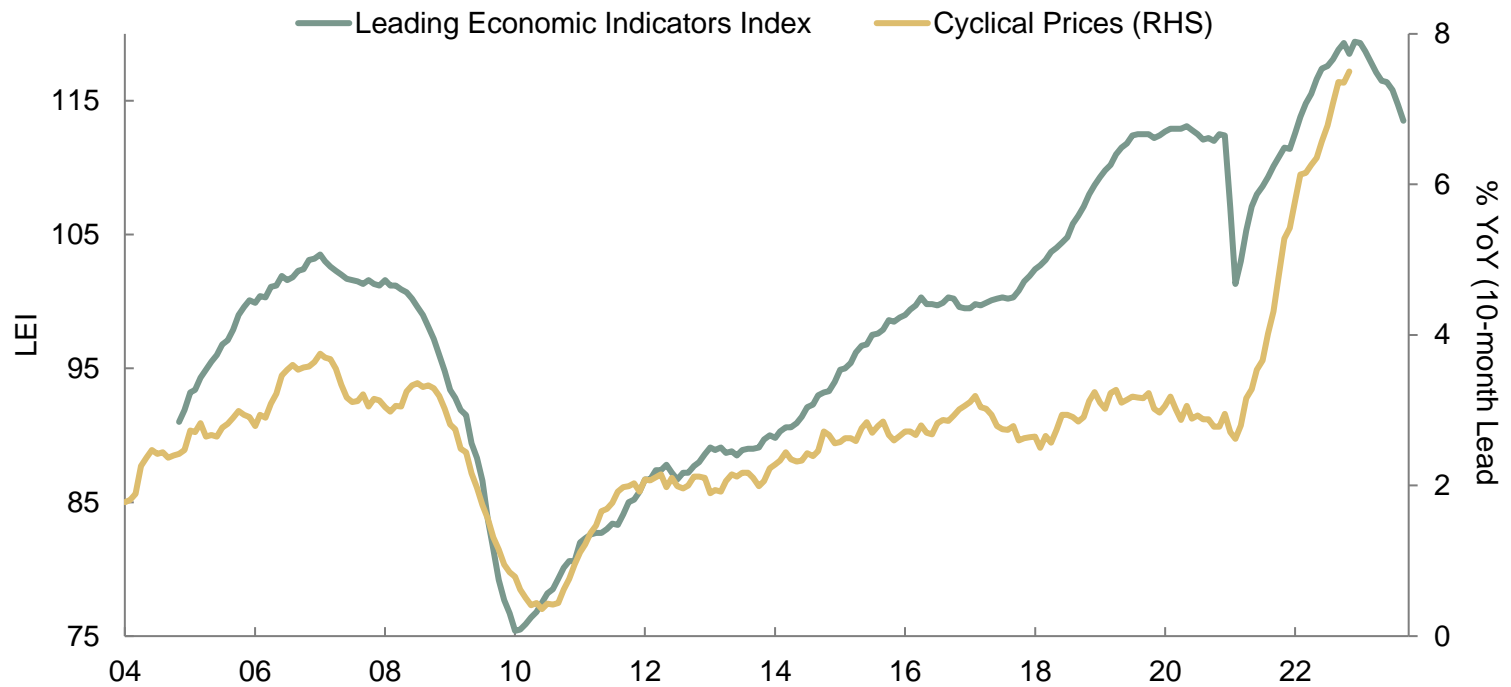
Breaking Inflation Into Two Halves: Part I

- Healthcare is the largest component of the core PCE deflator. Further moderation is expected.



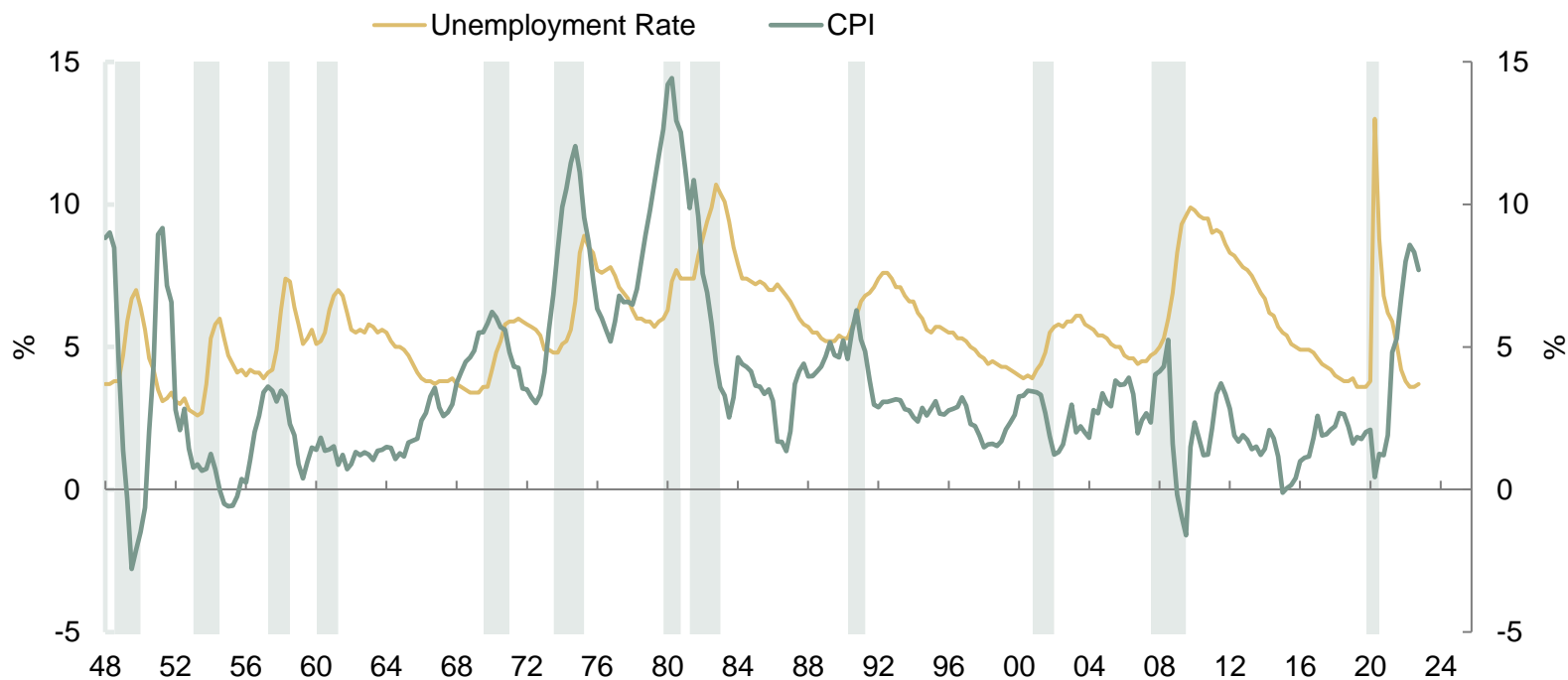
Breaking Inflation Into Two Halves: Part II

- The expected slowdown in the economy means that cyclical prices should weaken sharply.



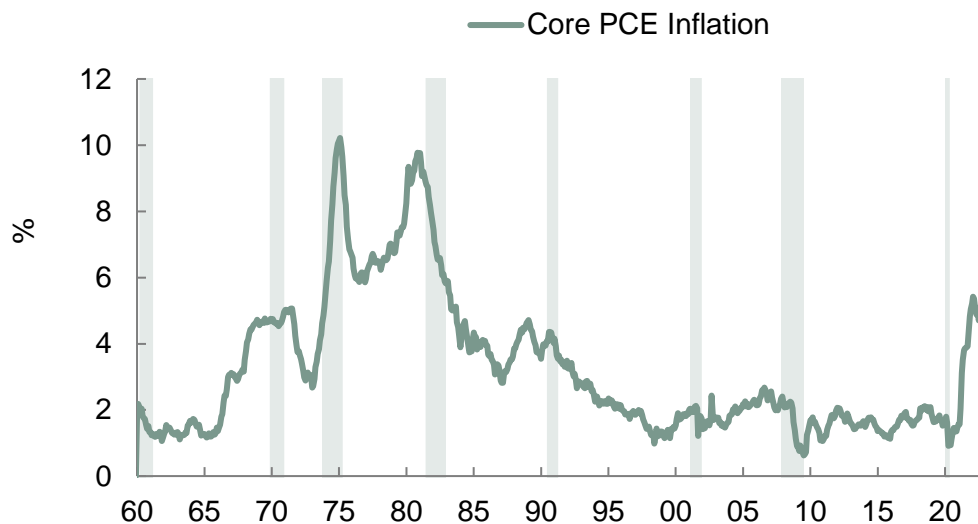
Leading And Lagging Indicators

The unemployment rate spikes quickly ahead of recession. Meanwhile, inflation peaks after the recession has begun.



Core PCE and Inflation Cycles

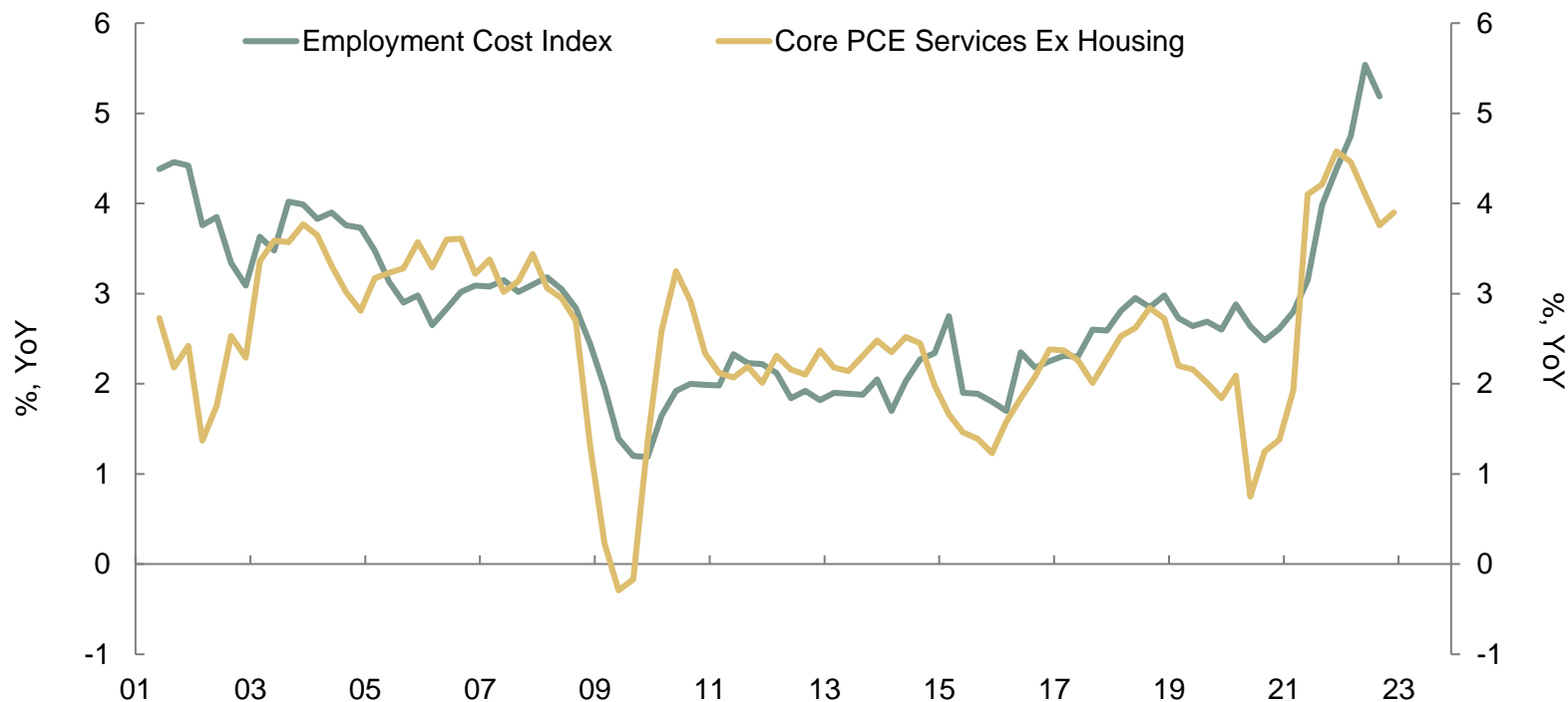
The core personal consumption expenditures (PCE) deflator is the Fed's preferred inflation series. In the past, the peak to trough decline in core PCE has been nearly 60%.



Inflation Cycles			
Peak	Trough	Bps	Percentage
Feb-60	Nov-61	-110	-50%
Dec-69	Jan-73	-210	-44%
Feb-75	Jul-76	-430	-42%
Jan-81	Mar-87	-700	-71%
Aug-90	Jun-98	-340	-77%
Jul-01	Jan-02	-70	-33%
Dec-07	Jul-09	-180	-75%
Average >		-291	-56%

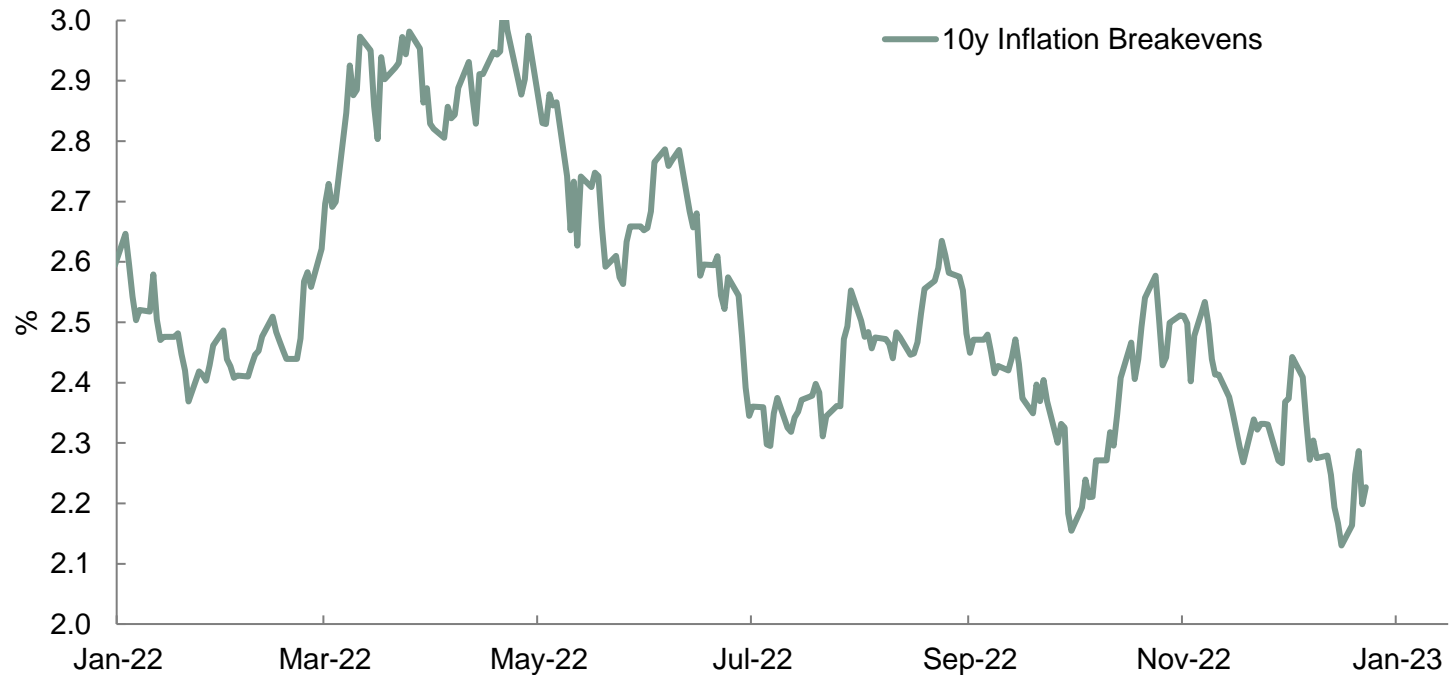
Chair Powell's New Metric

The Fed has recently narrowed its focus to core PCE services excluding housing. This subsection of the core PCE deflator has closely tracked the trend in employment costs.



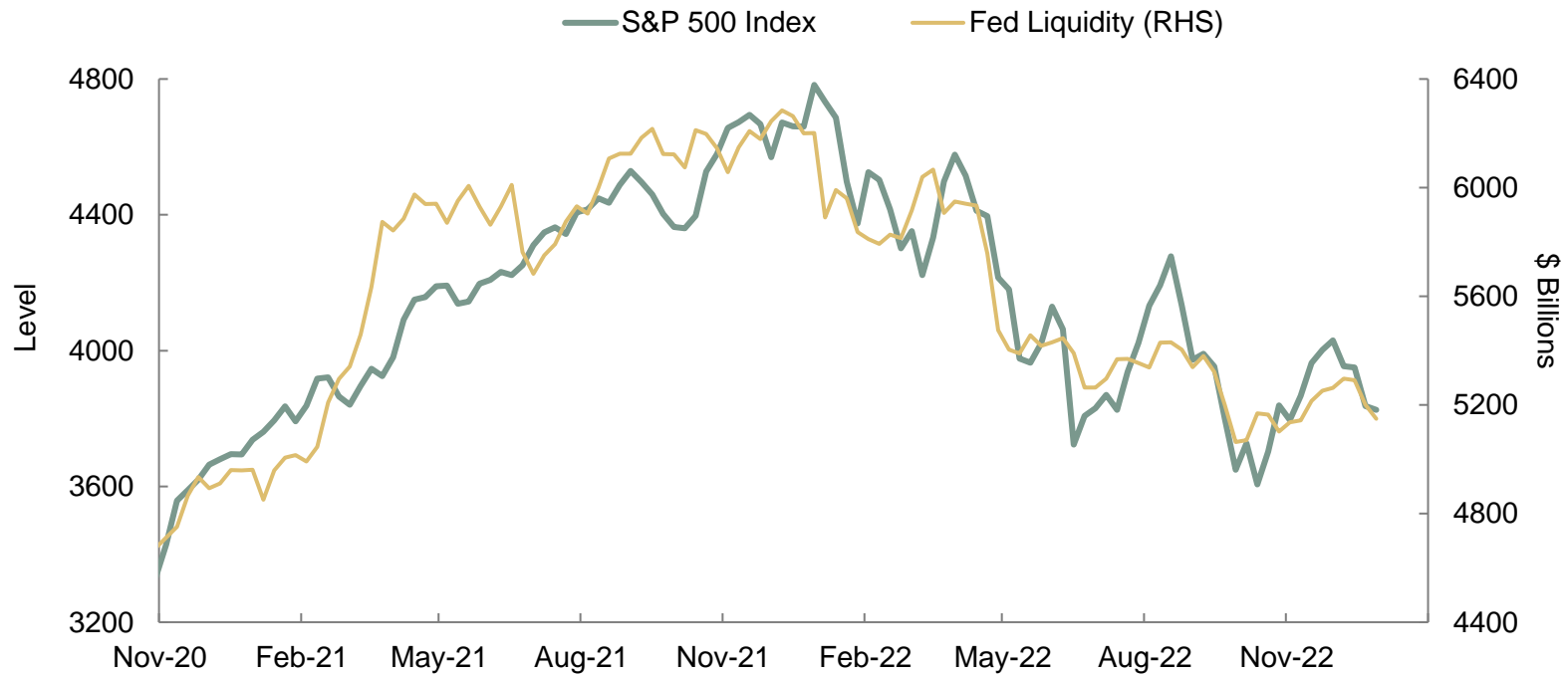
Stable Inflation Expectations

Despite record high inflation readings, the bond market remains sanguine on the inflation outlook. This is confirmed by consumer surveys of long-term inflation expectations as well as the inflation dollar swaps market.



Fellow Travelers: Liquidity and Stocks

Over the past few years, the equity market has closely tracked Fed-provided liquidity. Hence, quantitative tightening will continue to be a headwind on stocks.



Source: Haver, Bloomberg, Federal Reserve, SMBC Nikko

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