WELLS FARGO

Special Commentary — June 15, 2022

U.S. Recession in 2023 Now Seems More Likely Than Not

Summary

- We are changing our base case forecast for next year from an economic soft landing to a mild recession starting in mid-2023.
- Recent data suggest that inflation is becoming increasingly entrenched in the economy. High inflation is eroding real income, which likely will weigh on consumer spending growth in coming quarters.
- Additionally, the Federal Reserve is becoming increasingly more hawkish. The FOMC has already raised its target range for the federal funds rate by 150 bps since March, and we look for the Committee to hike rates by an additional 275 bps by early next year. Higher interest rates will eventually depress interest-rate sensitive spending.
- Other financial conditions have tightened significantly recently. Credit spreads have widened, most major stock market indices have slipped into bear market territory, and the dollar has strengthened considerably. Tighter financial conditions will also impart slowing effects on the economy.
- Many underlying fundamentals generally remain sound. Household and business balance sheets are generally in good shape, and the banking system is well capitalized. Consequently, we do not expect the downturn we are forecasting to be especially deep or prolonged.
- In our view, the recession will be more or less equivalent in magnitude and duration to the downturn of 1990-1991. That recession lasted for two quarters with a peak-to-trough decline in real GDP of 1.4%.
- Recession next year is not necessarily assured, and the Fed may still be able to pull off an economic soft landing. But prospects of a soft landing are looking increasingly less credible, and we now judge that recession next year is more likely than not.

Economist(s)

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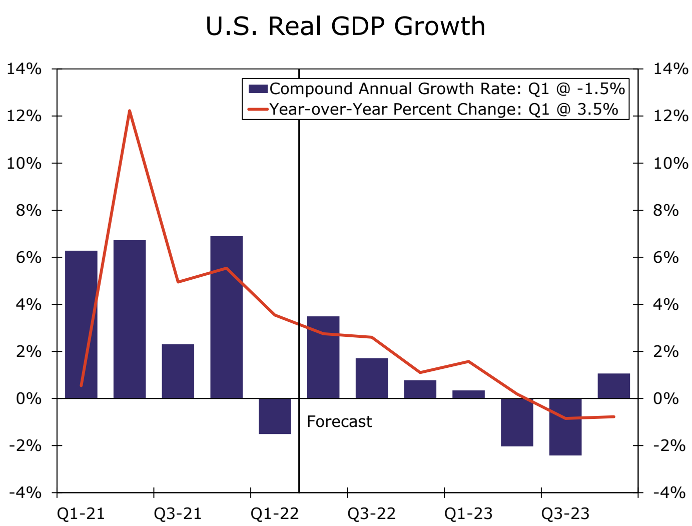
We Look for the U.S. Economy to Experience a Mild Contraction in Mid-2023

A "soft landing" is no longer our base case.

We have been forecasting that the current U.S. economic expansion, which the National Bureau of Economic Research (NBER) deems to have started in May 2020, would continue through at least the end of 2023. But we now forecast that the economy will slip into recession in mid-2023 (Figure 1). Is an economic downturn assured? No, very little in life is totally assured. But whereas our base case just a week or so ago was that the Federal Reserve would be able to more or less engineer a "soft landing," our base case now is that the economy likely will experience a mild contraction next year. A soft landing is still possible, but it is no longer our base case.

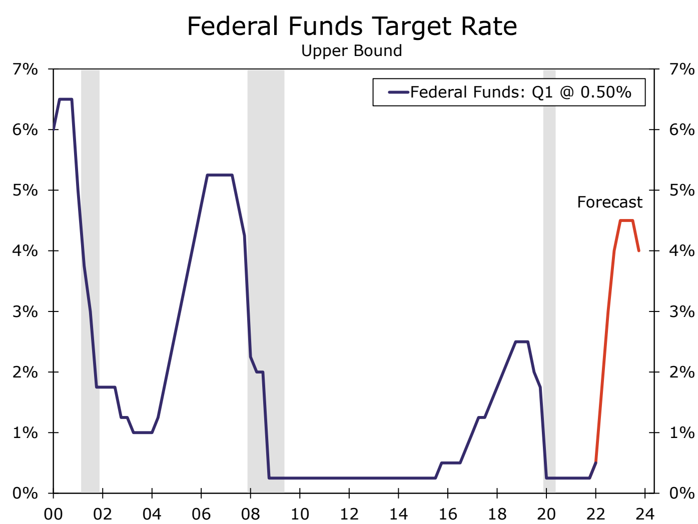
What has changed? The CPI data for May, which printed on Friday, June 10, were a game changer for us. Not only did the overall rate of CPI inflation jump to a year-over-year rate of 8.6% in May, but the underlying details showed that price pressures remain broad-based. For example, prices of "core" goods, which exclude food and energy, rose 0.7% in May despite some signs that supply chain bottlenecks have started to ease up a bit and with some retailers reporting an unintended build up of inventories. Prices of "shelter," which accounts for roughly one-third of the overall CPI, were up 0.6% relative to April and 5.5% on a year-ago basis. In addition, survey data from the University of Michigan showed that consumers currently expect inflation to average 3.3% over the next 5-to-10 years, the highest rate of long-term inflation expectations in 14 years. In short, inflation is starting to become more entrenched, and it likely will take sharp deceleration in demand, if not outright contraction, to bring inflation down to more tolerable rates in the foreseeable future.

Figure 1



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 2



Source: Federal Reserve Board and Wells Fargo Economics

Significant Fed Tightening Ahead

We look for the FOMC to hike rates by an additional 275 bps between now and early 2023.

Evidence that inflation is becoming more entrenched has caused the Federal Reserve to turn even more hawkish in recent days. Not only did the Federal Open Market Committee (FOMC) raise its target range for the fed funds rate by 75 bps at its meeting on June 15, but the Committee signaled via its so-called "dot plot" that more tightening lies ahead. In that regard, the median dot now stands at 3.375% at the end of this year, which indicates that the median Fed policymaker anticipates that an aggregate of 175 bps of additional rate hikes will be appropriate over the four remaining FOMC meetings in 2022. Because we have a higher inflation forecast than the Fed—we look for the overall rate of PCE inflation to average 6.1% in Q4-2022 versus the FOMC forecast of 5.2%—we anticipate the FOMC will end up tightening a bit more than the median dot suggests. Specifically, we look for the Committee to hike rates by 225 bps by year-end (i.e. 75 bps in July and 50 bps at each meeting in September, November and December). We also look for 50 bps of additional rate increases in early 2023, which would take the top end of the target range for the fed funds rate to 4.50% (Figure 2).

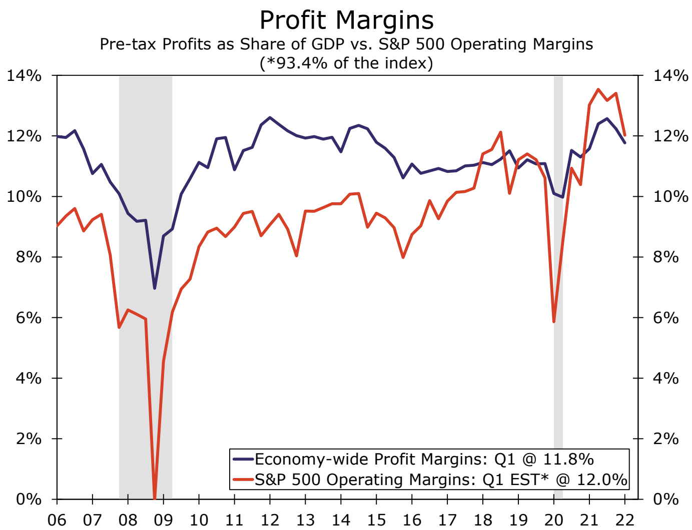
These expected rate hikes are not the only form of monetary tightening that will impart a slowing effect on the economy. The Fed is currently allowing up to $30 billion of maturing Treasury securities and up to $17.5 billion of mortgage-backed securities to roll off its balance sheet every month. These caps will be raised to $60 billion and $35 billion, respectively, starting in September. The reduction in the amount of securities that the Fed holds on its balance sheet also acts as a form of monetary tightening, although its effects are not as well understood as the effects of rate hikes. Additionally, credit spreads have widened, which raises the borrowing costs of businesses. Many major stock market indices have moved into bear market territory. Not only do weaker equity prices raise the cost of capital for issuers, but they can also weigh on consumer spending via a negative wealth effect. The dollar has strengthened versus many foreign currencies, which will help to depress growth in American exports. All of these financial market effects represent additional forms of financial tightening.

Higher interest rates will weigh on interest rate-sensitive spending.

Higher interest rates will weigh on interest rate-sensitive spending. We look for real consumer spending on durable goods to slip 5% between late 2022 and the end of next year. We also forecast that the sharp rise in mortgage rates will cause housing starts to tumble about 13% in 2023 relative to the 1.65 million pace that we project for this year. The high rate of inflation is eroding consumer purchasing power. Real disposable income has declined in seven of the last nine months, and it currently sits 3.7% below its level in July 2021. Consumers have financed solid rates of spending growth by bringing down their saving rates and by running up credit card debt, but as we discussed in a recent report, these measures are not sustainable.

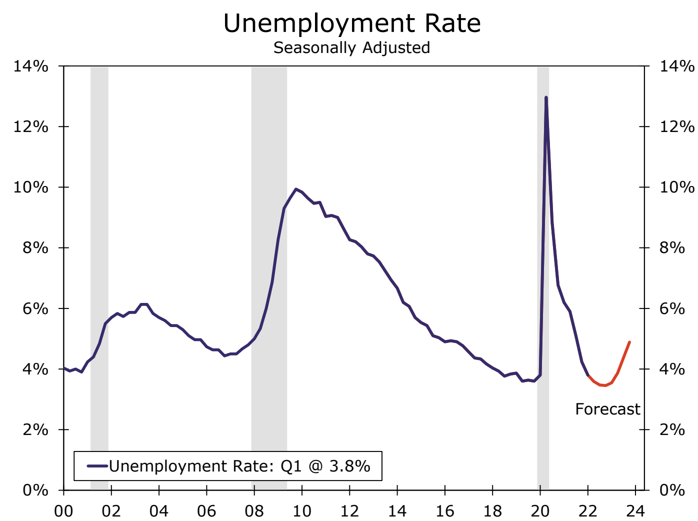
As profit margins get compressed further (Figure 3), we look for operating earnings to weaken in coming quarters. The GDP accounts show that economy-wide profits fell 2.3% in Q1-2022, and we forecast that profits will drop by another 7% or so by mid-2023. Declining profits are a recipe for cutbacks in cap-ex and employment. In that regard, we look for growth in business fixed investment spending to turn negative starting in the second quarter of next year, which coincides with the modest decline we expect will occur in payrolls. We forecast that the unemployment rate will rise from 3.5% in Q1-2023 to nearly 5% by the end of next year (Figure 4).

Figure 3



Source: U.S. Department of Commerce, S&P Global and Wells Fargo Economics

Figure 4



Source: U.S. Department of Labor and Wells Fargo Economics

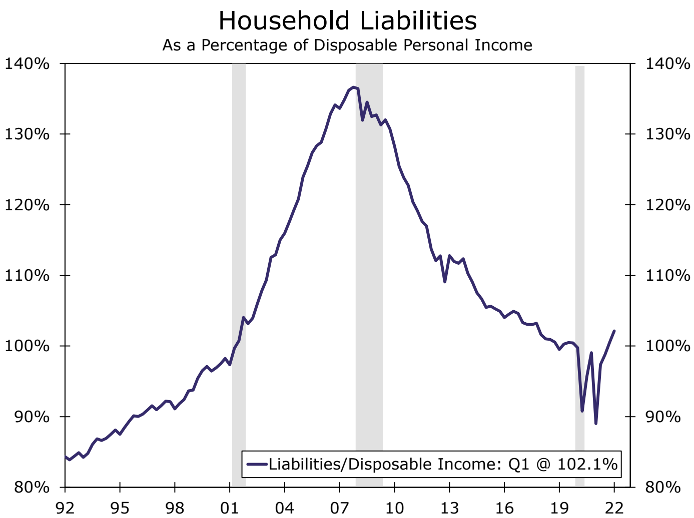
How Bad Will It Get?

The last two recessions were bruising affairs. Real GDP fell nearly 4% on a peak-to-trough basis between Q4-2007 and Q2-2009, and the 10% nosedive in output that occurred in the first half of 2020 was the sharpest economic downturn in the post-World War II era. Will the recession we are forecasting be as painful as the last two downturns? Probably not. The nosedive in economic activity in 2020 was brought about by the social distancing protocols that shut large parts of the economy. Those circumstances were unique to that cycle. Excessive household debt and over-levered financial institutions led to a full-blown financial crisis that caused economic activity to weaken sharply in 2008. As shown in Figure 5, the ratio of household liabilities-to-disposable income mushroomed during the housing bubble.

Households have delevered significantly over the past 15 years or so, and the household liabilities-to-disposable income ratio has returned to its pre-bubble level. In short, the financial position of the household sector is generally solid at present, making a nosedive in consumer spending seem unlikely. Unlike households, however, the non-financial business sector has levered up over the past decade or so. But the ability of most businesses to service their higher debt loads, as measured by the interest coverage ratio, currently stands at a multi-decade high (Figure 6). Consequently, we do not worry, at least not at this time, about a full-blown debt crisis in the business sector that would lead to a sharp downturn in economic activity. Furthermore, the banking sector is well capitalized at present, which should allow it to cope adequately with a reasonable amount of non-performing loans.

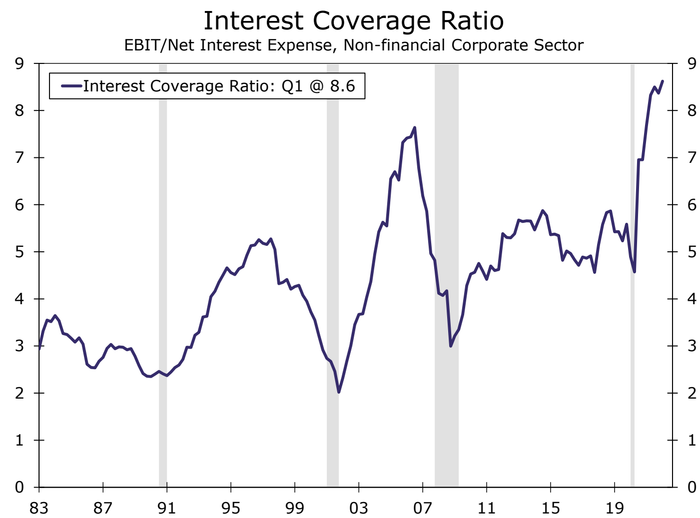
Balance sheets are generally in solid shape at present.

Figure 5



Source: Federal Reserve Board and Wells Fargo Economics

Figure 6



Source: Federal Reserve Board and Wells Fargo Economics

We forecast that real GDP will decline for two consecutive quarters in mid-2023 with a peak-to-trough contraction of about 1%. How bad is that? There have been 12 U.S. recessions since the end of the Second World War. On average, these downturns have lasted four quarters with a peak-to-trough contraction in real GDP of 2.7%. So our forecasted recession would be one of the milder downturns in the post-WWII era. It would be roughly similar in magnitude to the recession of the early 1990s when real GDP fell by 1.4% between Q3-1990 and Q1-1991. Because many of the underlying fundamentals of the economy are generally sound at present (i.e. household and business balance sheets are generally in good shape and the banking system is well capitalized), we think a mild and relatively short downturn is more likely than a deep and protracted one.

We think the recession will be roughly similar in magnitude to the downturn of the early 1990s.

How does this recession end? Because we think the downturn will not be especially deep, we do not expect the labor market to fall completely apart. After contending this year with the tightest labor market in living memory, employers are likely to be cautious about reducing payrolls en masse. Consequently, nominal income should not weaken significantly. As inflation recedes next year from its present lofty rates, the headwinds to real disposable income should dissipate. Additionally, we look for the FOMC to start cutting rates at the end of 2023 as inflation cools off and the unemployment rate rises. But financial markets will begin to anticipate Fed easing well before it actually occurs. Consequently, longer-term interest rates, including mortgage rates, should start to move lower in early to mid-2023. Easing of financial market conditions should sow the seeds of the next recovery.

As we noted previously, the recession that we are forecasting for next year is not necessarily assured, nor is the magnitude and length that we anticipate. The recession, should it indeed occur, could actually be deeper and longer than we forecast. The stresses associated with an economic downturn can expose imbalances that hitherto had been largely undetected. These imbalances can then exacerbate the downward adjustment in the economy. On the other hand, however, adept policymaking by the Federal Reserve in coming months could bring about an economic soft landing next year. But the elevated rate of inflation and the Fed's response to it are making prospects of a soft landing looking increasingly less credible, in our view. In short, our base case has changed from an economic soft landing to a mild and relatively brief recession starting in mid-2023.

Prospects of a soft landing are looking increasingly less credible, in our view.

Wells Fargo U.S. Economic Forecast

	Actual									Forecast							Actual		Forecast	
	2020				2021				2022				2023				2020	2021	2022	2023
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q				
Real Gross Domestic Product (a)	-5.1	-31.2	33.8	4.5	6.3	6.7	2.3	6.9	-1.5	3.5	1.7	0.8	0.3	-2.0	-2.4	1.1	-3.4	5.7	2.5	0.0
Personal Consumption	-6.9	-33.4	41.4	3.4	11.4	12.0	2.0	2.5	3.1	3.8	1.4	0.6	-0.5	-1.3	-0.7	1.2	-3.8	7.9	3.1	0.1
Business Fixed Investment	-8.1	-30.3	18.7	12.5	12.9	9.2	1.7	2.9	9.2	4.6	4.3	4.3	2.0	-1.7	-2.6	1.3	-5.3	7.4	5.3	1.5
Equipment	-21.3	-36.2	55.9	26.4	14.1	12.1	-2.3	2.8	13.2	2.0	4.2	4.0	0.5	-3.0	-4.0	1.0	-8.3	13.1	5.3	0.5
Intellectual Property Products	3.8	-10.6	8.1	10.2	15.6	12.5	9.1	8.9	11.6	10.0	5.0	4.8	3.3	-1.8	-2.2	2.6	2.8	10.0	9.2	2.5
Structures	-0.9	-46.8	-15.3	-8.2	5.4	-3.0	-4.1	-8.3	-3.6	-1.5	2.5	3.8	3.0	2.5	0.7	-1.5	-12.5	-8.0	-3.0	2.1
Residential Investment	20.4	-30.7	59.9	34.4	13.3	-11.7	-7.7	2.2	0.4	-9.5	-6.0	-2.5	-2.0	-6.0	-7.5	-9.0	6.8	9.2	-4.0	-5.0
Government Purchases	3.7	3.9	-2.1	-0.5	4.2	-2.0	0.9	-2.6	-2.7	1.4	2.1	1.7	1.3	1.0	0.7	0.5	2.5	0.5	-0.6	1.3
Net Exports	-841.9	-774.8	-1021.3	-1132.8	-1226.1	-1244.5	-1316.6	-1350.1	-1543.5	-1495.1	-1516.5	-1538.0	-1516.8	-1492.2	-1472.5	-1460.3	-942.7	-1284.3	-1523.3	-1485.5
Pct. Point Contribution to GDP	-0.1	1.5	-3.3	-1.7	-1.6	-0.2	-1.3	-0.2	-3.2	1.0	-0.4	-0.4	0.4	0.5	0.4	0.2	-0.2	-1.9	-1.2	0.2
Inventory Change	-30.4	-252.8	25.3	88.8	-88.3	-168.5	-66.8	193.2	149.6	112.7	128.8	123.4	112.7	48.3	-37.6	-37.6	-42.3	-32.6	128.6	21.5
Pct. Point Contribution to GDP	-0.5	-4.0	6.8	1.1	-2.6	-1.3	2.2	5.3	-1.1	-0.7	0.3	-0.1	-0.2	-1.3	-1.7	0.0	-0.6	0.1	0.8	-0.5
Nominal GDP (a)	-3.9	-32.4	38.7	6.6	10.9	13.4	8.4	14.5	6.5	11.3	8.0	4.7	3.4	-0.6	-0.4	3.3	-2.2	10.1	9.6	3.4
Real Final Sales	-4.6	-27.6	25.9	3.4	9.1	8.1	0.1	1.5	-0.4	4.2	1.4	0.9	0.6	-0.8	-0.7	1.1	-2.9	5.3	2.0	0.7
Retail Sales (b)	1.1	-7.9	4.5	4.4	15.1	32.5	15.2	17.3	12.6	7.8	8.3	6.3	0.9	-3.8	-5.5	-5.6	0.6	19.7	8.7	-3.5
Inflation Indicators (b)																				
PCE Deflator	1.7	0.6	1.2	1.2	1.8	3.9	4.3	5.5	6.3	6.5	6.7	6.1	5.1	3.6	2.6	2.2	1.2	3.9	6.4	3.4
"Core" PCE Deflator	1.8	1.0	1.5	1.4	1.7	3.4	3.6	4.6	5.2	4.7	4.6	4.3	3.8	3.4	3.0	2.6	1.4	3.3	4.7	3.2
Consumer Price Index	2.1	0.4	1.3	1.2	1.9	4.8	5.3	6.7	8.0	8.6	9.2	8.5	6.9	4.5	2.6	2.0	1.2	4.7	8.6	4.0
"Core" Consumer Price Index	2.3	1.3	1.7	1.6	1.4	3.7	4.1	5.0	6.3	6.0	6.2	6.1	5.4	4.4	3.4	2.7	1.7	3.6	6.2	4.0
Producer Price Index (Final Demand)	1.1	-1.0	0.0	0.7	2.9	6.9	8.4	9.7	10.8	10.9	10.3	9.3	6.7	4.1	2.5	2.0	0.2	7.0	10.3	3.8
Employment Cost Index	2.8	2.7	2.4	2.5	2.6	2.9	3.7	4.0	4.5	5.0	4.9	4.9	4.4	3.9	3.5	3.2	2.6	3.3	4.8	3.7
Real Disposable Income (b)	1.6	12.5	6.9	4.0	15.1	-4.3	-0.9	0.1	-11.7	-4.3	-3.3	-1.9	-0.4	0.6	0.8	0.7	6.2	2.3	-5.5	0.4
Nominal Personal Income (b)	3.3	10.9	7.1	4.8	16.1	1.6	5.3	7.5	-2.8	4.4	5.2	5.5	4.9	4.2	3.5	2.9	6.5	7.5	3.0	3.8
Industrial Production (a)	-6.7	-42.4	44.5	8.2	4.0	6.5	3.4	3.8	7.6	8.8	1.8	1.5	-3.5	-5.2	-2.1	-0.1	-7.2	5.5	5.4	-1.1
Capacity Utilization	75.3	65.6	71.9	73.4	74.1	75.2	75.8	76.4	77.6	79.1	79.3	79.4	78.6	77.5	77.0	76.8	71.6	75.4	78.8	77.5
Corporate Profits Before Taxes (b)	-5.6	-18.6	2.3	0.9	17.6	45.1	19.7	21.0	12.5	0.0	-4.5	-6.2	-5.0	-5.0	-4.0	-1.0	-5.2	25.0	0.0	-3.8
Corporate Profits After Taxes	-3.8	-18.3	2.1	1.1	14.7	43.4	18.2	19.7	9.5	-1.1	-5.8	-7.3	-3.8	-5.4	-4.1	-0.8	-4.7	23.2	-1.5	-3.5
Federal Budget Balance (c)	-387	-2001	-388	-573	-1133	-532	-538	-378	-291	179	-311	-396	-541	-62	-301	-373	-3132	-2776	-800	-1300
Trade Weighted Dollar Index (d)	112.7	110.3	106.5	103.3	104.2	102.8	105.3	108.2	109.7	115.0	115.8	116.5	117.0	117.3	116.8	116.3	109.0	104.6	114.2	116.8
Nonfarm Payroll Change (e)	-261	-4449	1324	288	645	422	543	637	539	367	250	163	100	-83	-170	-175	-774	562	330	-82
Unemployment Rate	3.8	13.0	8.8	6.8	6.2	5.9	5.1	4.2	3.8	3.6	3.5	3.5	3.5	3.9	4.4	4.9	8.1	5.4	3.6	4.2
Housing Starts (f)	1.47	1.09	1.45	1.57	1.58	1.59	1.57	1.68	1.72	1.68	1.62	1.58	1.52	1.47	1.40	1.37	1.38	1.60	1.65	1.44
Light Vehicle Sales (g)	15.0	11.3	15.4	16.2	16.8	16.9	13.3	12.9	14.1	13.8	15.3	16.8	16.8	16.3	15.6	16.3	14.5	15.0	15.0	16.2
Crude Oil - Brent - Front Contract (h)	51.0	34.7	43.8	45.5	60.9	68.6	72.5	79.0	95.7	113.8	126.0	120.0	114.0	110.0	104.0	101.0	43.7	70.3	113.9	107.3
Quarter-End Interest Rates (i)																				
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	1.75	3.00	4.00	4.50	4.50	4.50	4.00	0.50	0.25	2.31	4.38
Secured Overnight Financing Rate	0.01	0.10	0.08	0.07	0.01	0.05	0.05	0.05	0.29	1.55	2.80	3.80	4.35	4.35	4.40	3.90	0.36	0.04	2.11	4.25
3 Month LIBOR	1.45	0.30	0.23	0.24	0.19	0.15	0.13	0.21	0.96	2.05	3.30	4.35	4.70	4.75	4.65	4.05	0.65	0.16	2.67	4.54
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.50	4.75	6.00	7.00	7.50	7.50	7.50	7.00	3.50	3.25	5.31	7.38
Conventional Mortgage Rate	3.50	3.13	2.90	2.66	3.17	3.02	2.88	3.11	4.42	5.70	5.85	5.90	5.85	5.65	5.40	4.95	3.12	2.95	5.47	5.46
3 Month Bill	0.11	0.16	0.10	0.09	0.03	0.05	0.04	0.06	0.52	1.85	3.10	4.10	4.40	4.40	4.25	3.70	0.36	0.04	2.39	4.19
6 Month Bill	0.15	0.18	0.11	0.09	0.05	0.06	0.05	0.19	1.06	2.45	3.50	4.30	4.40	4.35	4.15	3.55	0.37	0.06	2.83	4.11
1 Year Bill	0.17	0.16	0.12	0.10	0.07	0.07	0.09	0.39	1.63	3.10	3.75	4.15	4.25	4.15	3.90	3.25	0.37	0.10	3.16	3.89
2 Year Note	0.23	0.16	0.13	0.13	0.16	0.25	0.28	0.73	2.28	3.55	3.85	4.00	4.10	3.90	3.60	3.00	0.39	0.27	3.42	3.65
5 Year Note	0.37	0.29	0.28	0.36	0.92	0.87	0.98	1.26	2.42	3.60	3.85	3.95	4.00	3.85	3.50	3.00	0.53	0.86	3.46	3.59
10 Year Note	0.70	0.66	0.69	0.93	1.74	1.45	1.52	1.52	2.32	3.55	3.70	3.80	3.75	3.60	3.40	3.00	0.89	1.45	3.34	3.44
30 Year Bond	1.35	1.41	1.46	1.65	2.41	2.06	2.08	1.90	2.44	3.50	3.60	3.70	3.65	3.55	3.45	3.20	1.56	2.06	3.31	3.46

Forecast as of: June 15, 2022

Notes: (a) Compound Annual Growth Rate Quarter-over-Quarter
(b) Year-over-Year Percentage Change
(c) Quarterly Sum - Billions USD; Annual Data Represents Fiscal Yr.
(d) Federal Reserve Advanced Foreign Economies Index, 2006=100 - Quarter End
(e) Average Monthly Change
(f) Millions of Units - Annual Data - Not Seasonally Adjusted
(g) Quarterly Data - Average Monthly SAAR; Annual Data - Actual Total Vehicles Sold
(h) Quarterly Average of Daily Close
(i) Annual Numbers Represent Averages

Source: U.S. Department of Commerce, U.S. Department of Labor, IHS Markit, Federal Reserve Board and Wells Fargo Economics

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Required Disclosures