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Macroeconomic Update

Fed to Get the Recession It Wants in 2023

The Fed will likely overdo it with rate hikes, viewing a recession as the least bad outcome for the economy.

The Fed has abandoned talk of a soft or even "softish" landing, with the September Summary of Economic Projections pointing to a 90-basis point rise in the unemployment rate to 4.4 percent by end-2023, an increase consistent with a recession. The seemingly endless string of upside inflation surprises has cemented the Fed's view that the labor market needs to soften and aggregate demand needs to weaken further, which will require keeping policy restrictive for some time.

Signs are piling up that the economy is heading in the direction the Fed wants. While gross domestic product (GDP) rebounded in the third quarter to an inflation-adjusted 2.6 percent, private domestic demand (consumption and fixed investment) continued to slow, growing just 0.1 percent. The slowdown was led by a collapse in housing activity, historically the first sector to be hit by rising rates, cutting about 1.4 percentage points from GDP's growth rate. The sharp tightening in financial conditions means a broader economic slowdown lies ahead, which should help to loosen up the labor market. Early signs of this can be seen in slower wage growth, job openings and quits trending down, and monthly job growth in October coming in at less than half the pace of early 2022.

Inflation remains unacceptably high, but several factors point to a substantial downshift in 2023. Goods prices have started to drop, and supply chain improvement along with input and import costs suggest further deflation in the goods sector lies ahead. Services inflation is now the main price stability concern, but even the Bureau of Labor Statistics and several Fed speakers have acknowledged that the lagged data on home rental prices doesn't reflect the sharp slowdown in market rents that has taken place (and that will start to show up in the data next year).

With the economy cooling and inflation likely to fall, we expect that rate hikes will be winding down in coming months, particularly with rising strains in global markets. But having been repeatedly burned by expectations that inflation would cool—and fearing a replay of the "stop-start" rate hike campaigns of the 1970s—the Fed will likely err on the side of overdoing it with rate hikes, viewing a recession as the least bad outcome for the economy. With a recession likely in 2023 and the bond market already pricing in a terminal fed funds rate near 5 percent, we think high quality fixed income looks attractive.

By Brian Smedley, Maria Giraldo, and Matt Bush

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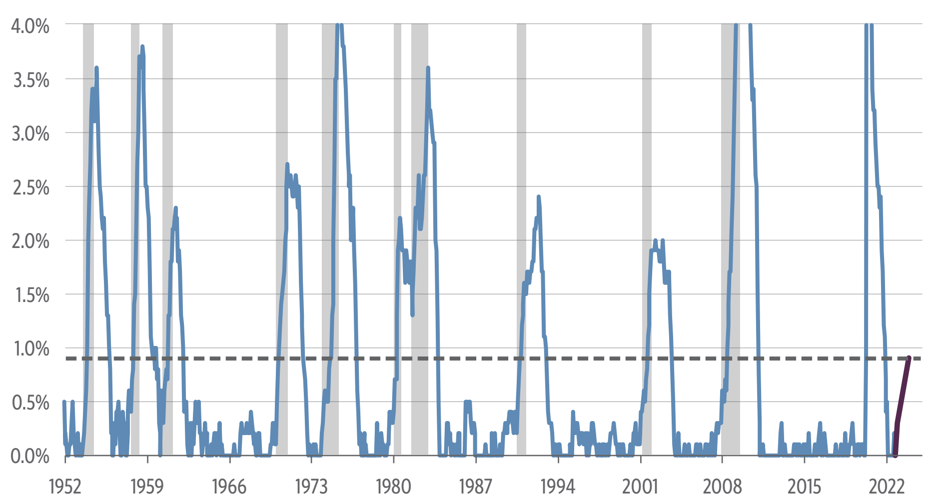
Fed's Unemployment Rate Forecast Suggests a 2023 Recession Is Likely

Increase from Trailing Two-Year Low



Source: Guggenheim Investments, Haver Analytics. Data as of 9.30.2022.

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