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MACRO STRATEGY

Four Scenarios: Recession, Soft Landing, Stagflation, or the Status Quo

Key Takeaways

- Economic forecasts are particularly uncertain right now, and an honest assessment requires considering multiple scenarios.
- We still expect a recession but see a soft landing as the most likely, off-base case scenario.

Two of the most important economic questions right now are how high the unemployment rate will rise, and how fast inflation will fall. We see a particularly uncertain economic path forward, and so we have constructed four scenarios for year-end 2023 around these two economic indicators.

As the most likely outcome, we expect a reduction in inflation combined with elevated unemployment.[1] However, other scenarios have a greater-than-usual chance of taking place and warrant a closer look.

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Table 1 | Probabilities by Scenario

		Core PCE y/y by Q4 2023	
		At or below 3%	Above 3%
Maximum unemployment rate 2023	At or below 4.5%	20% *Soft landing*	10% *High inflation*
	Above 4.5%	55% *Ordinary recession*	15% *Stagflation recession*

Ordinary Recession

We consider this to be the most likely outcome. We believe the Fed when it expresses its commitment to lowering inflation. Inflation has been stubborn this year, and while there is no guarantee that the Fed will be able to reduce inflation down to 2%, we do expect that the Fed's efforts are likely to lead to sub-3% core PCE growth.

At the same time, this effort is likely to entail raising the Fed Funds rates even higher than it currently is to sufficiently reduce demand. Demand reduction to the level required may ultimately only be achieved by increasing the unemployment rate to recessionary levels.

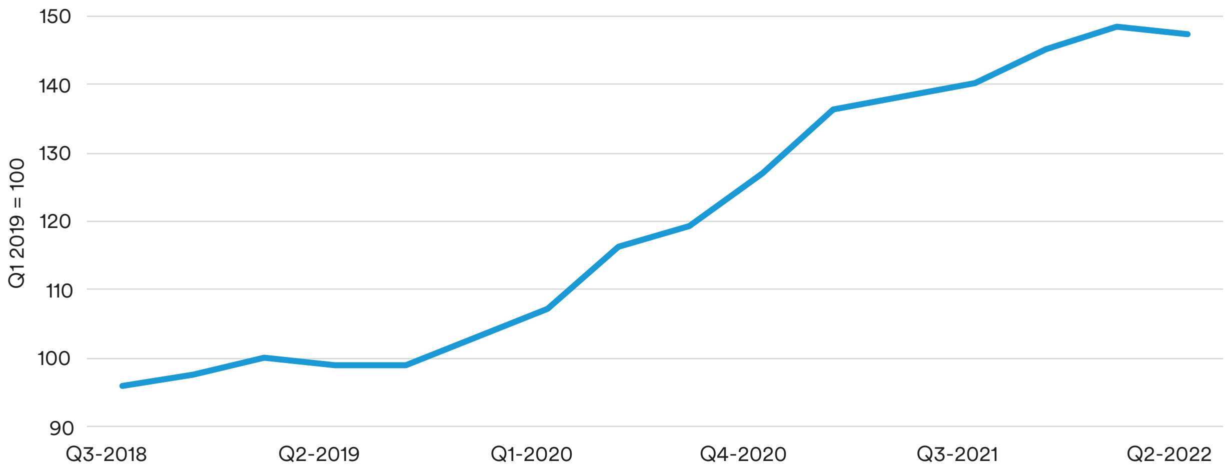
Consumers still have a lot of money saved up. Figure 1 shows households' liquid holdings (cash, checking, savings).

Normalized against Q1 2019, holdings peaked in Q1 2022 but are still nearly 50% higher than they were pre-COVID-19.[2] To counter this huge consumer war chest, the Fed appears to need to create income insecurity by pushing toward higher unemployment – i.e., recession.

This type of recession would be consistent with a continued tight monetary policy. It is particularly likely in cases where the Fed continues to raise rates despite the known lagged effect of the Fed Funds rate on inflation. It is also more likely in cases where the Fed maintains a tight monetary policy for an extended period of time.

Figure 1 | Household Liquid Holdings Nearly 50% Higher Than Pre-COVID Levels

Currency and Checkable, Savings, and Time Deposits



Source: Federal Reserve Board, Haver, MIM

Soft Landing

We feel that a soft landing is substantially less likely than an outright recession, but we see it as the second most likely outcome. A soft landing would require the Fed to do a Goldilocks: raise rates by just enough to rein in inflation but not enough to trigger a recession.

This balancing act will be difficult. The unemployment rate tends to have a tipping point where it suddenly shoots up once economic conditions deteriorate, as all companies seem to tighten their belts at once.

If the Fed does achieve a soft landing rather than a recession, it will likely be a result of luck—getting the level of monetary policy tightness just right, while experiencing no further inflation shocks.

Stagflation

Although stagflation has been much discussed, we believe this may be because the only inflationary episode in most Americans' living memory was the 1970s stagflationary episode. Most Americans have not lived through an "ordinary" inflationary episode.

The Fed has repeatedly said it is determined to subordinate its employment mandate to its inflation mandate in the near term as it seeks to get inflation under control. With long-run inflation expectations well anchored, as seen by both consumer sentiment surveys and market indicators of inflation expectations, we expect the Fed to succeed in taming inflation.

Therefore, the most likely situation in which inflation would not be well contained by the end of the 2023 is if there is some exogenous shock such as another oil shock, a natural or man-made disaster that affects critical resources, or a military escalation. Acute shortages, well beyond what are currently expected, where it may not be viable for the Fed to respond with a commensurate reduction in demand, may result in stagflation.

More prosaically, it is also possible that inflation heads in the right direction, but that it falls below 3% in early 2024, just missing our year-end 2023 call.

Continued High Inflation

The least likely scenario, in our view, is a continuation of the current situation: high inflation and low unemployment. The Fed is actively trying to shift the economy from the current situation with the most rapidly tightening financial conditions in a generation. It's quite unlikely that this rapid tightening will have no material effect on the macroeconomic landscape, even if it takes months for its effects to be broadly felt. Even now, a fair number of goods are already seeing outright deflation. The most likely way in which we could wind up in this scenario by year-end 2023 is if there is an unlikely combination of events—say, the beginnings of a soft landing combined with an exogenous shock that reignites inflation.

Conclusion

The next few FOMC meetings are likely to be particularly crucial toward determining which of these scenarios is likely to take place. The Fed's continued decisive action should have the benefit of substantially reducing the likelihood of prolonged inflation but will most likely lead to recession.

Endnotes

[1] High unemployment and recessions tend to occur at the same time. The unemployment rate of 4.5% is taken as a threshold point as it more than fulfills the Sahm rule of a 0.5% or more increase over the past year's unemployment rate, and is consistent with prior recession onsets that have seen a sharp, generally greater than one percentage point increase in unemployment, going into a recession.

[2] These data are through Q2; Bank of America has calculated data through August that show a modest decline in the first two months of Q3.

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