MetLife Investment Management

MACRO STRATEGY

July 18, 2023

U.S. Economic Monthly

Consumers Keep At It

Monthly Themes

- Inflation persists as the Fed prepares to hike again.
- Credit tightening to squeeze economic activity in the second half of the year.
- Consumers remain surprisingly resilient.

MIM now expects a recession to begin in 2024.

2023 is expected to continue to show mixed growth messages as the consumer maintains high enough growth to offset weakness in manufacturing. Absent a shock to the economy (from energy, banking or geopolitical), a strong desire to recoup lost time and experiences is likely to save Q4 even if consumers are feeling some strains. MIM believes the low point for growth this cycle should be 2024, when we expect the recession to start.

Inflation Persists

Inflation appears to have peaked in the United States as the rate of increase in service-sector inflation has moderated. We continue to see inflation above the Fed's 2% target rate but cannot rule out a brief period of deflation should the labor market weaken faster than we expect.

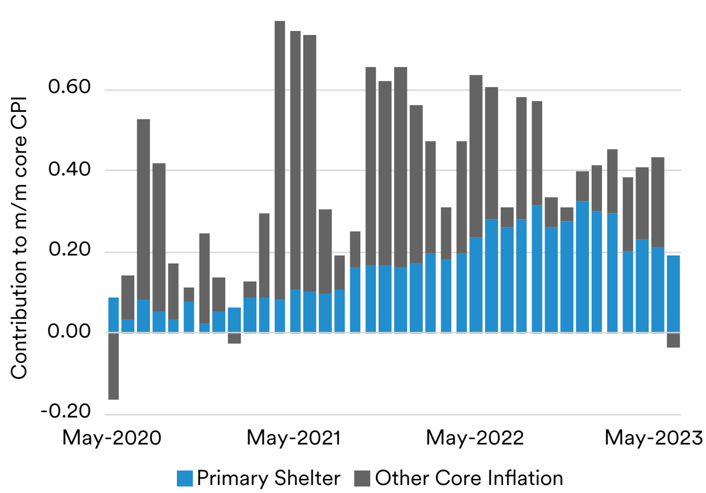
For now, month-on-month core inflation remains above target. This has sustained the Fed's concerns about price stability and lies behind its hawkishness around an additional rate hike in July.[1]

The Fed's past aggressive rate increases remain a concern. The Fed has raised rates by the most since the early 1980s, helping to create the conditions that have pressured the U.S. banking system and concern among business leaders.

Credit Tightening

MIM's proprietary default rate leading indicator for Q1 suggests we are in a period of "danger" for increased defaults.

Chart 1 | Inflation's Sluggish Response



Note: Primary shelter is shelter less lodging away from home.
Source: BLS, Haver, and MIM

Table 1 | Default Danger Rising

2023	Q1	**2020**	Q4	Danger
2022	Q4		Q3	Caution
	Q3		Q2	Safe
	Q2		Q1	
	Q1	**2019**	Q4	
2021	Q4		Q3	
	Q3		Q2	
	Q2		Q1	
	Q1			

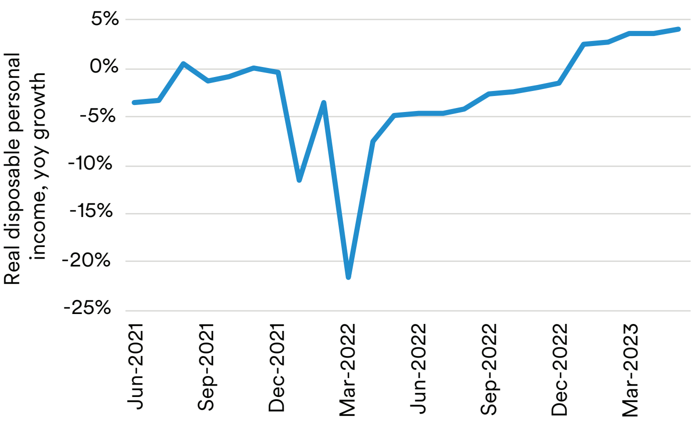
Source: OECD, Senior Loan Officer Survey, Moody's, Bloomberg, VIX, MetLife Investment Management

We expect the ongoing tightening of bank lending standards to continue. In our view, the additional stressors, such as the "rescue" of another regional bank in April, the subsequent regional bank volatility seen in equity markets, the increasing reliance on more expensive funding, such as Federal Home Loan Bank advances, and the continued burden of higher rates would add another headwind to economic activity.

Consumers Resilient

Consumers have been reaping the benefits from a tight labor market, as real disposable personal income has continued to improve over the past year. Over this time, the consumer has been maintaining a relatively healthy rate of consumption growth. Given the behavior of consumers post-COVID-19, we believe it is unlikely that consumers would willingly pull back on consumption during the end-of-year holiday season and, as a result, do not expect that we would see the start of the recession during the fourth quarter.

Chart 2 | Household Income Keeps Rising



Source: BEA, Haver, MIM

Nevertheless, we see the rise in credit usage, a higher savings rate and relatively poor consumer confidence as reasons for caution about the sustainability of this growth driver and believe that efforts to maintain consumption through the holidays may result in a sharper slowing when the labor market weakens.

Risks to the Outlook

The combination of aggressive rate hikes coupled with banking stress suggests a higher probability that the Fed is either stuck—unwilling to risk a banking crisis to curtail inflation pressures if that is what is required—or will be forced to push rates in excess of what is needed in the medium term to lower inflation to its target. We see the labor market has been more resilient than had been anticipated. This raises the risk of a low unemployment, higher, for longer inflation scenario at the expense of a normal recession or a soft-landing scenario (where the Fed seems set to achieve its inflation target with only a modest increase in unemployment).

U.S. Outlook Summary

We expect that a recession is likely to be avoided until 2024. Growth in the United States is expected to be 1.7% in 2023 but fall to -0.2% in 2024, when MIM anticipates three quarters of negative growth. Inflation is likely to be near 3% at year-end 2023 but move below that level during the recession.

The federal funds rate is expected to peak at 5.25-5.50% as the Fed hikes rates one additional time in 2023. We no longer expect the Federal Reserve to cut rates in 2023 but do expect a substantive rate cut cycle to begin in the first half of 2024.

We foresee a 10-year U.S. Treasury yield of 4.00% at year-end 2023. We continue to believe the peak in yields for this cycle has occurred. We expect the yield curve to remain inverted for some time. As with its other recent course changes, the Fed is likely to be slow, delaying cuts—and therefore yield curve normalization—until a recession is already under way.

As noted in our Q3 2023 Relative Value Allocation, we do not think credit markets have priced in sufficient downside risk yet. Looking forward, the credit cycle is expected to turn in the coming quarters, with spreads widening further on continued recession risk. As a result, we continue to tilt toward "up-in-quality."

Table 2 | MIM Forecast

U.S.	2023	2024
GDP	1.7	-0.2
CPI	3.0	2.8
10 Year	4.00	3.50
Policy rates	5.50	3.00

Note: GDP is annual average growth rate, CPI is Q4 year/year, 10 year is year-end, policy rate is upper bound
Source: Metlife Investment Management

Endnote

[1] Source: Summary of Economic Projections, June 14, 2023 (federalreserve.gov); Financial Stability and Economic Developments, speech by Chair Jerome H. Powell, June 29, 2023.

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