

Economic Monthly

Next Stop Deflation?

Monthly Themes

- Inflation has moderated, setting the stage for an end to the hiking cycle.
- Tight credit conditions persist.
- Consumers remain resilient.
- We raise our 2023 and 2024 GDP forecast but continue to expect a 2024 recession.

We expect the second half of 2023 to see the consumer maintain sufficient strength to offset manufacturing weakness.

Absent a shock to the economy (from energy, banking or geopolitical), we believe the desire to spend on experiences is likely to save Q4.

MIM believes the low point for growth this cycle will be 2024, when we expect the recession to start.

Inflation Vanquished?

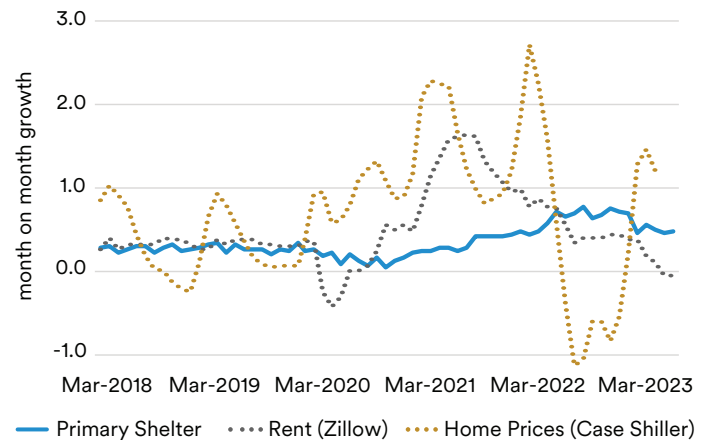
Monthly inflation over the last two months has, according to the BLS, tracked at 1.9%, below the Fed's 2% target.

BLS data also show goods prices have deflated over the past two months. Services, aside from shelter, have fallen below their long-run average inflation rate. Even rent has seen deflation over the past two months. But we don't expect outright headline deflation in the near term.

The main concern is housing. Housing shortages and lack of inventory have led to a rebound in home price growth since January, with the Case-Shiller home price index coming in at an annualized average of 13%, compared with its long-run average of 5%. The Housing Affordability Index, which considers price and mortgage rates, shows housing is at its least affordable since July 1985.

Looking forward, it's unclear how the situation will be alleviated. Housing construction hasn't had a robust response to the shortage, with Census data showing minimal growth in units under construction.

Home Prices Remain Elevated



Note: Primary shelter refers to shelter inflation less hotels/motels
Source: BLS, Zillow, S&P CoreLogic, Haver, MIM

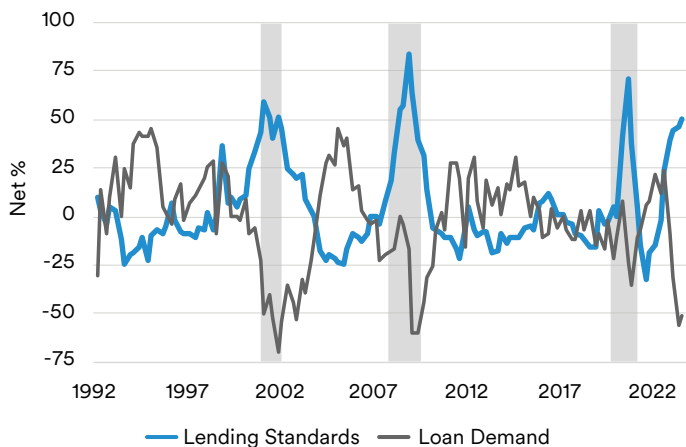
Credit Still Tightening

We expect the ongoing tightening of bank lending standards to continue for some time.

The most recent Senior Loan Officer Survey suggests that lending standards are close to recession levels. Loan demand remains weak. We believe recent bank downgrades will only exacerbate any unwillingness to lend.

On the consumer side, Federal Reserve data shows credit growth has declined from its peak of 7.6% in 2022 to 4.3% in June as consumers increased their debt burden more slowly. It has some ways to go before becoming contractionary but appears to be weakening.

Credit Approaching Recession-level Tightness



Source: Federal Reserve Board, NBER, Haver, MIM

Consumers Remain Optimistic

Consumers continue to reap the benefits of a tight labor market and moderating inflation, and consumer confidence has had two months of surprising improvements — moving the indicators from red to green in our table. We expect consumers to continue spending on services, and also increase goods purchases as prices fall due to goods deflation. Given the behavior of consumers post-COVID-19, continued strong consumption expenditures and the upcoming holiday season, we do not expect consumers to willingly slow down spending going into the fourth quarter.

	2023 Apr	2023 May	2023 Jun	2023 Jul
Confidence: Conference Board – Level	103.7	102.5	110.1	117
Confidence: University of Michigan - Level	63.5	59.2	64.4	71.6
Personal Income - 1 mo. chg.	-0.08%	0.33%	0.14%	
Personal Consumption Expenditures: Total - 1 mo. chg.	0.27%	0.05%	0.39%	
Avg. Hourly Earnings - Level	9.62	9.66	9.68	9.7
Real Retail Sales - 1 mo. chg.	-0.02%	0.82%	0.25%	0.90%

Source: University of Michigan, The Conference Board, Census Bureau, BEA, BLS, Haver, MIM

Warning Moderate Strong

However, higher credit usage, low savings rates and restarting student loan payments may cast a shadow on the sustainability of consumer strength and spending, especially if the labor market weakens.

Risks to the Outlook

The risks to the outlook remain significant. The U.S. fiscal situation is concerning and has deteriorated in recent months as the growth in interest payments accelerates, claiming an increasing share of tax revenue.

We do not expect substantial near-term effects from the U.S. credit downgrade, but a longer-term concern is the potential for other credit ratings to reset relative to the new debt rating.

Heading into the fall, we are likely to hear more about a potential government shutdown, which would increase market volatility, particularly in light of the credit downgrade.

U.S. Outlook Summary

We expect that a recession will likely be avoided until 2024. We have raised our U.S. growth forecast to 2.1% in 2023 on the back of an unexpectedly high Q2 GDP print. We have also raised our 2024 forecast to 0.0% (from -0.2% previously). Despite the improvement, we still expect at least two quarters of negative growth in 2024.

We believe the Fed has completed its hiking cycle with the July rate hike. We expect a rate cut cycle to begin in 2024, whether or not a recession takes place.

We foresee a 10-year U.S. Treasury yield of 4.00% at year-end 2023. We believe, the downgrade to U.S. debt is unlikely to lead to an enduring rise in rates, although they are approaching cycle highs.

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

MIM Forecast

U.S.	2023	2024
GDP	2.1	0.0
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 the upper bound year-end rate.

Source: MetLife Investment Management

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