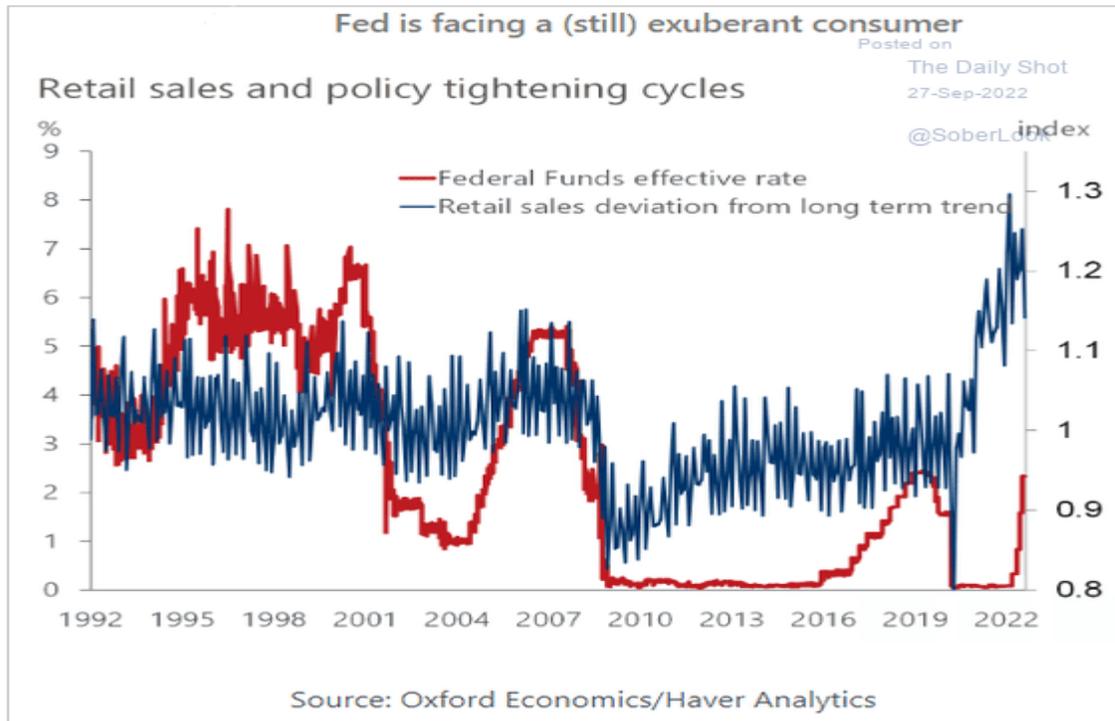


ECONOMIC REVIEW

October 2022

Recession Odds Are Rising: Despite significant inflation, consumer spending remains strong, with consumer credit card delinquencies near all-time lows. As shown below, retail sales continue to grow above their long-term trend.



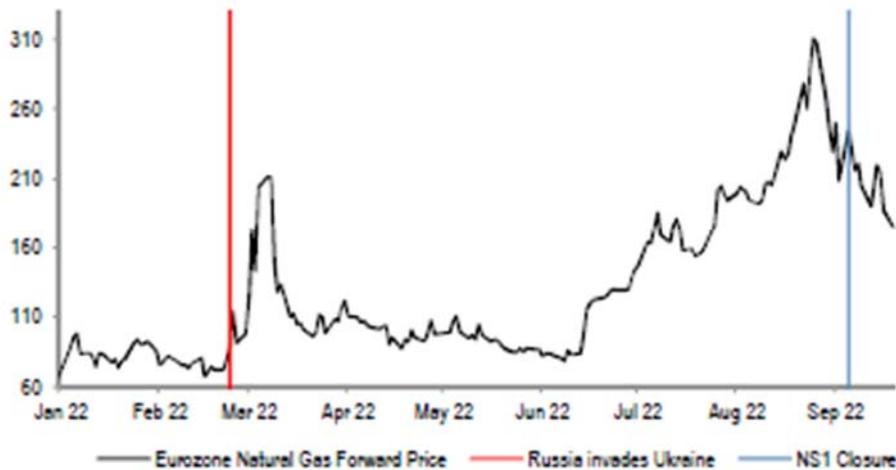
However, several signs point to rising recession risk over the next year. First, leading economic indicators have weakened recently, turning negative in late September. Second, the yield curve is flat and partially inverted, meaning that the yield on short-term Treasury bonds is higher than the yield on long-term Treasury bonds. This yield curve dynamic typically signals weaker economic growth ahead.

Also, Federal Reserve Chairman Jerome Powell gave an unusually direct speech in late August, in which he made it clear that the Fed intends to raise rates aggressively, causing economic pain: “Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain.”

In addition to raising rates aggressively, the Fed began to reduce its \$9 trillion balance sheet by \$100 billion a month in September, reversing some of its COVID-related stimulus. The consensus among economists is a 50% probability of recession within the next year and 70% in Europe. This compares to last quarter’s recession odds of 33% and 30%, respectively.

Winter Is Coming: Economic risks are higher in Europe due to sharply higher energy prices, although prices have decreased in recent weeks, as shown below. A cold winter could present challenges for many countries, and governments could be forced to limit corporate energy usage to favor consumers, which would restrict economic growth. The EU is considering implementing price caps on energy, although this is still being negotiated at the end of September.

Eurozone Natural Gas Price

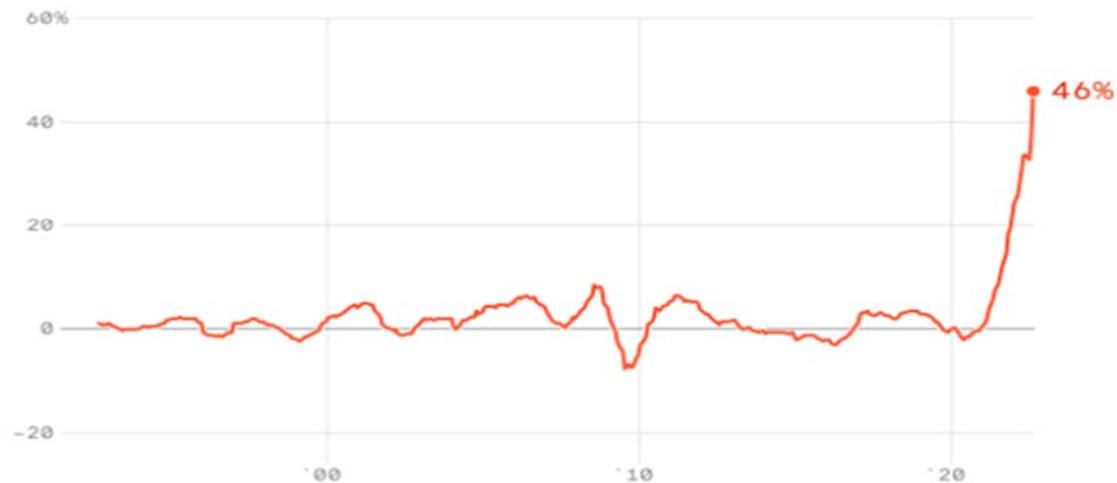


Source: JP Morgan

Another way to see the impact of this energy price spike is on prices paid by manufacturers, as reflected by the following chart of German PPI (producer price index). This price shock has led the German government to nationalize its biggest natural gas importer in an attempt to control prices.

German producer price inflation

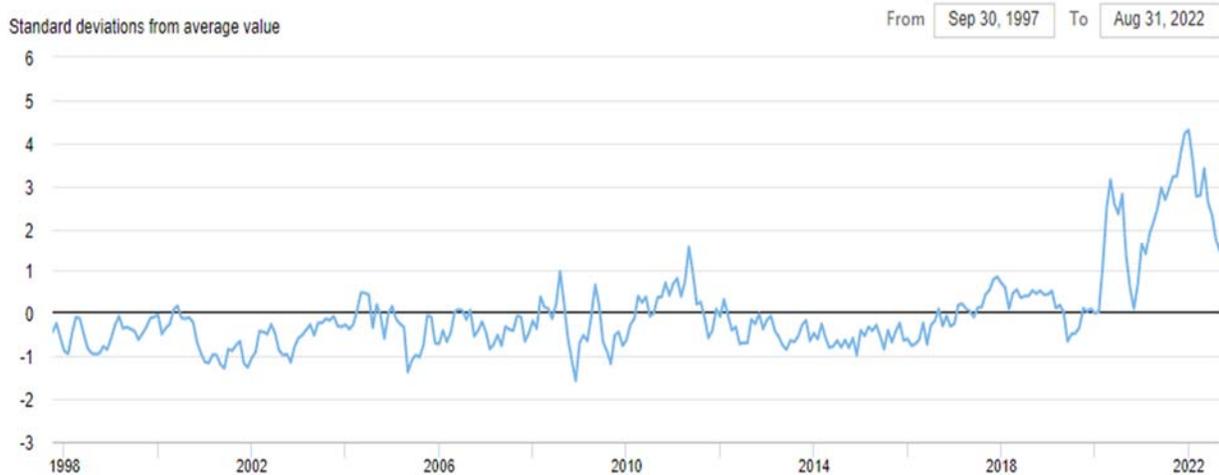
Year-over-year change; Monthly; September 1992 to August 2022



Data: Destatis, FactSet; Chart: Axios Visuals

Inflation Remains Stubbornly High: Inflation has declined from its mid-year peak, but remains quite high and may remain so for a while longer. Supply chain constraints have eased quite a bit, as shown below. According to research by the Federal Reserve Bank of New York, about one-third of recent inflation has been caused by supply issues; therefore resolving supply chain problems will help but not solve the inflation problem.

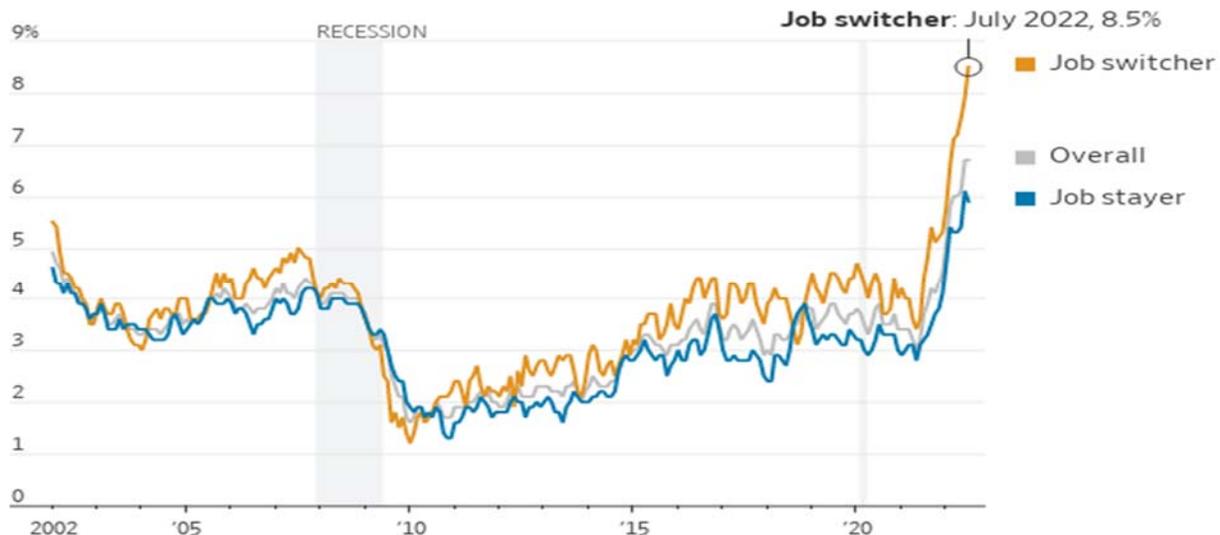
NY Fed Global Supply Chain Pressure Index



Source: Federal Reserve Bank of New York

Wage growth now appears to be the leading driver of inflation, as the labor market remains historically tight. The National Bureau of Economic Research (NBER) estimates that the unemployment rate needs to rise to 6% (from 3.7% today) before wage growth would no longer be inflationary. For now, wage growth continues to increase, particularly for job changers, who have experienced much higher wage growth recently than job stayers, as shown below.

Monthly median wage growth for job switchers

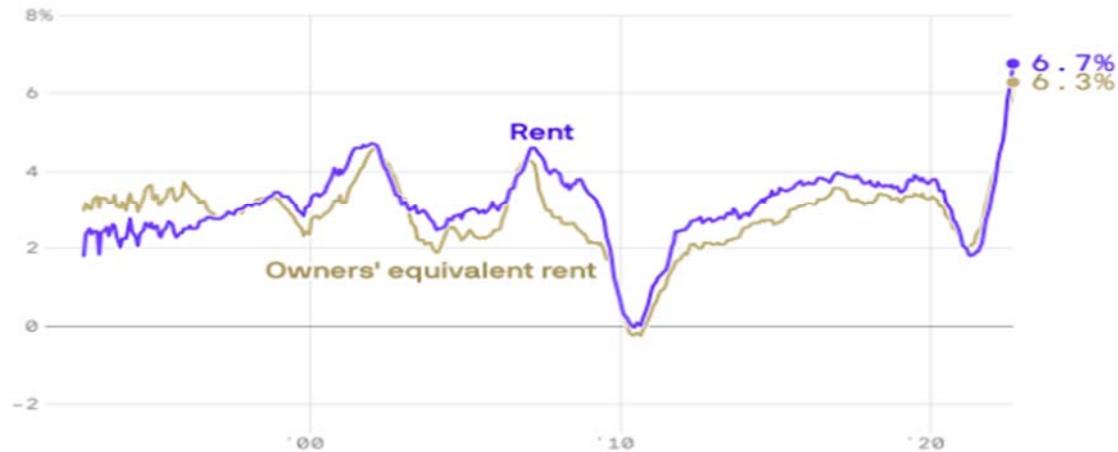


Note: 3-month moving averages of median hourly wage growth
Source: Atlanta Fed

Another sticky source of inflation is rent growth, which comprises about one-third of the CPI (Consumer Price Index). Rent growth takes time to show up in the CPI data, as annual leases end and new ones begin with higher rates. Housing prices have begun to weaken, which eventually should negatively impact rent growth.

U.S. shelter inflation

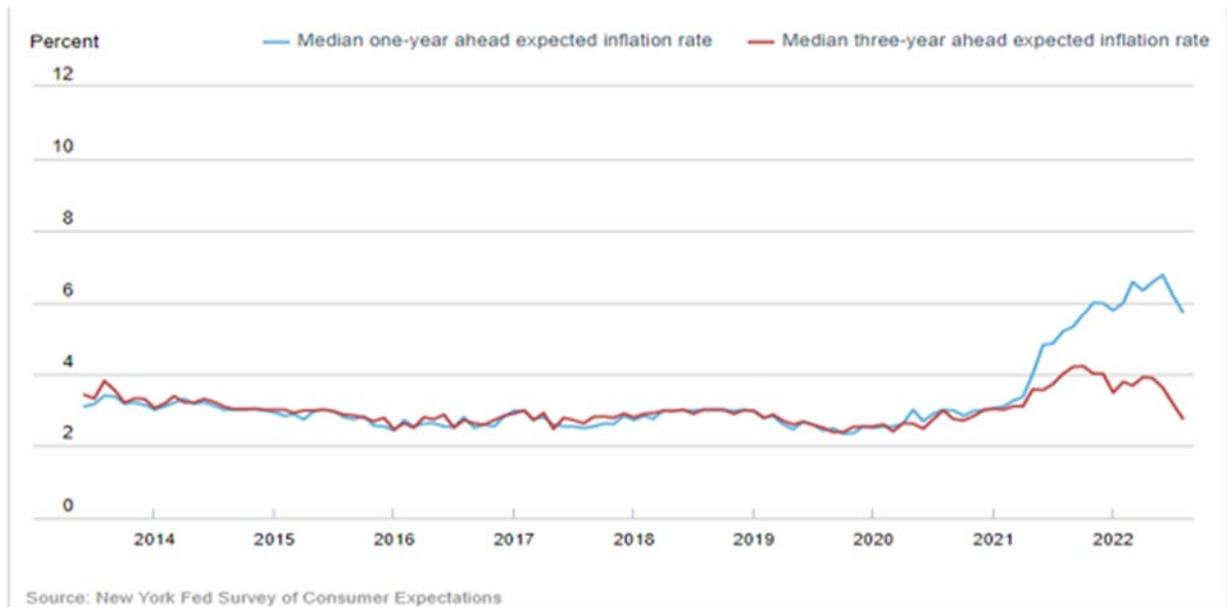
Year-over-year; Monthly; September 1992 to August 2022



Data: FactSet; Chart: Axios Visuals

Inflation Expectations Remain Mild: Importantly, while current inflation is high, long-term inflation expectations are mild and have declined recently, as seen below in one-year and three-year inflation expectations from consumer surveys. While short-term inflation is concerning, longer-term inflation expectations would have much larger implications for the economy.

Consumer Inflation Expectations



Source: New York Fed Survey of Consumer Expectations