

COMMENTARY

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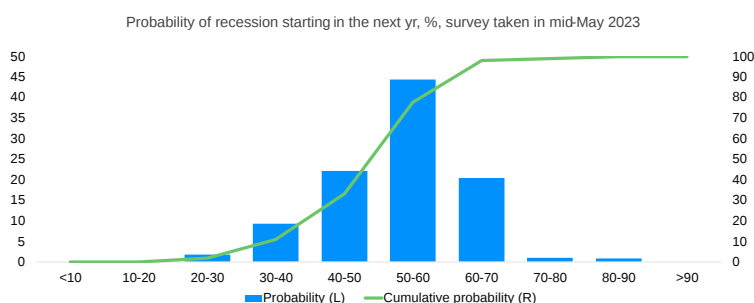
U.S. Outlook: The Resilient Economy

Despite all the slings and arrows, it is remarkable how resilient the economy remains. In just the past year, there has been the Russian war in Ukraine, a historic tightening in monetary policy, the banking crisis, and an increasingly dark debt limit drama. Yet the economic expansion continues.

- There are few believers that the economy will navigate through the next year or so and skirt recession.
- However, the unprecedented pessimism regarding the economy's prospects appears increasingly overdone.
- While history suggests that high inflation and an aggressive Fed mean recession is a serious threat, this time is different enough for the economy that a recession is avoidable.

Pessimism about the economy's prospects remains widespread. A strong consensus of economists, including the [Federal Reserve's staff economists](#), long-term Treasury bond investors, and a vocal group of CEOs, hold that a recession is dead ahead. In a survey of economists done by Moody's Analytics in early May, more than three-fourths of respondents thought that there were greater than even odds that a recession would begin sometime in the coming year. There are few believers that the economy will navigate through the next year or so and skirt recession.

Consensus of Economists Expect Recession



The pessimism is based on historical experience. In times past, when the economy was struggling with high inflation and the Federal Reserve was aggressively tightening monetary policy in response, recessions typically followed—although [not always](#). In the mid-1990s, the economy threatened to overheat, but the Fed was able to cool it off with interest rate hikes without precipitating a downturn. Of course, the inflation of that period was tame compared with what we are suffering today.

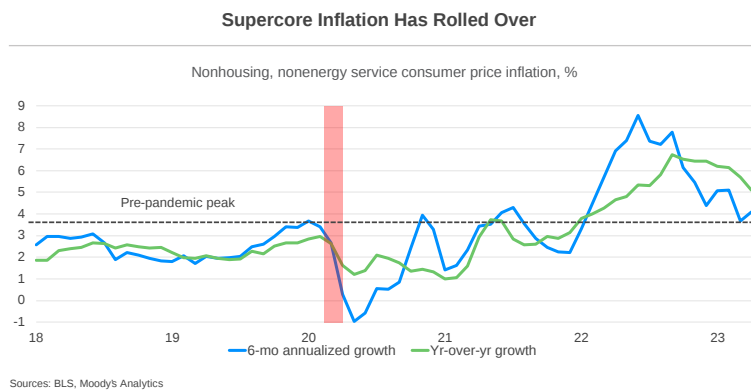
Moreover, many of the leading indicators that economists rely on to gauge recession risks are flashing red. The [deeply inverted Treasury yield curve](#)—short-term interest rates are much higher than long-term rates—is sending a resounding signal that a recession is likely by this time next year. The [Conference Board's trusty leading economic indicators](#), a compilation of various economic series that historically have presaged downturns, are also unambiguous in forecasting a coming recession.

Inflation abates

However, the unprecedented pessimism regarding the economy's prospects appears increasingly overdone. Inflation is still too hot to be sure, but it is cooling and appears to be headed back to the Fed's inflation target by this time next year. Most fundamentally, this is because the supply-side fallout from the COVID-19 pandemic and Russian war, the principal causes of the high inflation, is quickly fading.

Most encouraging is that prices for staples, including gas, food and rent, have been flat to down in recent months. This is critical for low-income households without savings and no choice but to borrow more to maintain their spending. It was also good to see new-vehicle prices fall in April, the first decline since pandemic-induced supply-chain problems caused global production to collapse and prices to soar. With vehicle production finally picking up in Japan and Germany as global supply chains normalize, there is [more inventory on dealer lots](#), and more price declines are in train. Last month's jump in used-vehicle prices also will not last long, given the improving supplies.

The cost of housing services, which is more than one-third of the CPI, will grow much more slowly in the coming months. [Market rents](#), which drive housing CPI with a long lag, are flat to down as there is plenty of new rental supply as pandemic-disrupted supply chains and labor markets normalize, and demand remains soft, given the previous surge in rents, which are now unaffordable. Even so-called supercore inflation—service prices excluding prices for housing and energy service—has rolled over. These services are labor-intensive and thus will be pressured to raise prices more quickly until wage pressures abate. While this will not fully happen quickly, it is in motion.

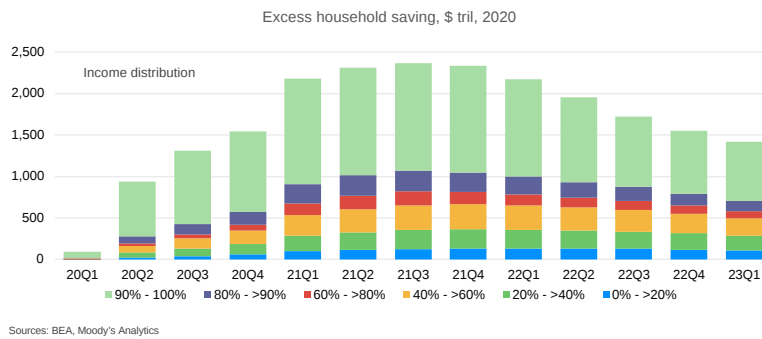


This sanguine and increasingly certain inflation outlook means that the Fed's rate hikes are likely over. The current federal funds rate of just over 5% will be the terminal rate, the highest the rate will go this cycle. And there are other good reasons for the Fed to end its rate hikes, including the fragile banking system and resulting tighter bank underwriting standards and the economy's now consistent below-potential growth and the cooling job market.

Excess savings

Optimism that the economy is resilient enough to avoid a near-term recession is also rooted in factors unique to this period. Most important is the considerable amount of excess household savings. Households sheltering in place during the pandemic and unable to spend accumulated savings greater than they would have if not for the pandemic. Low- and middle-income households also benefited from substantial government support during the pandemic, some of which they saved. At the peak of the excess savings in fall 2021, households had amassed an estimated \$2.5 trillion in excess savings, equal to about 10% of GDP.

Consumers Remain a Sturdy Economic Firewall



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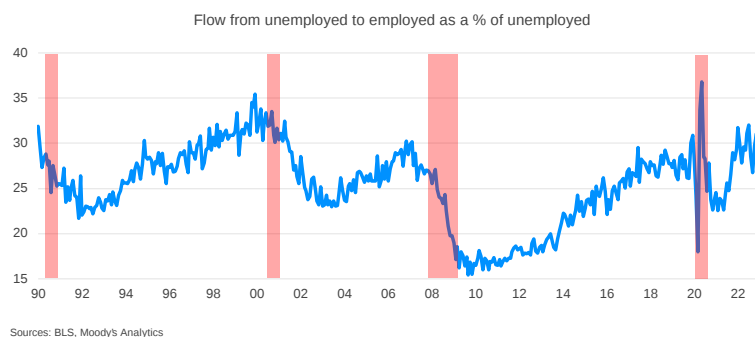
Since then, households have drawn down their excess savings to supplement their real incomes, which were hit hard when inflation took off. We estimate their excess savings have fallen to near \$1.5 trillion. Low-income households have largely spent their excess savings and have turned to credit cards and unsecured personal loans to maintain their spending, but middle-income, and especially high-income, households have plenty of savings left. Particularly since their need to draw down excess savings is ebbing with the moderating inflation and resumption of real income growth. It is uncanny how households are calibrating their drawn-down excess savings to [simply maintain their typical amount of spending](#), no more and no less.

Labor hoarding

Businesses are also atypically reluctant to lay off workers. They have been struggling with finding and retaining qualified workers since well before the pandemic and rightly feel this will continue as the large baby boomer generation retires and the nation grapples with its vexed foreign immigration policy. They also cannot forget how the pandemic shutdown and sudden restart severely complicated their staffing efforts, and they do not want to be whipsawed again. They are ignoring any weakness in their sales and recession fears and are maintaining their payrolls. By so doing, a recession is less likely, as large layoffs spook households to curtail their spending, igniting a self-reinforcing vicious downturn.

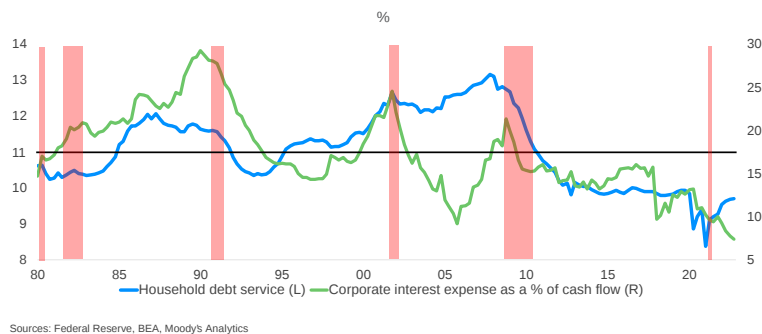
Layoffs have picked up since the banking crisis hit in March, but only close to something consistent with a well-functioning job market. At the start of the year, initial claims for unemployment insurance—an accurate and timely measure of layoffs—had been hovering at an extraordinarily low, nearly 200,000 per week. While they are almost 250,000 per week, they need to rise to more than 300,000 weekly claims to be consistent with a recession. It is encouraging that those losing their jobs are finding new ones extraordinarily quickly, given the still outside number of open positions.

Workers Losing Jobs Are Finding New Jobs Quickly



Household and corporate debt burdens are remarkably light. Households have managed their finances admirably well since the financial crisis, at least in aggregate. Their debt-service burden, or the percentage of their income that goes toward interest and principal payments for them to remain current on their debts, is about as low as it has been.

Low Household and Corporate Leverage



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They have also done well in locking in the previously record-low interest rates through several massive mortgage refinancing waves. Only about 15% of household debts have rates that adjust within one year of a change in market interest rates, which is about half the share at the peak in the early 1980s.

The same largely goes for corporations. Their debt payments as a percentage of their cash flow are about as low as they have ever been. They have also been good about locking in their previously low borrowing costs.

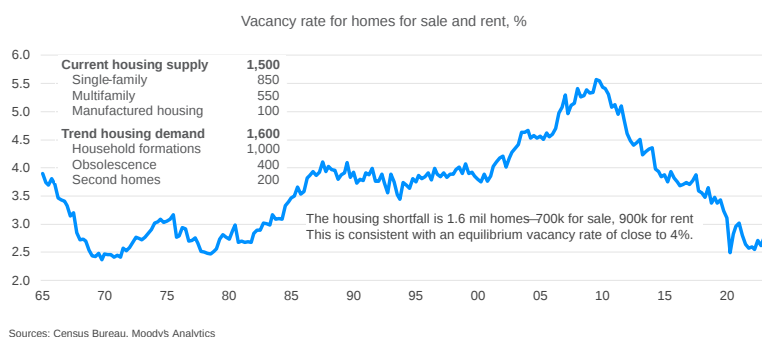
There are some problems brewing. Low-income and younger households have borrowed aggressively since the pandemic, and lenders effectively lowered their underwriting standards due to the credit score inflation prompted by the government's pandemic bailout packages, which required lenders not to report credit problems to the credit bureaus. Delinquencies on credit cards, unsecured personal loans, and auto loans are above pre-pandemic levels and rising quickly. With student loan payments likely to resume in September, as the Supreme Court seems set to rule against the president's debt-forgiveness plan, financial pressures will intensify.

The banking crisis also means higher borrowing costs for households and businesses, and with capital markets on edge, those companies that have levered up, largely by private-equity firms, may have difficulty with the financing they need to roll over their maturing debt. However, these critically stressed households and businesses are more the exception than the rule.

Underbuilt and pent-up

Typically, prior to recessions, real estate markets are overbuilt and household demand is spent-up. There is no sign of that currently. Indeed, if anything, it is the opposite. Housing is significantly underbuilt, with the homeowner vacancy rate at a record low, and while the rental vacancy rate is on the rise, it is still well below its historical norms. Single-family homebuilding has fallen sharply over the past year, and the banking crisis will ultimately take a bite out of multifamily building, as multifamily developers rely on banks for credit. But overall, homebuilding is near a bottom and will not be a significant economic drag.

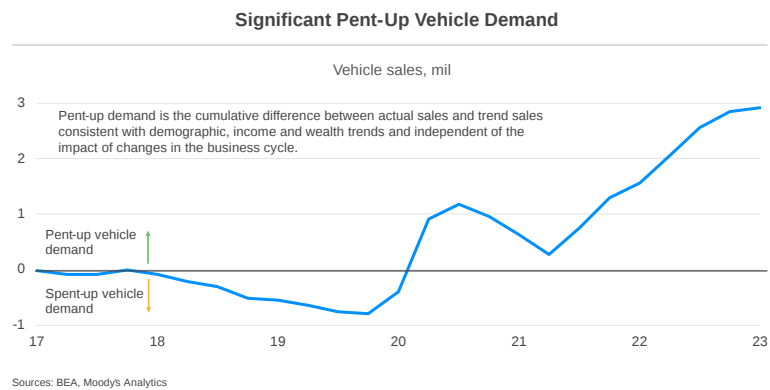
Housing Is Seriously Undersupplied



Many crosscurrents are impacting the rest of construction, but strong public infrastructure spending fueled by the [Bipartisan Infrastructure Law](#) and [Inflation Reduction Act](#) passed last year will more than offset the further weakness in office, hotel and warehouse construction. The construction industry is arguably the most interest-

rate-sensitive part of the economy and contributes significantly to downturns. That will not happen now.

In the lead-up to recessions, households generally have spent with abandon, well beyond what is implied by their demography, income and wealth. Vehicle demand is the poster child for this, as manufacturers and dealers offer significant price discounts and financing incentives to pull forward sales that would have otherwise happened in another year or two. This spent-up demand presages a significant pullback in spending when the economy turns down and layoffs pick up, exacerbating the downturn. Vehicle manufacturers have, until recently, been jacking up prices given their lack of inventory due to the pandemic, and many households that would have normally purchased a vehicle in the past several years cannot find or afford one.



This pent-up vehicle demand is arguably unprecedented and strongly argues that as production continues to improve and prices decline, demand will also improve. A struggling vehicle industry is a feature of past recessions, but it is more likely to boost the economy going forward.

Household demand for other durable and nondurable goods is arguably spent-up given all the buying during the pandemic when households were sheltering in place, but demand for travel, entertainment and other services is still pent-up. The net of all this on near-term spending is more or less a wash.

Flush S&L governments

Uncharacteristically, state and local governments will not be the drag on the economy they typically are when the economy falters. In times past, when the economy began to struggle, state and local governments quickly faced fiscal difficulties as tax and other revenues faltered and spending on income support programs increased. Given their balanced budget requirements and other budgetary constraints, they have little choice but to tighten their purse strings, weakening the economy.

In contrast, most state and local governments are currently in strong financial positions. Given the significant financial support they received from the federal government via the [American Rescue Plan](#) and increased infrastructure spending, their [rainy-day funds are full](#). Most state and local governments have also been prudent and have not used their windfall from the feds to establish programs that require funding in perpetuity. So, while state and local governments will not be a plus for the economy, at least they will not be the negative that they have been in past downturns.

Resilience over pessimism

It is important not to be Pollyannish about the economy's near-term prospects. Under almost any scenario, they will be difficult. GDP growth will halt, employment gains will come to a standstill, and unemployment will push higher. However, while history suggests that high inflation and an aggressive Fed mean recession is a serious threat, this time is different enough for the economy that a recession is avoidable. In my more than 30 years as a professional economist, I have never seen such recession pessimism. But I have also never seen such a resilient economy. Something has to give. I suspect it will be the pessimists.

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