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31 January 2023

Global Markets Research

Research Alert

Taking stock of the US economy

Inverted yield curve, weak economic data raised recession concerns in 2023

We expect any recession to be mild, supported by a solid labour market

Expect 25bps hike to 4.50-4.75% at upcoming FOMC meeting this week

Background

The US economy surprised on the upside in 4Q 2022, growing by an annualized rate of 2.9% in 4Q (3Q: +3.2%) and bringing the whole year GDP growth to 2.1%, based on advance estimate. The underlying details of the GDP, nevertheless, paint a less upbeat picture as half of the increase in GDP reflected inventory growth. In fact, for 2023, Fed in its December FOMC meeting, revised its GDP forecast downwards by 0.7ppts to 0.5% for 2023, while the World Bank revised its forecast by a whopping -1.9ppts to 0.5%. This is the weakest performance outside official recessions since 1970, and largely reflects spill over impact from 2022's sticky inflation rate as well as a much tighter monetary policy.

When

More importantly, with an inverted yield curve and weak economic data recently, this has raised concerns on whether the Fed has been undermining the impact from its FOMC decisions and underestimating the recession risks. Latest data pegged the probability of a US recession at 65% and in our view, a recession, if any, will be shallow as labour market has stayed resilient while corporate profits have stayed strong. Any recession will also mostly likely happen in May 2023. This is based on:

1) Lagged impact from monetary policy, which is typically 4 to 8 quarters and Fed first increased the fed funds rate in May 2022. In the housing market specifically, our estimate suggests a lag of 6 quarters between housing data and fed funds rate, while the Bank of International Settlement estimated 4 to 8 quarterly lags between interest rates and real price house price growths.

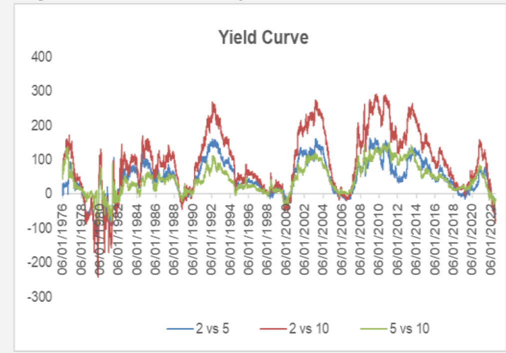
2) The first date when the yield curve turned negative to recession historically, bearing in mind not all yield curve was necessarily inverted during the previous recessions. On average, yield curve between the 2 and 10-year Treasury turned negative 10-12 months before recession (range from 7 to 18 months), and the yield curve first turned negative on 5th July 2022 in this cycle. (Figure 1)

Why shallow

Nevertheless, in our opinion, any recession, will be mild because:

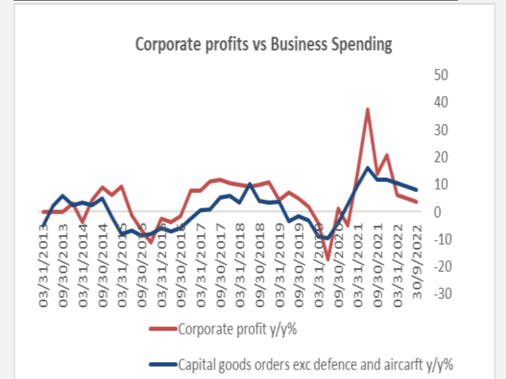
1) On the corporate side, capital expenditure has been under pressure as elevated inflation, higher financing costs and a strong US dollar chipped away at profit margins and earnings. The state of the corporate sectors is nevertheless still on a strong footing. Corporate profit increased 5.5% y/y in 3Q of 2022 to an all-time high of $3 trillion. Corporate profits after tax (without IVA and CCA/GDP) stood at $0.11238bn in July 2022, up from $0.10253bn long term average since 2010, suggesting that capital spending will be supported, albeit at a much slower pace and mass labour layoffs, could be avoided. (Figure 2)

Figure 1: Inverted yield curve



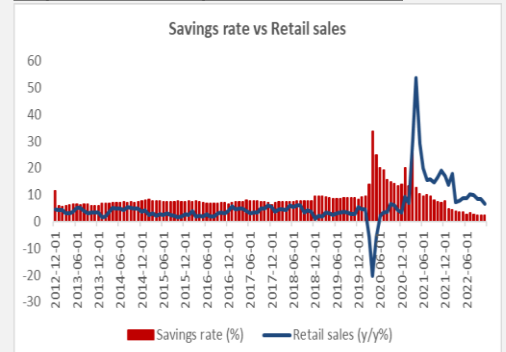
Source: Bloomberg, HLBB Global Markets Research

Figure 2: Corporate profit still strong



Source: Bloomberg, HLBB Global Markets Research

Figure 3: Savings rate has fallen



Source: Bloomberg, HLBB Global Markets Research

2) From Figure 3, it is also clear that consumers have been partially tapping on its savings to fund their spending, as mirrored in the direct, albeit lagged effect from retail spending to savings rate. Savings rate has fallen from its peak of 26.3% in March to 2021 and has been on a clear down trend since early 2022 to its low of 2.4% in September 2022. Nevertheless, savings rate has slowly inched up to 3.4% in December. The driver of this improved savings rate will provide the same support to consumer spending going forward. Average hourly earnings have decelerated, albeit still strong at +4.6% y/y in December. Inflation rate has eased, with core PCE prices the slowest pace in over a year at +4.4% y/y in December (Nov: +4.7% y/y), effectively paving the way for the Fed to dial down its rate hikes. Moving forward, this trend is expected is expected to persist, as indicated by University of Michigan's year-ahead inflation expectations receding for the fourth straight month, falling to +3.9% y/y in January (Dec: +4.4% y/y).

3) Pending home sales unexpectedly increased 2.5% m/m in December (+Nov: -2.6% m/m), the first time since May 2022 while mortgage applications jumped 7.0% w/w recently. Mortgage rates were the dominant factor driving home sales, and recent declines in rates are clearly helping to stabilize the market and as mentioned earlier, easing inflation rates could pave the way for Fed to manoeuvre its rates. In fact, Mortgage Bankers Association is expecting the 30-year fixed mortgage rates to fall further to 5.2% in 4Q 2023 from 6.6% in 4Q of 2022, this should help to cushion the impact for the housing sector. In nominal terms, house price growth also averaged 6% per year with the max of 18% and worst at -14%. Based on available data from NAR, mean sales price of existing homes peaked at $534,600 in June 2022 for the current cycle and as such, prices (and in tandem, household net worth) will bottom at $459,756. This is not far from $470,400 currently.

4) Jobs data continued to point to job growth, albeit slower pace. Non-farm payroll added only 233k in December 2022, the smallest increase since December 2020 but is still higher than before pandemic (2019: average of 164k). JOLTS survey showed that while job openings has fallen, job openings rate was down 6.4% from peak of 7.3% in March 2022. At 10.5m, this is down fractionally from October's total and 11.9m in March, but still higher than an average of less than 8.0m in 2019. Initial jobless claims also fell 15k to 190k for the week ending 14 Jan, the lowest since Sept and a level consistent with a tight labour market. The quits level at 2.7%, is higher than its long-term average of 2%, indicative of worker confidence that they can leave their jobs and find other employment.

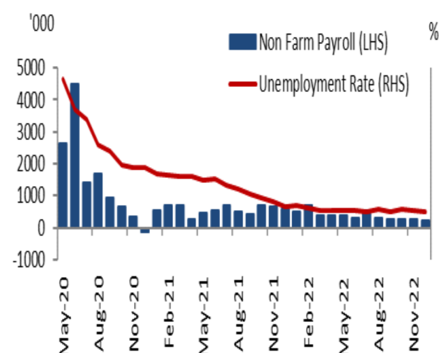
5) The University of Michigan's consumer sentiment remained low from a historical standard but has been rising for the past two months (+8.2% m/m to 64.6 in December). Current assessments of personal finances surged 16% to its highest reading in eight months on the basis of higher incomes and easing inflation. Although the short-run economic outlook fell modestly from December, the long-run outlook rose 7% to its highest level in nine months.

6) In tandem with this, consumer spending intentions has also rebounded slightly. According to the Conference Board, the percentage of respondents intending to take vacations within 6 months has risen 36.3% in June to 46.2% in December. The percentage of respondents intending to purchase appliances within 6 months has risen 41.1% in July to 43.1%. The percentage of respondents to purchase automobiles has risen from 9.5% in July to 10.5%. The percentage of respondents intending to buy homes has risen from 4.5% in July to 6.2% in December.

Risks and Fed

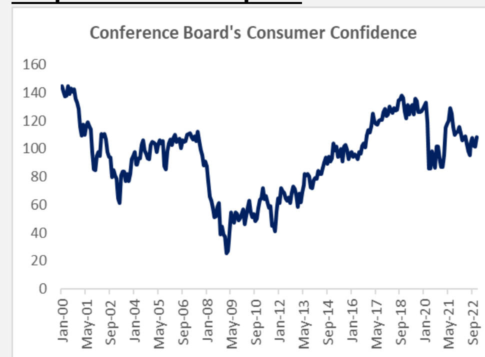
No doubt, there is an increasing risk of a recession, especially in the event of a sharper-than-expected increase in oil prices and interest rates, rapid weakening of the labour market or another sharp period of financial market volatility. Nevertheless,

Figure 4: Resilient labour market



Source: Bloomberg, HLBB Global Markets Research

Figure 5: Confidence remains low despite the small uptick



Source: Bloomberg, HLBB Global Markets Research

Figure 6: Tentative signs of some stabilisation in the US housing market

Source: Bloomberg, HLBB Global Markets Research

as we have highlighted earlier, we expect any contraction, if any, to be shallow on account of a relatively strong banking sector and expectations for inflation to soften as labour market stabilizes and wage pressure abates, which has eventually allowed for a dovish pivot. With this, our expectations is that Fed will raise the fed funds rate by 25bps to 4.50-4.75% in the upcoming FOMC meeting this week.

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