NRF National Retail Federation

MONTHLY Economic Review

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SYNOPSIS | Fed seeks balance between inflation and interest rates to avoid recession in new year

While the revelry has ended, and a new year is underway, economic data continues to reflect the same conditions that prevailed in the last days of 2022. This year starts with the possibility of easing inflation but also uncertainty as the Federal Reserve's ongoing interest rate hikes continue to increase the risk of a recession. There is no easy fix for high inflation and the Fed's job of trying to bring down rising prices without damaging the labor market or the rest of the economy is not enviable.

Inflation has been easing but remains near multi-decade highs and well above the 2.1% average in the three years before the pandemic. The Consumer Price Index – the most widely cited measure of inflation – was up 7.1% year over year in November. That was down from 7.7% in October and marked the fifth consecutive month of slowing inflation after a peak of 9.1% in June. But while the numbers confirmed that price increases are easing for goods, prices continued to swell in the labor-intensive services sector, with rents and recreation increasing strongly. Service-sector inflation is likely to linger since it reflects continued tightness in the labor market that is not expected to lessen in the near future.

The Fed responded by raising its benchmark interest rate another half a percentage point in December to the highest level in 15 years. That was less than the recent series of three-quarter-point increases but nonetheless signaled that the battle against inflation is still at hand.

The Fed's efforts to take what Chairman Jerome Powell calls "forceful action" to fight inflation by tightening monetary policy has gone on for nearly a year, but Americans are still out spending as the economy grows and households remain confident about their future.

Spending power has been supported by household balance sheets that are in good shape thanks to wage and job growth, careful use of credit and built-up savings. The Federal Reserve Bank of Atlanta's GDPNow, which tracks data in real time and adjusts continuously, showed fourth-quarter gross domestic product up 2.7% year over year as of late December.

While monetary tightening hasn't kept consumers from spending, it is having a more immediate impact on interest-sensitive sectors such as residential real estate and business structures. Home building declined at a 26.4% annual rate in the third quarter, the sixth consecutive quarterly drop and the largest decline since COVID-19 first hit the United States. Meanwhile, business spending on structures slumped 6.9% year over year, an improvement from the 12.7% decline the previous quarter but still below last year's spending because of higher financing costs and uncertainty surrounding the economic outlook.

It is impossible to know whether the Fed's efforts will lead to a recession or how bad one might be if it does occur, but continuing rate hikes increase the chances. One complicating factor is the long lag between when monetary policy action occurs and when its impact is seen, particularly with inflation – six to nine months for an effect on output and as many as 18 months for inflation. Consequently, Fed rate decisions are ultimately a judgement call on where the economy is heading. Policymakers act knowing they will not see the impact for months and that their action comes at the risk of inducing a recession.

Recessions are caused by imbalances in the market and can be triggered by either external or internal factors. There are often no certainties, and we can't know when the next recession will come or how much it will shift economic activity. Debates about the outlook boil down to sharp differences of opinion over what recent data says about the labor and energy markets, trade and financial conditions. In essence, is the U.S. economy resilient enough to withstand these challenges and avoid a recession? It isn't impossible to sidestep a recession, but when the economy slows it becomes very fragile and the risk rises significantly. If a recession is in the cards, it will likely be rising interest rates that set it off.

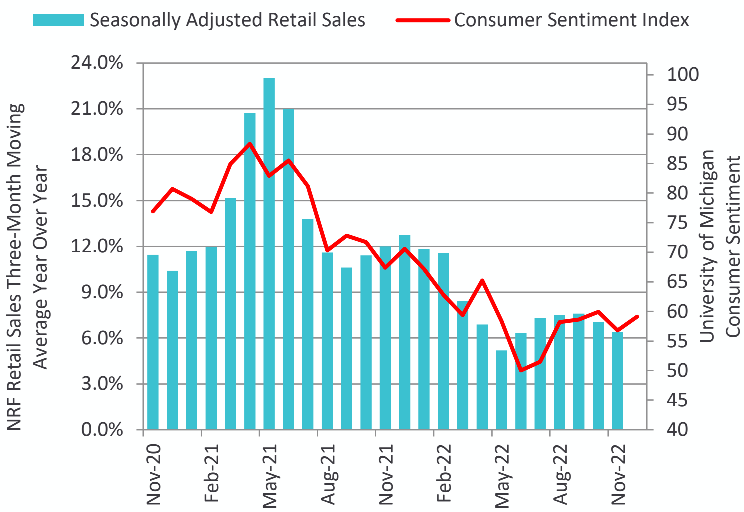
While inflation is falling, it remains in the pipeline and is not going away. Even excluding the largest and most volatile price increases, core inflation is still 6% and the labor market is still strong. Consumer spending has kept the economy afloat but keeping a critical eye on the composition of spending is required. How will the rotation from spending on goods to spending on services impact wage developments in the labor market since services are principally driven by wages?

The labor market and the consumer will shape the outlook for the economy as we go into 2023 and both are more consequential than ever. The rhythm of holiday sales continued at a healthy pace in 2022, showing that while consumers don't like higher prices, they are able and willing to pay them. Even with inflation, retail sales grew 7.2% year over year for the first 11 months of 2022, clearly antithetical to a recession. Spending remains elevated largely because jobs remain plentiful and unemployment risks appear low, but its future will likely be linked to job security.

If inflation comes down before the labor market cools, consumer spending should remain strong and keep the economy from contracting, giving us the "soft landing" the Fed is seeking. But the Fed wants to see consistent and cumulative evidence of inflation easing – most likely in the form of weak job and wage growth – before it will stop raising rates. The danger is that if the Fed overestimates the strength of the consumer and tightens too aggressively, the spending that has kept the economy growing could crater, resulting in a hard landing instead. There are downside risks both to doing too much and too little, and the Fed is well aware that the balance is delicate.

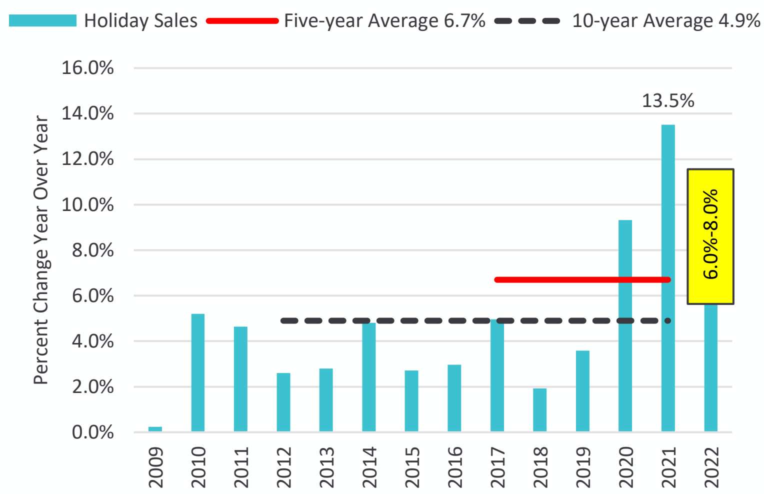
SALES AND SENTIMENT

Retail sales moderated in November, but consumers continued to spend. Consumer sentiment rose, likely sparked by lower gasoline prices and easing inflation.



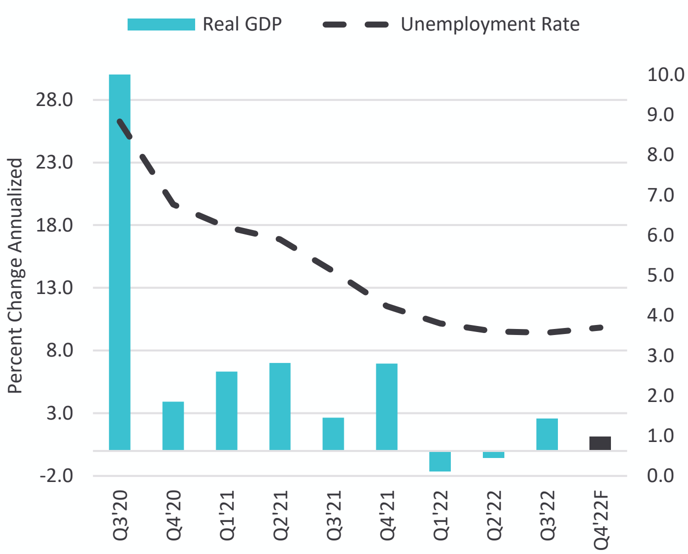
HOLIDAY SPENDING

The results from November – the first month of the holiday season – showed retail sales were on track with NRF's forecast for holiday spending to increase between 6% and 8% over 2021



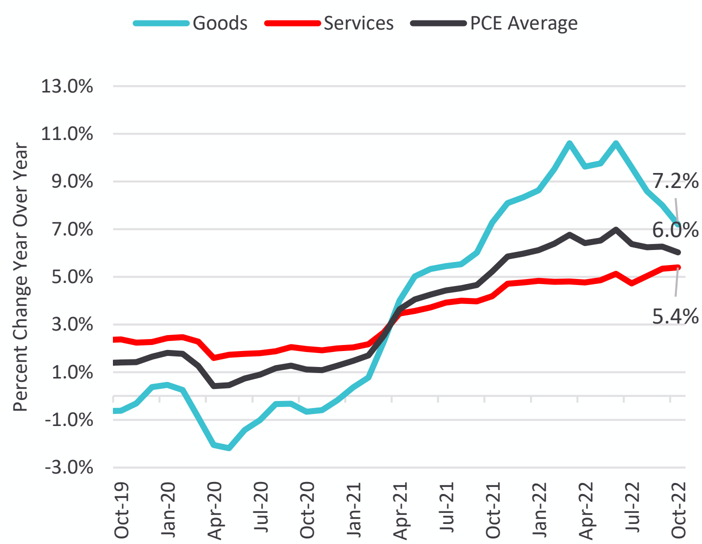
REAL GDP & UNEMPLOYMENT

Third-quarter GDP grew 2.9%. The economy is proving to be resilient, but GDP was expected to grow very gradually in the closing months of 2022.



PERSONAL COSUMPTION

The Personal Consumption Expenditures Price Index was up 6% year over year as of October. While goods prices have shifted down, services prices are rising.



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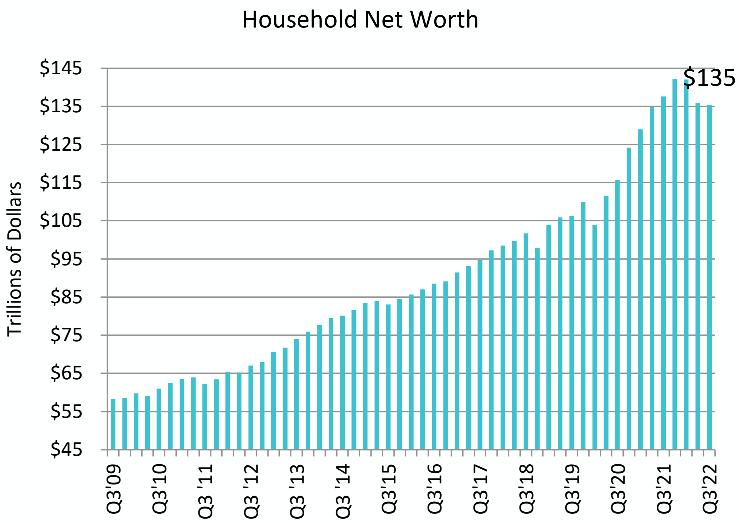
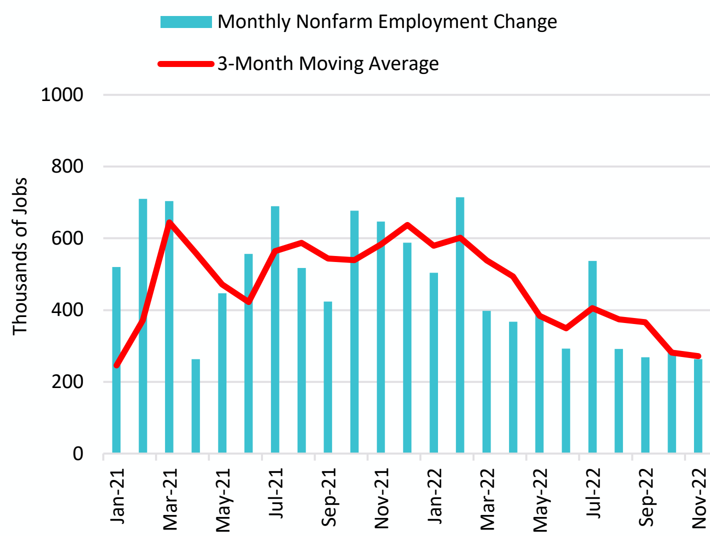
HOUSEHOLD NET WORTH

Household wealth fell again in the third quarter and the trend looks dim given that equity and home prices have turned lower.



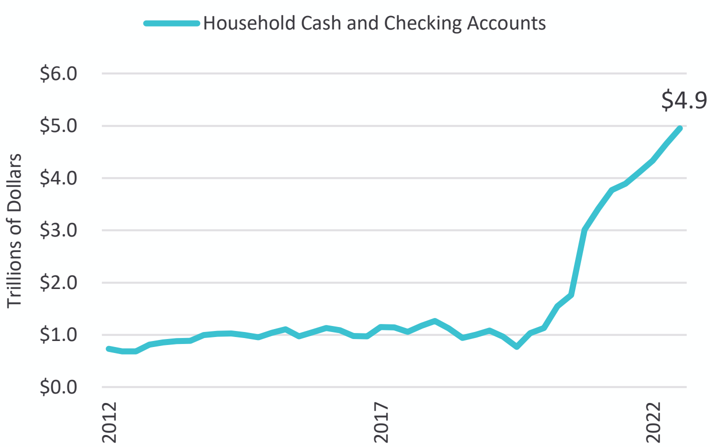
LABOR MARKET

While employment came in higher than expected in November at a gain of 263,000 jobs, it did not change the trend of a slowing labor market.



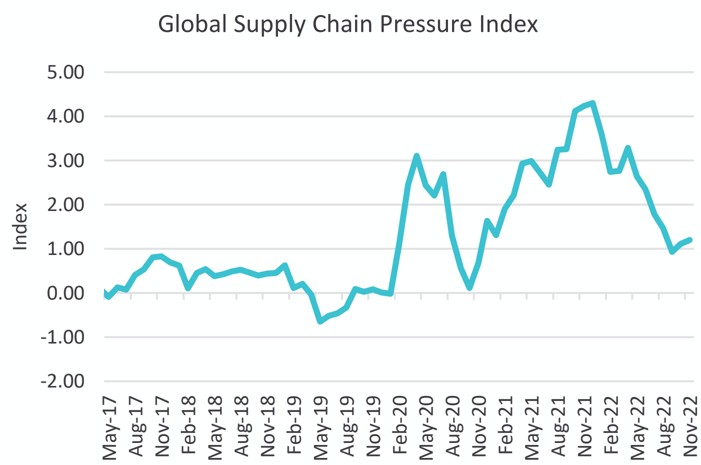
CONSUMER CREDIT

Household cash and checking accounts ticked up in the third quarter and were still considerably higher than before the pandemic. Consumers could be keeping more in their accounts as insurance against rising uncertainty.



SUPPLY CHAIN

The Federal Reserve Bank of New York's Global Supply Chain Pressure Index reported a level of 1.2 in November, one-quarter of its peak during the 2021 holiday season.



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