ECONOMIC OUTLOOK

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GREAT LAKES ADVISORS®

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ECONOMIC OVERVIEW

After closing the books on a tumultuous 2022, many individuals are likely hoping for a gentler ride in 2023. The combined impacts of surging inflation, geopolitical strife, monetary policy shifts, and slowing consumer activity greatly influenced economic and market results over the course of the year. However, the forces that drove the roller coaster in 2022 have not faded into the rearview mirror. In fact, some may have much more influence to exert on economic results in 2023.

INFLATION

Surging inflation seems to be the trigger point for many of the economic realities over the last year and will continue to guide policy action and economic results in 2023. The U.S. Fed has taken a singular focus to reduce inflation and avoid a 1970's-esque scenario of stagflation. At the same time, many of the pandemic-induced factors (supply chain issues, housing price increases, and massive monetary and fiscal stimulus) that drove inflation to peak in mid-2022 have been fading from the monthly reports before the lagged Fed actions of mid to late 2022 have seen their full impact felt in economic data. We anticipate that inflation will continue to decline in 2023, initially at a slower rate and then with renewed vigor as influences from housing prices fade further into the background in spring and consumers continue to adjust their activity to higher rates.

In light of the slowing pressure of inflation, the U.S. Fed has already started to downshift their aggressive monetary policy stance early in 2023. The question still remains if they have already done too much, too fast or if their four consecutive 0.75% hikes were the right policy response to create a soft landing. While better than expected economic data early in 2023 may encourage the Fed to reignite their hawkish policies, we believe a "wait and see" approach is more prudent given the pandemic-era influences set to fade in the early part of the year.

EMPLOYMENT MARKET

Employment markets normally react to higher interest rates and slowing consumer activity with falling wages, fewer job openings, and rising levels of unemployment. This cycle, employment markets have not yet reacted to monetary policy in the same way. Yes, the rate of increase in wages has started to subside but unemployment sits at a 53-year low of 3.4% with little signs of rising soon. Declining wage growth and increasing layoffs aside, such a low level of unemployment may be cause for the Fed to continue down its aggressive path for longer as they would view continued robust employment as a sign of economic strength in spite of higher rates.

CONSUMER SENTIMENT

The consumer has been significantly impacted by the run-up in prices and higher borrowing rates with stress showing in consumer activity in the fourth quarter of 2022. Despite a stronger showing for retail sales in early 2023, the combined stresses of higher prices and increased borrowing rates, that appear to be "higher for longer", do create a real headwind for economic growth. The first revision to Q4 2022 GDP clearly shows this impact with worse than forecast consumer activity taking a full 0.2% out of the revised report. We expect to see a continued fall in consumer activity as the year goes on and further impacts from higher rates further hamper consumption.

THE FED AND MONETARY POLICY

Where does all of this leave us for 2023? We anticipate that the magnitude of Fed policy action to date combined with deflationary impacts from the disappearing impact of pandemic-era influences – supply chains, stimulus, and real estate – will push the economy into a short and shallow recession. The American consumer can only persist at elevated levels of spending for so long, and there is already evidence of increased use of consumer credit, lower levels of consumption, and lower seasonal/weather adjusted consumer activity. To wit, a shallow recession actually aligns with the "soft landing"

articulated by several Fed participants, even going back to last year. This could be more of a "job-full" recession than prior recent examples with unemployment rates unlikely to rocket beyond 6% at their worst as segments of the economy still in need of labor are able to snap up those laid off from other segments as we have already seen with recent technology layoffs migrating to health care and financial services jobs. A mild recession would provide the leveling that the Fed has been seeking to bring inflation back near target levels while adjusting the supply-demand imbalances present in many areas, particularly in services.

This economic reset would also help to finally put the pandemic-era behind us and set the stage for America to resume a steady annual pace of growth more consistent with pre-pandemic trends. However, it will do little to fix many of the persistent economic realities that the pandemic has masked since 2020. Those will take the long-run course, articulated by thinkers like F.A. Hayek, or the intervention route, as espoused by John Maynard Keynes and others, to truly solve, but that's an endeavor for the future, and we still need to navigate a more volatile and difficult year ahead as the economy finds its post-pandemic footing.

Sources: Capital Economics, Department of Labor, Department of Commerce, National Bureau of Economic Research, Morningstar, Ycharts, Institute for Supply Management

JASON TURNER
CHIEF INVESTMENT STRATEGIST
HEAD OF MULTI-ASSET STRATEGY
jturner@greatlakesadvisors.com

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