United States

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Mid-year review: One revision away from a recession

It goes without saying that it has been a wild ride since our year-ahead piece last November. Russia has invaded Ukraine, causing a commodity and confidence shock, China has continued to struggle with its new economic policy regime and zero-COVID strategy, and most important, inflation has proved to be an even bigger problem than we had expected. Here we argue:

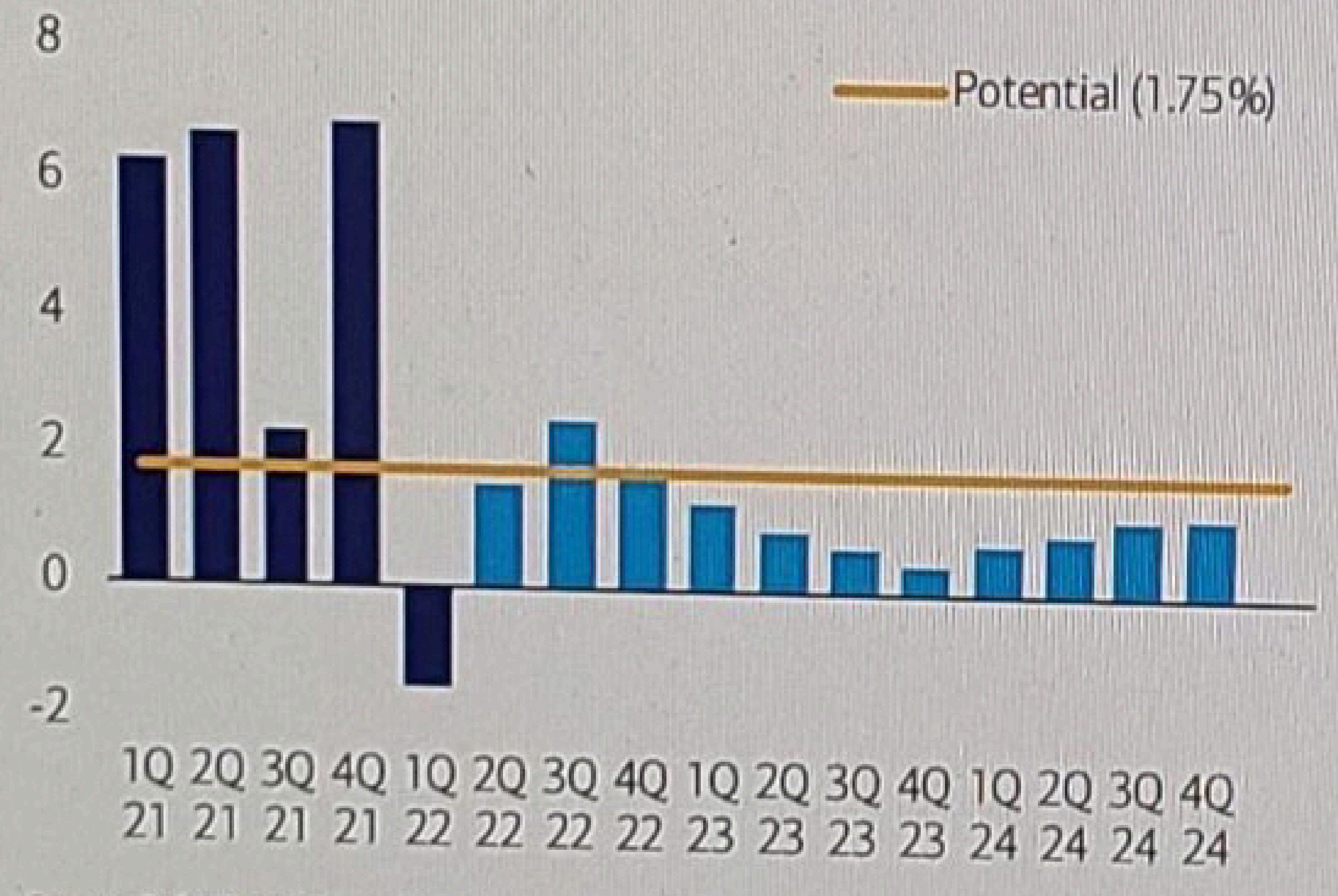
- The most likely outlook is very weak growth and persistently high inflation. We see roughly a 40% chance of a recession next year.
- Our worst fears around the Fed have been confirmed: they fell way behind the curve and are now playing a dangerous game of catch up.
- We look for GDP growth to slow to almost zero, inflation to settle at around 3% and the Fed to hike rates above 4%.

Growth; weak or worse

In the spring of 2021, we argued that the biggest risk to the US economy was a boom-bust scenario. We worried that the Fed would take too long to put the brakes on. We asked, if the fiscal authorities are doing so much stimulus, why does the Fed need to add fuel to the fire with unusually late policy normalization? Over time, the boom-bust scenario has become our baseline forecast.

This week, we have cut our growth forecast for this year and next and introduced a very weak projection for 2024 (Exhibit 3). We expect growth to fade to close to zero by the second half of next year as the lagged impact of tighter financial conditions cools the economy. We expect only a modest rebound in growth in 2024. The risk of a recession is low this year, but we put about a 40% chance of a recession starting next year. So our forecast is for "weak or worse".

Exhibit 3: Really weak GDP growth (%qoq, saar)
We have cut our growth forecast for this year and next and introduced a very weak projection for 2024



Source: BofA Global Research estimates

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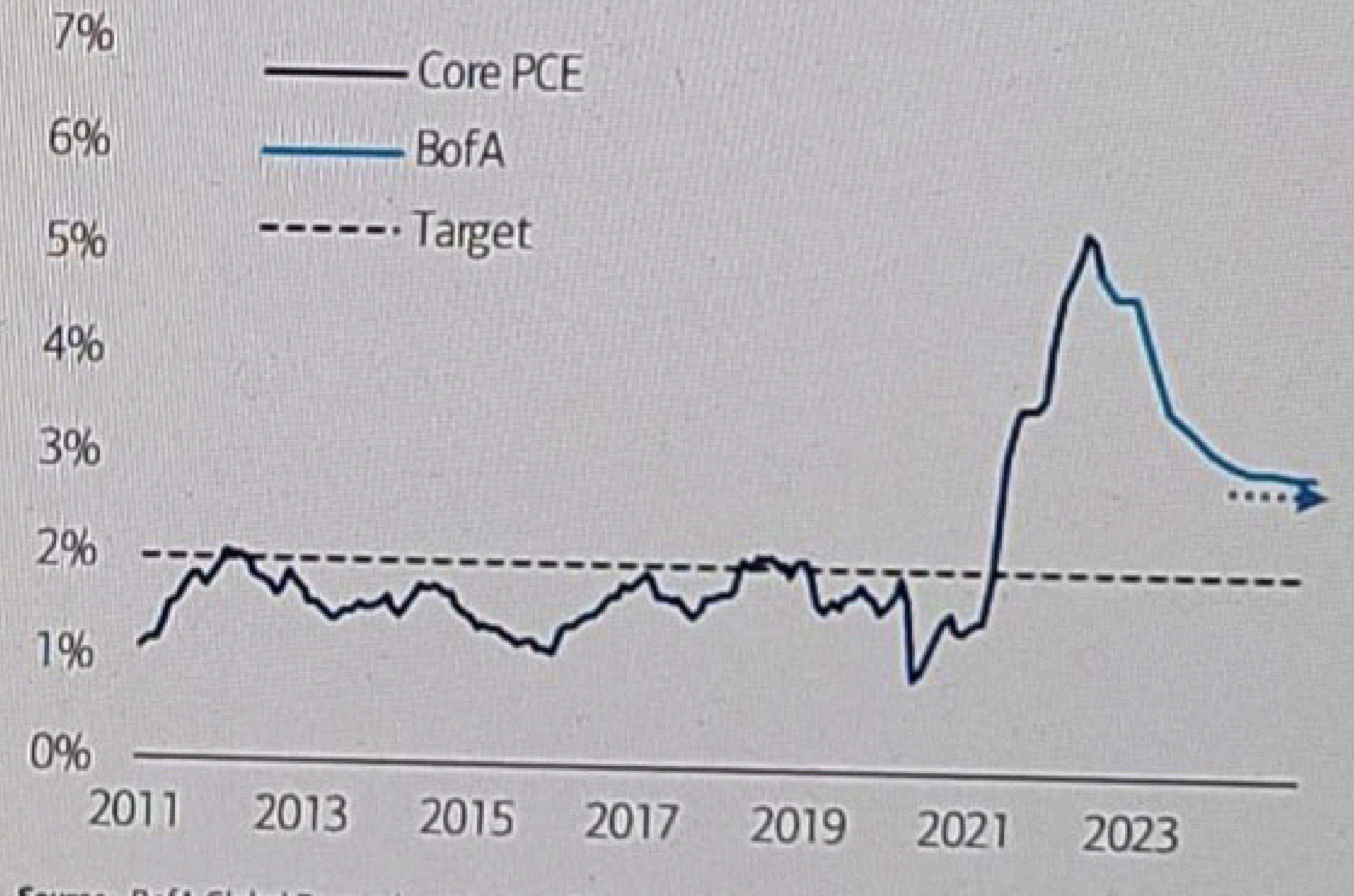
Exhibit 4: Core PCE and forecasts (%yoy)
We think PCE inflation will drop to about 3%, but then remain stuck there into 2024



Source: BofA Global Research estimates, Bloomberg

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A modest further rise in the participation rate should help push up the unemployment rate, but we think most of the increase will likely come from weaker demand for workers. By the end of next year, we hope the ratio of job openings to unemployed is down to the more normal highs of the last business cycle. Keep a close eye on this metric and timely indicators of labor market balance like jobless claims and survey questions on the job market.

Inflation: sticky high

One of our least favorite arguments about US inflation is that since it is caused by supply-side constraints, there is nothing the Fed can do about it. In reality, both hot demand and constrained supply are contributing to the problem. We think PCE inflation will drop to about 3%, but then remain stuck there into 2024 (Exhibit 4).

The good news is that the supply problems should ease. The massive surge in consumer demand for goods overwhelmed the production and distribution system. Now, consumer spending is both slowing down and rotating toward services. There are already signs of a bounce-back in inventories in the formerly hot sectors. In the months ahead, we expect goods demand to converge to rising capacity, ending most of the supply chain problems.

It will be much harder to reverse inflation caused by rising inflation expectations and a record tight labor market. Our favorite gauge of inflation expectations – 5 to 10 year expectations from the Michigan survey – started to unanchor to the downside late in the last business cycle and are now doing the opposite. Last week's jump to 3.3% was particularly troubling as it pushed expectations 0.5% above the historic norm. Wage pressures are also going to be hard to reverse. While there may have been some one-off increases in some pockets of the labor market, the upward pressure extends to virtually every industry, income and skill level.

Fed: like a deer in the headlights

Back in November, we were wondering if the Fed would ever get serious about fighting inflation. We pointed to the steady acceleration in wages, inflation expectations and measures of underlying inflation like the median and trimmed mean PCE deflator. We also pointed to the very strong momentum in the labor market, suggesting the economy would not just hit, but blow through full employment. Fast forward to today, and these trends have been worse than expected. Hence, we have all been playing catch-up in forecasting the funds path with the Fed particularly behind the curve.

The good news is that with the Fed's decision this week, we believe they are no longer behind the curve. The median dot now forecasts a 3.75% funds rate by the end of next year. That is in spitting distance of our own forecast of 4.00 to 4.25%. Where we disagree with both the Fed and the markets is the idea that the Fed will be cutting in 2024. That is certainly possible if there is an outright recession. However, our baseline forecast assumes the Fed will be like a deer in the headlights: unsure over whether to react to very weak growth or still high inflation.

Risks: more downside than upside

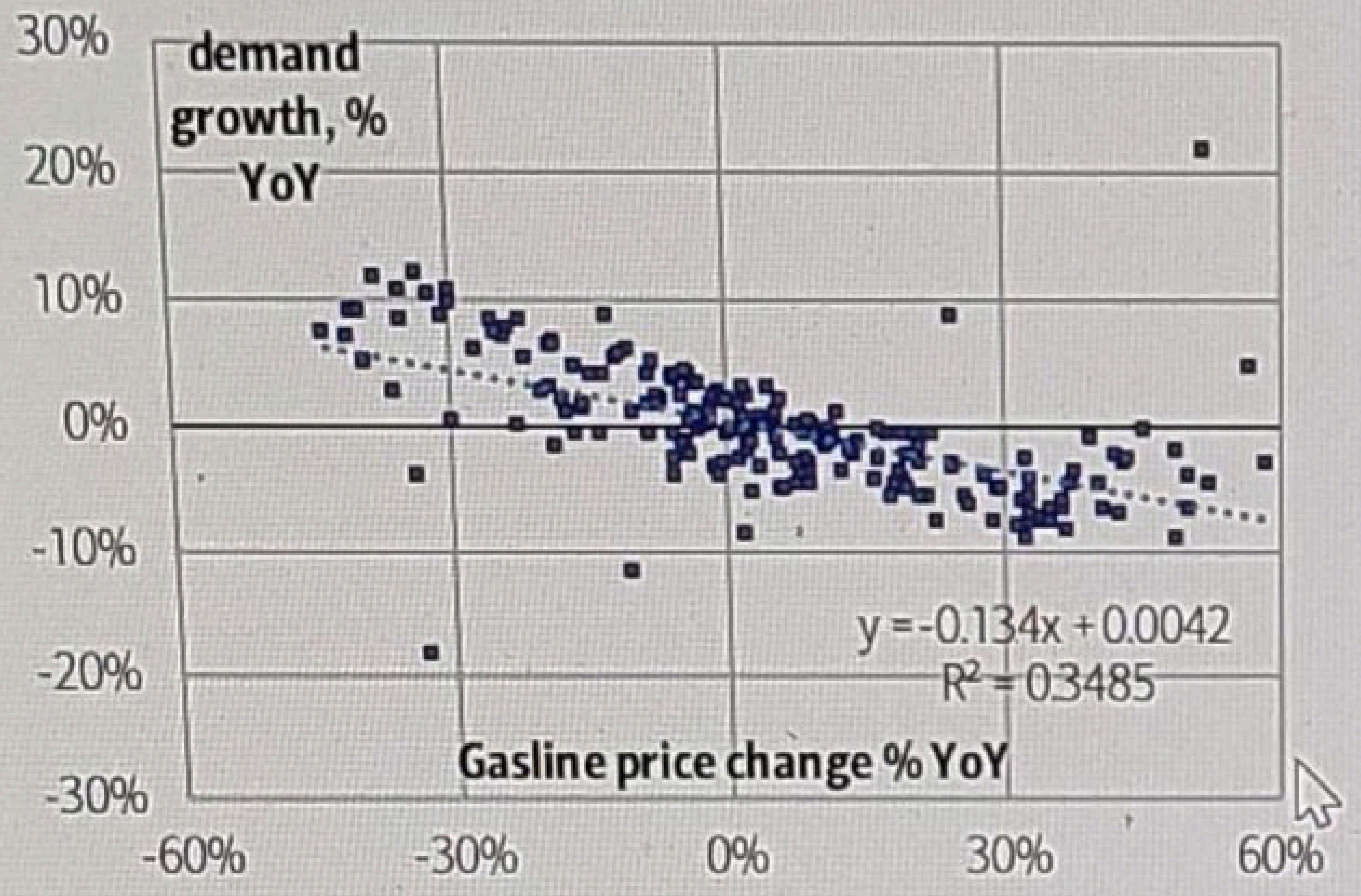
Despite our weak forecast, risks are skewed to the downside. One set of risks relates to the external environment. We can't rule out additional shocks from the Ukraine invasion, including a renewed spike in energy prices, a widening of the war and the spread of sanctions to supporters of Russia including China. The main home grown risk is that inflation refuses to converge toward a level that is acceptable to the Fed. We think that threshold is 3%, but perhaps they are serious about getting back to the low twos. In our view, getting there would require that the Fed deliberately trigger a recession.

We are less concerned about the "accidents" that can happen when the economy weakens. In our view, there is only one major imbalance in the US economy – high inflation. Hence slow growth is unlikely to reveal some hidden weaknesses like in the 2008-9 recession. Moreover, in our view, it is easier for the Fed to manage a sharp slowdown if Fed policy is the cause of the slowdown. For the same reasons, we think that if there is a recession, it will likely be mild.

data appears to be lower than the reported EIA survey data (Exhibit 33) too, although we have seen some convergence. One might logically conclude that demand at the pump drives the EIA implied demand figures, which represent gasoline volumes leaving refiner and blender operations (to supply retail gasoline stations), however we have found that this lead-lag relationship is not statistically significant at a monthly frequency.

Exhibit 32: US gasoline demand implied by aggregated BAC card data and gasoline prices* (monthly data, Jan 2006-April 22)

BAC US card data suggests that US consumers are actually quite responsive to gasoline price changes at the pump



Note: To calculate a proxy for gasoline demand, we divide monthly BAC card spend on gas stations by US gas prices. **Source:** Bloomberg (Gasoline prices), BAC internal data, BofA Global Research

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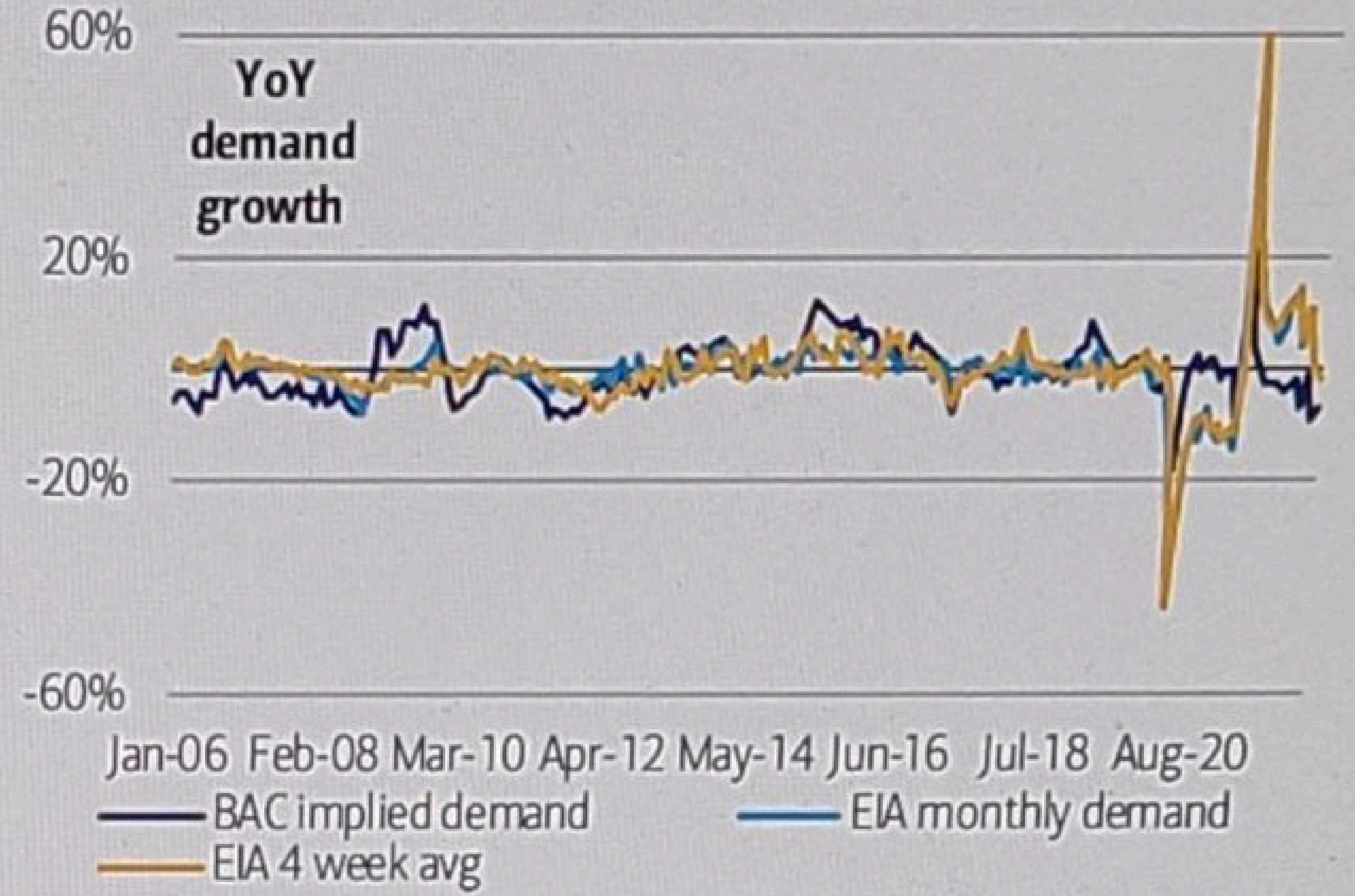
Exhibit 33: Gasoline demand implied by BAC card data and EIA data

Gasoline demand growth in the US implied by BAC card data appears to be lower than the reported EIA survey data



Source: BAC internal data, EIA, BofA Global Research. "BAC implied demand" refers to BAC card data implied demand

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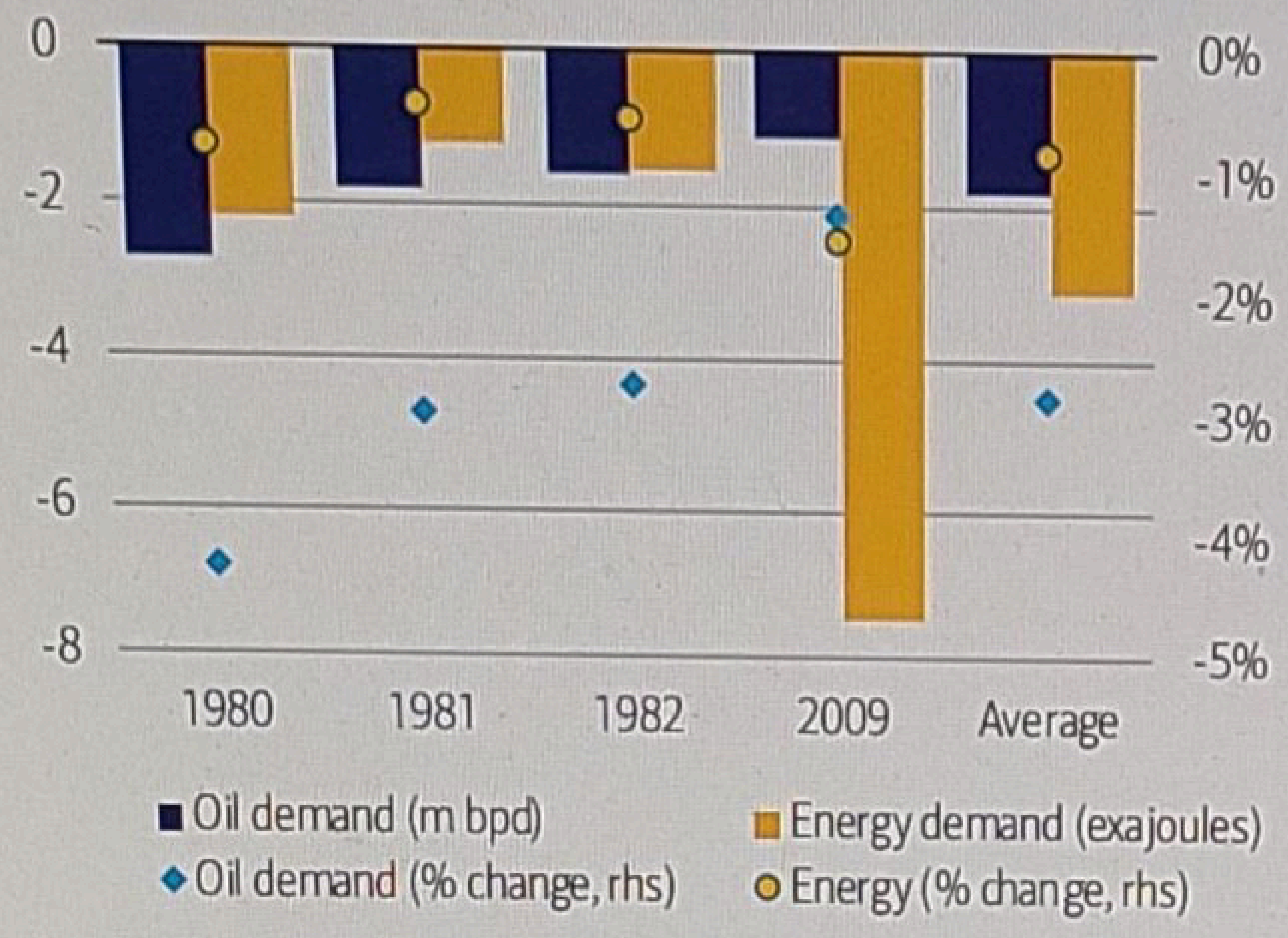
Yet we find only 5 years in the past 50 when energy demand fell

Looking back at the last 50+ years, we note that global energy demand has significantly contracted only three times: during the double-dip recession of 1980-82 triggered by the Iran revolution, during the global financial crisis in 2008-09, and during the widespread lockdowns of the Covid-19 pandemic in 2020. During this period, energy and oil demand fell by an average of 3.1 EJ and 1.8mn b/d, excluding 2020 when the collapse was much greater and driven by the pandemic lockdowns (Exhibit 34). Throughout history, we note that supply also tends to drop in recessionary periods and, in some cases, more so than demand (Exhibit 35).

Exhibit 34: Change in global oil and energy demand in years with negative year-on-year energy demand growth

Looking back at the last 50+ years, we find that energy and oil demand fell by an average of 3.1 EJ and 1.8 mn b/d in those periods, excluding 2020



Source: BP, BofA Global Research

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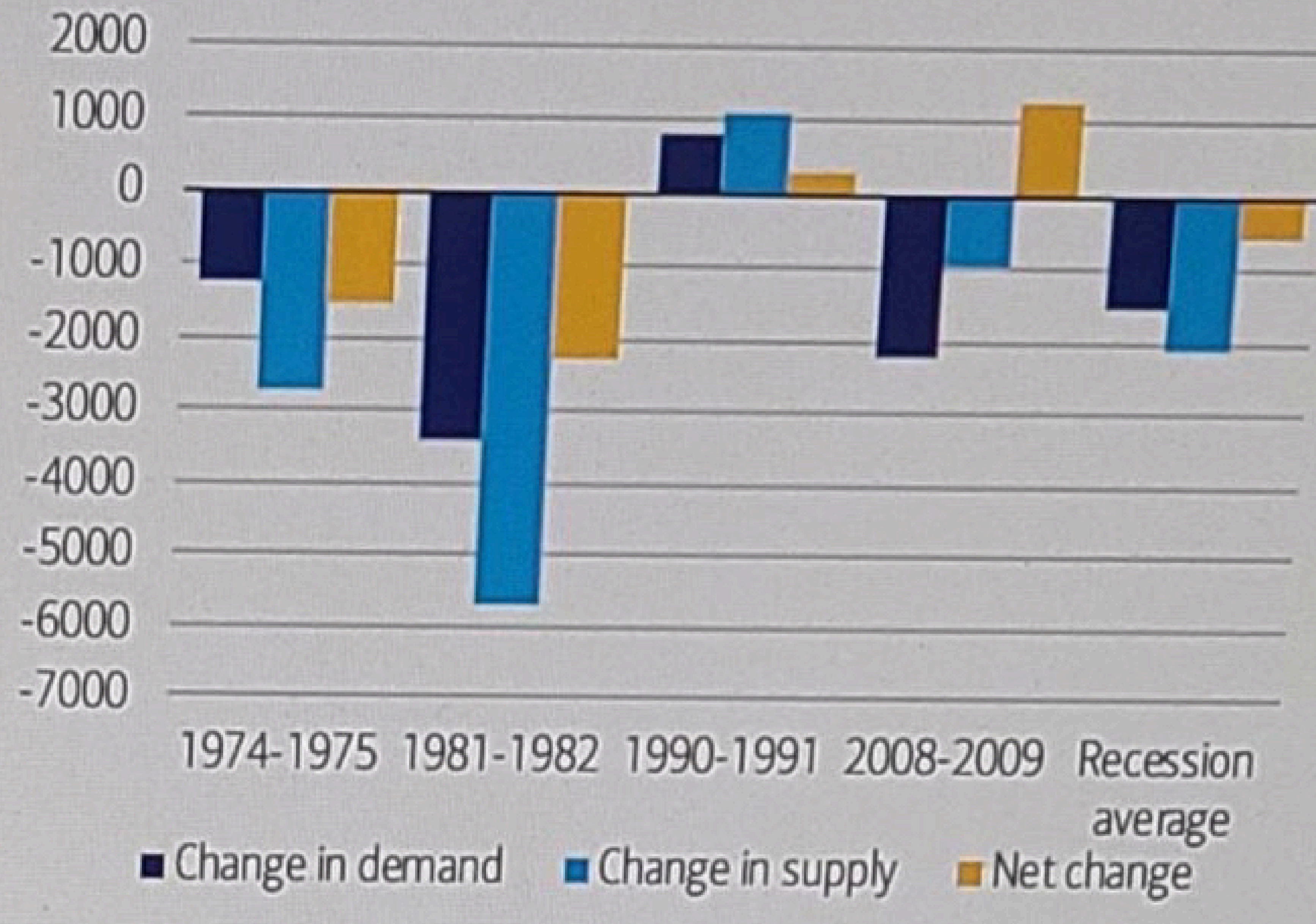
Exhibit 35: Annual change in oil demand, supply, and net balance acr global recessions

Looking back at history, we note that supply also tends to drop during recessionary periods and, in some cases, more so than demand



Source: BP, BofA Global Research

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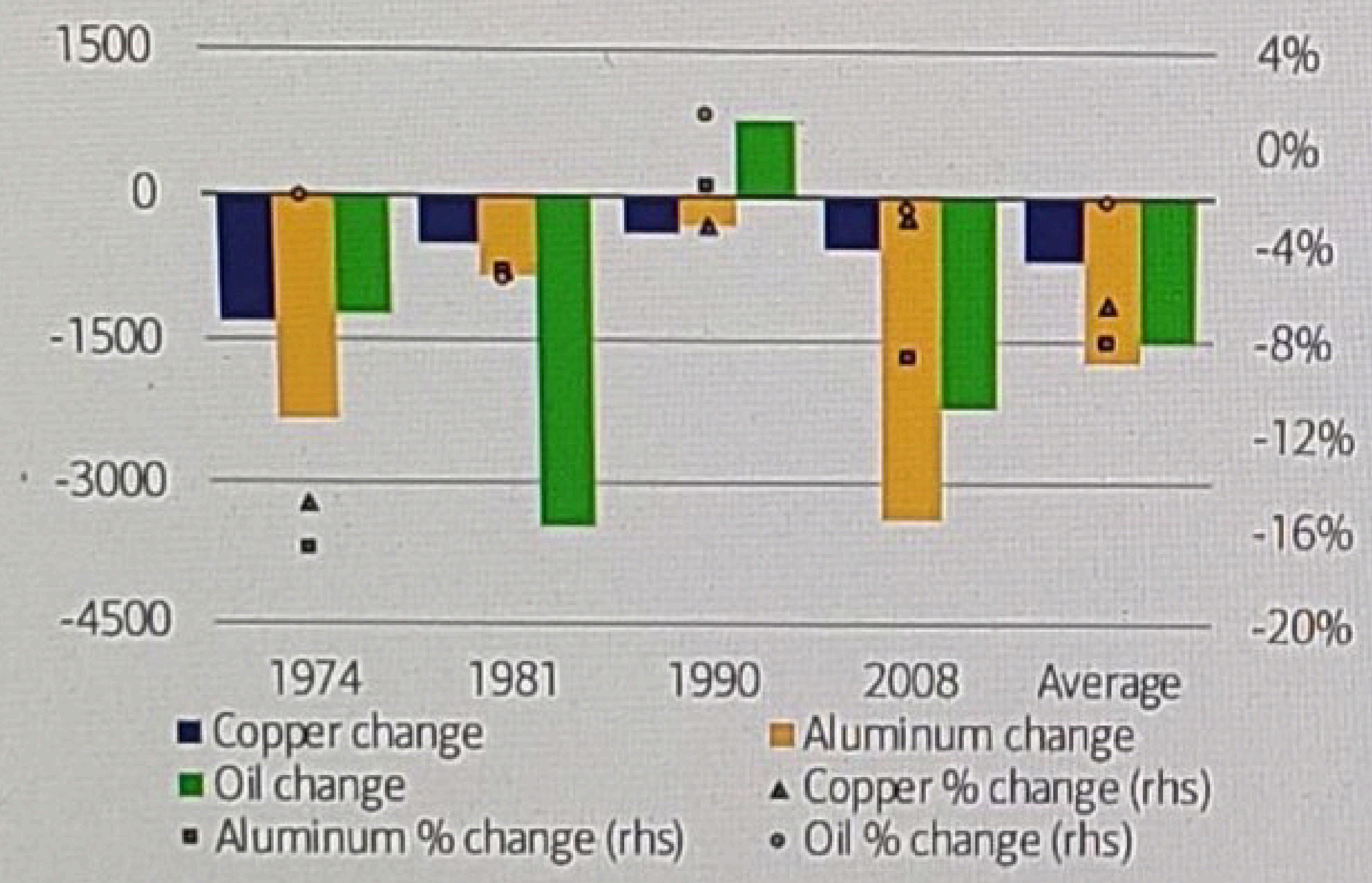
Only major recessions usually lead to energy demand contractions

The bottom line is that adjusting global energy or oil demand down is not going to be easy, even in a recessionary environment. This is because oil demand is much less sensitive to down cycles than demand for key metals like copper or aluminium (Exhibit 36), which often experience double-digit demand declines during periods of economic duress. Only once in a generation economic downturns like the double-dip recession of 1980-82 or the Global Financial Crisis in 2008-09 have resulted in oil demand contractions in excess of 2mn b/d (Exhibit 37). To put this number in context, Russian energy exports were about 8mn b/d before the war started, stressing the difficulty of blocking large quantities of Russian oil off the global market.

Exhibit 36: Change in world oil and metals demand across global recessions

In general, oil demand is much less sensitive to down cycles than demand for key metals like copper or aluminium



Source: BofA Global Research

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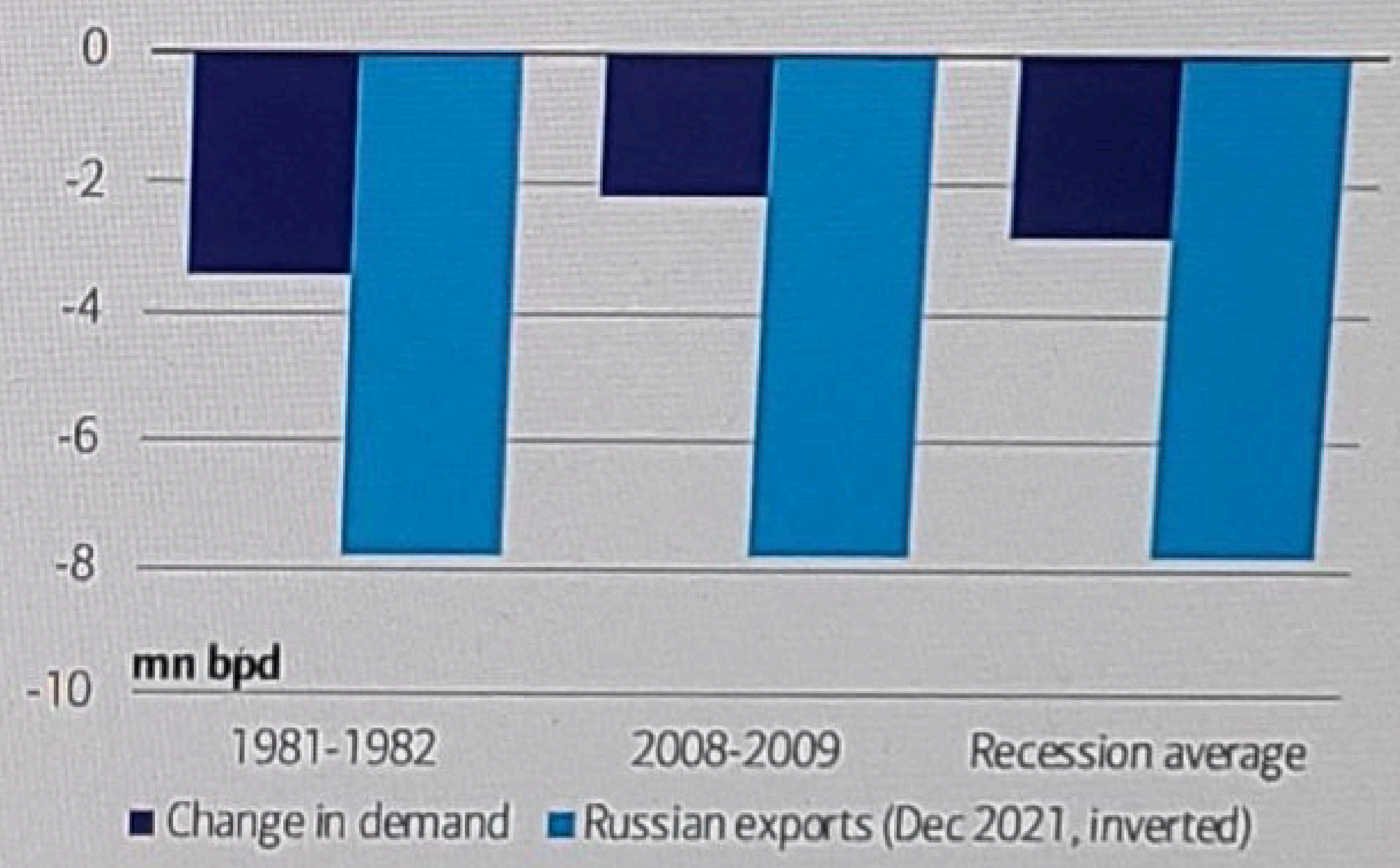
Exhibit 37: Change in global oil demand across largest recessions compared to Russian exports in Dec 2021

Only once in a generation economic downturns like the double-dip recessior of 1980-82 or the Global Financial Crisis in 2008-09 have resulted in oil demand contractions in excess of 2mn b/d, a quarter of Russia's exports



Source: BP, IEA, BofA Global Research

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