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2023 RECESSION?

IS THIS 1981 ALL OVER AGAIN?

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Introduction

Most economists agree that as we move into the new year, we will begin to see an economic downturn that has perhaps already begun. In terms of economic recessions, it appears the one we are entering has many similarities to that of the Recession of 1981-82. Throughout 2022, inflation has risen at a rate which we have not seen since the early 1980s, and in turn the Federal Reserve is enforcing the most aggressive monetary policy the country has seen in four decades. However, the economy today is not identical to that of the 1980s in that unemployment remains surprisingly low, simultaneously benefiting and overheating the economy. Because of this key difference, the outcome of the Recession of 1981-82 cannot be relied upon to determine what the state of the economy will be in 2023. Today, economists, businesses, and consumers alike are debating what this new year will bring; throughout this paper we will discuss what we have seen before, what is new, and how we believe those factors will impact the economy in 2023.

What Causes Inflation?

Inflation is a persistent, economy-wide trend of price increases, year over year. Year after year, the purchasing power of each dollar decreases and becomes slightly less valuable, forcing prices to rise on account of that devalued dollar[8]. However, inflation is not all bad – in fact, a healthy economy should experience a rate of 1.5 - 2.0% inflation[6]. This healthy level of inflation increases wage rates, stimulating consumption and therefore, production. Furthermore, inflation eases the pressures of debt by making the principal amount slightly less expensive year over year.

Unfortunately, there are instances in which inflation gets out of control, hurting the economy much more than it benefits it. When inflation goes outside the healthy zone, layoffs often occur, consumer wages cannot keep up with rising prices, and new debt becomes too expensive for both businesses and consumers to invest in the future. The early 1980s and 2022 are both examples of inflation far overshooting that healthy 2%, but what caused it?

Oil Prices

When oil prices become higher, the prices of all goods and services reliant on oil increase, creating inflation. Drastic spikes in oil prices cause not only consumers to panic, but businesses as well due to their heavy dependence on oil.

Early 1980s: Inflation, measured by the consumer price index (CPI) began to skyrocket in the early 1970s in part due to the oil crisis that caused OPEC oil prices to nearly quadruple[14].

Today: In 2022, similar effects on the economy were seen with the energy crisis that came out of the war in Ukraine. West Texas Intermediate Crude Oil reached a peak of $114 per barrel in June 2022, with the largest year-to-year price difference occurring in March with a $46 increase per barrel[3]. Fortunately, throughout the second half 2022, oil prices began to lower closer to a price per barrel America has become accustomed to over the past decade, suggesting an ease of the pressure oil prices have had on inflation and the American economy[3].

Supply Chain Issues

Supply chain disruptions create severe strain on supply and demand, very strongly impacting the prices of various goods and services. If the supply of goods is unable to keep up with the demand for that good, prices are driven higher and higher as a result, creating inflation.

Early 1980s: In the early 1980s, supply chain management was beginning to take off as a concept and continued to improve throughout the decade with new management theories, stronger offshoring plans, and the introduction of a global market.

Today: In recent years, supply chain management has become so intricate and pervasive that disruptions in supply chains create severe strain for businesses around the world. The COVID-19 pandemic, rising energy costs, geopolitical unrest, and a lack of raw materials have all been factors affecting the supply chain since 2020[3]. Fortunately, strain on the supply chain has created opportunities for innovation in supply chain management once more. By November 2021, 95% of businesses reported an implementation of formal supply-chain risk-management processes, with 59% of those businesses adopting new risk-management processes altogether post-COVID[2].

With supply chains recovering and becoming more resilient, the strain of excess demand on the economy is beginning to wane, slowly reducing inflationary pressures on the economy.

Monetary & Fiscal Policy

While both energy prices and the health of supply chains have great effects on inflation, it is frequently monetary and fiscal policy that have the largest impacts on how quickly inflation progresses because both directly affect the amount of money circulating within an economy at any given time.

Early 1980s: Leading up to the Recession of 1981-82, a form of monetary policy called "stop-go" had been adopted with the belief that unemployment could be lowered by relaxing the money supply and letting inflation rise for a period of time. Once the tables had turned and inflation became the larger issue, the Fed would then tighten the money supply, causing unemployment to increase as inflationary pressures eased off. The theory behind the "stop-go" monetary policy was that, by combatting inflation with unemployment and unemployment with inflation, the Fed would be able to gradually lower both economic stressors and maintain a stable economy. Unfortunately, "stop-go" monetary policy did the exact opposite and led to record highs in both unemployment and inflation[14].

Today: Ineffective monetary policy was the catalyst for high inflation during the Recession of 1981-82; however, in 2022, inflation came out of exorbitant government spending, or expansionary fiscal policy. When the COVID pandemic of 2020 struck, the United States Government began distributing money across the nation in order to encourage individuals and businesses to continue to spend money and stimulate the economy. Between Q1 and Q2 of 2020, real gross domestic product, or GDP, dropped 8.5%; in comparison, the most significant quarter to quarter dip in real GDP during the Recession of 1981-82 was a 2.1% decline[3]. It was essential for the government to stimulate the economy in order to avoid a deep COVID recession, which was successfully avoided; however, by spending too much in too short a time, the government pumped too much money into the economy, overstimulating it and creating inflation.

What Perpetuates Inflation?

Expectations & Confidence in the Fed

One of the largest obstacles the Fed faces when it comes to lowering inflation is the public's expectations of how quickly it will do so. Expectations play a key role in the economy because individuals and businesses spend their money differently depending on whether they have a positive or negative outlook on the future.

Early 1980s: In 1979 when Paul Volcker became chair of the Federal Reserve, the public had little faith that he could make any real changes to the economic conditions America faced. Because consumers expected inflation to continue rising, they made purchases immediately in order to get a lower price; this surge in demand from consumers then led businesses to increase prices, increasing inflation as a result. This lack of confidence, and the mounting inflation that came as a result, forced the Fed to take more aggressive actions against inflation to gain credibility and adjust short term consumption[14].

Today: On the other hand, when consumers and businesses believe the Fed will be successful in lowering inflation, they expect prices to either remain stable or begin to decline, making it less urgent and enticing to spend money immediately. People's confidence in the Fed leads to relaxation in consumption, allowing the Fed's monetary policy to be more effective and put less strain on the economy. Today, Americans are less pessimistic than they were in the 1980s regarding the Fed's abilities to stabilize the economy, with 43% of American's saying they have a "great deal" or "fair amount" of confidence in Jerome Powell[7]. With confidence in the Fed being relatively high, actions taken by the Fed are more likely to bring down inflation gradually but quickly, and much more efficiently than in the early 1980s.

Unemployment

The unemployment rate directly affects consumers' confidence and therefore heavily influences their spending habits. If unemployment is high, individuals are worried about future layoffs and lack of promotional opportunities which in turn makes them less willing to spend money, easing inflationary pressures. On the other hand, when unemployment is low, consumers are increasingly confident in future job opportunities and wage increases. This confidence can be seen in increased consumer spending which then signals to businesses that they should increase their prices because of the increased demand from consumers. With each price increase, inflation is perpetuated.

Early 1980s: From the late ‘70s to the mid ‘80s, high unemployment plagued the American economy. Reaching a peak of 10.8% in December of 1982, the unemployment rate kept the American consumer very frugal for the most part with relatively low spending and high savings [3]. Although low consumer spending hurt the nation’s GDP, the lack of spending helped ease the pressures of inflation.

Today: In December of 2022 the unemployment rate sat at just 3.5%, a rate that most economists agree means the economy is at full employment [3]. A benefit to such low unemployment is that if that rate rises, as it often does with the fight against inflation, the labor market is starting from an extraordinarily strong state and can tolerate that increase in unemployment. However, the strong labor market can also be a liability in the fight against inflation because high consumer confidence leads to increased spending and higher prices. Because consumers are so confident, they are also likely to negotiate higher wages, successfully in today's economy, increasing the costs for businesses, further incentivizing them to increase their product prices.

Consumer Savings & Spending

Consumers’ saving and spending habits are tied directly to their confidence in the economy and their expectations for the future. When confidence is low, the personal savings rate throughout the nation tends to increase because individuals are worried about being laid off, prices continuing to rise, and decreasing opportunities for future earnings. As the savings rate increases, consumer spending decreases, easing inflationary pressures. Conversely, when confidence is high, the personal savings rate tends to fall and consumer spending rises, perpetuating inflation through higher prices and more money circulating within the economy.

Early 1980s: Throughout the Great Inflation of 1981-82, the personal savings rate rested anywhere between 10 and 13%, meaning 10-13% of disposable income was saved each month [3]. This relatively high savings rate reflected the concerns most Americans had about the state of the economy at that time and helped to work alongside the Federal Reserve’s efforts to lower inflation.

Today: As of December 2022, American consumers held approximately $1.7 trillion in savings above what would have been projected prior to the pandemic [15]. This is likely due to government stimulus and higher-than-normal tax returns Americans have received in the past few years. While high amounts of reserved savings often indicate positive things for an economy, in 2022 it meant the continuation of inflation.

These high savings reserves were coupled with high consumer confidence, meaning instead of continuing to save, American consumers spent. Black Friday and Cyber Monday saw record sales in November 2022 with a 2.3% and 5.8% increase in year-to-year sales respectively[1]. This increase in consumer spending is also reflected in the dramatic decline in the personal savings rate throughout 2022, with only 2.2% of monthly disposable income being saved in October[3].

Business Investment

Just as consumer spending perpetuates inflation, spending by businesses does as well. When businesses feel confident that they can continue to raise prices and consumers will still buy their products, businesses tend to increase their expenditures, hire more employees, and invest in new opportunities. When businesses spend more, more money circulates throughout the economy, perpetuating inflation.

Early 1980s: Similar to consumers during this time, businesses were very conservative when it came to spending. Business expenses kept climbing with little consumer spending to support it, forcing most businesses to cut costs, frequently through layoffs. While bad for business and GDP, the decrease in spending from the business sector helped to ease inflationary pressures, alongside the slow in consumer spending.

Today: Government stimulus after the economic slowdown of the COVID pandemic meant businesses reached an all-time net private savings high of $1,300 billion in Q2 of 2022. Comparatively, the pre-pandemic peak rested just above $1,000 billion in 2012[3]. These excess savings can be tied to the low unemployment rate and why businesses have been willing to pay higher wages in recent months, because they have the savings to do so. Furthermore, businesses have had access to incredibly cheap loans since the pandemic, given to them by the government via PPP loans.

Excess savings and low-cost borrowing have allowed businesses to invest heavily in new equipment, higher wages, and new properties; again, pumping more and more money into the economy, perpetuating inflation. Reaching a peak of $3,900 billion in Q1 of 2022, business spending declined over the course of 2022, suggesting an ease in inflationary pressures leading into 2023[3].

How Does the Fed Fight Inflation?

In March of 1980, the CPI peaked at 14.6% and the Federal Reserve decided it was time to take increasingly aggressive actions to fight inflation. While inflation today has not yet reached the extremes of 1980*, the US economy saw the fastest increase in inflation since the early 80's with a peak of 9.00% in June 2022[3]. As a result, the Federal Reserve is once more taking up the arduous task of lowering inflation to its target 2%.

Targeting the Money Supply

When Volcker became Chair of the Fed, he continued to increase interest rates to fight the extreme inflation of the 1980 recession. After it became clear that increases in rates were not lowering inflation fast enough, Volcker decided to take the more aggressive and often more painful approach to fighting inflation: targeting the money supply directly[14]. The Fed can directly target the money supply by increasing the amount of cash banks are forced to have on hand, and by selling treasury bonds. Both actions physically remove cash from the money supply, helping to bring inflation down.

Volcker took such aggressive actions because it became clear to him that raising interest rates was not doing enough in the fight against inflation. The relative ineffectiveness of rate hikes in the early 1980s can be seen explicitly with the federal funds rate. In January of 1981, before the recession began, the CPI sat at 11.79% while the federal funds effective rate was 19.08%. Comparatively, the CPI for November 2022 was 7.12% with an effective federal funds rate of 3.78%, the highest it has been in over a decade[3].

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*It is important to note that the methodology of calculating the CPI has changed since the 1980s. One of the two major changes to the calculation was the removal of mortgages within the basket of goods. The Bureau of Labor Statistics now represents all housing prices in terms of rent to get a more accurate depiction of how inflation impacts the costs of housing. This benefits inflation estimates comparing years after 1983, when the change was made, but makes comparisons of inflation today and inflation before 1983 less straight forward.

Housing costs for property owners are now measured by "owners' equivalent rent," an estimation of how much it would cost to rent that property if they did not own it. This was done in order to depict the effects of inflation more accurately on housing; owning a home is an asset that appreciates over time while renting a house is strictly consumption because there is no added value for the renter in terms of investment. While this change does influence the direct comparison of inflation today and inflation in the early 1980s, its estimated effect on inflation measurements today would be approximately +1.25 percentage points according to the research firm, Inflation Insights. The Quarterly Journal of Economics found the effect of this adjustment to be an estimated +3.6 percentage points for the month of February in 2022, a more inflated estimate.

The second way in which the CPI calculation has changed over time is the more frequent adjustments in the weighting of goods within the basket. Prior to the start of the 21st century, the CPI basket was rarely adjusted, which failed to reflect how consumers change their spending over time as new alternatives to goods become available. Today the weighting of goods within the basket is altered around every two years to capture what exactly individuals are spending their money on today[20].

Raising Interest Rates

Today, Jerome Powell and the Federal Reserve have continued to use interest rates as the primary tool to fight inflation[3]. Throughout 2022 interest rates rose continuously with the intensity of those rate increases finally starting to slow towards the end of the year with a 0.5% increase as opposed to the previous 0.75%[21]. The Fed uses interest rates to fight inflation by making it more expensive to borrow money each time those rates are raised. When rates rise, the effect can be seen in people's willingness to borrow by using credit cards, taking out car loans, and businesses being less willing to invest in new equipment.

Anti-Inflation Actions Leading to a Recession

If used properly, the tool of raising interest rates slows down the economy just enough so inflation settles back down without bringing economic activity to an abrupt halt. In 1981, rate hikes by the Fed and its further actions of targeting the money supply directly collapsed both consumer and business spending, two aspects that made up 60% and 20% of GDP respectively in 1981[3]. With such aggressive Fed action, real GDP not only stopped growing, but began receding, creating the Recession of 1981-82. While a deep recession was the outcome of aggressive Fed action in the early 1980s, the economic environment of 2023 is not identical to that of when Volcker was chair, and therefore the same outcome cannot be relied upon, but also cannot be ruled out.

Potential Outcomes

The actions the Federal Reserve has taken and its anticipated plan for 2023 have sparked serious debate in reference to the economic outlook for this year. The two main projections are a hard-landing scenario and a soft-landing scenario, and there are merits to both projections.

Hard Landing Scenario

There is a possibility that, just as aggressive Fed action shut down economic activity in the early 1980s, a similar scenario could play out with the fight against inflation in 2023. As of 2021, consumer spending made up 68% of GDP while business investment made up another 18% of GDP[3]. A decline in spending from either or both groups would have a drastic effect on the economy, very quickly slowing down economic growth. The Federal Reserve hopes to use interest rates to calm the spending from these groups enough to lower inflation, but there is a risk that these actions could once more be taken too far and freeze over the economy as opposed to cooling it down.

A hard-landing scenario would likely occur if inflation cannot be controlled quickly enough, forcing the Fed to take more aggressive actions, a similar narrative to that of the Recession of 1981-82. The Fed could be pushed to be more aggressive against inflation largely because of businesses' indifference to interest rate increases. As mentioned earlier, businesses have excess savings as well as cheap loans that have already been given to them, such as the PPP loans. Businesses are not being deterred by higher interest rates because the loans that came out of the pandemic from the government are supporting their spending already. Their excess savings also allow them to continue spending more than they would even without access to cheap credit. Business spending, or private domestic investment, makes up around 20% of economic activity, so even if consumer spending were to wane, businesses could still perpetuate inflation, forcing the Fed to be more aggressive [3].

Unemployment remaining low and wages remaining high could also contribute to a hard-landing scenario as well. If consumers continue to remain optimistic in their ability to find work and higher wages, they will continue to spend money. If their relative indifference to higher prices remains as well, businesses will continue to be incentivized to raise prices, and inflation will continue rising. Furthermore, if the public’s confidence in the Fed begins to decline, spending from both consumers and businesses will become more short-sighted, and inflation will become increasingly difficult to control.

The fear in the hard-landing scenario is that, as the Fed becomes more aggressive, consumers will simultaneously be rapidly running out of their excess stimulus savings and quickly come to the realization that the level of consumption they have maintained over the past few years cannot be supported on the minimal amounts of savings contributions they have made in recent months[15]. As a result, consumer spending will come to a crashing halt, forcing businesses to drastically reduce their expenses because of a sudden and substantial reduction in revenue. If this were to happen, businesses would most likely reduce their expenses by laying off employees, further decreasing consumer spending and creating a deep recession in 2023.

Soft Landing Scenario

On the other hand, many argue that the Fed’s actions so far have been enough and will continue to be sufficient in bringing inflation down gradually but quickly, citing the fall from 9% to just over 7% CPI from June to November 2022[3]. Not only does the CPI indicate a soft-landing scenario, but other factors point to this more positive outcome as well.

Oil prices have been falling since their peak in June 2022, decreasing expenses for consumers and businesses, relieving some inflationary pressure. Supply chains are beginning to mend, confidence in the Fed remains relatively high and government spending is slowly beginning to return to its pre-pandemic progression. Each of these factors ease inflationary pressure on the economy, not bringing inflation down to the target 2% immediately, but steadily decreasing it at a rate that is tolerable for both consumers and businesses alike.

If inflation continues to calm at this rate without increasingly aggressive actions by the Federal Reserve, the economy will gradually cool down with stabilized prices creating less demand for higher wages and firms reaching a point at which they are no longer hiring so rapidly but are also not laying workers off. In this soft-landing scenario, the economy would have minimal growth, but not a drastic decline in productivity throughout 2023[3] .

Expected Effects on the Market

Whether 2023 brings a hard-landing or soft-landing, there is a strong possibility that the market has already priced in the worst-case scenario, and we have already borne the brunt of the recession's effects on the market. During the Recession of 1981-82, the decline in gross domestic product was approximately 3% over the course of those 16 months [11] . The effect of that 3% contraction was seen most substantially on the stock market. During that same period, the S&P 500 lost approximately 27.11% of its value, a great blow to the investments of many individuals and businesses [10] .

The most pessimistic projections for GDP in 2023 estimate a contraction of 2.0%, a shallower recession than that of the early 1980s. If a 3.1% contraction in 1981-82 created a loss of 27% in the S&P 500 and a 4.3% contraction in 2008-09 lead the S&P 500 to lose 48% of its value, it is reasonable to assume a 2.0% contraction could lead to an approximate loss of 20% in the S&P 500. Throughout 2022, the S&P 500 lost a total of 19.4%; however, growth in GDP for 2022 is estimated to be between 1.6 - 1.9% by the Survey of Professional Forecasters carried out by the Federal Reserve Bank of Philadelphia [4] .

Losing almost 20% of a benchmark index during a year with fairly positive projected growth in GDP indicates that the worst-case scenario for 2023 has already been priced into the market. It is likely that rising inflation has frightened investors enough to the point at which the worst for the market is over, even though we have yet to see the slowdown in economic activity.

Furthermore, that 2% contraction is the most pessimistic projection for GDP in 2023, with most forecasts falling between 0.0 - 1. 1% GDP growth; slow, but positive overall, creating a good recovery period for the markets.

Conclusion

The good news? Usually when a recession is announced, the trough stage of the business cycle has already occurred, and the worst is over. Furthermore, at Parks Capital, we will help guide you through economic downturns and make sure that your finances outperform those of the downturned market. Regardless of a hard or soft landing, the economy has been through it before and has always recovered, whether it be at the lightning speed of the 2020 recession or a bit slower like that of the 16-month downturn of 1981-82. Deep or shallow, a recession in 2023 will bring some much-needed calming of the markets to remind us of what is valuable and what is not. Though often difficult and disruptive, recessions provide opportunity for economic restructuring and lead to a more robust, efficient economy in the long run.

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