U.S. Economic Outlook 2023

A 'soft landing' or 'deep recession?'

Teneo Insights
March 2023

Teneo

Foreword

The U.S. economy is currently experiencing levels of inflation that have not been seen in 40 years.

Supply chain disruptions, rising global commodity and energy prices, volatility in major economies and underlying demographic factors have all contributed to rising prices. To manage this, the Federal Reserve has reacted quickly, raising interest rates earlier and more aggressively than any other major economy.

In this paper, Teneo utilizes a combination of modelling, detailed analysis and commentary from highly respected advisers across a range of subjects, including politics, economics and consumer demand, to develop a comprehensive view of how the challenges the U.S. economy faces are likely to evolve in the next 12-18 months. Included are forecasted key macroeconomic factors such as inflation, GDP and employment, and considerations of a wide range of implications for businesses, including consumer spending and behavior patterns, as well as employment, rising inventories and access to credit.

Contents

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Section 01

Executive Summary

Executive Summary

While there is evidence of growth against a backdrop of global uncertainty for the U.S. economy, there remains a very real risk that the U.S. could be about to enter a prolonged recessionary period.

The U.S. government is currently trying to navigate its economy through a challenging inflationary period and orchestrate an outcome that has never been achieved. In other words, manage the dual challenges that rising inflation and rising interest rates have on economic growth while avoiding a recession and achieving its fabled soft landing.

Positive indicators point to its achievability – inflation is down, the labor market remains strong. Despite evidence of declining real wages, this has not yet translated into declines in household consumption. The line between a soft landing and a recession is thin.

Consumer confidence is at record lows, and the U.S. is seeing the biggest real wage declines in the wealthiest income brackets, which make up the majority of consumption.

In this paper, we outline four potential economic scenarios for the U.S. going forwards; from a soft landing to the risk of long-term inflation and a deep recession.

While there is cause to be optimistic about the U.S. economy, there remains a significant macroeconomic uncertainty, with the very real possibility that the economy could be about to enter a deep and lengthy recession.

Source(s): Teneo Research & Analysis

Note: [1]Levels of Inflation forecast for December 2023, [2]Interest rate outlook as of December 2023, [3]Annual GDP growth outlook for 2023, [4]Following the commencement of the recession

Negative outlook | Moderate outlook | Positive outlook

Soft Landing

The Fed's current policy is effective, inflation returns to pre-2022 levels, and consumer output increases as real wages trend upwards. As a result, the U.S. does not enter a recession but experiences 12-18 months of slow growth.

Mild Recession

The Fed decides that further interest rate rises and/or the Fed's current policy results in more slowdown than anticipated and the economy enters recession beginning in Q4 2022 and lasts 3-4 quarters.

	Soft Landing	Mild Recession
Inflation[1]	2-3%	2-3%
Interest rates[2]	2-4%	2-5%
GDP[3]	0-2%	-1-0%
Duration	n/a	2-4 quarters[4]
Overall outlook	→/↗	→/↘

Deep Recession

Greater downside than forecast. Potentially driven by instability in the job or housing market, leading to a reduction in consumer spending or geopolitical factors keeping prices up. This would result in a steeper decline in GDP and likely last 4+ quarters.

Long-term Inflation

Inflation remains high despite fiscal policy intervention from the Fed. The economy may not enter a recession; however, it could result in a prolonged period of slow or declining growth (well into 2024) as wages fail to keep up with prices.

	Deep Recession	Long-term Inflation
Inflation[1]	2-4%	4-5%
Interest rates[2]	2-5%	5-6%
GDP[3]	-2-4%	-1-1%
Duration	4+ quarters[4]	4+ quarters[4]
Overall outlook	↘	↘

Where the U.S. lands within this range of outcomes depends materially on how quickly inflation returns to target levels. Prolonged high inflation will have a substantial impact on consumption, which could tip the U.S. into a recession.

Six Key Takeaways

While we expect to see a **material softening on inflation in 2023 compared to 2022 figures**, there is a real risk that inflation remains at the **4-5%** level for the foreseeable future. This is impacted by wage pressures, continued geopolitical turmoil and lack of interest rate effectiveness.

Interest rates are expected to remain high across 2023. While they will help in managing inflation, they will also continue to impact borrowing and activity in the housing market. This is, in itself, a risk to the long-term stability of the U.S. economy. However, a repeat of the previous housing crisis is extremely unlikely.

Real wages fell across 2022. Without a material softening of inflation towards the 2% level, we will see real wages continue to fall across 2023. The U.S. bucks the global trend with more well-off home owners seeing larger declines.

Real wage declines coupled with low consumer confidence **will translate into a drop in consumption.** This is expected to be **most acute in higher income groups**, which have seen the largest declines in real wages.

Unemployment is expected to stay below 5% in 2023; however, **supply-side shortages** within the labor market risk driving further inflation as upwards pressure on wages continue.

While inflation has fallen significantly over the past few months, further falls at this magnitude and/or even greater levels will likely be required to avoid a recession. But this is by no means guaranteed.

Source(s): BLS, Reuters, Factset, Teneo Research & Analysis

Section 02

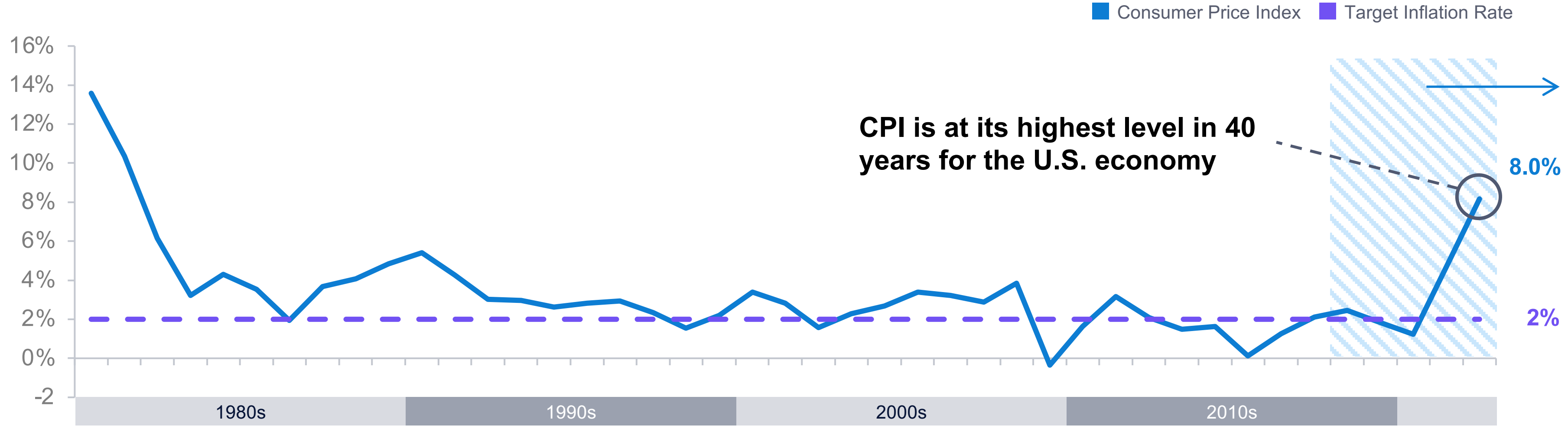
The Current Situation

2022 saw levels of inflation reach a 40-year peak

The U.S. is currently facing a period of intense inflationary challenge, with the highest rates of consumer price rises in over 40 years and interest rates rising steeply.

A confluence of factors, including the aftermath of the supply chain disruptions and costs relating to the COVID-19 pandemic, underlying demographic challenges and the ongoing impacts of the Russia-Ukraine conflict on energy and commodity prices, have driven U.S. inflation to a 40-year high.

U.S. Consumer Price Index; 1980-2022



Source(s): Bloomberg, BLS

Energy

There have been significant increases in energy prices driven by the Russia-Ukraine conflict and subsequent sanctions. Fuel oil prices increased by **65.7% in the 12 months to November 2022.**

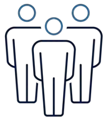
Commodities

The Russia-Ukraine conflict, along with supply chain issues caused by COVID-19, has created shortages and rising commodity prices.

In 2022, the average wheat price was 35% higher than in 2021.

Pent-up demand

Following COVID-19, there was an unwinding of pent-up demand in the form of delayed purchases. This increased demand and prices for many goods and services as **U.S. households spent from their $2.1 trillion excess savings accumulated during the pandemic.**



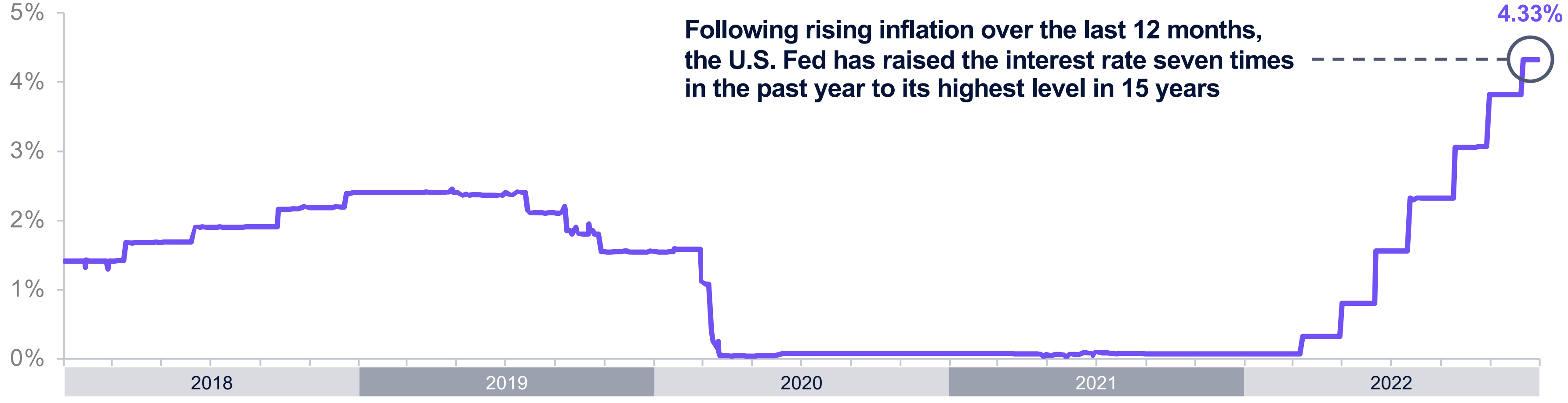
Structural demographics

A tight labor market, caused by a shortage of workers and cultural shifts in the workplace, has meant that businesses have had to increase wages to retain and/or hire workers. To accommodate this increase in wage cost, businesses are forced to raise prices, thereby contributing to inflation.

Source(s): JP Morgan Asset Management, Macrotrends, Teneo Research & Analysis

To control inflation and bring it back down towards the U.S. government's target, the Fed has begun raising its fund rate. While raising the fund rate helps to lower inflation, it also slows the economy down and dampens growth.

Effective Federal Funds Rate; 2018-2022



Source(s): Bloomberg, Federal Reserve

How interest rates manage inflation and preserve the value of currency:

Inflation:

Higher interest rates increase the cost of borrowing, in turn reducing overall spend. Reduced demand for goods and services forces prices to increase more slowly, curbing the rate of inflation.

Currency:

In addition to reducing inflation relative to other countries, higher interest rates in the U.S. offer lenders greater return relative to other countries, thereby attracting foreign investment and causing the exchange rate to rise.

Source(s): JP Morgan Asset Management, Macrotrends, Teneo Research & Analysis

Note: [1]The Federal Reserve increased the fund rate further on the 1st February 2023, to an effective rate of 4.58%. This sits outside the time-series shown on the graph

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High inflation and rising interest rates are translating into negative headwinds across leading consumer and business indicators, putting the U.S. at a growing risk of recession.

With price increases outpacing wage growth and resulting in declining real wages, consumers are seeing their household budgets squeezed. As household incomes fall in real terms and consumers have less money to spend, there is already growing evidence of negative headwinds across leading indicators of business output and household consumption in the U.S. Taken together, these indicators are linked to a slowdown in GDP.

Source(s): BLS, Reuters, Factset, Teneo Research & Analysis

Wage Growth and Real Disposable Income

5.1% Although **strong wage growth** has been observed, standing at 5.1% in Nov 2022, it is still well below inflation.

-2.0% This translates to a **decline in real disposable income** (-2.0% Nov 2021 to Nov 2022), eroding the purchasing power of consumers.

Consumer Confidence

Consumer confidence has deteriorated against a backdrop of declining real disposable income. Consumer confidence is currently lower than at any point during the COVID-19 pandemic and the Global Financial Crisis.

Unemployment

3.7% This is in the context of a tight labor market, with **unemployment standing at 3.7%** (Nov 2022), down from 4.5% (Nov 2021). Upwards wage pressure created by labor shortages risks driving inflation further.

Profit Margins

The net profit margins for the S&P 500 have **declined for five consecutive quarters,** from 13% in Q2 2021 to 12% in Q3 2022.

Business Confidence

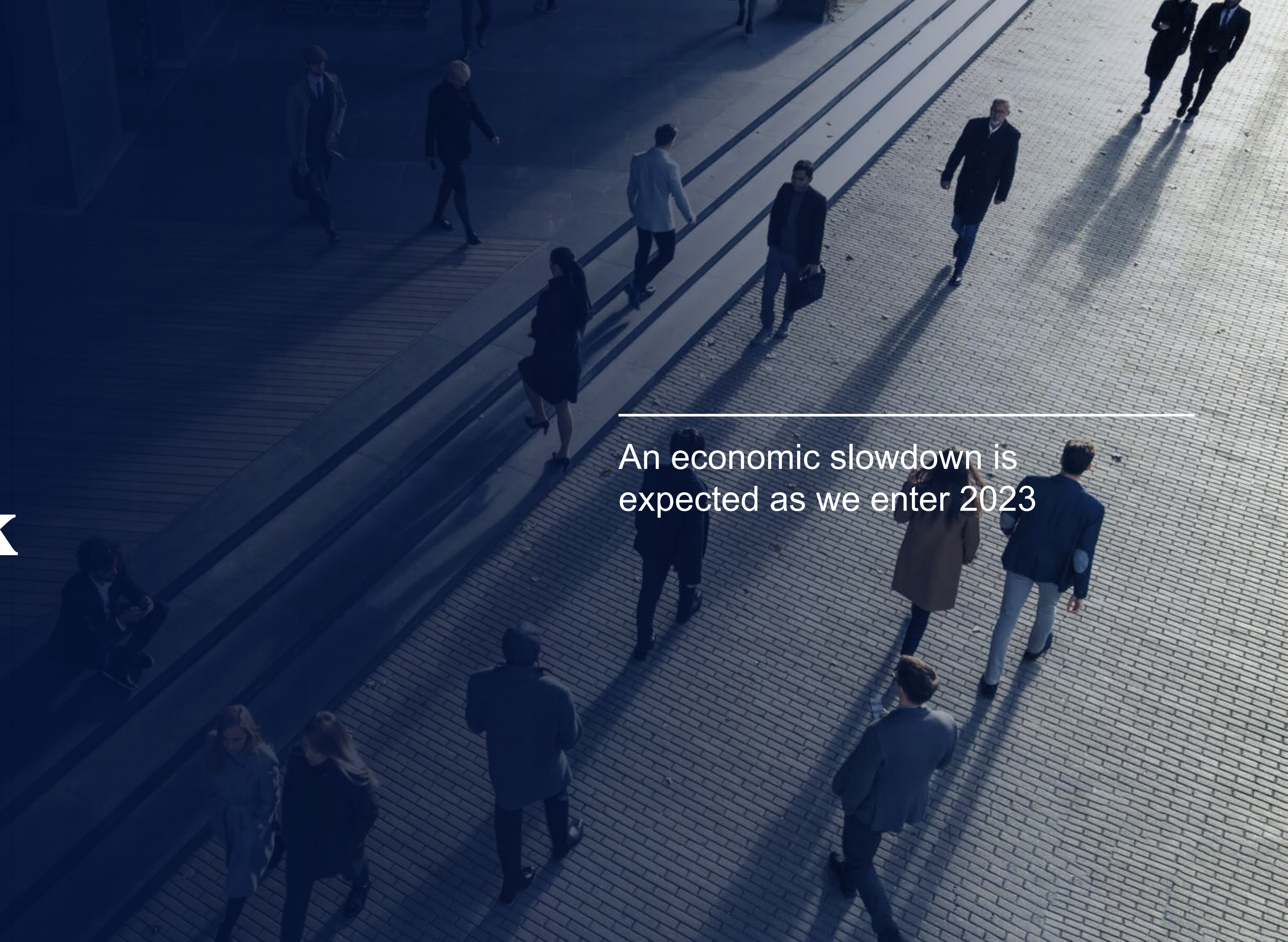
Business confidence has declined YoY, with current levels reminiscent of those seen during the U.S.-China trade war in 2019; however, it is still higher than the levels seen during the GFC.

Inventories

Business inventories have been rising throughout 2022 and were **16.5% higher in October 2022** compared to 12 months prior. This is indicative of slowing demand and a worsening cash position for businesses.

Section 03

Overall Outlook



An economic slowdown is expected as we enter 2023

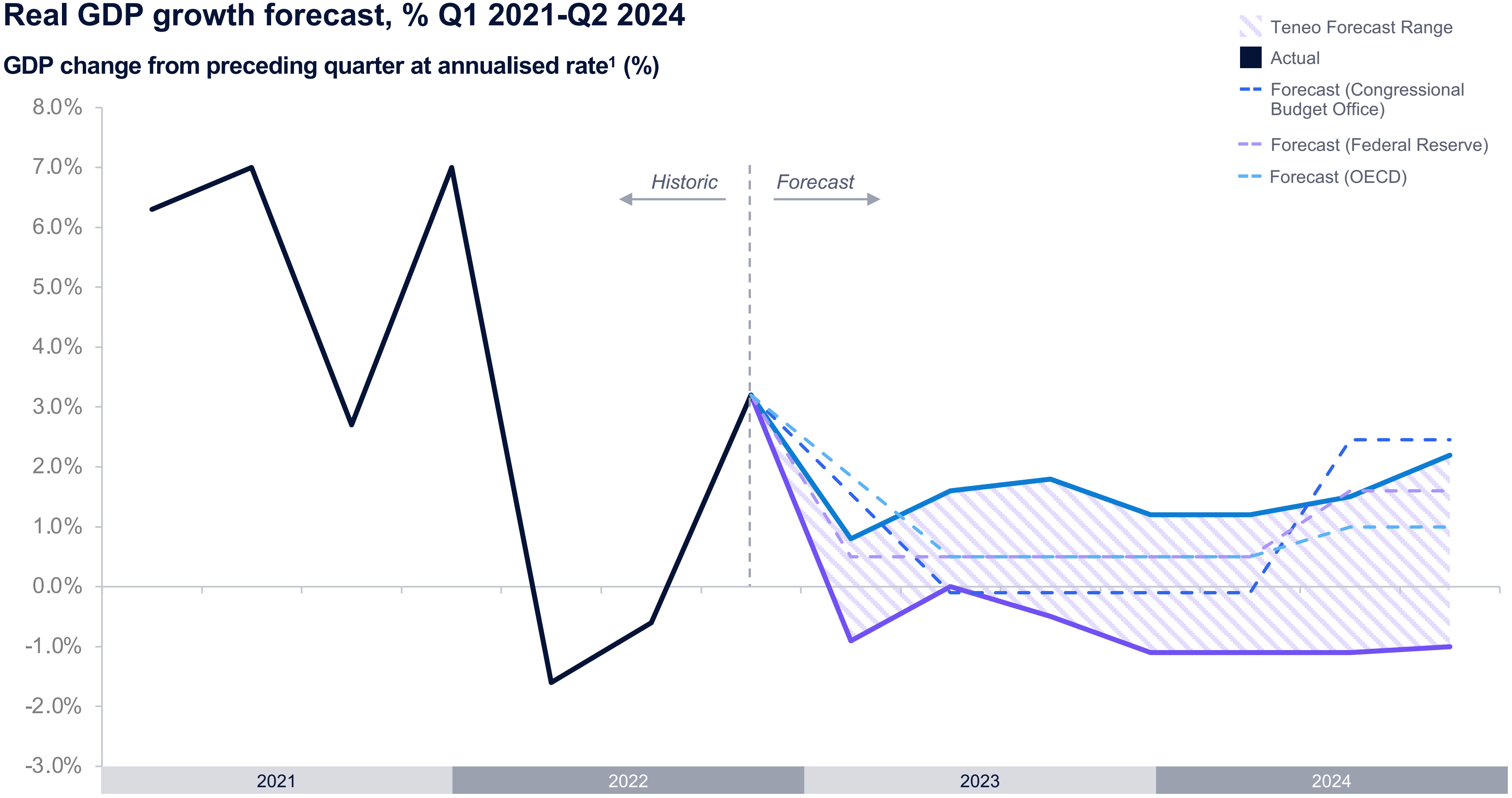
While the U.S. is seeing an economic slowdown with a recession as a very real possibility, there are diverging views on what the economic outlook looks like for the next 12-18 months.

There is broad consensus that the U.S. is likely to see an economic slowdown in Q1 2023 as the impacts of the Federal rate rises from late 2022 start to feed into the economy; however, there is a significant divergence with regards to the quarters that follow.

In a best-case scenario, the U.S. will likely see a 'soft landing' with low/slow growth across 2023 before picking up in 2024. However, a downside scenario is a real possibility and could see the U.S. enter a prolonged recession lasting well into 2024, as is currently forecast for the UK and Germany. Over the following pages, we assess the different scenarios that are likely to dictate where the U.S. economy lands within these ranges.

Real GDP growth forecast, % Q1 2021-Q2 2024

GDP change from preceding quarter at annualised rate[1] (%)



Source(s): BEA, OECD, CBO, Federal Reserve, Teneo upper and lower bound based on consolidation of forecasts (Conference Board, TD Economics, Bloomberg, SPF, Deloitte), Teneo Research & Analysis

Note: [1]Seasonally adjusted

Actual GDP growth will likely be dictated by a small number of key factors.

Highly likely / high magnitude · Likely / medium magnitude · Unlikely / low magnitude

Potential downsides	Further raising of interest rates by the Fed	Slower-than-expected inflation deceleration	Declines in consumer spending	Weakening labor market	Potential housing market distress	Unforeseen instability in the financial markets	External geopolitical factors	Change of Government in 2024
Description	The Fed has committed to continue interest rate hikes to curb inflation in 2023 despite fears of sparking a recession	Despite interest rate hikes, the Fed's policies may not be effective in reducing inflation in the short-term due to persistently high labor demand and other continued price pressure	Consumer spending is heavily dependent on individual circumstances as well as expectations	The U.S. labor market is currently strong; however, a weakening labor market and increases in unemployment could destabilize growth further	Higher mortgage costs and lower consumption, if combined with exacerbating factors such as high unemployment, may lead to a slowdown in activity and housing market crash	The current economic conditions may result in instability in part of the financial market, resulting in significant downside (e.g., derivatives or PE)	Broader supply chain issues brought about by COVID-19-related delays and geopolitical events	The upcoming election in early 2024 will impact policy decisions which subsequently feed through to the economy
Key implications	• Higher interest rates will likely further slow growth via increased borrowing costs • Higher than anticipated interest rate rises could tip the balance from slow growth to decline	• High inflation will continue to erode consumers' real disposable income, leading to lower consumption • In an extreme scenario, this may lead to stagflation or result in a deeper recession as the Fed has to raise interest rates further and more aggressively	• GDP is highly sensitive to consumer spending • Declines in consumer confidence can lead to delays and reductions in purchases and have a significant impact on outlook • Both real and perceived threats impact confidence, and customers may choose to reduce spend even if their personal circumstances are unaffected	• If the slowing of the economy results in a significant uplift in unemployment, the effects of the slowdown could be compounded by significant declines in consumer spending	• With mortgage rates rising, we anticipate a slowdown in activity as individuals delay buying and selling; this can have a significant impact on GDP, with real-estate-related activities contributing to 15% of output • In a worse case scenario, mortgage defaults may lead to a housing crash, further exacerbating economic distress	• While the financial markets are, on the whole, well regulated, there is still a small risk that under adverse conditions, significant instability may arise • Depending on the size of the market that is impacted, this could represent a large downside risk • A number of different markets have been cited as potential risks, including cryptocurrency, PE and derivatives	• To the extent that geopolitical issues persist or worsen (e.g. deterioration of U.S.-Chinese trade relations and escalation of the Russia-Ukraine conflict), supply chain constraints and shortages may bring about higher input costs and bolster inflation	• An election cycle and potential subsequent change of government midway through a recession / recovery risks introducing further instability
Likelihood of downside								
Magnitude of downside	High	Med	High	Med	Med	High	High	Low

Source(s): Teneo Research & Analysis

To understand how these factors will affect the overall outlook, we outline four potential scenarios and consider how key macroeconomic metrics would look in each scenario.

Negative outlook | Moderate outlook | Positive outlook

Four most likely broad economic scenarios

Soft Landing
The Fed's current policy is effective, inflation returns to pre-2022 levels, and consumer output increases as real wages trend upwards. As a result, the U.S. does not enter a recession but experiences 12-18 months of slow growth.

Mild Recession
The Fed decides that further interest rate rises and/or the Fed's current policy results in more slowdown than anticipated and the economy enters recession beginning in Q4 2022 and lasts 3-4 quarters.

Deep Recession
Greater downside than forecast. Potentially driven by instability in the job or housing market, leading to a reduction in consumer spending or geopolitical factors keeping prices up. This would result in a steeper decline in GDP and likely last 4+ quarters.

Long-term Inflation
Inflation remains high despite fiscal policy intervention from the Fed. The economy may not enter a recession; however, it could result in a prolonged period of slow or declining growth (well into 2024) as wages fail to keep up with prices.

	Soft Landing	Mild Recession	Deep Recession	Long-term Inflation
Inflation[1]	2-3%	2-3%	2-4%	4-5%
Interest rates[2]	2-4%	2-5%	2-5%	5-6%
GDP[3]	0-2%	-1-0%	-2-4%	-1-1%
Duration	n/a	2-4 quarters[4]	4+ quarters[4]	4+ quarters[4]
Overall outlook	→/↗	→/↘	↘	↘

Source(s): Teneo Research & Analysis
Note: [1]Levels of Inflation forecast for December 2023, [2]Interest rate outlook as of December 2023, [3]Annual GDP growth outlook for 2023, [4]Following the commencement of the recession

Section 04

Outlook Across Key Economic Metrics

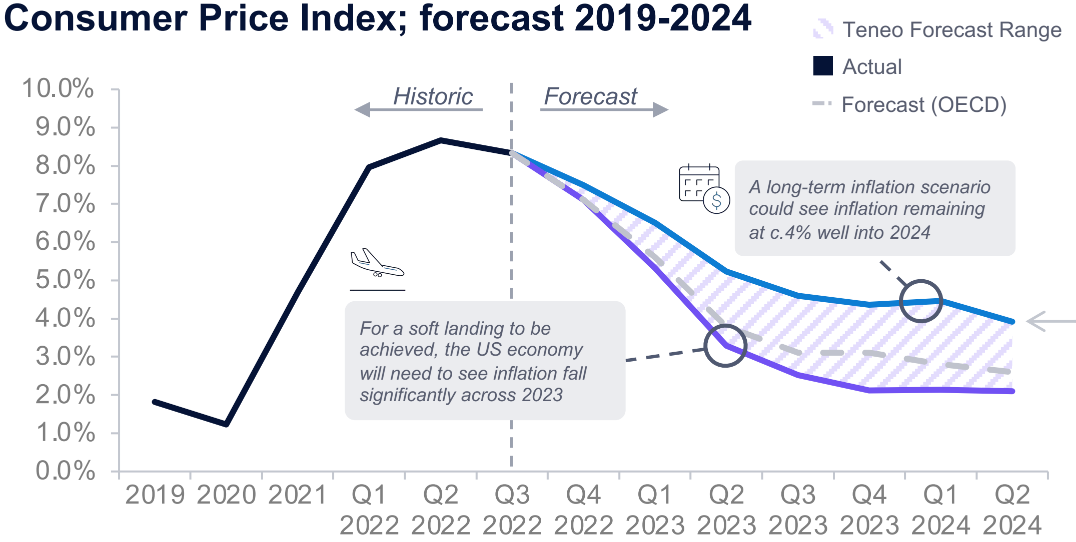
A small number of key economic factors are likely to dictate the overall outlook

The speed and the extent to which inflation returns to pre-2021 levels depend on a number of key factors. In all scenarios, we expect to see a material softening of inflation in 2023, returning to target inflation levels of 2% by 2024 in the case of a 'soft landing.'

Integral to the economic outlook over the next 12-18 months is how quickly inflation returns to pre-crisis levels. Inflation will naturally fall across 2023 as prices are compared to the already high levels seen in 2022. Furthermore, with the Fed raising interest rates earlier and more aggressively than other geographies, it hopes to return to the target levels of 2% by 2024.

However, there are several headwinds facing the U.S. that may result in medium to long-term inflation remaining high, and it is not a given that the U.S. will continue to see the low levels it has seen historically.

Consumer Price Index; forecast 2019-2024



Impact of long-term inflation (scenario 4)

Long term-inflation will mean that the Fed will have to keep interest rates at current levels (or potentially higher)

This is likely to impact GDP as consumers reduce spending, in response to prolonged real wage declines, and businesses reduce investment

In this scenario, the U.S. is likely to see low or declining growth for a prolonged period

Source(s): BLS, Teneo upper and lower bound based on consolidation of forecasts (TD Economics, SPF, Deloitte, OECD, Bloomberg, CBO)

Key drivers of go-forward inflation

Fed Response

Raising interest rates increases the cost of borrowing, which in turn impacts demand, putting downward pressure on prices.

The Fed has been proactive in raising interest rates as a response to inflation, with this strategy expected to continue.

Geopolitical Issues

Continued geopolitical turmoil in Europe, as well as COVID-19 outbreaks in China, could continue to disrupt the supply chain and create excess demand through shortages, driving prices upwards.

Labor Supply Shortages

There are structural issues in the labor market, which have included inactivity and long-term sickness, which have resulted in skill shortages.

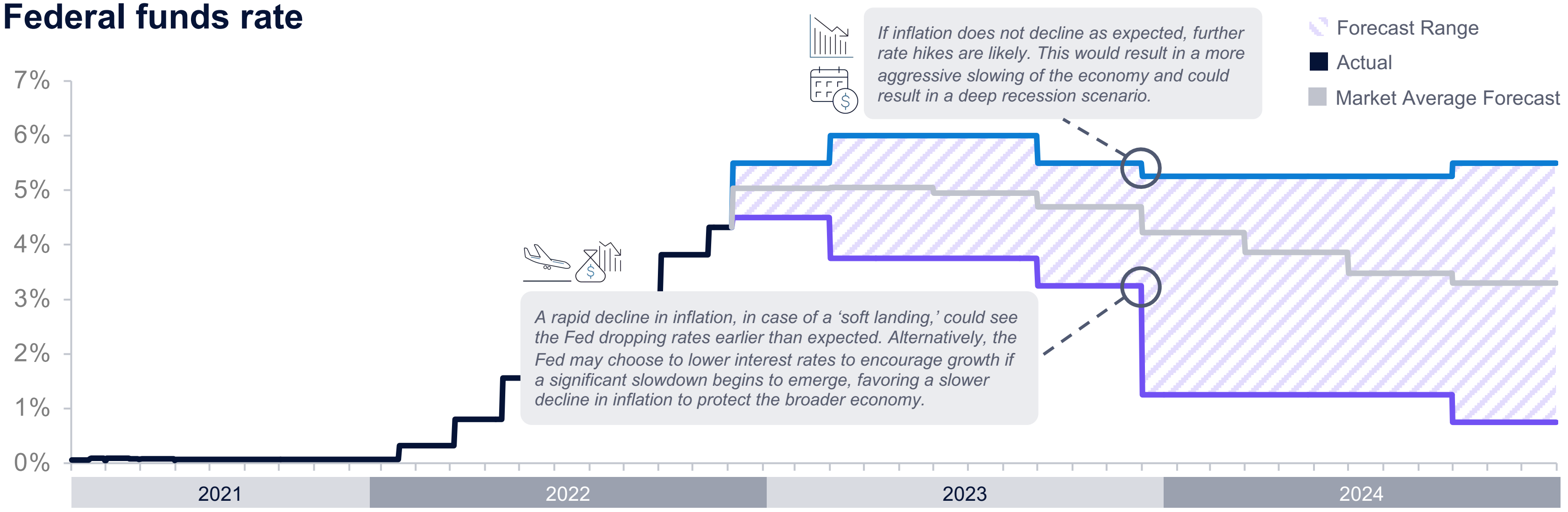
While this lowers the risk of widespread unemployment being triggered by a downturn, it has placed upward pressure on wages, which may drive further inflation.

Interest rates are expected to continue to rise through the first half of 2023 before declining from 2024 onwards.

While consensus appears to be that the Fed is likely to begin lowering interest rates in the second half of the year, there are a number of scenarios in which a significantly different profile may be seen.

If inflation turns out to be harder to unwind than anticipated, the Fed may choose more aggressive rises at the expense of growth. On the other hand, a faster easing of inflation or a more significant slowdown arising from interest rate rises may result in earlier lowering.

Federal funds rate



Source(s): Bloomberg, Federal Reserve, Teneo Research and Analysis

When could the Fed keep raising interest rates?

Inflation proves to be harder to unwind than expected

If inflation remains higher for longer than expected, the Fed may have to increase interest rates further so that long-term inflation expectations can be managed back to the target level.

When could the Fed lower interest rates?

Inflation returns to target quicker than expected

If inflation starts to show signs of falling in early 2023, the Fed may choose to lower interest rates earlier than expected.

Instability in the labor or housing market

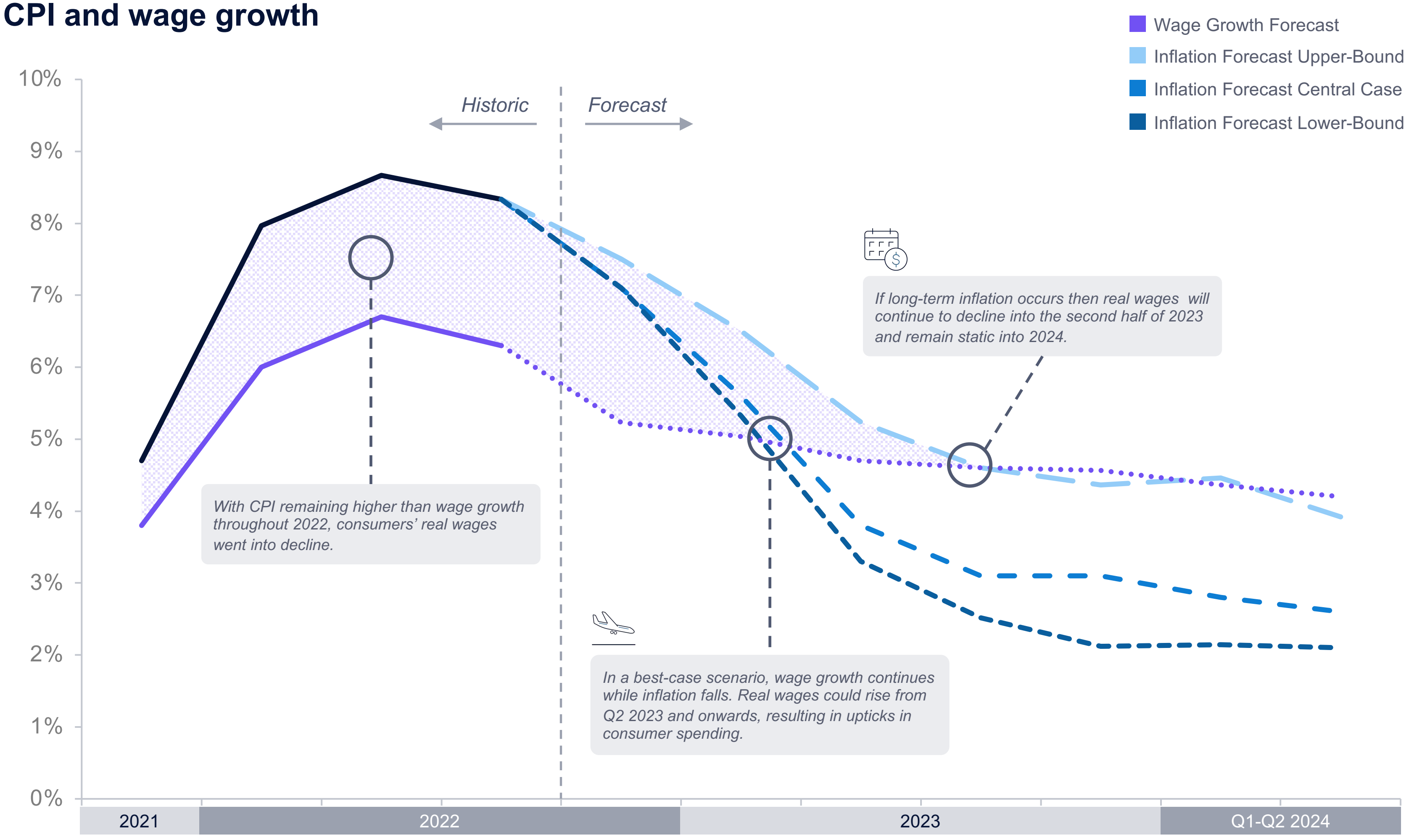
If the housing market or labor market begins to show significant signs of trouble, such as large upticks in unemployment or significant declines in house prices, the Fed may choose to lower rates earlier to encourage growth.

A soft landing or a mild recession could mean real wages start to increase by mid-2023.

How quickly real wages return to growth is critical for the economic outlook and a key driver of consumer spending. Individuals saw declines in real wages across 2022 and, as a result, have begun feeling less well-off than they did 12 months ago. This is further exacerbated as savings accumulated during the pandemic are reduced. In a soft landing scenario, real wages are expected to grow again by early 2023.

However, long-term inflation could see real wages declining throughout 2023 and then remaining static for a prolonged period. It is in this scenario that we would expect to see the greatest impact on consumer spending.

CPI and wage growth



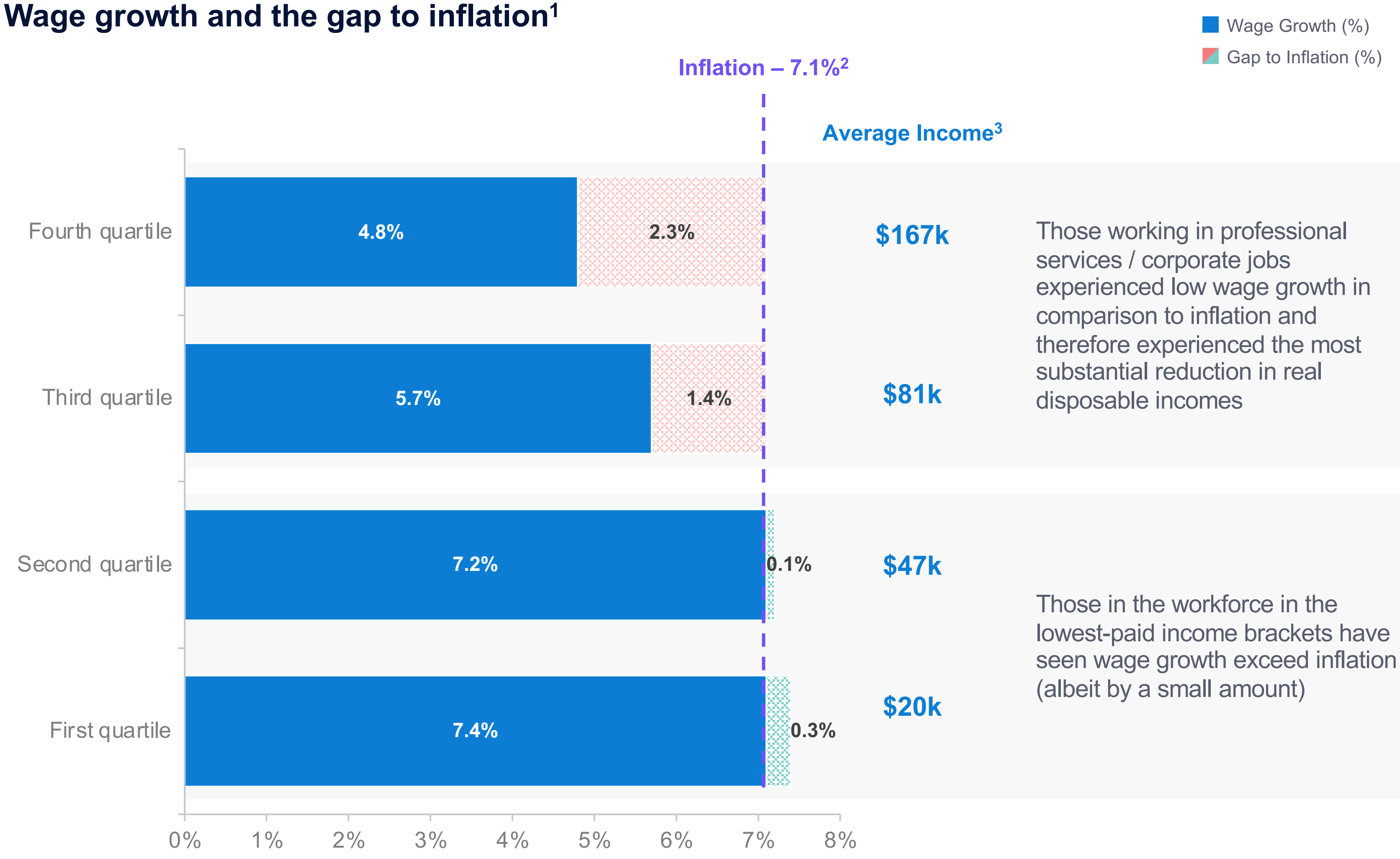
Source(s): BLS, Bloomberg, OECD, Atlanta Fed, PIIE, Teneo Research & Analysis

Over the past 12 months, individuals across lower income brackets have seen faster wage growth, reversing historic trends.

The impact of these declines is not evenly distributed, with high-income households being disproportionately impacted by declines and, therefore, more likely to see the largest drops in consumption.

This is distinct from what is being observed in other geographies, such as the UK, where wage growth in higher income groups has outpaced lower income groups.

Wage growth and the gap to inflation[1]



Those working in professional services / corporate jobs experienced low wage growth in comparison to inflation and therefore experienced the most substantial reduction in real disposable incomes

Those in the workforce in the lowest-paid income brackets have seen wage growth exceed inflation (albeit by a small amount)

Source(s): BLS, Atlanta Fed, FRED, Teneo Research & Analysis

Note: [1]Covers 12 month moving average of median wage growth and inflation by income as of November 2022 [2]Inflation November 2022 [3]Average income is after taxes and includes all sources of income for 2021

Declines in real wages, coupled with low consumer confidence, are likely to translate into a drop in consumption in the highest income groups.

Real wage declines in the top income brackets are resulting in drops in consumer confidence as households feel less well-off. Consumer confidence is now at lower levels than during the 2008 GFC and the COVID-19 pandemic.

Going forward, this is expected to have a knock-on impact on consumption, with low confidence resulting in households choosing to preserve savings and reduce consumption. Reduced consumption, particularly in high-income groups who make up a significant proportion of overall consumer spending, is likely to have a significant impact on outlook and has the potential to tip the economy into a recession.

Anticipated impact on consumption

Negative outlook | Moderate outlook | Positive outlook

Income bracket	Wage increase[1]	Inflation[1]	Implied real wage growth	Overall proportion of expenditure	Consumer confidence	Consumption forecast
Upper quartile	4.8%	7.1%	-2.3%	44%	↘	↓
Third quartile	5.7%		-1.4%	25%	↘	↘
Second quartile	7.2%		0.1%	18%	→	→↗
Lower quartile	7.4%		0.3%	12%	→	→↗

Source(s): BLS, Atlanta Fed, FRED, Teneo Research & Analysis

Note: [1]Covers 12 month moving average of median wage growth and inflation by income as of November 2022

Higher income groups are likely to reduce consumption

Larger drops in consumption are expected in groups that have experienced a real wage growth decline over the last 12 months.

Since the highest income bracket accounts for 44% of expenditure, even a small decline in real wages and confidence can have a significant impact on overall outlook.

Lower income groups are likely to maintain consumption to cover spend on essential goods

Since the lowest income quartiles have had real wage growth, we do not expect to see the same declines in consumption.

In the scenario of a 'soft landing,' it is possible that consumption of discretionary products may increase if wage growth momentum continues and inflation falls within this group.

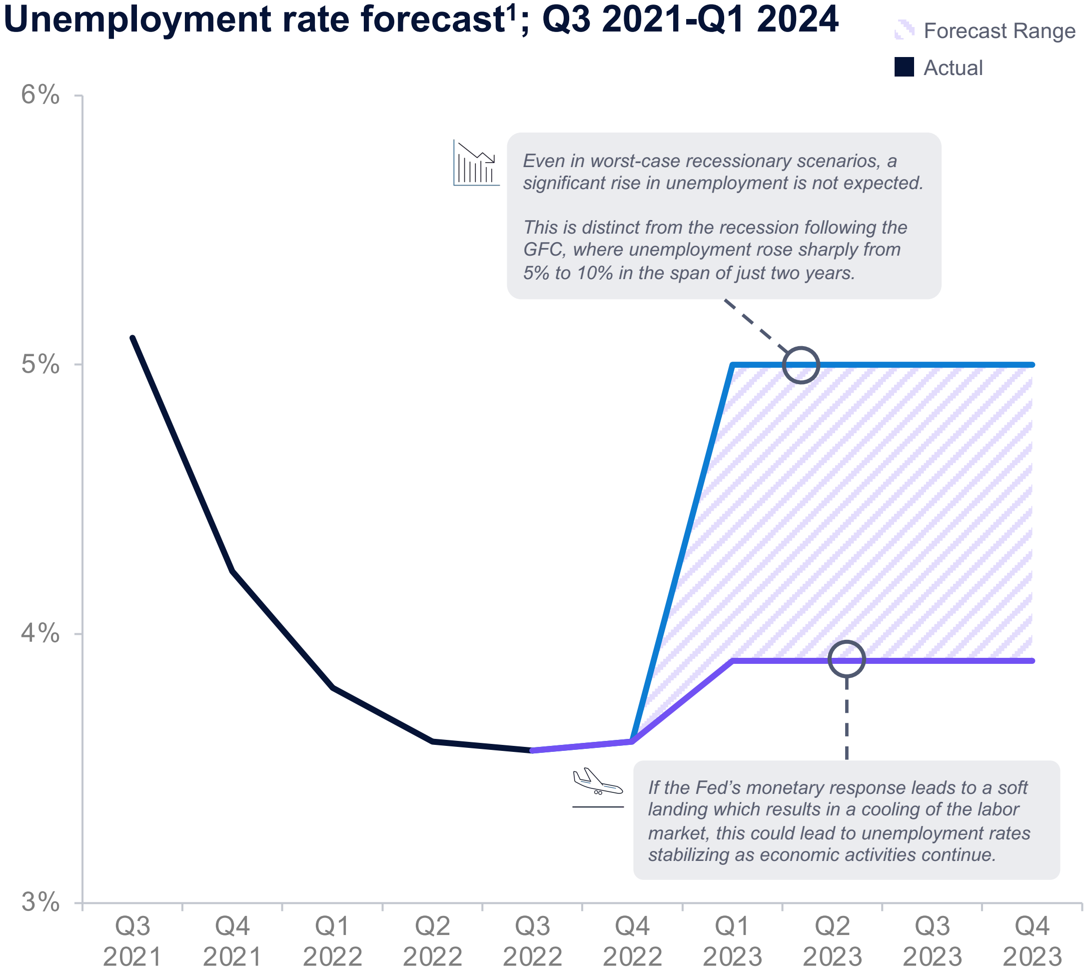
While the U.S. labor market seems healthy on the surface, there are structural challenges that have the potential to create headwinds in the upcoming 12-18 months.

The U.S. labor market, on the whole, appears strong. Low levels of unemployment and high amounts of open positions mean that although unemployment is likely to increase as a result of interest rate rises, the general consensus is that this softening in the labor market will be modest. Even in worst case or more pessimistic forecasts, unemployment is only set to rise to 5%, well below the levels seen during the GFC. However, while unemployment may not rise significantly, structural challenges in the labor market, including low participation and high levels of long-term sickness, are creating supply challenges that may put further pressure on inflation.

Sources: United Nations, Prudential, Statista, Teneo Research & Analysis

Note: [1]Not seasonally adjusted

Unemployment rate forecast[1]; Q3 2021-Q1 2024



Source(s): FRED, Teneo upper and lower bound based on consolidation of forecasts (Conference Board, TD Economics, Federal Reserve, SPF, Deloitte, OECD)

Structural challenges facing the U.S. labor market

Low participation rates

Over the last 20 years, the labor force participation rates in the U.S. have been declining from an all-time high of 67.3% in January 2000 to 62.1% in November 2022, resulting in labor shortages.

High levels of long-term sickness

U.S. life expectancy has declined by 0.6 years in the period from 2010 to 2022; 78.8 in 2010 to 78.2 in 2022.

In Europe, the increase over the same period has been 1.4 years to 82.1 in 2022.

Rising chronic health problems mean that workers are less productive and absenteeism increases, thus reducing economic output.

In fact, the CDC estimates that six in ten adults in the United States live with a chronic disease.

Cultural shifts

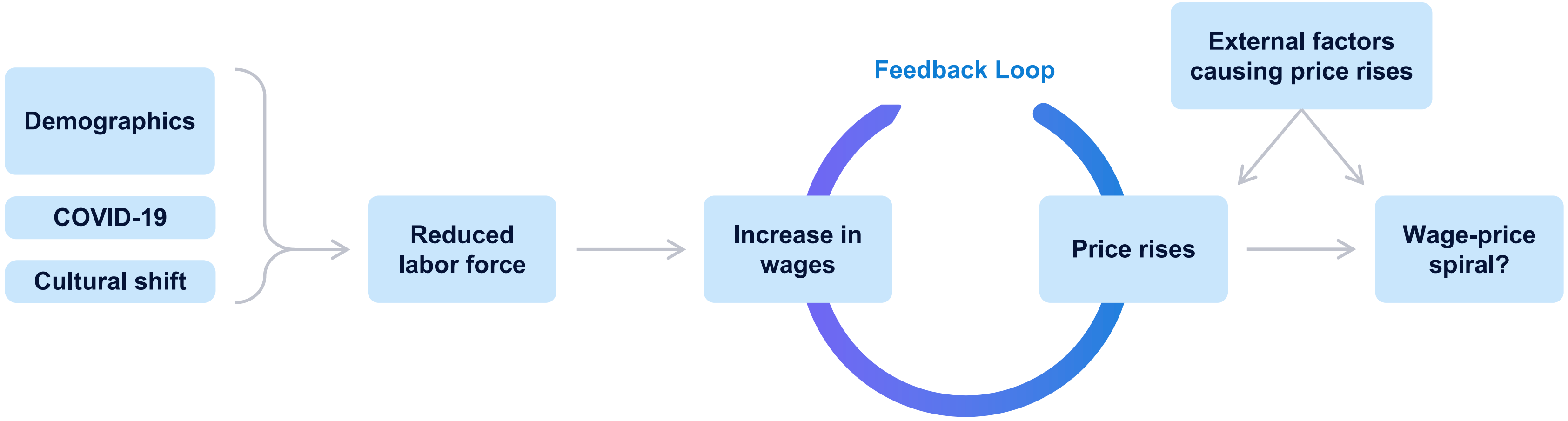
Following the pandemic, 38% of workers looking for a new job were doing so because of work-life balance challenges.

Since certain job roles are limited by the type of flexibility they can offer, certain sectors will likely face labor shortages as workers transition to alternative careers.

Supply-side shortages created by structural challenges in the labor market could lead to further wage pressure and drive up inflation as a result.

While low levels of unemployment and high amounts of open positions today generally point to a strong labor market, this is a dynamic primarily driven by supply-side shortages rather than strong growth in business output. These supply-side shortages are creating upwards pressure on wages. While this wage growth has helped individuals partially cover the cost of rising inflation, it can also be a driver of further inflation.

How supply-side shortage can lead to a wage-price spiral



As the economy began to recover following the easing of lockdowns, **businesses across the economy started hiring**. However, there were **supply-side problems** which meant that workers were unwilling or unable to return to work.

For those that did start working, cultural shifts meant that willingness to work certain jobs was reduced.

Wages rose as a result, which meant that businesses had to counteract the increased input wage costs by **increasing their prices…**

…the **Russia-Ukraine conflict and pent-up consumer demand from the pandemic compounded** this effect by raising demand, thereby causing further inflationary pressure.

If this feedback loop continues between wages and prices, we could see a **wage-price spiral**, which may result in long-term inflation.

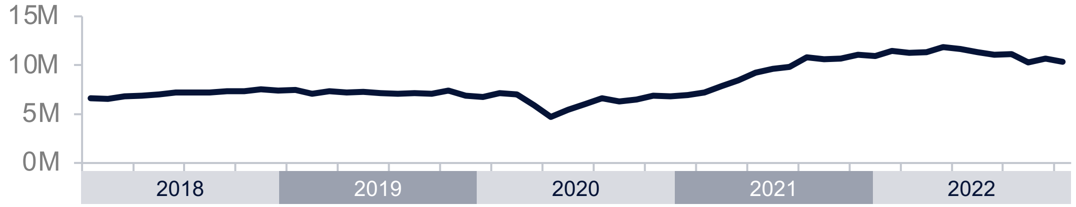
Unfilled job vacancies

There were **10.3 million unfilled job vacancies** across the U.S. economy in **October 2022**

Prior to the pandemic, there were 7.4 million unfilled job vacancies in October 2019

Total unfilled job vacancies

Source(s): FRED



Changes to interest rates, inflation and suppressed consumer demand will have a direct impact on business output.

Highly likely / high magnitude   Likely / medium magnitude   Unlikely / low magnitude

Industry	% of total U.S. output	Sensitivities				Commentary
		Sensitivity to change in interest rates	Sensitivity to inflation	Sensitivity to change in consumer spend	Overall outlook	
Finance and real estate	20.2%	High	Medium	Medium	↓	Increasing interest rates are likely to result in lesser borrowing and lower demand for real estate and mortgages
Industrials[1] and construction	14.9%	Medium	Medium	Low	↘	Large-cap construction projects are likely to be delayed significantly due to higher borrowing costs; high materials costs are likely to dampen industrials
Professional services	13.0%	Low	Low	Low	→	Professional services are likely to remain resilient as they are less exposed to interest rates and consumer spending, but may face increased labor costs via wage inflation
Retail and wholesale trade	12.1%	Low	Medium	High	↓	A decline is expected as consumers seek to reduce discretionary spending and retailers face higher goods and labor costs
Government	11.6%	High	Medium	Low	↘	Recession may increase need for social security and welfare payments, exacerbating the existing budget deficit brought about by COVID-19 spending
Education and healthcare	8.3%	Medium	Medium	Low	→	Health spending is likely to remain resistant due to its non-cyclical nature; however, the strong dollar may deter foreign investment
IT and communications	5.4%	Low	Low	Low	→	Although not severely impacted by interest rates or consumer spending, customers may choose to delay upgrades or 'trade-down' for lower cost providers or services levels
Agriculture and mining	3.3%	Medium	Medium	Low	↘	Higher interest rates may impact debt repayments on capital expenditure, while inflation is likely to drive up the cost of raw materials
Transport and storage	3.2%	Medium	Medium	High	↘	Consumers will likely reduce non-essential travel, and airlines seek to recoup losses from COVID-19 travel bans
Accommodation and food	3.1%	Low	Medium	Low	→/↘	Despite being essential, overall spending is likely to decline where consumers choose to trade down to cheaper alternatives
Energy and utilities	1.8%	Medium	Medium	Low	↘	Spend will likely increase as energy prices remain high
Arts, entertainment, and recreation	1.0%	Low	Medium	High	↓	Sector will likely decline as consumers reduce non-essential spending

Source(s): US Bureau of Economic Analysis, Teneo Research & Analysis **Note:** [1]Includes manufacturing, and materials

Section 05

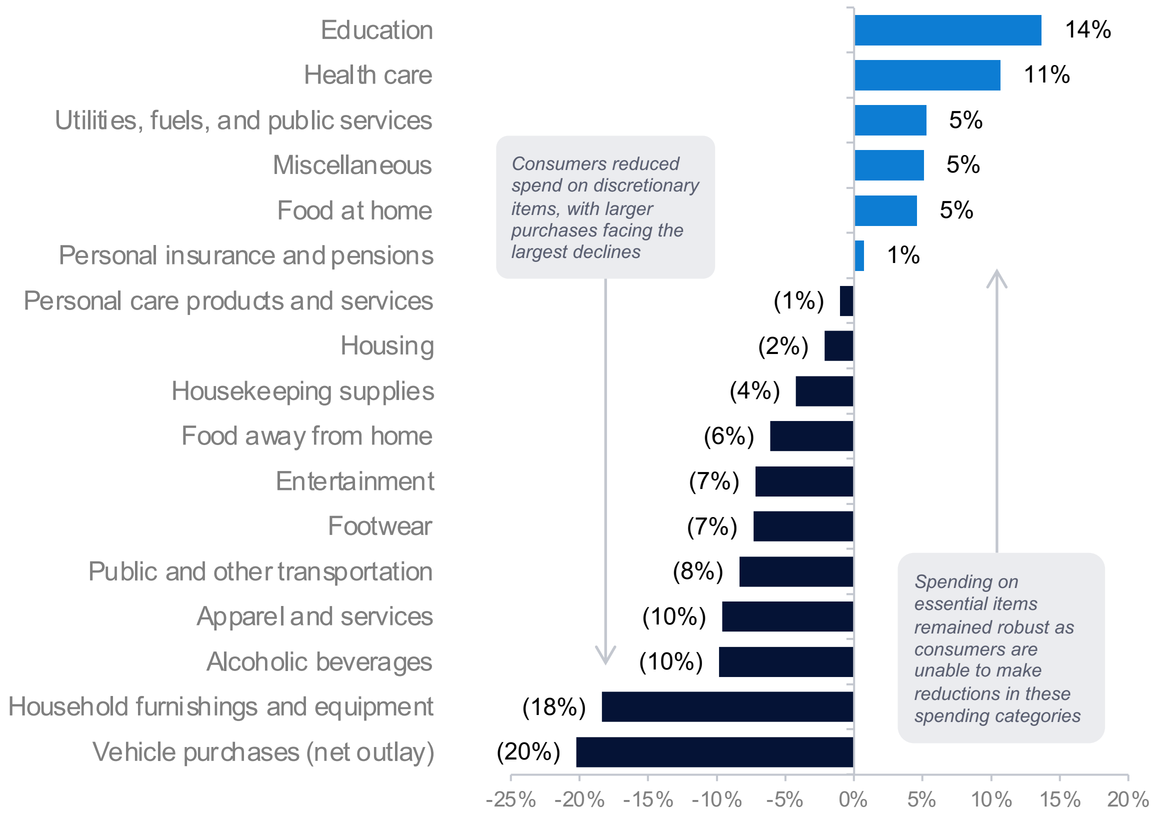
Sector-Specific Outlooks

We expect reductions in consumer spending, rising cost of capital and reduced investment to acutely impact certain industries

Consumer-Facing Industries

Any reductions in consumer spending are expected to acutely impact discretionary consumer-facing industries, as individuals re-prioritize spending as household income declines.

% change in average consumer expenditure towards each expenditure category, 2007-2010, U.S.



Source(s): Consumer Expenditure Survey (US Bureau of Labor Statistics)

As consumption declines, significant changes in spending behaviors are expected

Evidence from the 2008 GFC is informative regarding where consumers may cut back. For instance, between 2006 and 2010, U.S. consumers materially adjusted their proportional household spend in order to prioritize certain goods and services over others. However, today's environment is different in several ways.

Greater competition for spend

There are a number of goods which were previously considered discretionary but are now considered essential and therefore are fighting for a wallet share, including broadband, mobile telephone and streaming services.

Latent demand for unavailable COVID-19 activities

Consumers have been prevented from travel and tourism activities. There is evidence that consumers are looking to travel more and prioritize that spend. In 2022, 60% of travellers planned on visiting a new desitination[1]. This makes it likely that consumers trade down in other areas of expenditure categories.

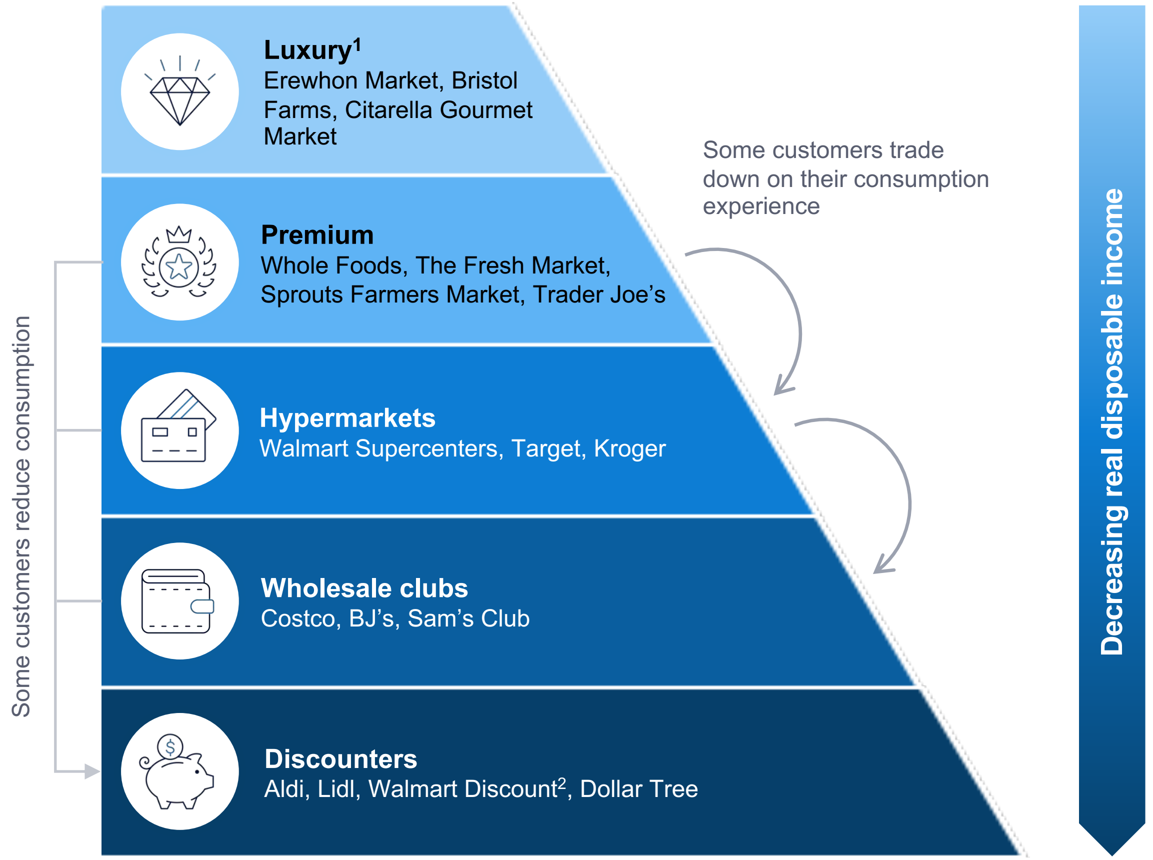
Source(s): Labor Turnover Survey (US Bureau of Labor Statistics); Morgan Stanley; CNN Business, OAG, Teneo Research & Analysis

Note: [1]Results from a survey in April and May 2022 via OAG's flight tracking app

Consumer-Facing Industries

Beyond a reduction in spending, consumers are also more likely to ‘trade-down’ their current spending for cheaper alternatives. Retailers that can demonstrate value for money are likely to win over trade-down customers.

Indicative ‘trade-down’ behavior for major U.S. supermarkets



Key discounters have reported greater-than-expected earnings as consumers aim to save money – Walmart reported 8.2% growth in Q3 2022

Consumers may switch to cheaper alternatives due to current economic conditions

Signs of ‘trade-down’ behavior are emerging, with a consumer survey from September 2022 indicating that 70% of respondents indicated they were trading down[3].

In the event of persistently high inflation and low growth, it is likely that consumers will continue to ‘trade-down’ throughout 2023 to offset reduced real incomes.

For businesses to retain customers and protect against trade-down behavior, they need to be competing on the value for money they provide – offers and loyalty will become increasingly important.

In addition, unlike previous slowdowns, another emerging ‘trade-down’ market segment is poised to see significant gains:

Resale market growth
Increasingly environmentally aware consumers will look to save money by purchasing second-hand. The second-hand fashion market is set to grow by 26% across 2023[2].

Source(s): [3]US Consumer Pulse Survey (Morgan Stanley); 2thredUP, Teneo Research & Analysis
Note: [1]Luxury segment tends to trend more regional than national, [2]Corporate identifies discount stores separately to supercenters

Real Estate

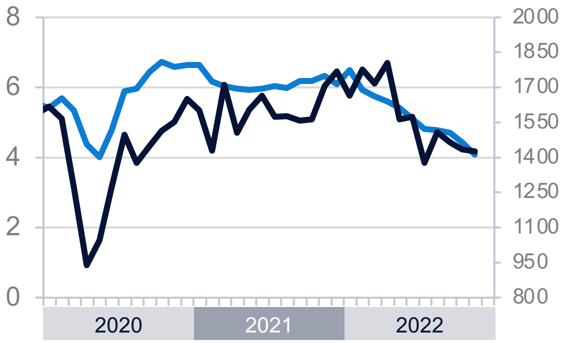
Interest rate rises have had a major impact on the housing market with mortgage rates doubling in the last 12 months, resulting in steep declines in activity and falls in house prices.

Increasing mortgage rates are pricing consumers out of the market...

Period	Avg 30 yr mortgage rate	Est. total mortgage repayment, 30 years[1]
Q4 2023 (forecast)	6.2%	$811,800
Dec 2022	6.4%	$830,880 (46% increase in repayments)
Dec 2021	3.1%	$566,640

Source(s): Mortgage Bankers Association of America, Freddie Mac, Teneo Research & Analysis

...resulting in large declines in home sales and falling prices



-5.6%

...predicted **fall in house prices** over **2023**[2]

Source(s): FRED Economic Data, US Census Bureau, Teneo Research & Analysis

Impact on demand and household income

Reduction in demand
As mortgage rates rise, consumers are priced out of the market. **Over 70% of the U.S. population cannot afford the median mortgage rate** as it stands.

Reduction in supply
As demand dries up, supply can also be affected, as homeowners choose not to move until mortgage rates are more favorable and house prices stronger.

Cost of living
Any homeowners on variable mortgages will have to endure increased monthly repayments, diverting spend from other areas of the economy.

Impact on wider economy

Decline in wealth/ Wealth effect
As wealth declines in the economy, **consumers tend to tighten** spending and increase savings, even more so if there is widespread negative equity.

Reduced borrowing
Homeowners are **less likely to undergo equity withdrawals** when the price of their home is lower than expectations. Subsequently, activity in financial markets may fall.

Reduced construction activity
Declining house sales impact the wider contraction and real-estate industries. Fewer house sales lead to lower associated activity, such as home improvements.

Source(s): FRED Economic Data, Mortgage Bankers Association of America, Freddie Mac, Teneo Research & Analysis
Note: [1]Calculated using the average mortgage value of a house: $387,600 (Dec 2022) multiplied by the Avg. 30 year mortgage rate [2] Forecast from Case-Shiller survey of 25 house pricing strategists

Industrials

Though initial warning signs are there, the industrial and manufacturing sector is likely to be more insulated than other industries due to pent-up demand, offsetting price pressure.

Sources: ISM PMI, Teneo Research & Analysis

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Purchasing Managers Index (PMI) indicates the industry is in decline

PMI is a leading indicator, calculated using survey responses from purchasing managers in the U.S. economy, that gauges the outlook for the manufacturing sector based on five key components (right).

PMI (Dec 2022)

48.4

Previously 49.0

A score above 50 suggests the industry is in expanding

A score below 50 suggest the economy is contracting

The latest readings suggest the industry is in decline and will continue to decline

- **Overall sector outlook is neutral/negative for 2023**, as high order backlogs, easing supply chain pressures and margin tailwinds from recent price increases offset weaker macroeconomic growth.
- **Pent-up demand has driven solid orders through Q3 2022 for most issuers,** which should support mid-single digit sector revenue in 2023.
- **Demand risks include** China's Zero Covid policy, the Russia-Ukraine conflict and capital spending.

PMI underlying components

Expanding / Contracting

PMI components	Dec Index	Nov Index	Ppt. Change	Direction
New orders	45.2	47.2	-2.0	↘
Production	48.5	51.5	-3.0	↘
Employment	51.4	48.4	+3.0	↗
Supplier deliveries	45.1	47.2	-2.1	↘
Inventories	51.8	50.9	+0.9	↗

Additional indicators	Dec Index	Nov Index	Ppt. Change	Direction
Pricing	39.4	43.0	-3.6	↓
Order backlog	41.4	40.0	+1.4	↗

In the manufacturing sector, downward pressures are coming from a lapse in new orders, production and supplier deliveries. Additionally, inflation pressure is driving up costs, though this is expected to lessen for 2023.

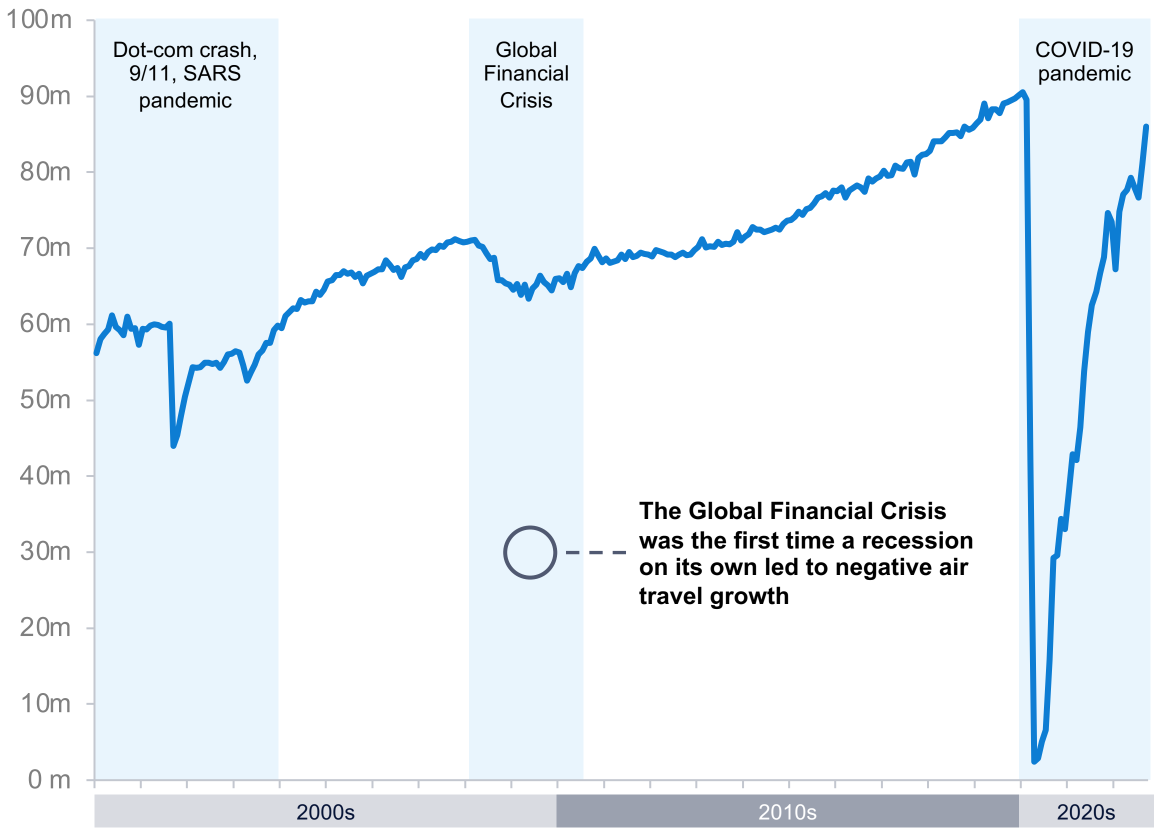
That being said, employment is **expanding,** and though inventory levels are unusually high, the risk of write-off is limited, largely due to products waiting on components for completion and companies holding higher a safety stock of key raw materials. Additionally, a backlog of orders is supporting growth.

Aerospace and Aviation

Aerospace and aviation are highly cyclical businesses and are heavily connected to the state of the economy.

Source(s): US Department of Transportation; (Franke and John, 2011) What comes next after recession? – Airline industry scenarios and potential end games, Teneo Research & Analysis

Revenue passenger miles (number of miles travelled by paying passengers) for domestic and international flights in the U.S., Jan 2000-Sep 2022



Source(s): US Department of Transportation

Key features of the airline performance during recessions

Cyclicality with GDP Growth

Airline profit cycles closely follow that of the economy, as aviation demand is primarily a consumption-led phenomenon – in 2009, at the height of the GFC, air traffic dropped 6.1%.

Lagged recoveries

Passenger numbers generally lag behind the recovery in industrial output due to reliance on employment and household incomes; this lag is exacerbated further for 'premium' class travel as opposed to 'economy' class.

Freight often recovers before passenger travel

As freight is linked inextricably to industrial output, and is typically a preferred mode of transport for shipping due to its low transit times, it often recovers first – during the GFC, freight began recovery four months before world trade and two months before industrial production.

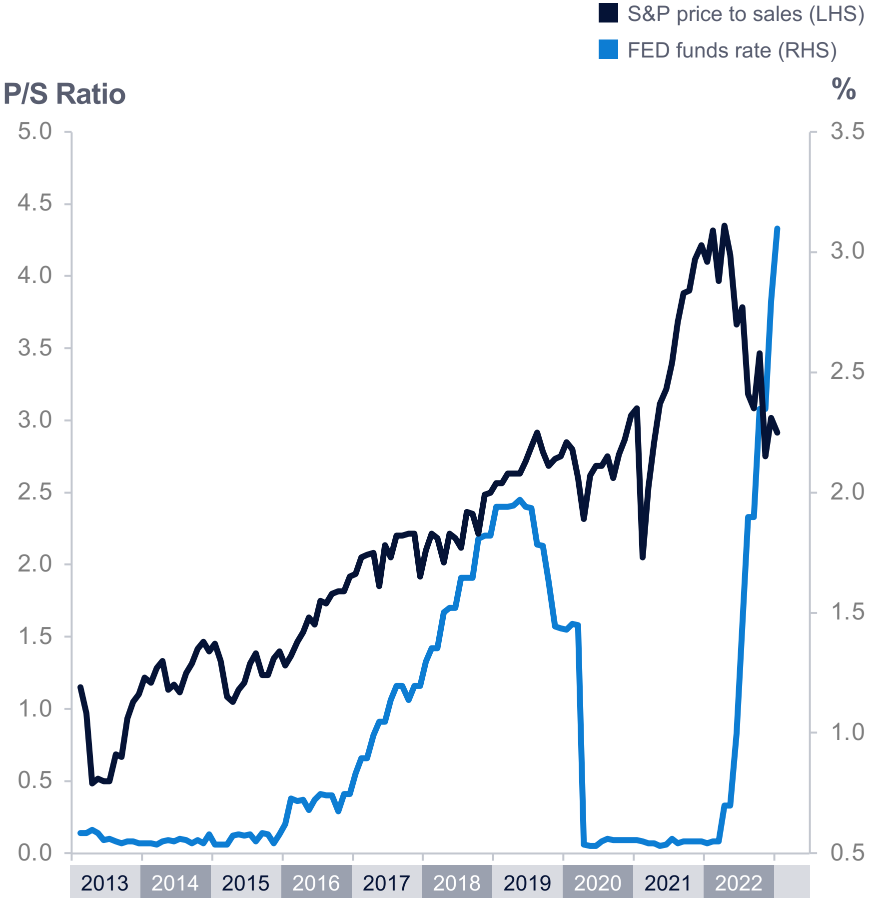
Aviation and aerospace players should see the looming recession as a considerable headwind

Private Equity

Private equity houses have become accustomed to operating in low-interest rate and low-inflationary environments. The highly leveraged nature of this industry poses potential risks to the sector going forward.

Source(s): S&P Capital IQ, FRED Economic Data, Teneo Research & Analysis

Valuations are falling as interest rates are on the rise….



Source(s): S&P Capital IQ, FRED Economic Data, Teneo Research & Analysis

…and there are a number of challenges faced by the sector

Economic uncertainty
Over the past five years, private debt funds have done exceedingly well, with fundraising almost doubling. However, inflation and the rising cost of capital continue to alter deal values and influence the financial markets.

Rising interest rates increasing cost of debt
Historically PE firms have enjoyed low cost of debt due to low-interest rates; as interest rates rise to curb inflation this poses higher risk to PE firms.

Decreasing capital calls
During the previous financial crisis, capital calls (collecting funds from limited partners) dropped substantially, though this is expected to be less pronounced than the crisis of 2008/09 given the more sustainable pace of contributions over the past decade.

Re-direction of investment
With the high-interest rate environment, investors may seek to re-direct funds away from riskier investments and lock in a guaranteed return. That being said, if the Federal Reserve starts a cycle of interest rate cuts this may well see an uptick.

Dollar strength
Strength in the dollar typically leads to more outbound M&A and less inbound M&A given relative prices, though this trend is known to break during times of recession.

EBITDA multiples
Private equity has enjoyed significant value creation at the point of sale through EBITDA multiple expansion; as multiple expansion slows, we expect the value created by PE firms to decline.

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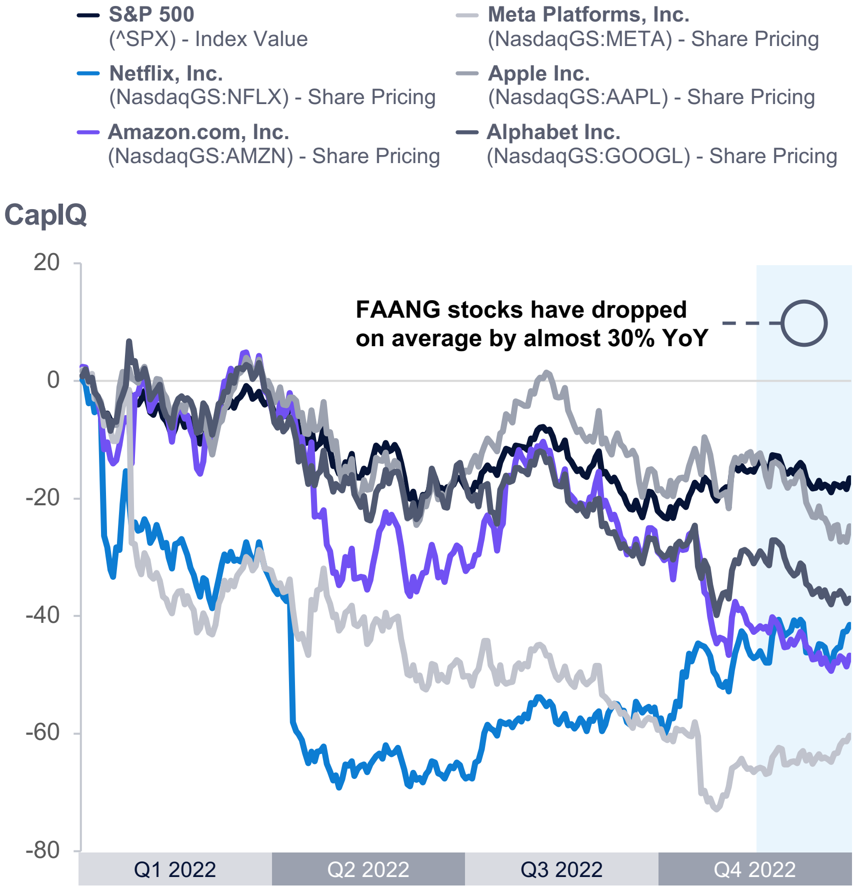
Technology

Amid increasing interest rates, investors fail to see the value in technology stocks as the path to growth is unclear.

FAANG stock performance versus S&P 500 (2022)



Source(s): Barron's, Garnter, Forbes, Reuters, CNBC, CBInsights, Deloitte, S&P Global, Teneo Research & Analysis

Increasing interest rates will lead to a number of hurdles for the industry

Limited access to cheap capital
Rising interest rates have discouraged investors from making risky moves. VC investment dropped ~34% QoQ in Q3 2022, the largest drop in a decade.

Revenue growth below expectations
Investment has been high in technology companies assuming ambitious growth targets. These expectations have not been borne out.

Decline in ad spend
Tightening budgets have caused advertisers to pull back on spend. For many tech firms like Meta, ad spend is the primary revenue stream.

Decline in consumer purchases
Consumers are putting off device purchases due to decline in purchasing power. E-commerce sales are also expected to continue to taper off into 2023.

Continued pressure on labor market
90,000+ tech worker layoffs occurred as part of double-digit percent layoffs in 2022. This comes amidst a broader labor shortage affecting up to two million manufacturing workers.

Continued strength of the dollar
Tech sectors have more international revenue exposure than the rest of the S&P 500 and are experiencing the dollar cutting into revenues from abroad.

Section 06

Comparisons

Compared to Europe, the U.S.'s outlook has improved in recent months

Previous U.S. slowdowns and recessions can inform the likely outlook of the next 12-18 months.

	1970s stagflation	Early 1980s recession	Early 1990s recession	Early 2000s dot-com crash	2008 Global Financial Crisis	2020 COVID-19 recession	Today
Scale and length	**Five consecutive quarters** of negative growth between Q2 1974 and Q2 1975, bottoming out at -2.3% growth q-o-q	**Four consecutive quarters** of negative growth between Q1 1982 and Q4 1982, bottoming out at -2.6% growth q-oq	**Three consecutive quarters** of negative growth between Q1 1991 and Q3 1991, bottoming out at -0.9% growth q-o-q	**No consecutive quarters of negative growth,** but seven consecutive quarters of declining growth from Q3 2000 to Q4 2001	**Four consecutive quarters** of negative growth between Q4 2008 and Q3 2009, bottoming out at -4.0% growth q-o-q	**Three consecutive quarters** of negative growth between Q2 2020 and Q4 2020, bottoming out at -8.4% growth q-o-q	While there are diverging views on the exact profile, market consensus suggests slow growth and/or declines lasting throughout 2023
Causes	**External shocks** via the 1973 oil crisis and the fall of the Bretton-Woods system, exacerbated by **policy intervention** to curb inflation	**Contractionary monetary policy** to reduce inflation caused by **external shocks** via the 1979 energy crisis and the Iranian Revolution	**Contractionary monetary policy** to reduce inflation caused by **external shocks** via the 1990 oil price shock and **internal shocks** via the Tax Reform Act	**Contractionary monetary policy** to reduce inflation caused by a **stock market bubble** which precipitated lower consumer and business confidence	**Financial crisis** via the U.S. housing market crash and liquidity crisis, which reduced consumption and investment activity substantially	**Government policies** to combat the effects of the COVID-19 pandemic, primarily lockdowns and social distancing	**Contractionary monetary policy** to curb inflation caused by **rising energy prices** and **a strong labor market**

Comparisons to 2023

The Federal Reserve needs to **balance boosting economic activity while maintaining inflation**, which limits the extent to which expansionary monetary policy can be leveraged and may result in a prolonged period of challenge

A **soft landing scenario most closely mimicking the dotcom crash**, defined by a prolonged period of slow growth

A **deep recession/long-term inflation scenario** may be closer to the stagflation of the 1970s

Businesses should seek to prepare for a prolonged high interest rate environment, unlike previous recessions

Source(s): Teneo Research & Analysis

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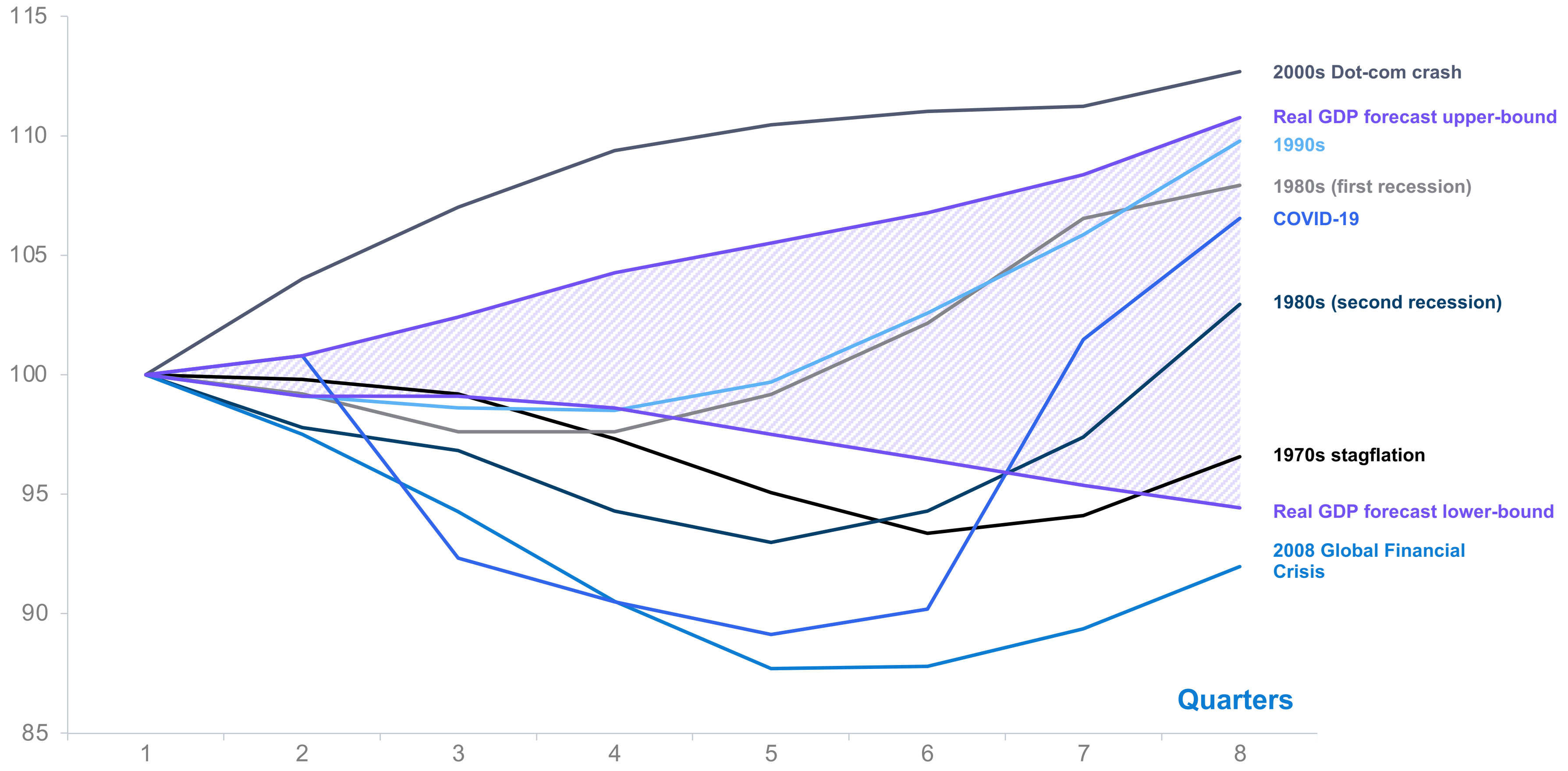
Previous U.S. slowdowns and recessions can inform the likely outlook of the next 12-18 months.

Real GDP growth in the U.S., indexed to one quarter before the start of the recession caused by these events (re-based to 100)



Source(s): Teneo Research & Analysis

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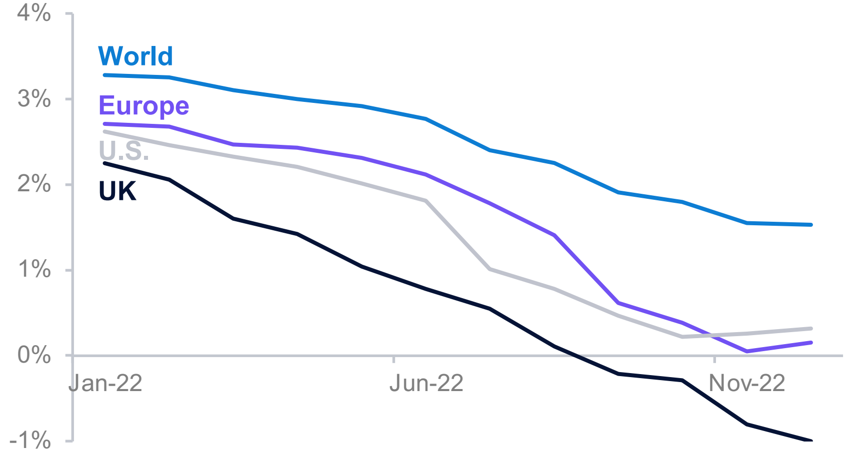
Compared to Europe, the outlook for the U.S.'s GDP growth in 2023 has improved in recent months due to stronger economic performance.

For the majority of 2022, U.S. growth in 2023 was forecasted to be lower than that in Europe. This trend has reversed since Q4 2022. The U.S. is now expected to perform better than Europe throughout 2023 for several key reasons:

- U.S. response to inflation in 2022 was rapid – the Fed raised interest rates before other major economies.
- European dependence on energy from Russia meant that the 2023 outlook for real GDP in Europe has been further revised downwards as the conflict continues.

GDP annual growth forecast for 2023 of selected countries, revised over the course of 2022



Source(s): Consensus Economics, Teneo Research and Analysis)

Factors contributing to improvements in the U.S.'s economic forecasts

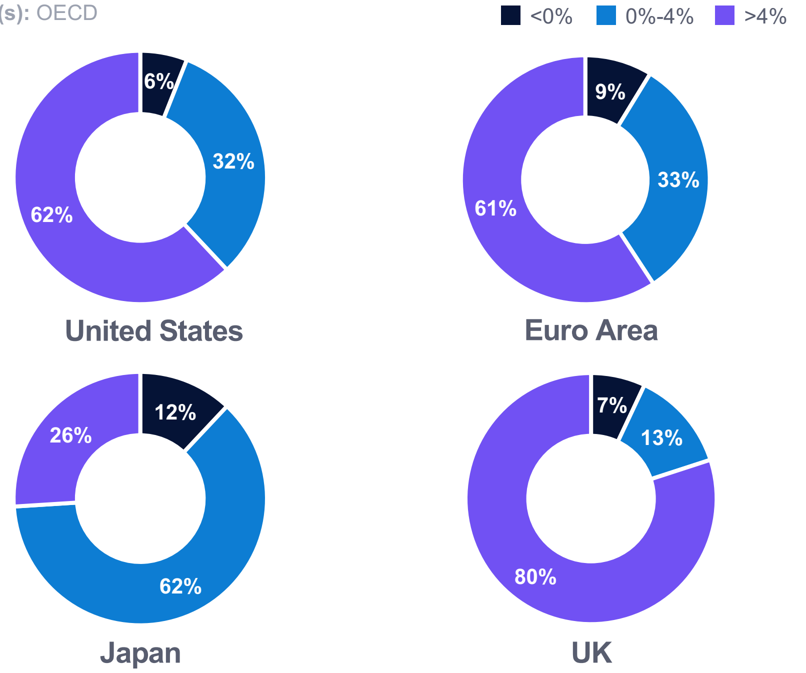
Raising interest rates early in 2022 when inflation initially appeared

Strong performance in the labor market throughout 2022

Less exposure to cheap energy from Russia in comparison to European countries

Inflation impact on % of consumer baskets around the globe (OECD)

Source(s): OECD



Country	Current Interest Rate	Nov-22 Inflation Rate
United States	4.5%	7.1%
Euro Area	2.5%	10.1%
Japan	-0.1%	3.8%
UK	3.5%	9.3%

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