KPMG Economics

Bursting the Pandemic Bubble: Rate Hikes and the Consumer

Diane Swonk, Chief Economist
KPMG U.S.

"…it was far from obvious that bubbles, even if identified early, could be preempted short of the central bank inducing a substantial contraction in economic activity – the very outcome we would be seeking to avoid."

I was in the audience when former Federal Reserve Chairman Alan Greenspan defended the Fed's strategy of cleaning up after bubbles burst. It was August 2002. The internet bubble had burst. The economy was still struggling to generate jobs long after the 2001 recession had ended.

Fast forward 20 years and his words seem both prescient and omnipresent. Rapid rate hikes are deflating the pandemic-induced bubble in housing and goods. We bought a lot of stuff, to alleviate the monotony of quarantines, that we no longer want. Used boats and jet skis are widely available for resale.

This edition of *Economic Compass* takes a closer look at the consequences of rate hikes and the fallout for consumer spending and inflation. The slowdown in spending thus far has failed to derail inflation, which has prompted the Fed to move the goal post yet again on peak rates. Chairman Jay Powell was clear at his last press conference that he intends to "stay the course until the job is done," even if that means a higher peak in rates and a recession.

Bursting bubbles is a messy business. The drop in home values and rents could be substantial and accelerate the cooling of inflation. This is not a repeat of the 2008-09 subprime crisis in housing, when the drop in home values pushed millions of mortgages underwater. Lending standards have tightened considerably; the cushion on equity is expected to remain substantial.

Peak Growth in the Third Quarter

Real GDP rose by 2.6% in the third quarter after contracting during the first two quarters of the year. An improvement in trade more than accounted for that gain: Exports accelerated while imports plummeted. Domestic demand came close to stalling out. Consumer spending slowed, housing cratered and retailers began to drain bloated inventories. Business investment and government spending rose modestly.

Real GDP is expected to slip back into the red by 0.8% in the fourth quarter. A pickup in spending on services is expected to offset another drop in spending on goods, while a drop in mortgage applications suggests even larger losses for housing and business investment. In September, core factory orders fell at the fastest pace since April 2020. The trade deficit could improve with a drop in imports offsetting a smaller decrease in exports. Government spending is poised to flatline.

Real GDP is forecast to fall at an average 2.5% pace in the first half of 2023 as the effects of rate hikes cumulate. The collapse in housing is expected to spill over to consumer spending. Businesses are expected to pull back and draw down excess inventories. Both exports and imports are expected to fall. Government spending will rise slightly with the largest inflation-adjusted boost to social security in decades, some rebuilding due to Hurricane Ian and a rise in automatic stabilizers. Infrastructure projects are beginning to ramp up.

© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Why Target Employment?

Inflation continued to accelerate in 2022 despite a significant slowdown in growth. The largest, single reason for the persistence of inflation is the unyielding strength in the job market.

The economy generated 4.1 million jobs between January and October, nearly double the annual pace of the 2010s and the second largest increase since 1978. Only 2021 was more robust. That is a stunning number of new paychecks coming on line to buoy aggregate demand and, by extension, inflation.

When job openings rebounded in late September, the ratio of job openings to unemployed, a closely watched measure by the Fed, jumped to 1.9. That is the second highest ever. Labor turnover slowed, which tempered wage gains but not enough to slow the upward pressure on core (nonfood and energy) inflation.

Productivity growth has plummeted, which is also raising unit labor costs. The drop in the first three quarters of 2022 represented the worst since 1982.

The only way the Fed can be sure to derail inflation given those shifts is to cool labor demand below the level of labor supply. That now means hammering demand, while simultaneously raising the supply of workers via an increase in unemployment.

Further complicating the Fed's job is the excess savings that consumers amassed during the pandemic. That hit an estimated $2.4 trillion peak in late 2021 and fell to $1.8 trillion in the third quarter, which is still substantial. (See Chart 1.)

The problem is the composition of what is left; it is now more concentrated in higher income households than it was at the start of the year. Data in the second quarter revealed that households in the lowest income quintile drained those excesses. (See Chart 2.)

The most recent household pulse survey suggests stress moved up the economic food chain over the summer. More than 40% of households were having a "somewhat or very difficult time covering usual household expenses" in late October. That was the highest share reporting such stress since the survey's inception in August of 2020.

Other factors buoying demand are credit card usage, which rebounded after plummeting during the pandemic. I see that more as a sign of economic stress than strength. Costs of carrying higher credit card balances will compound rapidly as rates rise.

Defaults and delinquencies remain low but the data lag. The higher cost of debt will no doubt add to the pinch that the bottom 40% of households is feeling.

Chart 1

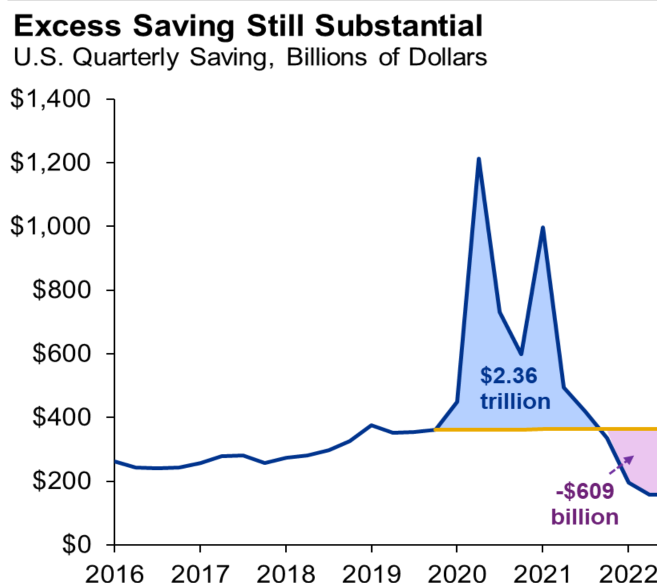
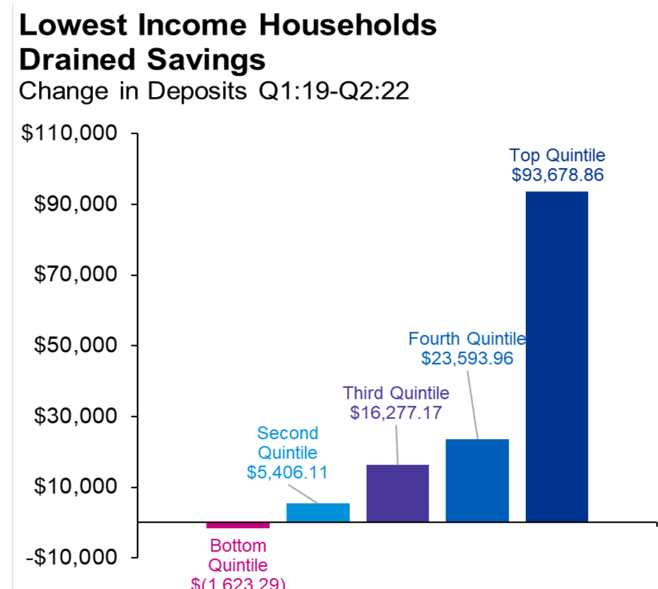


Chart 2



© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The last of government-sanctioned loan forbearance is slated to expire on January 1, 2023. Student loan payments, which were put on ice during the pandemic, will need to be serviced again. Student loans have the highest rate of default of any loan category. The administration's proposed $400 billion in student loan forgiveness remains snarled in the courts.

Whatever your views on that policy, there is little doubt it would alleviate the upward pressure on delinquencies and defaults. My own view is that student loan forgiveness does not solve the problem of soaring tuition costs.

I take issue with estimates that forgiveness will spur inflation. Students who were able to delay loan payments for more than two and a half years have already adjusted their monthly expenses to reflect what they would have spent on student loans.

To add insult to injury, household net worth has been decimated. The blow to the value of financial assets was $7.3 trillion in the second quarter, the largest decline since 1946. We estimate another $2 trillion loss for the third quarter. (See Chart 3.)

Nearly every poll reveals most Americans believe the economy is either in or on the cusp of a recession. Those who had jobs at the start of the year have lost all that they gained in raises, and then some, to inflation; they experienced an erosion in living standards.

That does not rise to the bar of what economists define as a recession but nonetheless feels like one. In response, consumers are expected to prioritize seeing their loved ones in person instead of shipping them gifts under the tree this holiday season.

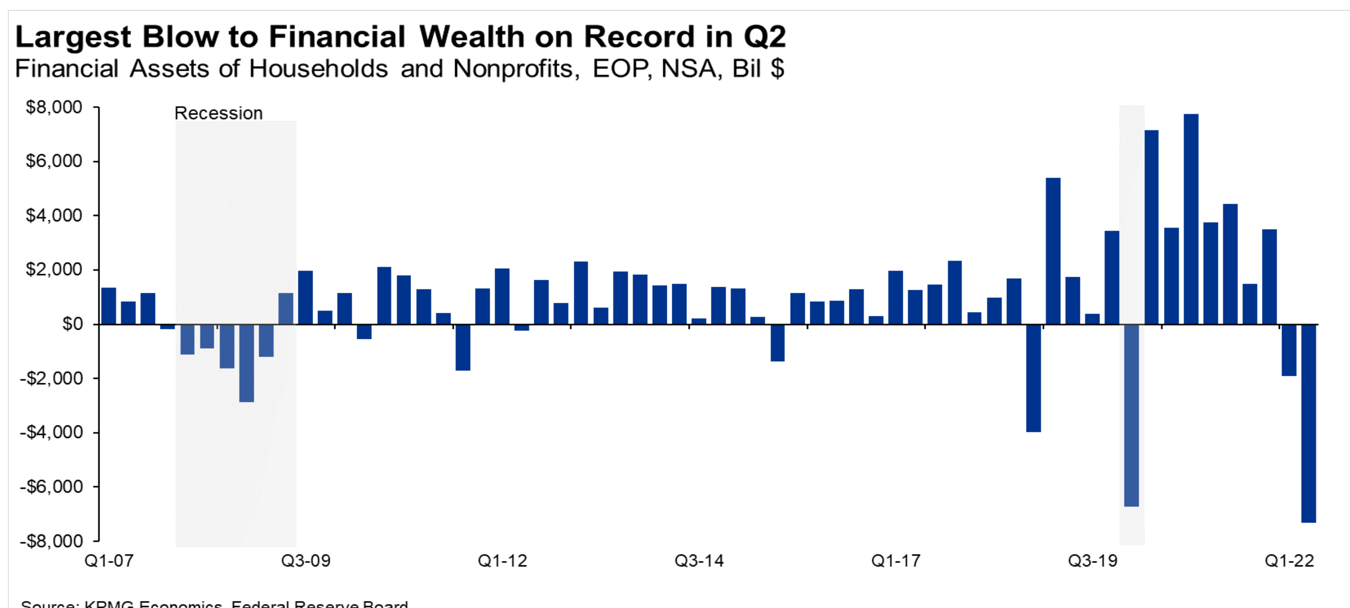
Collateral Damage from Housing

The housing market is already in a recession. The back-to-back drop in home buying and building we saw in the second and third quarters was the largest since the subprime crisis. Recent mortgage applications, which plummeted for home purchases again in October, suggest conditions will worsen.

Why do we care? Because home buying and building spur a lot of additional spending. We tend to repair, remodel and fill the homes we just bought. Even vehicle sales get a boost as younger buyers flee downtown apartments for the suburbs where a vehicle is needed to get around. Add the pandemic buying that made everything from working from home to entertaining outside easier and the correction in spending on goods is expected to accelerate.

The lags from housing market losses will exacerbate the pullback in spending on big-ticket durable goods. Those purchases are often financed, which is now more costly. The zero-percent deals that once allowed consumers to space out the payments will be relegated to history books.

Chart 3



© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The final blow is home values, which ballooned in response to the demand unleashed by the pandemic. Some of the hottest second-tier markets have already slipped into the red. Rapid rate hikes, a hiring freeze in the tech sector and a sharp slowdown in migration are exacerbating declines.

Even all-cash buyers flipping to rent instead of selling have disappeared. They are waiting on the sidelines for prices to fall further. No one wants to catch a falling knife, or invest in an asset that is depreciating in value.

Anecdotes of people walking away from large down payments have fueled that narrative. The proximity of the subprime crisis is important. Many wrongly believed that home values could not fall before that crisis; now they know they can and are.

What is remarkable is how fast home prices and rents are in descent. This is despite still-tight inventories. Homeowners who locked into low rates would rather stay where they are than suffer higher mortgage payments and a larger blow to equity.

Builders are driving the correction in prices, unloading properties that are not selling by cutting prices or renting them. That is lowering both home values and rents. High frequency data on home values and rents show they have peaked and are beginning to recede.

It will not be long before we see an overhang of luxury rentals, given the surge in construction in the multifamily sector. Multifamily under construction is currently at the highest level since 1973.

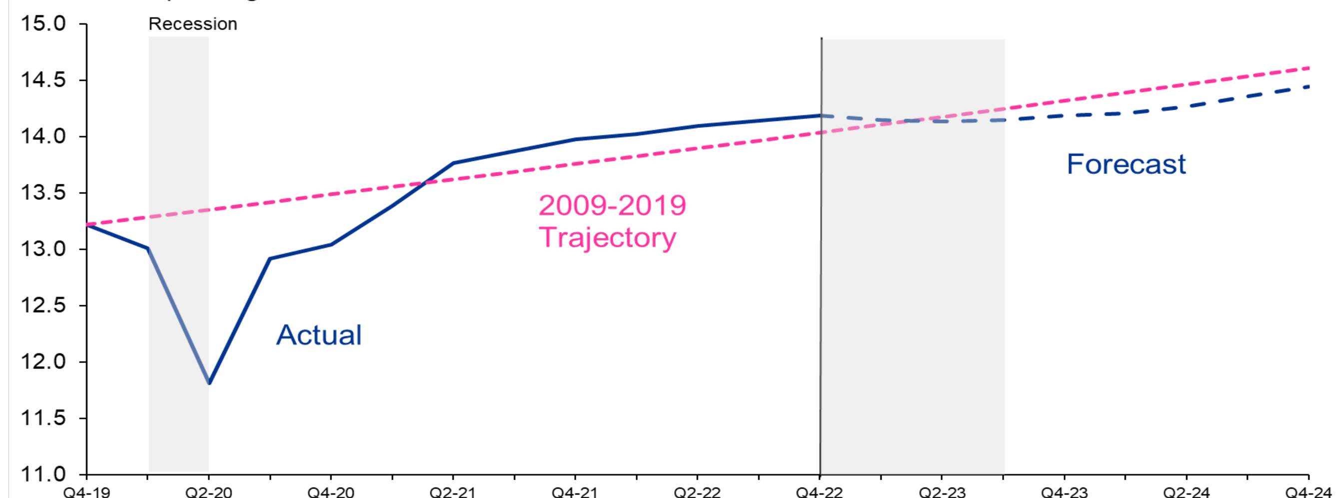
Home values could easily fall 20% by year-end 2023; that would push back home values to December 2020 levels. The risk is that they will fall further with the Fed's push to keep raising rates. It is worth repeating; this is not a redux of the subprime crisis in 2008-09, although this is when lenders need to be extra vigilant.

Homeowners who are losing ground on the value of their homes are not as likely to tap their savings to keep spending afloat. The drag on spending from that loss in wealth will hit a greater share of households than the blow to financial assets we have seen; homes are the largest asset for most households.

Making matters worse is what is known as the “bullwhip effect.” Many builders paid to buy retail appliances to finish homes that were delayed, while keeping wholesale orders in place. They thought they would need those appliances to finish homes on backlog. What they failed to anticipate were cancellations.

Inventories swelled and appliance makers cut production over the summer. Those losses, coupled with the lags on spending due to the housing correction, suggest the worst drop in spending will hit in the first half of 2023.

Chart 4



© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

A Contraction in Consumer Spending

Chart 4 lays out the forecast for consumer spending. Consumers are expected to opt to travel and spend more time with, rather than on, their loved ones this holiday season.

Retailers curbed orders for the holiday season. Some of the largest online behemoths have announced hiring freezes which could lead to a significant fall in retail hires in November.

The correction in spending is expected to accelerate as we move into 2023. An easing of monetary policy later in the year will help recoup those losses in 2024.

Risks are to the downside this winter, given the trifecta of illnesses that are cropping up. Pediatric ICUs are filling up with kids who have RSV (an upper respiratory virus that hits the young and the elderly hard), the flu and yet another round of COVID infections. A small swath of the population has accepted the newest boosters, while our collective immunity is waning.

Those shifts could suppress our desire to congregate and spend during the holiday season, although pandemic fatigue is real. The ranks of those unable to work because they had to care for children hit a record high in October, while the number of those out sick and unable to work swelled.

Winners and Losers: Airlines, resorts, rental car companies and restaurants are all expected to continue to gain business in the fourth quarter. Larger retailers, online stores, garden and building material stores and heavy manufacturers are expected to be left in the cold. Warehousing, trucking, and shipping have already slowed dramatically.

Implications for Inflation

Goods prices have already begun to moderate. Those shifts are necessary to offset the surge in inflation coming from the service sector. Shelter costs are a primary driver of those gains.

The Fed is well aware of the lags in the official measures of inflation. It can take anywhere from 12 to 18 months for a shift in home values to show up in owners' equivalent rent. Rent shifts can take a year, given the length of leasing contracts.

It seems reasonable to expect a compression of those lags, depending on how pronounced the correction in prices becomes. We saw this in the extreme during the height of the subprime crisis. A rapid drop in home values showed up almost instantaneously in shelter costs. This means that official measures of inflation cool much sooner than the Fed currently expects. That may not stop the Fed from hitting higher rates than previously expected but it could accelerate rate cuts.

Fed Stays the Course

The Fed is now expected to raise short-term rates to 5-5.25% by spring of 2023. That is 1.25% higher than today and 0.75% greater than we expected just a month ago. The result will be a deeper recession with the worst of the losses occurring during the first half of 2023. Unemployment is expected to approach 6%.

The good news is that a more rapid cooling in inflation should enable the Fed to reverse course and cut rates sooner than forecast. The fed funds rate is expected to end 2023 at 2.75-3% and fall to a neutral range of 2.25-2.5% by the spring of 2024.

Rates are not expected to return to zero unless the Fed hits a trip wire and credit markets seize. The Fed has pledged to take financial stability into account when it makes decisions. That is one of many reasons it plans to slow the pace of rate hikes going forward; it is allowing financial markets more time to adjust.

Bottom Line

Greenspan was prescient. Bubbles are tough to identify. It was particularly hard to delineate between the rebound in prices following initial lockdowns, the pandemic-induced bubble in housing and housing-related goods and the broader surge in prices we have endured for the better part of a year.

Powell heeded Greenspan's warnings well into the pandemic, opting to support growth and a more rapid healing of the economy instead of worrying about bubbles or inflation. He was proven wrong. The war in Ukraine did not help.

Now he is all in on rate hikes, even if they precipitate a recession. The bursting of the housing bubble has upped the risk of recession; it will also help cool inflation. I would like to believe that one could occur without the other. I have learned not to believe in fairy tales or bet against the Federal Reserve. That is what a bet against recession now means.

Is avoiding a recession still possible? Yes, but not probable. The better bet is to hedge against the probability that the Fed succeeds in raising unemployment and be pleasantly surprised if that doesn't occur.

© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Economic Forecast —November 2022

	2022	2023	2024	2022:1(A)	2022:2(A)	2022:3(A)	2022:4	2023:1	2023:2	2023:3	2023:4	2024:1
National Outlook												
Chain Weight GDP[1]	1.8	-0.9	1.5	-1.6	-0.6	2.6	-0.8	-3.7	-1.2	0.5	1.0	2.3
Personal Consumption	2.6	0.3	1.2	1.3	2.0	1.4	1.3	-1.2	-0.4	0.4	1.0	0.7
Business Fixed Investment	3.3	-2.4	-0.1	7.9	0.1	3.7	-0.6	-5.5	-5.1	-2.5	-1.0	0.7
Residential Investment	-10.7	-22.5	16.3	-3.1	-17.9	-26.4	-27.7	-33.8	-14.9	-3.3	-4.9	61.9
Inventory Investment (bil $ '12)	108	-14	36	215	110	62	44	-3	-38	-24	7	16
Net Exports (bil $ '12)	-1355	-1230	-1309	-1480	-1421	-1265	-1254	-1272	-1220	-1208	-1221	-1253
Exports	7.4	1.7	0.8	-4.6	13.8	14.4	1.3	-2.3	-1.2	-1.1	-0.3	0.6
Imports	8.5	-2.1	2.6	18.4	2.2	-6.9	-0.2	0.2	-6.0	-2.0	1.2	3.8
Government Expenditures	-1.0	1.3	1.0	-2.3	-1.6	2.4	-0.4	3.4	1.0	0.9	1.2	1.2
Federal	-3.0	1.3	0.3	-5.3	-3.4	3.6	-2.1	5.7	0.4	0.2	0.1	0.4
State and Local	0.3	1.3	1.4	-0.4	-0.6	1.7	0.6	2.1	1.4	1.4	1.8	1.7
Final Sales	1.1	-0.4	1.3	-1.8	1.3	3.3	-0.4	-2.8	-0.6	0.2	0.4	2.1
Inflation												
GDP Deflator	7.1	3.9	1.9	8.4	9.2	3.9	6.1	4.2	0.9	3.5	1.7	1.7
CPI	8.2	4.2	2.3	9.2	10.5	5.7	5.9	4.6	0.1	3.5	2.4	2.4
Core CPI	6.2	4.3	2.3	6.5	6.7	6.4	5.6	4.7	1.3	3.7	2.1	2.2
Special Indicators												
Corporate Profits[2]	6.0	-6.4	3.0	10.9	7.7	8.3	6.0	1.0	-5.5	-7.4	-6.4	-0.3
Disposable Personal Income	-6.3	2.7	4.4	-10.6	-1.5	1.7	2.3	4.0	1.9	3.7	5.1	6.3
Housing Starts (mil)	1.54	1.16	1.39	1.72	1.65	1.46	1.34	1.16	1.12	1.14	1.23	1.31
Civilian Unemployment Rate	3.7	5.1	5.3	3.8	3.6	3.5	3.7	4.3	5.1	5.4	5.6	5.5
Total Nonfarm Payrolls (thous)[3]	4488	-2215	687	1720	1226	1161	381	-666	-1142	-360	-47	119
Vehicle Sales												
Automobile Sales (mil)	3.0	3.4	3.7	3.0	3.0	2.9	3.2	3.7	3.4	3.2	3.4	3.5
Domestic	2.1	2.3	2.4	2.0	2.1	2.0	2.3	2.4	2.4	2.2	2.2	2.3
Imports	0.9	1.1	1.3	1.0	0.9	0.9	0.9	1.3	1.0	1.0	1.2	1.2
LtTrucks (mil)	10.9	11.0	11.6	11.2	10.6	10.6	11.3	10.7	10.9	11.2	11.3	11.6
Domestic	8.5	8.7	9.0	8.8	8.3	8.2	8.7	8.4	8.5	8.8	8.9	9.0
Imports	2.4	2.4	2.5	2.4	2.3	2.4	2.6	2.3	2.4	2.4	2.4	2.6
Combined Auto/Lt Truck	13.9	14.5	15.2	14.2	13.5	13.5	14.5	14.4	14.3	14.4	14.7	15.1
Heavy Truck Sales	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Total Vehicles (mil)	14.4	14.9	15.7	14.7	14.0	14.0	15.0	14.8	14.7	14.8	15.1	15.5
Interest Rate/Yields												
Federal Funds	1.7	4.7	2.4	0.1	0.8	2.2	3.8	4.7	5.1	5.0	3.7	2.5
10 Year Treasury Note	3.0	4.0	2.7	2.0	2.9	3.1	4.2	4.3	4.1	4.1	3.3	2.7
Corporate Bond BAA	5.3	6.4	5.0	4.0	5.1	5.4	6.6	6.9	6.6	6.4	5.6	5.0
Exchange Rates												
Dollar/Euro	1.04	1.00	1.03	1.12	1.06	1.01	0.98	0.98	1.00	1.01	1.01	1.02
Yen/Dollar	132.8	141.8	136.0	116.4	129.7	138.0	147.0	145.0	142.0	140.0	140.0	138.0

[1] In 2021, GDP was $19.6 trillion in chain-weighted 2012 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

kpmg.com/socialmedia

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.