New Year; old Challenges

KPMG Economics

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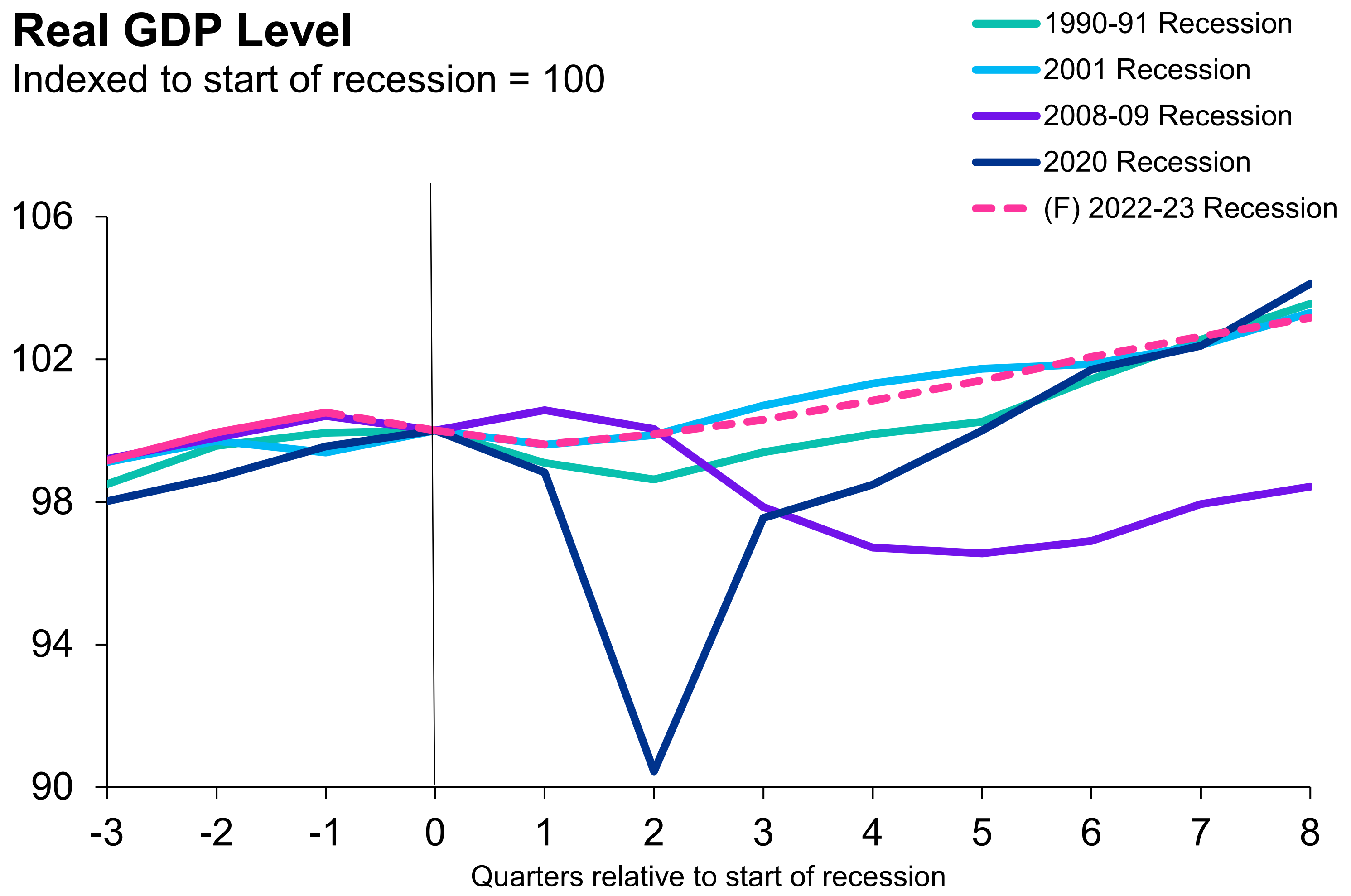
Mild recession ahead



Note: Forecasts are inherently time sensitive and dated as of January 9, 2023
Source: KPMG Economics, Bureau of Economic Analysis

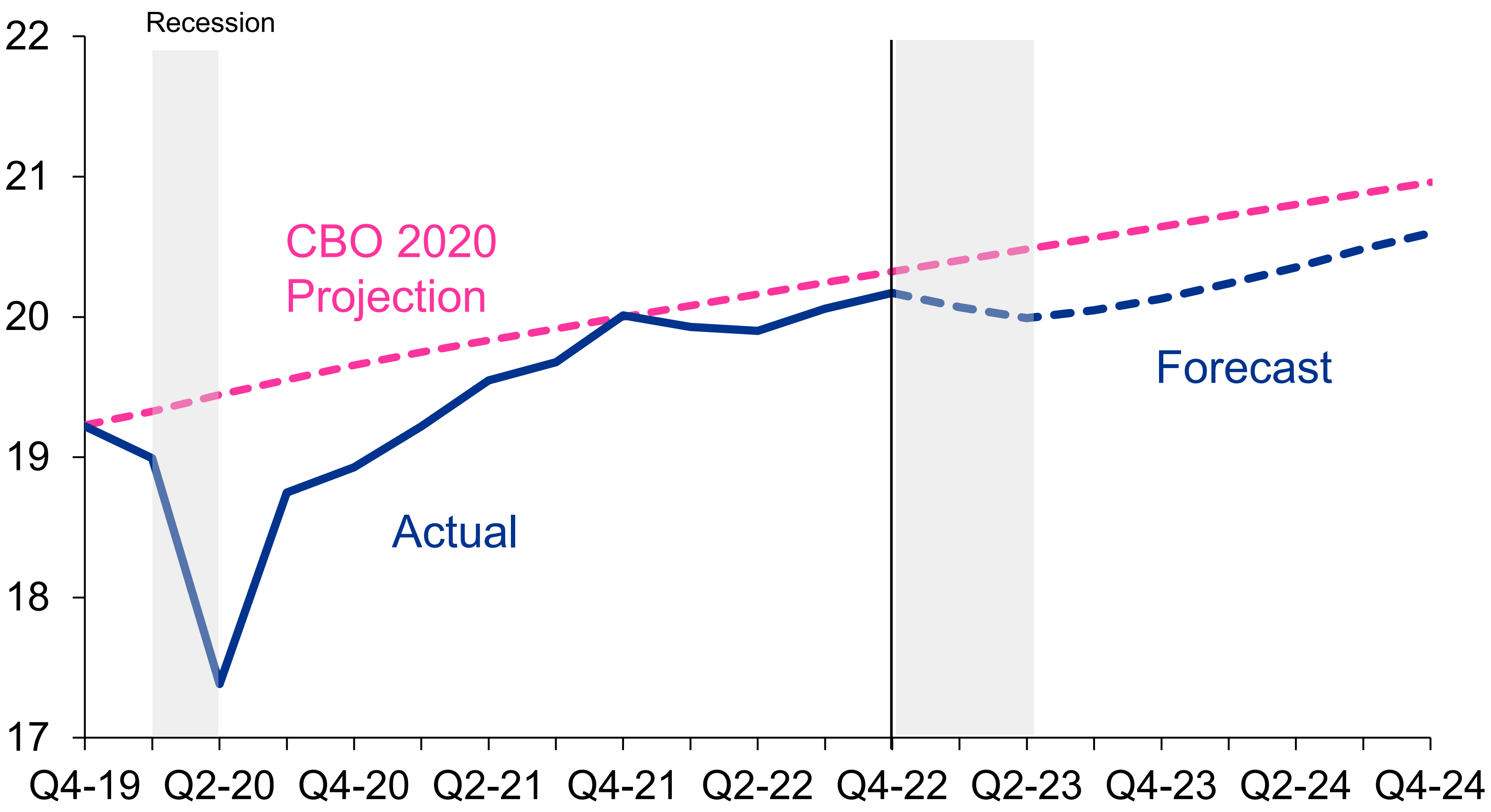
Our forecast suggests that a mild recession begins in Q1 2023.

- The losses are expected to be close to the 2001 and 1990-91 recession but well short of the carnage of 2008-09 or 2020.
- Fed-induced recessions are easier to recover from than balance sheet recessions (like 2008-09). Risks on the rebound in 2024 are to the upside.
- The largest limit to the recovery will be labor shortages, as they could cap the economy's ability to generate new jobs without triggering another bout of inflation.

Growth stalls below trend

GDP Growth Slows

GDP, 2012 $, Trillions



Note: Forecasts are inherently time sensitive and dated as of January 9, 2023

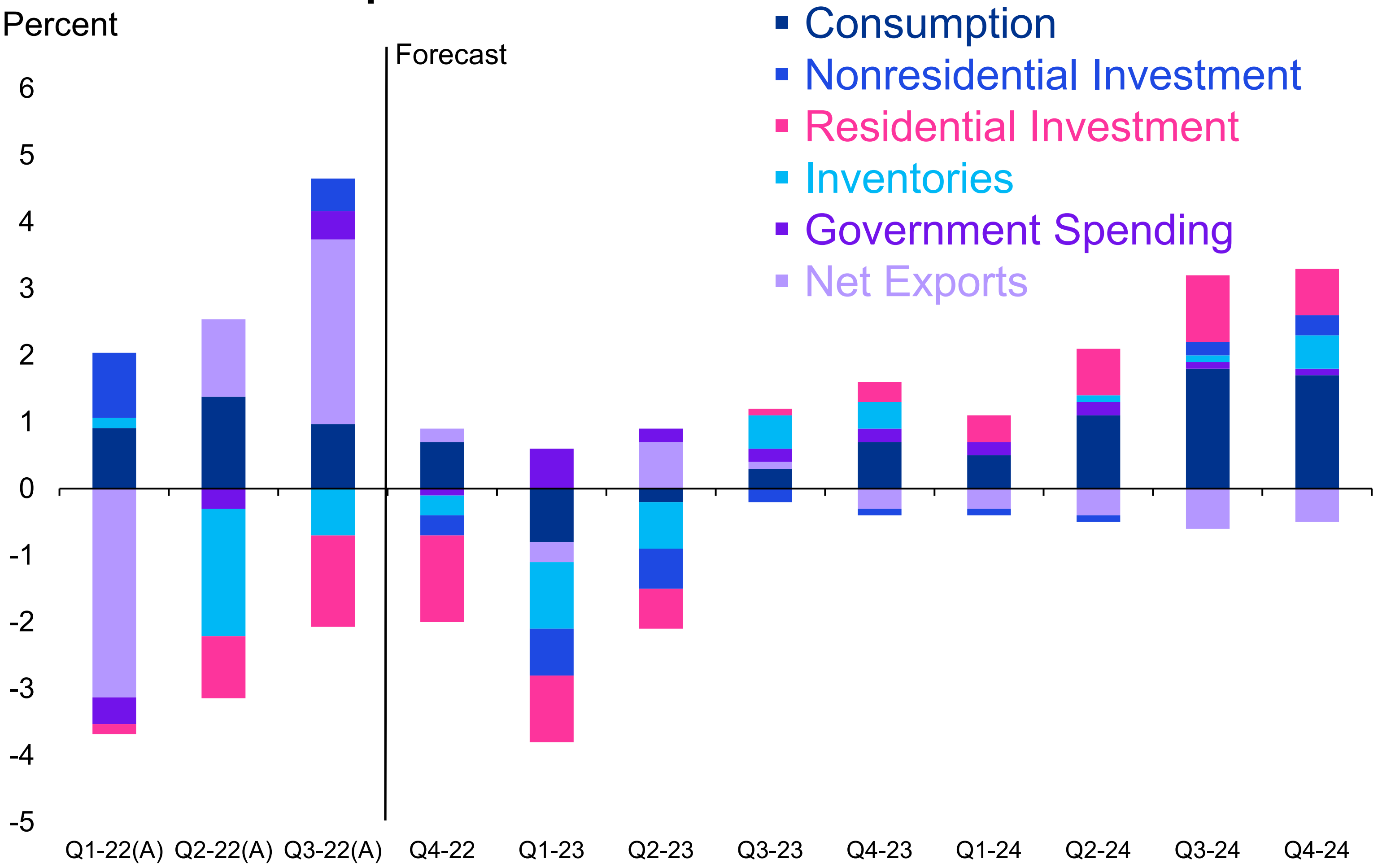
Source: KPMG Economics, Bureau of Economic Analysis

Rate hikes will stall the economy.

- Rate hikes by the Federal Reserve and weaker growth abroad are expected to trigger a shallow recession in 2023.
- The rate hikes will trigger both higher unemployment but slower inflation.
- Fed-induced recessions are inherently easier to recover from than balance sheet recessions, like 2008-09. The consumer and businesses are in a better position with their balance sheets. The Fed will eventually begin to ease, spurring a rally.

Consumption sputters; investment drags on growth

GDP Growth Components



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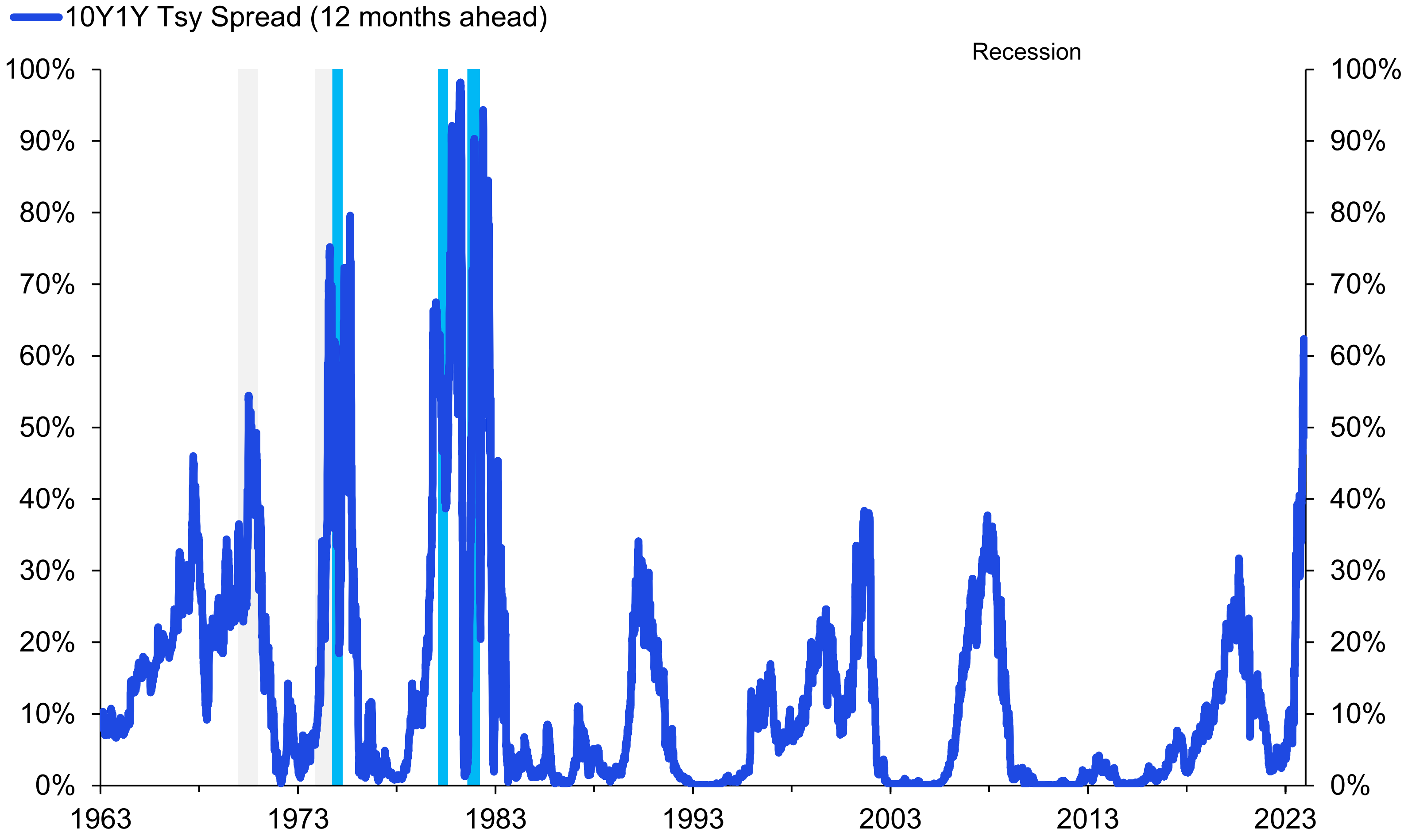
Source: KPMG Economics, Bureau of Economic Analysis

GDP growth negatively impacted by domestic demand and weak investment.

- Real GDP growth expanded at a revised 3.2% annual pace in the third quarter, reversing two quarters of declines. The overwhelming bulk of that “strength” was due to a sharp narrowing of the trade deficit.
- Spending on services helped buoy consumption in the fourth quarter, even as traditional holiday spending floundered.
- Fourth-quarter-to-fourth-quarter real GDP growth is expected to contract by 0.2% in 2023. Surging federal debt has limited the fiscal space to offset the impact of a recession.

Recession probability highest since 1982

Implied Probability of U.S. Recession



Source: KPMG Economics, U.S. Treasury

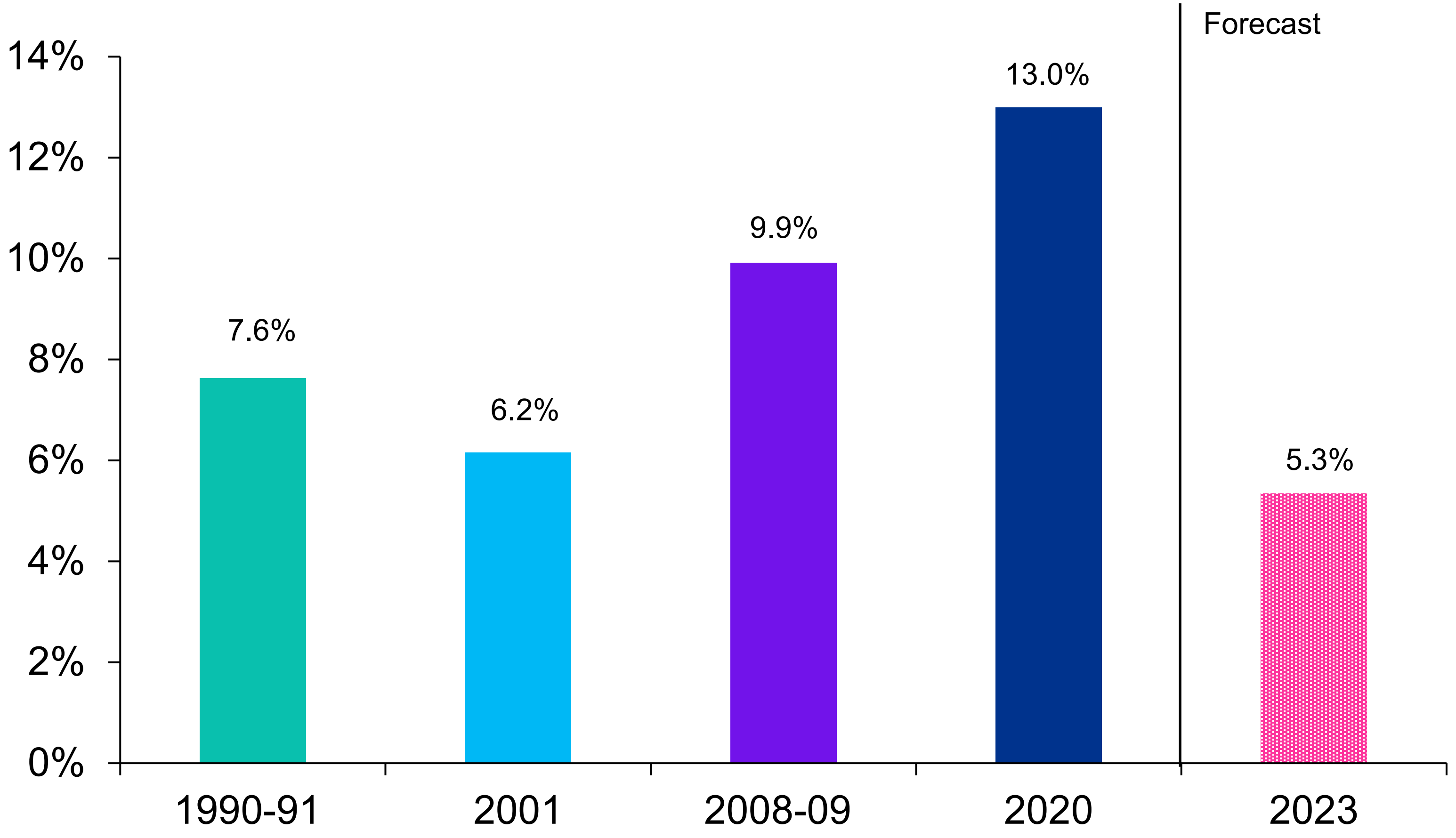
Yield curve inversions signal recession on the horizon.

- The yield curve, or the difference between short- and long-term yields, has inverted. That can be a sign of a recession. The Fed's reduction in its bloated balance sheet is exacerbating that signal. Our model of recession based off of the yield curve inversion shows the highest probability of a recession since 1982.
- The Fed's baseline forecast assumes rate hikes will stall the economy and raise unemployment. At the December meeting the Fed concluded that risks were to the downside; the baseline forecast shows even weaker growth. Two participants forecast a full-blown recession.

Labor shortages limit rise in unemployment rate

Peak Unemployment Rate

Percent (%), quarterly average, by cycle



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Source: KPMG Economics, Bureau of Labor Statistics

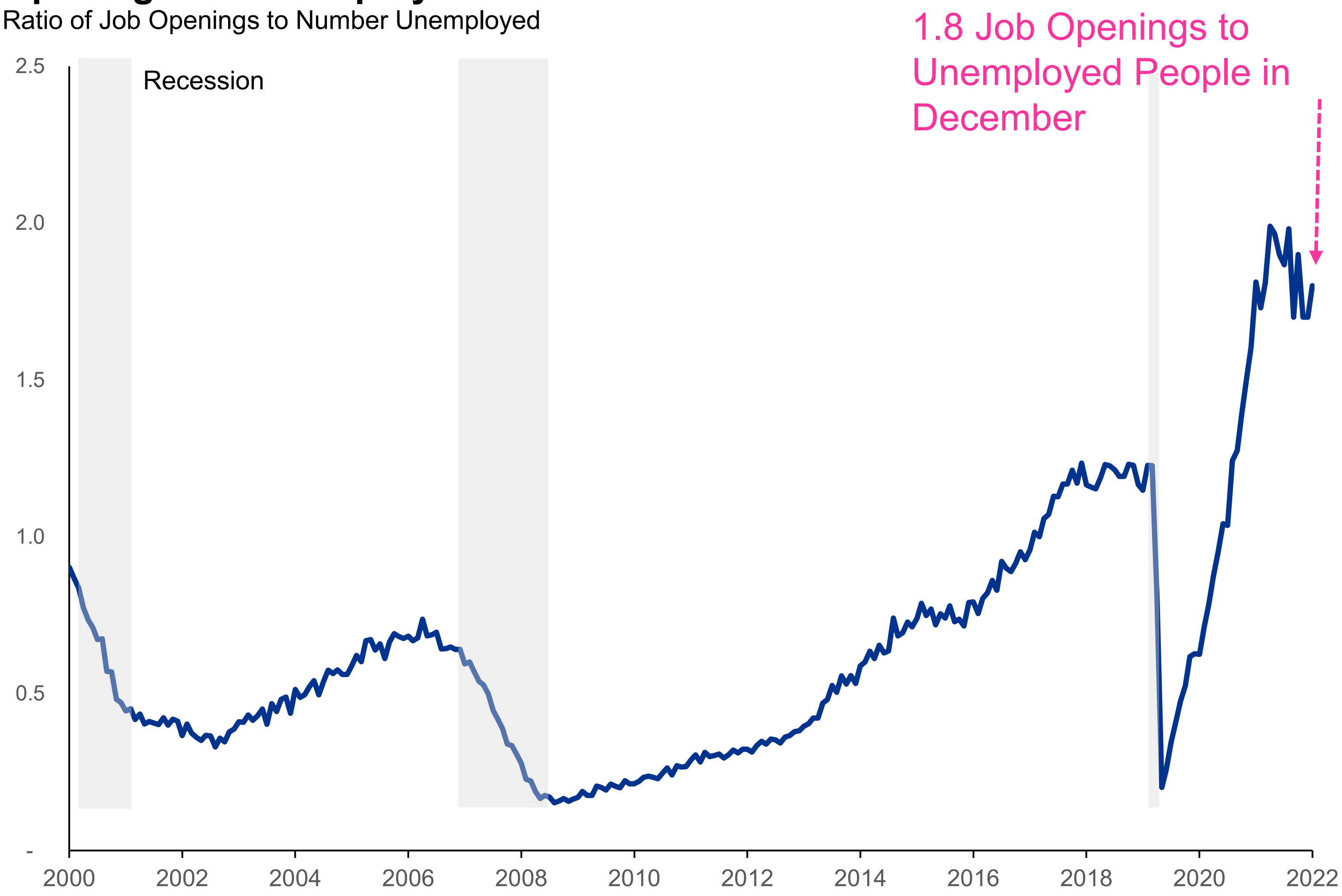
The unemployment rate is expected to approach 5.3% by year-end 2023.

- 5.3% is low when compared with other recessions.
- Rising retirements, ongoing staffing shortages and the desire by firms to hold on to workers they fought hard to hire are expected to dampen the impact on unemployment.
- Research by the Fed suggests that more than 2 million of the 3.5 million missing from the labor force are retirees.

Labor shortages more structural than cyclical

Openings vs. Unemployed Elevated

Ratio of Job Openings to Number Unemployed



Note: Data from the Indeed Hiring Lab was used to estimate December 2022 job openings.
Source: KPMG Economics, Bureau of Labor Statistics, Indeed Hiring Lab

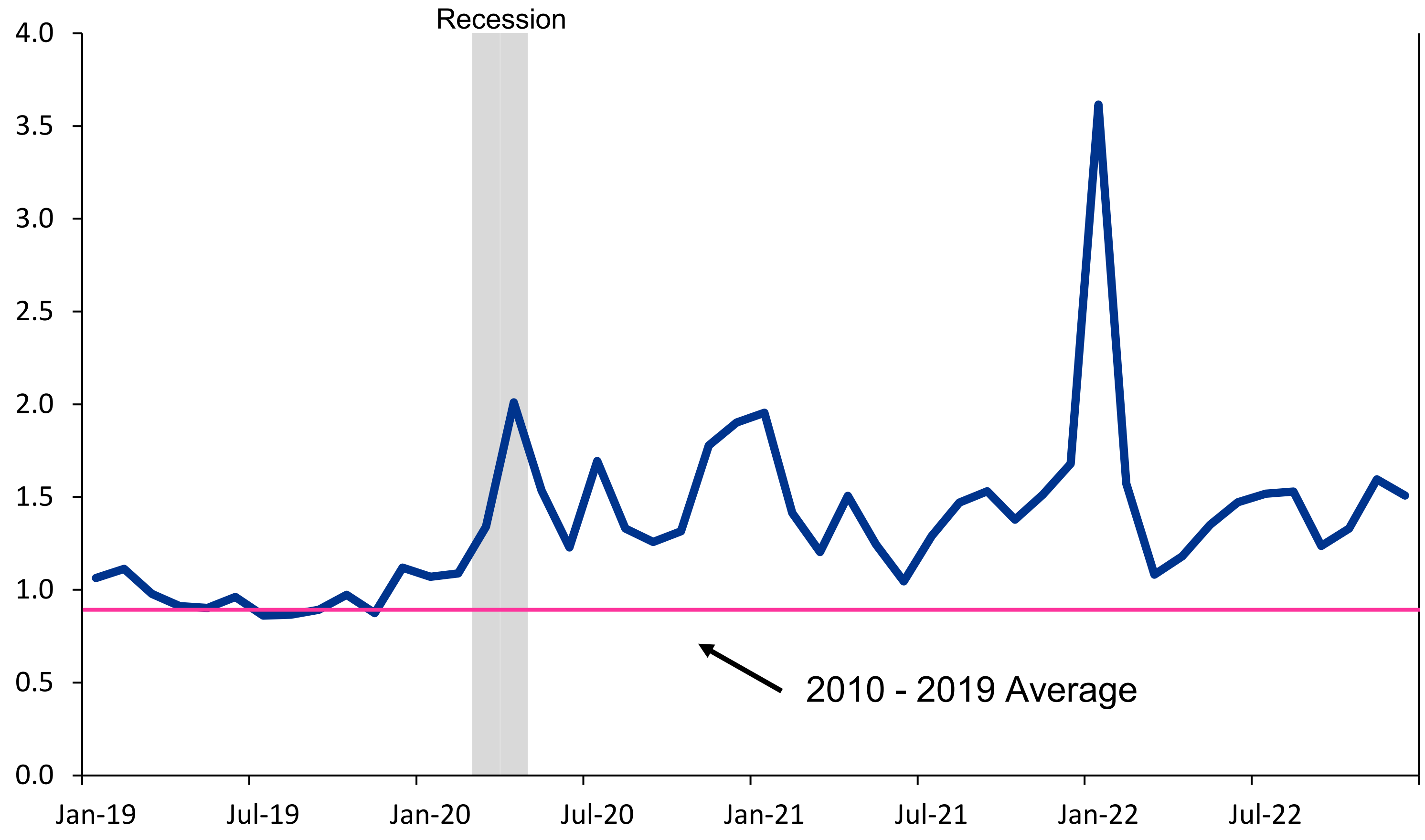
There will be continuing imbalances in labor demand and supply.

- Aging demographics, the pandemic and a sharp slowdown in legal immigration have left us with fewer workers than needed.
- The December employment report showed a labor market that continued to add jobs at a solid clip. Wage growth decelerated slightly to 4.6%, but is still hotter than the 3-4% range the Fed sees as necessary to get inflation back down to its 2% target.
- A one-time rise in unemployment may not solve the problem; unemployment may have to remain higher, even after the Fed has derailed inflation.

More people out sick than pre-pandemic

Not at work due to own illness

Millions



Source: KPMG Economics, Bureau of Labor Statistics

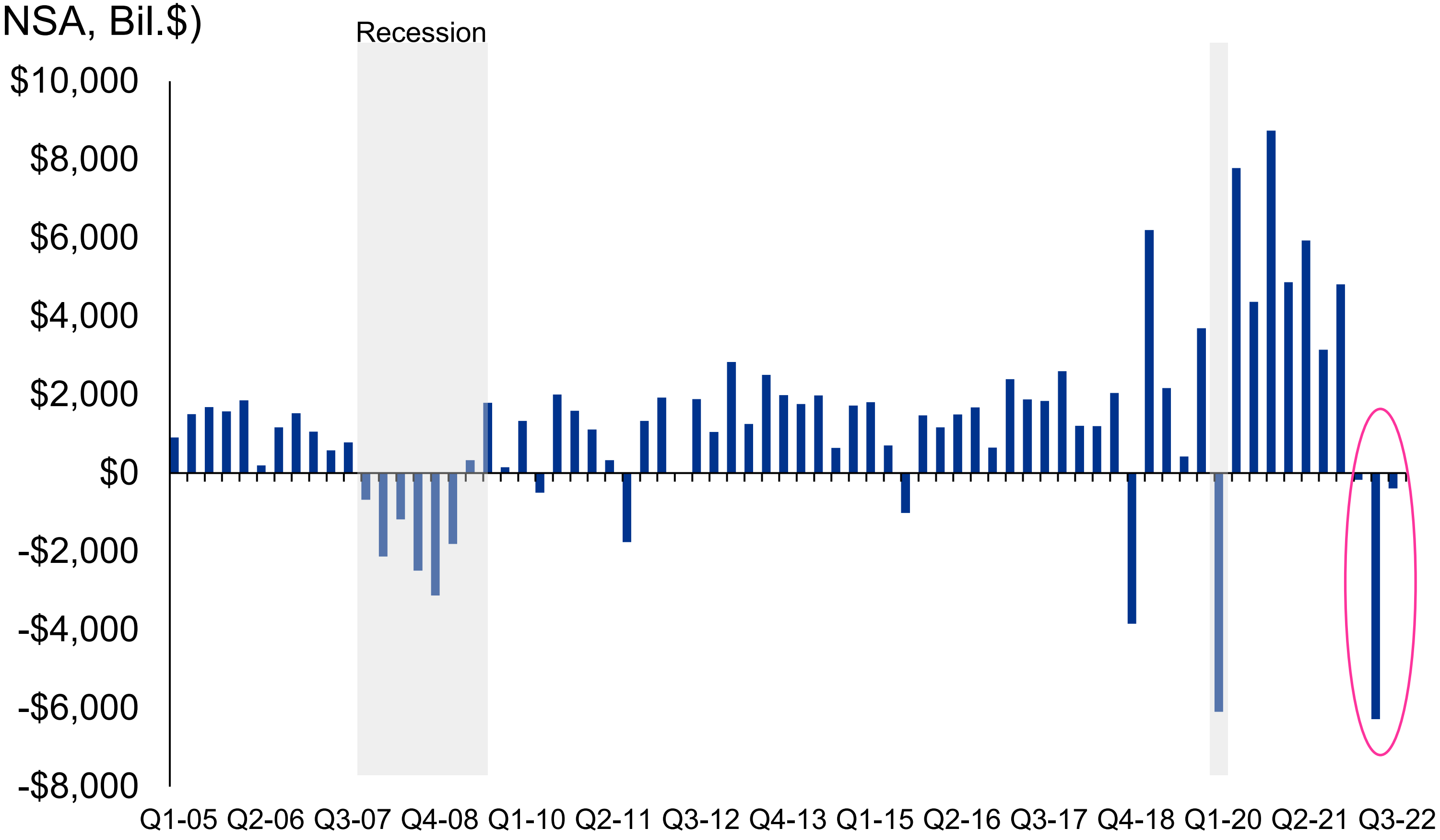
Nearly 60% more workers out sick each month than pre-pandemic average.

- The scars of the pandemic are adding to staffing shortages. The number of those out sick and unable to work hit 1.5 million in December; that left 560,000 more people on the sidelines than in any month of the 2010s. Fatalities to date are higher than other developed economies.
- Many older workers had COVID and are unable to work due to long COVID. Younger retirees are now needed to care for grandchildren and elderly parents, due to acute shortage of child and long-term care workers.
- Those out from work due to childcare problems reached an all-time high in October as more children were sick with RSV, Flu, and COVID-19.

Household net worth impacted by stock market losses in 2022

Household Net Worth

$ Change in Households and Nonprofit Orgs' Net Worth (EOP, NSA, Bil.$)

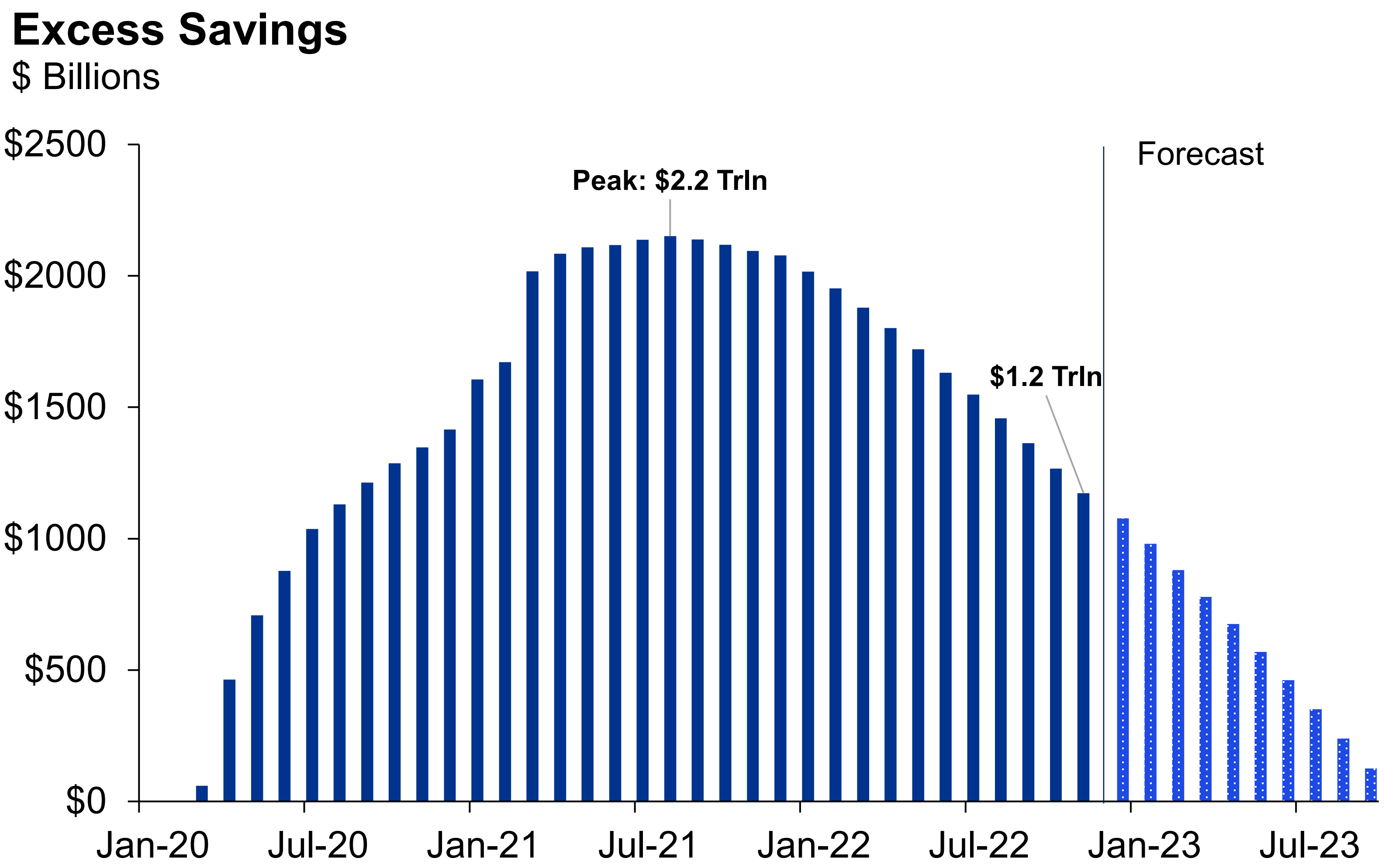


The hit to household wealth was the worst since 1946. Non-housing equity dropped by a combined $10.7 trillion in 2022.

- Stock prices should rally once an end in rate hikes becomes apparent. The problem is getting from here to there. A slowdown in demand, margin compression and higher rates are all expected to take a toll on stock returns in the near term.

Source: KPMG Economics, FRB, Haver Analytics

Excess saving eliminated by end-of-year 2023



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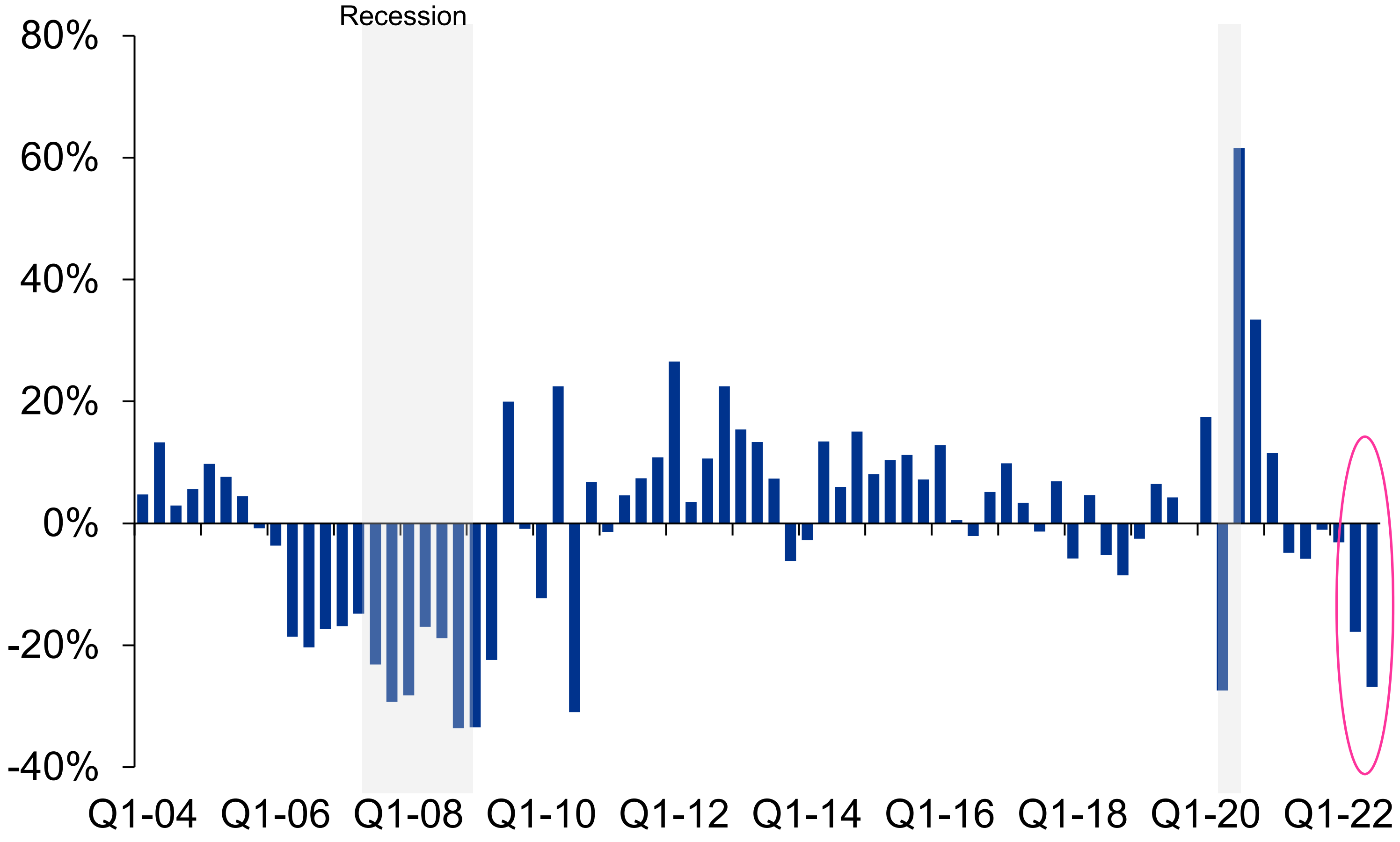
Source: KPMG Economics, Bureau of Economic Analysis

The saving rate plummeted to 2.4% in November as households struggled to offset high inflation.

- Excess saving from the pandemic is dwindling. A rise in the ranks of the unemployed and retirees will continue that trend.
- If savings trends from 2022 continue into 2023, excess savings from the pandemic could be eliminated by the end of next year.
- Consumers are also counteracting inflation with debt. Credit card debt and "buy now, pay later" loans (BNPL) are surging after consumers paid them down during the pandemic.

Worst two quarters for residential investment since sub-prime crisis

Residential Fixed Investment
Percent (%) Change, Annualized Rate



The contraction in single-family home buying and building in the second and third quarters was the worst since the subprime crisis.

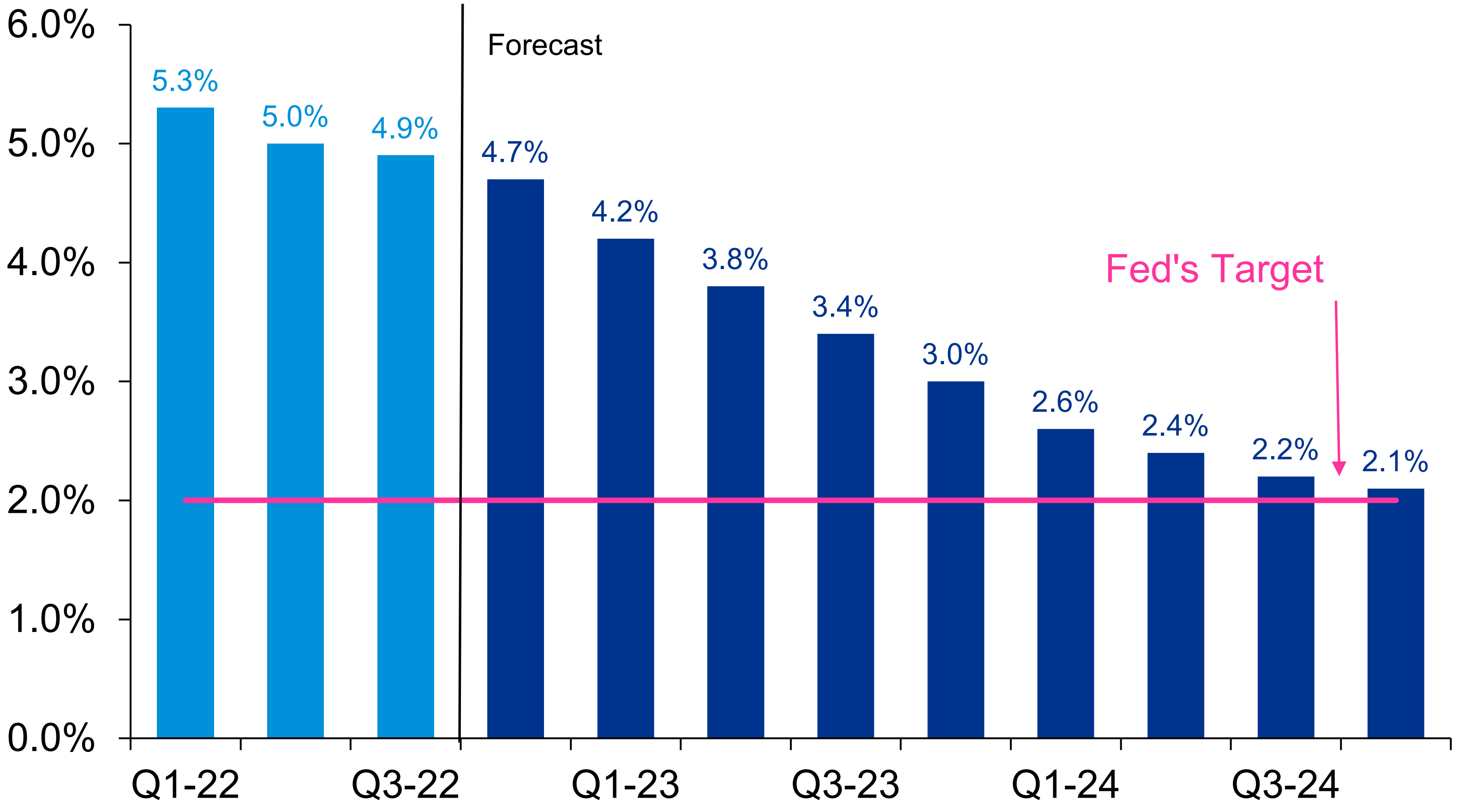
- We expect home prices to drop 20% on a fourth-quarter-to-fourth-quarter basis in 2023. That is the first drop since 2011 and pushes prices back to December 2020 levels.
- Better underwriting standards and a smaller jump in unemployment is expected to keep foreclosures in check; the cushion in equity is substantial.
- Capitalization rates remain low for multifamily but could rise with a drop in rents. Rental lease companies could see a slowdown in activity.

Source: KPMG Economics, Bureau of Economic Analysis

Inflation cools faster than the Fed expects

Core PCE

Percent Change, 4Q/4Q



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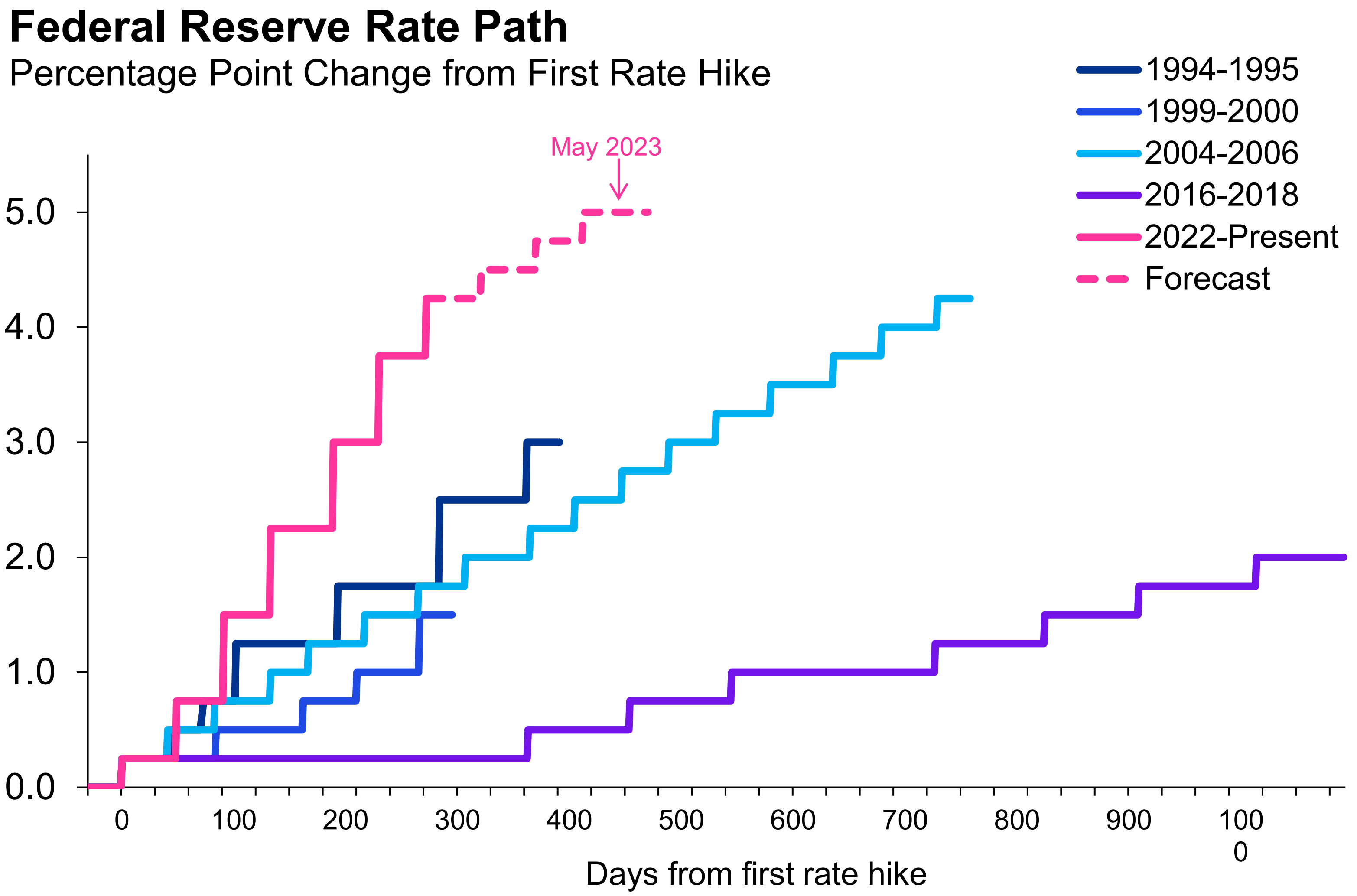
Source: KPMG Economics, Bureau of Economic Analysis

We expect the core personal consumption expenditures (PCE) index, which the Fed targets at 2%, to slow faster than the Fed expected in its last round of forecasts.

- A recession is the primary reason for cooler inflation.
- Supply chain problems, which have been a significant driver of inflationary pressures, are receding.
- Commodity prices are now falling, after surging in response to the war in Ukraine.
- Home values and rents are cooling.
- The problem is core service sector inflation. The December CPI report confirmed inflation was still accelerating in this sector; staffing shortages are playing a key role in those gains.

Fed funds rate peaks at 5.25%



Note: Forecasts are inherently time sensitive and dated as of January 9, 2023
Source: KPMG Economics, FOMC

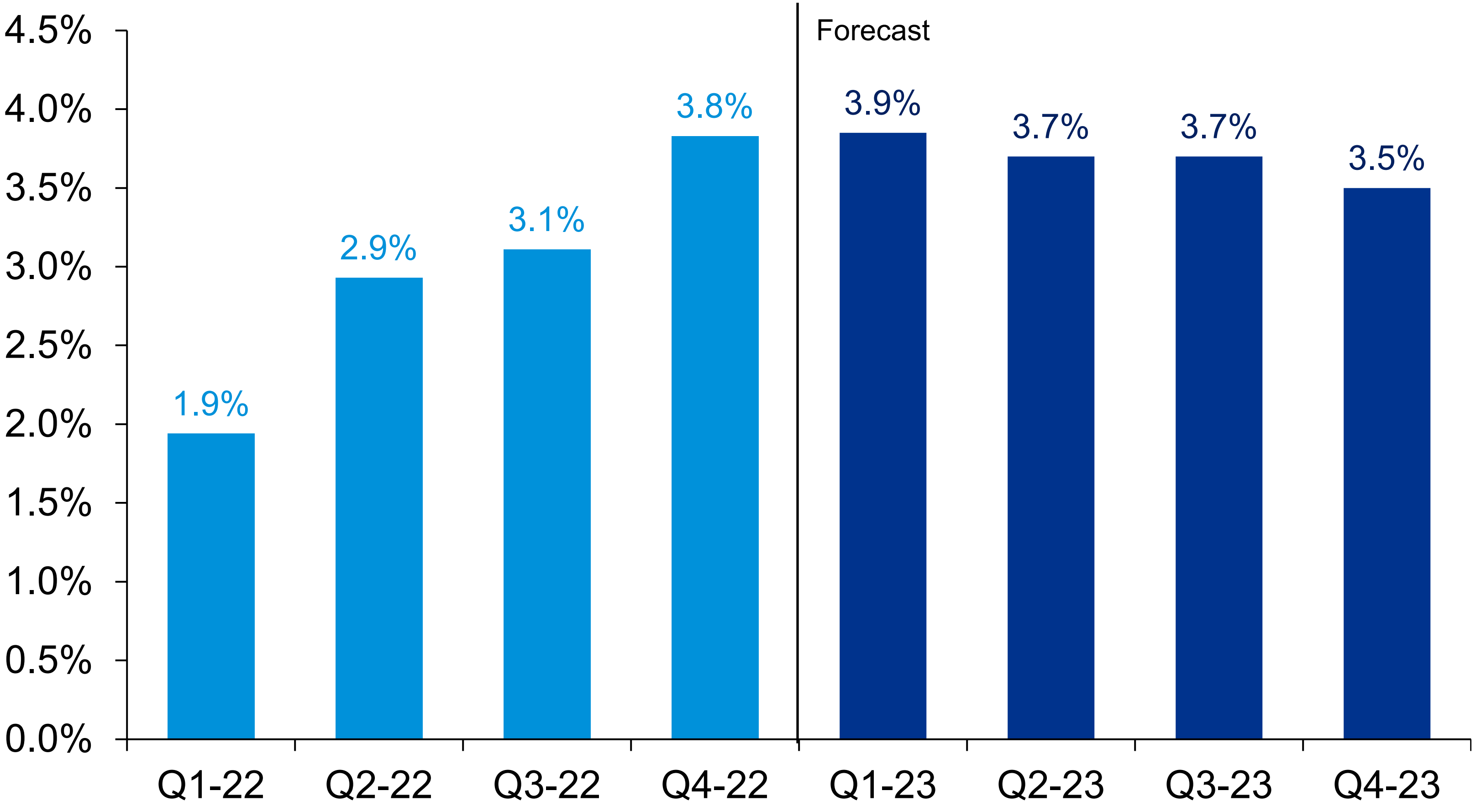
The fed funds rate is now expected to peak at 5.25%, 0.5% higher than the Fed expected in September.

- Data since the last FOMC meeting has left the Fed more comfortable with 0.25% rate hikes.
- The Fed is expected to raise its estimate for unemployment and further reduce its forecasts for growth in 2023. The Fed currently does not plan to cut rates until 2024.
- We expect rate cuts in the latter part of 2023, with inflation cooling in response to an actual recession. But don't expect a return to zero rates anytime soon.

Yields peak in Q1 2023

10-Year Treasury Note Yield

Constant Maturity, Percent (%)



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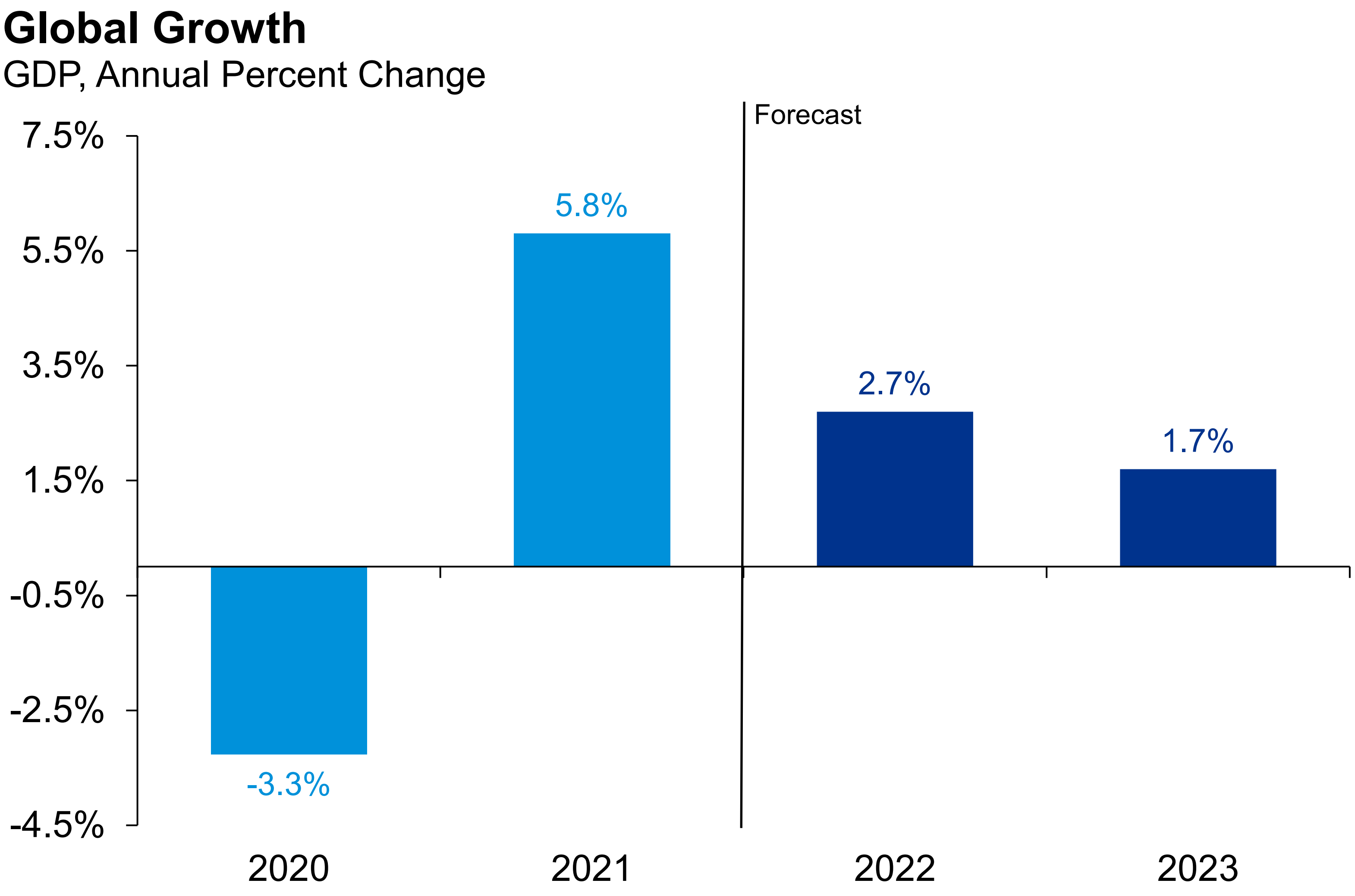
Source: KPMG Economics, Federal Reserve Board

Bond yields are expected to peak ahead of a Fed rate cut.

- The Fed's reduction in its bloated balance sheet is exacerbating yield curve signals of recession.
- The Fed has reduced the size of its bloated balance sheet by over $400 billion since its peak in June. Reductions in its Treasury bond holdings have fallen faster than its holdings of mortgage-backed securities.
- Liquidity in the Treasury bond market has grown thin as the Fed has pulled back. The Fed will likely have to stop well short of its goal to reduce the balance sheet by $3 trillion.

Global growth slowing



Source: KPMG Economics, KPMG Global Economic Outlook, World Bank.

The global economy is expected to slip below 2% growth in 2023.

- Below 2% growth is recession territory for much of the world; it means that many countries will lose ground on a per capita basis.
- Weak global growth will weigh on U.S. exports. Trade will no longer be a buffer.
- Developing economies, which were the drivers of economic growth, are struggling along with many developed economies. China should pick up in 2023, given weak 2022 comparisons and an easing of zero-COVID policies but gains are expected to remain a fraction of what the country experienced in the 2010s.

Sector winners and losers

Key Sectors: Short-Term Outlook
Transport and Shipping
Retail Suppliers/Warehousing
Vehicle Dealers
Manufacturing
Construction
Mortgage brokers, Realtors, Rentals
Media and Entertainment
Hotels, Resorts, Restaurants, Airlines
Health care providers
Large Retailers
Agriculture
Oil & Gas
Banking
Tech
Renewable Energy
Insurance

Key Sectors: Long-Term Outlook
Transport and Shipping
Manufacturing
Agriculture
Retail Suppliers/Warehousing
Hotels, Resorts, Restaurants, Airlines
Large Retailers
Oil & Gas
Banking
Tech
Renewable Energy
Insurance
Construction
Health care providers
Vehicle Dealers
Media and Entertainment
Mortgage brokers, Realtors, Rentals

Sectors more sensitive to interest rates, debt, the dollar and the business cycle are likely to fare worse than others in the near term.

- The pandemic accelerated many trends in place which catapulted us from a world in which growth and inflation were tepid and change was slow to one that is more volatile and requires more agility and resilience. That does not make it good or bad, just different. Firms that lean into those shifts will find opportunity; those that don't will lag.
- In the long term, the geopolitical climate, climate change and aging demographics will impact sectors differently than in the short term.

Red signifies hardest hit sectors; green least negatively affected sectors.

Source: KPMG Economics

Thank you

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