

# Executive briefing

## Macroeconomic outlook and impact on businesses

March update  
Week of March 20, 2023



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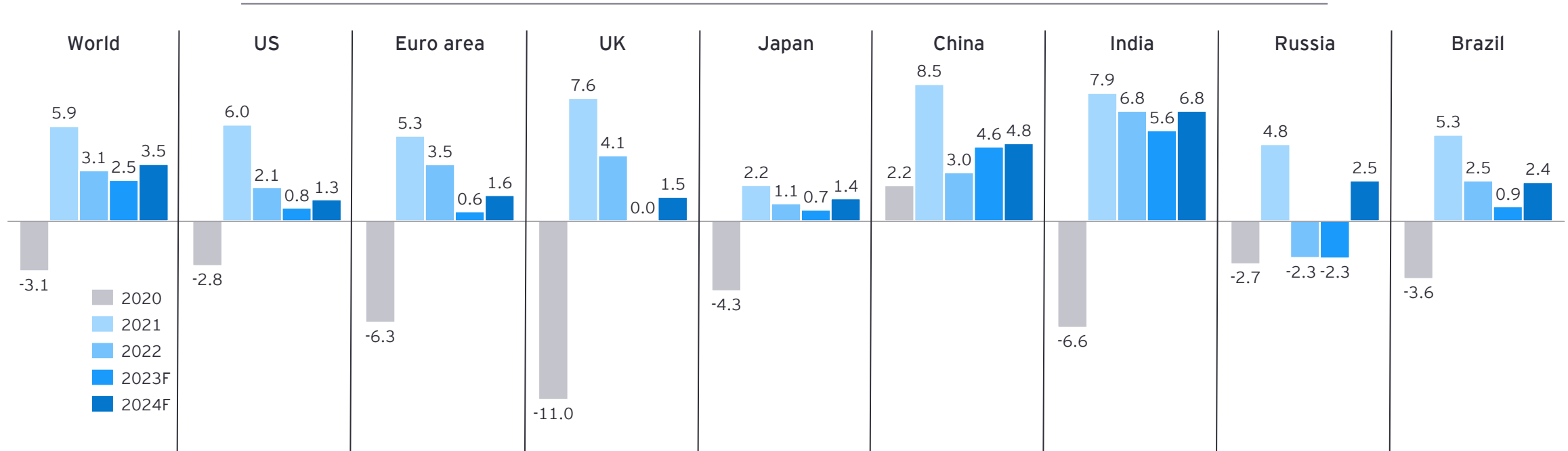
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# Global economic activity has slowed, and downside risks to the outlook have risen amid severe banking sector stress, dollar funding concerns and fear of financial contagion

## Global snapshot

Y/y percent change in real GDP  
2019-24F

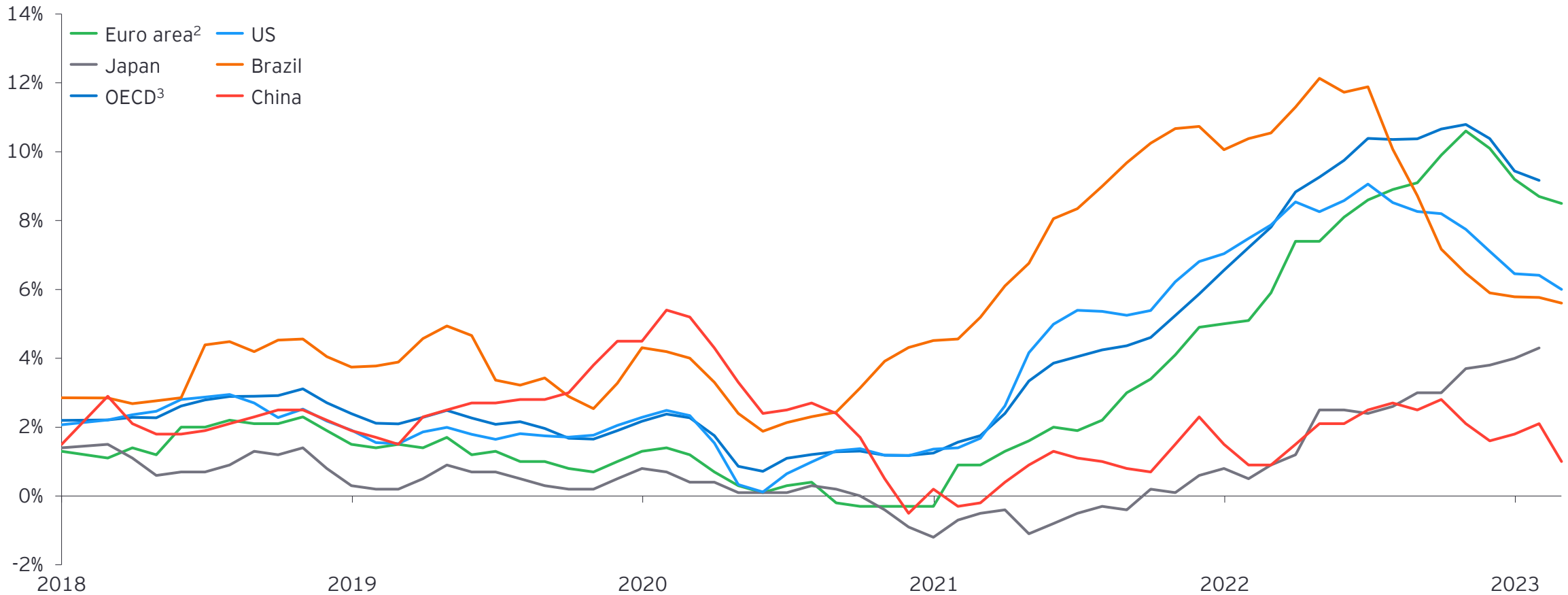


- ▶ US banking sector turmoil, global contagion and dollar funding stress are clouding the global outlook. To address growing fears of financial contagion, the Fed and other major central banks have announced a coordinated action to enhance the provision of US dollar liquidity to the financial system by expanding the frequency of dollar swap line operations.
- ▶ Global inflation is moderating but remains elevated and is showing some signs of persistence. Assuming the current bout of financial market turbulence remains contained, central banks will favor maintaining higher terminal rates to avoid the risk of losing the battle over inflation.

# A global disinflationary process is underway, but elevated inflation will remain a major constraint on consumers and businesses around the world

## Global snapshot

Y/y CPI growth rate  
January 2018-February 2023<sup>1</sup>



1. Data for Japan and OECD only available through January.

2. Euro area includes 19 countries.

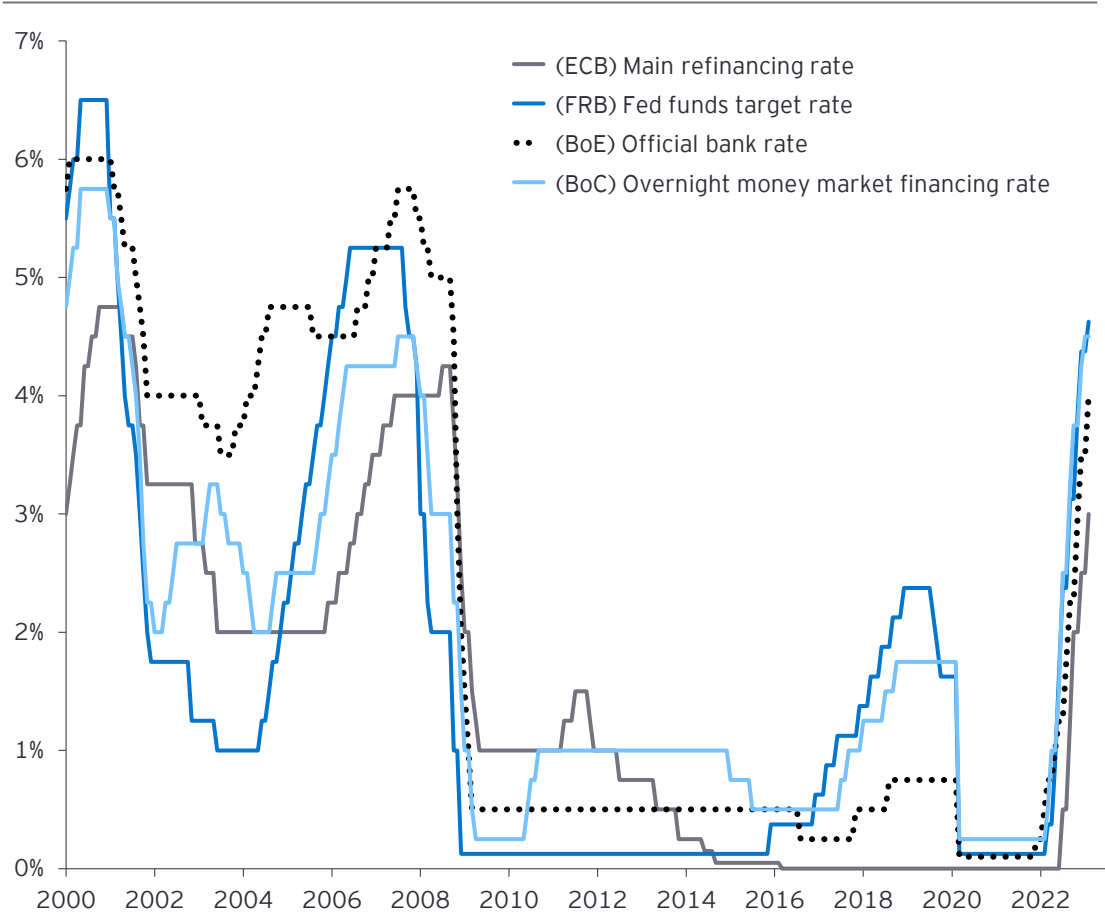
3. OECD total includes all 38 OECD member countries.

Source: OECD; EY-Parthenon

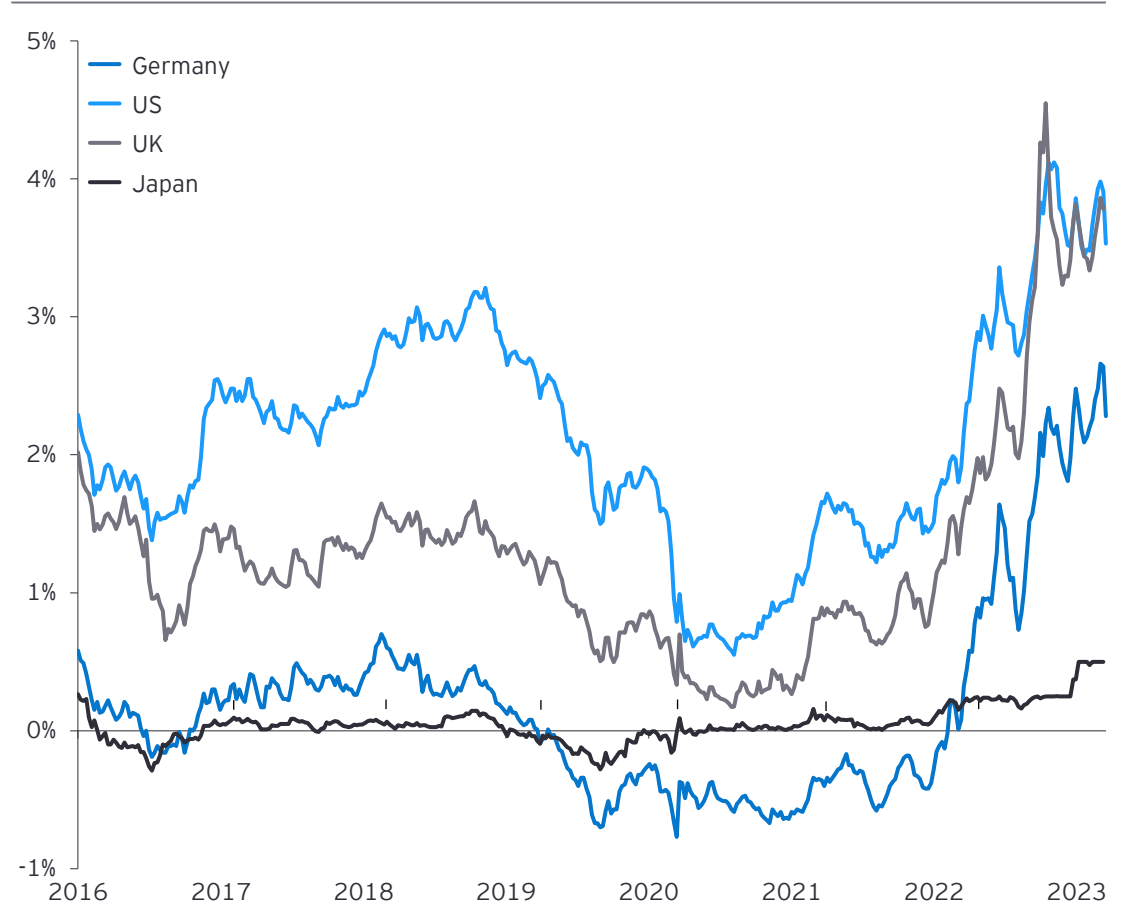
# Sharply higher interest rates have exposed vulnerabilities; central bankers must tread carefully as they balance financial stability risks and price stability risks

## Global snapshot

### Central bank rates 2000-23



### Long-term interest rates<sup>1</sup> January 2016-March 2023



# Financial market volatility, tighter financial conditions and a likely credit crunch have raised the odds of a US recession

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## US outlook

- ▶ **Outlook:** The US economy is facing increased headwinds with the fastest Fed tightening cycle since the late 1980s exposing underlying economic fragilities. Banking sector turmoil has shaken private-sector confidence and will likely lead to tighter credit conditions constraining business investment, employment growth and consumer spending in the coming months. With housing activity still in a slump, manufacturing output under significant pressure and business executives looking to right size inventory needs, we anticipate a mild recession with a peak to trough GDP contraction around 0.5% this year. We forecast real GDP will grow 0.8% in 2023 and 1.3% in 2024, after a 2.1% advance in 2022.
- ▶ **Employment:** While the economy added a solid 311,000 jobs in February, the unemployment rate pushed higher to 3.6%, monthly wage momentum softened, and the number of hours worked fell back. Labor market tightness will remain a feature of this business cycle – given business executives' reluctance to let go of their valuable and prized talent pool and a shrinking talent pool - but we continue to anticipate reduced hiring, strategic resizing decisions and wage growth compression. We see the economy losing around 600k jobs in the coming quarters with the unemployment rate rising toward 4.5% by year-end.
- ▶ **Consumer behavior:** While household finances aren't excessively concerning, fragilities are appearing in the form of rising new delinquencies, increasing debt-servicing ratios and tighter credit conditions. Recent data on household spending and credit growth point to a K-shaped consumer spending pattern in 2023 with low- and median-income families exercising more spending restraint, and families at the higher of the income spectrum still spending, albeit with more discretion. We anticipate consumer spending will advance a modest 1.0% in 2023 after a 2.8% increase in 2022. Next year, we should see moderately faster momentum, with growth around 2.0% as personal income outpaces inflation and provides a greater source of support to consumer outlays.
- ▶ **Inflation:** Inflation slowed less than expected in February, but the disinflationary process remained underway as monthly price gains were much smaller than last year. Headline Price Index (CPI) inflation cooled 0.4ppts to 6.0% y/y – the lowest annual gain since September 2021 – while core inflation fell 0.1ppts to 5.5%, matching the lowest since December 2021. Wholesale price disinflation and declining consumer price inflation expectations are encouraging developments. We expect inflation will fall with accelerating momentum this year, but headline and core inflation will likely remain above 3% until mid-2023 and end the year well above the Fed's 2% inflation target.
- ▶ **Federal Reserve:** The Fed slowed the pace of monetary policy tightening in February with a 25-basis-points rate hike bringing the federal funds rate to 4.50%-4.75%. The January employment and inflation readings will comfort the Fed in signaling at least two additional 25-basis-points rate increases in March and May to a peak of 5.00%-5.25%. Rate cuts are unlikely before the end of the year at the earliest – as a policy recalibration exercise rather than a pure stimulus decision.
- ▶ **Domestic risks:** The odds of a recession have risen due to heightened financial market volatility and economic uncertainty. While labor market conditions still look relatively resilient, an abrupt shift in sentiment along with a rapid tightening of financial conditions could push the economy into a recession with businesses and consumers retrenching. The need to raise the debt ceiling represent another risk to the outlook, as a failure to raise or suspend the statutory debt limit would trigger severe financial market turbulence and potentially lead to a self-inflicted recession. Geopolitical tensions between the US and China are an important geopolitical risk to monitor.

# Bond markets and banking sector equities have come under severe pressure while volatility has surged in the face of a fluid situation straining confidence

## US outlook

Nasdaq bank stock indices  
December 10, 2020-March 20, 2023

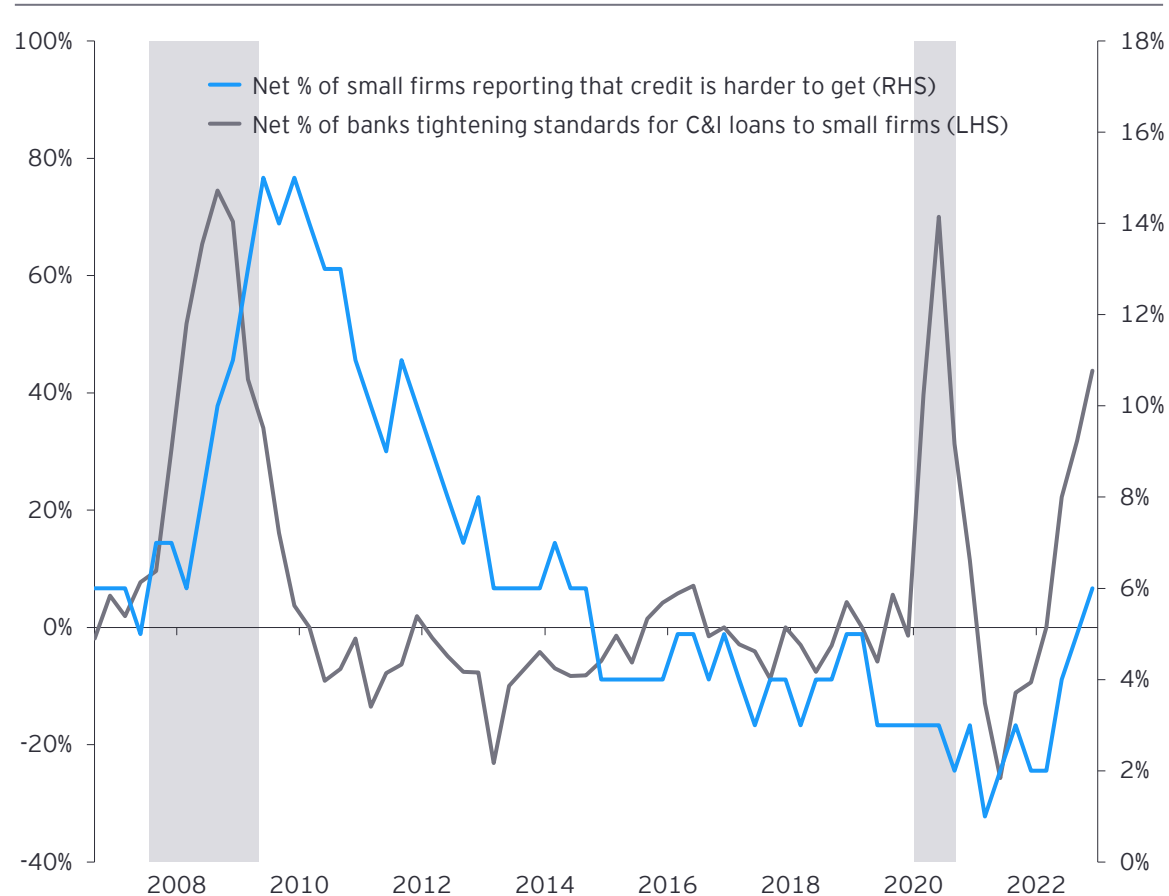


- ▶ Economic and market uncertainty remains elevated amidst banking sector distress and emerging cracks in the global financial system. Current developments are a direct reflection of global central banks' rapid and synchronized policy tightening, policy flip-flopping on the part of the Fed and idiosyncratic management and supervision issues in the banking sector.
- ▶ Comparisons with the 2007-2009 global financial crisis should be nuanced and discrete as the economic, policy and financial markets conditions are distinct. First, most of the immediate risk appears to be interest-related rather than credit related. Second, the global banking sector is much better capitalized and regulated. Third, the policy and regulatory response has been swift.
- ▶ Still, the situation remains fluid and complacency would be misguided.
- ▶ In the current environment, 'known unknowns' and 'unknown unknowns' are risks. First, there is the risk of contagion from the idiosyncratic stress on a finite number of banking institutions into large domestic and global systemic financial institutions which could be the catalyst for a banking crisis. Second, as the Federal Reserve's Monetary Policy Report and Financial Stability Report indicate pension funds, mutual funds, life insurers and commercial real estate show the most vulnerabilities.

# Even if contained, the current banking stress episode will put a dent on the US economy through tighter credit standards to businesses and consumers

## US outlook

Credit conditions for small businesses  
Q3 2006 - Q4 2022



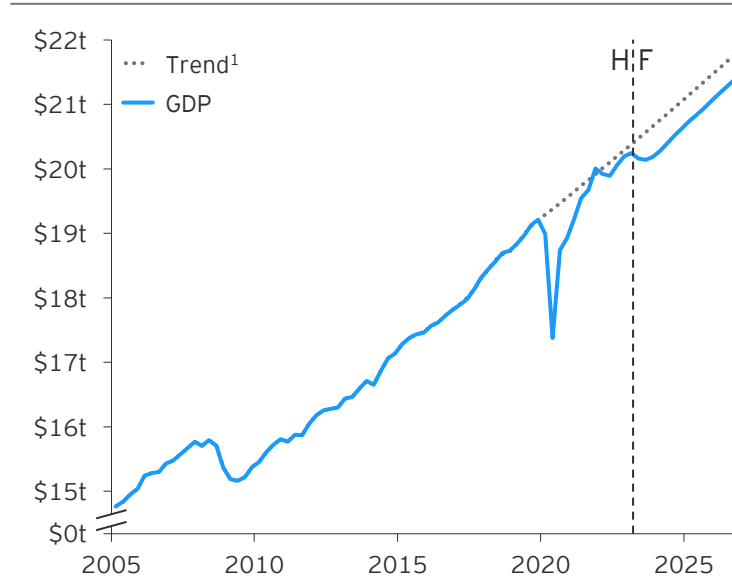
- ▶ Even if the current episode of banking sector distress is rapidly resolved, the economy won't escape unscathed and smaller businesses may suffer the brunt of the impact via tighter credit conditions.
- ▶ While labor market strength and consumer spending resilience through February indicate the absence of any significant retrenchment in private sector activity, the current developments will make banks even more wary of lending and weigh on businesses' decisions to hire and invest.
- ▶ Lending standards had already tightened markedly before the current banking sector stress episode. The Senior Loan Officer Opinion Survey (SLOOS) from the Fed revealed that nearly half of banks had tightened standards on C&I loans to firms of all sizes at the end of 2022.
- ▶ Assuming the stress remains contained, we estimate that tighter credit and financial conditions will represent a drag on the US economy worth around 0.5% of GDP over the next 18 months.
- ▶ Moreover, the this will increase the odds of a US recession. While economic conditions still looks relatively resilient, tighter credit growth along with financial market strains could push the economy into a recession.



# The US economy will likely lapse into a mild recession, with a modest GDP contraction in coming quarters and deteriorating labor market conditions

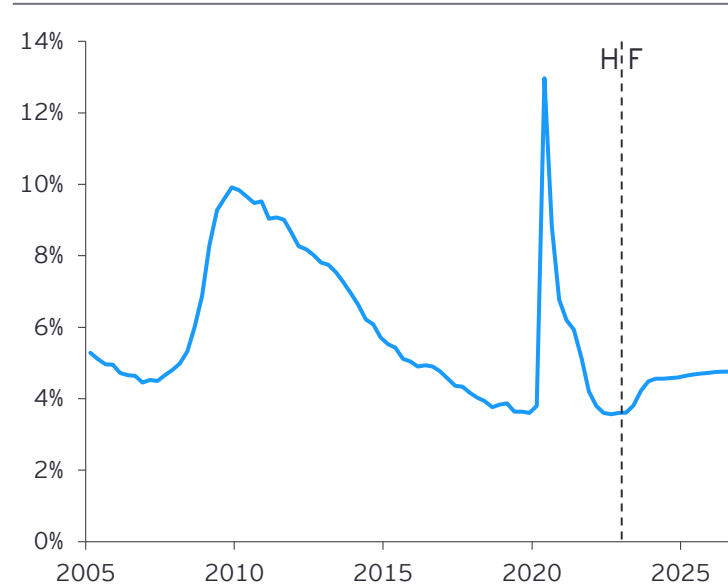
## US outlook

US real GDP  
2005-26F



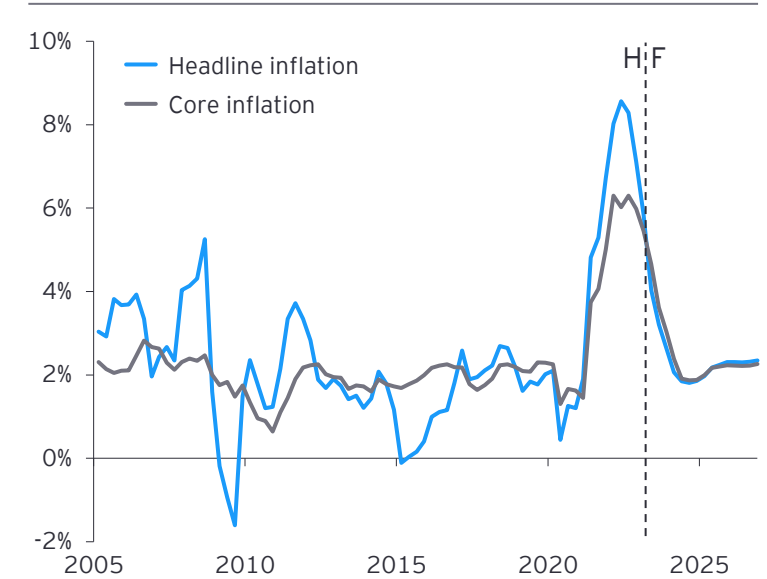
**GDP growth**  
2022: 2.1%  
2023F: 0.8%  
2024F: 1.3%

US unemployment rate  
2005-26F



**Unemployment rate**  
Q4 2022: 3.6%  
Q4 2023F: 4.5%  
Q4 2024F: 4.6%

US y/y percent change in CPI  
2005-26F



**Core CPI inflation (y/y)**  
Q4 2022: 6.0%  
Q4 2023F: 3.0%  
Q4 2024F: 1.9%



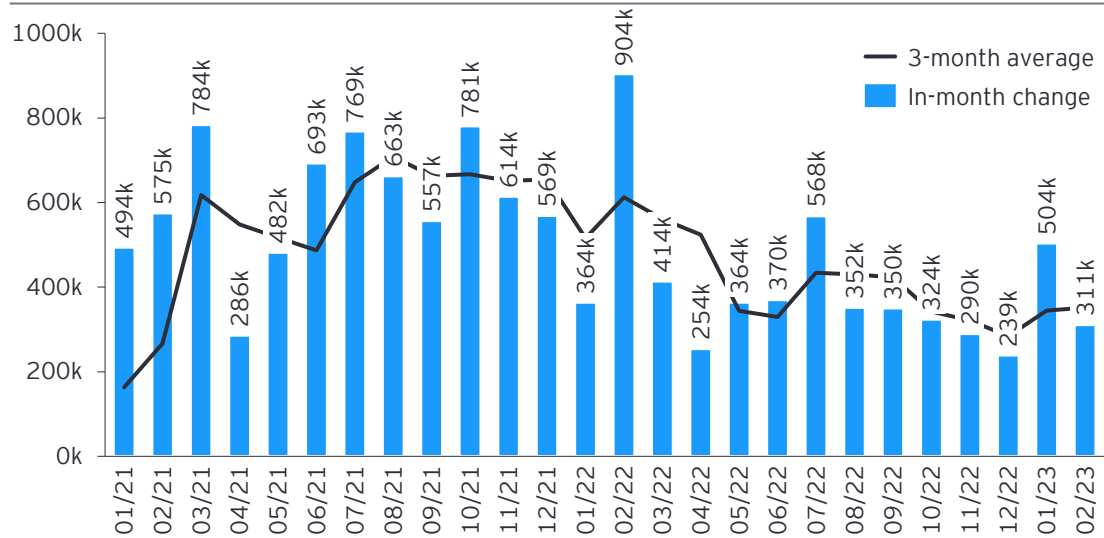
**Key risks: financial market turmoil, Fed policy tightening, global recession, debt ceiling**

1. Pre-COVID-19 trend line reflects annual GDP growth at 1.9% through 2026.  
Source: EY-Parthenon

# The labor market remains strong, but a slowdown is poised to take hold as weaker economic conditions lead employers to make more strategic hiring decisions

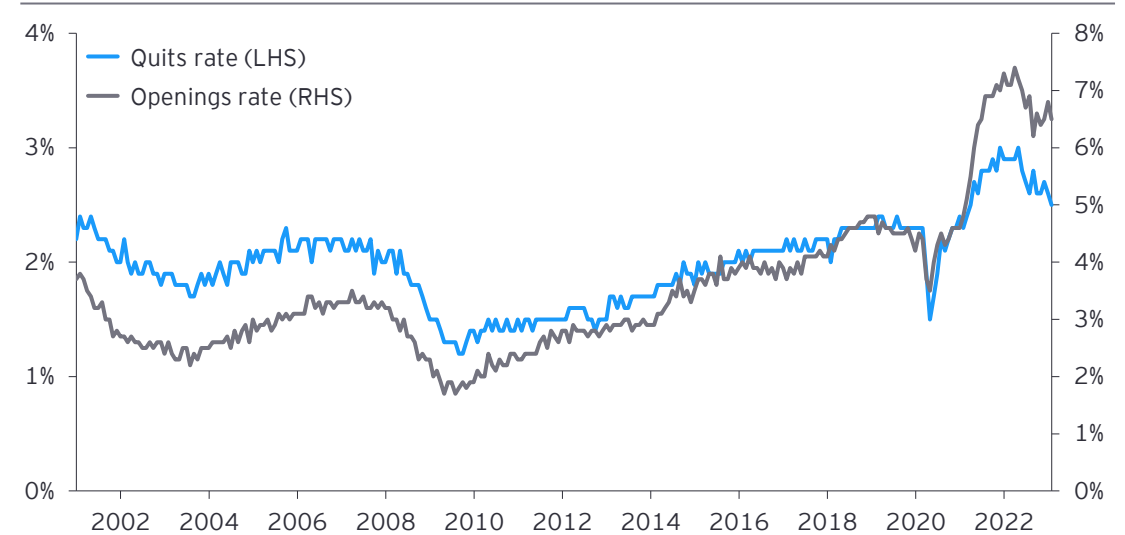
## Employment

US m/m change in total nonfarm employment  
January 2021-February 2023



- ▶ The economy added a robust 311k jobs in February following a downwardly revised 504k jobs surge in January. Revisions to the prior two months showed 34k less jobs than previously reported, and the three-month moving average of job gains firmed to 351k.
- ▶ Jobs gains were broad-based with the private sector adding 265,000 jobs and the government sector adding 46,000 jobs - mostly education jobs. Importantly though, average weekly hours worked in the private sector fell back 0.3% after a 0.6% gain.
- ▶ The unemployment rate grew 0.2ppts to 3.6% in February from 3.4% the month prior, which was the lowest rate since 1969.

JOLTS openings rate vs. quits rate  
December 2000-January 2023

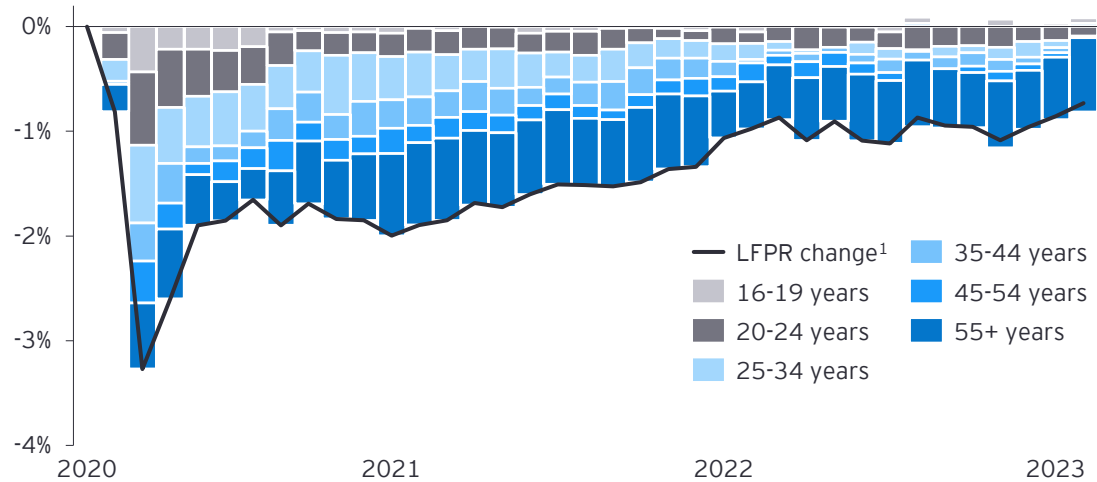


- ▶ The latest Job Openings and Labor Turnover Survey (JOLTS) also pointed to still tight labor market conditions. Job openings declined 400k to 10.8m in January but remain well above their 7m average in the year leading up to the pandemic. And there were only 53 unemployed workers for every 100 job openings in January, near the lowest level on record.
- ▶ Layoffs edged up to 1.7m in January compared to 1.5m in the prior month but remain very low as companies hold onto their valued talent pool. Meanwhile, the number of quits declined but stayed at an elevated level of 3.9m compared to 4.1m in December and a peak of 4.4m in March 2022.

# Pandemic staffing challenges and structural labor shortages point to a mild labor market downturn as companies hold onto their existing workforce

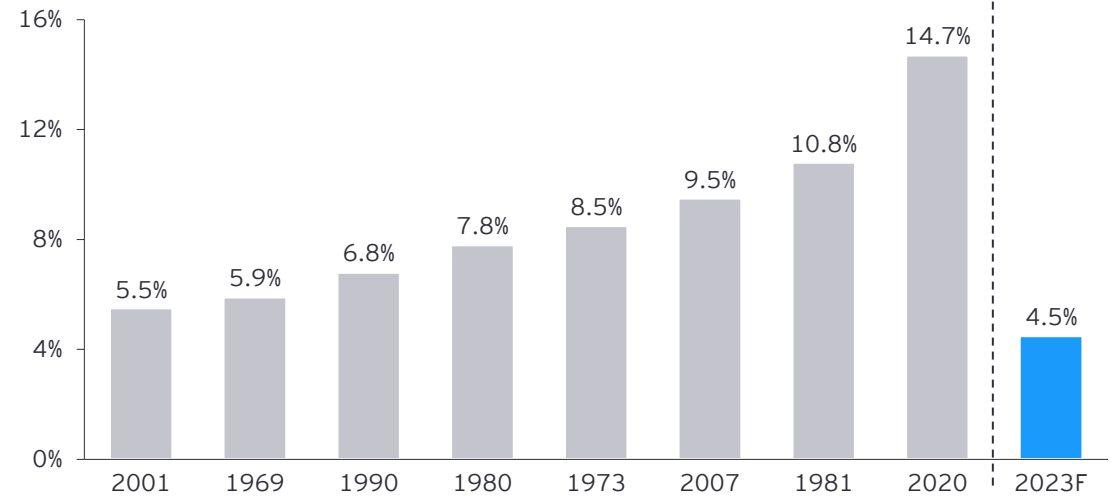
## Employment

Contribution to US labor force participation rate change relative to Feb 2020  
February 2020-February 2023 (Feb 2020=0)



- ▶ In February, the labor force participation rate rose for a third consecutive month to 63.5%. And the prime-age (25-54 years) participation rate jumped to 83.1% from 82.7%, reaching its pre-pandemic level for the first time since the onset of the pandemic.
- ▶ The cyclical rebound in labor force participation is very encouraging as a stronger supply of labor can act as a relief valve against elevated wage pressures. At the same time, labor force participation is increasingly constrained by the ongoing retirement of baby boomers as well as the continuing immigration shortfall.

US peak unemployment during recessions  
1969-23F

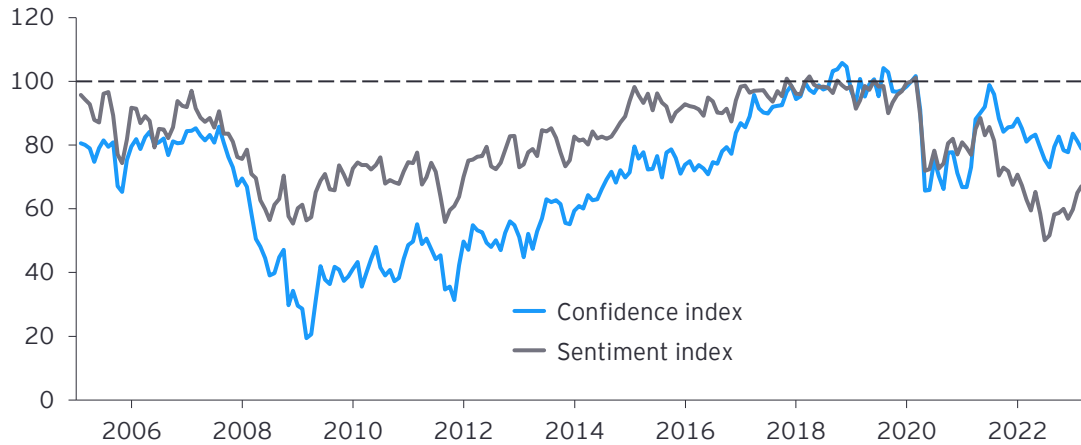


- ▶ With much effort having been poured into hiring and training over the last 18 months, executives are reluctant to let go of their prized talent pools. As such, layoffs remain low, and instead, reduced hiring and wage growth compression are being considered as alternatives to keep a lid on labor costs.
- ▶ Looking ahead, we expect labor demand will soften as companies grapple with slower demand, weaker profitability, continued cost pressures and tight financing conditions. Yet, the labor market downturn will be mild by historical standards, with the unemployment rate likely to peak near 4.5% by year-end.

# Wary consumers will exercise more caution amid dwindling savings buffers, tighter credit conditions and growing financial market volatility

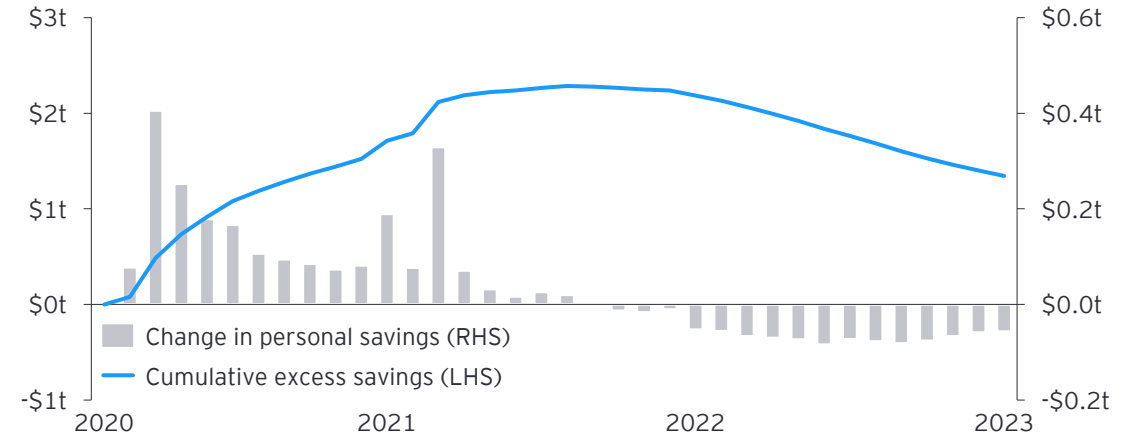
## Consumer behavior

US consumer confidence and sentiment index  
January 2005-March 2023<sup>1</sup> (January 2020 = 100)



- ▶ Consumer attitudes took a step back in March after improving for three consecutive months and remain historically low. Looking ahead, rising financial market and economic uncertainty will likely weigh on consumers' morale in coming months.
- ▶ Encouragingly, inflation expectations for the year ahead declined markedly to 3.8% from 4.1% in February, reaching their lowest level since April 2021. Long-run inflation expectations also edged down from 2.9% to 2.8%.

US change in and cumulative excess personal savings<sup>2</sup>  
February 2020-January 2023



- ▶ Households' excess savings accumulated during the pandemic, which many continue to view as fueling consumer spending, have declined about 40% to \$1.3 trillion. For lower-income families, their excess savings have vanished, and they are now dipping into their regular savings and using credit to offset the burden of inflation.
- ▶ With about a third of the excess savings used to pay down debt, and another significant portion likely invested in financial or real estate assets, excess savings should no longer be viewed as an alternate source of income supporting consumer spending. And the recent rise in the personal savings rate may be an indication of precautionary savings heading into turbulent times.

1. Data for confidence index only available through February 2023.

2. Excess personal savings is defined as the cumulative stock of savings above what consumers would have saved if income and spending would have maintained their pre-pandemic pace.

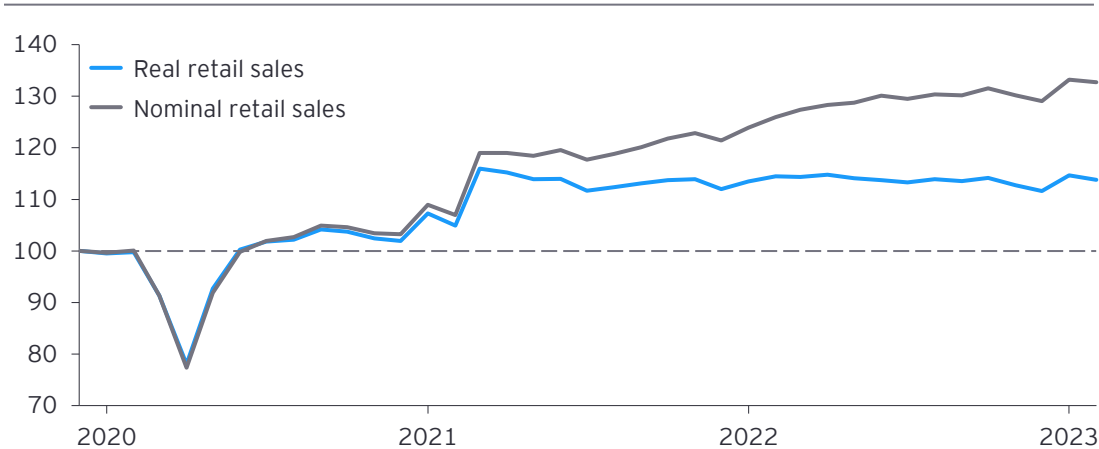
Source: US Census Bureau; Bureau of Economic Analysis; EY-Parthenon



# Recent data on household spending and credit growth indicate that we will likely see a K-shaped consumer spending pattern in 2023

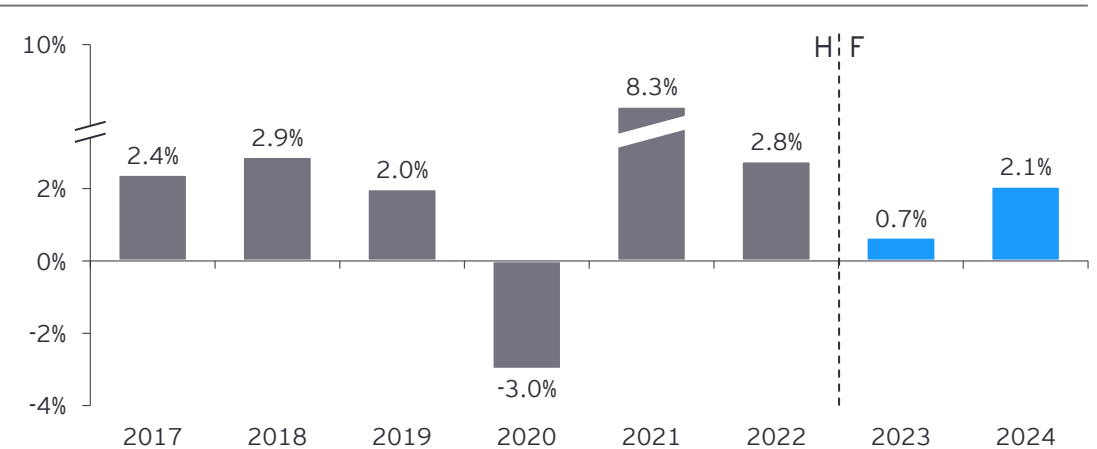
## Consumer behavior

US nominal and real retail sales indexes  
December 2019-February 2023 (December 2019 = 100)



- ▶ Retail sales fell back last month after surging in January and showing considerable volatility at the turn of the year. Nominal sales declined 0.4% in February, but the volumes fell 0.8% when adjusted for prices. Weaker purchases of motor vehicles were a drag on top-line retail sales. Consumers also spent less at restaurants and bars and on some discretionary items such as furniture and clothing.
- ▶ Control retail sales - a key gauge of broader consumer spending trends that strips out the volatile components - posted a moderate 0.5%. The latest data, along with the slight upward revisions to the January figures, keeps consumer spending growth on track to grow around 2%-2.5% (annualized) in Q1 2023.

US y/y percentage change in real personal consumer expenditures  
2017-24F

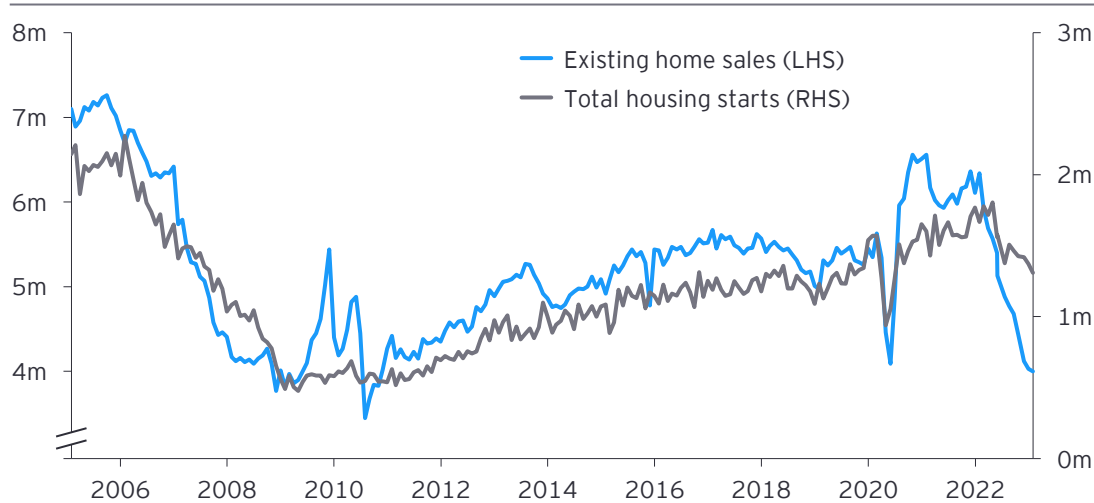


- ▶ Slowing employment growth, tighter credit conditions, and still elevated inflation will likely dampen households' willingness to spend.
- ▶ Recent data on household spending and credit growth point to a K-shaped consumer spending pattern in 2023 with low- and median-income families exercising more spending restraint, and families at the higher of the income spectrum still spending, albeit with more discretion.
- ▶ We anticipate consumer spending will advance only 0.7% in 2023 after a 2.8% increase in 2022. Next year, we should see moderately faster momentum, with growth around 2.0% as personal income outpaces inflation and provides a greater source of support to consumer outlays.

# The housing market is showing some signs of stabilization at very low levels, but elevated mortgage rates, low affordability and tighter credit conditions will limit growth

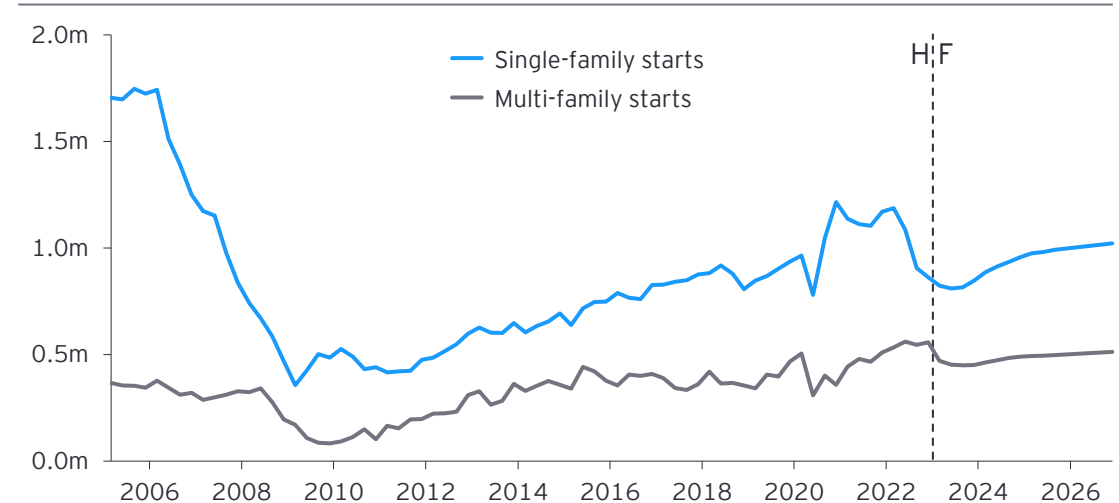
## Housing and real estate

US existing home sales and housing starts  
January 2005-January 2023



- ▶ The housing market remains under pressure even though recent data point to some stabilization in activity. After falling for five straight months, housing starts jumped 9.8% to 1.45m unit in February. The gain was concentrated in the volatile multi-family starts segment while single-family permits posted their first monthly gain in a year.
- ▶ The National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index (HMI)<sup>1</sup> continued to recover in March, with sentiment rising 2 points to 44 on the back of rising current sales and higher traffic of prospective buyers.

US new housing starts  
2005-26F



- ▶ While recent declines in Treasury yields will put some downward pressure on mortgage rates, they remain historically elevated. This will maintain pressure on sales in the coming months, especially as credit conditions tighten.
- ▶ Against this backdrop, the slowdown in home prices should intensify. We forecast annual home price growth to contract over 6% y/y by the middle of 2023.

1. The NAHB Housing Market Index is a gauge of builder opinion on the relative level of current and future single-family home sales.  
Source: Mortgage Bankers Association; US Census Bureau; National Association of Realtors; EY-Parthenon

# Global supply chain pressures have eased considerably despite lingering vulnerabilities, and some of the easing reflects rapidly cooling manufacturing activity

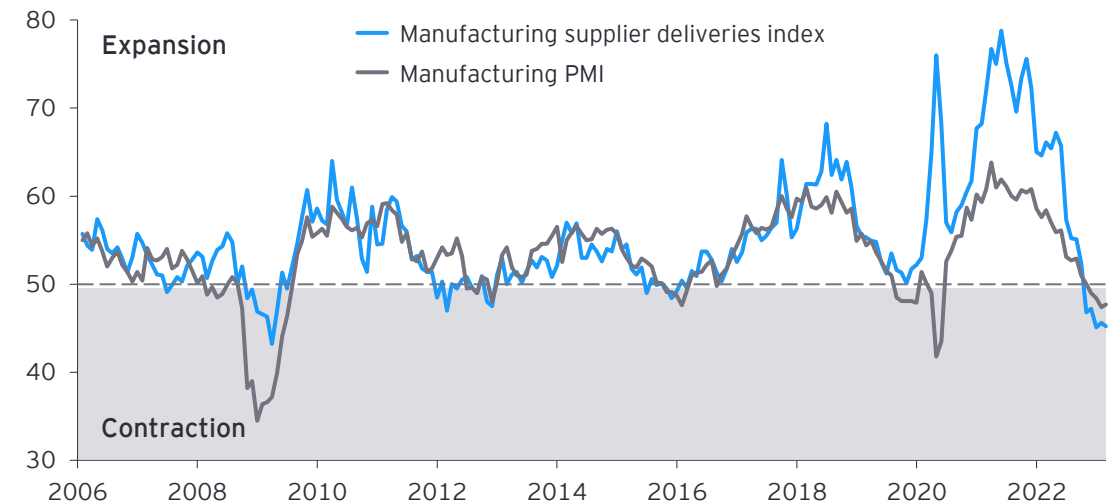
## Business activity

Global supply chain pressure index (GSCPI)<sup>1</sup>  
January 2010-February 2023



- ▶ The GSCPI, which tracks the evolution of global supply chain pressures, eased considerably in February and is now below the historical average. Most of the subcomponents contributed to the decline, with the largest negative contribution from European Area delivery times.
- ▶ While conditions appear to have normalized, the pandemic has exposed key vulnerabilities in global supply chains which will continue to be challenged by geopolitical risks, elevated input costs, labor shortages and lingering disruptions from the pandemic.

US manufacturing PMI and supplier deliveries subindex<sup>2</sup>  
January 2006-February 2023



- ▶ Manufacturing activity is showing continued signs of weakness as the headline ISM manufacturing index remained in contraction territory for a fourth straight month in February. Fourteen of the 18 manufacturing industries surveyed reported a contraction in activity last month.
- ▶ The new orders index rose 4.5 points while the production index fell 0.7 points. However, both remained in contraction territory signaling weak current and future factory activity.

1. Index scaled by its standard deviation (0 = average value).

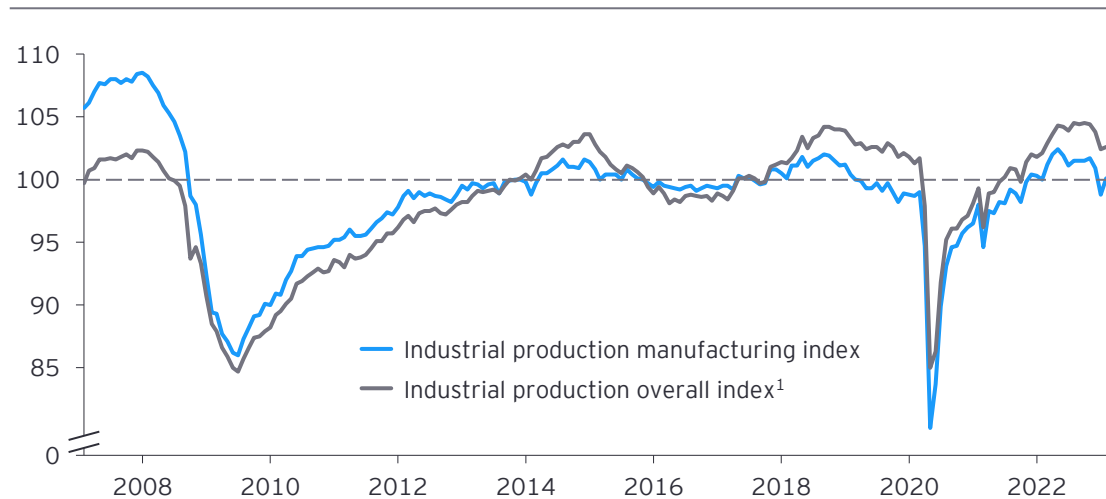
2. The ISM (Institute for Supply Management) measures PMI (Purchasing Managers' Index) by surveying manufacturing and service firms on their orders, production, employment, deliveries and inventories. The index indicates business activity in both sectors. This is a diffusion index, with readings above 50 indicating expansion and readings below 50 indicating contraction in activity.

Source: Federal Reserve Bank of New York; ISM; EY-Parthenon

# A deeper slowdown in industrial activity will take hold as weaker demand at home and abroad, along with tighter credit conditions weigh on business spending plans

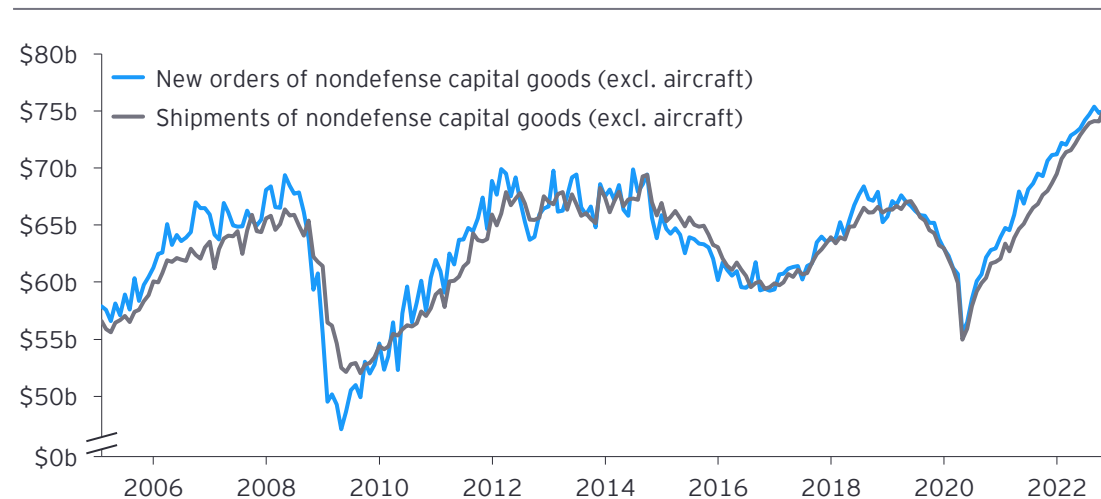
## Business activity

US industrial production indexes  
January 2007-February 2023 (2017 = 100)



- ▶ Industrial production was steady in February following an upwardly revised 0.3% gain in January. Manufacturing output increased 0.1% on the month while mining output fell 0.6%. Utilities production rebounded 0.5% after plunging 10.1% in January as unusually warm weather curbed demand for heating.
- ▶ The industrial sector had demonstrated resilience in the face of the broader economic slowdown for most of 2022, but the momentum has softened markedly. Higher interest rates and credit availability amid banking turmoil will weigh on industrial activity and business spending in the coming months.

US value of new orders and shipments of nondefense capital goods  
(three-month moving average; nominal)  
January 2005-December 2022



- ▶ Durable goods orders jumped 5.6% in December following an upwardly revised 1.7% decline in the prior month. The details of the report were less encouraging, as the surge in headline orders was due to a jump in nondefense aircraft orders. Excluding transportation, new orders slipped 0.1%.
- ▶ Both core orders (nondefense capital goods excluding aircraft) and core shipments were down 0.2% and 0.6% on the month, respectively, pointing to weak business investment trends. Looking ahead, the combination of lingering inflation, weak business sentiment, a higher cost of capital and weaker profitability will increasingly constrain investment growth.

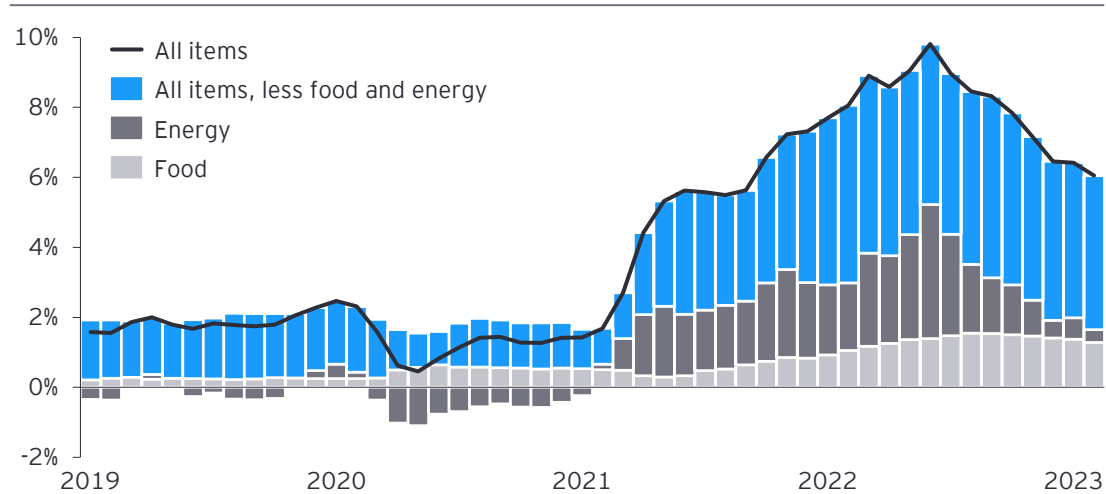
1. Overall index includes manufacturing as well as mining and electric and gas utilities.  
Source: US Census Bureau; EY-Parthenon



# Despite recent bumps on the road, we expect inflation will fall with accelerating momentum this year as disinflationary forces intensify

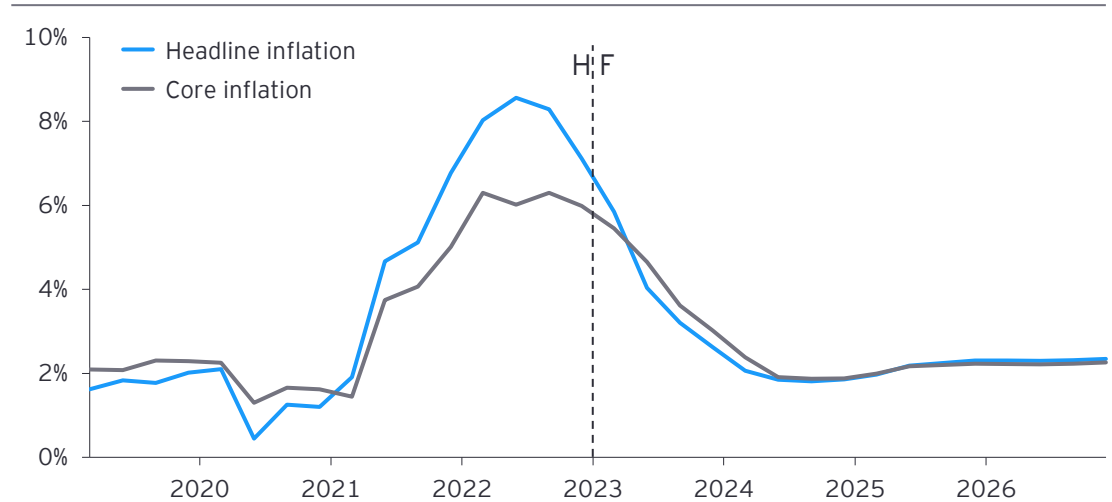
## Inflation

US y/y percent change in CPI, contribution by category  
January 2019-February 2023



- ▶ Headline Consumer Price Index (CPI) rose 0.4% month over month (m/m) in February following a 0.5% gain in January.
- ▶ The 0.5% advance in core prices - driven by shelter inflation - points to a noteworthy mild re-acceleration in prices. Still, a look into the details doesn't show excessive cause for concern.
- ▶ Core goods prices were flat while services prices excluding energy and shelter increased a mild 0.3%. This is reassuring, as it points to strong disinflationary forces once shelter costs begin to fade.

US y/y percent change in CPI  
2019-26F

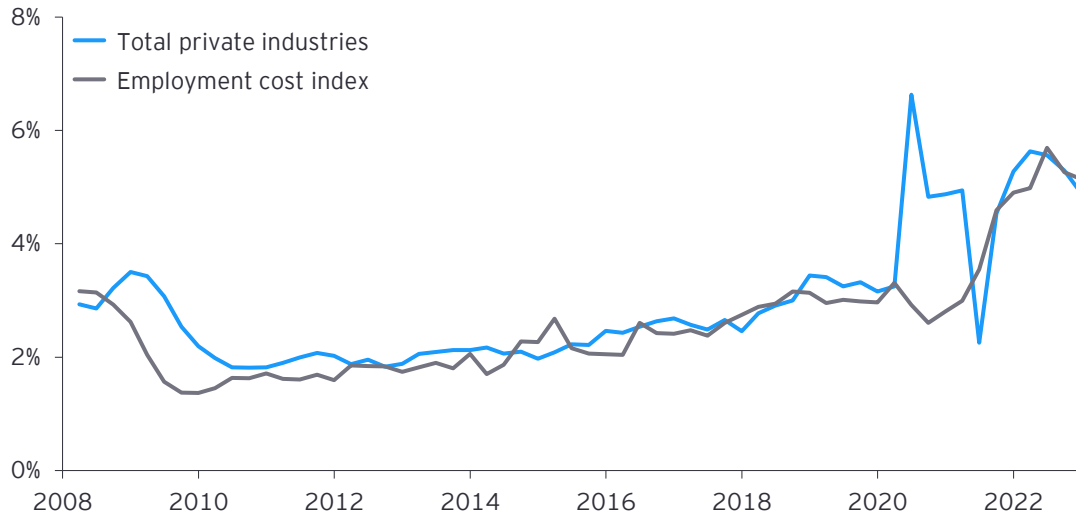


- ▶ Despite recent bumps in the road, the disinflationary process is still underway as monthly price gains are much smaller than last year. Headline CPI inflation cooled 0.4ppt to 6.0% y/y in February – the lowest annual gain since September 2021. Core inflation fell 0.1ppt to 5.5%, matching the lowest since December 2021 and 1.1ppt below its September 2022 peak.
- ▶ Overall, inflation is clearly on a decelerating path with gradual consumer price disinflation, accelerating wholesale price disinflation, import price deflation and a notable pullback in consumers' inflation expectations. But it will take time for inflation to sustainably return to the Fed's 2% inflation target as we see headline and core inflation remaining above 3% until mid-2023.

# The moderation in wage inflation should gather pace as the large imbalance between strong labor demand and weak labor supply gradually decrease

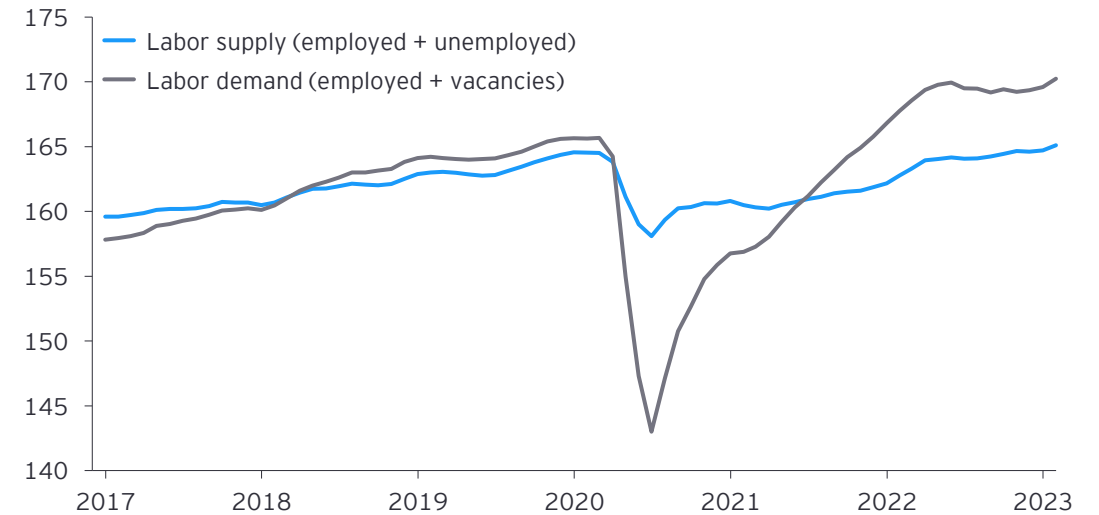
## Inflation

US y/y percent change in wages and salaries  
Q1 2008-Q4 2022



- ▶ Wage inflation remained elevated in the final quarter of 2022, though moderating sequential momentum indicates the pressure has begun to ease. The Employment Cost Index (ECI) posted a 1% quarter over quarter (q/q) advance in Q4, after a 1.3% gain in Q3. And the all-important private-sector wages and salaries gauge advanced 1% q/q – its smallest gain since Q4 2021.
- ▶ Despite the moderation, headline ECI compensation growth rose 0.1ppt to 5.1% y/y, matching its fastest pace since Q3 1990. Encouragingly, private-sector wages and salaries growth eased 0.2ppt to 5.1% and is now 0.6ppt below its 2022 peak.

US labor demand and supply  
December 2016-January 2023

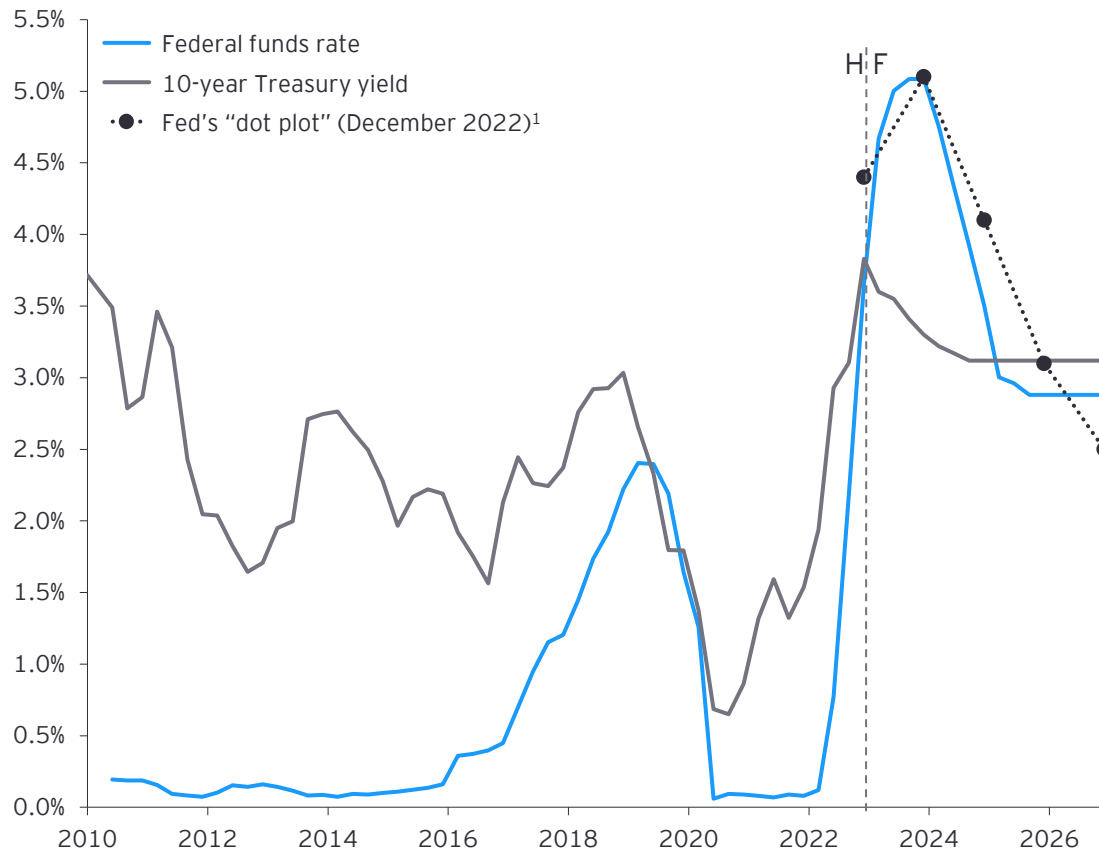


- ▶ The latest monthly data on wage growth was also encouraging, with average hourly earnings growth decelerating to 0.2% m/m in February following 0.3% m/m growth in January. On a year-over-year basis, wages grew 4.6% versus 4.4% in January because of a flat reading for earnings in February of last year.
- ▶ Looking ahead, we anticipate that wage gains will continue to moderate as the demand for workers softens and comes closer into better balance with a limited pool of available workers. This view is corroborated by our conversations with business executives, which indicate that companies are opting to reduce their hiring efforts and wage bill to keep a lid on labor costs.

# The Fed is on track to lift the policy rate above 5%, but recent financial market turbulence highlight the risk of overtightening and the lack of policy anchor

## Federal Reserve

### US interest rate forecasts, federal funds rate and 10-year Treasury yield 2010-26F



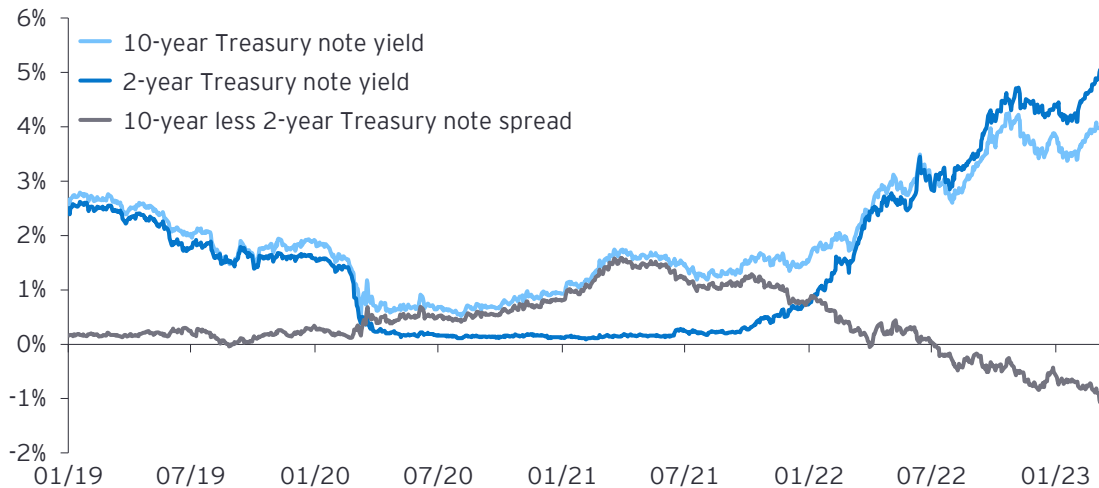
- ▶ The Fed raised the federal funds rate by 25bps to 4.50%-4.75% at the January 31-February 1 Federal Open Market Committee (FOMC) meeting. This move to a slower pace of monetary policy tightening after a historic four consecutive 75bps rate increases and a 50bps rate hike in December will better allow the FOMC to assess the economy's progress toward its goals, as it determines the "extent" of future increases.
- ▶ Recent banking stress has put the Fed in a very uncomfortable position: it can't do everything, everywhere, all at once. The elevated inflation backdrop means that it is in a very delicate situation compared with the past 40 years. Whereas previously, the Fed had been able to discount the price stability risk and respond unwaveringly to the financial stability risk, conditions today are very different with inflation still too high.
- ▶ The major question for the Fed isn't whether it should pause its tightening cycle - as a prudent risk management approach would suggest - but whether it will. And legacy may be the defining factor. Fed Chair Powell and most policymakers do not want their legacy to be a failure to bring inflation down to the 2% target.
- ▶ As such, we believe the Fed may consider adopting a dual track policy approach, similar to the ECB, distinguishing monetary policy from macro-prudential policy. In doing so, the Fed would be able to continue tightening monetary policy gradually - likely in 25bps increments - while closely monitoring financial market developments and addressing risk concerns with its macro-prudential tools.
- ▶ In our view, the optimal approach would be to pause the tightening cycle in order to assess economic and financial conditions over the next couple of months. This would allow a better anchoring of monetary policy to the totality of data rather than excessive backward-looking data dependence.

1. "Dot plot" charts the median interest rate projection from the FOMC. The projections for the federal funds rate are the values at the end of the specified calendar year.  
Source: Federal Reserve Board; EY-Parthenon

# While Treasury bond yields have plunged on a flight to safety, financial conditions have tightened significantly pointing to increased constraints on private sector activity

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US 10-year, 2-year, and 10-year less 2-year Treasury note spreads  
January 1, 2019-March 14, 2023



- ▶ Treasury yields collapsed at the height of the recent banking stress, with the move led by the front end of the yield curve as market participants adjusted their expectations for the Fed's policy path downward. The 2-year yield fell by 57bps in a single day and is down 90bps from its March 8 peak while the 10-year Treasury bond yield is about 45bps lower.
- ▶ The yield curve, measured as the spread between the 2-year and 10-year Treasury yields, has steepened as a result although it remains in negative territory. Historically, an inverted yield curve has been viewed as an indicator of a pending economic recession.

Bloomberg US financial conditions index<sup>1</sup>  
January 2, 2007-March 20, 2023



- ▶ Over the past two weeks, financial conditions have tightened markedly in the wake of several regional US bank failures and growing fears of contagion in the global banking system. The Bloomberg financial conditions index has declined to its tightest level since last fall.
- ▶ A rapid and disorderly tightening of financial conditions represents a key risk to the outlook as it can lead to an abrupt private-sector retrenchment. Moreover, it is important to note that as the economy slows, it becomes more vulnerable to tighter financial conditions.

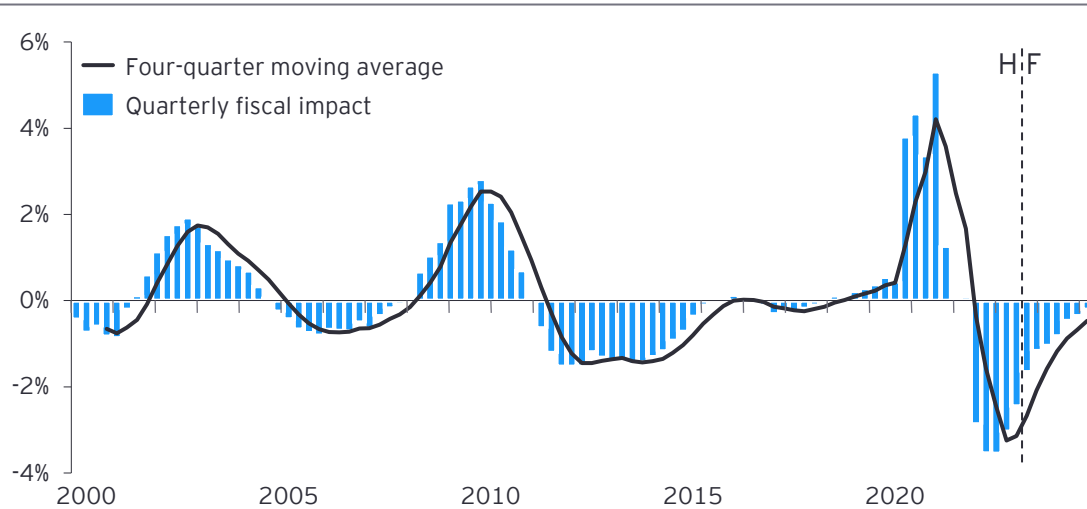
1. Weighted average of riskless interest rates, the exchange rate, equity valuations and credit spreads.  
Source: Federal Reserve Board; Bloomberg; EY-Parthenon



# The worst of the fiscal drag is behind the US economy, though the impulse remains deeply negative; the budget deficit is set to fall toward \$1.1t in FY 2023

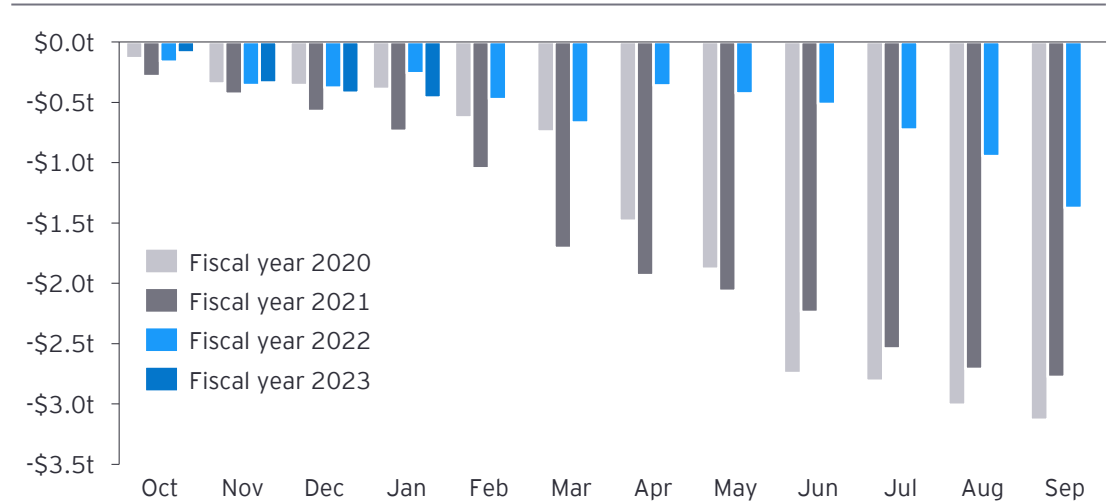
## Federal Reserve

US contribution of fiscal policy to real GDP growth, annual rate  
2000-24F



- ▶ As most federal pandemic support measures expired, the fiscal impulse, which tracks the impact of the change of the federal budget on the economy, turned sharply negative in 2022, reaching a near 4ppt drag on real GDP growth.
- ▶ While the fiscal impulse is expected to remain a burden on the economy in 2023, the impact on the economy will gradually ease this year. Still, the effect on growth is expected to remain negative over the next couple of years.

US federal budget deficit, annual total  
FY2020-FY23

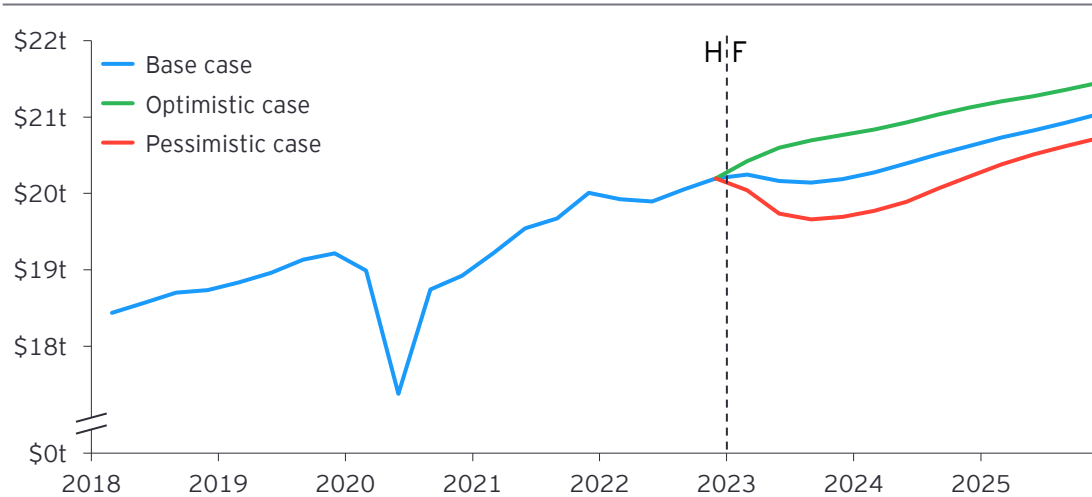


- ▶ The federal budget deficit was \$1.4t in fiscal year 2022, about half of the deficit in fiscal year 2021. Treasury reported a budget deficit of \$262bn in February and for the 2023 fiscal year to date, the federal government registered a budget deficit of \$723bn, compared to \$476bn for the same period last year.
- ▶ We anticipate the federal budget deficit will narrow to around \$1.1t in fiscal year 2023 (which runs from October 2022 through September 2023). This would be the lowest budget deficit since fiscal year 2019, though we see risk of a larger deficit given the expected deterioration in the economic backdrop.

# Amid elevated financial market uncertainty, key downside risks stem from a disorderly tightening of financial conditions with still-elevated inflationary pressures

## Risks and opportunities

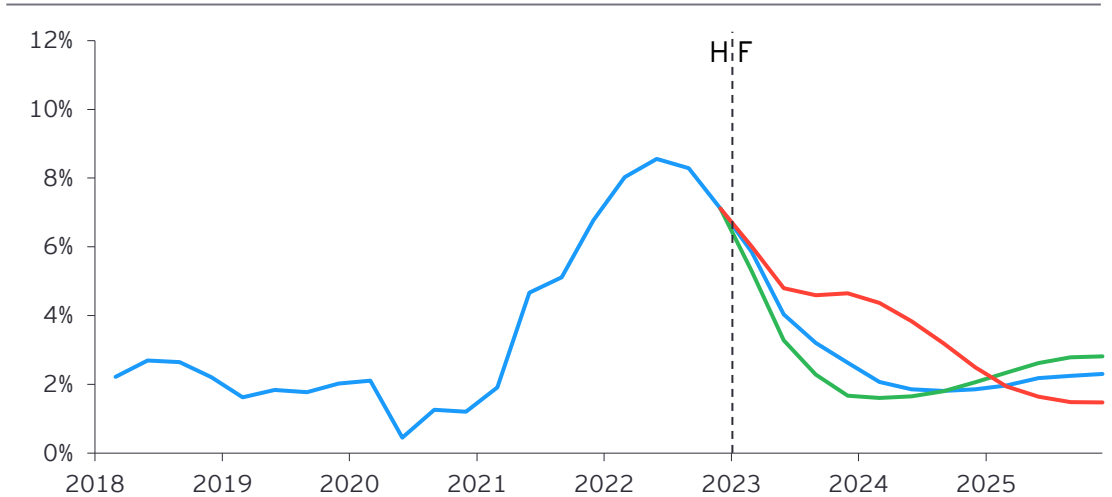
US real GDP  
2018-25F



### Characteristics of a potential optimistic case:

- ▶ Significant easing of supply-side constraints, with global supply chain strains diminishing and the labor market rebalancing, and greater business efficiency gains leading to a significant easing of inflationary pressures.
- ▶ The consumer shows resilience, thanks to continued labor market gains, and continues to support domestic economic activity.
- ▶ Amid a sharp deceleration in inflation, the Fed pivots to a less hawkish stance and raises interest rates to a lower terminal rate than anticipated, managing a so-called “soft landing” of the economy.

US y/y percentage change in headline CPI  
2018-25F



### Characteristics of a potential pessimistic case:

- ▶ Renewed global supply shocks stemming from geopolitical tensions lead to a renewed spike in energy, commodities and food price inflation, while persistent tightness in the labor market keep wage growth and services inflation elevated.
- ▶ Rising inflation expectations lead the Fed and other central banks to tighten monetary policy more aggressively, leading to a severe and disorderly tightening of global financial conditions, with surging bond yields and plummeting stock prices.
- ▶ The cost-of-living crisis deepens, undermining private-sector confidence and keeping consumers and businesses wary of spending. Labor market conditions deteriorate rapidly, with the unemployment rate rising sharply.

# In the current environment, firms must look to transform uncertainty into opportunity, which requires a holistic strategy framework factoring multiple alternative scenarios

## Risks and opportunities

### Three themes for 2023-24

- 1 A multispeed global economy
- 2 Peak inflation and employment robustness
- 3 Central banks tightness with consequences

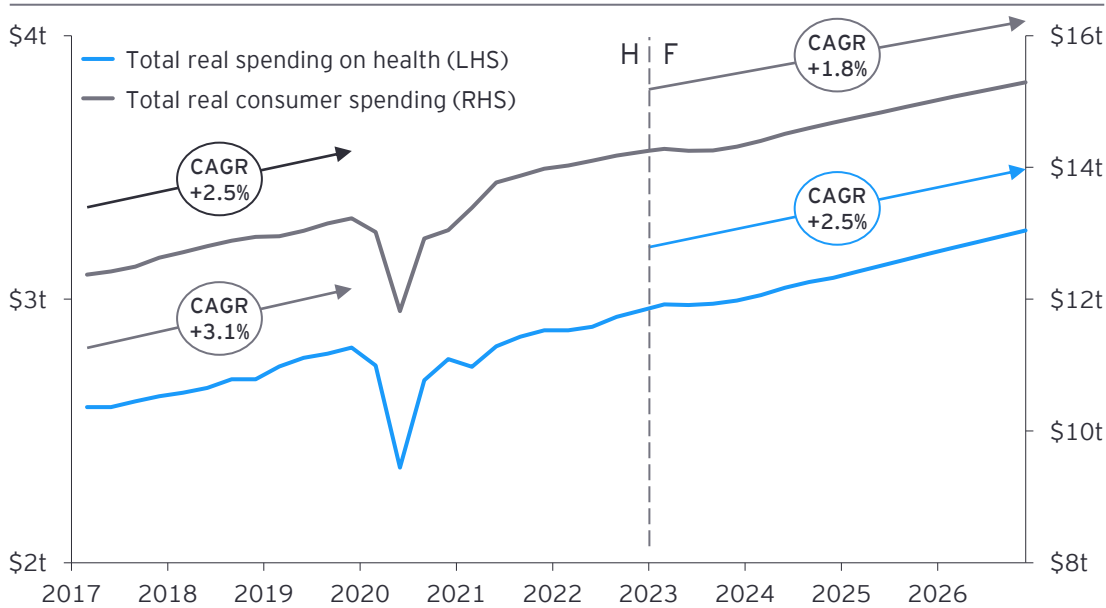
### Five “no-regret” actions for business leaders

- 1 Execute upon a holistic pricing strategy
- 2 Maintain talent resilience and productivity
- 3 Understand supply-side drivers
- 4 Adapt to the new cost of capital
- 5 Align strategies with stakeholder priorities

# While health care expenditure has recovered, providers are facing rising wages that outpace inflation in the sector

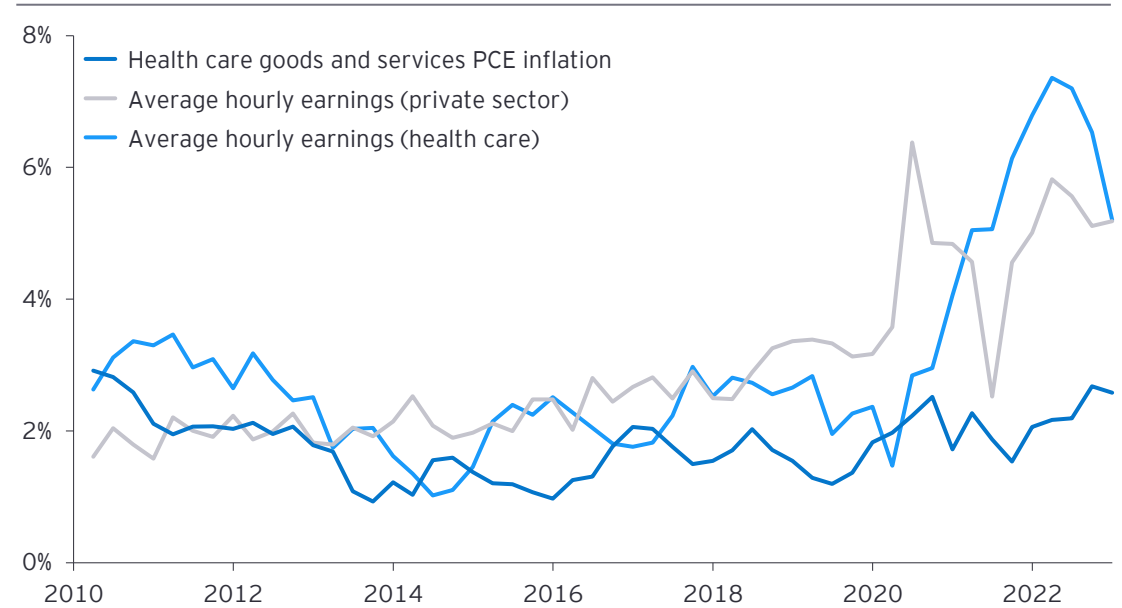
Sector single click: Health sciences and wellness

US total real consumer spending  
2017-26F



- ▶ Consumer spending on health goods and services has recovered from COVID-driven pullbacks such as the cancellation of elective care.
- ▶ Compared to the pre-COVID period, real consumer spending on health care is projected to grow at a slightly slower pace. We anticipate growth rates p.a. between 2-3% over the forecast horizon, outpacing broader consumer spending as health care continues to grow as a share of total spend.

YoY % change in US average hourly earnings and health care inflation  
January 2010 - December 2022



- ▶ The health care sector has experienced elevated wages, though somewhat delayed and more recently persistent relative to the broader economy, a byproduct of labor shortages acutely felt in this labor-intensive sector. Simultaneously, health care goods and services inflation has been stable in the range of 2-3% annually.
- ▶ This combination of elevated labor costs and relatively laggard pricing levels is putting pressure on the cost base and bottom line for health care providers. With consumer health care spend activity recovered from COVID pressures, providers are contending with maintaining appropriate staffing levels and growing wages.



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