2023

WHAT TO WATCH:

Five Economic Trends to Expect in 2023

In kicking off the new year, we at the Kenan Institute want to highlight five topics we anticipate will be top of mind for business leaders and policymakers during the 12 months ahead. Although some of these challenges – such as the recession we expect – can be painful, they also present opportunities. To help you navigate this rapidly evolving economic landscape, the Kenan Institute will work to provide solutions-focused analysis on the following as well as related issues throughout 2023.

KENAN INSTITUTE of Private Enterprise
UNC KENAN-FLAGLER BUSINESS SCHOOL

American Growth Project

1

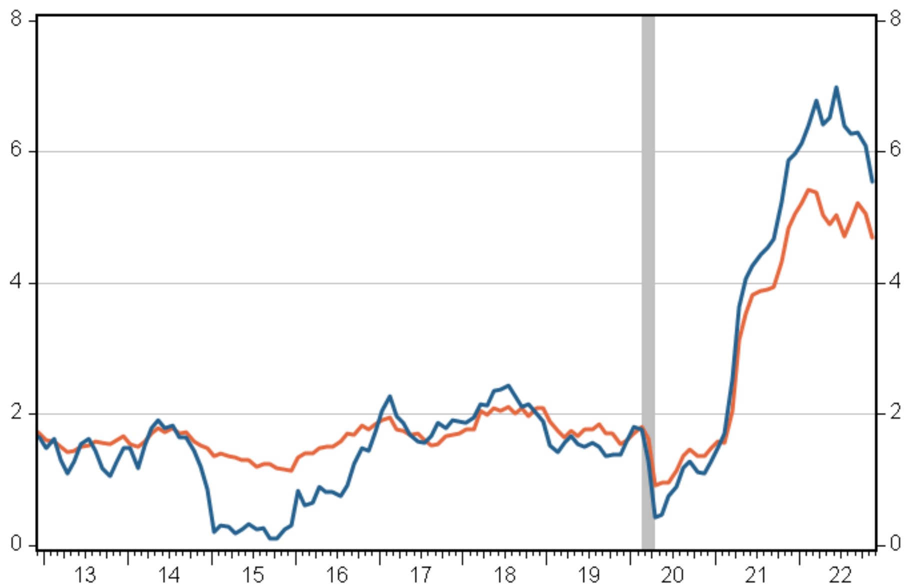
Is the Fed Likely to Cause a **Recession?**

Yes, but we are not there yet. The latest employment data – with job creation of 263,000 in November and an unemployment rate of 3.7%, hovering near 50-year lows – indicate that the economy is not in recession and is showing few signs of a meaningful slowdown. Even sectors such as tech, with its spate of layoff announcements, and real estate, with a doubling of mortgage rates, are continuing to see job growth, albeit at a slower pace. At that same time, inflation remains well above the Federal Reserve's 2% target. The Fed's preferred measure of prices was up 5.5% in the year ending November 2022, while measures that strip out the volatile food and energy sectors gained 4.7%.

This leaves the Fed in a difficult position. Monetary policy works with long and variable lags, which means the Fed knows that its policies will eventually bite. In fact, its own forecast has the economy slowing meaningfully, and many economists, including me, are expecting a recession during the next year or so. But to maintain its inflation-fighting credibility and make up for past mistakes (the Fed should've raised rates earlier and more aggressively), it now has to show its mettle and is very likely to push us into a recession. The only way of achieving a soft landing will be a substantial slowdown in inflation during the next several months, and it might already be too late for that. Watch the inflation numbers carefully, especially the Fed's preferred measure, the Personal Consumption Expenditures Price Index.

PCE: Chain Price Index
% Change - Year to Year *SA, 2012-100*

PCE less Food & Energy : Chain Price Index
% Change - Year to Year *SA, 2012-100*



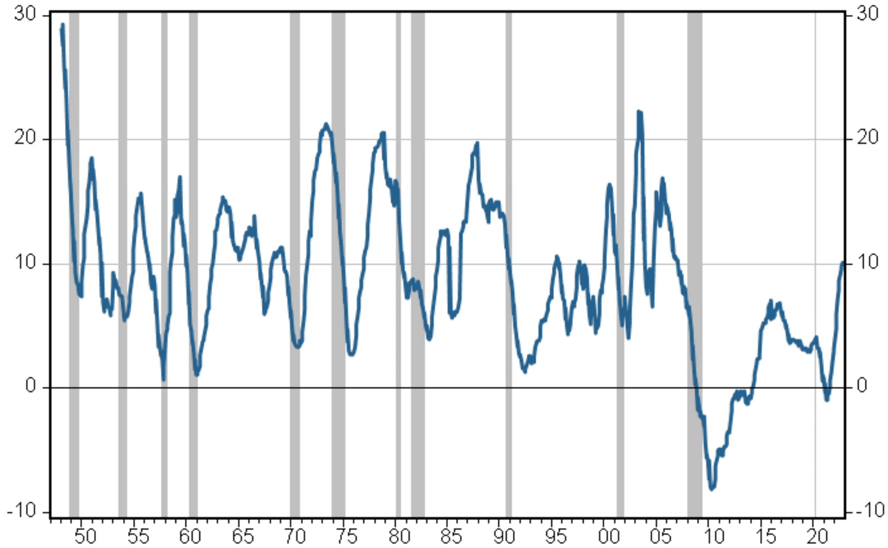
Souce: Bureau of Economic Analysis

2

Will the Recession Be **Shallow or Deep?**

Real Estate Loans: All Commercial Banks

% Change - Year to Year *SA, $*



Souce: Federal Reserve Board / Haver Analytics

My favorite economic indicator, the spread between 10-year and 3-month Treasurys, recently turned negative. As I discussed in a previous commentary, this measure has accurately predicted every recession since the early 1970s, with a lead time of roughly one year. As I noted above, to date, we are seeing few recessionary signs. But Fed actions are likely to push us into a recession, in my opinion, starting the second half of 2023 or early 2024.

I believe it will be a fairly mild recession on a national scale. That's because households have more than $2 trillion of excess savings accumulated during the last few years, which should cushion the downturn. Moreover, the amount of household and business borrowing is relatively low. As we experienced in the Great Recession of 2008-09, the collapse of the housing bubble had far-reaching consequences because many households walked away from underwater mortgages, leaving lenders holding the bag. This meant that even healthy borrowers were unable to borrow money to buy new homes or expand their businesses. Job losses stemming from the looming recession will slow or contract consumer spending, causing further pain, but the lack of leverage accelerant means the pain will likely be limited. We will be watching lending and bankruptcy data to assess risks.

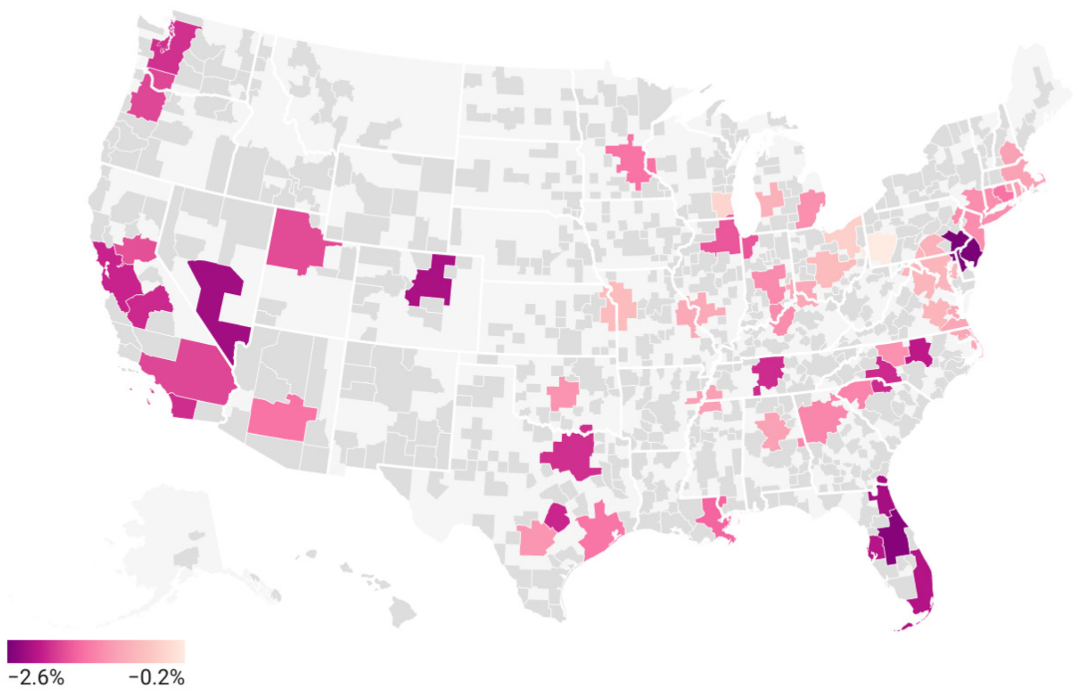
3

How Will **Local Economies** Fare?

While national statistics tell a story of averages, they fail to account for the true drivers of economic expansion and contraction. It is only upon examining America's microeconomies – our cities, towns, suburbs and rural communities – that we can begin to appreciate the myriad and complex determinants of broader U.S., and sometimes even global, economic trends. We recently launched the American Growth Project, to help decision-makers understand the divergent economic conditions across the United States, and to do so in real time.

How will the 50 largest Extended Metropolitan Areas in the U.S. fare during 2023? Despite the woes of the tech sector, San Francisco remains our fastest-growing city, with an expected growth of 2.9% in 2023 – thanks to the power of productivity. Yet it is also experiencing one of the biggest slowdowns in the country along with other tech-heavy areas such as Austin, Denver and our very own Research Triangle. Tourism-focused areas will also take it on the chin, with Orlando, Las Vegas and Miami expected to be hit hardest. A combination of local housing policy changes and higher interest rates appear ready to take their toll on Philadelphia. Meanwhile, San Antonio and Oklahoma City – both among our productivity top gainers – join the ranks of our top 10 fastest-growing cities, with slow but still positive growth. For more information, see "Big-City GDP in 2023: Who'll Grow, Who'll Falter and Why," and keep an eye out for our next report on small and midsize city growth.

Change in GDP Growth from 2022 to 2023

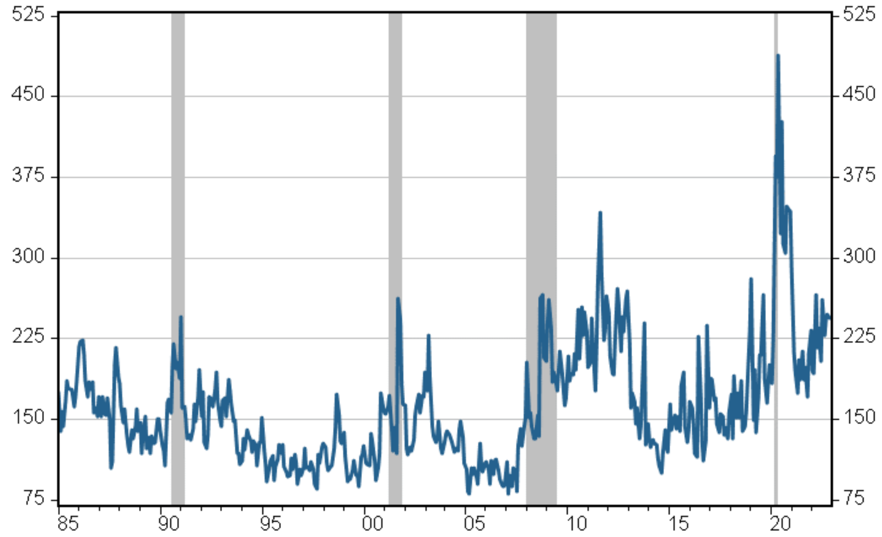


4

How Will **Markets** Handle More Uncertainty?

Economic Policy Uncertainty Index

2005=100



Souce: PolicyUncertainty.com

Perhaps forward-looking markets have correctly anticipated the paths of the economy, as well as fiscal and monetary policy. As we discussed earlier, the Fed is extremely data dependent – particularly regarding inflation readings – and as illustrated by its bungled inflation forecast last year, economic data can be difficult to predict. Moreover, because of the Fed's impact on the cost of capital, the flow of data holds significant consequences for economic outcomes such as corporate earnings in 2023 and 2024. At the same time, a divided Congress with razor-thin majorities and leadership challenges in the House could hamper passage of needed policies such as raising the debt ceiling. All of this means we expect measures of uncertainty to remain elevated. (*Note that these measures are important to watch because they can create negative feedback loops as investors, businesses and individuals shy away from uncertainty.*)

5

– How to Engage a Skilled and Diverse **Labor Force**? –

The onset of COVID-19 highlighted shifting trends in employment dynamics – workers who are looking for more out of their jobs and employers, such as flexibility on location and hours, female-oriented benefits, and having companies share their ESG values. At the same time, employers are finding it harder to hire workers with the right set of skills – and those skills are changing rapidly, as evidenced by the seemingly human writing of artificial intelligence-driven ChatGPT. How is AI likely to affect workers? The impact of AI on workers is a complex and multifaceted issue. On the one hand, AI has the potential to automate many tasks and make workers more efficient, which could lead to increased productivity and economic growth. On the other hand, AI could also potentially displace workers who perform tasks that can be automated, leading to unemployment and other social issues. (*The previous economist-sounding passage was written by ChatGPT*).

As part of its grand challenge for 2023 – Workforce Disrupted: Seeking the Labor Market's Next Equilibrium – the Kenan Institute will explore how shifts in labor supply and demand are changing employment dynamics through a series of Kenan Insights, commentaries, webinars, events and other activities. Scholars and business leaders will come together to separate cyclical trends from structural ones and discuss the opportunities and trade-offs of this complex topic. We hope you will join us.

Gerald Cohen
Chief Economist, Kenan Institute of Private Enterprise

Gerald provides strategic vision and leadership of the translational economic research, and policy initiatives at the Institute.