Moody's
ANALYTICS

COMMENTARY
21 February, 2023

Author
Mark Zandi

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

Keeping Faith

It will be a difficult year for the U.S. economy, but as long as consumers, businesses and lenders do not lose faith, there are better than even odds of skirting a full-blown downturn.

- Consumers have not lost faith in the economy, but they are wavering.
- Small businesses are on edge, lenders have turned skittish, and many leading indicators suggest recession is ahead.
- But a strong labor market, the excess savings still in many consumers' pockets, and a financial system on firm ground argue against recession.
- We are nearing the moment of truth for this business cycle.

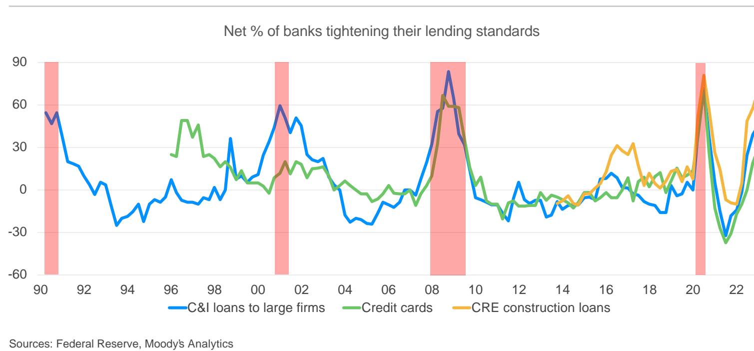
Economic recessions are ultimately a loss of faith. Consumers lose faith that they will hold on to their jobs and curtail their spending. Businesses lose faith that they will be able to sell whatever they produce and lay off workers. Lenders lose faith they will be repaid in a timely way and aggressively tighten lending terms. A vicious self-reinforcing cycle takes hold: Consumers pull back on spending, businesses respond by laying off workers, and lenders curb credit, further spooking consumers who cut back even more. A broad-based persistent decline in economic activity—a recession—is ignited.

Consumers have not lost faith in the economy, but they are wavering. In the 70-plus years that the University of Michigan has surveyed the mood of American households, there were less than a handful of times that sentiment was weaker than it is now. Sentiment slumped to a record low in June as gasoline prices surged to a record high.

Small businesses are similarly on edge, according to the 50-year survey by the National Federation of Independent Business. Respondents are especially down on the economy's prospects later this year. And while the Moody's Analytics survey of global businesses, which we have conducted weekly for nearly 20 years, is not as bleak, it is consistent with an economy struggling to avoid recession.

Lenders have also turned skittish. The Federal Reserve's quarterly survey of senior loan officers at commercial banks shows most banks rapidly tightening their underwriting standards, particularly for commercial real estate loans and commercial and industrial loans to businesses of all sizes. The stiffening in underwriting is comparable to the tightening in the lead-up to past downturns.

MOODY'S ANALYTICS / Copyright © 2023, Moody's Analytics, Inc.All Rights Reserved.



There are good reasons for the frayed nerves. Inflation remains painfully high, forcing the typical American family to shell out almost $400 more per month to buy the same goods and services it did just a year ago. And interest rates have soared as the Fed works hard to quell this inflation. The typical homebuyer needs to shell out a prohibitive nearly $600 more per month in principal and interest on a mortgage than they would have a year ago. Businesses and real estate developers are also grappling with much higher borrowing costs and lenders with flattening net interest margins, slumping investment portfolios, and a turn up in delinquency rates.

Economists know from times past that when inflation is high and the Fed is stepping hard on the monetary brake, recessions typically follow. The Fed aims to raise interest rates high enough, fast enough to rein in inflation but not so high and fast as to undermine the economy. But the only time the Fed has arguably pulled this off was in the mid-1990s, and then inflation was meaningfully lower than it is today.

Moreover, many of the historically tried-and-true leading indicators economists rely on also strongly signal that a recession is dead ahead. The most prescient, an inversion of the Treasury yield—with short-term yields rising above long-term yields—first occurred almost a year ago. Indeed, the consensus among economists is that a recession in coming months is more than likely. To think otherwise would be to think this time is different. But most of the time it is not.

Of course, each business cycle has its own idiosyncratic features, and the current one has a number that collectively argue this time is indeed different enough. Despite history and the leading indicators, barring another significant shock, the economy has a fighting chance of skirting recession in the coming year as consumers, businesses and lenders hold on to their faith in the economy.

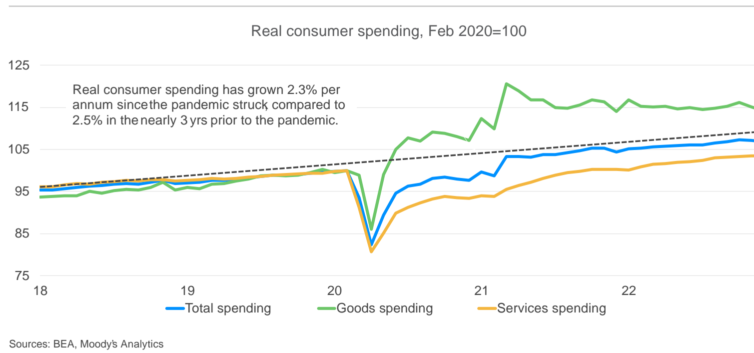
Consumers do their part

What makes this time so different for consumers is the so-called excess savings they built up during the height of the pandemic. This is the extra saving consumers did above what they would have done if there had not been a pandemic—in other words, as if they had maintained the same saving rate during the pandemic as prior to it.

Low- and low-middle-income households initially saved a significant amount of the government support they received to financially navigate the pandemic, including three rounds of stimulus checks, enhanced unemployment and rental assistance, and moratoriums on student loan and mortgage payments. High-income households saved prodigiously as they sheltered in place, unable to spend much of their incomes. Across all households, we estimate household excess saving peaked in September 2021 at almost $2.5 trillion, equal to an astounding 10% of GDP.

There was plenty of concern that with so much cash sitting in people's checking accounts there would be a spending boom once the economy reopened. Consumer spending did pick up with the COVID-19 vaccine rollout and government support provided in the American Rescue Plan in spring 2021, but consumers have not spent with abandon. They have simply done their part, spending at a pace consistent with pre-pandemic spending trends. Real consumer spending is consistent with what it would have been if spending had continued to grow at the underlying pre-pandemic pace.

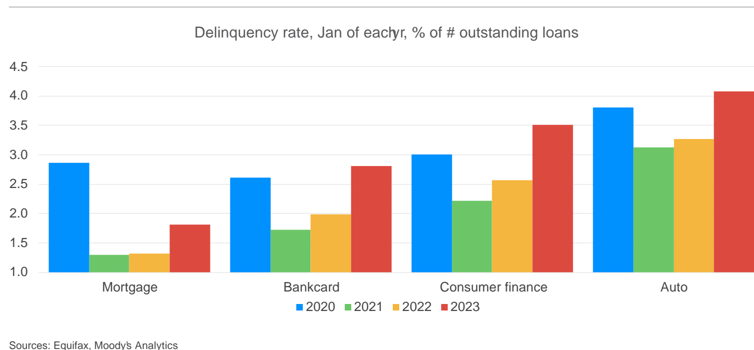
MOODY'S ANALYTICS / Copyright © 2023, Moody's Analytics, Inc.All Rights Reserved.



This excess saving has provided vital financial support to consumers struggling to maintain their spending in the face of the surge in inflation and the hit to real income inflicted by the pandemic and Russian war in Ukraine. As of January, consumers had drawn down their excess savings by close to $1 trillion to supplement their incomes and maintain their purchasing power.

Despite that significant drawdown, the $1.5 trillion in excess saving that remains largely in bank accounts is considerable and should be more than sufficient to allow consumers to maintain their spending. Particularly since inflation is receding and real after-tax incomes are on the rise again. Consumers will not need to rely on their excess saving in the coming year nearly as much as they did in the past year.

That said, many low- and low-middle-income households have likely used up most of their excess savings. Consistent with this is the significant pickup in borrowing via credit cards and unsecured personal loans such as buy now pay later loans. Loan outstandings are growing at a meaningful double-digit pace, particularly among borrowers with lower credit scores—borrowers who are generally of more modest means. Also indicative of the financial stress on these households, delinquency rates are fast on the rise and already higher than pre-pandemic. This should be a bit of a headwind to consumer spending, but not enough that it would push overall spending off course since about 85% of consumer spending is done by those in the top half of the income distribution.

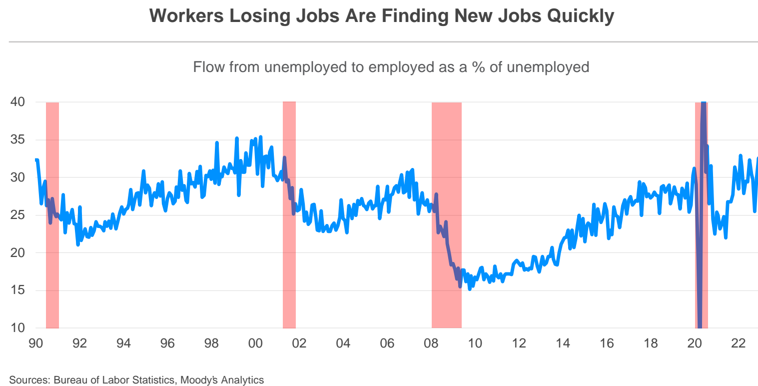


This time is also meaningfully different for businesses managing a labor shortage that came to the fore just prior to the pandemic and was exacerbated severely by it. Labor force participation is still depressed by young parents unable to find affordable childcare and by potential workers infected with long COVID. Businesses recognize that even when the fallout from the pandemic fades and the economy gets to the other side of its current troubles, finding and retaining qualified workers will remain their number-one problem.

Baby boomer retirements are also behind the persistent labor shortage. Foreign immigration should help, but unless lawmakers are able to pass immigration reform allowing substantially more immigrants to live and work here—a highly doubtful development any time soon—the labor force and job growth will weaken considerably. Over the past decade job gains have averaged 165,000 per month, but in the coming decade the labor force will only grow enough to support average monthly job gains of 50,000.

MOODY'S ANALYTICS / Copyright © 2023, Moody's Analytics, Inc.All Rights Reserved.

Given this long-term demographic reality, businesses are loath to lay off workers even if their revenues are under pressure. Layoff announcements at technology firms, retailers and housing-related businesses are up a lot in recent months, but those losing jobs are quickly hired by other firms. Unemployment insurance claims, a clear read on economy-wide layoffs, remain extraordinarily low at below 200,000 per week. In a well-functioning economy, UI claims are closer to 250,000 per week, and in a recession, claims would surge to well more than 300,000 per week.

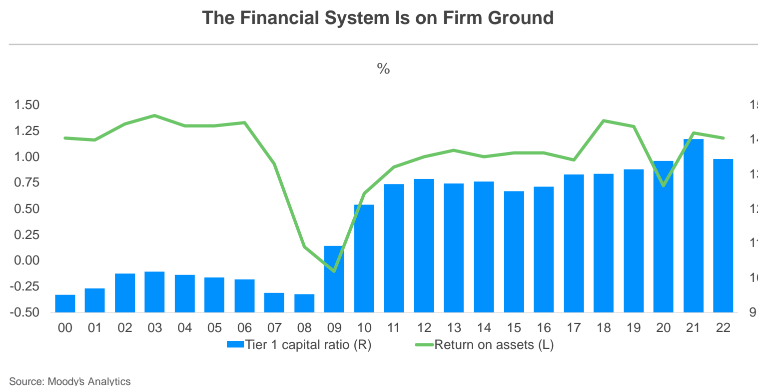


Job growth is slowing, not because of more layoffs but because businesses are throttling back on hiring, which is down to where it was pre-pandemic. This also helps explain the elevated number of unfilled positions. Workers continue to quit their jobs at a high rate, resulting in more job openings, but businesses appear to be slow-walking hiring to fill those open positions. It is much less costly and disruptive to businesses to reduce payrolls through less hiring than through more layoffs.

It is also much less scary to consumers. Losing a job is a much bigger blow to the psyche than not being able to quickly find a new job. To be sure, layoffs will pick up in coming weeks and return to something more consistent with historical norms. But if that is the worst of it as businesses remain focused on their longer-term labor needs, it is difficult to see consumers losing faith and packing it in—and a recession ensuing.

Firm financial ground

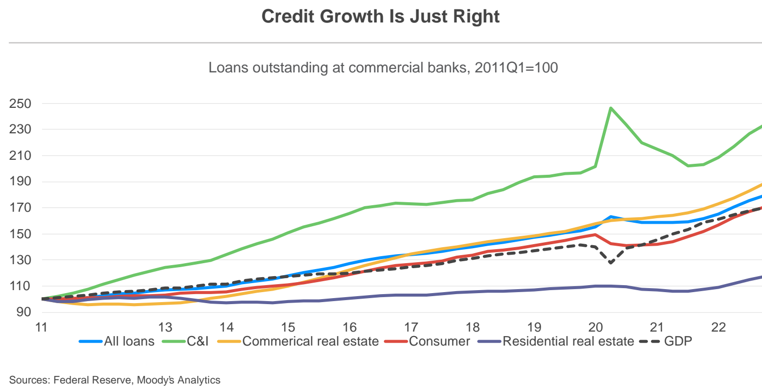
The financial system has also arguably never been on firmer ground. This is due largely to the system's regulatory overhaul in the wake of the financial crisis. Most notable, the 2010 Dodd-Frank legislation that required banks to hold much more capital, engage in annual stress tests to identify vulnerabilities, and have more liquid balance sheets. This applied particularly to large systemically important institutions. The legislation also imposed reforms on all corners of the non-bank so-called shadow financial system, from insurance companies and hedge funds to the securities markets.



It has long been difficult for the financial system to strike a balance between too much credit and not enough. Too much credit leads to too much leverage, a financial crisis, and recession. Not enough credit induces a credit crunch and stunted economic growth. Regulators looking down on the financial system from up high would like to see credit growth consistent with growth in the economy, which reflects the ability of consumers and

MOODY'S ANALYTICS / Copyright © 2023, Moody's Analytics, Inc.All Rights Reserved.

businesses to make good on their debts. And that is what they have seen, more or less, since the post financial crisis reforms—bank loans outstanding have grown at nearly the same pace as GDP.



There are fissures in the financial system that are under stress given how fast and high interest rates have risen. One is the previously mentioned rapid growth in credit card and other consumer lending. The capital adequacy and liquidity of independent mortgage banks that originate the bulk of FHA, Fannie Mae and Freddie Mac loans, which collectively account for approximately three-fourths of all originations, are also questionable given the housing recession. Liquidity in the Treasury bond market is a concern, as is the opaque part of the leveraged loan market—consisting of loans to riskier, more indebted businesses—that is neither rated nor backs collateralized loan obligations. And there is the speculative and fraud-riddled crypto market.

But these fissures still appear largely benign or too small to matter much to the broader financial system and economy. This is different from most prior business cycles that often were plagued with a major fault line and resulting earthquake in the financial system.

Conclusions

We are nearing the moment of truth for this business cycle. Will the economy suffer a recession, or will it be able to skirt one? The answer ultimately rests on whether consumers, businesses and lenders lose faith in the economy and stop spending, investing and lending. Looking at past business cycles, when the economy was struggling with similar problems of inflation and high and rising interest rates, there was invariably a collective loss of faith, and recession ensued. This time is different enough that this should not happen. We are lowering our subjective odds that a recession will begin sometime in the coming year to 45% from 50%. Our baseline (most likely) outlook has been recession-free, but we are increasingly confident in this outcome.

MOODY'S ANALYTICS / Copyright © 2023, Moody's Analytics, Inc.All Rights Reserved.

Copyright © 2023, Moody's Analytics, Inc. and/or its licensors and affiliates (together, "Moody's"). All rights reserved. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by Moody's from sources believed by it to be accurate and reliable. Because of the possibility of human and mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. Under no circumstances shall Moody' have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of Moody's or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if Moody's is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The financial reporting, analysis, projections, observations, and other information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell, or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER. Each opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation prior to investing.