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My Perspective on the 2022 Economy & Looming Recession

To assess the current economic condition, I must first tell you that I see warning lights flashing for the U.S. economy. A growing number of forecasters now believe a recession is on the horizon. We've just witnessed the Federal Reserve raising interest rates by half a percentage point. This move follows a .25% increase in March when the Fed attempted to reduce liquidity in financial markets. These increases to attempt to tamp down the highest inflation we have experienced in 40 years. Will this be effective, are these moves too late?

History has shown that the Fed has never been able to correct even smaller overshoots of inflation and employment without pushing the economy into a significant recession. If the Fed overtightens, this could easily send the economy into recession. Plus, given the high rate of inflation, particularly in oil and food, it's not hard to imagine consumers pulling back their spending to compensate. While taking some spending out of the economy is one reason the Fed is raising rates, economic growth could stall if consumers feel forced to cut back too much.

Am I being overly pessimistic given the economy is strong by many measures? Employers have added nearly 6.5 million jobs in the last 12 months and unemployment has fallen to just 3.6%. I continue to see employers struggle to hire workers to keep up with surging consumer demand. I see an economy reeling from the flood of fiscal and monetary stimulus spending, and the Fed being too patient to act. The pandemic-rebounded economy and the hot labor market further fuel my recession concerns.

So, what exactly is a 'recession'? You will find many definitions and indicators of a recession. Generally, a period of two consecutive quarters of negative economic growth is commonly considered a recession. By that definition, however, it's often hard to recognize a recession until it's already taken hold for six months. There have been a few times when the National Bureau of Economic Research, the organization that officially declares a recession, has done so without two negative quarters. The spring 2020 period following the onset of the coronavirus pandemic is an example of such an occurrence.

Here are indicators to watch:

- The Federal Reserve's strategy on current high inflation. After down-playing inflation for much of 2021, the Fed has finally decided to tackle price growth. The Fed began to tighten monetary policy in January of this year when Fed Chair Jerome Powell announced that the Fed would lower its $9 trillion balance sheet sometime in 2022 and begin the process of withdrawing cheap money from the economy. This put pressure on stocks across the board—especially tech companies that thrive in such an environment. Powell rolled out the next step by not only raising the federal funds rate in

March, but also signaling that there could be as many as seven rate hikes this year. Some economists fear the Fed will begin to be even more aggressive in upcoming meetings, raising rates by 50 basis points instead of just 25 basis points. Inflation assumptions are nothing more than the idea that people come to believe there will be higher prices in the future, and they have a raft of consequences—like accelerating wages—which can make it even harder to get inflation back toward the Fed’s 2% target. At first glance, the Fed’s strategy might seem reasonable. But today we find the consumer price index (CPI) is at 40-year highs. Economists worry that after downplaying the pace of inflation in 2021, the Fed will be too forceful as it increases borrowing costs. Should the Fed overtighten, the economy could easily slip into recession.

- A negative yield curve. This metric compares what investors can earn on short-term Treasury securities versus longer-term Treasury securities. In a healthy economy, investors demand higher yields on longer-term debt to compensate for taking on longer-term risks. When the difference between these two yields shrinks—as investors demand higher yields on shorter-term debt—it signals concern that tough times are around the corner. The yield curve has seen this exact scenario recently, suggesting that investors expect economic growth to slow in the future. Yields on shorter-term and longer-term Treasury securities have been converging, raising another signal of impending recession.

- Gross Domestic product (GDP). GDP measures the output of goods and services in the U.S. for a three-month period. Gross domestic product in the U.S. declined at a 1.4% pace in the first quarter of 2022, below analyst expectations of a 1% gain. Compare this to the 7% annual growth in the fourth quarter of 2020. Prices increased sharply during the first quarter, with the GDP price index deflator rising 8%. GDP ratings and forecasts have been cut by 0.2% and now predictions have been decreased to 3.5% national GDP growth for the remainder of year. The Fed has also lowered its expectations for 2022 GDP growth from 4% to 2.8%.

- Consumer prices. Price hikes have accelerated all year. Consumer prices in March were up 8.5% from a year ago, the sharpest increase since December 1981. Relief on the supply side is taking longer than many analysts expected, and Russia's invasion of Ukraine has only added to disruption, jeopardizing exports of both food and energy. Add in a rising interest rate environment—another cost for businesses and for working families who must borrow for mortgages, auto financing, and student loans—and this sets the stage for a recession.

My biggest fear is that the Fed's aggressive rate hikes will push the economy into a recession by the end of this year. In addition, in my day-to-day life as a community banker, I visit with customers who are not feeling very optimistic about their finances. Many still feel the COVID malaise. I see housing sales decline as financing costs rise. In my experience, I have seen financial upsets come upon us after a long time in the making and suddenly be disastrous, yet temporary. My advice is to stay positive, keep spending in check, pay down debt and build your emergency fund. All of us here at Anahuac National Bank are available help you plan and navigate a rocky year. We thank you for your confidence.