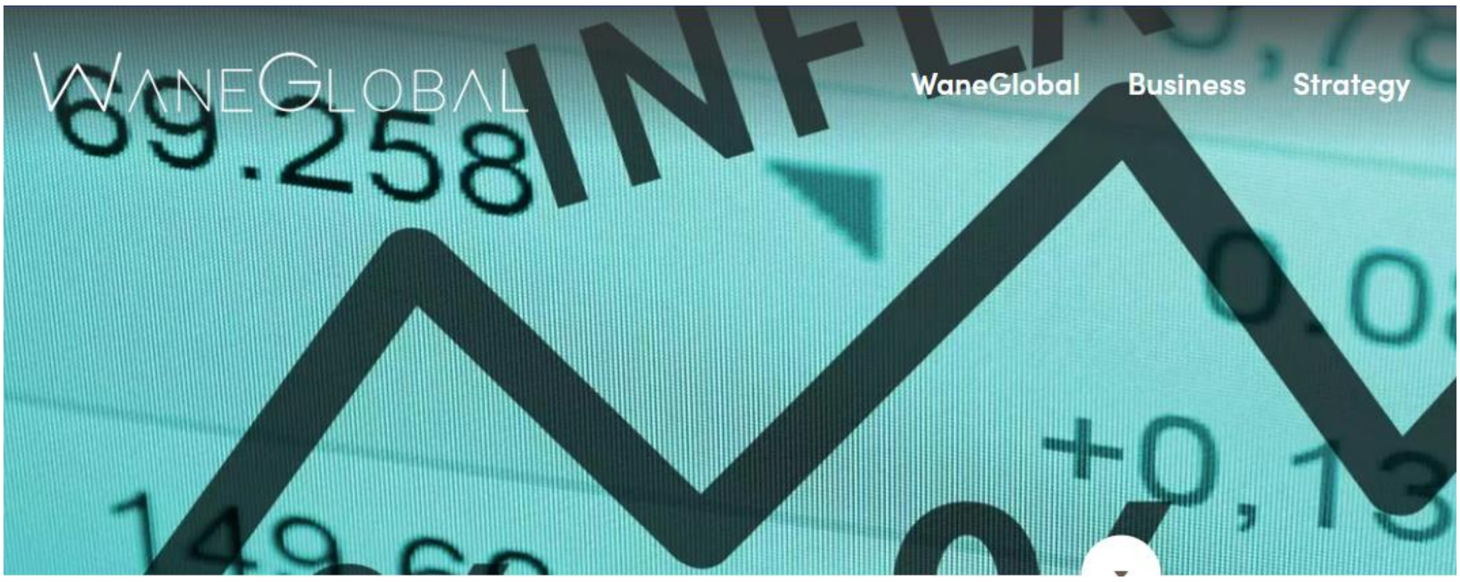

4 Ways Inflation Could Playout in the U.S. Economy

Recession and inflation have become the new talking points for the American people, who have had to change their consuming and saving behaviors in light of this unique landscape. In June 2022, the U.S. saw its largest annual surge since 1981 for consumer prices, boasting a 9.1 % yearly increase. Coupled with the news that economic growth fell 0.9 % in Q2 this year (its second quarter of negative growth), the economic landscape of the U.S. is looking uncertain at best.

But has the U.S. entered a recession? And if so, what has happened for it to get here?

Is the U.S. in a recession?

According to estimates from the Bureau of Economic Analysis, the U.S. economy experienced two consecutive quarters of declining growth; a 1.6% decrease in GDP for Q1 and a 0.9% decrease in Q2. So, we can say that America has entered a "technical recession" which constitutes two-quarters of continuous GDP decline.

The National Bureau of Economic Research (NBER) is the body that determines if America is in a recession. The data utilized is much broader than just quarter-toquarter GDP decline. The NBER uses indicators such as real personal consumption expenditures, employment rates, and wholesale-retail sales, to name a few, to make their models and de ne the accuracy of the statement "the U.S. economy is in a recession."

When taking a deeper look, it is clear that some indicators, such as the unemployment rate, don't support the recession conclusion.

As the graphs above from the National Bureau of Labor Statistics show, nonfarm payroll employment continues its upward trajectory returning to its pre-pandemic levels, signaling that a recession in its deeper meaning is not likely happening at the moment.

Unemployment rates, which are not considered in NBER indicators, maintain a slight but steady decrease – returning to a 3.5% last seen in February 2020 before the Covid-19 pandemic. This trend signals labor market strength for the rest half of 2022. Even though some critical indicators show themselves healthy, there has been a six month decrease in economic activity.

Until the NBER releases its oficial statement regarding the recession status of the U.S., we can speculate on why GDP is declining while being mindful of important indicators that are not following a recession trend.

How we got here

In March 2020, the economy ground to a halt marking the beginning of the Covid-19 pandemic. Many businesses met with the prospect of shutdowns, or remote-only operations, with few considered essential companies resuming operations under somewhat normal metrics. However, as the U.S. population went into lockdown and people stayed in their homes, consumption behavior began to change.

Following a signi cant dip in personal consumption expenditures in April 2020, mainly given the uncertainty of what would happen with the pandemic, Americans began to spend big.

With amassed savings due to lockdown and two separate stimulus acts (CARE act by former president Trump and Joe Biden's $1.9 trillion relief bill), consumers had money to spend. The trend saw buyers leaning mostly toward goods because lockdown policies limited access to services and experiences. With spending allocation shifting and an in ux of government aid, families kept spending. As a result, goods like cars, electronics, furniture, and tness gear saw massive demand surges.

On the other side, businesses faced unusually high demand. Factory shutdowns due to lockdowns or COVID-19 outbreaks, supply chain bottlenecks worldwide, and reduced production from the factories operating at low capacity, resulted in a shortage of manufacturing materials. Businesses saw an unnatural high demand relative to their supply of goods, leading rms to charge more for their products.

Rising prices of energy throughout the last year have also in uenced inflation rates. Gas prices in the U.S. rose to an average of $5 per gallon in June 2022, falling to an average of $4.63 in July. This increase is due in part to the rising cost of the price of crude oil, which has been increasing since October, peaking in May 2022 at around $120, and currently sitting at approximately $90 a barrel. Energy prices also increased due to global sanctions imposed on Russia for the ongoing Russian-Ukrainian war. It is noteworthy that Russian oil production is 12% of the global supply.

The Russian-Ukranian war also had enormous impacts on food prices. Since Ukraine could not secure its food production supply with rising worldwide demand, food prices have seen a 10.9% year-over-year increase in the U.S.. With Ukraine as one of the world's largest wheat exporters, the war has a ected its production capacity. In 2022, wheat production in Ukraine fell 41% from the previous year to 19.5 million metric tons. A lower supply of wheat that does not satisfy the market demand leads to prices in certain foods like bread, that for example, rose 8.01% from 2021, to go up.

Bad harvests and droughts also pushed food prices.

In addition to increasing food and oil prices, post-COVID consumer behavior has shifted back towards services and experiences, making demand outpace supply. As food and labor costs rise, the restaurant and hospitality businesses have also seen an uptick in prices. Being able to travel again, Americans have leaned heavily on tourism during the rst six months of the year. With higher energy and labor prices, these industries have also experienced increasing costs, including a 33% increase in year over-year airfare prices.

Growing demand for housing has made real estate prices rise. Traditionally, mortgage rates have remained low for some time in the U.S., making the housing market competitive. However, recently mortgage rates have almost doubled, making nancing harder for many citizens who start to choose to rent. Hence, the demand for housing rent increased signicantly before cooling in the latter half of 2022 due to federal interest rate hikes.

The last piece of the puzzle comes from the great resignation. Equipped with new bargaining power due to a tight labor market, many workers have returned to the labor force securing higher paying salaries. Although this is helpful for employees facing stagnation wages, this trend translates to higher prices for goods and services for consumers.

Impacts of recession and inflation on consumers and businesses

The implications of inflation and a looming recession directly impact business and consumer decision-making. An inflationary economy makes planning and investment decisions more di cult for companies. Because the future is unwritten, businesses don't know how much future goods will cost and cannot predict future capital, which influences their pricing strategy. Cautious decision-making in an inflationary economy also hinders growth because businesses are hesitant to make decisions without good information.

Recessions also impact businesses on a micro and macroeconomic scale. For example, during a recession, businesses frequently experience dwindling sales and pro ts, resulting in decreasing investments and budget cuts. These cuts typically result in slashed budgets for marketing, research and development, and employee layo s.

For consumers, inflation impacts spending habits. Many consumers lower their spending by changing the type of products they buy, opting for cheaper alternatives to the products they consume - even if the savings are marginal.

During a recession, consumers typically reduce spending, particularly on major purchases like expensive technology or automobiles. However, discretionary expenses such as consumer services and travel are the rst areas to be impacted by in ationera consumer spending habits.

If inflation keeps rising, sooner or later, a recession will occur. Moreover, small businesses will experience declining pro ts as prices increase, and some will never recover. But a slowing down of the economy, though troublesome, might indicate that the FED's measures to ght inflation are working.

4 inflation scenarios to consider moving forward

Businesses can reinforce their inflation business practices by equipping themselves to respond. Although we can't predict where inflation will head, several scenarios may occur that decision-makers should consider:

Inflation decreases

Inflation continues to decrease following its trend since July 2022. This trend, coupled with solid indicators such as reducing unemployment and increasing nonfarm payroll, may result in pre-pandemic economic indicators. However, gas prices will need to stay relatively level for this to occur, which is unlikely if the war in Ukraine stretches into the winter months.

Maintain status quo

If inflation continues in the 8-10% range, we can expect to maintain the status quo. However, the disparity between rising costs and salaries adjusted for inflation will pinch consumer spending. This phenomenon may result in increased expenditures, creating uncertainty for businesses regarding managing production and payroll, but without the disruption of consistently rising in ation. The economy would become more challenging for business owners because consumers will likely remain cautious regarding spending decisions. In this scenario, government spending would need to stay low to avoid triggering a rush of spending and further price increases.

Inflation could continue to rise

Since June, there have been back-to-back federal interest rate hikes to control in ation. If the rates continue to go up without breathing room, and if scal expenditure continues to go up, the economy might be in for a shock. More expensive borrowing costs would mean problems for businesses to grow or face their nancial needs. Sudden hikes could cause more visible in ation, reducing consumer and business con dence. Fewer businesses operating at their desired capacity or increasing business closures due to scal expansion policies would fail to contain in ation, giving way to price hikes.

If this does happen, several events could occur:

- Consumers will be faced with higher prices for the goods they want to purchase.
- Salaries not adjusted for inflation means individual households could have more di culty making ends meet.
- Expenditure would drop for discretionary costs and a bleak economic landscape because of a looming recession and future layo s.
- Unemployment would rise as companies cut costs resulting in scal policies adjusted for newly unemployed citizens.

Federal intervention contains in ation

Another likely scenario is federal e orts to contain inflation by pursuing interest rate hikes will cause a recession in the U.S. economy. The fed has set its target rate at the bracket of 3% 3.25%, and its chairman, Jerome Powell, has been vocal that the central bank "will keep at it until it is done", indicating that interest rate hikes could continue. This practice would mean that the American economy's risk of a recession would become more prominent. A sudden increase in interest rates usually correlates with a slowdown in growth. This idea has come to reality given that the growth projection for 2022 recently changed from 1.7% to 0.2%, meaning that the U.S. economy would become almost still. A further rate increase could likely make this number go down, making the U.S. enter a recession.

In high inflation and recession economy, low-income households are most impacted, with loss of income disadvantaging Black and Latino households at a higher rate. For middle and uppermiddle-class families, cautionary spending will shift consuming habits and what brands they endorse.

Compared to large enterprises, small and medium businesses experience the greatest toll in high inflation economies and often do not survive the landscape. However, for larger companies with signi cant capital, inflation economies are a favorable opportunity to merge or acquire smaller competitors at a discounted price.

How companies can mitigate the impacts of uncertain inflation and recession

When indicators point to a rise in inflation and a possible recession, businesses can fortify themselves to handle the situation the best way they can. For example, businesses can research high-demand items during previous periods of inflation and double down on these products to satisfy the upcoming demand.

Businesses can also penetrate the new needs of consumers for cheaper products, either providing them or putting themselves in an advantageous position to cater to these individuals. Companies can achieve this by o ering lower quality products at discounted prices which people are willing to pay for a cheaper alternative.

Here's a few ways businesses can prepare themselves:

Liquify assets to increase cash ow. Sell non-income generating assets or investments to increase capital in preparation for a more signi cant economic downturn.

Detect market opportunities. Either in competitors that might be acquired because of nancial trouble or companies that might help integrate a supply chain side of the business. Also, be on the lookout for companies that can become a source of revenue in the future with the know-how the main business posses.

Hedge inflation with di erent nancial assets. Some examples are:

- Buying precious metals like gold and silver.
- Shifting funds from bonds to stocks, especially preferred shares.
- Real estate investment trusts, since real estate usually performs well during in ation.
- Adding global stocks or bonds to the company's portfolio helps to hedge local in ation.

Be a winner in a losing economy

Even though these are uncertain times, it is always a wise strategic decision to prepare one's business for a possible high inflation scenario. Knowing what to do and how to hedge inflation can lead to better planning, greater nancial stability in uncertain times, avoiding bankruptcy, and lead to economic opportunities for businesses poised to act, rather than react, to changing economic circumstances.

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