

# What's in the tails? Why the coming recession will be worse than expected

#PositiveImpact

We are undergoing a paradigm shift in macroeconomics. Consensus forecasts have been consistently wrong over the last decade, and over the last couple of years alone they underestimated the scale of the pandemic rebound, the inflationary impact of the stimulus packages, and the fact they weren't transitory. But those same forecasters now think we can bring down inflation with a soft landing, from a starting point from which we've never achieved a soft landing before.

Given this, it's remarkable that our official house view call for a US recession in late-2023 is the outlier rather than the consensus. If anything, we think the risks are skewed towards a much more significant recession, as inflation proves more persistent than is generally expected.

What drives this view? First, broader trends such as demographics and a reversal in globalisation are set to put upward pressure on prices over the coming years. Second, the drivers of inflation have broadened out and the labour market is extremely tight. Third, inflation psychology has shifted dramatically, with sellers increasingly willing to pass cost increases onto their customers. Fourth, expectations of future inflation are rising, and we expect them to rise further still given they are usually influenced by what's happened to actual inflation recently. Finally, the moves from the Fed currently envisioned by markets will be too slow to restrain inflation, and would still leave the federal funds rate substantially negative in real terms.

The bottom line is that while inflation may fall somewhat from its 40-year high in March, multiple factors are set to keep it elevated well above target for some time. We would not be surprised to see core PCE inflation sustained in the 4-5% range well into 2023, before receding after the recession hits.

To drive home how far the Fed is behind the curve, our US economics team have produced a new measure that we label the Fed's "misery index". It looks at how far the economy has strayed from the Fed's mandates of price stability and maximum sustainable employment. Positive readings mean the Fed has work to do in a tightening direction, as is the case now. What is noteworthy is that every time this index has

David Folkerts-Landau, Ph.D.  
Chief Economist, Global Head of Research

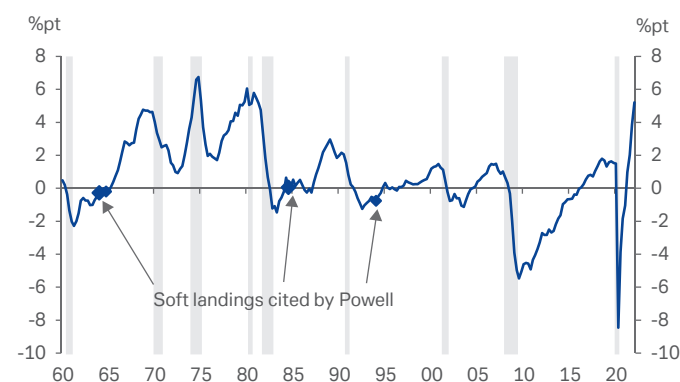
Peter Hooper, Ph.D.  
Global Head of Economic Research

Jim Reid  
Head of Thematic Research

moved noticeably above zero, the economy has gone into recession within a few years due to monetary tightening. On this basis, the Fed is further behind the curve than it has been since the early 1980s. And when they did manage to achieve a soft landing (in the mid-60s, the mid-80s and mid-90s), the index was essentially at zero. So the Fed has plenty of work to do to catch up.

The combined effect will be to push the US economy into a significant recession by late 2023, with unemployment ultimately rising several percentage points. As we found in the 1970s and 1980s, this will be tough, but the only way to minimise the economic, financial, and societal damage of prolonged inflation is to err on the side of doing too much. Otherwise, inflation will only become more entrenched, inflicting further damage, and requiring even tougher action to remove.

## Distance from Fed's policy objectives for inflation and unemployment



Source: Deutsche Bank

Deutsche Bank Research clients can access the full report [here](#).

What's in the tails?: Inflation: The defining macro story of this decade. [Here](#).