Executive briefing

Macroeconomic outlook and impact on businesses

June update
Week of June 19, 2023

EY Parthenon
Building a better working world

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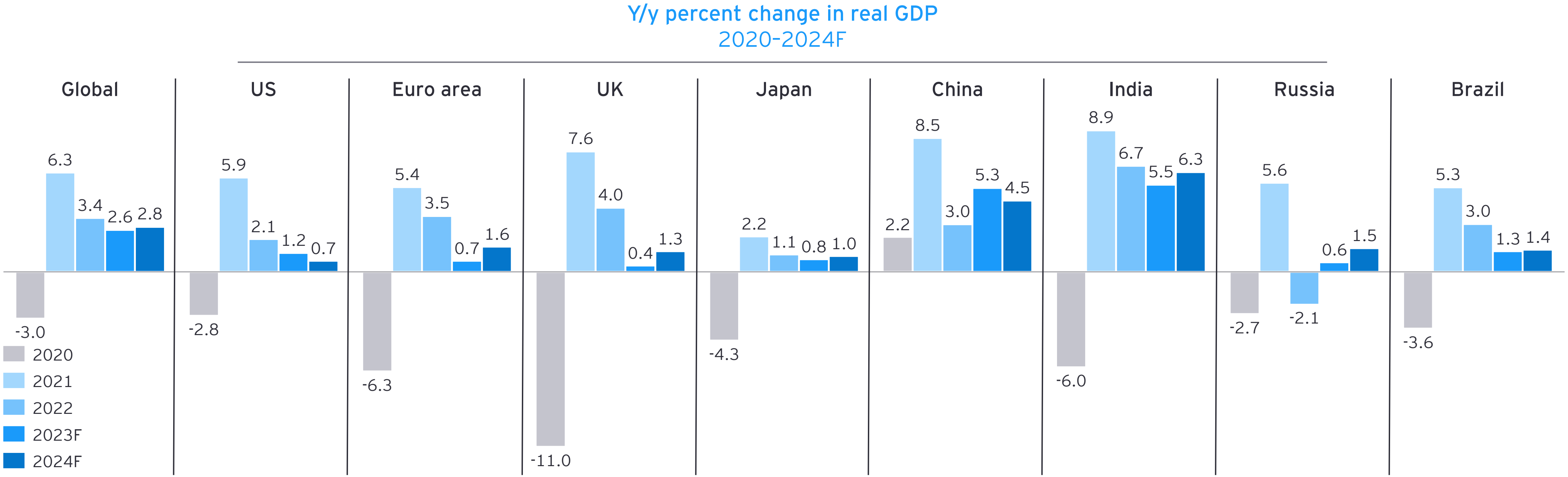
EY Parthenon

Most economies around the world are experiencing a slowdown, but the magnitude and breadth of the slowdown are far from homogenous

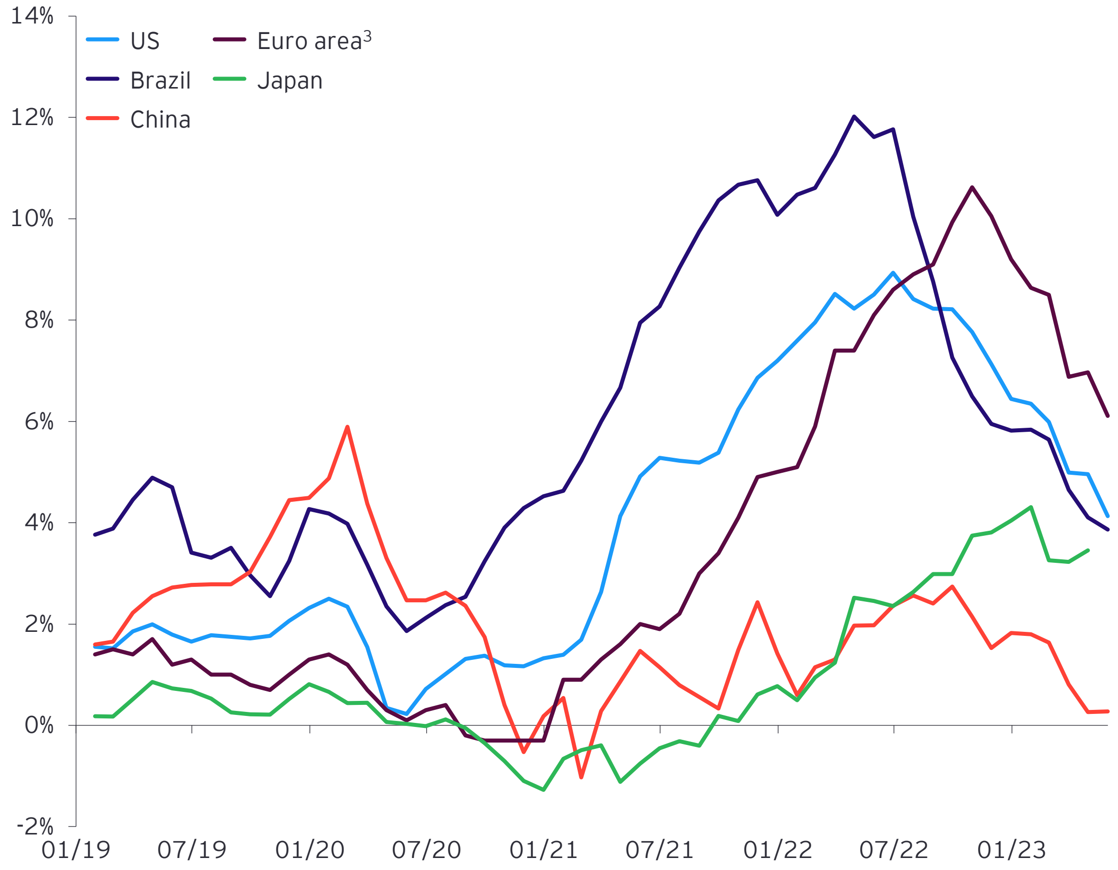


- Global economic activity is slowing, but the nature of the slowdown across major economies is far from homogenous. We anticipate global GDP growth will slow to 2.6% in 2023 – the slowest pace outside of a recession since 2001 – and only accelerate modestly to 2.8% in 2024. Below-trend growth is expected across most advanced economies in 2023-24, with localized recession in Europe, near stall-speed growth in the UK and weakening momentum in the US. We anticipate mainland China real GDP growth around 5%, but the downside risks to growth are notable given the weakening of manufacturing and consumer spending activity.
- Global inflation is on a downward trajectory, but core inflation (excluding food and energy) remains elevated, and central banks continue to view the risks of overtightening being less than the risks of undertightening and allowing for inflation and inflation expectations to remain permanently anchored at a higher level.

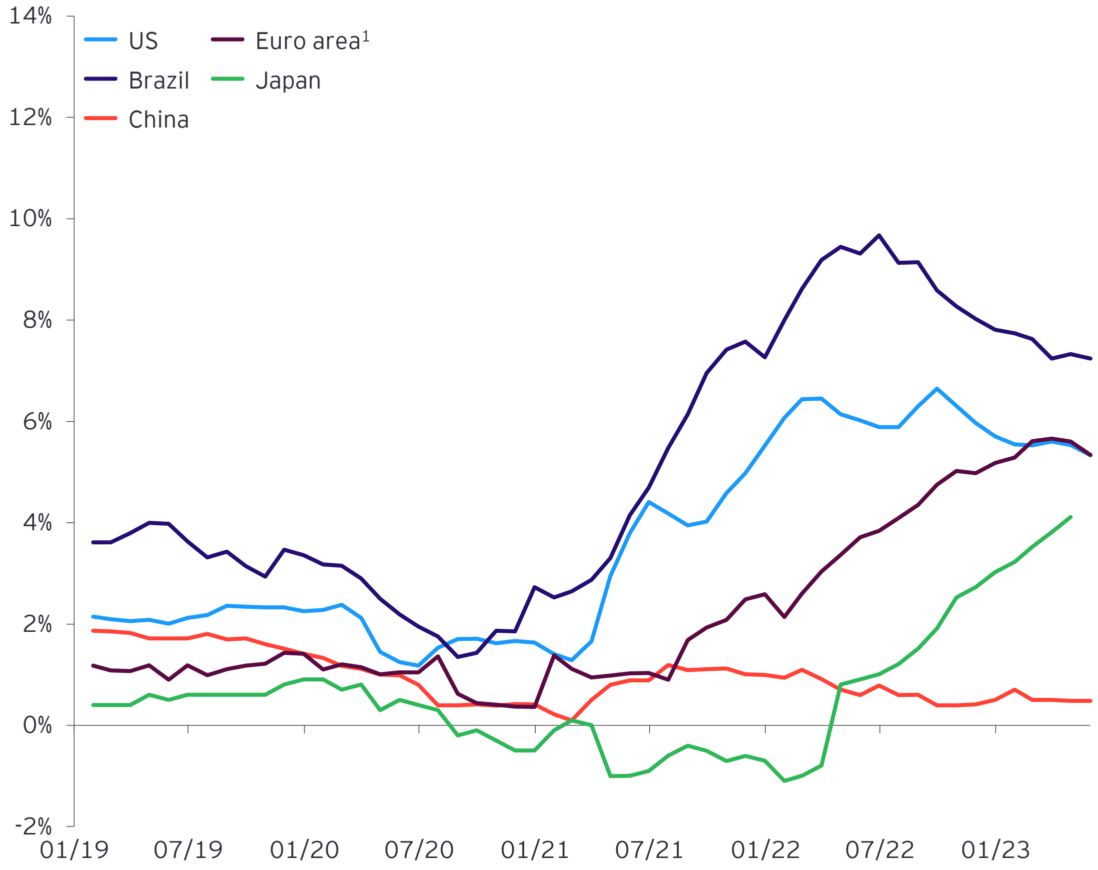
Source: EY-Parthenon

While global inflation is easing thanks to lower commodity and goods prices, central banks will retain a tightening bias, as core inflation remains persistently elevated

Y/y headline CPI[1] growth rate
January 2019–May 2023[2]



Y/y core CPI[1] growth rate
January 2019–May 2023[2]

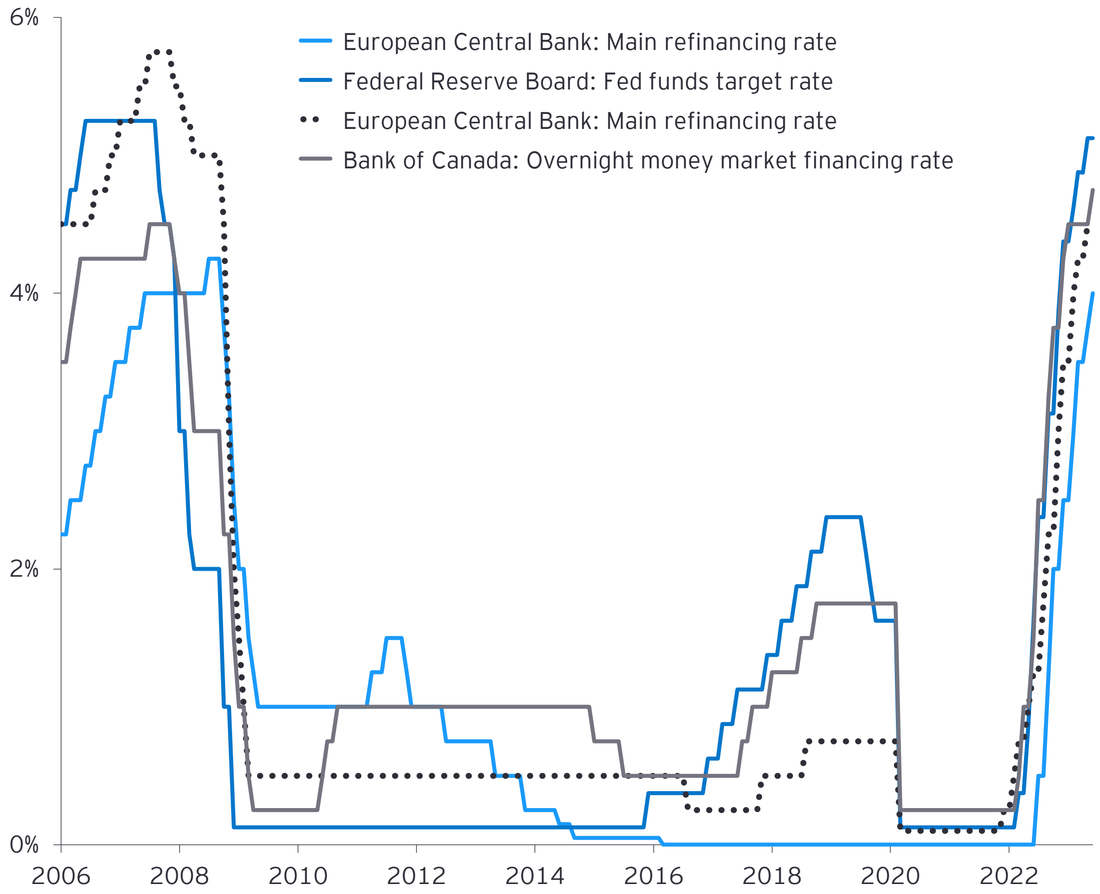


1. Headline Consumer Price Index (CPI) includes the prices on a fixed basket of goods. Core CPI removes the CPI components that can exhibit large amounts of volatility from month to month, such as food and energy.
2. Data for Japan is shown through April, while data for the US, Brazil, China and Euro area is shown through May due to data availability.
3. Euro area includes 20 countries.

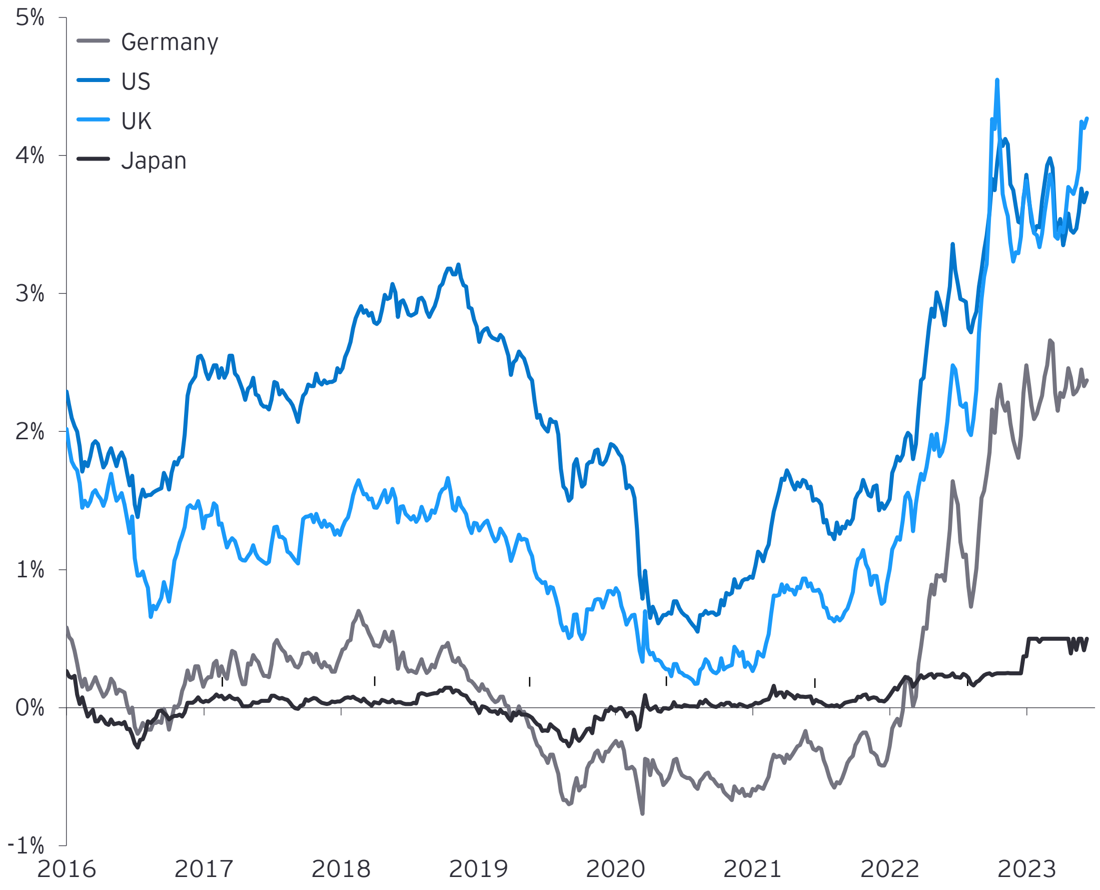
Source: EY-Parthenon

The end of the global monetary tightening cycle is near, but central banks will keep a tightening bias in the near term and maintain restrictive policy stances well into 2024

Central bank rates
January 2006-June 2023[1]



Long-term interest rates
January 2016-June 2023



1. The rates of the Bank of England are shown through May, while the rates of the European Central Bank, the Federal Reserve Bank and the Bank of Canada are shown through June due to data availability.
Source: Respective countries' central banks; EY-Parthenon

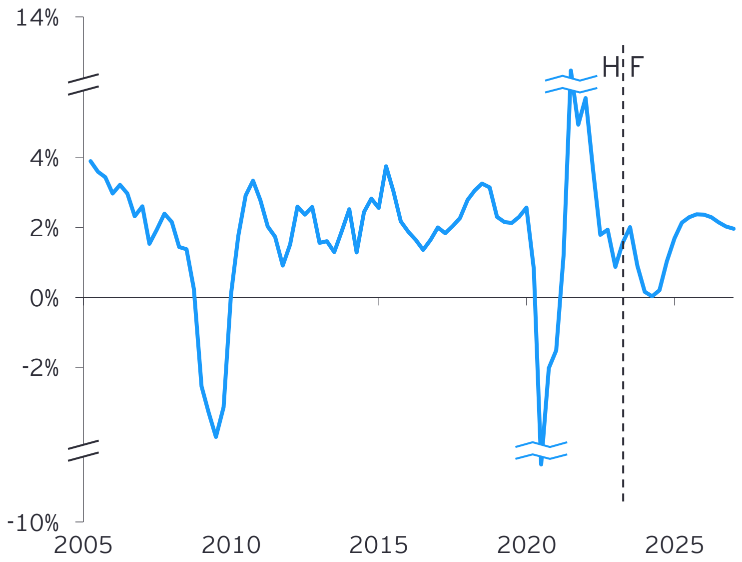
US recession postponed: could this time be different with the economy holding up through midyear?

- **Scope for hope:** In this unique business cycle defined by unusual labor market characteristics, there is scope for hope that the US economy could escape a recession. Unlike prior downturns, business executives have proven reticent to dispose of the pool of talent they struggled to hire, train and retain post-pandemic, translating into a limited drag on household income and spending. Simultaneously, the need to address supply shortages across the economy has supported robust construction activity, prevented a severe manufacturing pullback, and helped price and wage pressures ease. Still, there are notable headwinds from persistently elevated prices and costs, tightening conditions and rising interest rates. As the Fed continues tightening policy and interest rate hikes work their way through the economy, we still believe a recession is more likely than not, but we have lowered our recession odds to 55%. We see real GDP growing 1.2% in 2023 and expanding at a muted 0.7% pace in 2024.
- **Labor market cooling:** Job growth surprised to the upside in May as companies added 339k jobs, well above expectations. Still, a broader set of labor market indicators along with our conversations with business executives indicate that conditions are progressively softening with less diffuse job gains across sectors, reduced hours worked, cooling wage growth, slower hiring, a reduced number of quits and an uptick in layoffs. We continue to foresee hiring freezes and strategic resizing decisions along with some wage growth compression in the coming months, but we don't anticipate a severe employment pullback. We foresee the unemployment rate rising toward 4.1% by year-end and above 4.5% in 2024.
- **Consumers under pressure**: While consumers are still spending, they are exercising more discretion as lingering inflation and the Federal Reserve's tightening cycle take their toll. Household finances aren't unhealthy, but vulnerabilities are increasingly apparent in the form of rising delinquencies and an increased reliance on credit. With employment and household disposable income growth expected to moderate in the second half of the year, the slowdown in consumer spending will accelerate as the buffer from excess savings shrinks, student loan repayments restart and credit conditions tighten further. We anticipate consumer spending will advance a modest 1.8% in 2023 and 0.7% in 2024.
- **Bumpy disinflation:** Inflation pressures remain elevated, but the disinflation process continues. Headline CPI inflation fell sharply in May, down 0.9 percentage points (ppt) to 4.0% year over year (y/y) — its lowest since March 2021. Core CPI inflation fell 0.2ppt to 5.3% y/y and is now 1.3ppt below its September 2022 peak. Sequential price momentum points to persistent disinflationary dynamics, but it won't be a smooth process. Headline CPI will likely be in the low 3% range in June, while core CPI will likely have a 4% handle. Thereafter, favorable base effects from lower energy prices will subside, but easing demand for goods and services, the pass-through from softer housing price inflation, and cooling wage growth should lead to ongoing disinflation leading into 2024.
- **June "skip" likely followed by July Fed hike:** The Fed maintained the federal funds rate range unchanged at 5.00%-5.25% at its June policy meeting but signaled two more rate increases are likely this year as officials remain concerned about core inflation being too high relative to the 2% target. Given our softer growth and inflation outlook, we anticipate the Fed will raise interest rates only once more in July before holding rates steady throughout the remainder of the year as it assesses the impact of its tightening on the economy and inflation. While we do not anticipate rate cuts in 2023, we foresee the Fed starting to discuss policy recalibration in the latter half of 2023, highlighting that, with inflation cooling, it will consider slowing cutting nominal interest rates to maintain real rates steady.

Source: EY-Parthenon

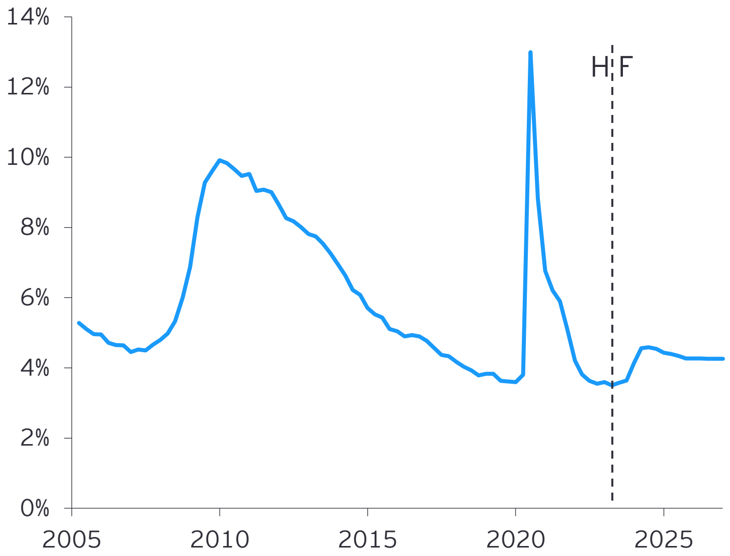
Our baseline anticipates a modest GDP contraction in the coming quarters, with the unemployment rate creeping up toward 4% and inflation cooling toward 3%

US y/y real GDP
2005-2026F



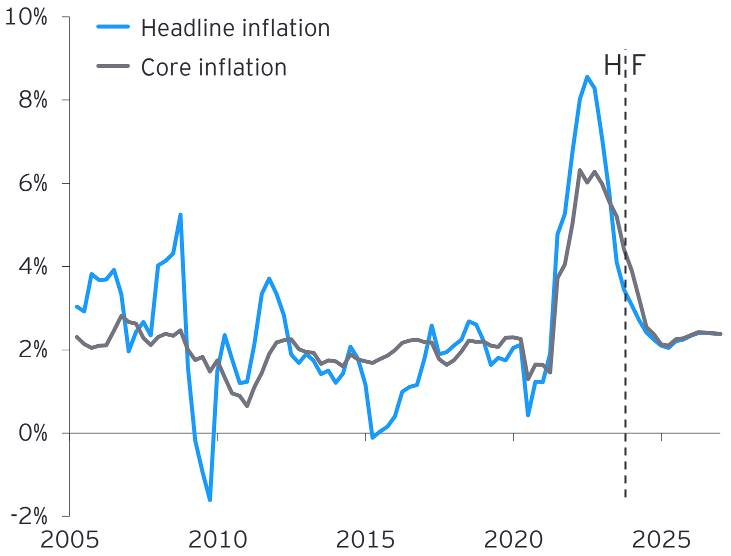
GDP growth
2022: 2.1%
2023F: 1.2%
2024F: 0.7%

US unemployment rate
2005-2026F



Unemployment rate
Q4 2022: 3.6%
Q4 2023F: 4.1%
Q4 2024F: 4.4%

US y/y percent change in CPI
2005-2026F



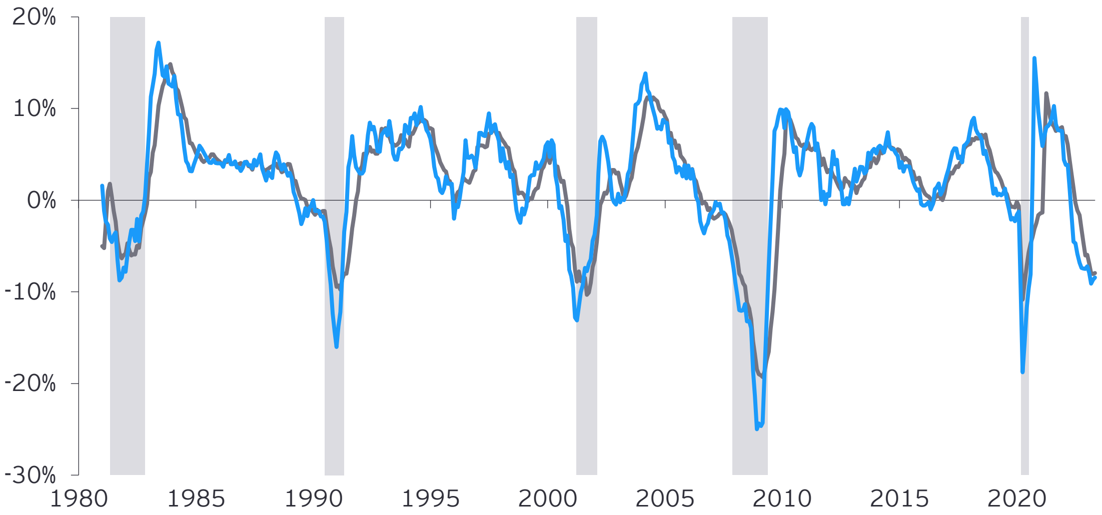
Core CPI inflation (y/y)
Q4 2022: 6.0%
Q4 2023F: 3.9%
Q4 2024F: 2.1%

Key risks: financial market turmoil, banking stress, Fed policy tightening, global recession

Source: EY-Parthenon

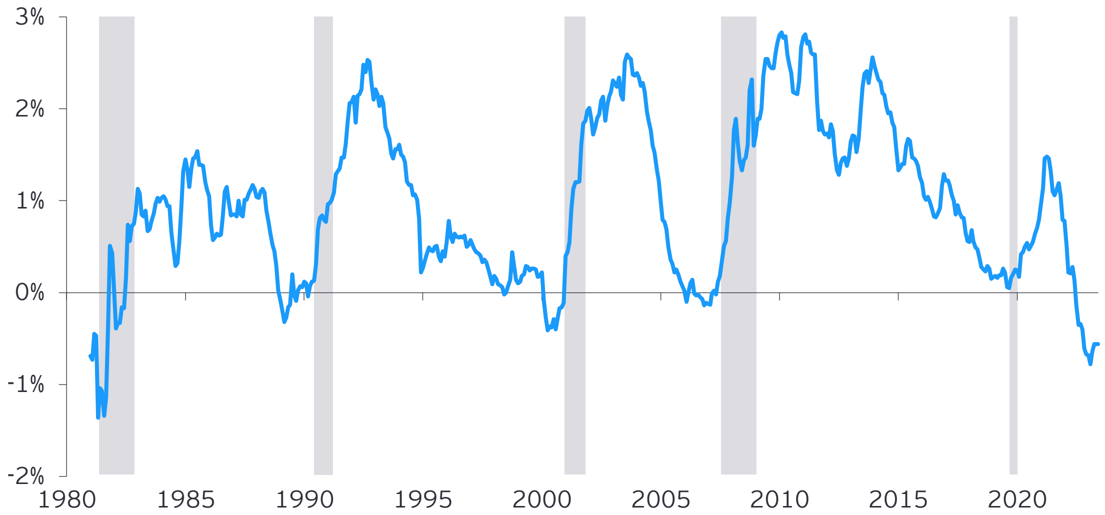
Leading economic indicators point toward recessionary conditions and increased pressure on financial intermediaries, but this cycle is unique

US Leading Economic Index[1]
January 1981-May 2023



- Leading economic indicators suggest the economic slowdown has become widespread and point to a forthcoming economic contraction. The Conference Board Leading Economic Index (LEI) declined for a 14th consecutive month in May and fell 0.7% month over month (m/m) to 106.7 — its lowest level since July 2020.
- The weakness in the LEI was broad based, reflecting softer consumer expectations for business conditions, a deterioration in manufacturing orders, a negative yield spread and tighter credit conditions. The y/y trend remained deeply into negative territory at -7.9% compared to 8% y/y in April, which marked the index's largest contraction since May 2020.

US 10-year less 2-year Treasury note spreads
January 1981-May 2023



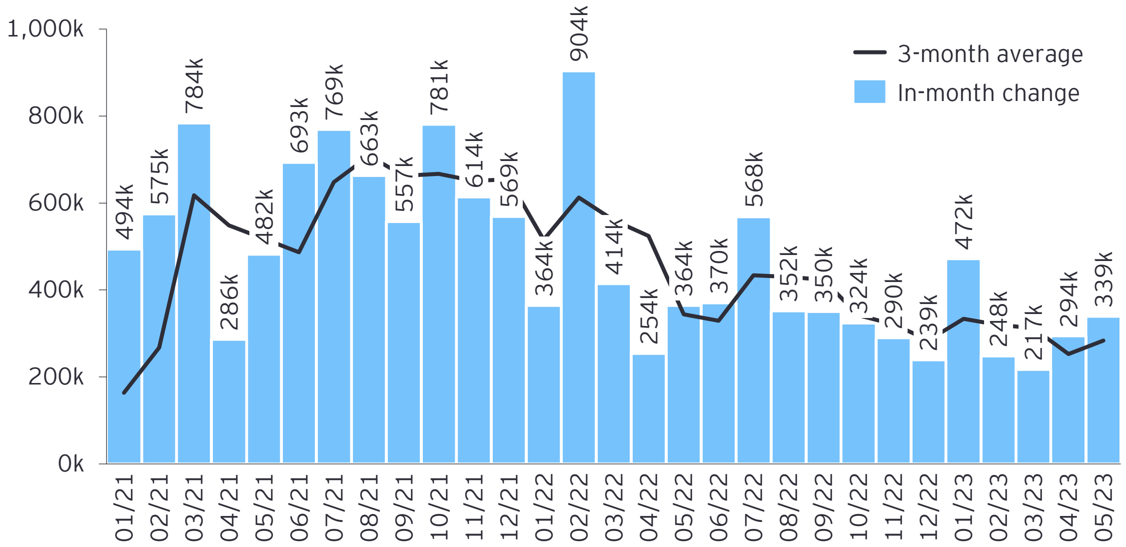
- The yield curve, as measured by the spread between the 2-year and 10-year Treasury yields, has remained deep in negative territory for several months. Historically, an inverted yield curve has been viewed as an indicator of a pending economic recession, while a renewed steepening of the curve typically signals that the downturn is imminent.
- The unique nature of this business cycle makes for a very difficult environment to decipher, especially given the labor market resilience. We place the odds of a recession over the next 12 months around 55%.

1. The Conference Board Leading Economic Index is a predictive variable that anticipates (or "leads") turning points in the business cycle by around seven months. It is based on 10 economic indicators that typically lead the business cycle.

Source: Bureau of Economic Analysis; Conference Board; EY-Parthenon

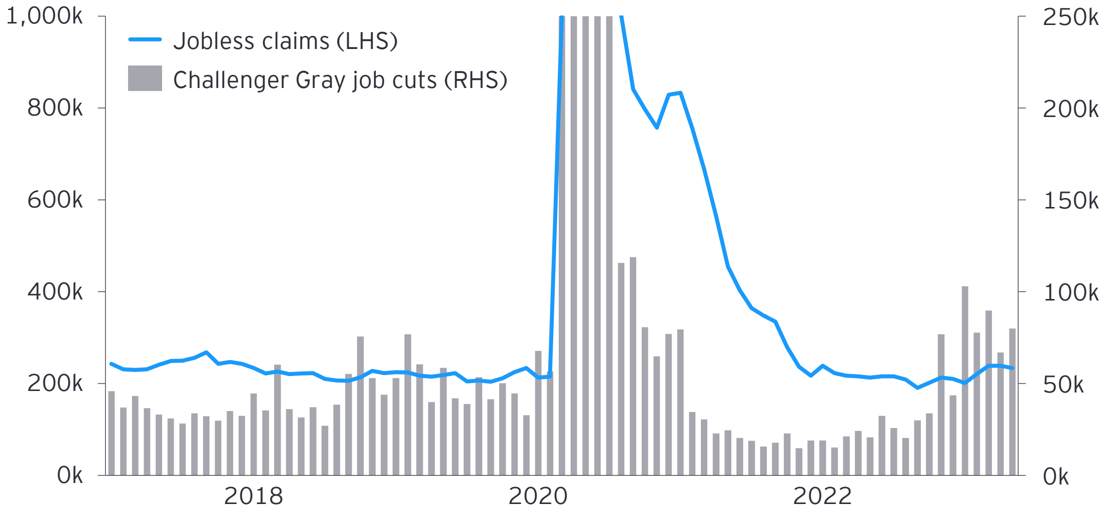
Hiring continues to show surprising resilience, but the lagged impact of Fed and credit tightening will likely result in modest job losses in coming quarters

US m/m change in total nonfarm employment
January 2021-May 2023



- Job growth surprised on the upside in May with a 339k gain, well above the consensus expectation of 195k. Additionally, net revisions to the prior two months showed 93k more jobs than previously reported, which pushed the three-month moving average up to 283k from 253k in April.
- Still, beneath the strong headline print, the labor market showed some signs of cooling. The unemployment rate jumped from 3.4% to 3.7%, wage growth momentum slowed and hours worked fell. Moreover, the employment diffusion index — a measure of how many private sector industries are adding jobs — remained near its lowest post-pandemic level at 60%.

US jobless claims and cuts
January 2017-May 2023

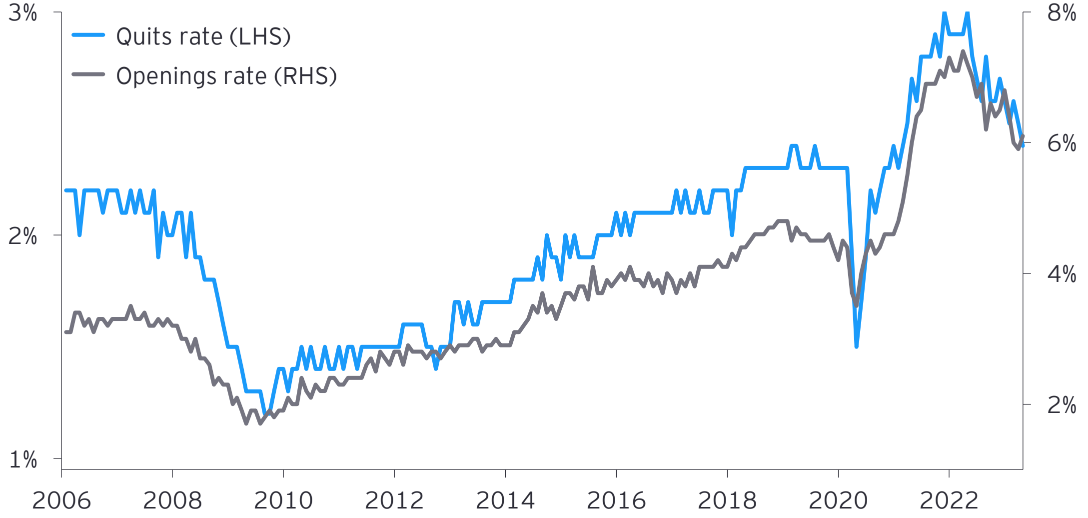


- The ongoing decline in hours worked along with weak job growth diffusion portend a more pronounced labor market slowdown. The rise in new weekly filings for jobless claims, a proxy for layoffs, in recent months also indicates that cracks in the labor market are forming.
- Our conversations with business executives confirm that labor market conditions are softening. We continue to anticipate a deterioration in labor market conditions in coming quarters featuring hiring freezes, strategic resizing decisions and wage growth compression. We foresee the unemployment rate rising toward 4.1% by year-end and above 4.5% in 2024.

Source: Challenger, Gray & Christmas; Bureau of Labor Statistics; EY-Parthenon

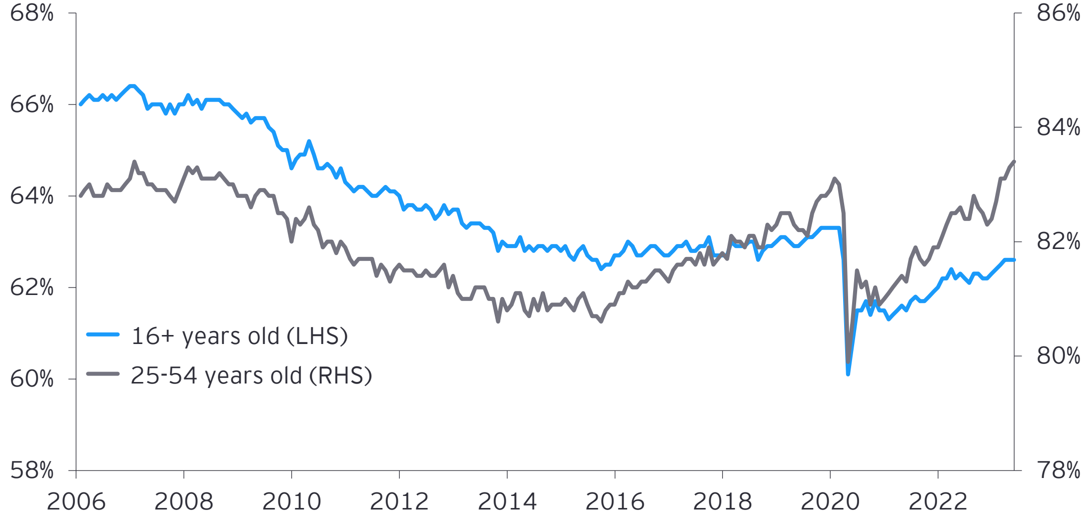
Conditions remain tight, but there are signs that the labor market is coming into better balance, with labor demand gradually slowing and labor force participation rising

US job openings and quits rates
January 2006–April 2023



- Job openings increased 358k to 10.1m in April after falling for three straight months, and they remain well off their March 2022 peak of 12 million. The hiring rate remains at its lowest since December 2020 while the quits rate, which reflects workers' confidence in the jobs market, declined for a second consecutive month by 0.1ppt to 2.4% – its lowest since February 2021.
- The ratio of job openings per unemployed worker remained historically high in April and climbed to 1.79 from 1.68 in March, suggesting that the labor market remains tight.

US labor force participation rates
January 2006–May 2023

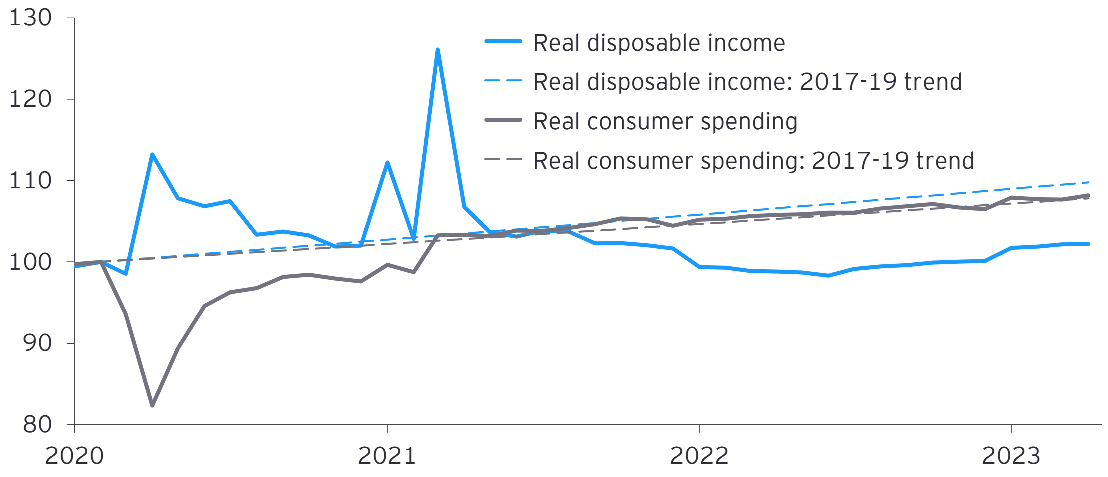


- On the supply side, the labor force participation rate held steady for a third straight month at 62.6% in May, and participation among the key prime-age cohort (25- to 54-year-olds) climbed 0.1ppt to a 15-year high of 83.4%.
- The recent rebound in prime-age labor force participation is a sign that robust labor demand is pulling workers back into the labor force. However, participation could come under pressure in coming quarters as labor demand softens and job opportunities become scarce.

Source: Bureau of Labor Statistics; EY-Parthenon

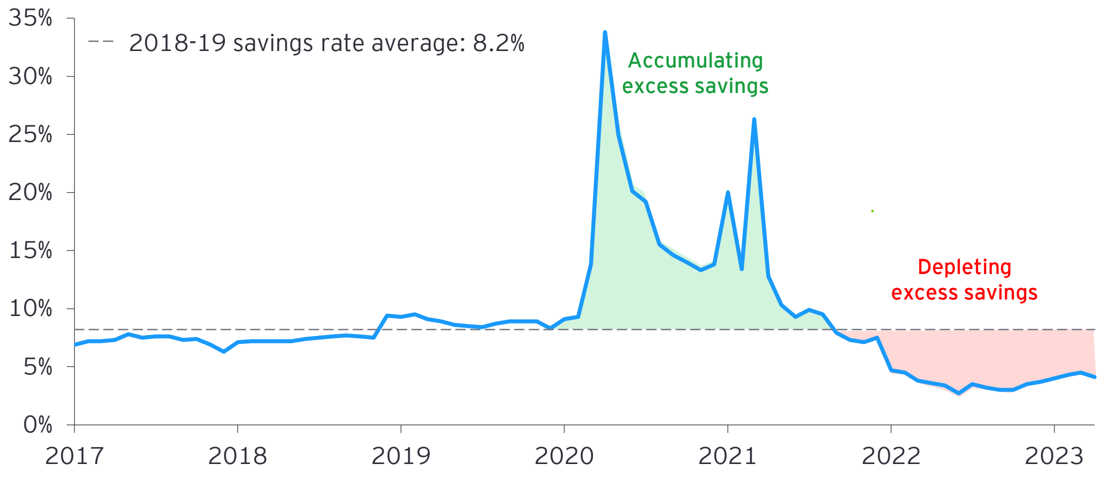
A low level of consumer optimism and dwindling excess savings point to a risk of sudden retrenchment if labor market conditions were to deteriorate rapidly

US real consumption expenditures and disposable income
January 2020–April 2023 (February 2020 = 100)



- The ongoing rebound in real disposable income — reflecting still-solid wage gains amid cooling inflation — represents a key support to consumer spending. Real disposable income rose for a 10th straight month in April, supporting consumers' purchasing power as they continue to face elevated prices.
- With the resolution of the debt ceiling issue and lower prices at the pump, consumer sentiment revived in early June as the University of Michigan's consumer sentiment index rose 4.7 points to 63.9. However, sentiment remains historically depressed and continues to point to cautious consumers amid elevated prices and rapidly dwindling excess savings.

US personal savings rate
January 2017–April 2023

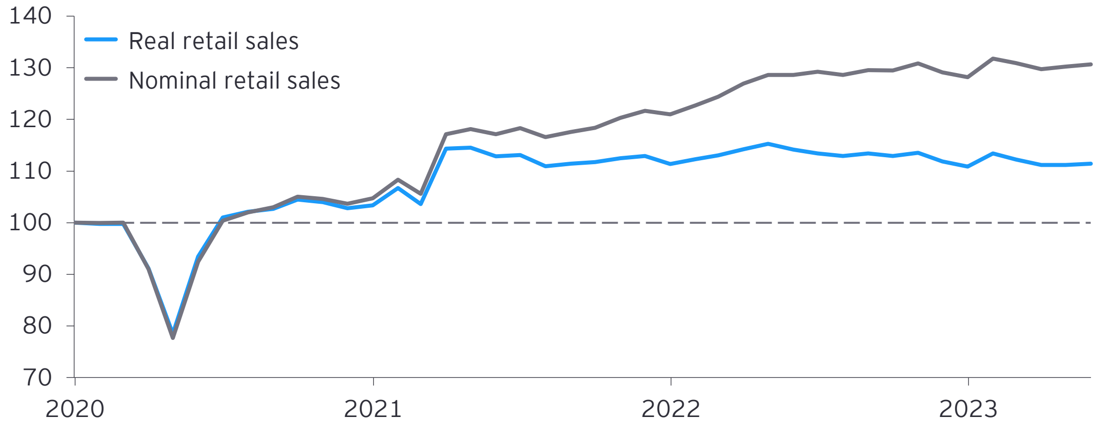


- After building up savings at an unprecedented rate during the pandemic, households have been drawing down on these funds rapidly over the past year and a half. We estimate that excess savings have declined about 55% to $1.1 trillion on aggregate and that excess savings for lower-income families have largely been depleted.
- While the remaining excess savings, along with robust labor market gains, help explain consumers' resilience to higher inflation and interest rates, the impetus is rapidly fading. As such, excess savings should not be viewed as a key source of income supporting a steady pace of spending going forward.

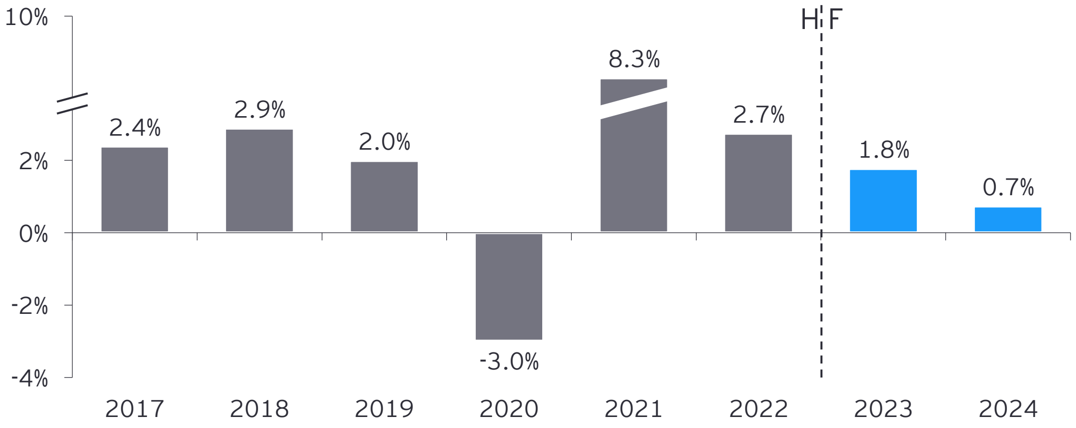
Source: US Census Bureau; Bureau of Economic Analysis; EY-Parthenon

Consumers are holding up, but they will come under increasing pressure in the second half of the year, as the labor market turns less supportive and prices remain elevated

US nominal and real retail sales indexes
December 2019-May 2023 (December 2019 = 100)



US y/y percentage change in real personal consumer expenditures
2017-2024F

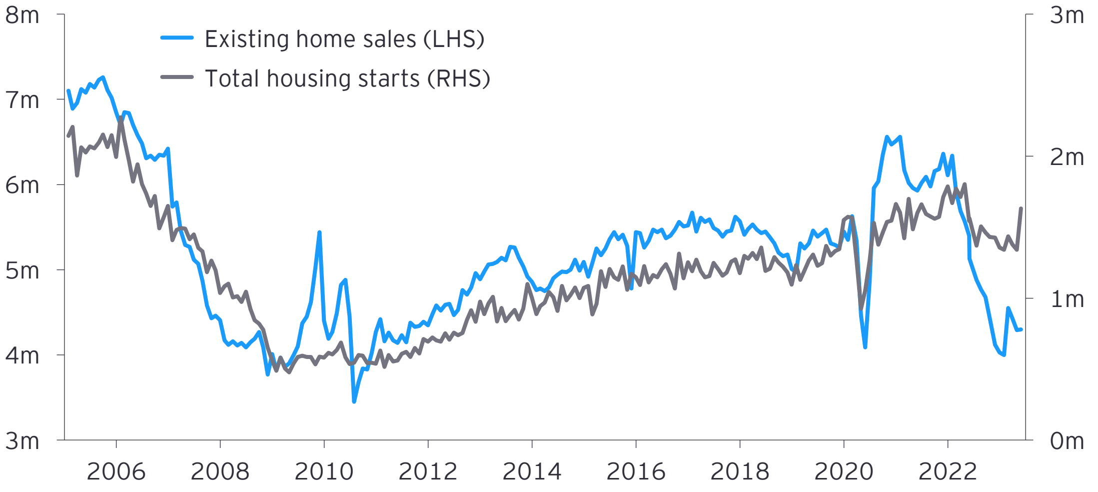


- Retail sales grew more than expected in May, rising 0.3% m/m as consumers splurged on select goods such as cars, building materials and dining out. The volume of sales rose 0.2% when accounting for the 0.1% increase in consumer prices, suggesting that consumers remain willing to spend despite higher borrowing costs and elevated prices.
- Control retail sales, a key gauge of broader consumer spending trends removing volatile components, posted a modest 0.2% increase following a robust gain in April. Downward revisions to the prior months' data suggest somewhat softer momentum in goods spending heading into Q2. But overall, the latest data keeps consumer spending growth on track to grow around 1.5%–2.0% in the second quarter of the year.
- Looking at the broader trend, retail sales momentum has cooled markedly from 7.4% y/y at the start of the year to just 1.6% y/y last month, and sales are down over 2% relative to last year in inflation-adjusted terms.
- While consumers are still spending, they are becoming more financially cautious, as lingering inflation and the Federal Reserve's rate hikes take their toll. Looking ahead, we expect the slowdown in consumer spending to deepen in the second half of the year, as labor market gains falter, the buffer from excess savings shrinks and credit conditions tighten further. We anticipate consumer spending will advance a modest 1.8% in 2023 and 0.7% in 2024.

Source: US Census Bureau; Bureau of Economic Analysis; EY-Parthenon

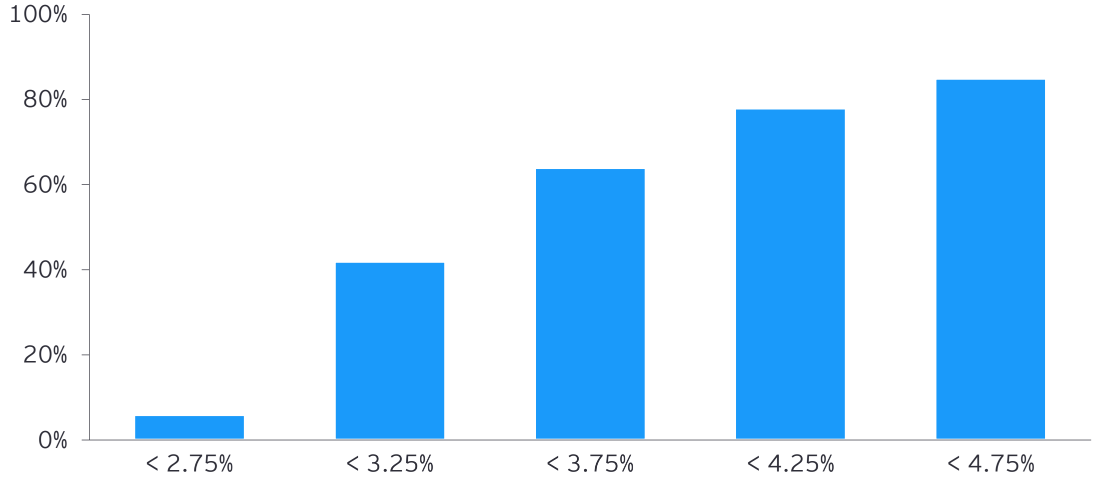
Elevated mortgage rates, low affordability and tight credit conditions will continue to restrain home buying activity, but supply shortages will support construction activity

US existing home sales and housing starts
January 2005–May 2023



- Recent housing data indicates that the worst of the housing market correction is behind us. Housing starts were much stronger than expected in May, rising 21.7% to 1.63 million units, which was their highest level in a year. The strength was broad based, with single-family starts jumping 18.5% and starts in the more volatile multifamily segments surging 27.1%. Building permits registered a more moderate increase last month.
- The National Association of Home Buildings (NAHB)/Wells Fargo Housing Market Index (HMI)[1] continued to recover in June, showing sentiment up for a sixth straight month to its highest level since July 2022. The continued recovery in sentiment comes on the back of improving supply chain conditions and as a lack of existing inventory supports activity.

US share of outstanding 30-year mortgages by interest rate
As of March 2023



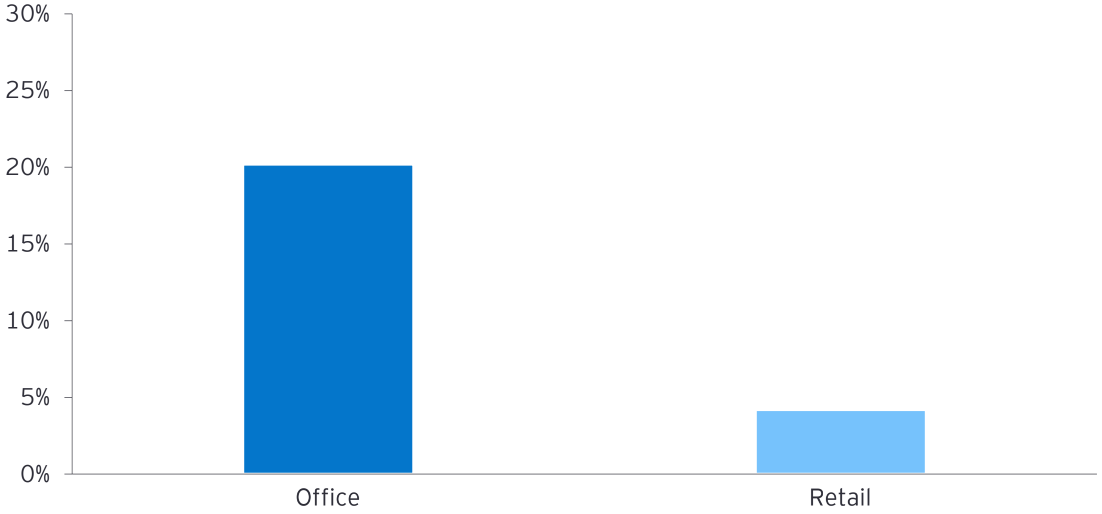
- Many would-be first-time buyers are continuing to rent, given the depressed affordability conditions, while many homeowners have locked in historically low mortgage rates. About three-quarters of mortgage borrowers are locked in with mortgage rates at 4.25% or lower.
- Amid markedly tight supply conditions, construction activity has stabilized, and the historically strong pipeline of multifamily construction should help alleviate rent inflation in the coming months.
- With mortgage rates oscillating at elevated levels and lending standards for real estate loans likely to tighten further, we expect housing activity will remain under pressure in the coming months. Home sales are likely to stay low, and prices could decline further.

1. The NAHB Housing Market Index is a gauge of builder opinion on the relative level of current and future single-family home sales.

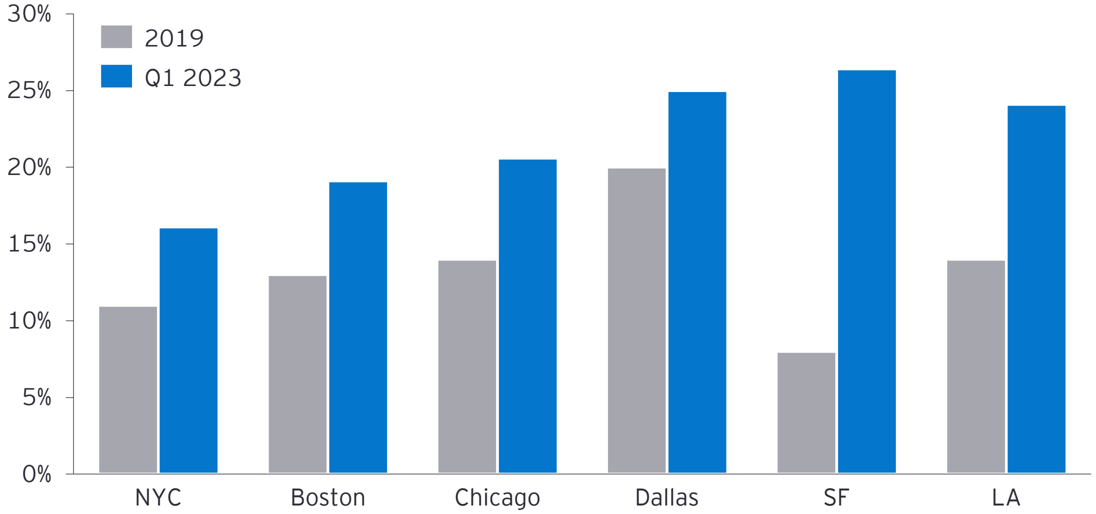
Source: eMBS; Mortgage Bankers Association; US Census Bureau; National Association of Realtors; EY-Parthenon

The commercial real estate sector will remain under pressure from higher interest rates and structural shift in work habits, but the multifamily and industrial sectors offer hope

US commercial real estate vacancy rates[1]
Q1 2023



US office vacancy rates in select market
2019 vs. Q1 2023



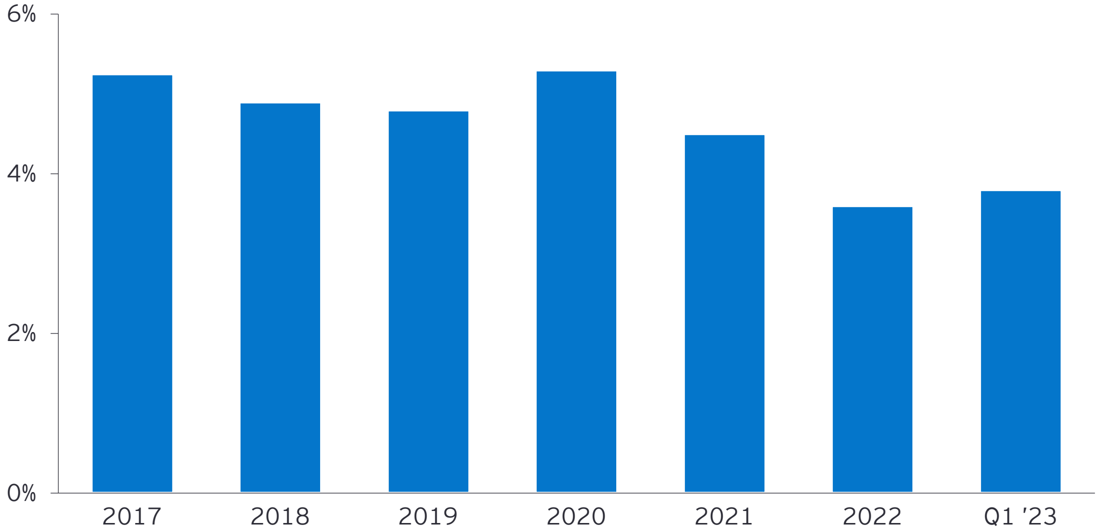
- Commercial office occupancy rates are facing multiple headwinds, including a softening economy and labor picture as well as the persistence of work-from-home trends. About a third of workers with jobs that can be executed remotely (representing 40% of the labor force) are now exclusively doing so. While down from levels seen during the pandemic, this is markedly higher than pre-COVID-19 estimates of 5%–10%. An additional 40% of this remote-work-eligible population now have hybrid on-site and work-from-home schedules. These considerations are set against an interest rate backdrop that is unfriendly to developers even if demand were not historically soft.
- While retail vacancies have shown resiliency, softening consumer fundamentals driven by lingering inflation and a slowing labor environment will translate to reduced consumer spending and impact brick-and-mortar retailers. Trends have favored discounters (e.g., grocery, dollar, fashion), fast-casual restaurants and experiential concepts (e.g., arcades, indoor recreation). Alternatively, some big box and specialty retailers (e.g., home goods, bridal) have struggled and shuttered locations. Malls, which have been challenged, have seen some boost from nontraditional tenants such as multifamily, sports and recreation, and experiential concepts.

1. Retail includes general retail, mall, neighborhood center, power center and strip center.

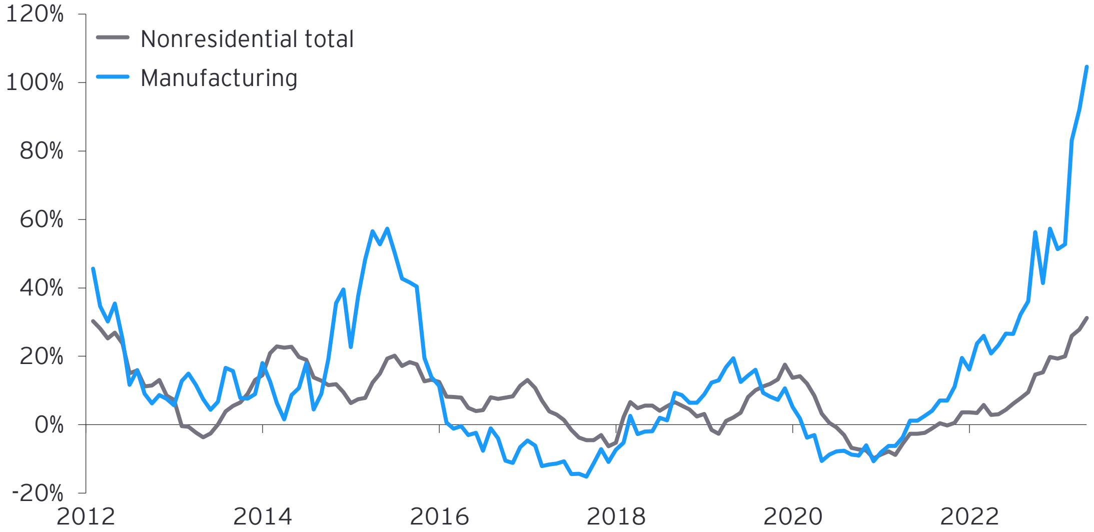
Source: JLL; Pew Research Center; EY-Parthenon

Industrial real estate has shown resilience, and construction levels have accelerated, supported by IRA funding; however, broader economic headwinds pose risks

US industrial vacancy rate[1]
2017-Q1 2023



Y/y % change of value of construction put in place
January 2012-April 2023



- Industrial vacancy rates have been low since 2022. This limited availability, coupled with government incentives such as the Inflation Reduction Act (IRA), have spurred a marked jump in construction activity in the industrial sector.
- The IRA will steer nearly $400 billion of funding to various industries, including clean energy, manufacturing, electric vehicles and transportation, via tax incentives, grants and loan guarantees, much of which benefits the industrial space directly. This impact has contributed to the rapid ramp-up of construction activity in the manufacturing sector.
- Still, the industrial space will face pressure from the broader economic environment, including cooling final demand from cautious consumers as well as reduced firm investment activity amid elevated interest rates and capital costs.

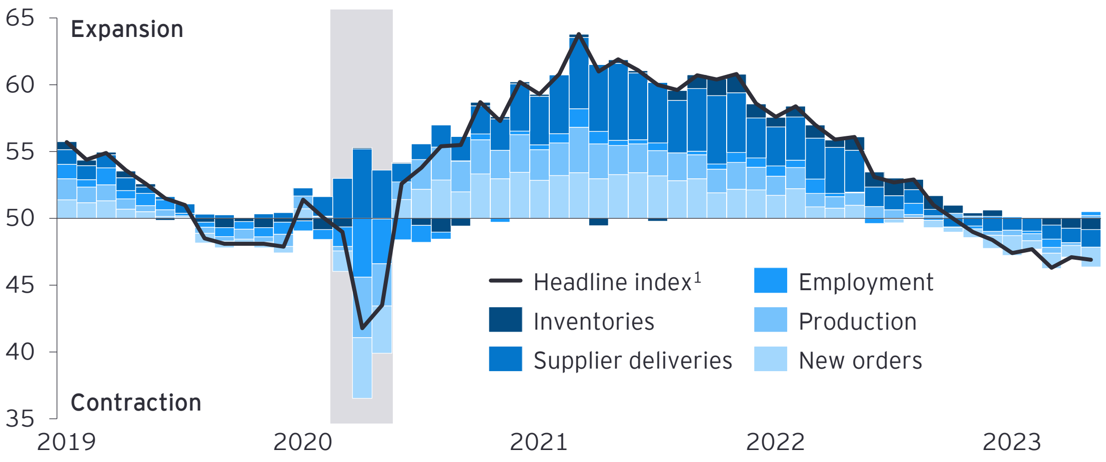
1. Industrial includes warehouse and distribution and manufacturing.

Source: JLL; Census Bureau; EY-Parthenon

The manufacturing sector is under increasing pressure, as weaker demand at home and abroad, tighter credit conditions, and excess inventory restrain activity

US ISM manufacturing index by component contribution[1]

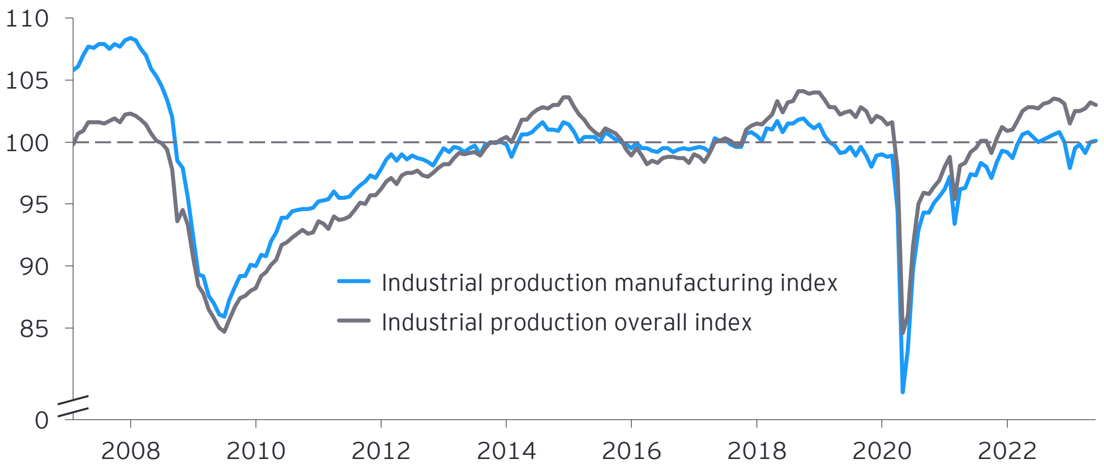
January 2019–May 2023



- Factory activity showed continued weakness in May as the headline Institute for Supply Management (ISM) manufacturing index declined 0.2 points to 46.9 and remained in contraction territory for the seventh straight month.
- Looking at the subcomponents of the survey, the forward-looking new orders index slipped and has remained below the 50 threshold for nine consecutive months. However, the production index rose back into expansion territory after five months of contraction, signaling that current activity is holding up. Meanwhile, the prices paid index sank 9 points and hit the lowest level since last November, suggesting that the disinflation process continues.

US industrial production indexes[2]

January 2007–May 2023 (2017 = 100)



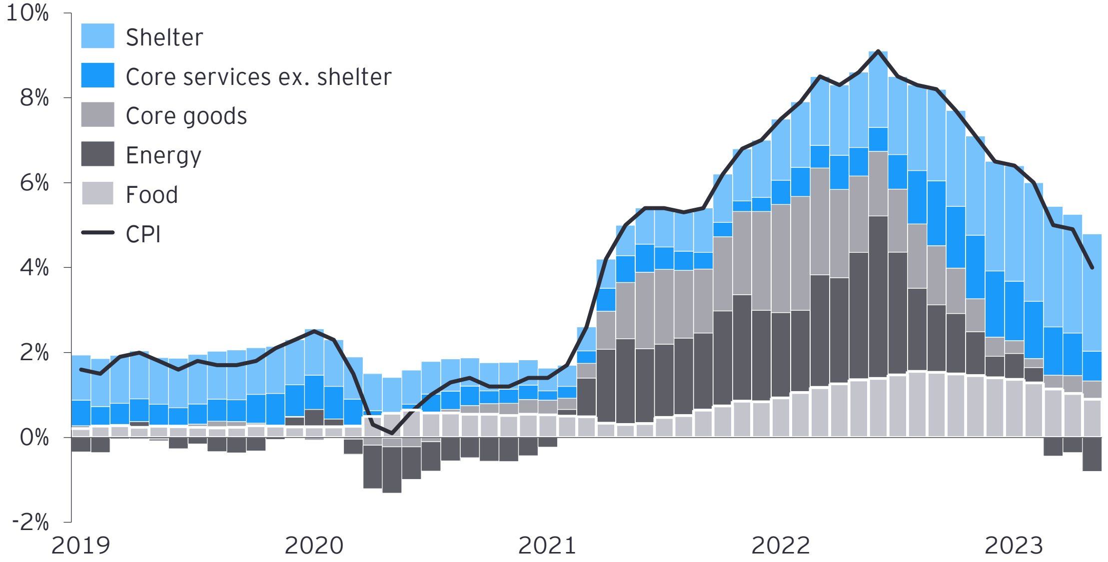
- Industrial production fell 0.2% in May, with the decline driven by drops in mining and utilities activity. Manufacturing output was also subdued, edging up 0.1% as stronger durables production was offset by a decline in nondurables activity. The May data added to evidence of sluggish activity in the manufacturing sector.
- Industrial activity is facing increasing pressure from slower global demand, tighter credit availability and a higher cost of capital, which will continue to weigh on factory activity and business spending in the coming months. It is increasingly likely that we'll see a business investment contraction in Q3 and potentially Q4.

1. The ISM (Institute for Supply Management) measures PMI (Purchasing Managers' Index) by surveying manufacturing and service firms on their orders, production, employment, deliveries and inventories. The index indicates business activity in both sectors. This is a diffusion index, with readings above 50 indicating expansion and readings below 50 indicating contraction in activity.
2. Includes manufacturing as well as mining and electric and gas utilities.

Source: Federal Reserve; ISM; EY-Parthenon

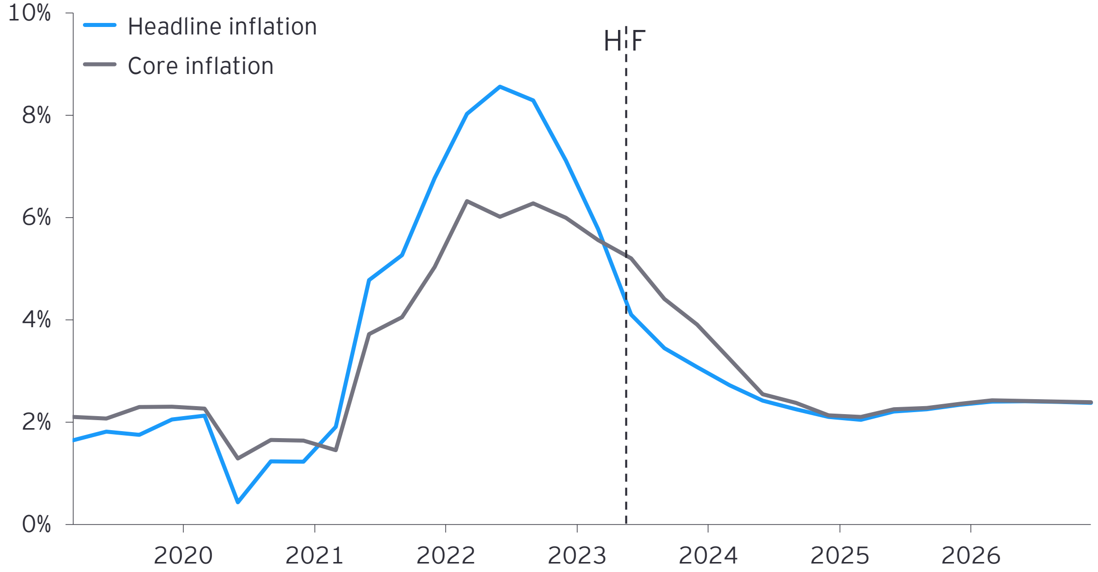
Sequential price momentum points to disinflationary dynamics, but it won't be a smooth process, as core inflation remains persistently elevated

US y/y percent change in CPI, contribution by category
January 2019-May 2023



- Headline CPI[1] rose a modest 0.1% month over month in May, down from a 0.4% increase in April. Lower energy prices and softer food inflation helped keep headline inflation in check. Core CPI prices were still rising too quickly for comfort in May, up 0.4% m/m — in line with the average 0.4% m/m gain over the prior six months.
- However, the picture looks much less concerning without the 4.4% surge in used car prices. Excluding those, core prices only rose 0.3% m/m. The story is the same for core goods prices, which posted a second consecutive 0.6% m/m advance. Excluding used cars, however, core goods prices were flat on the month.

US y/y percent change in CPI
Q1 2019-Q4 2026F



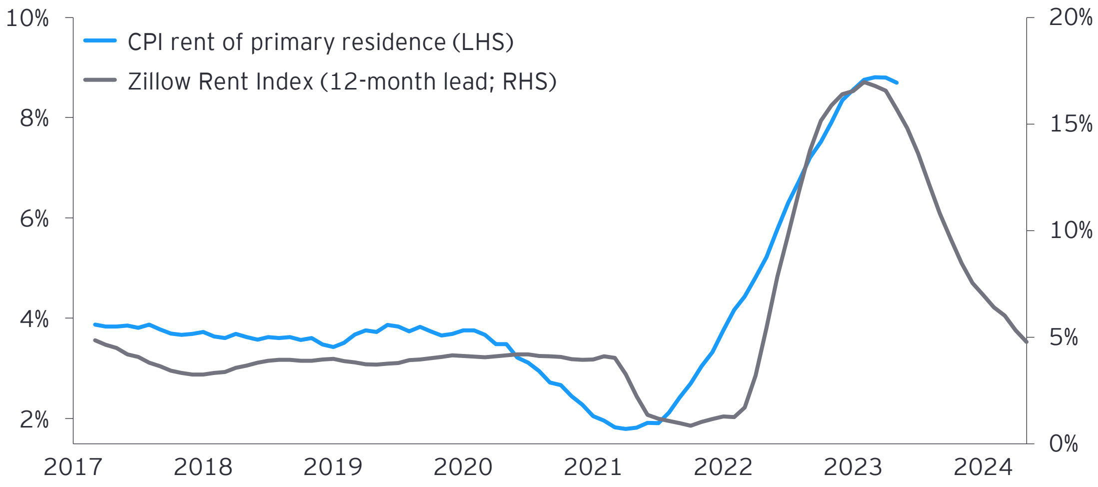
- Sequential CPI momentum has eased considerably relative to last year, helping push inflation much lower. Headline CPI inflation cooled 0.9ppt to 4.0% y/y — 5.1ppt below its June 2022 peak and its lowest since March 2021. Core CPI inflation fell 0.2ppt to 5.3% y/y — 1.3ppt below its September 2022 peak.
- Looking ahead, we expect headline CPI will be in the low 3% range in June reflecting favorable base effects from lower energy prices, while core CPI will likely have a 4% handle amid sticky services inflation. Thereafter, favorable base effects will subside, but easing demand for goods and services, the pass-through from softer housing price inflation, and cooling wage growth should lead to faster disinflation.

1. Headline CPI includes the prices on a fixed basket of goods. Core CPI removes the CPI components that can exhibit large amounts of volatility from month to month, such as food and energy.

Source: Bureau of Labor Statistics; EY-Parthenon

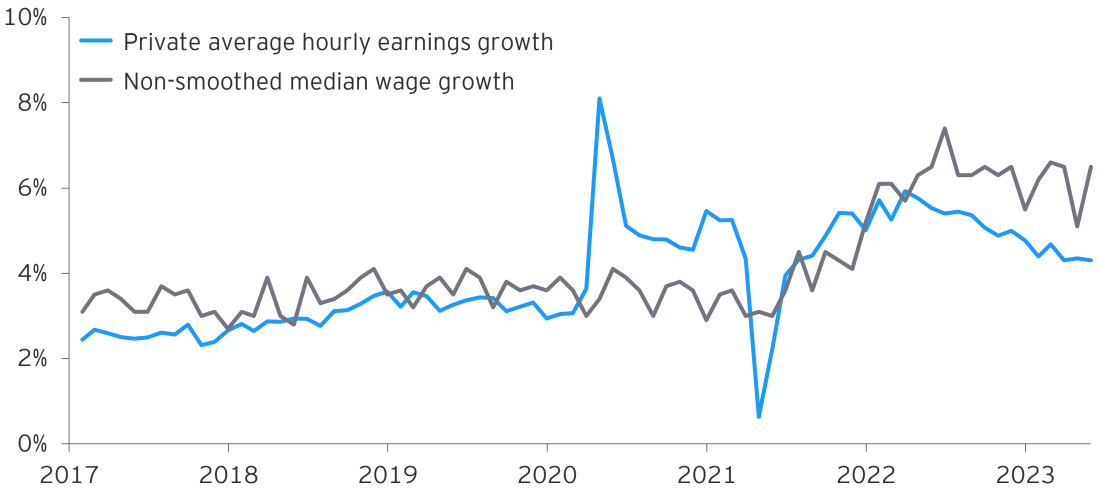
Shelter costs and wage growth are key drivers of services inflation, but forward-looking indicators point to a pullback in housing costs and moderating wage growth

US y/y growth in rent
March 2017–May 2024F



- Services inflation remained elevated in May at 6.4% and now accounts for over 87% of consumer price inflation, compared to about 30% a year ago. Housing costs are a key driver of services inflation led by rising home values and surging rental costs.
- Encouragingly, we appear to be past peak inflation on the housing front. Data such as the Zillow Rent Index, which captures rents of units currently advertised on the open market, point to a rapid cooling in the rental market. We have also seen, and continue to expect, easing home price inflation. Against this backdrop, we expect the deceleration in shelter costs will pick up momentum in the coming months.

US y/y growth in median wage and private average hourly earnings
January 2017–May 2023

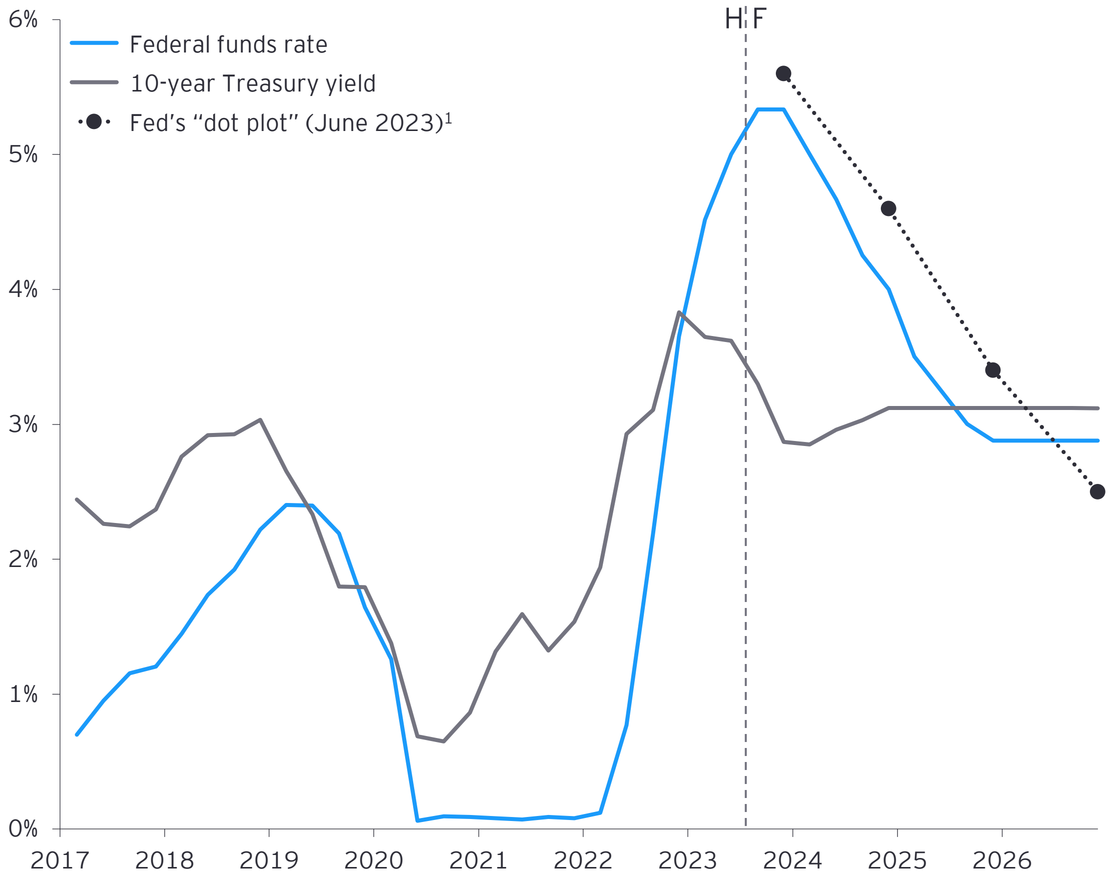


- Wage growth remains elevated and well above a rate that would be consistent with the Fed's 2% inflation target. Average hourly earnings from the monthly jobs report rose 0.3% m/m in May, down from a 0.5% gain in April. Year-over-year wage growth eased 0.1ppt to 4.3%.
- We anticipate that wage gains will moderate further as labor market conditions deteriorate and the demand for workers comes closer into balance with a limited pool of available workers. This, along with slowing shelter inflation, should lead to a more pronounced slowdown in core CPI inflation heading into 2024.

Source: Bureau of Labor Statistics; Zillow; EY-Parthenon

The Fed skipped a rate hike in June, but one is nearly guaranteed in July, and while the terminal rate is within sight, rate cuts won't occur until 2024

US interest rate forecasts, federal funds rate and 10-year Treasury yield Q1 2017-Q4 2026F



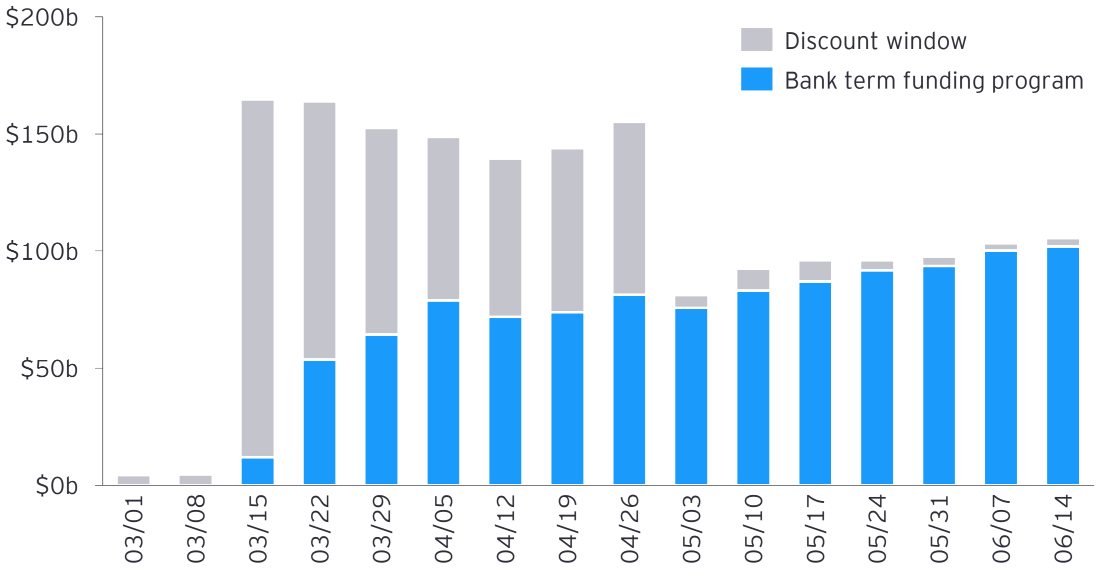
- As widely telegraphed, the Fed maintained the federal funds rate range unchanged at 5.00%-5.25%. The Federal Open Market Committee (FOMC) statement along with the Federal Reserve's new economic projections and Fed Chair Jerome Powell's press conference were an illustration of the current "cognitive dissonance" at the Fed. While extreme data dependence has convinced policymakers of the need to raise the federal funds rate by an additional 50 basis points (bps), the FOMC unanimously decided to maintain the policy rate unchanged in June.
- The June dot plot revealed a higher-than-expected interest rate path compared to March, with the new median federal funds rate projections indicating the Fed will proceed with two additional 25bps rate hikes in 2023 until it reaches a terminal federal funds rate of 5.6%. The recent strength in payroll data along with robust core CPI inflation print appear to have convinced most Fed officials that there is a need for a higher terminal rate to quell inflation.
- The economic projections showed that Fed officials now expect higher economic growth and inflation. GDP growth was revised up from 0.4% y/y in Q4 2023 to 1% and slightly down from 1.2% to 1.1% in 2024. The unemployment rate in Q4 2023 was revised down markedly to 4.1% from 4.5% in the March projections. On the inflation front, core personal consumer expenditures (PCE) inflation is expected to be noticeably higher at 3.9% y/y by the end of 2023 compared to 3.6% in March and 2.6% by the end of 2024 – still well above the Fed's 2% inflation target.
- With financial markets pricing Fed "skip" in favor of a July rate increase, Powell suggested further tightening could be warranted without entirely pre-committing to such an eventuality. As such, Powell reiterated that the Fed would evaluate the need for further tightening on a meeting-by-meeting basis. We now expect another 25bps rate hike in July, after which the Fed will likely pause its tightening cycle throughout the remainder of the year to assess the impact of the tightening to date.

1. "Dot plot" charts the median interest rate projection from the FOMC. The projections for the federal funds rate are the values at the end of the specified calendar year.

Source: Federal Reserve Board; EY-Parthenon

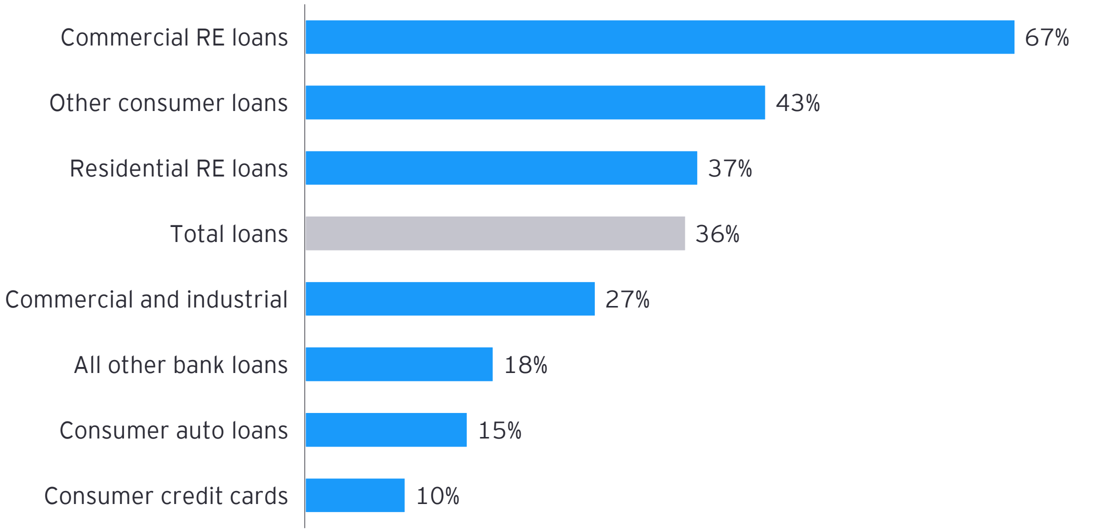
Banking sector turmoil is contained but not over, and the impact on the economy will linger as smaller banking institutions play a key financial intermediation role

Federal Reserve lending outstanding, selected programs
March 1, 2023–June 14, 2023



- As stress rose in the banking system, banks borrowed a record amount from the Federal Reserve's discount window, which provides short-term loans to banks, and used its new Bank Term Funding Program (BTFP) to offset deposits flight.
- In a sign that financial stress is lingering, banks continue to rely on the Fed's new liquidity facility, though lending through the discount window has declined markedly. In the week of June 14, banks tapped a record $102 billion from the Federal Reserve's BTFP program, the most since the beginning of the banking turmoil.

US small and medium-sized banks' share of total bank loan value
As of May 2023

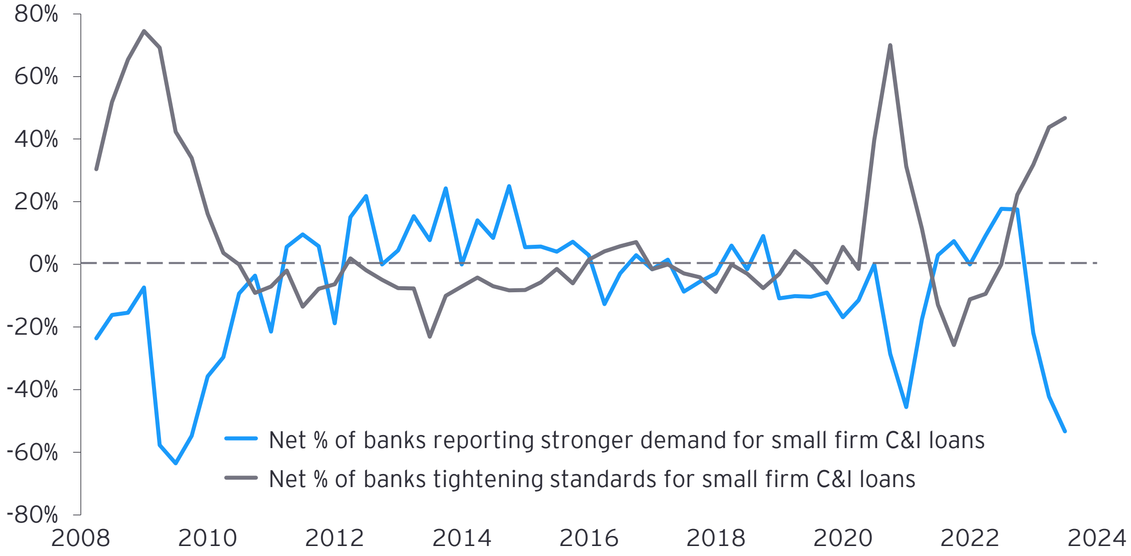


- Smaller banking institutions play an important role in the US economy, as they are a key source of bank lending to businesses and consumers. They account for about 36% of total bank loans outstanding and a sizeable 67% of all outstanding commercial real estate (RE) bank loans. And small business loans represent a larger share of small banks' portfolios than that of larger institutions.
- Looking ahead, increased bank funding costs and deposit volatility will keep pressure on small and midsized banking institutions, leading to tighter credit conditions and lingering effects on private sector activity.

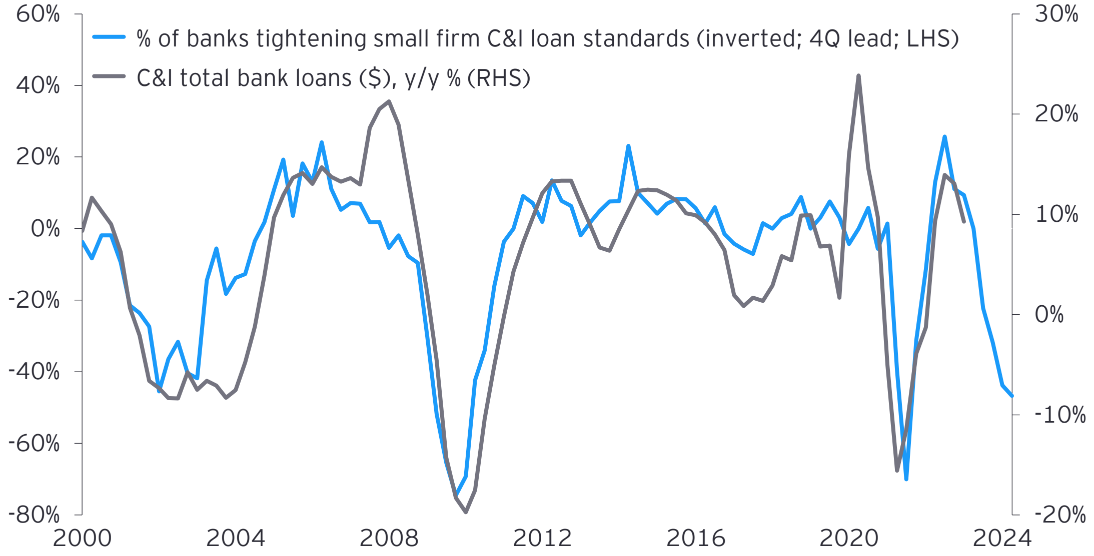
Source: Federal Reserve Senior Loan Officer Opinion Survey; Federal Reserve Board; EY-Parthenon

Credit conditions have tightened further in the wake of the banking sector turmoil, but not dramatically, and we anticipate a moderate credit drag on private sector activity

US lending conditions for small businesses
Q1 2008–Q2 2023



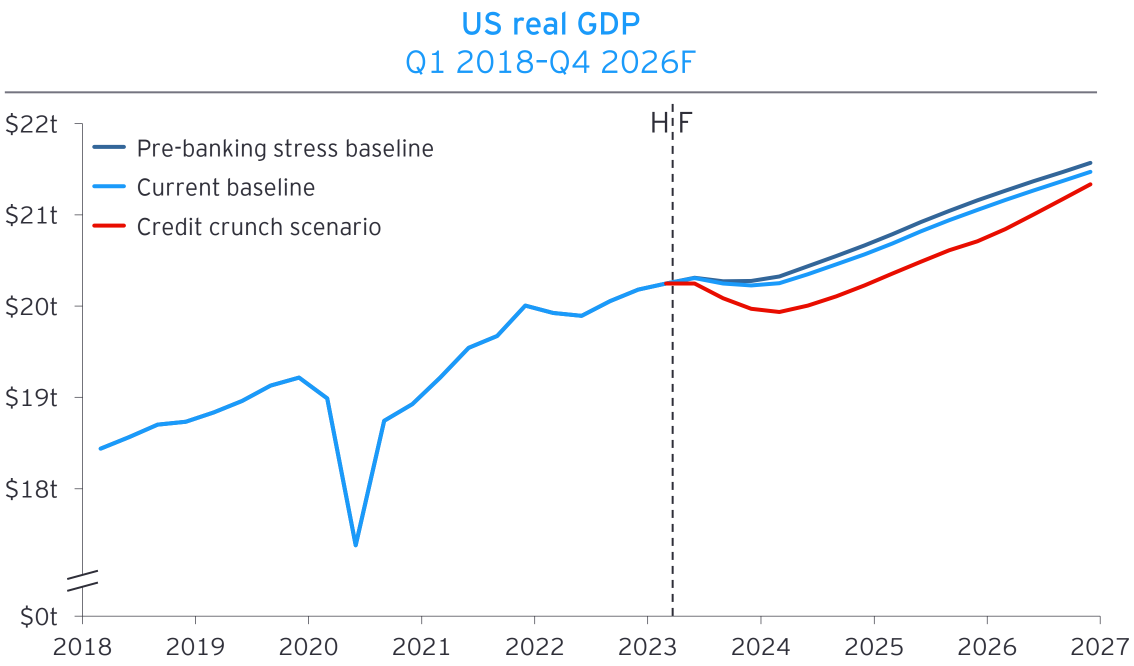
US C&I bank lending conditions
Q1 2000–Q2 2023

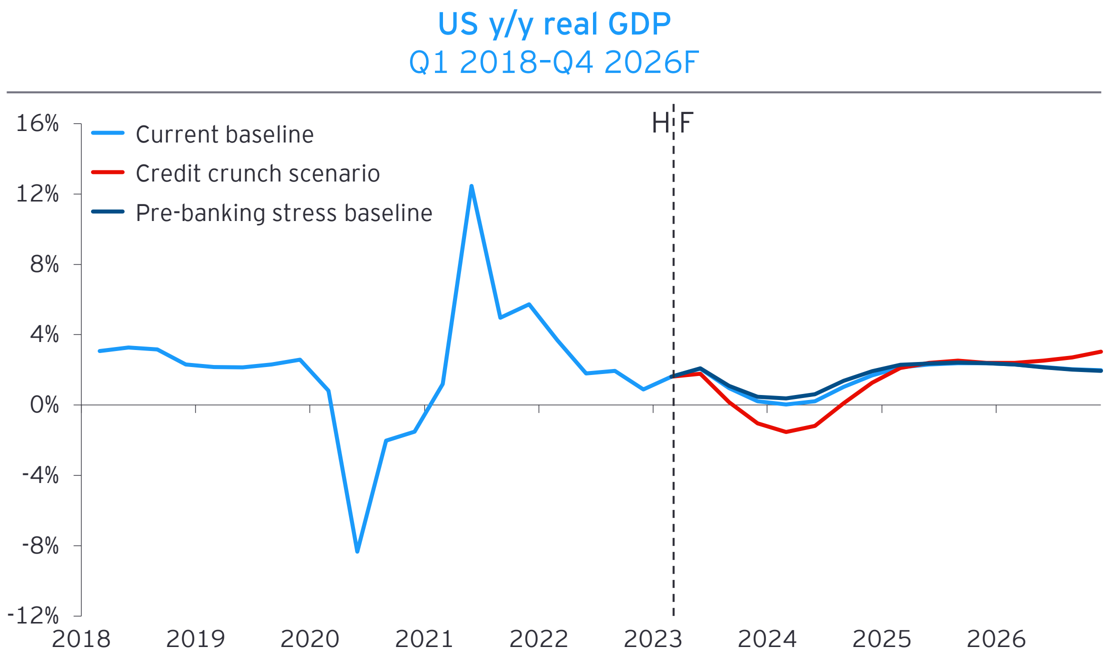


- Survey evidence points to a marked tightening of lending standards in recent quarters. The Federal Reserve's survey of bank-lending conditions showed that a net 47% had tightened standards on commercial and industrial (C&I) loans to firms of all sizes at the start of 2023. The data showed some moderate additional tightening in the wake of the banking turmoil, although banks widely reported expecting to tighten lending standards further over the rest of the year.
- Lending standards on credit card, auto and other consumer loans have also become more stringent. A net 25%–30% share of banks reported tightening standards for auto, credit cards and mortgage loans.
- Reduced credit demand is also driving the slowdown in lending activity. The Senior Loan Officer Opinion Survey (SLOOS) revealed rapidly falling demand for loans from consumers and businesses as the more challenging economic environment and increased economic uncertainty curb their willingness to spend and invest.
- Historically, swings in lending standards typically lead credit growth in the overall economy by about 12 months. This suggests that the full impact of the current tightening of credit conditions will increase significantly in the coming months.

Source: Federal Reserve Senior Loan Officer Opinion Survey; Federal Reserve Board; EY-Parthenon

Risk spotlight: A credit crunch scenario, with more bank failures and a severe tightening in credit conditions, would push the economy into a deeper recession





- In a more pronounced credit crunch scenario, we assume that banking stress spreads more broadly with severe funding pressures on businesses and further bank failures — putting significant strain on the availability and cost of credit.
- The consequences for the economy are dire, with consumer spending, residential and business investment retrenching. In the credit crunch scenario, real GDP growth is reduced by 1ppt to -0.3% in 2024, the unemployment rate rises 1ppt above our baseline to 5.5% and headline CPI inflation is 0.9ppt lower at around 2% by Q4 2023.
- The US banking sector crisis leads to severe global financial market stress and a tightening of credit conditions across the world economy. Overall, world GDP growth falls 0.4ppt below our baseline in 2024 to 2.4%.

Source: Federal Reserve Board; EY-Parthenon

In the current environment, firms must look to transform uncertainty into opportunity, which requires a holistic strategy framework factoring multiple alternative scenarios

Five "no regret" actions to build resilience amid elevated uncertainty

1. Maintain a holistic pricing strategy
2. Reinforce talent resilience and productivity growth
3. Understand the supply-side drivers
4. Adapt to the new cost of capital
5. Align strategies with stakeholder priorities

Source: EY-Parthenon

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