



# The Inflation Outlook

Four Scenarios for 2023-2025

April 2023

# Overview: The Inflation Outlook Revised

A little over a year ago, amid growing concerns over rising inflation in the U.S., Deloitte published *The Inflation Outlook*, which described four scenarios to suggest how the data available then could point to very different futures for inflation over the following 12-24 months.

## **Inflation did, in fact, increase more than many people had expected:**

Russia's invasion of Ukraine, combined with China's "zero-COVID" policy, caused serious supply chain problems that, along with other factors, drove up costs and prices. By June 2022, inflation peaked at 9.1%<sup>1</sup>, even as the U.S. Federal Reserve raised interest rates to try to cool the economy and bring down rising prices.

In 2023, we have a year's worth of new data and new uncertainty: **Unemployment is at a 50-year low**, and the labor market remains tight even after a year of rising interest rates<sup>2</sup>. As of March 2023, inflation has fallen consistently for 9 months to 5.0%<sup>3</sup>. However, this is still far from the Fed inflation target of 2.0%.

Questions remain regarding whether inflation will continue to fall and whether the historically low unemployment figures will

show up in rising wages. Most recently, **shocks in the banking sector have raised concerns** about how the Fed can reign in inflation without causing additional widespread problems in the economy (e.g., declining valuation of low-interest bonds, falling consumer confidence in bank liquidity).

So, while the drivers of inflation and the contributors to economic uncertainty have changed, the need to understand these drivers, analyze their impact, and prepare for a world of high uncertainty remains critical to the success of any future-focused enterprise. The question remains:

## **What can business leaders do to prepare their organizations to prosper no matter what the future of inflation holds?**

In continued collaboration with Deloitte's U.S. and Global economists, we have **updated our scenarios and extended our hypotheses through the end of 2025 to incorporate key changes to the economic environment.**

## What's Inside

- *Changes to the U.S. inflationary environment since the start of 2022*
- *Key macro uncertainties that may continue to impact the economic outlook*
- *Four potential economic scenarios spanning a 3-year horizon*
- *Recommendations for "no-regrets" moves that enable businesses to capitalize, regardless of scenario*
- *Key questions to address economic outlook uncertainty*

As always, **these scenarios are neither forecasts nor predictions**, and we don't claim to cover every possibility. Rather, our hope is that they inspire thinking about how the future could defy our expectations and surprise us—and what we may want to prepare for or monitor as a result.

1. U.S. Bureau of Labor Statistics, "12-month percentage change, Consumer Price Index, selected categories," accessed March 2023.

2. Federal Reserve Bank of St. Louis Economic Research, "Unemployment Rate," accessed March 10, 2023.

3. U.S. Bureau of Labor Statistics, "12-month percentage change, Consumer Price Index, selected categories," accessed March 2023.

# Last year's scenarios captured important elements of what happened over 2022, but macro-economic and geopolitical events generated new uncertainties to consider

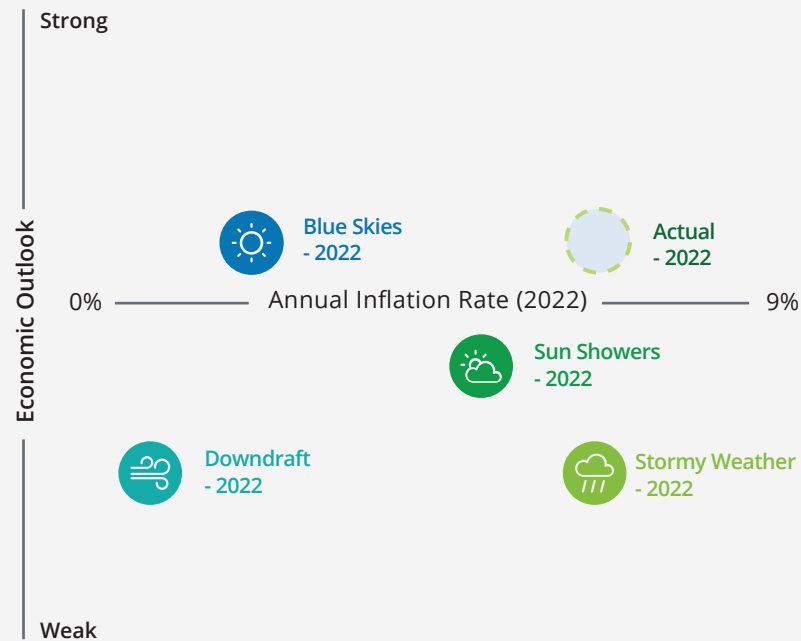
Deloitte's 2021 *Inflation Outlook* projected four potential scenarios

However, the drivers of the inflation story have changed significantly

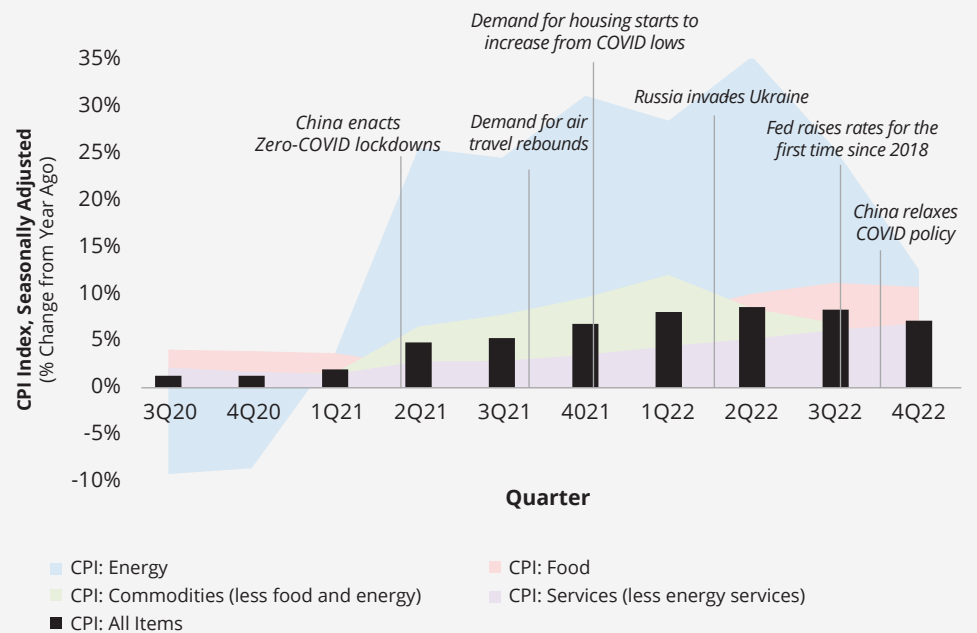
In 2022, inflation matched the "Stormy Weather" estimate but GDP growth more closely resembled that of "Blue Skies".

The outbreak of war in Ukraine, China's lifting of Zero-COVID restrictions, and the Fed's nine rate hikes since March 2022 all create new dynamics that shape the path for inflation.

## Inflation rate and Economic outlook 2022 Snapshot\* Scenarios for 2022 vs. 2022 actual outcome



## Changes in Inflation rate by CPI Component vs. All Items



\*Note: The positioning of scenarios reflects 2022 scenario states and is not indicative of the full scenarios. Refer to **Appendix 2** for the full details of each scenario.

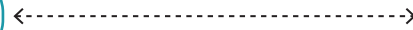
Source: U.S. Bureau of Labor Statistics, Consumer Price Index, retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/>, February 24, 2023

# A number of critical uncertainties will shape how inflation evolves over the next two years

## How will consumer spending habits evolve?



*Heightened demand for goods over services*



*Rebalanced demand for goods and services*

### Factors to watch

- Consumer propensity towards spending vs. saving, given recessionary fears and lasting changes in consumer attitudes
- The rate at which consumers shift towards or away from recessionary shopping behaviors (e.g., increased price sensitivity, shift towards value brands, and deceleration in non-essential spend)

## What will be the Fed's next steps in response to the changing economic outlook?



*Hawkish monetary policy*



*Dovish monetary policy*

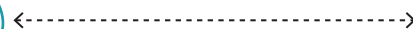
### Factors to watch

- The indicators that may suggest whether the Fed has been too aggressive or not aggressive enough in raising rates (e.g., monthly unemployment claims, foreign economic growth, and financial market volatility)
- The emergence of new variables that the Fed must consider in setting benchmark rates (e.g., concerns of fragility in the banking system)

## How will the labor market evolve?



*Softens with rising unemployment*



*Remains tight*

### Factors to watch

- The balance of jobs available and individual wage growth across industries
- Shift in the labor market equilibrium (i.e., the so-called natural rate of unemployment)

## How long will supply chain disruptions last?



*Supply chains remain constrained*



*Supply increases to meet demand*

### Factors to watch

- The economic impact of further escalation in the Russia-Ukraine war
- The implications of continued U.S.-China trade tensions
- The net impact of increased production from the easing of Chinese lockdowns on the global economy

## Additional Uncertainties



### Business/Economics

- Effects of supply chain diversification on costs (e.g., nearshoring)
- Disruptions to commodity markets (e.g., food and energy)
- Investor sentiment and market turbulence
- Impacts of emerging technology (e.g., AI and automation) on workforce efficiency



### Environment

- Frequency and impact of natural disasters and severe climate events
- Prevalence and economic impact of climate-focused initiatives



### Society

- Consumer expectations of future inflation



### Government/Politics

- Immigration policies
- Timeliness and impact of debt ceiling decision

# Recent changes in the economic environment yield four new scenarios out to 2025

## Soft Landing



**Inflation reverts to the Fed target rate (2%)** as supply chain disruptions settle in 2023 and consumer demand for services vs. goods normalizes to pre-pandemic levels. The Fed's policy is effective in reducing inflation but does not lead to a recession.

## Bumpy Landing



**Inflation slowly falls but lingers above 2%** over the next few years, as supply chain disruptions ease but the labor supply remains somewhat constrained. Firms and consumers adjust, and growth continues, albeit unevenly across industries.

## Hard Landing



**Inflation falls below 2% target** as a result of overly aggressive Fed monetary policy and a faster than expected resolution of supply chain disruptions coupled with diminished consumer demand as "pandemic savings" are spent resulting in a drop of prices across goods and services.

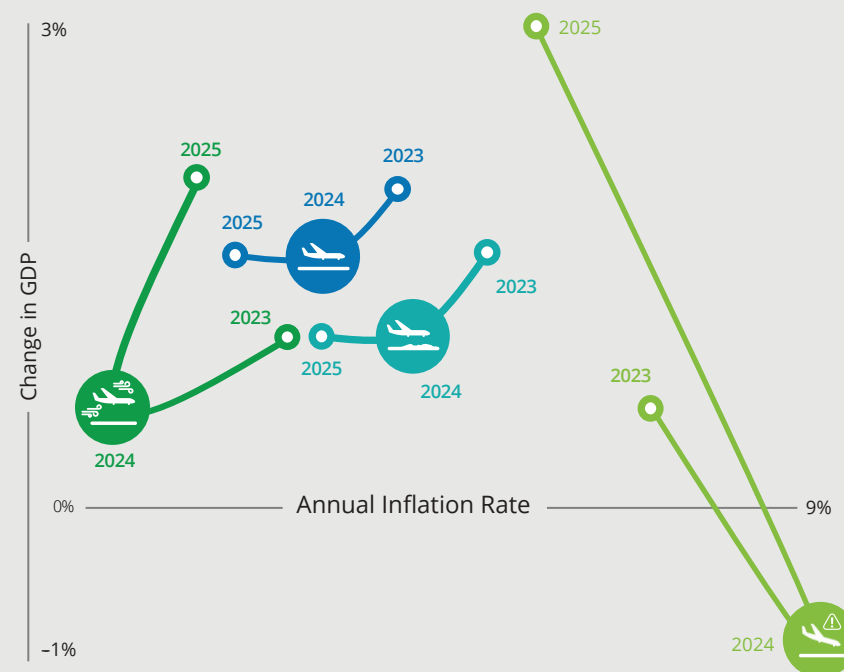
## Crash Landing



**Inflation remains high (6%)** as supply shocks from geopolitical conflicts disrupt supply chains and the rapid rebound of China's economy results in higher demand in energy markets. Entrenched inflation expectations and a wage-price spiral necessitates a strong response from the Fed.

## Inflation Rate vs Change in GDP

Click each icon for additional scenario details



For a more detailed view of each scenario's trajectory, please review the scenario-specific slides in **Appendix 1**.

While we considered additional scenarios (e.g., the Fed eases up on interest rates too soon, allowing persistent inflation to take hold), they were deemed unlikely compared to the four presented.

## Recommended courses of action

### Soft Landing



**Prepare for growth opportunities** by focusing on development of novel offerings and expansion into adjacent markets. Consider pricing strategy to prepare for new consumer expectations.

**Optimize for:** Growth, market share, and resiliency

### Bumpy Landing



**Mitigate risks to input costs,** especially those related to fuel and transport, by maneuvering away from sources directly affected by the war in Ukraine. Review talent strategy to increase employee loyalty and reduce attrition.

**Optimize for:** Stability and consolidation

### Hard Landing



**Prepare for decreased customer spending** with focus on marketing and sales efforts. Maximize delivery and fulfillment capabilities through process improvements, automation, and AI. Consider finance options to capture opportunity of reduced interest rates.

**Optimize for:** Process efficiency, innovative sales and marketing initiatives

### Crash Landing



**Improve resiliency by rationalizing existing supplier relationships and partnerships.** Consider options to increase operating efficiency and protect liquidity. De-risk exposure to geopolitical shocks for both materials and market access.

**Optimize for:** Risk identification and mitigation

## “No-regrets” moves across all scenarios

### Develop robust cost analytics capabilities

Analyze major drivers of spending to understand trends, allocate funds towards strategic priorities, and reduce nonessential consumption

### Optimize workforce delivery models

Revamp work performance models through automation, off- and near-shoring, and rationalization of roles

### Build a strategic market sensing function

Develop internal capability to monitor how the future is evolving, especially with regards to evolving customer needs and pricing opportunities

### Realign real estate strategy

Take advantage of expected changes in real estate prices and COVID-driven adaptations to support business objectives

### Diversify supply chains

Minimize dependence on single countries or regions to develop hedges that enhance resiliency in all conditions

# Questions to keep in mind regardless of the scenario outcome

While these scenarios address the data available as of April 2023, they do not exhaust all future possibilities. The interplay between evolving global conflict, the varied responses of governments around the world, the evolution of the public’s inflationary expectations, and the possibility of other, yet-unknown shocks, makes it impossible to declare with certainty the most likely inflationary outlook in 12, 18, or 24 months.

To prepare for future uncertainty, business leaders should consider asking the following questions:

Business Priorities	Key Questions	
<b>Strategic Development</b> 	<p>How well positioned are we in our current market and <b>how can we expand into adjacent sectors</b> to capture evolving demand?</p>	<p>How can we define our <b>key strategic initiatives in order to allocate resources effectively</b> in an uncertain world?</p>
<b>Supply Chain</b> 	<p>How do we build resiliency against <b>the complexity and disruptions</b> caused by geopolitical tensions while maintaining a global footprint?</p>	<p>How can we more effectively monitor and adjust <b>internal capability development with external expertise and sourcing</b> based on changing circumstances?</p>
<b>Margin Optimization</b> 	<p>What <b>pricing and cost levers</b> can we pull to <b>positively impact our bottom-line</b> and counter inflationary pressures?</p>	<p>How can we respond to real-time fluctuations in demand to develop a <b>flexible product mix strategy</b> in the face of economic uncertainty?</p>
<b>Human Capital</b> 	<p>How can we <b>enable cost-effective workforce flexibility and productivity</b> to allow the enterprise to navigate uncertainty?</p>	<p>How do we ensure that our <b>workforce is appropriately supported and skilled</b> to succeed in changing environments?</p>

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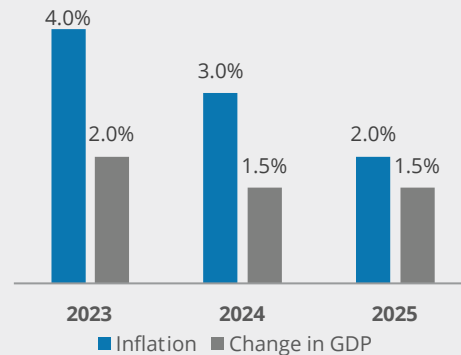
# Appendix 1: Scenario Deep-Dive

## Soft Landing: A closer look

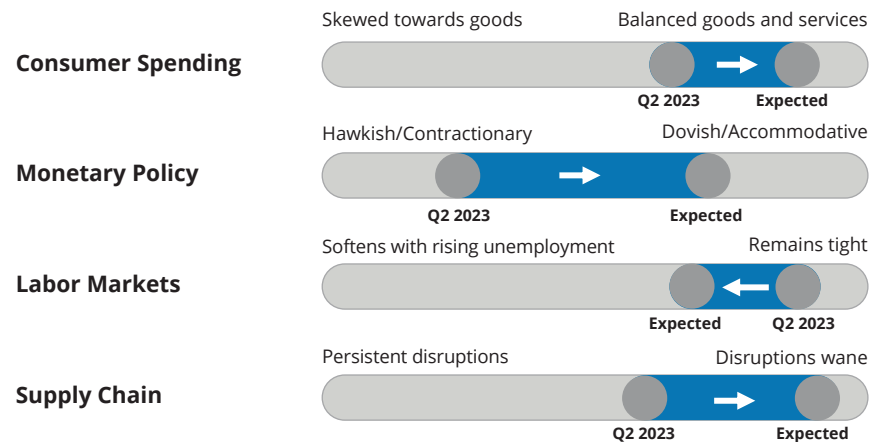


### Economic Outlook<sup>1</sup>: Low Inflation, Moderate Growth

**Inflation reverts to the Fed target rate (2%)** as supply chain disruptions settle in 2023 and consumer demand for services vs. goods normalizes to pre-pandemic levels. The Fed's policy is effective in reducing inflation but does not lead to a recession.



### State of Uncertainties in This Scenario



#### 1. Scenario Model Inputs:

- Based on soft landing as defined by Alan Blinder in "Landings, Soft and Hard: The Federal Reserve, 1965-2022." *Journal of Economic Perspectives*, vol. 37, no. 1, pp. 101-120
- Reviewed post-WWII economic landings and consulted Deloitte economists to model scenario, validating feasibility based on soft landing of 1995
- Uses Atlanta Fed's GDPNow Q1 2023 estimate of 2.2%

### Scenario Narrative

The disruptions that plagued supply chains in 2020 and 2021 have subsided, and the impact of the war in Ukraine on fuel and commodity markets has eased as supply chains adapt. Few new threatening Covid strains have emerged, which has enabled countries around the world to remain open. While China's relaxation of its "Zero-Covid" policy has increased global demand, it has not outpaced supply as Chinese manufacturing activity has rebounded.

Paired with this supply chain relief, the Fed's interest rate hikes have cooled inflation while minimizing the contractionary impact on U.S. GDP. Unemployment reverts toward historic averages as labor supply and demand normalizes without widespread layoffs.

### Early Scenario Signals

- Fed halts rate increases by mid-2023
- Unemployment begins to return to historic norms from recent lows
- Shelter prices begin to decrease in early-mid 2023

### Our Rationale for this Scenario

While a great deal of uncertainty remains, the decline in COVID-19 infection rates and the reopening of China's economy provides reassurance that there is a scenario in which low inflation and moderate growth are achieved in the near-term.

Furthermore, the combination of revitalized supply chains, a resilient U.S. labor market, and a proactive and vigilant Fed, strengthens the possibility of a soft landing.

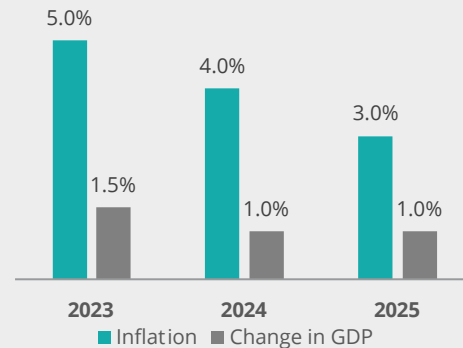
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## Bumpy Landing: A closer look

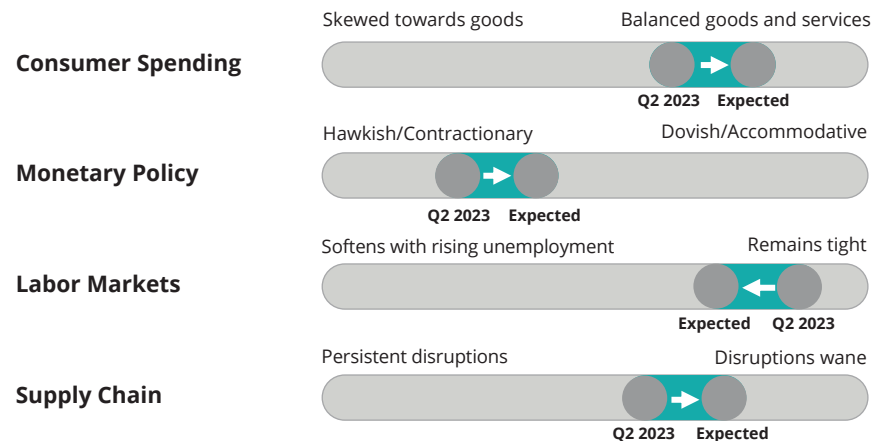


### Economic Outlook<sup>1</sup>: Moderate Inflation, Low Growth

**Inflation slowly falls but lingers above 2%** over the next few years, as supply chain disruptions wane but the labor supply remains somewhat constrained. Firms and consumers adjust, and growth gradually continues, albeit unevenly across industries.



### State of Uncertainties in This Scenario



<sup>1</sup> Scenario Model Inputs:

- Based on landing as defined by Alan Blinder in "Landings, Soft and Hard: The Federal Reserve, 1965-2022." *Journal of Economic Perspectives*, vol. 37, no. 1, pp. 101-120
- Reviewed post-WWII landings and consulted Deloitte economists to model scenario, validating feasibility based on landing of 2000
- Uses Atlanta Fed's GDPNow Q1 2023 estimate of 2.2%

### Scenario Narrative

While the overall health of supply chains has improved from pandemic lows, the ongoing war in Ukraine keeps fuel costs high in Europe and squeezes staple crops and other commodity supplies worldwide, threatening supply chain stability across industries. The Fed's monetary policy has reduced inflation, but it remains stubbornly above target even as the economy slows.

Service providers still struggle to match consumer demand for services. High fuel prices continue to trouble the airline industry, and restaurants continue to grapple with a stubbornly tight labor market. Inflationary pressure now stems from service-side supply constraints but to a much lesser degree than the goods inflation of 2021.

### Early Scenario Signals

- Unemployment remains historically low, but wage growth still trails the inflation rate
- CPI continues to hover around 4-6% in mid-2023
- Fed moves to smaller 25 basis point increases to combat inflation

### Our Rationale for this Scenario

Ongoing geopolitical conflicts point to a scenario in which disruptions persist, especially as the war in Ukraine shows no signs of near-term resolution. Fortunately, combat spillover into NATO countries seems unlikely, which would induce a much graver scenario than described here.

This scenario explores the implications of the re-emergence of consumer demand for services paired with an unusually tight labor market and elevated commodity prices from the ongoing conflict, a combination which may lead to continued inflationary pressure.

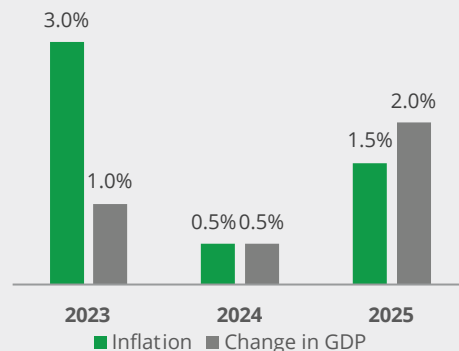
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## Hard Landing: A closer look

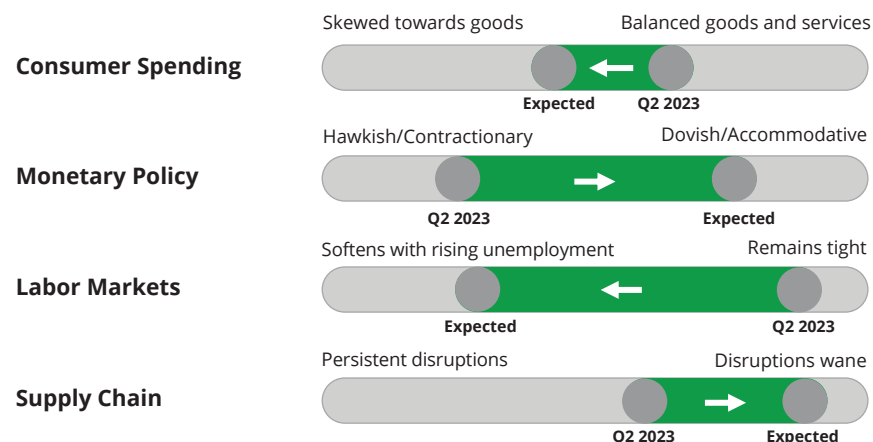


### Economic Outlook<sup>1</sup>: Low Inflation, Economic Contraction

**Inflation falls below 2% target** as a result of aggressive Fed monetary policy and a faster than expected resolution of supply chain disruptions coupled with diminished consumer demand, as “pandemic savings” are spent, resulting in a drop of prices across goods and services.



### State of Uncertainties in This Scenario



#### 1. Scenario Model Inputs:

- Reviewed post-WWII recessions and consulted Deloitte economists to model scenario, validating feasibility based on recession of the early 1980s
- Assumes recession peak-trough magnitude of 1%
- Uses Atlanta Fed's GDPNow Q1 2023 estimate of 2.2%

### Scenario Narrative

Supply chain disruptions stemming from COVID-19 and global conflict have eased, reducing supply-side inflationary pressures more quickly than expected. At the same time, the Fed has remained aggressive in its battle against inflation. The lagging impact of Fed Funds Rate increases on long-term interest rates decreases demand for durable goods. Firms that had ramped up production to address previously unmet demand are forced to heavily discount excess inventory leading to a decrease in prices.

As supply outpaces demand, firms begin instituting layoffs, resulting in falling wages and increased unemployment. The rapid fall in prices and the rise in unemployment forces the Fed to reverse course to prevent further disinflation.

### Early Scenario Signals

- By mid-2023, CPI stalls, with minimal price increases for services and a reduction in prices for goods
- Unemployment begins to increase and wage growth stagnates in mid-2023
- Fed continues hiking rates with 25 or 50 basis point increases

### Our Rationale for this Scenario

Given the possibility of economic turmoil due to overly aggressive Fed monetary policy, a scenario in which interest rate hikes induce a recession must be explored. This is especially pertinent given the negative impact of recent rate hikes on the stability of regional banks.

Thus, this scenario explores the impact of an over-correction by the Fed. Supply chain disruptions did not require the subsequent level of Fed intervention, which in turn triggers contraction across the U.S. economy.

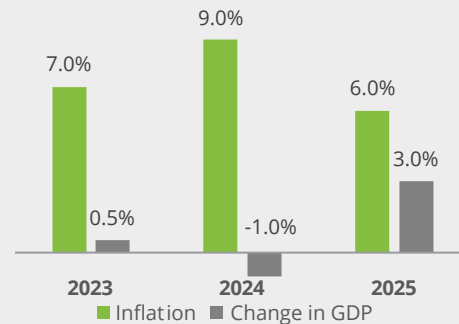
# Appendix 1: Scenario Deep-Dive

## Crash Landing: A closer look



### Economic Outlook<sup>1</sup>: High Inflation, Economic Contraction

**Inflation remains high (6%)** as supply shocks from geopolitical conflicts disrupt supply chains and the rapid rebound of China's economy results in higher demand in energy markets. Entrenched inflation expectations and a wage-price spiral necessitates a strong response from the Fed.



### State of Uncertainties in This Scenario



<sup>1</sup> Scenario Model Inputs:

- Reviewed post-WWII recessions and consulted Deloitte economists to model scenario, validating feasibility based on recession of 1975
- Assumes recession peak-trough magnitude of 2% (in line with average post-war recession)
- Uses Atlanta Fed's GDPNow Q1 2023 estimate of 2.2%

### Scenario Narrative

The war in Ukraine has grown more severe and U.S.-China relations have further deteriorated. The result: escalating economic sanctions and further disruption across various industries. Firms must scramble to re-shore manufacturing and localize supply chains to prevent additional pain. High inflation expectations become further entrenched, raising the cost to reduce them.

As inflation persists, the Fed accelerates interest rate hikes through 50 basis point increases. While necessary to slow inflation, the Fed's moves hamper consumers and businesses alike, who are strapped for cash from already high prices and who exhausted their pandemic savings long ago. As firms look to cut costs, layoffs spread across industries and unemployment rises.

### Early Scenario Signals

- Escalation of global conflict, e.g., a new phase of the war in Ukraine or increased Chinese aggression towards Taiwan
- A sudden increase in inflation in mid-2023, despite Fed action
- Shelter prices continue to rise through 2023

### Our Rationale for this Scenario

The potential for severe economic disruption remains through the escalation of global conflict stemming from the war in Ukraine and the continued deterioration of U.S.-China relations.

While this scenario's narrative focuses on global conflict as the catalyst for economic distress, there are several other shocks that could trigger such a scenario or worse. For instance, OPEC+ could continue to restrict oil production, exacerbating global inflationary pressures. Furthermore, a binding of the debt limit would have negative implications, the worst of which would be a severe recession and a complete loss of confidence in the Treasury's stability and liquidity.

# Appendix 2: 2021 *Future of Inflation* Report Scenarios

## Blue Skies



**Current inflation is temporary and reverts to recent historical norms (~2%)** as supply chain disruptions settle in 2022 and consumer demand for services vs. goods rebalances

- **Labor supply stabilizes** as individuals reenter the workforce as pandemic ebbs
- Fed responds with **limited and gradual interest rate increases**

## Stormy Weather



**Inflation rises to 8–9%** as inflation becomes embedded in worker expectations and a “wage-price spiral” takes off. Sluggish economy dampens both consumer and business spending

- **Supply chain issues** deepen, exacerbated by new COVID-19 strains
- **Fed sharply raises interest rates** to put the brakes on inflation, triggering a recession in 2023

## Sun Showers



**Inflation settles at 3–4%** through 2024 as supply chain disruptions persist and the labor supply remains somewhat constrained. Firms and consumers adjust and growth continues, albeit unevenly, across industries and players.

- Consumer spending and **economic activity remain stable**, but remain skewed towards goods vs. services
- **Fed response is moderate** due to weakness in the labor market

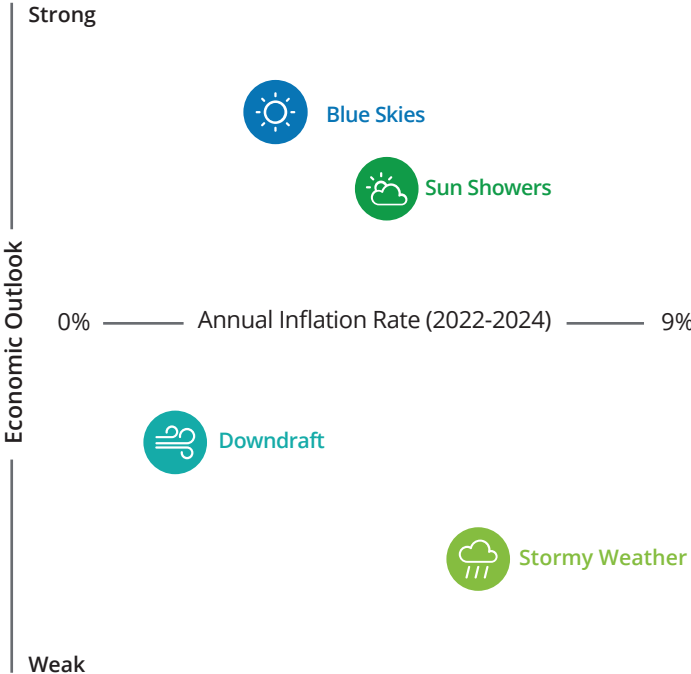
## Downdraft



**Disinflation to 0–1%** as a result of a faster than expected resolution of supply chain disruptions coupled with diminished consumer demand as “pandemic savings” are spent down

- **Low growth** lowers corporate profits and raises unemployment
- **Fed keeps interest rates at historic lows** and explores increased bond buying activities

## Inflation Rate vs. Economic Outlook





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