Bell Bank

Commercial Insights

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How Businesses Should Navigate an Economic Slowdown in 2023

For many businesses, navigating the financial and economic landscape has never been more challenging. Higher costs due to inflation, whipsawing financial conditions, and tight labor markets have made it difficult to maintain staffing and production levels, let alone expand and plan for the future. Fault lines have also formed in economic forecasts around the possibility of a recession in 2023. At best, many economists expect slower growth this year before a potential rebound in 2024. Fortunately, many businesses have been resilient and may be strategically well-positioned once the dust settles. In this challenging climate, what do business leaders need to be aware of as they plan for the coming year?

To better understand today's business context, it's important to remember that last year opened with two quarters of negative growth across the U.S. The economy then rebounded when GDP grew at a real rate of 3.2% in the third quarter and 2.9% in the fourth. The Federal Reserve rapidly raised rates eight times throughout this period which often impacts the economy with a lag, since higher policy rates filter through to consumer and business activity over time. This has tightened financial conditions and has weakened interest rate-sensitive sectors such as the housing market.

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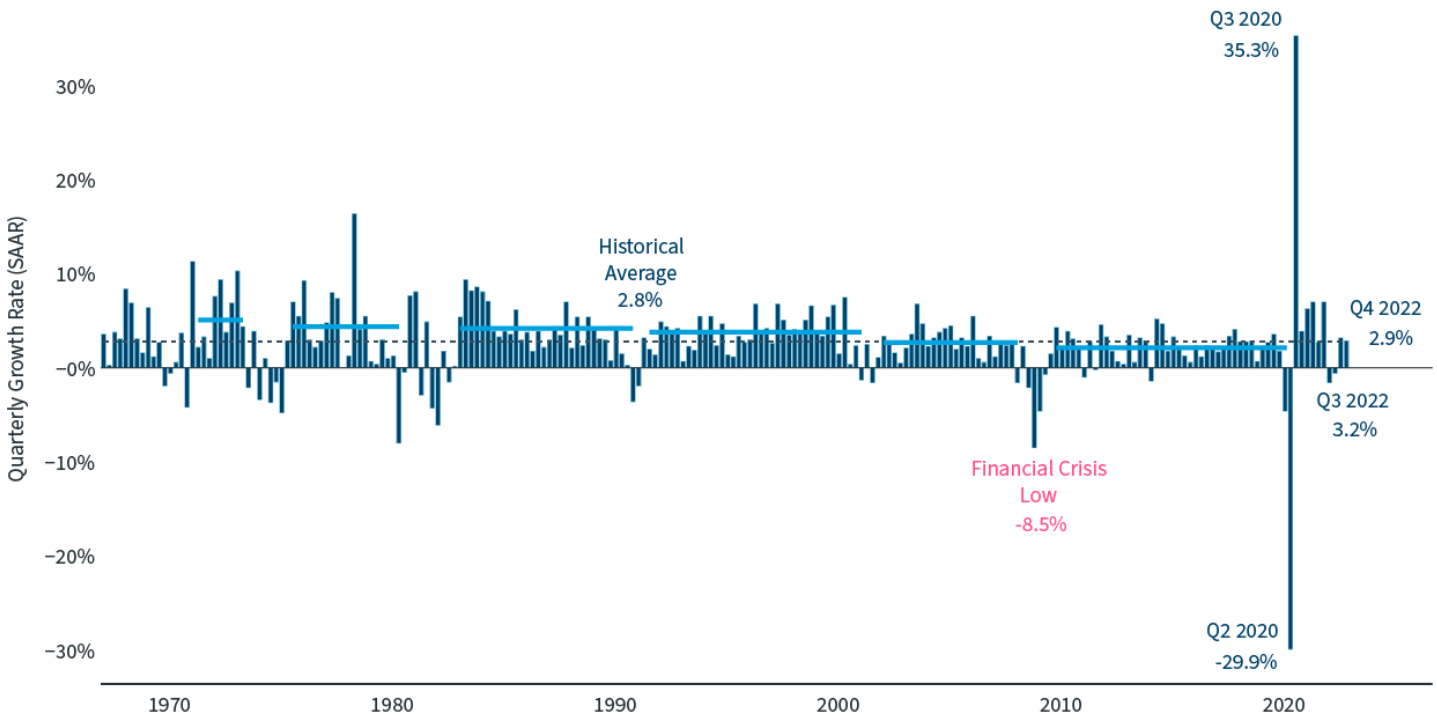
U.S. GDP Growth Rates Since World War II

Quarterly GDP, seasonally adjusted annual rate



Latest data point is Q4 2022
Sources: Clearnomics, U.S. BEA, NBER

For these reasons, many economic forecasters expect slower growth this year. Despite these growth headwinds, many trends are pointing in the right direction. Inflation is easing across many categories including energy due to lower oil and gas prices, and important areas such as shelter (i.e., rent and housing costs) are expected to improve in the coming months. Many businesses are optimistic about future growth with the level of job openings still well above historic averages and unemployment falling to a mere 3.4%. Unemployment is even lower in many parts of the Upper Midwest, including 2.5% in Minnesota.

The Growth Environment Across the U.S. and the Midwest

How do the trends of the past three years affect the economy today? One way to categorize businesses is between those that make goods and those that provide services. Much of the growth over the past couple of quarters has occurred in the services industry as demand has recovered from the sharp declines during the pandemic. In contrast, goods production was red hot during the pandemic but has weakened more recently, acting as a drag on nationwide growth.

This is also true for the "Plains region" - a term in the government data that represents North Dakota, South Dakota, Nebraska, Kansas, Minnesota, Iowa, and Missouri. The contribution from the production of goods was a significant detractor throughout most of the year in this region, whereas services boosted the economy, especially in the first and fourth quarters. Overall, the Plains region experienced strong growth in 2022 except during the third quarter when goods and services were both negative.

However, one differentiator in this region compared to the rest of the country is the sizable contribution from agriculture. Agricultural activity depressed regional growth during the fourth quarter of 2021 by 2.8 percentage points. Lower commodity prices, droughts and crop yields have led to swings in economic growth in these states relative to the rest of the country. Of course, these factors are highly uncertain and could just as easily contribute to growth in the coming quarters.

Consumer Trends

Another important factor driving economic growth and corporate revenues in the commercial sector is the financial health of consumers. After all, strong consumer spending, which constitutes over two-thirds of the spending that occurs throughout the economy, creates a tailwind for businesses by driving top-line

Contributions to Real GDP in the Plains region

Contributions to quarterly GDP growth over the prior four quarters

Latest data point is Q3 2022
Sources: Clearnomics, U.S. BEA

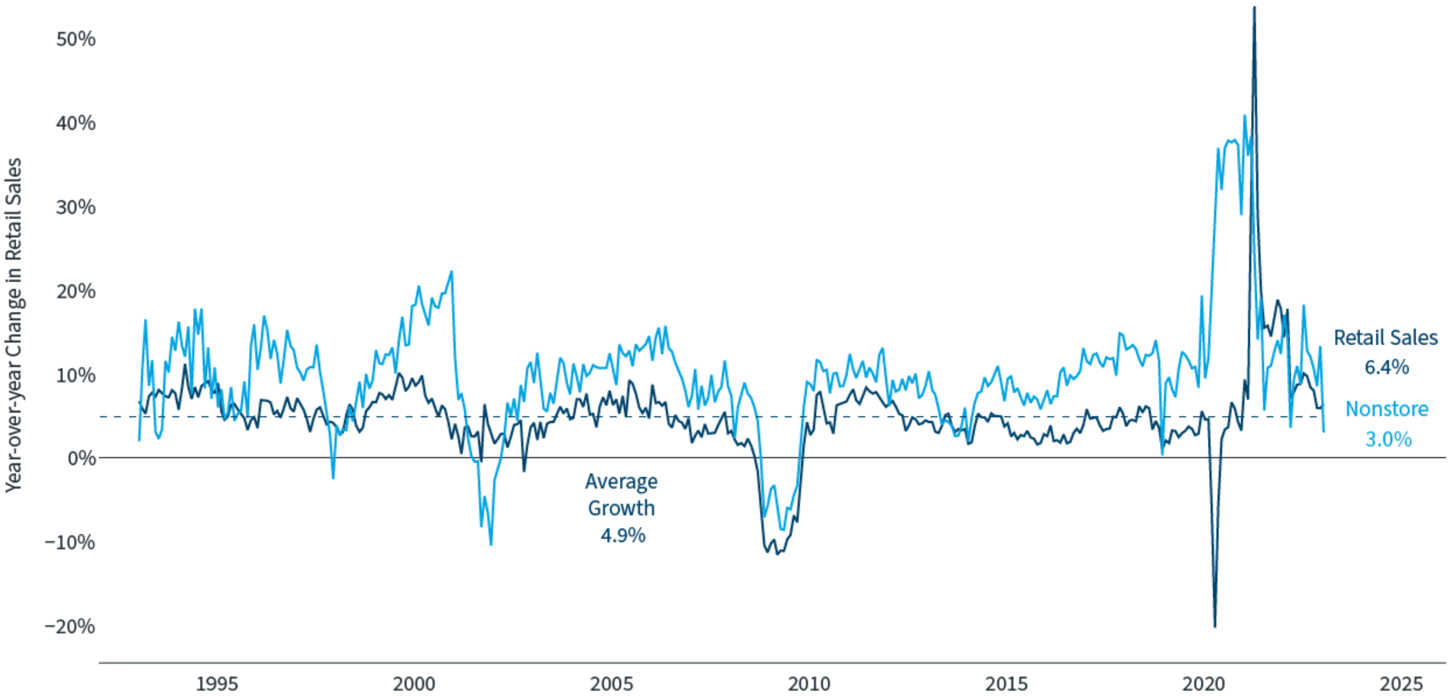
revenue growth, fueling expansion. Conversely, poor consumer sentiment can have ripple effects across the economy, as it has over the past year. Consumer confidence and spending can turn quickly as economic conditions change.

During and immediately after the pandemic, technology and consumer sectors benefited as households spent their pandemic savings and stimulus checks, while also taking on more debt. This fueled rapid hiring activity and led to record job openings and strong wage gains. This in turn pushed inflation higher and made it more difficult for businesses to compete for qualified workers.

Some of these trends reversed at the end of 2022, spurring layoffs in these sectors. National retail spending declined across several measures as consumers responded to higher prices and reduced savings. The U.S. Census Bureau's retail sales numbers

Retail Sales Have Slowed

Retail Sales, YoY % Growth, SAAR



Latest data point is Jan 2023
Sources: Clearnomics, U.S. Census Bureau

show that spending declined 1.1% last December and the Bureau of Economic Analysis's personal consumption expenditures data, which are adjusted for inflation, fell 0.1% in November and 0.2% in December. Some of these data have improved since then, but are still not expected to return to their recent highs.

While national data is valuable for assessing the health of the national economy, Minneapolis Fed surveys indicate that consumer spending was more upbeat for the Midwest, with some businesses quoting sales growth of 5 to 10 percent. More broadly, the business survey notes that consumer spending grew modestly since November and holiday sales were robust despite poor weather. So, while the national data will determine whether the economy tips into recession, regional sales trends appear to be more positive across much of the Midwest.

Prospects for 2023

Looking forward, the paths of inflation, the job market and consumer spending will likely play key roles in determining if the country enters recession, and how strong a subsequent rebound might be. These factors are highly uncertain and hard to predict. This is why businesses will need to stay disciplined as the job market remains tight and interest rates remain high.

The good news is that if inflation continues to improve, the Fed may slow its rate hikes and eventually ease monetary policy, providing relief to the economy and businesses. This will be balanced with the ongoing strength of the job market, including wages which grew 5.1% over the past year. The housing market, which represents a large proportion of consumer balance sheets, could also experience a pickup in activity if this occurs. With interest rates expected to remain high for quite some time, businesses that effectively manage their borrowing and cash may be rewarded.

For these reasons, while 2023 may be challenging, there is a light at the end of the tunnel. Well-prepared business leaders should continue to keep an eye on costs while preparing for growth.

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