Recession Watch

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Scenarios and strategies for an unstable environment
The world has moved past the era of COVID lockdowns and massive stimulus but has entered a period of high economic uncertainty – inflation in the US and Europe nearly hit levels of the early ’80s, central banks seek to walk a narrow path of taming inflation without creating a recession, Europe is experiencing the deadliest military conflict since 1945, and geopolitical and trade tensions are reaching high levels.

Recession fears dominate the news cycle, and, unusually, key recession indicators have been flashing for nearly a year without a US recession: the US yield curve has been inverted since July 2022, economists have predicted a >40% likelihood of recession since June 2022, US Federal Reserve and European Central Bank (ECB) have increased rates steeply since May/June 2022 (though the US Fed paused, at least for now, in June).

Inflation in the US and Europe continues to fall from its peak, but slowly. Uncertainty remains on how long it will take to get back to central bank targets and how high interest rates might need to go to achieve that, with both the Fed and ECB emphasizing their commitments to fight inflation.

It is critical that business leaders prepare plans to handle a wide variety of risks – both economic (inflation, recession, and capital costs) and geopolitical (trade tensions, sanctions, and war) – that could threaten many business models.

No one can say with a high degree of certainty the exact timing, depth, or length of the next recession – and those who claim to should be treated skeptically – but this document aims to provide a framing for the risk and context against other recent recessions, to help companies understand the variety of scenarios to plan for and what the latest data says.

Several key developments in the last month:

- The US debt ceiling was raised, averting potential for a financial crisis. No other large banks have seen crises since the sale of First Republic to JP Morgan on May 1, though vulnerabilities remain.
- US inflation has fallen from its 9.1% year-over-year (YOY) peak in June 2022 to 4.0% in May 2023, below consensus estimates and down from 4.9% in April 2023, but well above the 1990-2020 average of 2.4%.
- Revised eurozone data shows a moderate recession, with -0.1% quarter-on-quarter (QOQ) growth in Q4 2022 and Q1 2023. Eurozone inflation has fallen from its 10.6% YOY peak in October 2022 to 6.1% in May 2023.
- The Fed and ECB have both signaled a continued focus on inflation, but at its June meeting, the Fed paused rate increases, at least for now, while the ECB continued to hike.
- China continues to have very low inflation, unlike the US and Europe, but its snap back from COVID restrictions has been disappointing.
- Geopolitical tensions remain high. Companies with significant operations that could be disrupted by an escalation should carefully play out scenarios.

Sources: Refinitiv; OECD; US Bureau of Labor Statistics (BLS); IMF
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Recession Watch
Major economy PMIs are above 50, up further from Q1 2023

Purchasing Managers’ Index (PMI), seasonally adjusted, monthly

>50 INDICATES GROWTH

<50 INDICATES CONTRACTION

MOST RECENT DATA

<table>
<thead>
<tr>
<th>Country</th>
<th>May 2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>54.3</td>
</tr>
<tr>
<td>Eurozone</td>
<td>52.8</td>
</tr>
<tr>
<td>China</td>
<td>55.6</td>
</tr>
<tr>
<td>UK</td>
<td>54.0</td>
</tr>
<tr>
<td>Japan</td>
<td>54.3</td>
</tr>
<tr>
<td>India</td>
<td>61.6</td>
</tr>
</tbody>
</table>

Source: S&P Global (from Macrobond)
While US, eurozone, and UK inflation rates peaked last year, they have not yet fallen to central bank targets.

**Inflation (Yoy % change), not seasonally adjusted, monthly**

**Most recent data**
- **US (May)**: 4.0%
- **Eurozone (May)**: 6.1%
- **China (May)**: 0.2%
- **UK (May)**: 7.9%
- **Japan (Apr)**: 3.5%
- **India (May)**: 4.3%

Note: UK data refers to Consumer Prices Index including owner occupiers' housing costs (CPIH).
Central bank rate increases have occurred at the steepest rate in recent history in the US and EU.

**US Federal Funds Rate, months after first increase**

**EU Main Refinancing Operations rate, months after first increase**

Note: 2005 and 2011 rates tracked each other through month 5.
Sources: US Federal Reserve; European Central Bank (ECB, from Macrobond)
Major economies have maintained positive YOY growth, though the eurozone has had two quarters of negative QOQ growth.

Real GDP (YOY % change), quarterly

Consumer confidence levels remain below the long-term average globally, but have risen somewhat in recent months.

OECD Consumer Confidence Index, seasonally adjusted, monthly (100 = long-term average)

Source: OECD (from Macrobond)
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While CHI is at its 5-year average, our internal research suggests that the risks remain to the downside.
Post-pandemic inflationary pressure continues despite a potential pause in US monetary policy tightening

**Most Recent Data**

- **Producer Price Index (PPI - May):** 1.1%
- **Consumer Price Index (CPI - May):** 4.0%
- **30-Year Fixed Mortgage Rate (As of 6/15):** 6.7%
- **Fed Funds Rate, Upper Target (June):** 5.25%

Sources: Board of Governors of the Federal Reserve System; US Bureau of Labor Statistics (BLS); Freddie Mac, Fannie Mae (30-year mortgage forecast); Congressional Budget Office (Fed funds effective rate & inflation forecast); EIA (PPI forecast) (from Macrobond)
Inflation has continued to decline materially in every category except shelter.

Key components of US CPI, monthly (pp contribution to YOY inflation)

<table>
<thead>
<tr>
<th>Month</th>
<th>Weight</th>
<th>May YOY Inflation</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>All other</td>
<td>30%</td>
<td>2.2%</td>
<td>This category (includes medical, personal care, apparel, education, etc.) has seen relatively low and consistent inflation on an annual basis</td>
</tr>
<tr>
<td>Food</td>
<td>14%</td>
<td>6.6%</td>
<td>Food has continued to contribute to inflation significantly, though grocery prices have declined YOY</td>
</tr>
<tr>
<td>Utilities</td>
<td>5%</td>
<td>0.9%</td>
<td>Although utilities are still increasing YOY, recently they have not contributed significantly to overall inflation</td>
</tr>
<tr>
<td>Shelter</td>
<td>34%</td>
<td>8.0%</td>
<td>Now the largest contributor to overall inflation at &gt;50%, rent and Owners’ Equivalent Rent (OER) inflation have risen, from ~4% YOY in January 2022 to ~8% YOY in May 2023</td>
</tr>
<tr>
<td>Transportation</td>
<td>17%</td>
<td>-2.0%</td>
<td>Transportation was the largest component of inflation until October 2022. Price of gas and used cars spiked from March/April 2021 to April/May 2022, and gradually declined since. YOY inflation in this category turned negative in March 2023, was near zero in April, then fell further in May</td>
</tr>
</tbody>
</table>

Source: Bureau of Labor Statistics (BLS, from Macrobond)
The 10-2 Treasury spread has remained negative since July 2022

10-year minus 2-year US Treasury yield spread, monthly average (pp)

Note: Data represents difference between 10-year Treasury yield and 2-year Treasury yield
Source: US Department of the Treasury (from Macrobond)
Unemployment has returned to historical lows with labor force participation trending toward pre-COVID levels.

Unemployment rate, monthly, seasonally adjusted

Labor force participation rate, monthly, seasonally adjusted

Notes: U-3 unemployment shown for US; CIVPART shown for labor participation rate
Source: US Bureau of Labor Statistics (BLS, from Macrobond)
Though interest rates remain high, housing prices and starts saw small dips followed by increases in May.
## Key economic indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Latest</th>
<th>Next release</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real GDP (YOY % change)</strong></td>
<td>1.6%</td>
<td>Q1 2023</td>
<td>Jun 29 2023 (Final)</td>
</tr>
<tr>
<td>10-year minus 2-year US Treasury yield spread</td>
<td>-0.8pp</td>
<td>Jun 15 2023</td>
<td>Traded on open market</td>
</tr>
<tr>
<td><strong>Composite PMI</strong></td>
<td>54.3</td>
<td>May 2023</td>
<td>Jul 6 2023</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>3.7%</td>
<td>May 2023</td>
<td>Jul 7 2023</td>
</tr>
<tr>
<td>Labor force participation</td>
<td>62.6%</td>
<td>May 2023</td>
<td>Jul 7 2023</td>
</tr>
<tr>
<td><strong>Bain Consumer Health Index</strong></td>
<td>97.7</td>
<td>May 2023</td>
<td>Updated weekly</td>
</tr>
<tr>
<td>Real advance retail sales and food services (YOY % change)</td>
<td>-2.4%</td>
<td>May 2023</td>
<td>Jul 18 2023</td>
</tr>
<tr>
<td>Case-Shiller housing index (YOY % change)</td>
<td>0.7%</td>
<td>Mar 2023</td>
<td>Jun 27 2023</td>
</tr>
<tr>
<td>Housing starts, total units (YOY % change)</td>
<td>5.7%</td>
<td>May 2023</td>
<td>Jul 19 2023</td>
</tr>
<tr>
<td>Consumer Price Index, urban consumers (CPI-U) (YOY % change)</td>
<td>4.0%</td>
<td>May 2023</td>
<td>Jul 12 2023</td>
</tr>
<tr>
<td>Producer Price Index, final demand (PPI) (YOY % change)</td>
<td>1.1%</td>
<td>May 2023</td>
<td>Jul 13 2023</td>
</tr>
<tr>
<td>30-year fixed mortgage rate, average monthly</td>
<td>6.7%</td>
<td>Jun 15 2023</td>
<td>Updated weekly</td>
</tr>
<tr>
<td>Federal funds rate, upper target</td>
<td>5.25%</td>
<td>N/A</td>
<td>Jul 26 2023</td>
</tr>
</tbody>
</table>

Sources: Bureau of Economic Analysis (BEA); US Bureau of Labor Statistics (BLS); US Census Bureau; S&P Global; Bain CHI; US Department of the Treasury; Federal Reserve Bank of St. Louis; S&P Dow Jones Indices; Freddie Mac; Board of Governors of the Federal Reserve System (from Macrobond)
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Recessions are a certainty; only the timing and depth are unpredictable.

**US real GDP growth, quarterly**

**YOY % CHANGE**

- 1990-91: Savings and loan crisis
- 2001-02: Dotcom bubble
- 2007-09: Global financial crisis

The world’s economy is on a razor’s edge and could easily fall into recession if financial conditions tighten.

Sources: US Federal Reserve; OECD
A US or European recession may take several different forms in the near term (examples)

<table>
<thead>
<tr>
<th>Perfect landing</th>
<th>Market correction</th>
<th>Inflation fatigue</th>
<th>Stagflation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Central banks raise interest rates just enough to stall an inflationary spiral while short-term pressures are resolved</td>
<td>Central banks tighten rates until they induce a financial crisis</td>
<td>A gentle recession happens without sharp central bank rate rises, driven by consumer fatigue</td>
</tr>
<tr>
<td></td>
<td>Demand remains robust enough to avoid a meaningful recession</td>
<td>Market values are hit hard, disproportionately impacting top income earners</td>
<td>Recession lasts about 2-3 quarters with a moderate drop</td>
</tr>
</tbody>
</table>
Pandemic era stimulus, global supply shocks, and rising international tensions led to high inflation.

G20 real GDP growth and inflation, quarterly

Source: OECD
We’re keeping our eyes on key risks in the most important world economies

Across economies

GDP, inflation, exchange rates, central bank moves, purchasing manager and consumer confidence indices

Key economic drivers

UNITED STATES
- Housing market
- Banking system

EUROPE
- Energy prices
- German / Italian bond spread

CHINA
- Housing market
- Local government finances

Domestic and geopolitical risks

UNITED STATES
- Debt ceiling and budget passage
- Tensions over trade with China

EUROPE
- Tensions over energy prices and debt
- Russia-Ukraine war
- Intra-EU tensions

CHINA
- Tensions over trade with US/EU
- Tensions with Taiwan
## Five trends will continue to shape the world

<table>
<thead>
<tr>
<th>Thesis</th>
<th>2020-22 developments</th>
<th>Near-term path</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reemergence of great power rivalry and heightened levels of political, trade, and military conflict will end the United States’ ‘unipolar moment’ (since the 1991 collapse of the Soviet Union)</td>
<td>Mounting tensions between world powers, with the largest war in Europe since 1945, fast-escalating trade tensions between China and the US, and protectionist industrial policies all combining to make geopolitics center stage</td>
<td>Fundamental tensions are likely to only grow, with complex global trading systems continuing to decouple, and ongoing risks of kinetic and other conflicts (e.g., cyber)</td>
</tr>
<tr>
<td>Large investments in automation as technology improves and the labor force ages, adding to inequality and creating new challenges for governments</td>
<td>The sudden supply constraint on labor and attendant rise in cost amid COVID turbocharged the economics of automation. Innovation in robotics and AI has also increased the scope of what can be automated while decreasing the cost of automation</td>
<td>Automation will continue to spread turbocharged by AI, amid aging demographics and improving technology. This will particularly disrupt middle-income jobs</td>
</tr>
</tbody>
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**Post-Globalization**

**Labor Automation**
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<tbody>
<tr>
<td>Technology has reduced the ‘cost of distance,’ giving people greater choice of where they live and work</td>
<td>COVID and remote work have caused a step change in how people work. Some who could afford it wanted more space, moving farther from city centers</td>
<td>The pre-COVID working norms will not return. A portion of those who can work remotely will, accelerating migration to the outer suburbs/exurbs</td>
</tr>
<tr>
<td>The era of capital superabundance is drawing to a close, as the population of much of the world shifts from working savers to retired spenders</td>
<td>A massive surge of post-COVID inflation in the US and Europe became the key focus of policymakers amid supply constraints and strong demand, though it has passed its peak</td>
<td>Inflation will likely continue to decline from its peak. Ultimately, nominal interest rates will depend on central bank moves, but underlying pressures will be more inflationary than in the 2010s</td>
</tr>
<tr>
<td>Reducing carbon emissions will require large-scale investments at a global level and will likely raise the cost of energy throughout the period of transition</td>
<td>The Russia-Ukraine war and the global energy crunch that preceded it are causing a rethink of Europe’s, Japan’s, and the developing world’s energy approach, alongside energy investments in the US spurred by the Inflation Reduction Act (IRA)</td>
<td>A global transition will take more time and money than the public realizes, and no country has made the long-term commitments needed to achieve it. Progress is likely to be highly fragmented and slower, rather than globally coordinated and faster</td>
</tr>
</tbody>
</table>
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Critical choices in the past have been made by

**LOSERS**

**TRAPE 1: BURN THE FURNITURE**

Misconceived that aggressive cost-cutting is crucial to winning in a recession

Examples: ruled out acquisitions, slashed R&D and spending on S&M activities key to growth, let go of valuable talent

**TRAPE 2: TRY EVERYTHING**

Strayed from company’s core with desperate bid for growth by betting on everything

Examples: invested in ‘what’s hot,’ simultaneously expanded in multiple directions without a well-thought-out strategy

**TRAPE 3: LATE TO THE PARTY**

Waited too long before taking action, took a reactive (vs. proactive) approach to ride out the downturn

Examples: overlooked opportunity to leverage unstable period to leapfrog competitors, failed to set up signposts to act ahead and take no-regret moves swiftly

**WINNERS**

- **Restructured costs** before the downturn, without cutting muscle
- Put the financial house in order: diligently managed liquidity and balance sheet
- **Played offense** by reinvesting selectively for competitive outperformance
- Pursued a proactive M&A pipeline
Robust pre-recession planning helps companies prepare

Where we are today
- Which areas of your business have been most impacted by disruptions today? To what extent?
- What actions have you taken to limit recession risk, counter cost increases, and manage cash flow?
- What quick wins can you implement around products, pricing, procurement, eliminating work, etc. to reduce costs and maintain top line in a recession?

Stress testing
- What areas of the business are most exposed to and at risk in an economic downturn? To what extent?
- What are the trigger points for further actions to be taken? Which actions come first, second,...?
- What are signposts for different degrees of an economic slowdown? What other disruptions will be at play?

Key competitor & customer trends
- How will customer needs/preferences evolve with persistent disruptions coupled with a slowdown?
- What are our competitors’ responses to disruption and how will this change the competitive landscape?
- How will a reinvented supply chain look – one that is disruption-proof, flexible against customer needs, and contains costs?
- How should we redesign how work gets done to meet changing talent landscape and scale a self-funding automation program?

Resilience
- How do we create business resiliency and control costs in the face of likely continued disruptions and a downturn?
- In which areas do we want to outperform and build competitive advantage?
New recession playbook exists for today’s environment with an initial focus on recession and stress testing

**PRE-RECESSION SCENARIO PLANNING**

- Use stress testing to gain clarity on response plan in different scenarios based on signposts and triggers
- Create high-resolution visibility on spend and key response areas to support better decision-making
- Strengthen balance sheet management ahead of a downturn to position for liquidity and M&A investments

**PRE-RECESSION APPROACH**

- **Reset the cost base, prioritizing automation**
  - Simplify the work and prioritize automation to mitigate labor constraints
  - Create fuel to invest in key priorities (e.g., growth, ESG) through the downturn

- **Solidify new pricing & portfolio management capabilities**
  - Streamline the product offering and optimize mix to mitigate supply shocks and drive growth
  - Keep SKU-level pricing plans and capabilities evergreen

- **Win on purpose through sustained customer relationship building**
  - Enhance growth/share through superior customer engagement
  - Build business intelligence to target customer segments based on recessionary impact, competitive vulnerability

- **Double down on operational resiliency and traceability**
  - Execute on quick response actions to mitigate current disruptions
  - Build evergreen supply chain risk assessment and mitigation capabilities

- **Strategically allocate CAPEX, R&D, and M&A funding**
  - Take prudent decisions on CAPEX and R&D: where to cut and where to invest
  - Proactively pursue M&A and selectively exit businesses that no longer fit strategically, or are unprofitable

**NEW RECESSION PLAYBOOK EXISTS FOR TODAY’S ENVIRONMENT WITH AN INITIAL FOCUS ON RECESSION AND STRESS TESTING**
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