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COMMENTARY
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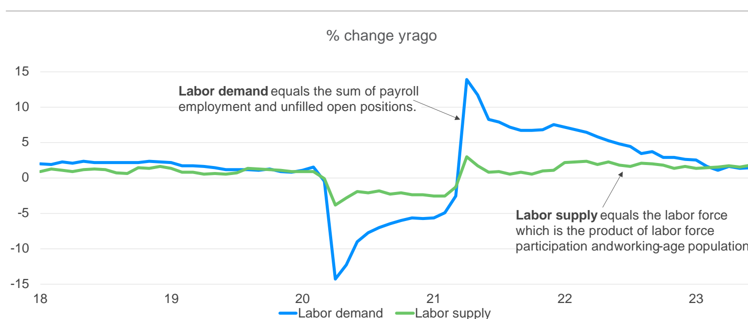
U.S. Outlook: The Economy Finds Footing

The economic data have been uniformly good this summer, showing resilient growth and easing inflation; recession risks are thus receding, but risks remain.

- Despite aggressive rate hikes by the Federal Reserve, U.S. growth remains strong.
- Inflation, though still too high, is abating, and slower job growth is due to businesses slowing their hiring (not layoffs).
- At the top of the list of immediate worries is the potential for a spike in oil prices.
- Mounting labor market strife could also fan inflation and pressure the Fed to hike rates more.
- While it is premature to declare that there will not be an economic downturn, that declaration feels increasingly close at hand.

The economy's recent performance could not be much better. Growth has been close to the economy's potential, with real GDP during the first half of the year advancing just over 2% annualized. Economic data for the third quarter have only started to be released, but so far the tracking estimate for real GDP growth indicates it will be another solid quarter.

Job gains are throttling back. Still, abstracting from the vagaries of the monthly data, they are close to a strong 200,000 per month (forthcoming revisions are likely to reduce this a bit more). This is consistent with the continued buoyant growth in the labor force, as participation by prime-age workers and immigration have fully recovered from the pandemic. Unemployment remains steadfast at near 3.5% as it has for well over a year.



It is encouraging that slower job growth is not due to layoffs—historically a key ingredient for recession. Indeed, layoffs remain low as the fillip in technology-related job cutbacks at the end of last year and early this has abated. Instead, businesses are generally slowing their hiring. They also appear to be paring back employee hours and temporary help instead of cutting jobs. They recognize that the aging out of the workforce by the large baby-boomer generation and weaker immigration ensure their number-one problem will be finding and retaining workers.

Low and stable unemployment notwithstanding, the labor market is cooling. The employment-to-population ratio for prime-age workers, while high and consistent with a full-employment economy, appears to have peaked. Moreover, workers are no longer rushing to quit their jobs at the record pace of a year or so ago. The quit rate—the percent of the labor force voluntarily leaving jobs—has fallen to where it was pre-pandemic.

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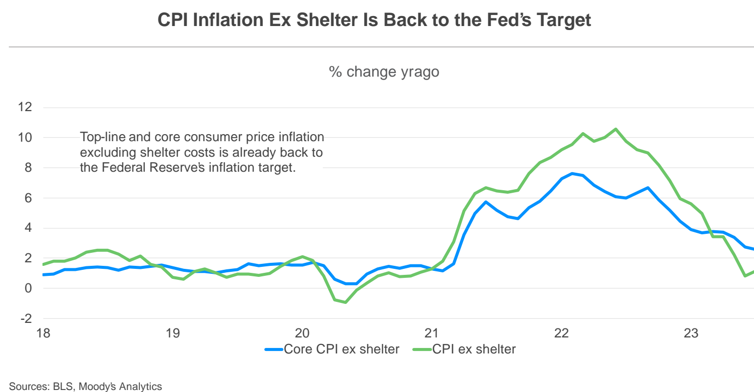
This is one reason for the recent slowing in wage growth, as job switchers typically get outsize pay increases. Labor compensation as measured by the employment cost index, which controls for the mix of industries and occupations, increased just over 4% annualized in the second quarter. This is down from a recent 5.5% peak and is closing in on the 3.5% pace thought to be consistent with the Federal Reserve's 2% inflation target and underlying productivity growth of 1.5% per annum.

There is some reasonable optimism that productivity growth will soon receive a boost from several tailwinds. That so many workers have switched jobs since the pandemic and are now in jobs that better suit their interests, skills and education should reap productivity benefits as these workers climb the learning curve in their new jobs. The impact of remote work on productivity is less clear-cut, but also should be a net plus to productivity as new businesses form and optimize around working from home. The adoption of generative artificial intelligence also holds significant promise, though it will likely take longer to be effectively adopted in business practices and improve productivity than the recent hype around AI suggests.

Back to target

Stronger productivity growth would be helpful in getting inflation back down to the Federal Reserve's target, but we are not counting on it, and the recent easing in inflation suggests it is not necessary. Consumer price inflation, which peaked last summer at 9% year over year, is now just over 3%, and while base effects will slow the disinflation, we expect inflation to be near the Fed's target by this time next year without a recession or even much of an increase in unemployment.

Consider that CPI inflation excluding shelter costs has already slowed to only 1% year over year, and core CPI inflation excluding food, energy and shelter to 2.5%. That is, inflation is already back to the Fed's target excluding the cost of housing. And prospects are good that the growth in the cost of housing services will moderate substantially further in the coming year.



That's because shelter inflation is tied to market rents with a long lag because most leases are for a year, and rents have gone flat to down since the end of last year. Rents will also remain under pressure given the record almost 1 million rental units in the construction pipeline that will be completed through the end of next year as pandemic-related supply chain and labor market problems resolve. While much of the new construction is for high-end class A apartment properties, rents for more affordable class B and C units will also see rents flag as they struggle to retain tenants enticed by the more attractive and now cheaper class A units.

To be sure, inflation for some goods and services is likely to accelerate in coming months. Most notable are medical care service prices, which have been steadily falling but will soon begin to rise. This is due to how the cost of health insurance is measured by the Bureau of Labor Statistics and the considerable pressure on the labor-intensive healthcare industry to pass along more of its increased labor costs.

However, this should be offset by continued price declines for new and used vehicles, as global production and inventories continue to increase while pandemic-related supply-chain problems wind down, and ultimately by a moderation in the cost of vehicle insurance and maintenance which are determined in part by vehicle prices. Also, electricity bills should get smaller as utilities powered by natural gas eventually pass along some of the benefit of lower natural gas prices. The net of all these cross-currents on overall inflation is likely a wash.

At the terminal rate

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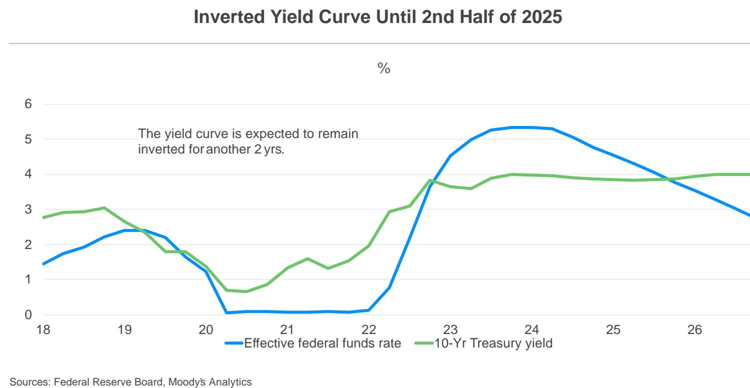
Now with a more-or-less clear path for inflation to get back to the Fed's target in a timely way, the Fed can end its interest rate hikes. The current federal funds rate target of just below 5.5% should be the terminal rate—the highest the rate will go this cycle. This is approximately double the estimated equilibrium rate or so-called r-star—that rate consistent with monetary policy neither supporting nor restraining growth.

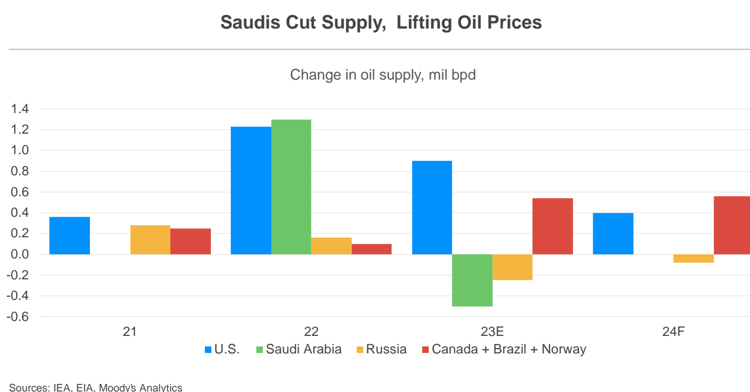
Monetary policy is thus highly restrictive, and likely to remain so until inflation is unquestionably returning to target. In our forecast, that will happen next June. We then anticipate the Fed will cut rates slowly, by 0.25 percentage point each quarter, bringing the funds rate back to r-star by the second half of 2026. Since we do not anticipate much change in the 10-year Treasury yield from its current near 4%, this suggests the yield curve as measured by the difference between the 10-year Treasury yield and the funds rate will not turn positive again until the second half of 2025.



If the Fed sticks to this script, recession through next year seems less than likely. We put the odds at about one in three. Without more rate hikes it is much less clear what would be the catalyst for a downturn. No doubt the slowing economy will be vulnerable to anything that goes wrong, but something else would have to go wrong.

Oil price spike, workers strike

Of course, something could go wrong. At the top of the list of immediate worries is the potential for a spike in oil prices. Just a few weeks ago, oil prices were hovering near $70 per barrel and a gallon of regular unleaded gasoline cost $3.50. But prices have since jumped to more than $80 per barrel and gas is closing in on $4. Pushing up prices is the decision affirmed by the OPEC+ cartel, led by Saudi Arabia, to cut production. The production cuts have reduced global oil supply to below demand, despite tepid global demand growth, and thus prices have increased.



The Saudis should be reasonably content with oil trading in the $80s, high enough to finance their considerable budgetary needs, but not too high as to undermine global oil demand. However, gauging the Saudis' motivations is difficult, and many other hard to assess factors could result in much higher prices. Those include China's demand for oil, which could rev up with that country's economy the effectiveness of Western sanctions on Russian oil exports; and the ability for nations to tap their depleted strategic petroleum reserves.

Oil prices of $90 per barrel and gas prices above $4 a gallon would sting but still would not undermine the

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economy. But if prices rise to $100 per barrel and $4.50 a gallon for more than a few weeks, then this likely would be too much for the economy to bear, and a recession would ensue. Nothing will be more pernicious to the economy than higher oil prices, since the resulting increase in inflation will sap consumers' purchasing power, cause inflation expectations to increase, and force the inflation-sensitive Fed to raise rates further.

Mounting labor market strife, further down on the list of worries, could also fan inflation and pressure the Fed to hike rates more. Work stoppages are still uncommon, but the high-profile feud between major Hollywood studios and striking actors and writers is a reminder that the tight job market makes conditions ripe for more labor actions.

Healthcare workers and hotel staff have walked off the job this year, and there have been vigorous organizing efforts by workers for warehouse services at Amazon, UPS and FedEx. Potentially much more disruptive would be a strike by the United Auto Workers, whose contract with the Big Three automakers expires next month. If vehicle production stops, then vehicle prices will not decline as anticipated and may even rise until after the strike is settled.

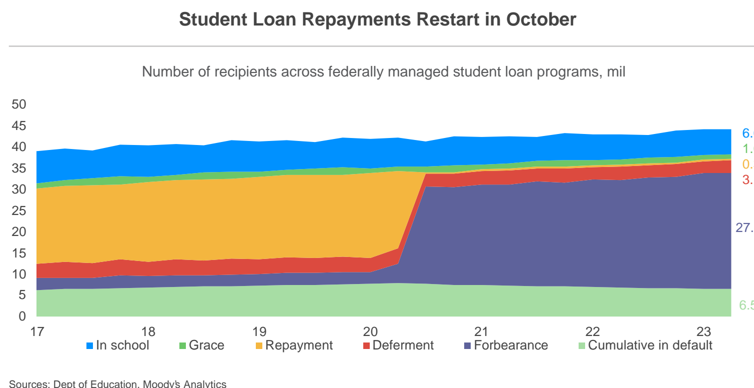
Shutdown and student loans

Another serious threat is a lengthy federal government shutdown beginning at the start of fiscal 2024 on October 1. House Republicans appear generally unhappy with the government spending cuts they agreed to in the recent legislation to increase the Treasury debt limit. They want more cuts, and unless they get them, they seem set on stymieing the budget process and withholding the funding the government needs to stay open.

We've been through numerous shutdowns since the current budget process was put in place in 1976, although most have lasted only a few days to a few weeks. The economic fallout was thus limited. A good rule of thumb is that every week the government is shut down shaves 0.1 percentage point off annualized real GDP growth in the quarter. The hit is softer in the first few weeks of a shutdown but more damaging if the drama drags on for more than a month or two.

This shutdown could last a while and potentially for the entire fourth quarter. That is because there may not be sufficient political pressure on lawmakers to come to terms until the start of calendar year 2024. That is when, as part of the debt limit deal, lawmakers agreed that if they could not agree on the budget, then discretionary spending on both defense and nondefense would be cut by 1%. Few lawmakers want this, so it seems likely they will strike a deal by year's end but perhaps no sooner. A shutdown for the entire fourth quarter will slam the economy. Already-soft real GDP growth could go into the red in the quarter. And a 1% sequestration next year would make recession more likely than not. It is hard to imagine that lawmakers would be so reckless, and we expect they will not be. But then again...

Another outcome of the debt limit deal is a requirement that student loan borrowers resume payments on their debts in October. Those payments were first suspended as part of the initial pandemic relief legislation and were then extended, until now. This involves an estimated 24 million borrowers owing average monthly payments of $275.



If all of these borrowers resumed paying and cut back on their spending by a like amount, consumer spending would fall by almost $80 billion annualized, which amounts to approximately 0.25 percentage point of GDP.

But not all of these borrowers will resume payment. In particular, President Biden issued an executive order

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requiring student loan servicers not to report nonpayers to the credit bureaus. Moreover, many of the borrowers have savings to spend, even while they make student loan payments. Still, though the impact of ending the moratorium should be modest, it bears close watching.

Fragile financial system

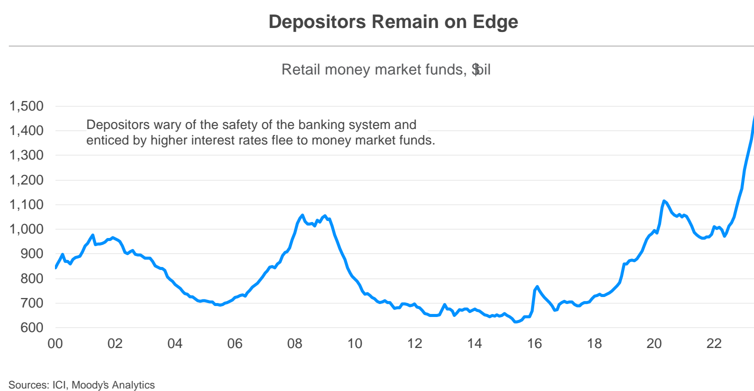
The economic consequences of the banking crisis that rattled the financial system in March has been surprisingly limited, but the financial system remains under extraordinary pressure, and the crisis may not be over. Indeed, until the Fed eases monetary policy, and the yield curve becomes positively sloped, financial institutions will have increasing difficulty maintaining their net interest margins and thus profitability. To date, most institutions have managed their NIMs admirably through hedging and matching, but they can only do this for so long given the costs.

Credit losses, which have been generally low since the pandemic hit given the previous record-low interest rates and extraordinary government support, are on the rise. Most disconcerting is the prospect for more defaults on commercial real estate loans, which are in train. But credit problems are also quickly mounting for credit-card, consumer-finance and auto loans. The credit quality of commercial and industrial loans and single-family residential mortgage loans should hold up better, but even if quality simply returns to pre-pandemic norms, there will be more delinquencies and defaults.

Bank profitability will also come under pressure as loan growth slows. Banks have significantly tightened their lending standards and raised the bar and cost to qualify for a loan. Regulatory costs are also on the rise; partly in response to the recent banking crisis, the Federal Reserve and other regulators have proposed raising capital standards and tightening liquidity requirements. It will take time for these proposals to be finalized and implemented, creating uncertainties that will make it difficult for banks to address their weak profitability through mergers and acquisitions. The Biden administration also appears reticent to allow bigger banks to combine.

Of course, the Fed and other regulators successfully provided a strong backstop to the banking system to stem the banking crisis. This includes insuring depositors of troubled institutions, even those with deposits greater than the deposit insurance limit, and establishing the Bank Term Funding Program, a facility allowing banks to borrow against their security holdings at par despite their significant loss of value due to the increase in interest rates. But as bank profitability erodes, weakening banks' capital positions, this may not be enough to stem bank failures. It is difficult to see how midsize or large institutions would falter given the support, but smaller institutions might.

In any other time, this probably would not be a material worry, but given how on edge and footloose depositors were during the banking crisis, small institutions may be more systemically important than seemed possible.



It is also increasingly important to consider the risk of a serious problem outside of the banking system in the nonbank or so-called shadow system. This part of the financial system is becoming a more important source of credit as the banking system comes under heavier oversight. The shadow system is only lightly regulated, and many parts of it remain opaque and its financial strength thus difficult to assess.

The economy is finding its footing, despite the Federal Reserve's aggressive interest rate hikes. Growth has moderated but remains strong, and inflation, while still too high, is abating. Recession risks are elevated, but

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they are receding. No doubt there are serious threats to the economy, so it is premature to declare that there will not be a downturn, but that declaration feels increasingly close at hand.

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