U.S. Retrospective and Outlook

We have consistently held that the economy would avoid a recession in 2023, but the economy has performed better than even we anticipated; while recession is less likely in 2024, the economy is not likely to outperform, and the risks remain to the downside.

- The U.S. economy bucked consensus and is on track for vigorous growth of nearly 2.5% for all of 2023.
- Inflation’s more-or-less graceful retreat is behind the surprisingly good performance marked by resilience in employment, consumer spending, and other areas of the economy.
- Most threatening to the economy is the prospect that the Fed will make a monetary policy mistake.
- It is prudent not to be overconfident as downside risks remain, but there is good reason to think that predictions of a recession in 2024 will prove wrong.

The strongly held consensus among economists and business leaders a year ago was that the U.S. economy would suffer a recession in 2023. This overarching pessimism was rooted in experience. In times past when the economy was plagued with high inflation and the Federal Reserve responded with aggressive interest rate hikes, a recession soon followed. To expect the economy to navigate through high inflation and interest rates without suffering a downturn was effectively saying that this time would be different.

Economists are loath to utter the words, “this time is different.” Most often it is not. But there are times when it is, and this appears to be one of those times. Inflation is steadily moderating without a recession or even an economic slowdown. Real GDP is on track for vigorous growth of nearly 2.5% this year. And the economy will create a whopping close to 3 million jobs and enjoy unemployment that remains steadfastly below 4%.

This time is different

Behind the economy’s surprisingly good performance is inflation’s more-or-less graceful retreat. What most pessimists got wrong was their view that inflation was largely fueled by overly strong demand, pumped up by stimulatory fiscal policy. If so, they reasoned, the only way to get inflation back down was for the Fed to jack up interest rates and hit demand hard, causing a recession.

But this was largely a misdiagnosis. The high inflation was instead largely the result of the supply shocks caused by the COVID-19 pandemic that scrambled supply chains and the job market, and by the Russian war in Ukraine and the resulting surge in oil, natural gas, agricultural and other commodity prices. The inflation caused by these massive shocks conflated and pushed up inflation expectations and wage growth. And that raised the specter of a dreaded wage-price spiral.

Fortunately, the inflationary fallout from these shocks is increasingly in the rearview mirror, inflation expectations have moderated, and the wage-price spiral never took root. The Fed’s rate hikes appear to be over; it is increasingly clear that a recession is not needed to get inflation back down to the central bank’s target in a timely way.

Consumers have been big beneficiaries of the lower inflation—while wage growth has slowed, wage gains have been outpacing inflation all year.
Consumers’ real incomes or purchasing power is improving, supporting their stalwart spending: this, on top of their low and stable debt service burdens, greater stock and housing wealth (recent price corrections notwithstanding), and still-prodigious excess savings that built up during the pandemic.

Businesses also appear to be managing their payrolls differently this time. Employers are extraordinarily reluctant to lay off workers. In response to any softness in demand for their wares, they pull back on hiring, pare hours worked, and reduce the use of temporary help. Anything but resort to layoffs. This probably stems from the difficulty of finding and retaining workers since well before the pandemic and an understanding that this will remain a perennial problem given the aging out of the workforce by the large baby boom cohort and the nation’s vexing immigration policies. Without lots of layoffs, it is hard to see why consumers would sharply curtail their spending—a necessary condition for recession.

The housing and vehicle industries are another reason to think that this time is different. These are the most interest-rate sensitive sectors of the economy, and while home sales are taking it on the chin with fixed mortgage rates recently breaching 8%, homebuilding has held up admirably. Completed housing units have yet to decline given the severe affordable housing shortage and record-low vacancy rates across the housing stock.

Housing starts are down, signaling weaker future completions, but that is at least a year away as there are a record number of multifamily units in the pipeline to completion.

Vehicle sales are also holding their own. Typically, in the good times in the lead up to downturns, vehicle producers pile on the incentives—remember 0% financing. Consumers, enticed by the deals, buy sooner than they typically would. So-called spent-up demand mounts. Then, when the economy turns, consumers stop buying, and vehicle sales plummet, contributing significantly to the broader downturn. This dynamic is not prevalent today. Indeed, it is just the opposite. Because of the pandemic and the collapse in global production, inventories and sales, consumers put off the normal buying they would have done. Now, vehicle demand is pent up, and sales are holding up despite much higher interest rates on vehicle loans.

Supply-side revival

Not only are the negative supply shocks caused by the pandemic and Russian war winding down, but the economy also enjoyed something of a supply-side revival this year. Labor force growth has remained
extraordinarily strong and is just shy of 2% year over year. This means the economy can add more than 250,000 jobs per month while unemployment remains steady, and that is what it has more-or-less done. More foreign immigration is powering strong labor force growth, as the number of foreign-born workers has jumped, and greater labor force participation, particularly by prime-age workers between the ages of 25-54.

Worker productivity growth has also bounced back to more than 2% year over year. The reasons are difficult to pinpoint, but given all the job switching during the pandemic workers are happier and more productive in jobs better suited to their skills and education. Remote work and the related surge in investment in information processing equipment and software early on in the pandemic are also likely contributing. Artificial intelligence is sure to boost productivity, but that is still very much a forecast.

This supply-side revival allows the economy to grow more quickly without fanning inflation. Even with strong 2.5% real GDP growth in 2023, capacity utilization declined and the tight labor market eased. The unemployment rate has risen half a percentage point from its low a few months ago to 3.9%. Historically, that would raise alarm bells that the economy is on the precipice of recession. Not now. The increase in unemployment is due to more workers in the labor force rather than layoffs and fewer jobs.

But we cannot count on the economy’s supply side to continue performing so well. Indeed, we expect labor force growth to throttle back to less than 0.5% per annum by this time next year. At that rate, the economy will support fewer than 100,000 added jobs per month, or the job market will tighten and wage and price pressures intensify. It would also be sensible to expect labor productivity growth to return to the 1.5% per annum underlying pace that has prevailed since prior to the pandemic. This would put the economy’s potential growth—the rate consistent with stable unemployment—at no more than 2% per annum. This is consistent with our forecast of 1.7% real GDP in 2024 and a small increase in unemployment to just over 4%.

Weighing the risks

Our generally sanguine no-recession outlook notwithstanding, it is prudent not to be overly confident. We put the odds of a recession beginning in 2024 at 25%. While this is as low as it has been since inflation took off over two years ago and compares favorably with the even odds we attached to a recession when we were most pessimistic this time last year, it remains uncomfortably high. In a typical year, recession odds would be near 15%, consistent with a recession once every six or seven years, as in recent decades.

Behind the still-elevated recession probabilities are the considerable number of downside risks evident in our U.S. risk matrix.
The horizontal axis shows the severity of the risk, which can be thought of as the present value of the macroeconomic loss if the risk were to occur. Climate change transition risk is to the left on the axis since the transition costs will play out over a long period of time, reducing their present value. The vertical axis shows the likelihood of that risk, which is our subjective assessment of that risk occurring. Student loan payment distress is at the top of the axis as borrowers resumed payment on their loans in October, although the macroeconomic impact should be modest.

The risks to focus on most are high risk and high probability. Most threatening is the prospect that the Fed will make a monetary policy mistake. The Fed has a tough job—it must raise rates high enough and fast enough to sufficiently slow growth and quell inflation, but not too high and fast that it undermines the economy. So far so good, and we expect the Fed to succeed. But it has misjudged before, when the central bank was too slow to raise rates from the zero lower bound when the economy was reopening from the pandemic shutdowns and supported by substantial fiscal stimulus. In fairness, there was substantial uncertainty regarding how the pandemic would play out, and when uncertainty is high the policy playbook says to err on the side of too much support. Regardless, the Fed got it wrong and could do so again, this time keeping rates too high for too long.

The potential for oil prices to spike is a near constant threat to the economic outlook. Despite the Israel-Hamas war and the potential that the conflict will engulf the rest of the Middle East and oil supplies, the sanctions on Russian oil, and big production cuts by Saudi Arabia, oil prices have receded.

Our sanguine baseline outlook expects oil prices to remain between $80 and $90 per barrel, consistent with gasoline prices of $3.50 to $4 a gallon. This would be manageable for most households. However, it would not take much to cause prices to jump. Stronger Chinese oil demand or a crackdown on those evading the Russian oil sanctions could be the spark. Prices much above $100 per barrel for more than a few weeks would undermine growth, fuel inflation and inflation expectations, and potentially prompt more Fed rate hikes. This would be all but impossible for the economy to bear.

**Fragile financial system**

With the Fed engaged in a higher-for-longer monetary policy, the operating environment for financial institutions is vexed and the potential is high for another event like the banking crisis in March. The Fed policy...
means short-term rates are likely to remain elevated well into next year and decline only slowly after that. Even though long-term rates have risen, prospects are that the **yield curve** will remain inverted, with short rates higher than long rates, for some time. Financial institutions are engaged in so-called maturity transformation —borrowing at lower short rates and lending at higher long rates. This represents their **net interest margin**, a measure of profitability, which is under pressure when the yield curve is inverted. Institutions can manage for a while through hedging and asset-liability matching, but the longer the curve is inverted the more prohibitively costly this becomes.

Financial institutions are also grappling with slower loan growth. They are tightening **underwriting standards** in response to the March crisis, and credit demand is softening with the slower-growing economy.

Weaker **credit conditions** are also an issue. They are still good by most historical standards. But even if conditions simply normalize from the pandemic lows, when borrowers benefited from government support, that’s a weight on financial institutions’ profitability and capital. Lenders with large commercial real estate portfolios are likely to suffer more serious credit losses. And then there is the stiffer and more costly regulatory environment with the Fed and other regulators proposing stiffer capital and liquidity requirements and amping up their supervisory oversight.

The traditional banking system’s concern is the possibility of a deposit run like the one it suffered in March. This seems more of a threat to smaller banking institutions without access to the range of funding sources that the larger institutions have. Depositors in smaller depositories are also more likely to run to the too-big-to-fail safety of the big guys. While it is hard to envisage even a rash of small bank failures becoming a macroeconomic problem, that was also the thinking around Silicon Valley Bank and Signature Bank a few months ago.

The nonbank part of the financial system is even more likely to run aground. The nonbanks are a mélange of financial institutions including insurance companies, pension funds, sovereign wealth funds, hedge funds, money market funds, mutual funds, and business development corporations. These nonbanks account for at least half of the credit provided to households and businesses, and their share is expanding quickly as the banking system pulls back as a source of credit. These institutions are also generally more lightly regulated than banks and their activities much less transparent.

As such, it is difficult to pinpoint what in the nonbank part of the system might bend or even break under the weight of higher-for-longer monetary policy. Possibilities are the freezing up of the private credit market (a key source of funds for smaller and less-creditworthy corporate borrowers), disruption to residential mortgage lending as the independent mortgage banking industry rationalizes, and illiquidity in the market for Treasury securities as the Fed steadily pulls back with its quantitative tightening and the void is filled by highly levered hedge funds. And these are the flashpoints of which we are aware. Given how opaque the nonbanks are, if a serious problem were to manifest, it would not be surprising if it emanated from a part of the system currently off the radar screen.

Economic forecasting is a fraught business. The economy is a complex, quickly changing set of nonlinear relationships among seemingly non-rational households, businesses and governments. It is continually buffeted by geopolitical, technological and environmental shocks. In forecasting, it is wise to remain humble. Having said that, even though the script is still being written and there are considerable risks, there is increasingly good reason to be confident that the pessimistic consensus that the economy will suffer a recession in 2024 will be
proven wrong, and that our more upbeat economic outlook will prevail.