NORTHERN TRUST

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U.S. ECONOMIC & INTEREST RATE OUTLOOK

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- **No Rush To Cut**

A year ago, we argued that the American economy was in a better state than was generally understood. Employment gains and unstoppable consumer spending gave us confidence recession could be avoided. Today, strong asset prices across a range of classes make us question whether the economic optimism is going too far.

Part of the bull market case is built on the expectation of lower interest rates. Our forecast is in line with consensus, expecting cuts to begin mid-year. But recent reports of strong job creation and firm inflation do not give the Federal Open Market Committee (FOMC) any reason to expedite their plans to ease. The higher-for-longer outlook could stretch even longer.

Our fundamental premise has not changed. The labor market is too strong to allow a downturn. However, we struggle to make the case for this being a breakout year, either. Following are our thoughts on recent data and developments.

Key Economic Indicators

	2023				2024				Q4 to Q4 change			Annual change		
	23:1a	23:2a	23:3a	23:4a	24:1f	24:2f	24:3f	24:4f	2023a	2024f	2025f	2023a	2024f	2025f
Real Gross Domestic Product (% change, SAAR)	2.2	2.1	4.9	3.2	2.5	1.5	1.5	1.5	3.1	1.7	1.6	2.5	2.4	1.5
Consumer Price Index (% change, annualized)	3.8	3.0	3.4	2.7	3.2	2.7	2.4	2.2	3.2	2.4	2.0	4.1	2.6	2.1
Civilian Unemployment Rate (%, average)	3.5	3.6	3.7	3.7	3.8	3.9	4.0	4.1				3.6*	4.0*	4.0*
Federal Funds Rate	4.52	4.99	5.30	5.38	5.38	5.32	4.92	4.58				5.05*	5.05*	3.38*
2-yr. Treasury Note	4.34	4.26	4.92	4.81	4.40	4.30	4.10	4.00				4.58*	4.20*	3.40*
10-yr. Treasury Note	3.65	3.60	4.15	4.45	4.10	4.30	4.20	4.10				3.96*	4.18*	4.03*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- The consumer price index (CPI) in February illustrated the challenge of containing inflation. The index ticked up by one-tenth to 3.2% year over year; the shift from falling to rising gasoline prices limited the opportunity for headline improvement. Excluding food and energy, core prices rose 3.8% from this time last year, with heat evident across most categories of services. Shelter inflation has remained stubbornly elevated (5.8%), but even excluding housing, core services like transportation, healthcare and communication are all showing signs of reflation.
    - The report did not offer the anticipated reprieve from elevated inflation in January, which was partially driven by one-off factors. The Fed's preferred inflation gauge (the deflator on core personal consumption expenditures) rose 2.8% year over year, too far above the 2% target to support a case for imminent rate cuts.

- February's employment report offered reasons for both hope and concern. The U.S. economy added 275,000 jobs, with gains seen in most sectors. Average hourly earnings grew only five cents month over month; temperate wage gains will add to confidence that inflation is settling durably. However, revisions to the prior two months were significantly downward, and the unemployment rate rose two tenths to 3.9%, its highest level since January 2022. On balance, the report is consistent with a cooling labor market, but not one that is yet under distress.
    - Through January, job openings held steady. The rates of hiring and quits each ticked down by a tenth of a percentage point, while involuntary layoffs held low. Workers are not leaving their jobs, and employers are not letting go of their workers.
    - Lower turnover is one factor supporting a rise in productivity, with total output per worker rising 2.6% year over year in the fourth quarter. Unit labor costs held flat through the second half, suggesting that wage gains will not necessarily prove inflationary.
- Messaging from the Federal Reserve has been consistent across venues—not just routine speeches by governors, but also Chair Powell's testimony to Congress and appearance on *60 Minutes*. Rate reductions are in sight this year, but not imminent; strong recent data support the caution expressed in the January FOMC meeting. Our forecast assumes cooler inflation in the next few months will set the stage for cuts starting at the June 12 meeting, but the exact timing is far from certain.
- U.S. house prices continue to gain, with the Case-Shiller index logging a full-year increase of 5.6% in 2023. Limited supply will keep a floor under house prices, despite high interest rates. When rates do eventually fall, they are poised to bring more buyers into the market and are unlikely to provide much relief to house shoppers.
- Congress narrowly averted a partial government shutdown last week, passing six of the twelve appropriations bills needed to fund the government. A shutdown still looms, though, with a current deadline of March 22 for the remaining six bills. President Biden has begun the fiscal year 2025 cycle with a proposed budget; the election and looming expiration of the cuts in the Tax Cuts and Jobs Act of 2017 will further complicate the negotiations later on this year.