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U.S. ECONOMIC & INTEREST RATE OUTLOOK

IN THIS ISSUE

- **Keeping Warm**

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Our team recently deliberated using Goldilocks as an analogy for the economy. On the one hand, the protagonist found the perfect balance of not too hot and not too cold, not too hard and not too soft. On the other hand, she let her guard down and ended her story running away from bears. We will keep our focus on the earlier portion of her story.

This year's challenge will be finding that moderate, balanced point between overheating and deterioration. Some increase in unemployment will be consistent with a cooling labor market, but too much could signal the onset of a recession. Cooler inflation is needed, but sticky readings or sudden declines could both signal distress. Rate cuts are in sight, but determining their magnitude and pace will be the top challenge for central bankers.

The recovery to date is consistent with that delicate balance. After avoiding a recession thus far, the soft landing remains our base case. However, growth is likely to run below potential in the quarters ahead, and the noise in monthly data could cause premature alarm or celebration. We will stay attentive, and we hope to keep the bears at bay.

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	2022a	2023f	2024f	2022a	2023f	2024f
Real Gross Domestic Product (% change, SAAR)	2.2	2.1	4.9	1.8f	1.1	1.0	0.9	1.0	0.7	2.8	1.0	1.9	2.5	1.8
Consumer Price Index (% change, annualized)	3.8	2.7	3.6	2.8	2.8	2.5	2.3	2.2	7.1	3.3	2.4	8.0	4.2	2.8
Civilian Unemployment Rate (%, average)	3.5	3.6	3.7	3.7	4.0	4.2	4.1	4.0				3.6*	3.6*	4.1*
Federal Funds Rate	4.52	4.99	5.30	5.38	5.38	5.32	4.92	4.58				1.69*	5.05*	5.05*
2-yr. Treasury Note	4.34	4.26	4.92	4.80	4.40	4.30	4.10	4.00				2.98*	4.58*	4.20*
10-yr. Treasury Note	3.65	3.60	4.15	4.44	4.10	4.30	4.20	4.10				2.96*	3.96*	4.18*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- The December reading of the consumer price index (CPI) was mildly discouraging, with the overall price index rising 0.3% over the prior month. Excluding food and energy, the core index showed a rise of the same magnitude. Measures of shelter costs continue to surprise to the upside, still weighing in at 6.2% over the past year. The report was neither evidence of reflation nor an encouraging sign of disinflation. We always expected the road to the 2% inflation target would be bumpy, and this was a modest setback.
- In December, 216,000 jobs were added, for a full-year payroll increase of 2.7 million; the unemployment rate held steady at 3.7%. Beneath the good headline, details were

less encouraging. The unemployment rate did not change because both the number of people working and the total size of the labor force moved down together. Average hourly earnings increased by 4.1% year over year, making wages a persistent inflationary risk.

- The Job Openings and Labor Turnover Survey (JOLTS) report for November showed that job openings remain elevated at 8.8 million; the slow retreat suggests these high levels may be the new normal. The rates of workers being hired or voluntarily quitting their jobs have returned to their pre-pandemic rates, showing that the Great Resignation has concluded. Encouragingly, the report showed no uptick in layoffs, as corroborated by steadily low levels of weekly initial claims for unemployment insurance.
- Readings of consumer activity through December showed a good holiday season, capping off a year of upside surprises to consumption. We have revised our estimate of fourth quarter gross domestic product (GDP) growth upward, but we see fewer reasons for optimism about the year ahead. High interest rates are slowing major purchases, while households continue to adapt to higher price levels following the bout of inflation.
- The fourth quarter featured a high degree of volatility in fixed income markets. We anticipate some of the rate rally to unwind as risk appetites find their balance, with a steadier outlook for the year ahead.
- At their final meeting of 2023, the Federal Open Market Committee (FOMC) provided economic projections showing that nearly the full committee agrees that rate cuts are in store by year end. The exact timing remains unclear. We believe that market expectations of cuts as soon as March are overeager; all committee members have emphasized the need to see inflation well on its way to the 2% target before cuts will be appropriate. We expect a hold until midyear, followed by a steady cadence of rate reductions.
- The FOMC will also need to set expectations of an end to its balance sheet reductions. Recent commentary shows that governors are giving thought to the timing of a taper, but no plan is in place. Markets have taken the reduction in stride thus far, but the risk of overshooting remains possible, especially with no terminal level announced.
- Congressional leaders have agreed to a top-line discretionary spending target of $1.66 trillion for fiscal year 2024, split between $886 billion for defense and $773 billion non-defense. A continuing resolution of the 2023 budget has deferred the staggered deadlines for approving a budget into March. The risk of a shutdown looms as long as appropriations have not been finalized.