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U.S. ECONOMIC & INTEREST RATE OUTLOOK

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- **Sticking The Landing**

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At mid-year, we reflected on themes that might derail the economy: banking stress, fiscal tightening, stubborn inflation, China's slowdown and sector-level downturns. Through it all, the broader U.S. economy has persevered. Recession concerns were justifiable but misplaced; instead, a gradual slowdown is taking shape.

This resilience has complicated central banks' efforts to end the cycle of tightening. After expressing an intent to hold rates steady, the Fed looks likely to return to rate hikes. While the pace of monetary policy changes will be nothing like the rapid hikes of 2022, they do create a challenging context for forecasting growth, inflation and appropriate policy.

It is premature to conclude that the Fed has engineered a soft landing. Risks to the outlook include high interest rates, tight bank lending standards and cooler consumer demand. But momentum is a powerful force, and we believe the economy can continue to perform in spite of these challenges.

Key Economic Indicators

	2022	2023				2024				Q4 to Q4 change			Annual change		
	22:4a	23:1a	23:2f	23:3f	23:4f	24:1f	24:2f	24:3f	24:4f	2022a	2023f	2024f	2022a	2023f	2024f
Real Gross Domestic Product (% change, SAAR)	2.6	2.0	1.8	1.0	0.8	1.1	1.1	1.9	1.9	0.9	1.4	1.5	2.1	1.9	1.2
Consumer Price Index (% change, annualized)	4.2	3.8	2.7	3.0	2.8	2.8	2.4	2.3	2.1	7.1	3.2	2.4	8.0	4.2	2.7
Civilian Unemployment Rate (%, average)	3.6	3.5	3.6	3.8	3.9	4.0	4.0	4.0	3.9				3.6*	3.7*	4.0*
Federal Funds Rate	3.66	4.52	4.99	5.34	5.63	5.63	5.63	5.13	4.63				1.69*	5.12*	5.26*
2-yr. Treasury Note	4.39	4.34	4.26	4.70	4.80	4.65	4.40	3.80	3.50				2.98*	4.53*	4.09*
10-yr. Treasury Note	3.83	3.65	3.60	3.75	3.65	3.50	3.25	3.25	3.25				2.96*	3.66*	3.31*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- Inflation appeared to improve in June, with the consumer price index (CPI) growing by 3.0% year over year; this is a two-year low. However, much of this modest headline figure reflects declines in energy prices since the summer of 2022. Excluding food and energy, core inflation eased to 4.8% over the last 12 months. The report was a step in the right direction, but far from a victory against higher prices. Shelter costs, in particular, have not moderated in the manner that many had hoped.
  - The deflator on core personal consumption expenditures, the Federal Reserve's preferred inflation measure, has been stuck at around 4.6% for several months.
- Labor markets are cooling marginally. In June, 209,000 jobs were created; this was the smallest gain in the COVID recovery cycle, and was accompanied by substantial

downward revisions to estimates for April and May. By contrast, the survey of households showed job gains, with the unemployment rate improving to 3.6%. Few workers remain on the sidelines, with the prime-age (25-54) labor force participation rate reaching a 22-year high of 83.5%; among women, the rate set a new record of 77.8%.

  - Average hourly earnings gains amount to 4.4% year over year, and appear stalled at that level. This will keep the pressure on service prices. On the brighter side, wages are increasing at a faster rate than inflation for the first time in over two years, which should provide support for ongoing consumption.

- The June meeting of the Federal Open Market Committee (FOMC) featured no rate hike but offered clear guidance that more tightening was expected. The Summary of Economic Projections (SEP) revealed that most FOMC members expect two more hikes in the balance of the year. A rate hike is assured at the July 26 meeting.

  - The favorable June CPI report shifted consensus, with many forecasters now expecting July will be the final hike. However, core inflation is still far above the 2% target, and we do not expect a rapid change in its course. The FOMC has erred on the side of hiking to contain inflation, and we do not doubt the path set in the SEP. Absent any stresses that would deter further tightening, a final hike in September is our base case.

  - Fixed income markets have been sensitive to evolving Fed expectations, with the two-year U.S. Treasury yield falling 30 basis points in two days following the encouraging CPI report. The yield curve remains deeply inverted, unlikely to steepen until rate cuts commence. We do not expect that to occur until the middle of next year.

- Retail sales rose a tepid 1.5% year over year in June. Excluding the volatile categories of autos, gasoline and building materials, retail sales grew a more sturdy 3.8% on the year. Spending at food establishments and drinking places was flat month over month, suggesting that reopening-driven enthusiasm is waning. Consumer spending is settling into a steadier rhythm, consistent with the slower year of growth we have anticipated.

- Housing markets have adapted to a regime of higher interest rates. Limited housing inventory and steady demand have prevented a material decline in house price indexes. A cooler housing market will be a necessary step to achieve a lower rate of inflation; thus far, the rapid runup in prices through mid-2022 has kept shelter as the leading inflationary force.

- The resumption of student loan payments in autumn is a risk to consumer spending. About one in five U.S. consumers carry a student loan, concentrated among younger adults. Enhancements to income-driven payment programs will help to cushion the blow.