# U.S. ECONOMIC & INTEREST RATE OUTLOOK

## IN THIS ISSUE

- Close Call

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We have been wrestling with our forecasts intensely for the past several months. Some of our peers are projecting a recession for the United States, starting late this year. We aren't ready to follow them, but the odds on a soft landing are getting longer.

At best, the next four to six quarters are likely to be sluggish. Our forecast of 0.6% full-year growth is far short of the 2% or more we would expect in a typical year. It may not be a recession, but such underperformance will feel like one.

An economy in a fragile state could be knocked into contraction by anything from a new COVID variant to a further energy shortage. Growing global stresses may prove contagious. In a steady world, there is a path for the economy to grow through the current challenges, but stability feels like an optimistic assumption.

## Key Economic Indicators

| | 2022 | | | | 2023 | | | | Q4 to Q4 change | | Annual change | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 22:1a | 22:2a | 22:3f | 22:4f | 23:1f | 23:2f | 23:3f | 23:4f | 2022f | 2023f | 2022f | 2023f |
| Real Gross Domestic Product (% change, SAAR) | -1.6 | -0.6 | 2.1 | 0.8 | 0.1 | 0.2 | 0.6 | 1.0 | 0.2 | 0.5 | 1.7 | 0.6 |
| Consumer Price Index (% change, annualized) | 9.2 | 10.5 | 5.7 | 4.2 | 3.5 | 2.8 | 2.6 | 2.5 | 0.2 | 2.9 | 8.0 | 3.9 |
| Civilian Unemployment Rate (%, average) | 3.8 | 3.6 | 3.6 | 3.7 | 3.9 | 4.0 | 4.2 | 4.3 | | | 3.7* | 4.1* |
| Federal Funds Rate | 0.17 | 0.82 | 2.26 | 3.70 | 4.38 | 4.38 | 4.38 | 4.38 | | | 1.74* | 4.38* |
| 2-yr. Treasury Note | 1.46 | 2.72 | 3.45 | 4.50 | 4.40 | 4.30 | 4.20 | 4.00 | | | 3.03* | 4.23* |
| 10-yr. Treasury Note | 1.95 | 2.93 | 3.10 | 4.00 | 4.00 | 3.90 | 3.80 | 3.70 | | | 3.00* | 3.85* |

a=actual
f=forecast
*=annual average

## Influences on the Forecast

- Inflation remains the central point of concern. The September consumer price index (CPI) gained 8.2% over the past year. The details of the report showed modest relief in some categories of goods, but services inflation was far too high. Services as diverse as shelter, airfare and auto repair were notably hot; the 6.7% gain in core CPI was a 40-year high. Food prices are another persistent challenge.
    - Lower energy prices have been a rare disinflationary bright spot in recent months, but the good news has come to an end. OPEC's decision to reduce production will keep upward pressure on the global price of oil. Domestic production remains scarred by recent losses. Gasoline prices are rising again.
- A reprieve for overheated labor markets is emerging.

   - The Employment Situation Summary for September revealed an unemployment rate that returned to its 50-year low of 3.5%. Though job creation continues, the recovery in the labor force has stalled, with the labor force participation rate for prime aged workers ticking down slightly.
   - Average hourly earnings grew 5.0% year over year, the slowest pace in the year to date. While still uncomfortably high, this inflationary pressure has hopefully passed its peak.
   - The closely-watched JOLTS report showed job openings fell by 1.1 million from July to August. Fewer openings will be the first step toward bringing the supply and demand for labor into better balance. However, the level of openings is still a third higher than its pre-crisis norm, while quitting and hiring activity have not slowed.
- With inflation high and labor tight, more Fed hikes loom likely. The September Summary of Economic Projections showed a median forecast of 125 basis points in hikes before year end. We expect the cycle will conclude with 75 on November 2 and 50 on December 14.
   - Central banks are facing mounting criticism for aggressive rate hikes. The United Nations uncharacteristically inveighed against further hikes, warning that rapid policy changes can cause significant damage to emerging markets.
- While the broad economy could yet find its way to a soft landing, the housing sector has clearly entered a recession. Residential investment has been in decline for a year. High interest rates have depressed demand for mortgages, and house price indices are entering a flat trend after several booming years. Though real-time readings of house prices and rents have stalled, the shelter component of inflation measurements works with a lag. We expect housing to be an inflationary force well into 2023.
- One of our most frequently heard questions is how we can expect inflation to fall to less than 3% in the year ahead. The table below illustrates one path to that outcome. Real-time readings of rents and residential real estate listings show that prices have leveled off. Transoceanic shipping rates have fallen quickly, almost returning to their pre-crisis costs, a good omen for goods inflation. Food and energy are always unpredictable, but even assuming higher-than-average inflation still allows room to end next year around 3%—a reprieve from today's rates.

| | | Year Over Year | |
|---|---|---|---|
| | **Weight** | **Sep 2022** | **End 2023** |
| Food & Beverages | 14.6% | 10.8% | 4.0% |
| Energy | 8.0% | 19.9% | 5.0% |
| Shelter | 32.6% | 6.6% | 3.0% |
| Goods | 24.6% | 9.5% | 2.0% |
| All Other | 20.2% | 2.8% | 2.0% |
| **Headline Inflation** | **100.0%** | **8.2%** | **2.9%** |

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