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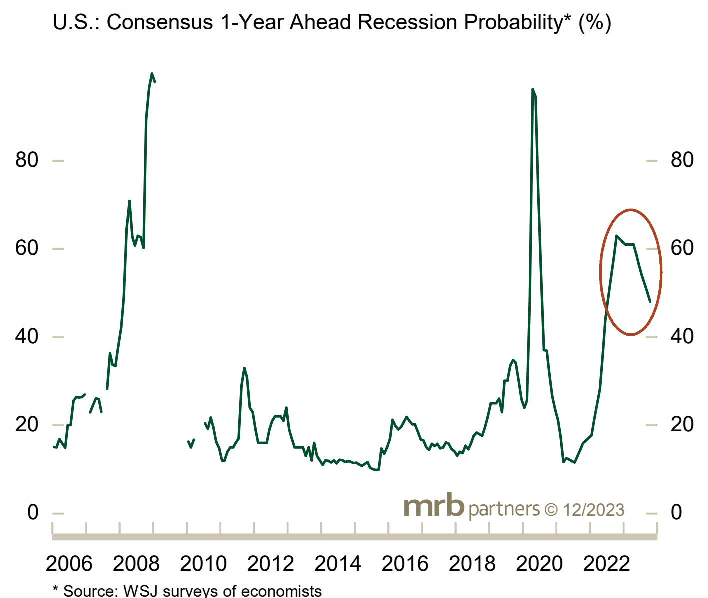
RESEARCH HIGHLIGHT
ECONOMY
December 7, 2023

2024 U.S. Economic Outlook: Continued Resilience

- The U.S. economy's interest rate sensitivity is still muted.
- Real GDP growth will moderate somewhat after a solid 2023 but will still exceed its potential rate next year.
- Although the labor market is rebalancing, aggregate income growth will remain historically solid, and along with remaining excess household savings, will support consumption.
- Core inflation will ease further next year, but it will bottom out well above the Fed's goal.
- Neither growth nor inflation will warrant rate cuts next year, but it increasingly looks like the Fed is leaning toward cutting rates anyway.
- Unmerited rate cuts next year will sow the seeds for even stronger growth and another inflationary upleg down the road.

The U.S. economy strongly defied consensus forecasts for a recession this year: real GDP has grown at an above-potential growth rate (up 3%YoY in Q3 2023) despite a meaningful rise in the policy rate and bond yields. This growth performance underscores the economy's underlying resilience to higher interest rates, which most economists have failed to recognize as being a definitive feature of this cycle.

Chart 1 Consensus Recession Odds Are Back Below Even



* Source: WSJ surveys of economists

MRB believes that this economic resilience will carry forward into 2024. Real GDP growth will slow somewhat after a solid 2023 but it will still exceed its potential rate of 1.8% next year, ***even if*** the Fed maintains the policy rate at its current level. Note that the consensus growth view has now shifted in our direction partially - the majority of economists no longer anticipate a recession over the next year **(chart 1).** However, their no-recession view seems to be conditioned on the Fed cutting rates by the middle of

Chart 2 **No Alarming Rise In Unemployment Yet**

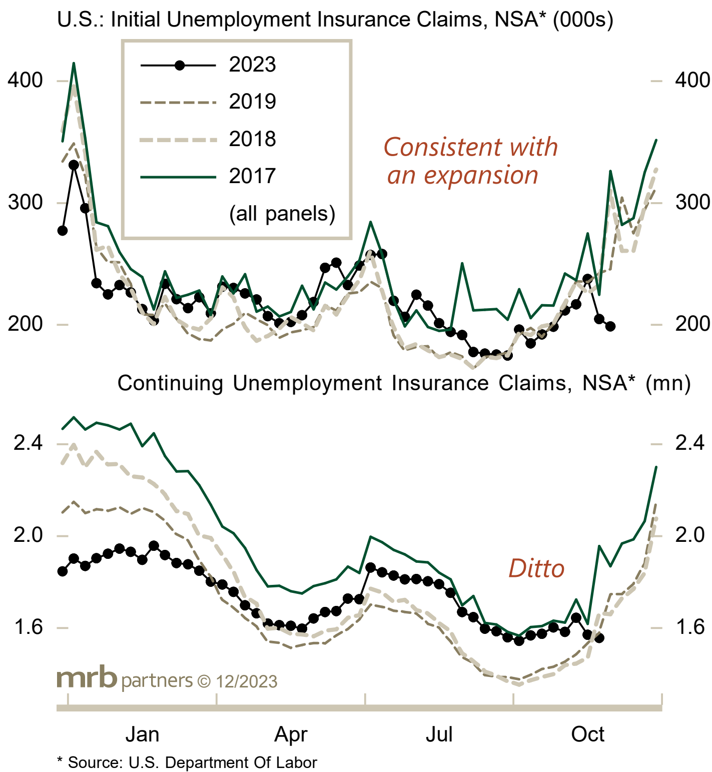
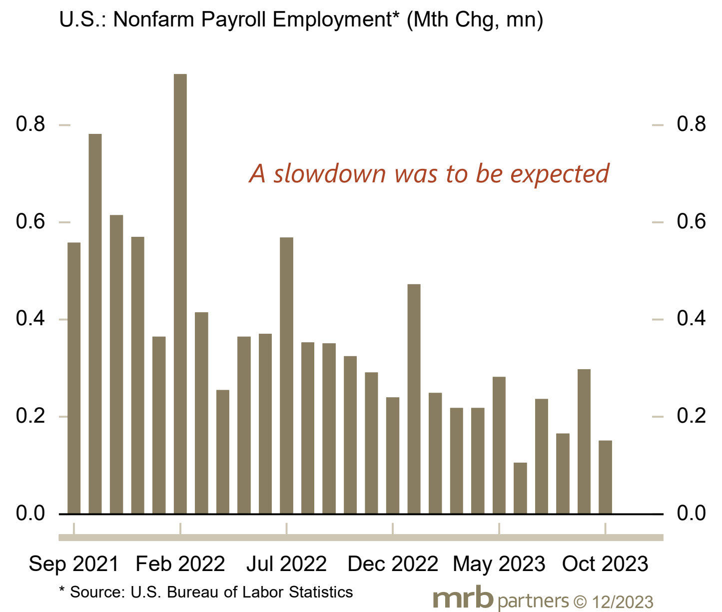


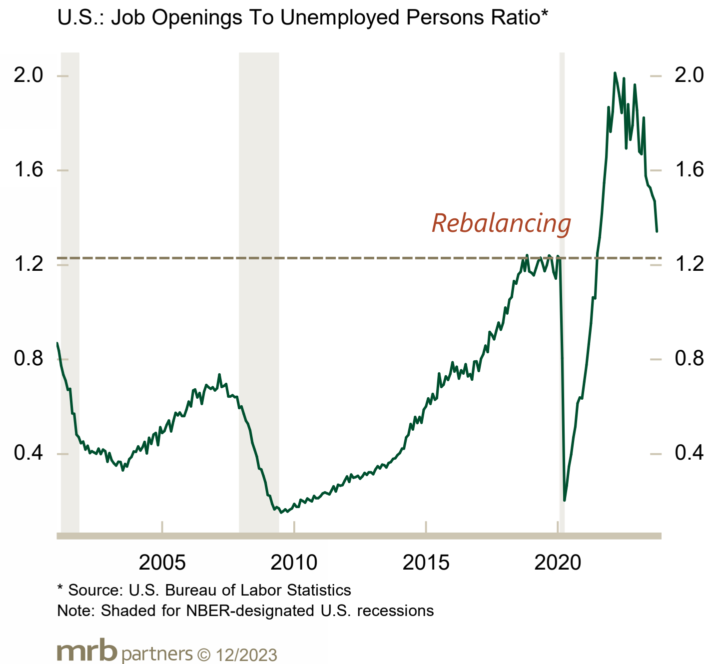
Chart 3 **A Clear Slowdown In Hiring**



next year. Our view is that the economic expansion will not ***require*** rate cuts next year.

As we had anticipated[1], the U.S. labor market has been cooling this year, albeit gently, i.e., without a material rise in unemployment **(chart 2)**. Employment growth and job openings have clearly moderated over the past six months, while prime-age labor force participation (labor supply) has risen solidly **(charts 3, 4 and 5)**. These forces combined have resulted in cooler wage growth this year. However, note that prevailing wage growth ***is still well above*** its pre-pandemic norm **(chart 6)**.

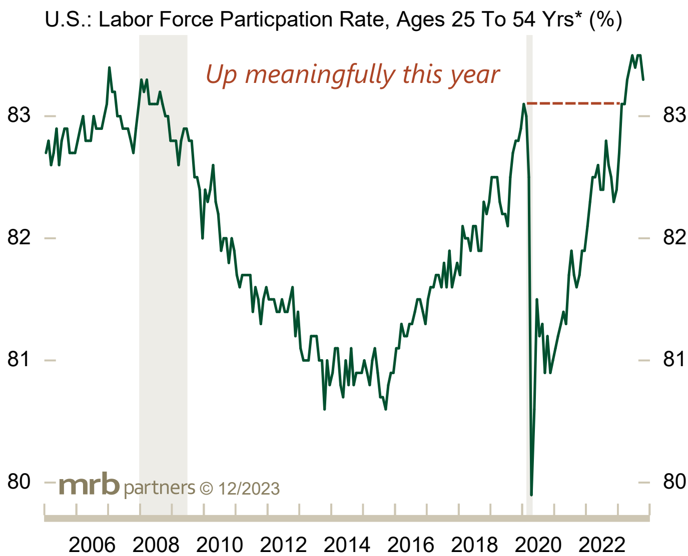
Chart 4 **The Frenzy In Openings Has Abated**



Overall, we expect that aggregate labor income growth will remain historically solid next year, supporting continued consumption growth. The latest round of consumer spending data have been strong **(chart 7)**.

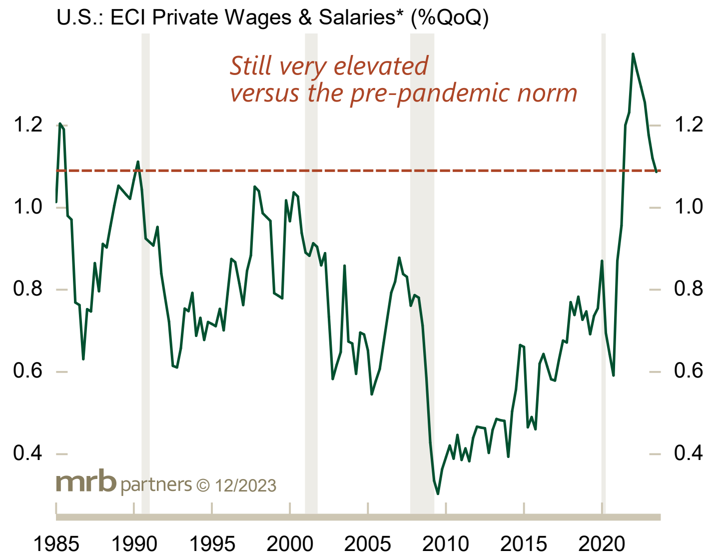
[1] **MRB *2023 U.S. Economic Outlook:* "*Sticking To A No-Recession Call*"**, December 15, 2022

Chart 5 **Prime-Age Labor Supply Has Improved**



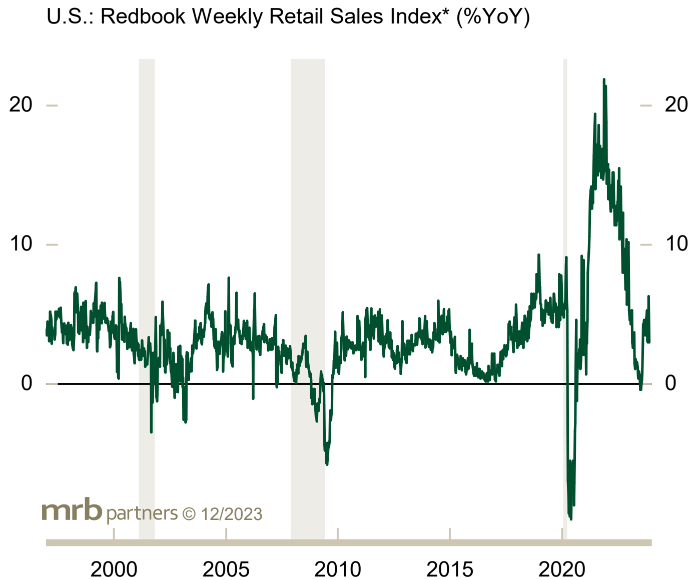
* Source: U.S. Bureau of Labor Statistics
Note: Shaded for NBER-designated U.S. recessions

Chart 6 **Wage Growth Is Cooler, But Still Quite Elevated**



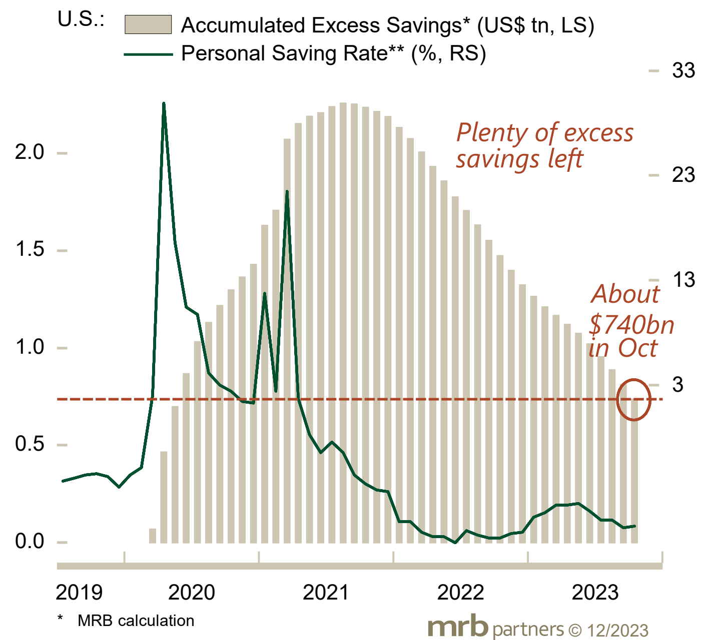
* Smoothed; source: U.S. Bureau of Labor Statistics

Chart 7 **Recent Consumption Data Have Been Solid**



* Smoothed; source: Redbook Research Inc.
Note: Shaded for NBER-designated U.S. recessions

Chart 8 **Excess Savings Will Remain A Source Of Support**

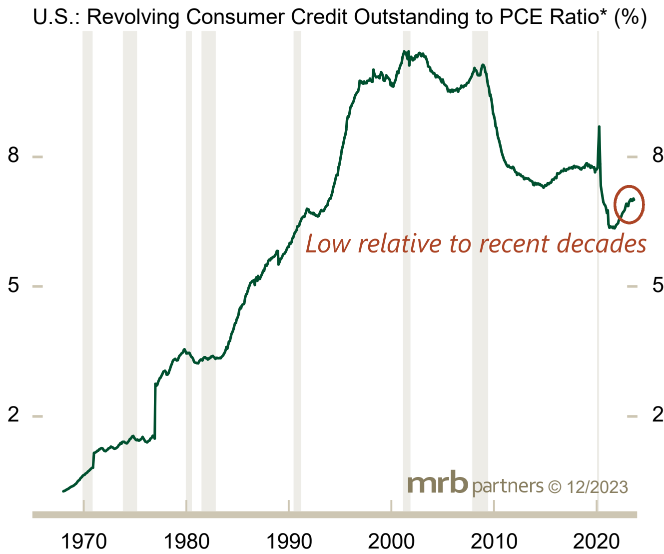


* MRB calculation

Household balance sheets are still very healthy due to the excess savings that consumers accumulated during the pandemic, and due to the appreciation of household asset holdings in recent years **(chart 8)**. Even after sizeable withdrawals from excess savings over the past year and a half, consumers had about US$740 bn in excess savings remaining as of this October. The further deployment of these savings should support consumer spending next year.

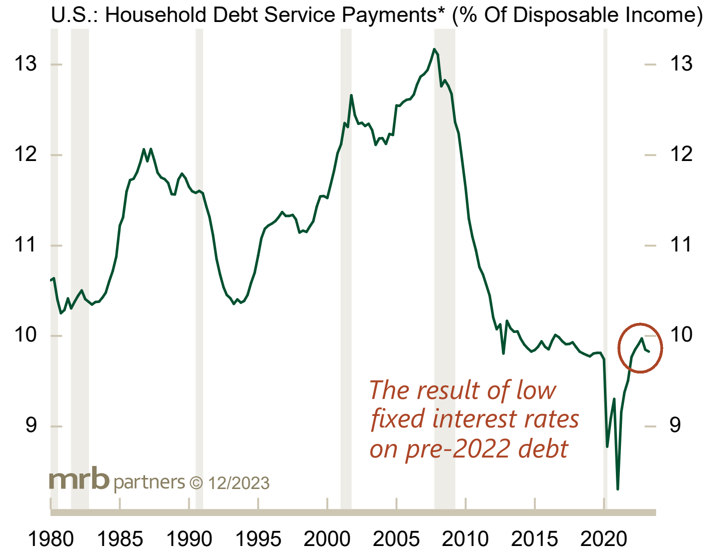
Household balance sheets are still very healthy

Chart 9 **Consumption Is Much Less Credit-Dependent This Cycle**



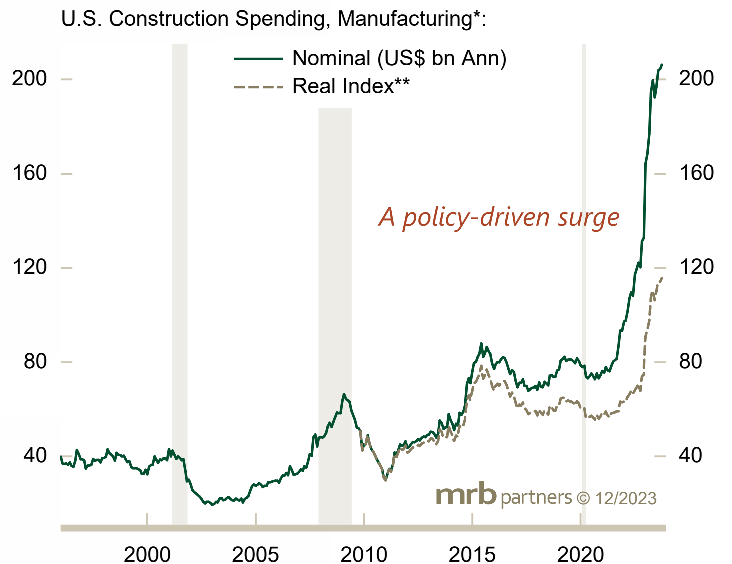
* Source: Federal Reserve & U.S. Bureau of Economic Analysis
Note: Shaded for NBER-designated U.S. recessions

Chart 10 **The Economy Will Remain Less Sensitive To Interest Rates**



* Source: Federal Reserve
Note: Shaded for NBER-designated U.S. recessions

Chart 11 **Policy Incentives Have Spurred Investment In Some Sectors**

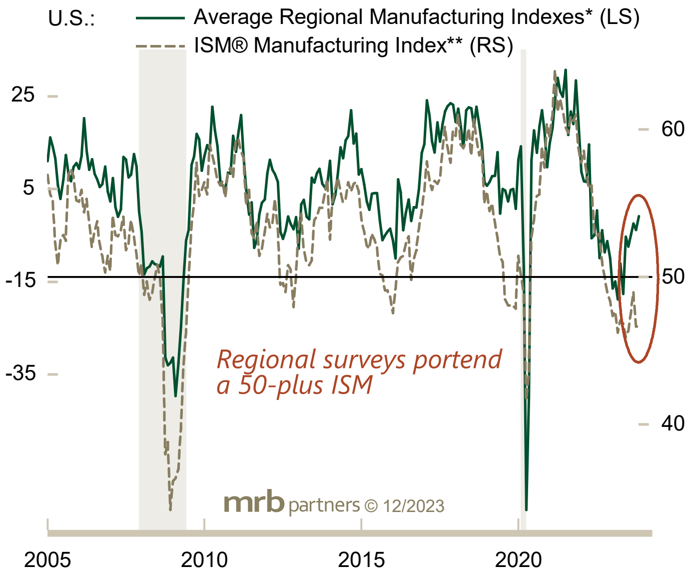


* Source: U.S. Census Bureau
** Deflated by the new industrial building construction PPI
Note: Shaded for NBER-designated U.S. recessions

Consumer borrowing as a share of spending remains well below normal **(chart 9)**. This, combined with the effect of the low mortgage rates locked in by pre-2022 homeowners, will keep the aggregate household debt service-to-income ratio historically low for some time **(chart 10)**. This is a key reason why the economy will remain relatively resilient to higher interest rates through 2024 and likely beyond.

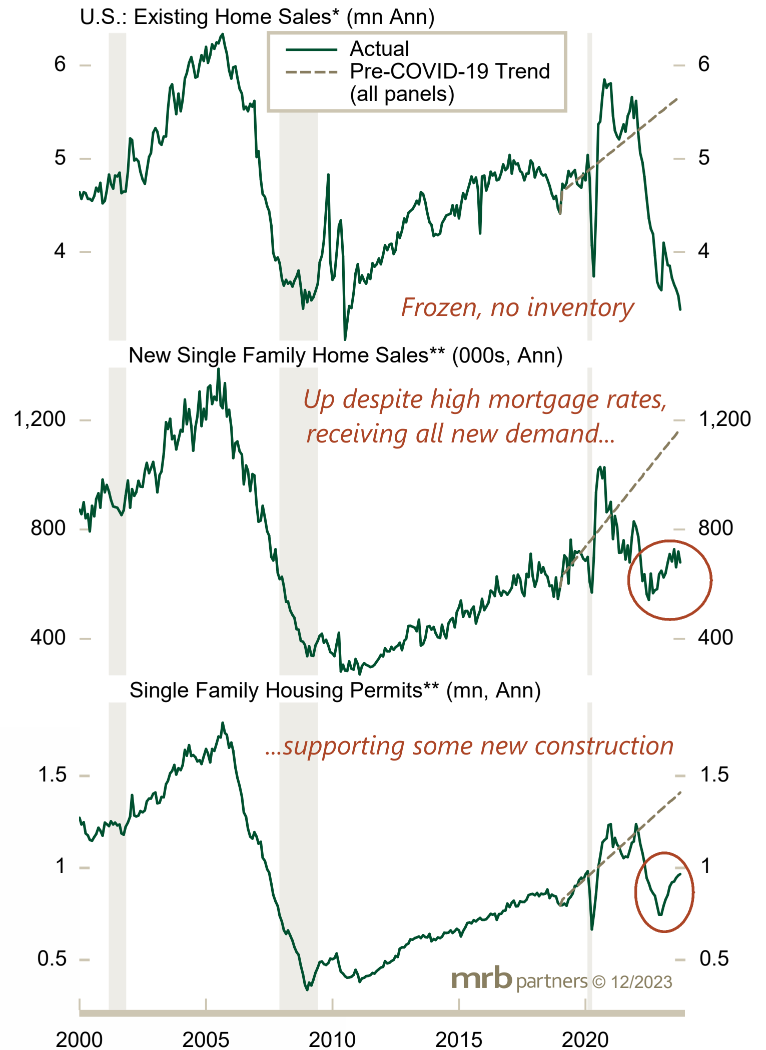
We expect that business spending growth will remain somewhat muted. Fiscal programs like the Infrastructure Act, CHIPS Act and the Inflation Reduction Act have had a meaningful positive impact on investment in select sectors **(chart 11)**. However, overall business fixed investment growth remains subdued, reflecting the lingering uncertainty on the duration of the economic cycle ahead. Like households, most businesses have not yet faced the brunt of higher interest rates, but a good share will have to roll their debt over at higher interest rates in 2025 and beyond.

Chart 12 **National Manufacturing Sentiment May Rise Ahead**



* Source: Federal Reserve Banks of New York, Philadelphia & Richmond
** Source: Institute for Supply Management®
Note: Shaded for NBER-designated U.S. recessions

Chart 13 **Housing Activity Will Chug Along At A Low Level**



* Source: National Association of Realtors
** Source: U.S. Census Bureau
Note: Shaded for NBER-designated U.S. recessions

Prospects for capital spending could surprise on the upside if the Fed were to ease policy ahead, and if businesses clearly sense an improvement in the global manufacturing cycle. The U.S. ISM manufacturing PMI has been weak this year, but note that the regional manufacturing surveys, as well as some global manufacturing surveys and trade data have moved up in recent months **(chart 12)**. On the flipside, capital spending plans face a downside risk in the form of potential policy uncertainty ahead of next November's national elections.

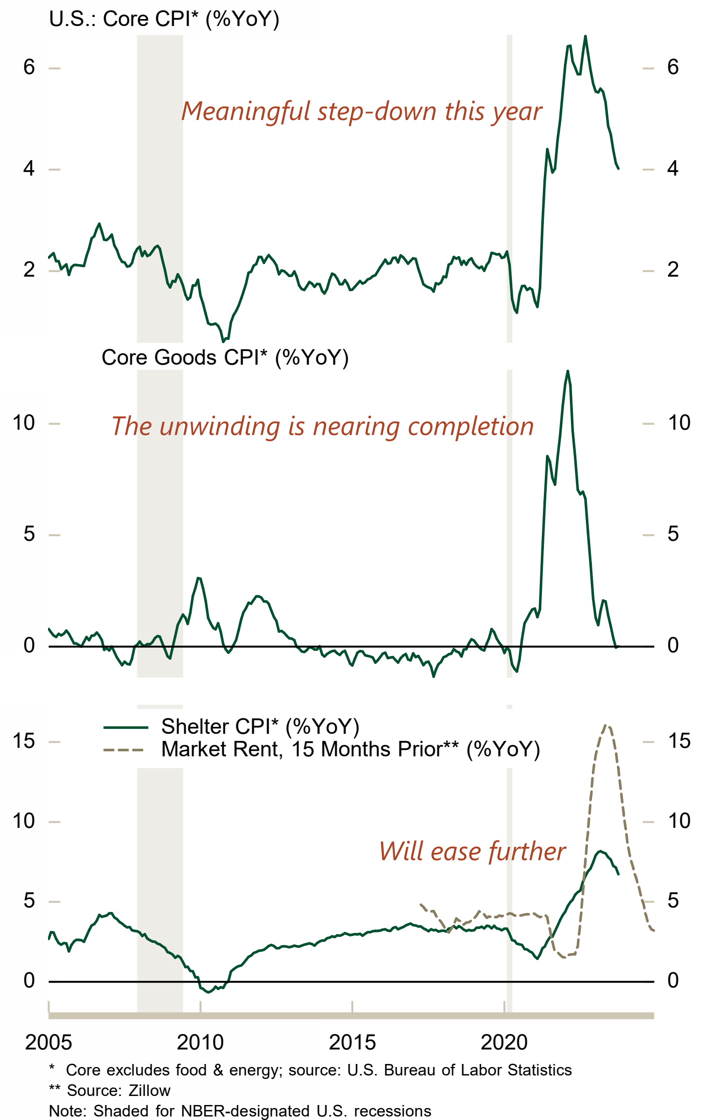
Regional manufacturing surveys have improved in recent months

Residential investment's drag on growth has faded this year. The resilience of the labor market and an underlying positive demographic impulse are spurring ***some*** homebuying, which in turn is propping up at least a low level of new construction activity amid a lack of existing housing inventory, (**chart 13**). Housing activity is likely to remain tepid however, with not much scope for a major rebound unless mortgage rates and/or home prices fall ***substantially*** (which does not look very likely in the foreseeable future).

Inflation & The Fed

As we expected, core inflation has moderated this year due to falling goods inflation, a well-anticipated moderation in rental inflation and easier base effects **(chart 14)**. Core inflation will ease further next year as rental inflation continues to descend on a year-over-year basis, and as the inflation rate for select goods like autos eases further.

Chart 14 Inflation's Descent Will Continue Ahead



* Core excludes food & energy; source: U.S. Bureau of Labor Statistics
** Source: Zillow
Note: Shaded for NBER-designated U.S. recessions

Healthcare services inflation will rebound ahead, slightly offsetting these downshifts[2]. More importantly however, we expect that the overall rate of services inflation excluding rents will remain historically elevated, and that core inflation will eventually bottom out well above the Fed's target.

In our view, 3%-plus core CPI inflation and still-above-potential GDP growth next year should underscore that rate cuts are not warranted. However, recent communication from the Fed suggests that multiple policymakers could push for rate cuts next year anyway. These Fed members likely believe that once inflation is definitively descending, the Fed should soon lower the policy rate toward its "neutral" level (which per the median member is only 2.5%), without waiting for inflation to be near the Fed's 2% goal.

Our view is that the economy's neutral policy rate is nowhere near 2.5% but is likely much higher, in the 4-4.5% range[3]. This means that policy is not excessively restrictive, especially since the economy is currently solidly expanding (policy rates typically need to remain above neutral to curb growth conditions).

Core inflation will eventually bottom out well above the Fed's target

The economy's "neutral" rate should really be contextualized to the aggregate cost of capital since a significant portion of private sector borrowing is linked to

[2] MRB *Research Highlight*: "U.S. Inflation: Beware The Current Complacency", August 17, 2023

[3] MRB *Research Highlight*: "R-Starring The U.S. Economy", September 6, 2023

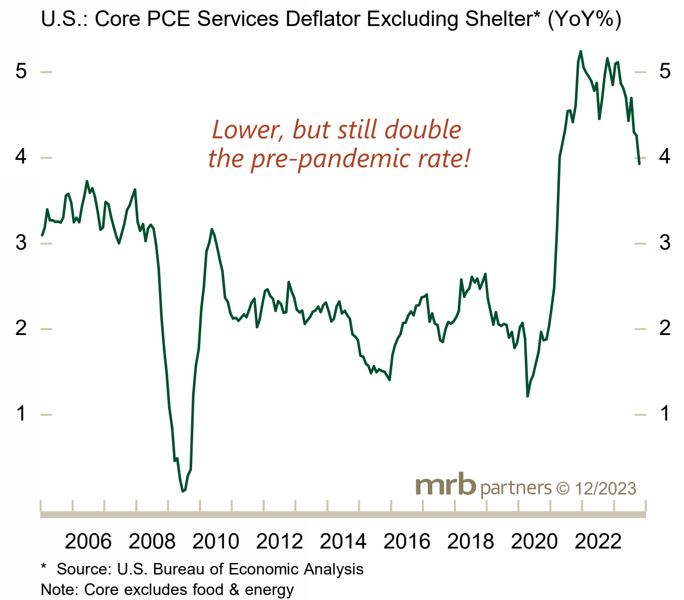
longer-term bond yields[4]. With bond yields currently well below policy rates, aggregate borrowing conditions are insufficient to trigger an economic contraction. In short, the risk of a recession next year is not very high.

We think that the Fed has become too complacent on inflation. Inflation's easing to-date has been primarily due to idiosyncratic (as opposed to cyclical) dampening forces. Non-rent services inflation has eased somewhat (base effects will help further ahead), but there is an insufficient basis to expect that it will ease ***meaningfully*** ahead like rent and goods inflation, given that economic growth is still well above potential and wage growth remains above normal **(chart 15)**.

Cutting rates before the economy has slowed even to its potential rate will prolong the cycle. However, the cycle is in no imminent danger of ending anyway, and the greater consequence of rate cuts will be to sow the seeds of another inflationary upleg down the road.

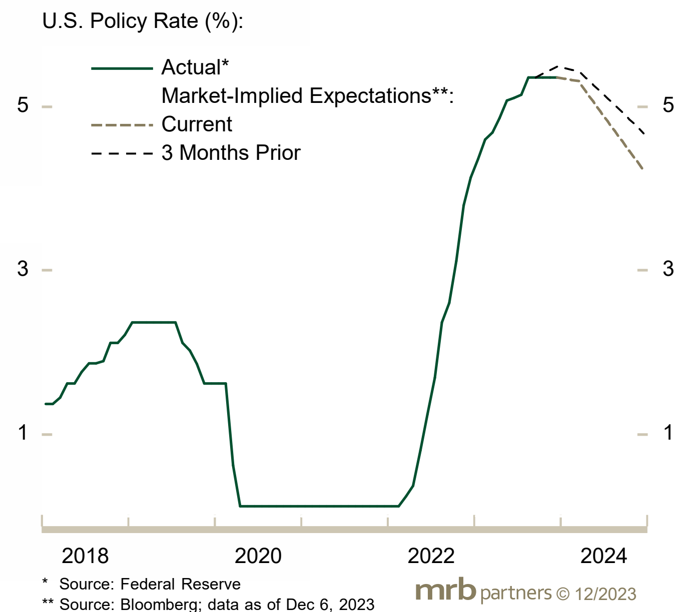
To repeat, the optimal policy decision would be to not cut rates next year. However, the reality is that the Fed has been using its discretion, rather than a rule, to set monetary policy for some time now. Right now, the Fed is undeniably signaling that it ***wants to cut rates next year.*** We view this as a policy mistake, even if it will take a while for the Fed and investors to appreciate it.

Chart 15 The Fed is Too Complacent For This Level Of Services Inflation



* Source: U.S. Bureau of Economic Analysis
Note: Core excludes food & energy

Chart 16 Rate Cut Bets Have Mounted On Inflation Optimism



* Source: Federal Reserve
** Source: Bloomberg; data as of Dec 6, 2023

The Fed will be wary of cutting rates too near the November presidential election, which leaves next December as a possible opportunity to ease policy. If the Fed is determined to cut rates earlier, it will have to do so fairly early next year. The forward market is endorsing the latter view, pricing in just under even odds of a rate cut by May and over a 75% chance of a rate cut by a June **(chart 16)**. Our view is that even if the Fed is determined to ease policy, inflation will likely be too high to justify a rate cut by mid-year.

The optimal policy decision would be to not cut rates next year

[4] **MRB *Theme Report***: "***Will Higher Bond Yields Break The Global Economy?***", October 20, 2023

Risks

We see the risks to our growth outlook as tilted to the upside. There is a meaningful chance that the Fed will ease the policy rate sooner than we expect, which would boost growth via easier financial conditions and better economic sentiment. Mortgage spreads could also decline from historically wide levels once policy pressure is removed, and spur housing activity.

Risks to our growth outlook are tilted to the upside

On the negative side, there is a modest chance that the full impact of the Fed's policy tightening may have yet to percolate through the economy and could generate greater economic weakness ahead than we expect.

Our core inflation outlook is already above consensus, so the risk of inflation surprising us on the downside in the near term is more prominent. On the other hand, cooler inflation (even if driven by idiosyncratic forces) in the near-term would encourage the Fed to cut rates more quickly (even if the economy is performing well). Unwarranted rate cuts would mean that there will be more upside risk for inflation over the medium-to-long term.

Unwarranted rate cuts would imply an upside risk for inflation down the road

Final Word: *Prospects for the U.S. economy for the next year remain solid. The U.S. consumer is in good shape; household balance sheets remain healthy. While the labor market is rebalancing, it shows no signs of destabilizing; income growth will remain historically solid. Overall, economic growth will slow somewhat after a robust 2023 but remain above potential next year, even without the help of policy rate cuts. Core inflation will continue to ease ahead but remain well above the Fed's 2% goal. In short, neither economic activity nor inflation will warrant rate cuts next year, but the Fed looks increasingly determined to cut rates anyway. A hasty return to policy easing next year would likely underpin a another inflationary upleg down the road.*

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Strategist, U.S.

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