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U.S. Economic Outlook, October 2023

The Northern Trust Economics team shares its outlook for U.S. growth, employment, interest rates and inflation.

The U.S. economy's remarkable resilience is complicating the lives of investors and the Federal Reserve. Despite war-disrupted commodity markets and one of the most aggressive monetary tightening phases in modern history, economic activity has remained strong. Consumers are still spending, and companies are still hiring and investing, though not at the same pace as last year.

Amid this positivity, the Federal Reserve has found it difficult to determine how high interest rates should go. But the recent tightening of financial conditions has caught the attention of U.S. central bankers, raising the likelihood that the Fed is headed for the exit ramp. We see the hiking cycle as complete, but the easing cycle is still distant.

While the U.S. economy has plenty of momentum, it also faces a series of headwinds, including the rise in organized labor actions, the potential for a government shutdown, and the resumption of student loan repayments. A slowdown still seems

to be a sound bet, but the odds of a recession have to be respected.

Key Economic Indicators

	2022	2023				2024				Q4 to Q4 change			Annual change		
	22:4a	23:1a	23:2a	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	2.1	3.4	0.8	0.9	1.1	1.3	1.5	0.9	2.1	1.2	2.1	2.2	1.4
Consumer Price Index (% change, annualized)	4.2	3.8	2.7	3.6	3.2	2.8	2.5	2.3	2.2	7.1	3.3	2.4	8.0	4.2	2.8
Civilian Unemployment Rate (%, average)	3.6	3.5	3.6	3.7	3.9	3.9	4.0	4.0	4.0				3.6*	3.7*	4.0*
Federal Funds Rate	3.66	4.52	4.99	5.34	5.38	5.38	5.38	5.13	4.63				1.69*	5.06*	5.13*
2-yr. Treasury Note	4.39	4.34	4.26	4.92	4.75	4.60	4.40	4.20	3.90				2.98*	4.57*	4.28*
10-yr. Treasury Note	3.83	3.65	3.60	4.15	4.40	4.25	4.10	4.00	4.00				2.96*	3.95*	4.09*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- Trailing 12-month inflation has slowed significantly after hitting a four-decade high of 9.1% in June 2022. But it remains elevated by historical standards. Energy prices revived over the summer, keeping the "headline" index at 3.7% in September. On the other hand, core consumer price inflation (excluding food and energy) continues to trend lower, moderating two-tenths to 4.1%. We are seeing disinflation in goods prices, but September saw a rebound in shelter inflation, which accounted for over 70% of the total increase in the core component. This suggests that the journey toward 2% inflation will be bumpy.
- The labor market is still sizzling. Employment growth smashed expectations last month, increasing by 336,000, the most since January. Growth in the labor market held the unemployment rate steady at 3.8%. Job openings also surprised by returning to growth in August, and jobless claims are holding very low. While average hourly earnings growth moderated further, to the weakest rate since May 2021, tight labor market conditions will make disinflation a gradual process.
- The continued strength in the labor market has supported spending, contrary to expectations of a dip in demand. The U.S. consumer remains resilient, with real consumer spending growing at an average 3.1% year over year in 2023. Incoming data suggests that growth in the third quarter will be the strongest in almost two years. The restart of student loan repayments will lead to belt tightening by a subset of consumers, but the solid gains in employment and real wages will continue to support household finances.
- Despite stronger than expected economic data since the September Federal Open Market Committee (FOMC) meeting, several FOMC participants have noted that the recent increase in Treasury yields will act like increases in the policy rate. The statements are seen as a signal that the current hiking cycle has ended. Since the September meeting, yields on 10-year Treasuries have continued to rise, with mortgage rates and corporate bond yields climbing in

continued to rise, with mortgage rates and corporate bond yields climbing in parallel. The steepening of the yield curve has tightened financial conditions, which will weigh on both demand for housing and investment decisions.
  - We expect the Fed to be cautious about a pivot, and see the first rate coming no earlier than the third quarter of 2024. Importantly, this is contingent on the real economy and inflation both slowing. If momentum persists and inflation reignites, then rate cuts are likely to be further away.
- The housing market remains the biggest challenge in Fed's inflation fight. Decades-high mortgage rates, elevated prices and a lack of inventory are having a significant impact on the housing market. The National Association of Home Builders sentiment index is down to its lowest level since January. Housing affordability worsened to a fresh low in August, with new home construction dropping to the lowest level since June 2020 in the same month. Low affordability will sideline aspirational homebuyers, and housing stock needs to improve for a more balanced residential market.
- The risk of a government shutdown has been postponed until mid-November, not avoided. The removal of Kevin McCarthy as Speaker of the House means that an agreement in budget negotiations or a new continuing resolution will be much harder to achieve, making a November shutdown more likely. The run-up in government borrowing costs will only inflame debates in Washington about the sustainability of fiscal policy.

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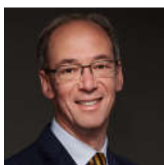

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