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U.S. ECONOMIC & INTEREST RATE OUTLOOK

IN THIS ISSUE

- **Cooling Commences**

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As the seasons change, signs are emerging of a cooling economy: job creation and gross domestic product (GDP) growth are returning to more familiar levels. Inflation's gradual descent continues, a pattern we will soon see in the leaves of deciduous trees.

It is taking time for the new normal to feel like, well, *normal*. Lower inflation only means price increases leveling off, not a return to the prices of old. Wage gains are welcome when they are announced, but are forgotten as costs of living rise. The resumption of student loan payments will be tolerable for most borrowers, but they are yet another challenge for households to address.

Amid so many transitions, the labor market has stood firm. Strong employment conditions continue to serve as the foundation for our expectation of continued growth. As long as we are working, spending will continue, supported by tamer inflation. The economy may not yet feel normal, but that does not mean a recession is imminent.

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	3.2	0.9	1.2	1.5	1.7	1.9	0.9	2.0	1.6	2.1	2.3	1.5
Consumer Price Index (% change, annualized)	4.2	3.8	2.7	4.0	3.0	2.8	2.4	2.3	2.1	7.1	3.4	2.4	8.0	4.3	2.6
Civilian Unemployment Rate (%, average)	3.6	3.5	3.6	3.7	3.8	3.9	4.0	4.0	4.0				3.6*	3.6*	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	4.95	5.00	5.00	4.75	4.40	4.10				2.98*	4.64*	4.56*
10-yr. Treasury Note	3.83	3.65	3.60	4.10	4.25	4.25	4.10	4.00	3.80				2.96*	3.90*	4.04*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- The August Consumer Price Index (CPI) increased to 3.7% year over year, up from a low of 3.0% in June. Rising motor fuel prices have been the main contributor to the CPI's recent rise. Annual core inflation (excluding food and energy) of 4.3% was the lowest reading since September 2021. The runup in used vehicle prices has ended, and shelter inflation is trending down. Core inflation is following a gradual path toward the Fed's 2% target, but the journey will have some ups and downs.
- Labor markets are cooling. In August, 187,000 new jobs were created, but estimates of June and July were revised downward by a total of 110,000. The unemployment rate rose to 3.8%, due to more workers returning to the labor force. Job openings were estimated at 8.8 million as of July, down from over 10 million at the start of the year. The rate of workers voluntarily leaving their jobs is back within its pre-pandemic

range, while involuntary layoffs do not appear to be rising. This is a healthy mix of outcomes.

- Given the marginally softer inflation and employment data to end the summer, the Federal Open Market Committee (FOMC) is likely to keep rates steady at its meeting next week. But in light of above-target core inflation and economic growth that has exceeded expectations, we expect one more rate hike before the end of the year to cement the Fed's restrictive posture.
    - The path for rate cuts is difficult to foresee at this time. Our forecast of cuts starting in third quarter 2024 is based on an expectation of a patient FOMC that will err on the side of holding rates higher for longer, to ensure inflation has sustainably improved.
- Second quarter GDP growth was revised down to an annualized rate of 2.1%, with adjustments made to business investment and inventory accumulation. Consumer spending growth of 1.7% (net of inflation) reflects a more sustainable pace. Business and household activity in the current quarter are poised to deliver another strong GDP reading, but we expect a reversion to a lower rate of growth thereafter.
- Fixed income markets have been sensitive to current events, with the ten-year U.S. Treasury yield reaching a 16-year high of about 4.3%. We believe the primary driver is the higher-for-longer outlook for monetary policy, causing a repricing for all tenors. Steady short rates and rising long yields have reduced the yield curve's inversion, though the negative spread between three-month and ten-year instruments is still historically wide.
    - High rates and high spreads have pushed mortgage rates over 7.7%, a 23-year high, slowing purchase activity. While limited inventory is keeping a floor under prices, high rates have made home purchases unobtainable for many consumers.
- The resilience of the U.S. economy and the increase in long-term U.S. interest rates over the past month led the U.S. dollar to a six-month high against a trade-weighted basket of currencies. The strong dollar helps to contain import prices but impairs the prospects for U.S. exports.
- Oil prices have increased by over $20 per barrel from the low at the start of the summer on news of supply restrictions. While inflation targets exclude food and energy, oil prices flow through as an input cost to many goods and services. Higher fuel prices quickly alter perceptions of inflation, raising the risk that inflation expectations may come unanchored just as monetary policy enters a new phase of steady rates.

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