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The U.S. Economic Outlook for 2023–2024
Executive Summary: November 2022

Slowing Momentum

After shrinking for two quarters in a row, real output expanded at a 2.6 percent annualized pace in the third quarter of 2022. Final sales to domestic purchasers added only 0.5 percentage points to headline growth in 2022Q3, though, down from its 2022H1 average of 0.8 percentage points. While consumption expenditures remain resilient, business investment fell. A decline in imports and a jump in exports jointly accounted for 2.8 percentage points of the headline reading. Net exports' outsized contribution is unlikely to be sustained with recessions expected in our key export markets.

The labor market remains tight. Despite a trend toward slowing job gains, August–October employment growth averaged a healthy 289,000 jobs per month. Weekly initial unemployment claims have ticked up in recent weeks but remain remarkably low, despite widespread media discussion of layoffs. The unemployment rate has inched up to 3.7 percent in October, still a low level. Sales of new light vehicles may finally be ready to contribute to growth again. In October, the annualized pace of sales improved to 14.9 million units, the second-best reading since June 2021. While the October reading may have benefitted from one-off factors such as delayed deliveries of earlier orders, the recent dynamics of production and inventories make this increase more likely to prove persistent.

The October Surprise

Inflation dynamics are a key driver of the outlook. The October CPI report came in far below projections, with the annualized monthly pace of core inflation dropping to just 3.3 percent. If the October surprise slowdown in core CPI proves to be both durable and equally visible in core PCE, the chances of the Fed delivering a soft landing will increase dramatically. We expect monthly inflation to tick back up in the next few months. As a result, we judge that the Fed will have to keep raising the fed funds rate through mid-2023, and it will likely take a mild recession to drive inflation down for good.

Many Warnings

There are many developments in the economy consistent with the business cycle peak drawing nigh. Several Federal Reserve districts' manufacturing 6-month ahead indices point to a broad-based deterioration in the outlook for regional manufacturing. The ongoing decline of goods consumption is one driving factor. A significant appreciation of the dollar over 2022 has certainly weighed heavily on the outlook as well. The Institute for Supply Management's diffusion index for manufacturing has hit the stall speed of 50 in the October survey. The share of banks in the Fed's Senior Loan Officer Survey tightening lending standards for commercial and industrial loans, as well as for commercial real estate development, suggests a high degree of caution in business lending. The spread between 10-year and 2-year Treasury bond yields has moved decidedly negative since mid-July—historically a development usually followed by recessions within 12–24 months. But the situation in the housing market is perhaps the most concerning.

Nuclear Winter in Housing

After a two-year period of eye-popping increases in house prices, the housing market appears to have run into a brick wall. Mortgage purchase applications have fallen by 45 percent from the start of the year, while pending home sales have fallen 31 percent year-over-year. The University of Michigan Survey of Consumers' sentiment index of conditions for buying a home has now fallen to its lowest reading since the survey's inception in 1951. Year-over-year home price appreciation has fallen from 20.8 percent in March to 13 percent in August. As mortgage rates have more than doubled, affordability has cratered to levels last seen at the peak of the mid-2000s housing price run-up. Despite this stress, residential construction employment has held up well so far this year, owing to a large backlog of projects. New starts are falling, however, and we think the housing sector is unlikely to bottom until mortgage rates have peaked and existing home prices have stopped falling.

The Captain Has Turned On The Seatbelt Sign

We think the FOMC is eager to avoid its mistakes of the 1970s and '80s and will try to extinguish the current inflationary momentum completely on the first try. As a result, we think the Fed is prepared to tolerate a mild recession if it minimizes risks to longer-term price stability. To conquer inflation, we think the Fed will lift the *fed funds rate above near-term inflation expectations, bringing short-term real yields into positive territory and keeping them there for a while.*

As a result, we expect the Fed to continue raising rates into late spring of 2023, albeit at a slower pace than recently. We project a terminal range of 5.25–5.5 percent for the fed funds rate in this cycle. We expect the Fed to hold the fed funds rate flat for the rest of 2023. As inflation gradually slows and unemployment inches up, the Fed will begin easing in 2024.

Divided Government, Most Likely

Partisan control of the House of Representatives is still up in the air ten days after the midterm elections. Regardless of the outcome, the narrow margin lowers the chances of significant fiscal action ahead.

We are projecting significant restraint for discretionary non-defense spending, but sizeable increases in defense spending due to the war in Ukraine and other global threats. We do not anticipate the mild recession in our outlook to entail any meaningful fiscal stimulus.

The 2023–24 Outlook

We expect headline growth to slip but remain in positive territory in 2022Q4–23Q2, supported by resilient consumption expenditures. In 2023H2, as job growth turns negative, consumption spending flatlines and real GDP declines slightly. By early 2024, the Fed begins easing monetary policy and economic activity starts expanding again. By late 2024, quarterly growth rebounds to a 2.4 percent annualized pace. Calendar-year GDP growth registers 1.9 percent in 2022 and remains positive on average for 2023, registering 0.5 percent. The mild recession we project in late 2023 holds average real GDP growth in calendar year 2024 to 0.8 percent.

Price inflation continues to moderate gradually over the next year, as overall consumer demand weakens and a rapidly cooling housing market propagates to lower shelter inflation. Core CPI inflation registers 6.2 percent in 2022, 4.3 percent in 2023, and 2.5 percent in 2024. By early 2024, the quarterly pace of PCE deflator inflation, the Fed's preferred measure, stands at 2.5 percent and falling, allowing the Fed to start easing policy.

As tight monetary policy bites, the pace of monthly payroll job gains decelerates through the middle of next year before the economy starts shedding jobs in 2023Q3. Over 2023Q3–24Q2, payroll employment declines by nearly 750,000 jobs. As a result, calendar-year average payroll employment declines by 400,000 in 2024.

Although we are forecasting an economic slowdown, we expect that pent-up demand will help vehicle sales grow through the period of economic weakness. We expect that light vehicle sales will increase from 13.9 million units in 2022 to 15.5 million units in 2024 as supply chains heal and inventories continue to normalize.

We project single-family starts to bottom in the second half of 2023 amid high mortgage rates and dismal affordability before staging a modest rebound in 2024. Multi-family starts decline more gradually, sustained by low vacancy rates, elevated rents, and a limited increase in unemployment. Total housing starts fall from over 1.5 million units in 2022 to 1.2 million in 2024.

	Actual	**RSQE Forecast**		
	2021	2022	2023	2024
GDP (billions of current $)	23315.1	25433.7	26726.2	27638.0
Real GDP (billions of 2012 $)	19609.8	19979.6	20075.7	20230.8
% change: year-over-year	5.9	1.9	0.5	0.8
% change: 4th-qtr-to-4th-qtr	5.7	0.4	-0.3	1.9
Nonfarm payroll employment (millions)	146.1	152.0	154.0	153.6
Civilian unemployment rate (%)	5.4	3.6	3.8	4.5
Capacity utilization, total industry (%)	77.4	80.0	79.3	77.8
Inflation (private nonfarm GDP deflator, % change)	4.5	7.1	4.6	2.6
Inflation (CPI-U, % change)	4.7	8.1	4.5	2.5
Inflation (core CPI, % change)	3.6	6.2	4.3	2.5
Light vehicle sales (millions)	14.9	13.9	15.1	15.5
Private housing starts (thousands)	1605.2	1545.4	1233.2	1213.4
3-month Treasury bill rate (%)	0.0	2.1	5.2	4.8
10-year Treasury note rate (%)	1.4	3.0	4.6	4.5
Conventional mortgage rate (%)	3.0	5.5	7.3	6.5
Real disposable income (billions of chained 2012 $)	16130.0	15090.6	15419.3	15580.3
% change	1.9	-6.4	2.2	1.0
Corporate profits after tax (billions of current $)	2749.8	2889.1	2919.6	3067.6
Value of U.S. $ (FRB broad index), % appreciation	-3.9	7.7	7.5	0.0
Current account balance (NIPA basis, billions of current $)	-861.4	-1014.7	-929.8	-834.7
Federal surplus (FY, NIPA basis, billions of current $)	-2948.9	-1081.0	-1215.2	-1296.3