ECONOMIC OUTLOOK

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January 2024

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Even More Stuff May Or May Not Happen In 2024 . . .

Our 2024 outlook is a natural follow-up to our 2023 outlook which, as some readers will recall, was "Lots of Stuff May or May not Happen in 2023." As we noted a year ago in this space, we thought that was about as clear and concise, not to mention precise, as we could be after three years of the pandemic and the policy response to it wreaking havoc on detailed predictions of how those years would play out. We considered our 2023 outlook to be the triumph of experience over hope, in that if the experience of the prior three years hadn't been enough to dissuade one from making detailed predictions as to how 2023 would play out, nothing ever would. And, at the risk of appearing immodest, our 2023 outlook wasn't just correct, it was spot-on, dead-bang, on-the-money correct, as lots of stuff did indeed happen in 2023 and lots of stuff indeed didn't happen in 2023. Moreover, some of the stuff that happened in 2023 was stuff we thought would happen, and some of the stuff that didn't happen in 2023 was stuff we didn't think would happen. Okay, fine, for those who want to quibble, some stuff we thought would happen in 2023 didn't, and some stuff we didn't think would happen in 2023 did, but, in our defense, who on earth at the start of the year had a certain global superstar single-handedly saving the U.S. economy from recession while also becoming a regular at games of a certain NFL team as part of their 2023 outlook?

So, sure, 2023 may not have played out exactly as we anticipated, but we think that approach to our annual economic outlook is still the way to go. After all, while "fumbling towards normal" was one of our main themes for the economy in 2023, it's hard to argue that the economy actually made it there. Or, it could just be that the economy did make it there but no one really knew it given that no one really knows what constitutes "normal" anymore. Either way, given that there are just as many open questions about the course of the U.S. economy at the start of 2024 as there were at the start of 2023, making a set of detailed predictions as to how 2024 will play out seems no less perilous as it did a year ago.

One thing that seemingly hasn't changed from a year ago is that as 2024 begins many of the open questions looming over the U.S. economy revolve around the paths of monetary policy and overall financial conditions and how those will, in turn, impact the broader economy. The obvious difference here, however, is that a year ago those questions were around how much higher the FOMC would push the Fed funds rate and how much overall financial conditions would tighten, whereas this year those questions are around when and by how much the FOMC will cut the funds rate and how much overall financial conditions will ease. As in 2023, the FOMC's calls on the funds rate in 2024 will be contingent on the path of inflation but the difference is that while a year ago we had what we described as the odd spectacle of central bankers openly talking about the degree of pain they would have to inflict upon the economy in order to push inflation back to their 2.0 percent target rate, we now have central bankers acknowledging progress but cautioning that it is too soon to declare "mission accomplished."

One thing that did not happen, and that we did not expect to happen, in 2023 was the U.S. economy slipping into recession. That we did not have recession as our base case put us at odds with the vast majority of our counterparts, or perhaps we should say kept us at odds with them. After all, many forecasters were quick to make recession their base case as soon as the FOMC began raising the Fed funds rate back in 2022 while others made recession their base case only after seeing how aggressively the FOMC was raising the funds rate. That the economy did not succumb to the weight of higher interest rates in 2022 did not deter those with recession as their base case, it simply led them to push back the start of their recession, often a quarter at a time until a mid-2022 start ultimately got pushed back to late-2023.

As 2023 wore on, however, more and more forecasters began to abandon their recession calls and embrace the "soft landing" narrative. To be sure, there are still some holdouts for whom recession remains the base case, with most in this camp seeing a recession start at some point in the first half of 2024. There are even a few hard-core holdouts who argue the economy is already in recession, with it being only a matter of time until the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), the unofficial arbiters of turns in the business cycle, declares that to be the case, an argument which we can best characterize as curious.

Many of those who maintain recession as their base case do so on the premise that monetary policy works with long and variable lags and, as such, the economy still hasn't felt the full force of higher interest rates, which we also find a somewhat curious argument. After all, market interest rates, including mortgage interest rates, credit card interest rates, and "benchmark" interest rates, such as SOFR, closely aligned with the Fed funds rate all pushed sharply higher as the FOMC pushed the funds rate higher, in turn weighing on household and business spending, while at the same time an appreciating U.S. dollar posed a higher and higher hurdle for U.S. exports. It seems a bit of a reach, then, to argue that there are still delayed effects of higher interest rates that will be sufficient to trigger a recession in 1H 2024, particularly given the dramatic reversal in market interest rates over the past several weeks.

While we have not at any point in the current cycle had recession as our base case, one thing we were clearly wrong on in our 2023 outlook was just how well the economy would hold up under the weights of elevated inflation and higher interest rates. Indeed, we argued that our baseline forecast, which anticipated only tepid real GDP growth and a rising unemployment rate over the first half of 2023, would not look or feel all that much different than the mild

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downturn many in the recession camp anticipated. As it turned out, the economy fared much better over the first three quarters of 2023 than we anticipated a year ago at this time. That of course was in keeping with the general pattern of the prior three years, when so little played out as anticipated in an environment in which there was a higher than normal degree of volatility, not only in the economic data but also in the financial markets.

While things seem to be, if not returning to normal then at least coming closer to whatever normal may be these days, we still find it hard to have much conviction in any detailed forecast of how 2024 may play out for the U.S. economy or the global economy. As with each edition of our *Monthly Economic Outlook*, we devote the last page of this edition to a summary of our updated baseline forecast. How much confidence we can, or should, have in that forecast is another question entirely. As such, we'll stick with the same approach we took with our 2023 outlook, i.e., laying out how, as of early-January, we expect the U.S. economy to perform in 2024 but spending more time discussing some of the key factors that will determine how the economy actually performs. Along the way, we'll also look back over last year's calls and see how those fared. We do this when presenting each year's outlook, in whatever form we present it in, which simply reflects our view that a critical look back is necessary before looking forward.

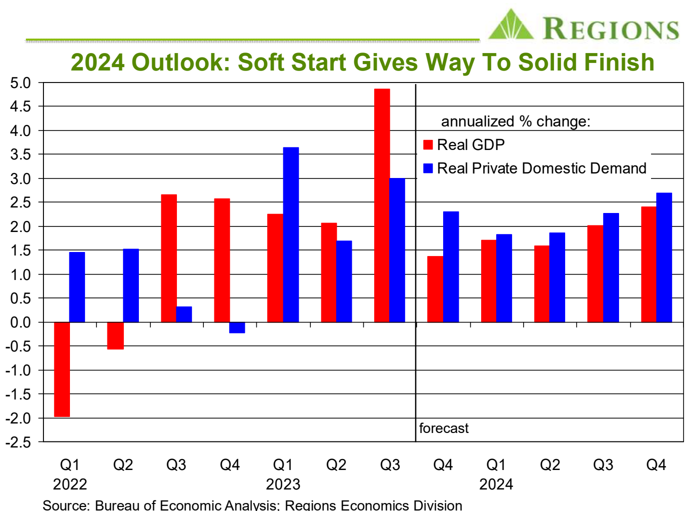
2024 Overview: After what we expect will be full-year 2023 real GDP growth of 2.4 percent (the Q4 GDP are due January 25), our baseline forecast anticipates real GDP growth of 2.1 percent in 2024. As noted earlier, the economy easily beat our easily above consensus forecast of 1.1 percent growth in 2023. Consumer spending, business spending on structures, and government spending grew at faster rates than we anticipated, while residential fixed investment, business investment in equipment/machinery, and net exports stuck to the script. One key to the economy outperforming our forecast in 2023 was the labor market holding up better than we expected. Job growth slowed much less than we anticipated while labor force participation rose slightly more than we anticipated, reflecting both higher participation amongst the prime-age (i.e., 25-to-54 years old) cohort and increased immigration. Moreover, labor productivity growth was stronger than we expected which, in turn, helped fuel faster real GDP growth. Between normalizing global supply chain and logistics networks, higher labor force participation, and faster productivity growth, 2023 was a very good year for the supply side of the U.S. economy, which of course comes as news to those seemingly unaware that there is actually a supply side to the economy.

That said, in lieu of the Q4 GDP data, the higher frequency data along with anecdotal evidence such as the Federal Reserve's *Beige Book* point to a markedly slower pace of economic activity in Q4, which we expect to carry into 2024. Though the monthly data have been highly volatile, the trend rate of job growth clearly slowed as 2023 wore on, as did the trend in aggregate private sector hours worked. This combination led to slowing growth in aggregate private sector labor earnings at a time when many lower-to-middle income households had exhausted whatever savings buffers they had built up. So, while 2023 holiday season spending was tracking in line with our forecast, Q4 growth in real consumer spending was still tracking at a much slower pace than seen in Q3, and we look for this more sedate pace of growth to prevail over the first half of 2024 before picking up over the second half of the year.

Real business investment in equipment and machinery fell in Q3 2023, the third contraction in four quarters, and while the Q4 data may bring some respite, we expect this softness to linger over 1H 2024. At the same time, the wave of business spending on structures seen over much of 2023 is subsiding, to the point that we expect real spending on structures to offer little, if any, support for real GDP growth in 2024. We do expect business investment in intellectual property products to return to its usual role as the fastest growing segment of real business fixed investment after having been displaced by spending on structures in 2023.

Higher mortgage interest rates weighed on the construction and sales of single family homes in 2023, but sales of new single family homes proved to be more resilient than our forecast anticipated. That, to a large extent, reflected the combination of still-significant pent-up demand for home purchases and the paucity of existing single family homes for sale, with higher mortgage rates effectively locking many homeowners in place. Builders were aggressive in the use of incentives, including mortgage rate buydowns, to help pare down larger than desired inventories of spec homes. With mortgage rates having turned lower, helping to ease affordability constraints but likely not doing much to unlock inventories of existing homes for sale, builders should fare better this year and, after what will likely be a double-digit decline for full-year 2023, real residential fixed investment should be a modest support for top-line real GDP growth in 2024.

That real government spending grew more rapidly in 2023 than our forecast anticipated is more a matter of timing than anything else. It was no mystery that funds to support infrastructure projects would at some point begin to flow down to state and local governments, but we were a bit off in the timing. Either way, such spending added to real GDP growth – that's how the GDP math works – and bolstered public sector job and earnings growth. That same support will be present in 2024, though to a lesser degree than was the case in 2023.



All of this adds up to real GDP growth of 2.1 percent in 2024, slower than 2023 growth but still right around what we see as at present being the economy's "speed limit," with "at present" being an important qualifier, as we'll discuss later. We expect slower job growth to put modest upward pressure on the unemployment rate and for further deceleration in inflation to pave the way for the

FOMC to begin cutting the Fed funds rate. We do see both upside and downside risks to our baseline outlook, which we'll outline after we discuss what we see as some of the key determinants of how the U.S. economy will actually perform this year.

Labor Market: Cooling, Not Crumbling. This seems a fitting place to start our discussion of some of the main determinants of how the U.S. economy will perform in 2024. After all, that the labor market outperformed our expectations in 2023 was a key factor in the broader economy doing the same. Our forecast anticipated total nonfarm payrolls rising by 0.7 percent, Q4/Q4, in 2023 with a Q4 average unemployment rate of 4.3 percent; the preliminary 2023 data show nonfarm employment rose by 1.7 percent, Q4/Q4, in 2023, with job growth slowing as the year progressed, and the unemployment rate averaging 3.7 percent in the year's final quarter. The labor force participation rate averaged 62.7 percent in Q4 2023, topping our forecast of 62.6 percent.

We were, however, mostly on the mark in how we thought the labor market would evolve over the course of 2023. For instance, though we anticipated the unemployment rate rising, we expected that would primarily be a function of slowing job growth rather than rising layoffs. Our argument was that given how hard and how expensive it had been for firms to find and retain labor, they would be unwilling to resort to large-scale layoffs in response to what they perceived would be a brief and fairly mild downturn in demand, with any softening in the demand for labor reflected in slowing hiring and falling job vacancies followed by reductions in hours worked, all of which the data show. Though we have absolutely no faith in the levels of any of the variables reported in the Job Openings and Labor Turnover Survey (JOLTS) due to ridiculously low survey response rates, we do have some trust the trends in the data, and those trends show a sharp decline in job vacancies over the course of 2023. At the same time, growth in aggregate private sector hours worked slowed sharply over the course of the year. There has not, however, been an appreciable increase in layoffs, with the rate at which workers are being laid off remaining slightly below the pre-pandemic norm.

Our 2024 labor market outlook is not that different than our 2023 outlook. We expect the trend rate of job growth to continue to slow, in turn putting upward pressure on the unemployment rate, which we expect average 4.0 percent in Q4 2024. As we did last year, we expect slowing job growth, as opposed to rising layoffs, to be the primary source of upward pressure on the jobless rate. We'll also note that we do not expect labor force participation to rise as much as it did in 2023, which limits the increase in the unemployment rate in our baseline forecast. Admittedly, we were surprised by the magnitude of the increase in the participation rate amongst the "prime working age" cohort, i.e., those 25-to-54 years old, with the rate amongst this cohort hovering near a two-decade high at year-end 2023. Still, we question how much more upside there is to participation amongst this key cohort, but if we are again surprised to the upside, job growth may again top our forecast in 2024.

Another potential support for job growth is increased immigration. The number of foreign-born workers in the labor force has jumped significantly since the end of the pandemic-related shutdowns and ended 2023 above where the pre-pandemic trend would, by our estimation, have had it. While it is not a given that the number of foreign-born workers will continue to increase at such a rapid rate, we do think this poses an upside risk to our job growth forecast.

In addition to what we think will be a less favorable labor supply story, there are a few other factors we expect to contribute to a slower pace of job growth in 2024. First, if the pace of economic growth slows as we anticipate, that suggests less demand for labor, but to the extent firms do wish to add to total labor input, the first lever they have to pull is hours worked. As noted above, growth in aggregate private sector hours worked slowed sharply over the course of 2023 and average weekly hours fell across most of the broad industry groups. As such, firms have the latitude to increase hours amongst their current workers, which would in turn limit the number of new workers they take on. Second, to the extent that the faster productivity growth seen over the middle quarters of 2023 can be sustained, that suggests less labor input would be needed than with a slower rate of productivity growth.

There are two things to watch for but hope to not see in the labor market in 2024. First, job growth became increasingly less broadly based across private sector industry groups over the course of 2023, as we've noted in our write-ups of the monthly data. To that point, the health care and social services industry group accounted for 45.4 percent of private sector job growth in 2023, more than double its 2022 share. It thus bears watching whether job growth becomes even less broadly based in 2024. Second, while thus far we have not seen a significant increase in layoffs as firms continue to hoard labor, that could, and will, change if firms become more downbeat about the prospects for demand growth or if slower revenue growth leads to layoffs as a means of preserving margins via cost cutting. Either way, at some point firms would find cutting workers, as opposed to cutting hours worked, to be the more feasible approach. Either of these things, let alone both of them, would suggest something much less benign than the deceleration in growth we anticipate is underway in the broader economy.

We also expect further slowing in job growth will lead to further slowing in wage growth. But, we still expect wage growth to remain between the trend rate that prevailed prior to the pandemic and the rate seen over much of the 2020-2022 period. We put far more emphasis on aggregate labor earnings than on average hourly earnings, and if we are correct in expecting job growth and wage growth to slow, then so too will growth in aggregate labor earnings, though increased average weekly hours would mitigate the extent of any slowdown. Either way, we expect growth in aggregate earnings to continue to run ahead of inflation, as has been the case over this entire period of elevated inflation.

Inflation: Lower, but still not there. "There" of course being the FOMC's 2.0 percent inflation target. While 2023 did see considerable further progress on the path to that target, inflation as measured by the PCE Deflator, the FOMC's preferred gauge, stood at 2.6 percent as of November and core PCE inflation stood at 3.2 percent (the December data are not yet available). To the point about progress, in November 2022 the PCE Deflator put headline inflation at 5.9 percent and core inflation at 5.1 percent. On a three-month annualized change basis, core PCE inflation was, at 2.16 percent as of November, even closer to the FOMC's target as 2023 drew to a close. Falling energy prices helped pull down headline inflation over the final few months of 2023, while falling core goods prices (i.e., prices of consumer goods excluding food and energy) also helped stem inflation pressures.

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Our 2023 outlook had core goods prices continuing to fall through the year, which by year-end would result in year-on-year declines. This was to be a key factor in overall inflation decelerating further. While core goods prices unexpectedly found a second wind in the first few months of 2023, they soon reversed course, falling in five of the six months ending with November, and were up 0.1 percent year-on-year as of November. Not quite the over-the-year decline we had anticipated, but the December data will likely show that. Note that as measured in the Consumer Price Index (CPI), core goods prices had declined in six straight months and were down slightly year-on-year as of November. Falling core goods prices mostly reflect global supply chain/logistics networks normalizing after the severe disruptions triggered by the pandemic and shifts in consumer spending patterns, away from goods and towards services, with a stronger U.S. dollar also playing a role.

With patterns in core goods prices mostly playing out as we expected, services prices were the primary source of inflation pressure in 2023 though, to some extent lagged measures of rents have exaggerated services price inflation. In last year's outlook we argued there had been more progress on services price inflation than the FOMC was acknowledging and argued that inflation could decelerate more quickly in 2023 than many, including the FOMC, were anticipating. That said, even we underestimated the extent to which core inflation would slow by year-end 2023.

Our baseline forecast has headline and core PCE inflation both at 2.1 percent in Q4 2024, with further slowing in the economy helping further ease inflation pressures. To the extent growth in consumer spending on discretionary services slows and growth in labor costs moderate further, ex-shelter core services price inflation should moderate at a faster pace than seen in 2023. While we think it unlikely that core goods prices will continue to fall through 2024, neither do we expect a meaningful rebound, albeit a weaker U.S. dollar would be a support for core goods prices. Still, on balance we expect core goods prices to be more or less a neutral factor in overall inflation in 2024.

To help grasp the importance of inflation continuing to decelerate in 2024, consider the following two points. First, with growth in labor earnings – far and away the largest component of personal income – continuing to decelerate, inflation doing the same means real labor earnings can continue to grow. Those surprised by the seeming resilience of consumers in 2023 often overlook that over this entire episode of elevated inflation, real aggregate wage and salary earnings have continued to grow, thus affording consumers increased purchasing power, at least in the aggregate. Those who look no further than average hourly earnings always miss this point. Second, further deceleration in inflation gives the FOMC latitude to begin cutting the Fed funds rate, even with inflation still above their two percent target rate. We discuss this point further in our discussion of monetary policy in 2024.

One wild card in the equation is the extent to which the burst of labor productivity growth over the middle quarters of 2023 will be sustained. A prolonged period of sustained rapid productivity growth would increase the economy's "speed limit" while allowing for faster wage growth without that coming at the expense of profit margins. While we're skeptical that productivity growth will make much of an impression on economic growth or inflation in 2024, we do see more hope over the longer-term. Indeed, we see that as the only path to inflation falling to the FOMC's 2.0 percent target rate on a sustained basis given unfavorable demographic trends and globalization being in retreat.

Consumer spending: Wallet winning over will? In our 2023 outlook, we noted that how rapidly consumer spending would grow could come down to not whether consumers were able to spend but instead whether they were willing to spend. Our point was that while we had few questions about their wherewithal to spend (which set us apart from many analysts), the monthly surveys of consumer sentiment suggested a rather downbeat mood that could weigh on consumer spending. That dichotomy prevailed over much of 2023, to the point that in our 2023 holiday spending forecast we said holiday season spending would come down to a battle of wallet versus will. It wasn't until December that the monthly surveys showed consumers' moods starting to lift, which is even more noteworthy given that retail gasoline prices had been declining rapidly since right after Labor Day.

Even with that late-year bump, measures of consumer sentiment remain mired at levels typically seen in and around recessions, and our premise is that consumers remain focused on the cumulative increases in prices over the past two-plus years, particularly prices for necessities, such that they find little cause for cheer in the news that prices are rising at a slower pace. Still, to the extent 2023 was a battle of wallet versus will, wallet seems to have won out, with growth in real consumer spending easily topping our forecast. Again, even with what we (correctly) expected would be slower growth in labor earnings in 2023, inflation slowing more than we anticipated meant growth in real disposable (after-tax) personal income topped our forecast. That, in turn, contributed to growth in real consumer spending doing the same, with falling core goods prices providing an added boost to real spending on goods. We'll also note that discretionary services spending was stronger in 2023 than we had anticipated would be the case.

Our forecast for 2023 consumer spending having fared so poorly won't deter us from trying again. As it works out, our forecast has full-year growth in real consumer spending matching the 2.2 percent pace that 2023 growth was tracking at, with a stronger second half offsetting a weaker first half. We continue to look for growth in discretionary services spending to slow, and if we are correct in not expecting continued declines in core goods prices throughout 2024, real goods spending will not be as strong as was the case in 2023. Still, growth in total goods spending should be a bit stronger than in 2023, largely negating the slower pace of growth in services spending we anticipate.

More importantly, despite anticipating growth in real after-tax income to slow from 2023's pace, we still see plenty of support for consumers' ability to spend. True, many lower-to-middle income households have exhausted savings buffers that had been built up on the basis of pandemic-related transfers and have come under increased financial stress under the weight of cumulative price increases over the past several quarters. In the aggregate, though, deposit balances remain above pre-pandemic norms and there is still a considerable pool of excess saving on household balance sheets. At the same time, with the obvious exception of credit card debt, consumers have been highly insulated from higher interest rates thanks to the preponderance of fixed-rate debt on household balance sheets. While this point has been overlooked by many,

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we've seen it as a meaningful support for consumer spending as interest rates have risen. Some point to rising levels of credit card debt, which now tops $1 trillion, as evidence of distress amongst consumers, which is more about "$1 trillion" than anything else. We continue to note that outstanding revolving consumer credit, the bulk of which is credit card debt, is equivalent to 7.9 percent of disposable personal income excluding transfer payments. Save for the period after the onset of the pandemic, when the level of credit card debt was declining, this is the lowest ratio since Q3 1994, while monthly principal and interest payments as a share of after-tax income continue to hover near all-time lows.

We'll also note that should mortgage interest rates continue to fall, this could at some point lead to greater extraction of housing equity in the form of cash-out mortgage refinancing or increased utilization of home equity lines of credit (HELOC). Indeed, after a thirteen-year run in which HELOC balances steadily declined, outstanding balances had risen in four straight quarters (Q4 2023 data are not yet available). While this could reflect borrowers drawing down housing equity to pay down other forms of higher-rate debt, should interest rates continue to fall we could see more equity extraction being used to facilitate consumption.

Our baseline forecast anticipates softer labor market conditions, consumers feeling less constructive about labor market conditions, diminishing pent-up demand for discretionary services, and less of a boost from falling core goods prices will weigh on growth in consumer spending in 2024, particularly in the year's first half. But, that there remain considerable financial supports for consumer spending suggests upside risk to our call, particularly if consumer moods begin to brighten.

Business investment: Big wave forming? Much like our outlook for consumer spending, our 2024 outlook for business investment will be very similar to our 2023 outlook. Last year we noted that firms making decisions on capital spending were facing strong crosscurrents that were complicating their decision making process. We argued that short-term factors, such as an uncertain demand outlook and pressures on corporate profits, would win out over longer-term factors, such as the availability and cost of labor, to weigh on capital spending in 2023, particularly investment in equipment and machinery. That part of our outlook proved to be correct; as noted earlier, real business investment in equipment and machinery had contracted in three of the four quarters ending with Q3 2023, and the monthly data on core capital goods orders suggest that weakness will carry into 2024. We also argued that longer-term concerns, particularly enhancing labor productivity, would ensure continued solid growth in investment in intellectual property products. The GDP data through Q3 suggest that was the case, even if growth seems set to fall a bit shy of our forecast.

The part of our forecast on business investment we got wrong was that we underestimated the strength of business spending on structures which, after adjusting for inflation, was on course for a double-digit increase for full-year 2023. Still, though some tout this as a "manufacturing renaissance," we'll note that much of this growth came from construction of facilities to produce semiconductor chips, electric vehicles, and electric vehicle batteries, i.e., areas benefitting from subsidies. Moreover, the monthly data show growth in construction of manufacturing facilities has slowed sharply, suggesting less support for overall business spending on structures and, in turn, real GDP growth, going forward.

Our 2024 outlook largely reflects the same dichotomy between shorter-term and longer-term factors. Investment in equipment and machinery remains on a weak trajectory, as seen in the monthly data on core capital goods orders, which leads the GDP measure of investment in machinery and equipment by several months. As such, our baseline forecast anticipates the GDP data will show contractions over the first two quarters of 2024 followed by a rebound over the second half of the year, the net result being a modest increase for full-year 2024.

In contrast, our forecast anticipates another year of solid growth in spending on intellectual property products, the vast majority of which is accounted for by computer software and research and development outlays. Spending on intellectual property products tends to front-run improvements in labor productivity, and it could be that the strong acceleration in labor productivity growth over the middle quarters of 2023 reflects the first wave of payoff from what has been several years of robust growth in spending on intellectual property products.

While our forecast anticipates much more restrained spending on structures in 2024, that is far more a reflection of how strong growth was in 2023 than of an expectation of a sharp downturn. As noted above, there will be significantly less support from construction of manufacturing facilities. It is interesting to note that surging domestic oil production in 2023 did not bring a jump in construction of exploration/mining structures or, for that matter, in spending on related equipment and machinery. We think it unlikely that output can be sustained at 2023 levels without further capital investment, so this could pose an upside risk to our forecasts of these two components of business investment.

We see even bigger upside risks from other sources. The push to adapt artificial intelligence could lead to even stronger investment in intellectual property products than our forecast anticipates. Perhaps more fundamentally, however, we noted in last year's outlook that at some point years of rapid growth in spending on research and development geared toward either enhancing labor productivity or substituting capital for labor would at some point lead to growth in spending on equipment and machinery, and we continue to cling to that view. Moreover, whether or not the pace of construction of manufacturing facilities fades, as those facilities are completed, they will have to be stocked with equipment. And, it is also possible that we'll see another wave of construction of manufacturing facilities, even without subsidies, as firms look to realign supply chains, with the bitter experience of the pandemic still fresh in minds. If so, as those facilities are constructed and then stocked, that would be a substantial support for capital spending. Whether, or to what extent, any of these supports turn up in 2024 remains to be seen, but we do see considerable upside risk to our forecast of relatively uninspired growth in real business fixed investment. It's the timing we are much less clear on.

The housing market: Latest chapter in a long story? For many, the story is "look what higher mortgage rates have done to the housing market." For us, the story is "look what more than a decade of chronic undersupply has done to the housing market,' in which higher mortgage interest rates are but the latest chapter. That many seem to neglect the supply side of the housing market isn't all that surprising given that, as we noted earlier, many seem unaware that there is a supply side of the broader economy. To

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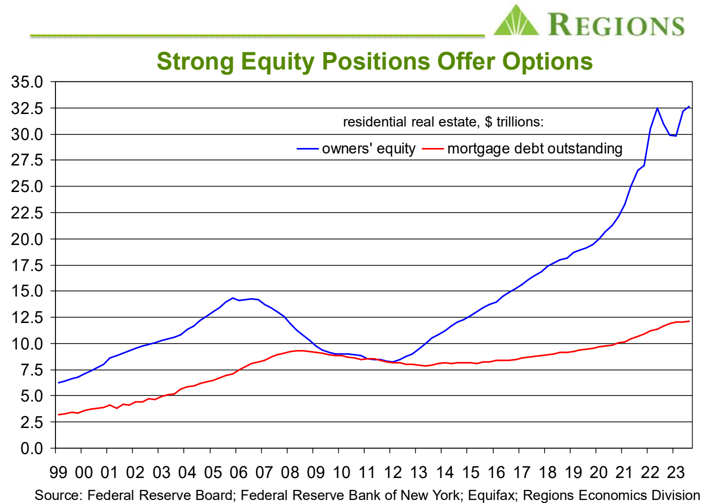
our point, however, while there is no denying that higher mortgage interest rates have taken a toll on the demand for home purchases, the reality is that home sales, new and existing, began to decline in mid-2021 which, as we've repeatedly pointed out since that time, was a supply-side, not a demand-side story. It was the lack of inventory that triggered the decline in home sales, with rising mortgage rates subsequently accelerating the pace of that decline. To be sure, extraordinarily low mortgage rates in 2020 and 2021 led to a spike in the demand for home purchases but rather than causing the supply-demand imbalance in the housing market, that spike exaggerated an imbalance which had been in place for years.

Our 2023 outlook anticipated higher mortgage rates triggering steep declines in home sales, with existing home sales faring much worse than new home sales. On a year-to-date basis through November, sales of existing homes were down by 20.3 percent in 2023, while new home sales were actually up by 4.6 percent, even with a November sales number we see as highly suspect. Given that, as we understand it, a 20.3 percent decline is much worse than a 4.6 percent increase, we nailed that one. Okay, fine, for those who want to quibble, we did not see the increase in new home sales coming, while the decline in existing home sales was much more severe than we had anticipated. All of which reflects two things we've been pointing to for some time, as in, years, now – extraordinarily lean inventories of existing homes for sale and the degree of pent-up demand for home purchases.

New home builders have been the prime beneficiary of these dynamics, and while they have had to resort to incentives such as mortgage rate buydowns and price discounts to facilitate sales, they sit in a stronger position than many, us included, would have anticipated. It is also worth noting that, while overall sales have fallen sharply, all-cash transactions accounted for a significantly higher share of existing home sales in both 2022 and 2023 than had historically been the case, while existing homes spent much less time on the market before going under contract than had historically been the case. That demand for home purchases held up better than we anticipated contributed to house prices doing the same. Our 2023 outlook anticipated a mid-single digit decline (peak-to-trough) in prices of existing homes, as measured by the CoreLogic House Price Index (HPI). That was notable in that it put us on the low end of forecasts, most of which anticipated double-digit declines, and even earned us a scolding from some who just knew a better than twenty percent decline was coming because, well, because that's what happened the last time around. In any event, the CoreLogic HPI had been falling over the second half of 2022, but January 2023 was the last month of decline, with a peak-to-trough decline of 2.7 percent in the unadjusted index. But, with house prices having been surprisingly resilient, the CoreLogic HPI will likely to be shown as having posted a moderate increase for the year as a whole when the final 2023 data are available.

While mortgage interest rates fell sharply over the final weeks of 2023, they nonetheless remain higher than had for years been the case. One reason that matters is because we think mortgage rates will have to fall much further before they unlock "pent-up supply" of existing homes for sale, which we think will begin happening to a meaningful degree should mortgage rates fall below 5.5 percent. Sure, that is still above where rates on many current mortgage loans are, but that could be close enough to induce more current homeowners to make a move. After all, much stronger equity positions afford current owners more options, such as putting a larger portion of equity realized from selling their current homes toward larger downpayments that can offset some, if not all, of the differential in payments due to the higher mortgage rate on loans used to purchase their next home.

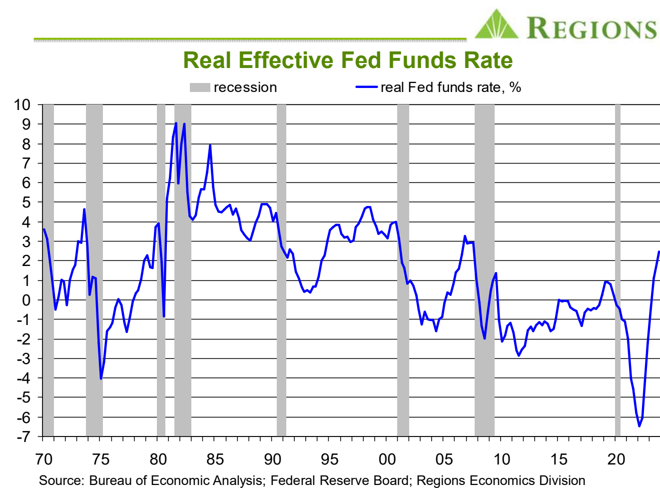


Still, as our baseline forecast has mortgage rates remaining above six percent, we think continued supply constraints will make 2024 another challenging year for existing home sales with a decline on an annual basis, though the second half of the year should see modest improvement. Our forecast anticipates another increase in new home sales, but keep in mind that builders continue to face challenges in the form of still-constrained supplies of materials and long-running labor supply constraints. This, rather than limited scope for further gains, likely caps any increase in new home sales in 2024 in the mid-single digits. While a sharper deterioration in the labor market and/or the broader economy would obviously pose downside risks to our baseline outlook, we look for the CoreLogic HPI to post sequential increases in each quarter of 2024, yielding a full-year increase of around 3.5 percent. As for new home prices, the median new home sales price was down 5.5 percent in 2023 on a year-to-date basis through November. How prices fare in 2024 will largely depend on how much further mortgage interest rates fall, whether there is any relief on the supply side of the market for existing homes, and the extent to which builders are able to increase production to fulfill demand – as it is, builders continue to sit on sizable backlogs of units awaiting construction. Our sense, however, is that the median new home sales price will post a moderate gain for full-year 2024.

FOMC: Room for cuts in 2024? Our 2023 outlook anticipated two twenty-five basis point Fed fund rate hikes in 2023 with the FOMC staying on hold for the rest of the year. That put us at odds with many, particularly those who had recession as their base case, anticipating funds rate cuts in 2023. As it turned out, the FOMC implemented four twenty-five basis point hikes in 2023, the last coming at their July meeting after which they remained on hold. As 2024 kicks off, it is almost universally anticipated that the FOMC will begin cutting the Fed funds rate this year, the questions revolving around the timing and magnitude of those rate cuts. As is typically the case, analysts, market participants, and FOMC members all seem to be on different pages. The December 2023

edition of the FOMC's "dot plot" implied seventy-five basis points of funds rate cuts by year-end 2024, our expectation is that there will be four twenty-five basis point cuts, while market pricing anticipates six such cuts which, barring a significant downturn in the U.S. economy, seems implausible.

Though not having anticipated it, the FOMC seems to at least be more confident that the deceleration in inflation seen over the course of 2023 will hold. In the December 2023 edition of their Summary of Economic Projections (SEP), not only did the FOMC's median forecast show a much slower rate of inflation than did the prior (September) edition, but more FOMC members saw the risks to their inflation forecasts (both headline and core) as being balanced than saw the risks as weighted to the upside, the first time that had happened since the March 2021 SEP. Sure, fans of irony will no doubt note that was right before inflation took off on the way to a more than four-decade high, but we're too polite to point that out. Oops . . . In all seriousness, though, that point is perhaps not lost on many FOMC members, including Chair Powell, who continue to stress that inflation remains above the FOMC's target and worry that inflation might reaccelerate should the economy remain more resilient than expected. To that point, even the December SEP show the median FOMC forecast has both headline and core inflation remaining above 2.0 percent in Q4 2025, albeit only slightly by that point.



What is important to consider, however, is that even with inflation remaining above their target rate, there is still room for the FOMC to begin cutting the Fed funds rate as long as inflation continues to decelerate. The chart above shows the path of the real, or, adjusted for inflation, Fed funds rate and, as seen in the chart, the real funds rate is higher than at any point since prior to the Great Financial Crisis. What we think to be even more relevant is that the FOMC's estimates of the "neutral" nominal funds rate and the long-term trend rate of inflation put their estimate of the neutral real funds rate at 0.5 percent. While we don't think most FOMC members see it as being that low, the broader point is that the current value of the real funds rate is well above the neutral rate. Should inflation continue to decelerate as we, and the median FOMC forecast, anticipate, that would push the real funds rate higher, effectively making policy more restrictive even absent any further hikes in the nominal funds rate. Though some dismiss the real funds rate, focusing instead on overall financial conditions, we see the real funds rate as a meaningful signal of the stance of monetary policy, as do many FOMC members, some of whom have acknowledged the rationale of cutting the funds rate to keep policy from becoming more restrictive than it currently is.

If we are correct in anticipating a slower pace of economic growth, a modestly rising unemployment rate, and inflation decelerating further in 2024, that would be consistent with the FOMC beginning to cut the Fed funds rate even with inflation not yet back down to their 2.0 percent target rate. Though the March FOMC meeting may prove to be too early of a start date for rate cuts, we'd put that start no later than the May FOMC meeting.

Final Thoughts/Forecast Risks: We closed last year's outlook by noting that about the only thing we could be certain of was that by the end of 2023 the economy was unlikely to look as we, at the beginning of the year, expected it to, though we did not at the time know why that would be the case. Wow, talk about spot-on, dead-bang, on-the-money correct . . . Okay, maybe not. As we discuss this year's outlook, however, we feel more nervous than uncertain. After all, it has been several years since our outlook has been as close to the consensus outlook as it is at the start of 2024, which makes us more nervous than confident. It isn't as though we've intentionally distanced our forecast from the consensus, that's just how it's worked out which, more often than not, has worked out well for us. One danger in flocking to the consensus is that one runs the risk of joining a chorus saying pretty much the same thing, which can easily lead to false confidence and to not being fully mindful of the risks to one's forecast.

That said, as we do each year when offering our annual outlook, we'll also list some of what we see as the main risks, upside and downside, to our base case outlook. One key downside risk is that stress on liquidity and/or capital positions and concerns over credit quality and/or collateral valuations in segments of the banking system weigh on bank lending and, in turn, on growth in business and household spending. This could become a more pressing issue as higher-rate deposits reprice in a lower rate environment. The Fed's quarterly surveys of commercial bank loan officers show these issues to be mostly confined to smaller banks, but this is something that could weigh on economic activity in communities with a heavy reliance on such banks. In a similar vein, considerable refinancing activity in the commercial real estate and nonfinancial corporate segments could lead to stress in the financial system as debt reprices at higher rates, an issue which the recent declines in market interest rates will alleviate but not eliminate. Renewed supply chain/shipping disruptions could again throttle the supply side of the economy, thus holding down production and pushing up inflation. Finally, in what we expect will be a slower revenue growth environment, pressure on profit margins could weigh on capital spending and/or employment.

To the upside, balance sheets across most of the household and corporate sectors remain quite healthy, which could support faster spending growth than our baseline outlook anticipates. Continued steady growth in labor force participation and/or a sustained faster rate of growth in labor productivity would yield faster growth while further tamping down inflation pressures (again, the supply side of the economy is what matters most). Along those lines, a faster deceleration in core inflation would give the FOMC more latitude to cut the Fed funds rate. On the whole, we see the risks to our baseline 2024 outlook as being balanced.

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ECONOMIC OUTLOOK

January 2024

Q2 '23 (a)	Q3 '23 (a)	Q4 '23 (f)	Q1 '24 (f)	Q2 '24 (f)	Q3 '24 (f)	Q4 '24 (f)	Q1 '25 (f)		2021 (a)	2022 (a)	2023 (f)	2024 (f)	2025 (f)
2.1	4.9	1.4	1.7	1.6	2.0	2.4	2.5	Real GDP[1]	5.8	1.9	2.4	2.1	2.4
0.8	3.1	2.3	1.9	2.1	2.2	2.4	2.6	Real Personal Consumption[1]	8.4	2.5	2.2	2.2	2.5
7.4	1.4	2.6	1.2	0.7	2.1	3.6	4.5	Real Business Fixed Investment[1]	5.9	5.2	4.4	2.0	3.8
7.7	-4.4	2.2	-1.0	-1.4	2.3	5.6	6.2	Equipment[1]	6.4	5.2	-0.1	0.4	4.9
2.7	1.8	3.2	4.0	4.1	4.6	4.8	5.0	Intellectual Property and Software[1]	10.4	9.1	4.4	3.6	4.9
16.1	11.2	2.0	-0.5	-2.4	-3.6	-3.2	-0.2	Structures[1]	-3.2	-2.1	12.6	1.4	-1.0
-2.2	6.7	2.0	3.1	2.8	3.1	4.6	4.2	Real Residential Fixed Investment[1]	10.7	-9.0	-10.7	3.0	3.3
3.3	5.8	3.2	3.4	2.5	1.7	0.8	0.8	Real Government Expenditures[1]	-0.3	-0.9	4.0	3.1	1.1
-928.2	-930.7	-960.4	-985.0	-1,010.4	-1,015.4	-1,022.7	-1,033.4	Real Net Exports[2]	-933.8	-1,051.0	-938.6	-1,008.3	-1,052.8
930	967	1,021	952	972	988	1,002	1,008	Single Family Housing Starts, ths. of units[3]	1,132	1,004	938	978	1,012
520	403	402	395	392	389	383	379	Multi-Family Housing Starts, ths. of units[3]	474	547	469	390	380
1.7	4.5	5.4	5.0	4.5	2.8	1.9	1.8	CoreLogic House Price Index[5]	15.5	13.4	3.8	3.5	2.6
15.8	15.7	15.5	15.7	15.8	16.1	16.2	16.4	Vehicle Sales, millions of units[3]	14.9	13.8	15.5	16.0	16.6
3.6	3.7	3.7	3.8	3.9	4.0	4.0	4.1	Unemployment Rate, %[4]	5.4	3.6	3.6	3.9	4.0
2.5	2.1	1.8	1.5	1.2	1.1	0.9	0.8	Non-Farm Employment[5]	2.9	4.3	2.3	1.2	0.9
3.3	0.3	2.4	3.7	1.8	1.9	2.7	3.6	Real Disposable Personal Income[1]	3.2	-5.9	4.2	2.3	2.8
3.5	3.2	2.7	2.3	2.5	2.3	2.4	2.5	GDP Price Deflator[5]	4.6	7.1	3.7	2.4	2.4
3.9	3.3	2.7	2.1	2.0	2.0	2.1	2.2	PCE Deflator[5]	4.2	6.5	3.7	2.0	2.1
4.1	3.6	3.2	2.7	2.6	2.3	2.2	2.3	Consumer Price Index[5]	4.7	8.0	4.1	2.5	2.3
4.6	3.8	3.1	2.3	2.0	2.1	2.1	2.3	Core PCE Deflator[5]	3.6	5.2	4.1	2.1	2.3
5.2	4.4	3.9	3.2	2.6	2.4	2.2	2.3	Core Consumer Price Index[5]	3.6	6.1	4.8	2.6	2.5
5.03	5.30	5.38	5.34	5.07	4.84	4.39	4.20	Fed Funds Target Rate Range Mid-Point, %[4]	0.13	1.73	5.07	4.91	3.87
3.59	4.15	4.44	3.98	4.01	4.08	4.14	4.13	10-Year Treasury Note Yield, %[4]	1.44	2.95	3.96	4.05	4.18
6.51	7.04	7.30	6.57	6.44	6.38	6.31	6.25	30-Year Fixed Mortgage, %[4]	2.96	5.34	6.81	6.43	6.27
-3.2	-2.9	-3.2	-3.3	-3.2	-3.1	-3.0	-3.0	Current Account, % of GDP	-3.5	-3.8	-3.1	-3.2	-2.9

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2017 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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