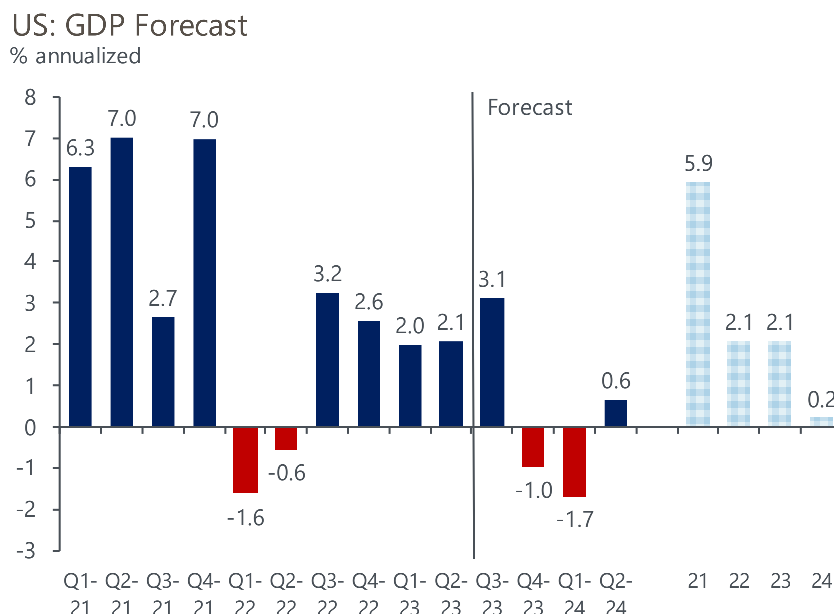
Research Briefing | US

Why a year-end slowdown is still our base case

- **We still think that the US economy is headed for a slowdown at the turn of the year. Three factors will increasingly weigh on growth: the impact of past rate rises; the drag from fiscal policy; and less resilient household finances.**
- **But we forecast only a mild contraction in output, so the downturn may not be broad or synchronized enough to meet the National Bureau of Economic Research's "widespread and persistent" criteria to classify it as a recession. That will be little comfort, though, for sectors such as real estate and manufacturing that are set to feel the brunt of the economic hardship.**
- **While we are sure about the three forces buffeting growth, the timing of their impacts is much less clear. It's very possible that they may not hit concurrently, which would avoid a contraction in activity but result in more persistent subpar growth.**
- **Alongside our pessimism on the growth outlook, we think inflation is likely to prove stickier than the market is anticipating. So, although our forecast for cuts to the Fed Funds Rate is broadly in line with market pricing, we think the risk of a more cautious Fed is skewed to the upside.**
- **Over the medium term, growth fundamentals still look uninspiring – we estimate potential growth will be around 1.5% over the medium term. Ultimately interest rates will need to fall back to a level that is consistent with this figure, but how quickly that happens will depend on the pace at which inflation expectations fall.**

Since the start of the year, the US economy has continually defied expectations of a marked slowdown. The resilience of consumer spending, the long lags of monetary policy, and a significant loosening of fiscal policy have all contributed to a better-than-expected outcome for growth. This in turn has kept inflation high and the Federal Reserve hiking more than many anticipated at the start of the year. But heading into 2024, is it right to expect this strength to hold up indefinitely, particularly if the Bureau of Economic Analysis is about to revise economic history, potentially altering the view on economic momentum?

Chart 1: Oxford Economics real GDP growth baseline forecast



Source: Oxford Economics/Haver Analytics

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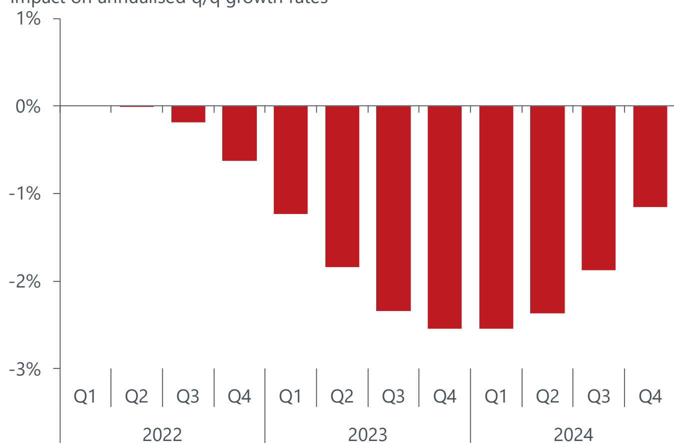
Our baseline forecast suggests not. It shows that we continue to expect a material slowdown in late 2023 and into early 2024. Our assessment is driven by our belief that the three supports for economic resilience so far are set to reverse, meaning we will see the impacts of tight monetary policy, tighter fiscal policy, and less resilient household finances showing more prominently in the data. Note, however, the -0.7% peak-to-trough contraction in output (**Chart 1**) that our forecast anticipates is so mild that the NBER may not classify it as a recession. Indeed, it would be similar in scale to the contraction in the first half of 2022, which didn't qualify.

The long-awaited impact from tighter monetary policy

It's hard to think of a time when the monetary transmission mechanism has been such a focus of attention outside of academic economics discussions, but it's crucial to understanding the chances of a soft landing. Those that argue that the transmission is quick, for example a few quarters, will feel that the economy has already withstood the worst of the tightening and faces a comparatively easy period ahead.

But we are not in that camp. Our analysis shows that, if anything, the lag in the monetary transmission mechanism has lengthened (**Chart 2**) as the debt maturity for firms and households has risen. This analysis suggests that the peak impact of higher rates is likely to occur around the turn of the year.

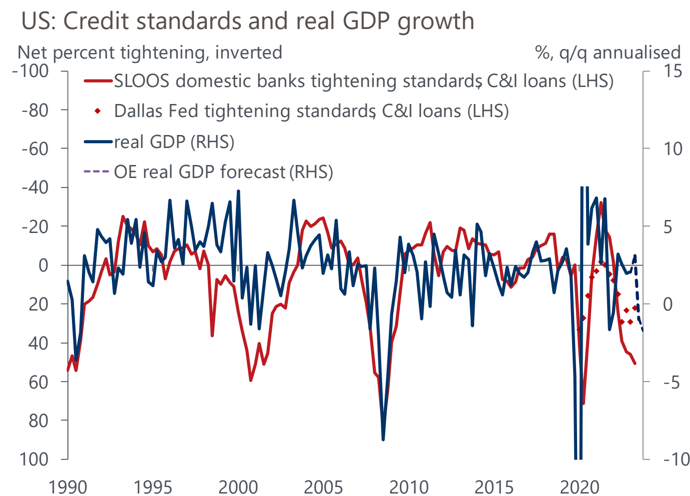
Chart 2: We estimate the negative impulse from past tightening will peak at the turn of the year



Source: Oxford Economics/impacts estimated using a Bayesian VAR over 2000q1 to 2022q4

A symptom of the tightening in monetary conditions from rising interest rates and quantitative tightening is the shift in bank credit standards. Having tightened significantly since the start of the year, these surveys are now at levels consistent with a contraction in output over the coming quarters (**Chart 3**).

Chart 3: Credit standards and real GDP growth



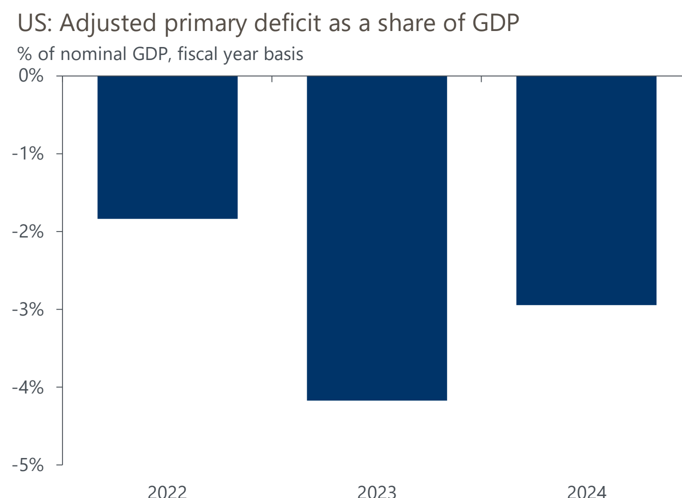
Source: Oxford Economics/Haver Analytics

Fiscal policy will start to drag

But monetary policy is not the only force acting on the economy. Since the pandemic, fiscal policy has been a major impetus for growth and has arguably helped to mask some of the impact of monetary policy. But that's set to change.

Accounting for changes in debt interest payments and the impact of student loan forgiveness, a clean read of the government deficit reveals that fiscal policy has been a significant boost to the economy this year (**Chart 4**). Several factors led to the underlying deficit widening this year: individual income tax collections were down nearly 19% for the fiscal year through August; social security beneficiaries received a record cost-of-living increase in 2023; and spending on infrastructure was higher. Such has been the magnitude of these factors that they have led to a widening deficit despite the expiration of the last of the pandemic support measures, including food stamps and Medicaid.

Chart 4: Adjusted deficit shows a tightening in fiscal policy is coming



Source: Oxford Economics

As we head into 2024, fiscal policy will shift from adding 2.3% of GDP to subtracting 1.2%, as the effects of the CHIPS and Inflation Reduction Acts wane. We also assume some reduction in discretionary spending in 2024 in line with the Fiscal Responsibility Act.

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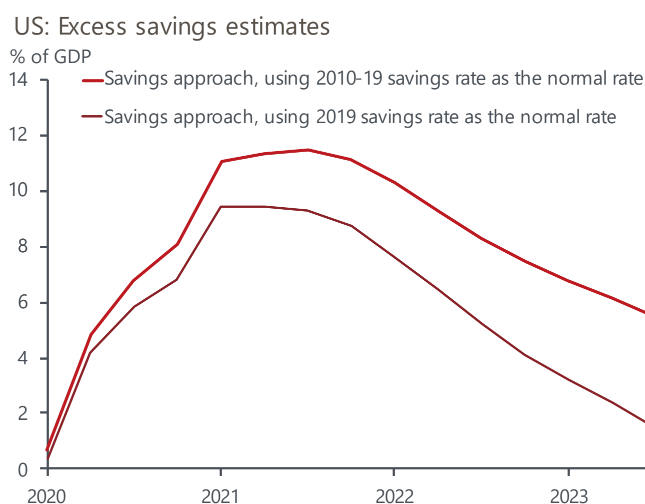
Consumers have used up their buffers

Relatedly, consumer spending is also set to switch from being a major boost to the economy this year to playing a more subdued role. We see two reasons for this: consumers have exhausted their excess savings buffers; and income growth is set to slow. Both are subject to considerable uncertainty, but in our view the most likely scenario is a significant slowing of consumer spending.

As we have discussed before, excess savings can be measured in many ways, but none are exact. We don't have a precise figure for the fundamental underlying rate of household saving, but we do know that on any measure the vast majority has now been spent (**Chart 5**). We tend to agree with the Fed, which believes that excess savings have now been entirely depleted and that the boost to consumer spending from savings is about to run out entirely.

The implication of depleted savings is that the savings rate should rise gradually from here to more normal levels. This would limit the growth of consumer spending relative to disposable income growth after a long period in which the opposite has been true.

Chart 5: Excess savings



Source: Oxford Economics/Haver Analytics

Meanwhile, as the labor market cools, household income growth is also set to decline. While wage growth is set to remain relatively high, employment growth has slowed, and this is a more important determinant of overall income growth. Add to that the impact of rising interest rates (debt interest is negative income), and we expect nominal household incomes to grow by 4.7% in 2024, down from 7.4% in 2023. In real terms, despite the cooling of inflation, real income growth is set to decline by around 1.4ppts to just over 2%. As a result, we see consumer spending slowing abruptly to just 0.6% in 2024, down from 2.4% this year.

Signs that

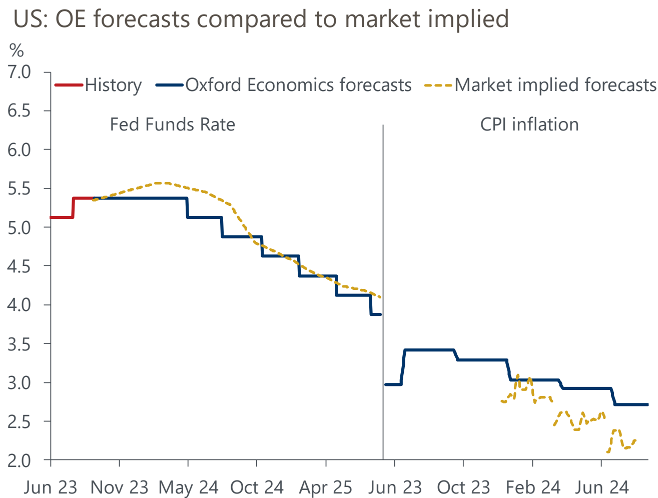
Other risks are marginal, but could play a role

In addition to these three factors – tight monetary policy, tightening fiscal policy, and slowing consumer spending – there are also near-term risks to growth in the form of a potential government shutdown and the United Auto Workers strike. By themselves, neither are likely to be catalysts for a deeper downturn, with activity bouncing back once agreements are struck. But they may just take momentum out of the economy at a point when it is struggling under the weight of policy tightening.

Market expectations are out of kilter

Rather than focusing on the three headwinds to growth, markets (and many other forecasters) have moved to price-in a much more benign outcome for the economy in the quarters ahead. This is largely due to the ongoing strength in activity data. So, when comparing our forecast for the Fed funds rate versus the market, they look very similar (**Chart 6**). Conversely, comparing our inflation forecast with the market, we appear far more pessimistic on how quickly inflation will fall. How do we explain this discrepancy?

Chart 6: Our baseline fed funds rate and inflation forecasts versus the market



Source: Oxford Economics/Haver Analytics/Macrobond

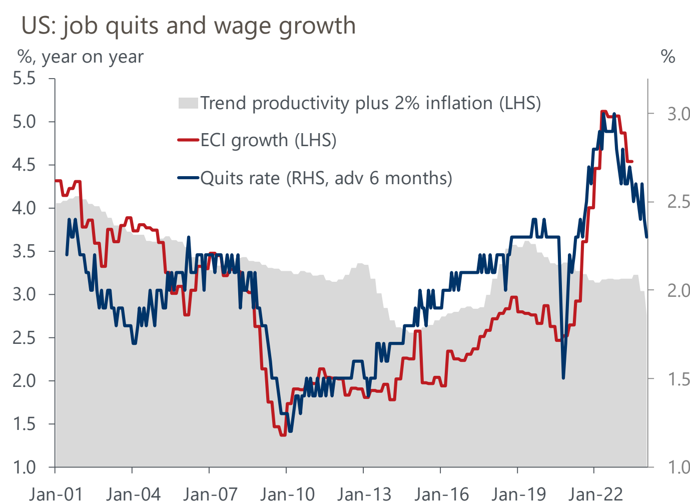
Ultimately, we are far more concerned about the stickiness of inflation than the market seems to be. Our inflation forecast, which is conditional on our below-consensus forecast for demand, is higher than market pricing. In our view, the next leg of the inflation battle is likely to be harder. Headline inflation has come down, but a large proportion of this is related to energy prices and one-offs that will not be repeated in the next few quarters. Even the most recent inflation data showed a 0.7% jump as energy prices rose, and there are upside risks as oil prices continue to climb.

Other risks include further supply disruptions which may impact goods disinflation. As we have noted, the UAW strikes come at a time when auto inventories are recovering from low levels and could result in further upward pressure on vehicle prices.

Furthermore, some of the recent disinflationary impetus in core inflation may prove less persistent than the market expects. Take wage growth for example. Wages have fallen back on most measures, as you would expect when employment slows. However, the difference between wage growth for job movers (which have fallen back from the peak in January of 7.7% to 6.8% in August) and stayers (at around 5.5% according to the Atlanta Fed) suggests that the disinflationary momentum over the longer term might disappoint.

In any case, what much of the discussion around wage growth and its near-term path misses is that with productivity growing at around 1%, wage growth has a long way to fall to the 3% approximate level that is consistent with 2% inflation (**Chart 7**).

Chart 7: Wage growth, productivity, and the quits rate



Source: Oxford Economics/Haver Analytics

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Relative to our view, we believe the risks to both growth and inflation are both to the upside. The timing of the impacts of the three forces that we have described is uncertain and they could easily fail to overlap, helping to raise the outlook for the economy. But in that scenario the risks to interest rates are also then to the upside, as the Fed would need to undertake further tightening to cool inflation.

Faced with this environment, we think that the Fed's FOMC will continue to place a lot of weight on developments in inflation data relative to activity, and will maintain a hawkish outlook over the course of next year. Added to that, the uncertainty surrounding where the neutral rate of interest is – and therefore how restrictive policy is – means we think the Fed will take a more cautious approach to reducing rates in this cycle, assuming no major slowdown in the economy.

The medium-term outlook remains subdued

Ultimately, we continue to think that rates will settle at a lower level in the long term as weak economic fundamentals reassert themselves. But the journey from the peak of this cycle to there could be protracted as inflation expectations may take a while to fall back after such a heavy jolt, which is looming large in households and firms' recent memories.

Our confidence on the prospects for the real side – i.e., adjusted for inflation – of the economy is much higher. We estimate potential growth in the US is around 1.5%, based on continued moderate labor supply growth, weakening dynamism, and a weaker rate of capital accumulation.

Over the next five years, this return to the pre-pandemic slow-growth equilibrium is likely to become more and more apparent as the effects of the pandemic disruption fade in labor and product markets. As is the case now, the nominal side of the economy will remain the larger uncertainty.