QUEST Economic Update | July 2023

The US consumer and US labor markets were resilient through first half of 2023 despite elevated inflation and historic monetary tightening

Despite a challenging economic landscape of persistent inflation and historic Federal Reserve tightening, the US economy's resilience during the first half of 2023 surprised many economic forecasters. In the first quarter, consumers spent at a robust pace despite higher prices. Businesses continued hiring workers, keeping the unemployment rate near historic lows as inflation slowly ticked down.

The June Consumer Price Index (CPI) increased by 3.0% from 12 months ago, well below its peak of 9.1% in June 2022. The Federal Reserve's steep interest rate hikes beginning in March 2022 were expected to both slow inflation and the economy. While inflation has gradually subsided, by some measures, it remains elevated and well above the Federal Reserve's 2% inflation target. In addition, the economy has shown surprising resilience with real gross domestic product (GDP) increasing by 2.0% (annualized) during the first quarter. Additionally, both consumer spending and retail sales picked up in April and May. The June unemployment rate remained near historic lows at 3.6%. These better-than-expected numbers tripled the Blue Chip consensus forecasts of 2023 growth from 0.5% in January to 1.6% in June.

Notwithstanding the good news on inflation in the June CPI report, inflation remains elevated. The Personal Consumption Expenditures (PCE) price index, the Federal Reserve's preferred inflation measure, had prices rising by 3.8% in May from a year ago. The core-PCE price index, which excludes the more volatile energy and food prices, increased by 4.6% in May.

Although the Federal Reserve appears near the end of its cycle of tightening, it is expected to increase the federal funds target rate by 25 basis points at its July 25-26 meeting with additional hikes if inflation remains elevated.

Ernst & Young LLP's Quantitative Economics and Statistics (QUEST) group's Economic Update summarizes the latest US economic trends and significant global developments.

Current as of 7/14/2023

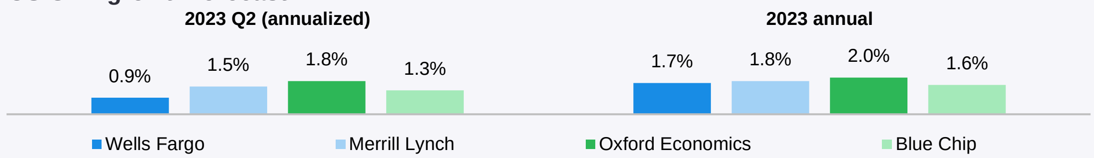
OVERALL US ECONOMY

The economic picture appears to have improved during the first half of 2023. Nevertheless, economic growth is expected to slow with some forecasts projecting a possible recession over several quarters, beginning in the second half of this year.

0.9% to 1.8% growth expected for 2023 Q2 (annualized)

1.6% to 2.0% growth expected for 2023

US GDP growth forecast



LABOR MARKETS

Labor markets remain tight, with the June unemployment rate falling to 3.6% from 3.7% in May. Some signs of loosening include a gradual decline in monthly job gains from last year and job openings falling from their highs in early 2022.

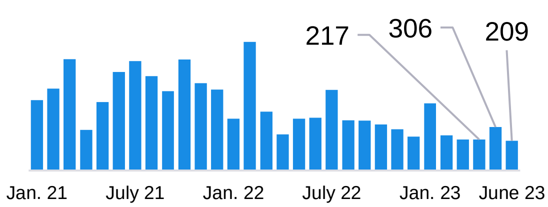
606k job gain on average in 2021

399k job gain on average in 2022

314k job gain on average in 2023

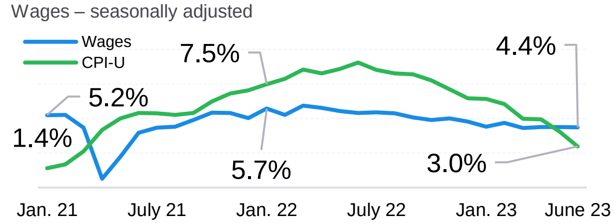
Nonfarm payroll employment

Month-over-month change (in thousands), seasonally adjusted



Hourly wages and CPI-U

Change from a year earlier, CPI - not seasonally adjusted, Wages – seasonally adjusted

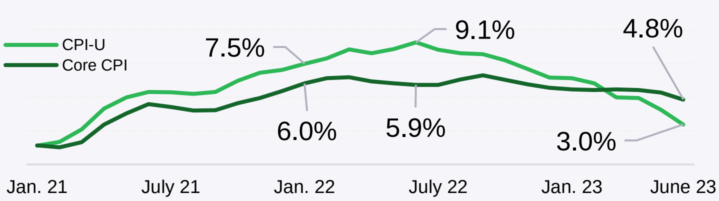


INFLATION / INTEREST RATES

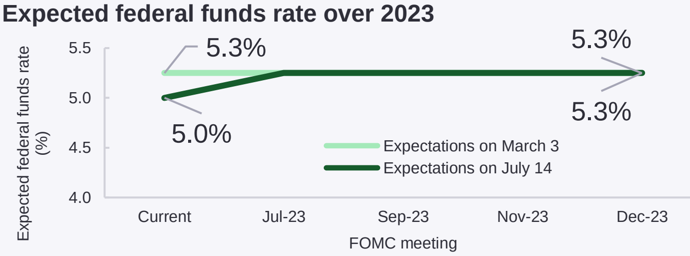
The June inflation numbers indicated that overall inflation subsided to a greater extent than expected. Nevertheless, core inflation, which excludes volatile energy and food prices, remains elevated. Market expectations are for the Federal Reserve to raise interest rates at its July 25-26 meeting and hold them constant through the end of 2023.

CPI-U and core CPI

Change from a year earlier, not seasonally adjusted

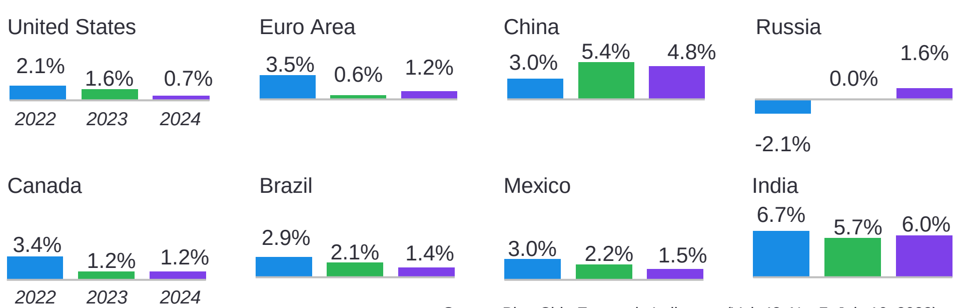


Expected federal funds rate over 2023



GLOBAL GROWTH

Forecasts, while generally still suggesting slowing global economic growth in 2023, have improved over the past few months. China's economy appears to be facing renewed challenges.



Source: Blue Chip Economic Indicators (Vol. 48, No. 7, July 10, 2023).

Upcoming economic data releases

- Housing starts for May, July 19
- Interest rates, Federal Open Markets Committee (FOMC) meeting, July 25-26
- GDP for the second quarter of 2023 (first estimate), July 27
- Job openings for June, August 1
- Employment situation for July, August 4
- Consumer Price Index for July, August 10
- Producer Price Index for July, August 11

Overall US economy

Although the US economy faced significant headwinds during the first half of 2023, it proved to be surprisingly resilient. The resurgence of inflationary pressures in January and February appears to have subsided in the subsequent four months and continues a steady, albeit slower than preferred, return to the Federal Reserve's 2% target.

With all these factors in play, the Federal Open Market Committee (FOMC) left the federal funds rate target unchanged at its June 13-14 meeting but is expected to increase the target rate by 25 basis points at its July 25-26 meeting and possibly leave rates unchanged until early 2024. Chair Powell has indicated that he does not expect inflation to reach the Federal Reserve's 2% target until 2025.

The June unemployment rate fell to 3.6% from 3.7% in May and remains well below the roughly 4.4% - 4.5% range that economists view as consistent with full employment. June job gains were 209,000, which was lower than the 306,000 job gains in May and lower than the average job gains of 283,000 in the prior sixth months.

The Conference Board's consumer confidence index increased to 109.7 in June from 102.5 in May. Housing starts rose 21.7% in May and are 5.7% above May 2022. The ISM Manufacturing Employment Index fell to 48.1 in June from 51.4 in May (values below 50 indicate contraction).

First quarter real GDP grew at an annualized rate of 2.0%, buoyed by strong consumer spending, which grew at a 4.2% annualized rate, mostly occurring in January. Retail spending rebounded in April and May after being nearly flat for two months. Consumer spending also picked up in April. The better-than-expected performance had caused some forecasters to lift their economic forecasts for the latter half of 2023. Nevertheless, some forecasters still see a possible recession or recession-like conditions lasting several quarters, beginning in the second half of this year.

Labor market

US labor markets remain tight. The June unemployment rate fell to 3.6% from 3.7% in May. The unemployment rate is well below the 4.4% average for the US economy from 2015 through 2019. Many economists view the unemployment rate at which the economy's resources are fully employed to be in the range of 4.4% to 4.5%. The economy added 209,000 jobs in June, below the 306,000 jobs added in May and lower than the average job gains of 283,000 in the prior six months. Weekly UI claims have been gradually increasing since mid-January and are now close to, albeit slightly below, pre-pandemic levels. Job openings in May fell by 0.5 million and are well below their highs from early 2022.

The labor force participation rate remained at 62.6% in June, 0.8 percentage point below the pre-pandemic level. The June underemployment rate, which averaged 8.7% from 2015 through 2019, rose to 6.9% from 6.7% in May. Average hourly earnings were up in June by 4.4% from a year ago, a pace above the rise in consumer prices signifying an increase in real wages.

Despite the current tightness of the labor markets, many forecasters see the unemployment rate rising by roughly one percentage point or more over the next year. The economic forecasts suggest that the Federal Reserve's higher interest rates will begin to take hold and slow the economy in the second half of 2023

Inflation

The June CPI report came in below expectations, with overall inflation suggesting that inflationary pressures continue to subside, albeit slower than preferred. Core inflation, which excludes the more volatile energy and food prices, remains elevated.

The overall CPI rose by 3.0% in June following its 4.0% increase in May. The monthly June CPI rose 0.2%, following its 0.1% increase in May. The core CPI rose by 4.8% (y/y) in June, slightly below its 5.3% increase in May. The monthly core CPI rose by 0.2% in June.

The price index for shelter, which rose 0.4%, was the largest contributor to the monthly increase in the overall CPI. The indices for food away from home, energy commodities, energy services, apparel, medical care commodities and transportation services also increased. The index for used cars and trucks was the only significant index that decreased.

The market expects the FOMC to increase the federal funds target rate by 25 basis points at its July 25-26 meeting, hold rates steady for the remainder of 2023, and begin lowering them in early 2024.

Global growth

The global economy is expected to slow during the rest of 2023, with growth in the 1.5% to 2.5% range. Economic growth is expected to slow in the United States, the United Kingdom and the Eurozone. That said, recent forecasts are somewhat less pessimistic than a few months ago, although recession risks remain in the United States, United Kingdom and Eurozone.

Although China showed significant strength coming out of its COVID lockdowns, its economy now appears to be experiencing some headwinds due to difficulties in its real estate sector, high debt levels, and weaker than expected consumer demand. In contrast to the United States and Europe, inflation is currently not a problem in China and its central bank recently lowered interest rates to help spur economic growth.

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