QUEST Economic Update | August 2023

The US economy continues to impress through the summer; inflation remains elevated

As summer's end approaches, the American economy's resilient growth and labor market continue to impress. Inflation has come down but remains elevated with some signs of possible resurgence. American consumers have not stopped spending and, although hiring slowed, businesses continue adding jobs, keeping the unemployment rate near historic lows. All this occurred even with inflation falling slower than anticipated and remaining elevated.

In the second quarter, US gross domestic product (GDP) growth was surprisingly strong at a 2.4% (real annualized) rate. Consumer spending was responsible for nearly half of the GDP growth. Rebounding private investment contributed nearly a percentage point to second quarter GDP growth. The July unemployment rate fell to 3.5%, remaining near 60-year lows for over a year. Retail sales grew for the fourth straight month after falling in February and March. With the better-than-expected numbers, the Blue Chip consensus forecast for 2023 GDP growth increased to 2.0% from the 1.6% reported in the prior month.

Even with the good news, inflation remains persistently elevated. The July Consumer Price Index (CPI) increased 3.2% from 12 months ago, somewhat higher than the 3.0% reported in June. The core CPI, which excludes the more volatile energy and food categories, rose by 4.7% in July from 12 months ago. The Federal Reserve's preferred inflation, the Personal Consumption Expenditure price index, also remained elevated at 3.0% in June. The Federal Reserve raised the federal funds target rate by 25 basis points at its July 25-26 meeting. The meeting minutes revealed considerable uncertainty and debate about the full effects of the rate hike cycle and whether the Federal Reserve is at the end of its interest rate increasing cycle.

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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 8/18/2023

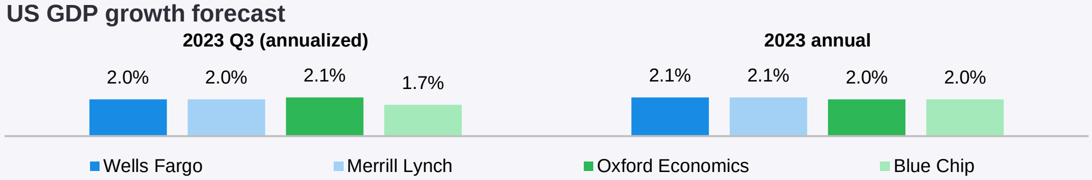
OVERALL US ECONOMY

The economic picture appears to have improved during the first half of 2023. Nevertheless, economic growth is expected to slow but fewer forecasts project a possible recession starting in 2023, although some suggest a recession or recession-like conditions during the first half of 2024.

Roughly 2.0% growth expected for 2023 Q3 (annualized)

Roughly 2.0% growth expected for 2023

US GDP growth forecast



LABOR MARKETS

Labor markets remain tight, with the July unemployment rate falling to 3.5% from 3.6% in June. Some possible signs of loosening include a gradual decline in monthly job gains from last year and job openings falling from their highs in early 2022.

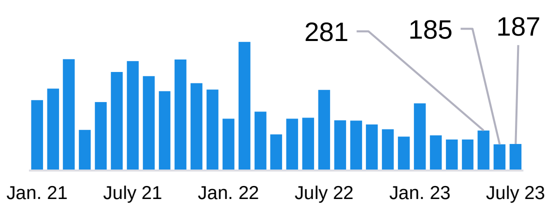
606k job gain on average in 2021

399k job gain on average in 2022

258k job gain on average in 2023

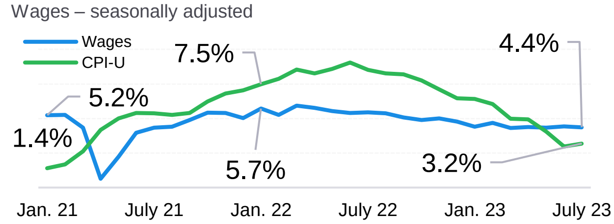
Nonfarm payroll employment

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

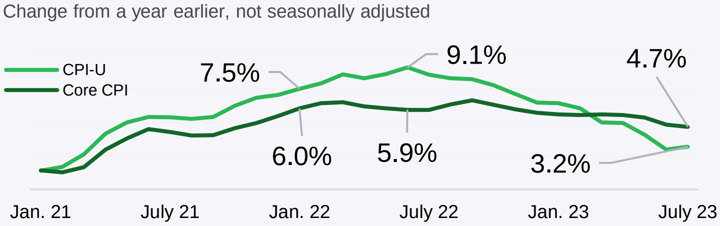


INFLATION / INTEREST RATES

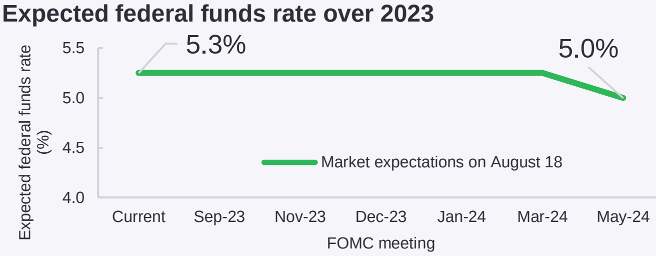
The July inflation numbers indicated that overall inflation, while below highs last year, is still elevated. Additionally, core inflation, which excludes volatile energy and food prices, remains elevated. The Federal Reserve raised interest rates 25 basis points at its July 25-26 meeting and markets expect them to hold constant through the end of 2023. The Federal Reserve's July meeting minutes indicate that future hikes could be on the table.

CPI-U and core CPI

Change from a year earlier, not seasonally adjusted

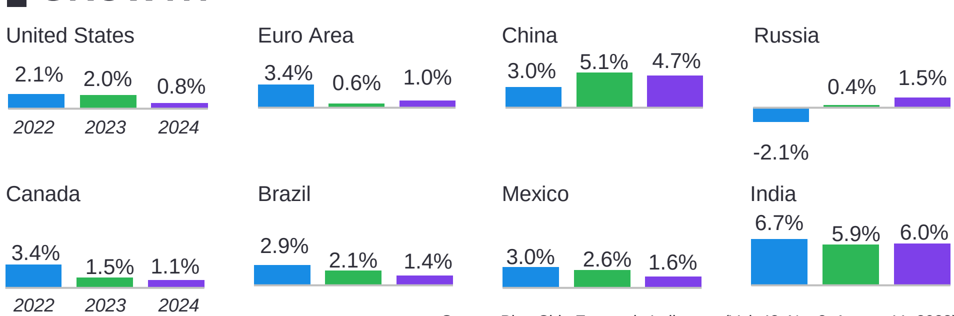


Expected federal funds rate over 2023



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 with the possibility of deflation.



Source: Blue Chip Economic Indicators (Vol. 48, No. 8, August 11, 2023).

Upcoming economic data releases

- Job openings for July, August 29
- GDP for the Q2 of 2023 (second estimate), August 30
- Employment situation for August, September 1
- Productivity for Q2 (revised), September 7
- Consumer Price Index for August, September 13
- Housing starts for July, September 19
- Interest rates, Federal Open Markets Committee (FOMC) meeting, September 19-20

Overall US economy

The US economy continued its resilient growth through July. The resurgence of inflationary pressures early in 2023 have subsided with a generally gradual descent of the overall inflation rate, albeit slower than anticipated. Strong economic growth could translate into renewed inflationary pressures.

Second quarter real GDP grew at an annualized rate of 2.4%, buoyed by strong consumer spending and private investment, which grew at 1.6% and 5.7% annualized rates, respectively. Private investment had robust growth after shrinking in the first quarter. Retail spending has rebounded in every month after starting the year with two nearly flat months. As the better-than-expected economic performance continues, more forecasters have lifted their economic forecasts for the latter half of 2023. The Federal Reserve Bank of Atlanta's GDPNow forecast projects real annualized GDP growth of 5.8% for the third quarter (as of August 16).

With all these factors in play, the Federal Open Market Committee (FOMC) raised the federal funds rate target by 25 basis points at its July meeting, as expected. Market expectations suggest that the FOMC will leave interest rates unchanged until early 2024. The minutes from the July meeting, however, suggest that there is debate within the FOMC about whether more hikes are appropriate.

The July unemployment rate fell to 3.5% from 3.6% in June, well below the roughly 4.4%- 4.5% range that economists view as consistent with full employment. July job gains were 187,000, essentially the same as the 185,000 job gains in June and lower than the average job gains of 270,000 in the first six months of the year.

The Conference Board's consumer confidence index fell slightly in July to 106.1 from 106.2 in June. Housing starts rose 3.9% in July and are 5.9% above July 2022. The ISM Manufacturing Employment Index fell to 44.4 in July from 48.1 in June (values below 50 indicate contraction).

Labor market

US labor markets remain tight. The July unemployment rate fell to 3.5% from 3.6% in June. 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 187,000 jobs in July, essentially the same as the 185,000 jobs added in June and lower than the average job gains of 270,000 in the first six months of the year. Weekly UI claims have been gradually increasing since mid-January and are now close to, albeit slightly below, pre-pandemic levels. Job openings in June were little changed from May but are well below their highs from early 2022.

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

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. Many economic forecasts suggest that the Federal Reserve's higher interest rates will begin to take hold and slow the economy in late 2023 and the beginning of 2024.

Inflation

The July CPI report matched expectations, with overall inflation suggesting that inflationary pressures continue to subside but could remain persistently higher than 2%. Core inflation, which excludes the more volatile energy and food prices, remains elevated.

The overall CPI rose by 3.2% (y/y) in July following its 3.0% increase in June. The monthly July CPI rose 0.2%, following its 0.3% increase in June. The core CPI rose by 4.7% (y/y) in July, slightly below its 4.8% increase in June. The monthly core CPI rose by 0.2% in July.

The price index for shelter, which rose 0.4%, was the largest contributor to the monthly increase in the overall CPI, contributing over 90% of the increase. The indices for food at home, food away from home, energy commodities, energy services, apparel, medical care commodities and transportation services also increased. The index for new vehicle and used cars and trucks were the only significant indices that decreased.

The market expects the FOMC to hold rates steady for the remainder of 2023 and begin lowering them in early 2024. The minutes from the July meeting, however, suggest that there is debate within the FOMC about whether pausing or more hikes are appropriate.

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 more optimistic than a few months ago, although recession or recession-like 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 headwinds due to difficulties in its real estate sector, high debt levels and weaker than expected consumer demand. Recent consumer price data from China suggest that the country could be experiencing deflation for the first time in two years. This is in contrast to the United States and Europe, where inflation is the problem.

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