QUEST Economic Update | May 2024

US economy continues to slow with tight monetary policy having its intended impact

The April Consumer Price Index (CPI) report brought better news on inflation, but the widespread view is that the Federal Reserve will likely have more work to do. Federal Reserve Chairman Jay Powell recently stated, "We'll need to be patient and let restrictive policy do its work." The Federal Reserve's restrictive policy appears to be impacting the economy as the labor market cools, economic growth slows, and retail sales stall. CPI inflation has been around 3.5%, but Personal Consumption Expenditures (PCE) inflation, the Federal Reserve's preferred measure, has been around 2.7%. The concern, however, is that inflation remains stubbornly above the Federal Reserve's 2% target.

In April, job gains slowed to 175,000 and the unemployment rate increased to 3.9%. Gross domestic product (GDP) expanded at a tepid 1.6% seasonally adjusted annual rate during the first quarter, but the Atlanta Fed's GDPNow projects GDP increasing by 3.6% during the second quarter. The consensus economic forecast sees the US economy growing by 2.4% in 2024.

Although the US economy appears to be slowing, there are no signs that it will stall. The US unemployment rate has been well below historical averages and average wages continued to exceed inflation in April. The mixed economic data, especially on the inflation front, suggests the Federal Reserve will likely hold interest rates at their current level for several months to assess progress on inflation.

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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 05/23/2024

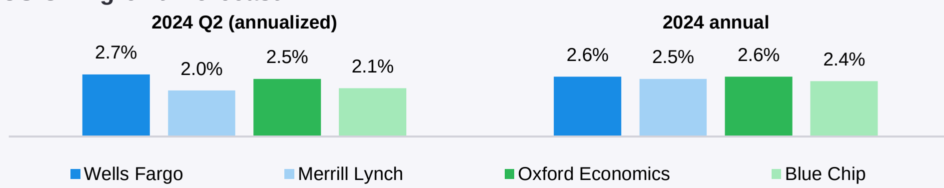
OVERALL US ECONOMY

The consensus is that the economy will achieve a soft landing with moderate growth. Real annualized GDP increased by 1.6% during the first quarter of 2024. The Atlanta Fed's GDPNow forecast sees GDP increasing by 3.6% during the second quarter of 2024 (as of May 16). The consensus forecast expects the economy to expand by 2.4% in 2024 overall.

Roughly 2.0% to 2.7% growth
expected for 2024 Q2 (annualized)

Roughly 2.4% to 2.6% growth
expected for 2024

US GDP growth forecast



LABOR MARKETS

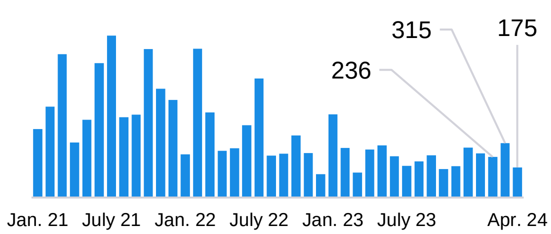
In April, the unemployment rate rose to 3.9% and job gains slowed to 175,000. The unemployment rate has remained in a narrow range of 3.7% to 3.9% since August 2023. Job openings have generally fallen but remain above the number of unemployed, and weekly unemployment insurance claims remain near historic lows. Overall, this data suggests some loosening but a labor market that remains tight.

377k job gain
on average in 2022

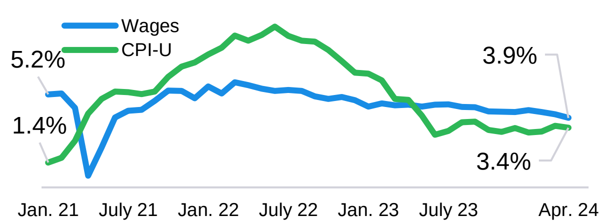
251k job gain
on average in 2023

269k job gain
on average in Q1 of 2024

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



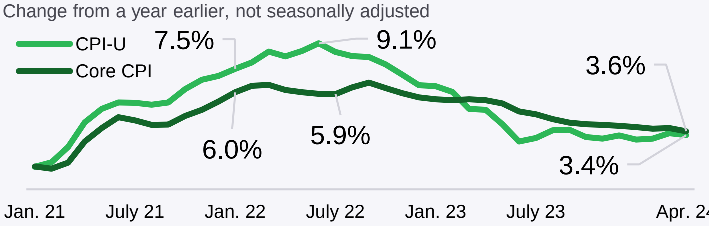
Hourly wages and CPI-U
Change from a year earlier, CPI - not seasonally adjusted,
Wages – seasonally adjusted



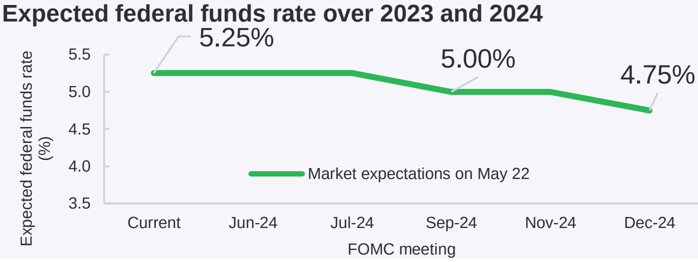
INFLATION / INTEREST RATES

Overall inflation remains elevated. In April, the overall and core CPI rose by 3.4% and 3.6%, respectively. The overall and core PCE price index, the Federal Reserve's preferred inflation measure when setting monetary policy, rose by 2.7% and 2.8%, respectively, in March. Market expectations suggest that the Federal Reserve will not begin to lower its target interest rate until September 2024 with a second reduction expected in December 2024.

CPI-U and core CPI
Change from a year earlier, not seasonally adjusted

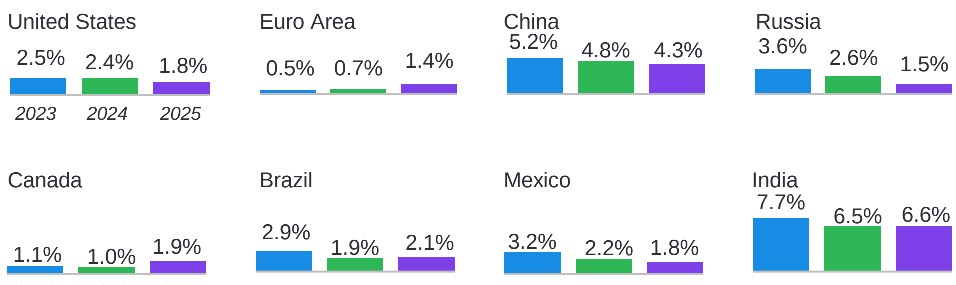


Expected federal funds rate over 2023 and 2024



GLOBAL GROWTH

Forecasts, while generally still suggesting slowing global economic growth in 2024, have improved over the past few months. China's economy, however, is facing challenges seen by weak consumer demand and high debt levels, especially in its real estate sector, as well as possible deflation.



Source: Blue Chip Economic Indicators (Vol. 49, No. 4, April 10, 2024).

Upcoming economic data releases

- Q1 2024 GDP (second estimate), May 30
- Personal Consumption Expenditure Price Index for April, May 31
- Job openings for April, June 4
- Employment situation for May, June 7
- Interest rates, Federal Open Markets Committee (FOMC) meeting, June 11-12
- Consumer Price Index for May, June 12

Overall US economy

The Federal Reserve, which has a price stability and full employment mandate, is likely not currently concerned about labor markets but is more worried about inflation. The US economy continued showing indications of slowing with April job gains of 175,000, an uptick in the unemployment rate to 3.9%, and first quarter GDP growing at a 1.6%. The data suggests some of the labor market metrics have some distance to go before they would become a concern. Alternatively, inflation has been higher for longer than the Federal Reserve or economists had expected.

The overall CPI increased by 3.4% in April (y/y) and the core CPI, which excludes the more volatile energy and food components, increased by 3.6%. Although these numbers are high, market participants welcomed them because CPI-inflation had been rising for the first three months of the year. The PCE price index reversed its decline in March with the overall index increasing 2.7% and the core index increasing 2.8%. Both are still above the Federal Reserve's 2% target. Even though the economy is slowing, it is slowing from very high levels and generally continues to grow above trend.

Inflation's stubbornness above the Federal Reserve's 2% target is a major factor contributing to the market's expectations that the Federal Open Market Committee (FOMC) will keep its target interest rate the same for the seventh time at its June meeting. Markets expect that the FOMC will keep rates "higher for longer" with the first reduction in the Federal Reserve's target rate occurring at the FMOC's September meeting followed by a second reduction at its December meeting.

If this moderate growth continues, the economy appears to be settling for a soft landing in 2024, with economic growth close to trend, the unemployment rate settling just above 4%, and inflation continuing to abate.

Labor market

US labor markets remain tight. The April unemployment rate increased to 3.9%, 0.1 percentage point above the 3.8% in March. Although the unemployment rate is above historic lows, it is still well below the roughly 4.5% rate at which most economists view the economy's resources to be fully employed.

The economy added 175,000 jobs in April, down from the 315,000 jobs added in March. First quarter job gains averaged 269,000, while they averaged 251,000 in 2023 and 377,000 in 2022. Weekly UI claims remain below pre-pandemic levels. Job openings have been generally falling since their high in early 2022 but remain well above unemployment.

The labor force participation rate remained at 62.7% in April, the same as March and 0.2 percentage point above the rate in February and January. The March underemployment rate, which averaged 8.7% from 2015 through 2019, increased 0.1 percentage point to 7.4% in April. Average hourly earnings were up in April by 3.9% from a year ago, a pace above the 3.4% increase in the overall CPI for April (y/y) and the 3.6% increase in the core CPI.

The continued tightness of the labor markets has pushed forecasters to project that the unemployment rate will settle between 3.8% to 4.2% in 2024, lower than previously expected.

Inflation

The gradual year and a half decline in inflation appears to have stalled, with inflation settling more than 70 basis points above the Federal Reserve's 2% target. The recent stubbornness of inflation likely played into the Federal Reserve's decision to keep interest rates the same at the past six FOMC meetings and is likely to be a factor at the June meeting where another pause is highly expected. The Federal Reserve has signaled that it may hold interest rates higher for longer. Markets expect the first reduction in the target rate to occur at the September FOMC meeting followed by a second reduction at its December meeting.

The overall CPI rose by 3.4% (y/y) in April, following its 3.5% increase in March and 3.2% increase in February. The monthly April CPI increased by 0.3%, after a 0.4% increase in March and February. The core CPI rose by 3.6% (y/y) in April, 0.2 percentage point lower than the rate in March. The monthly core CPI rose by 0.3% in April, 0.1 percentage point lower than the increase in March and February. Shelter prices rose 5.5% in April. Shelter and gasoline prices were responsible for over 70% of the CPI increase. The Federal Reserve Bank of Cleveland's inflation nowcast forecasts the increase in the CPI for May to remain unchanged from April (i.e., a 3.4% increase) (as of May 22).

The PCE price index, the preferred inflation measure of the Federal Reserve, increased by 0.3% in March, the same as its increase in February and below its 0.4% decrease in January. From its level 12 months earlier, the PCE price index increased by 2.7% in March above the 2.5% increase in February. The core-PCE price index increased by 0.3% in March, unchanged from February, and by 2.8% over the past 12 months, unchanged from February. The Cleveland Fed's inflation nowcast expects the core PCE to increase by 2.7% in April (as of May 22), suggesting stubbornness for bringing inflation down further.

The FOMC left interest rates unchanged at its May meeting. Markets expect the FOMC to hold rates steady at its June meeting and begin to lower them in September followed by a second reduction in December.

Global growth

The global economy is expected to slow during 2024, with growth in the 1.5% to 2.5% range. Although forecasts of recession have been dissipating, Germany and the United Kingdom all narrowly avoided two quarters of shrinking GDP, which would have signaled they were in a recession. Japan's economy shrank at a 2.0% annualized rate in the first quarter of 2024 and the Bank of Japan continues to intervene in foreign exchange markets to prop up the yen.

Although China showed significant strength coming out of its COVID lockdown early last year, 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, as well as possibly deflation.

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