3Q2023 U.S. Economic Outlook

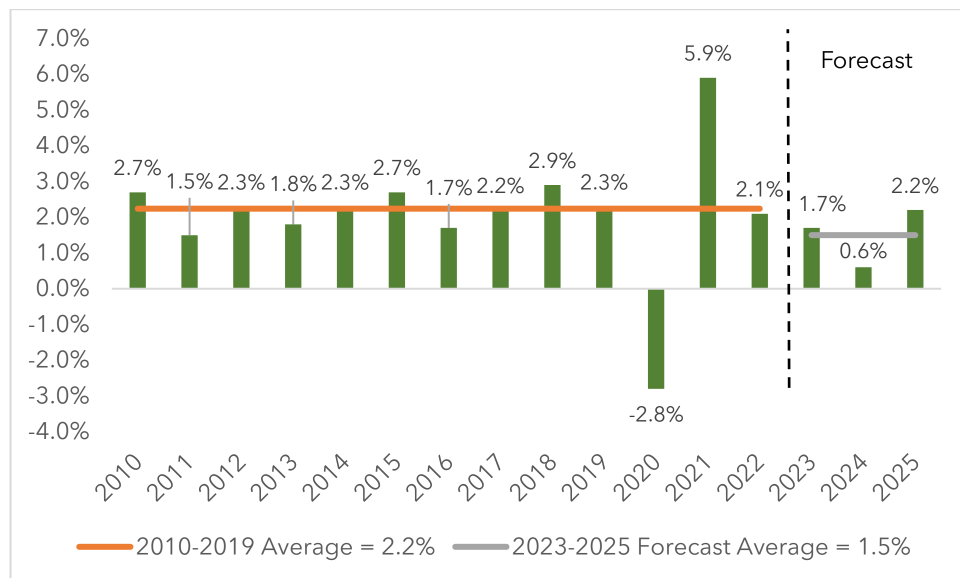
Highlights

- Economy can still avoid a recession
- Less labor market distress
- Inflation should continue slowing
- Rates unlikely to pull back much this year
- CRE in a holding pattern

Across key facets, the economy performed well during the second quarter. Economic growth continues to outperform expectations. The labor market remained incredibly tight, bolstering spending and consumer spirits. And inflation slowed significantly. All this supported equity markets, which pushed higher, into bull-market territory. But the Fed continued to tighten, risking an economic expansion that has entered its fourth year. Our outlook shows the economy avoiding recession in 2023, and likely doing so in 2024, if notable headwinds do not prove too great to overcome.

GDP

The U.S. economy reaccelerated during the second quarter. Annualized growth of 2.4% exceeded expectations, surpassed first quarter's 2% growth rate, and marked the fourth consecutive quarter of growth at 2% or greater. On a year-over-year basis, growth reached its highest level since the first quarter of 2022. Beyond the headline growth rate, the details proved heartening. Although consumption slowed following first quarter's unusually strong 4.2%, it still clocked in at 1.6%. Private investment, which has struggled in recent quarters, reached 5.7%. Spending on equipment and nonresidential structures posted solid growth rates, likely supported by government bills such as the CHIPS Act and the Infrastructure Investment and Jobs Act. Investment remains important for future growth, including its ability to boost productivity. Moreover, those fiscal stimulus measures also continue to boost government spending. After struggling for much of the last few years, government expenditures grew by 2.6% during the second quarter, the fourth consecutive quarter of growth of at least 2.5%.



Sources: BEA, BGO Research

Private spending via consumption and investment should carry momentum into the latter half of the year. But underlying growth is slowing under the weight of aggressive Fed hiking and private spending should ease. Fiscal stimulus should also have a fading impact over time.

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Nonetheless, the economy should avoid a recession in 2023, with growth likely near 1.7% for the year. The outlook becomes more challenging in 2024, with growth slowing near 0.6%. But a recession is still not inevitable and the road to a soft landing remains open if the economy can avoid monetary and fiscal policy mistakes.

Labor Market

While government stimulus has played a large role in supporting the economy over the last few years, the strength of the labor market has also played an important role. The labor market remains incredibly tight with the unemployment rate hovering near a half-century low. But signs of normalization are emerging. Wage growth accelerated significantly during the most acute phase of the labor shortage, but it is slowing as the labor market normalizes. Job growth is also slowing after a period of rapid recovery and expansion. The excess demand for labor is abating: the number of open jobs is declining, the quit rate is trending toward pre-pandemic levels, and the hiring rate has already returned to pre-pandemic levels. And importantly the labor force participation rate increased over the last few years. The tightness in the labor market has attracted workers back to the labor force as empirical research suggested would occur. While the overall participation rate remains below pre-pandemic levels, the participation rate for prime-age workers (those between 25 and 54 years of age) has rebounded near historically high levels. Over the balance of the year, we expect net job gains to slow. We foresee some upward pressure on the unemployment rate as persons returning to the workforce are met with a slowdown in hiring and some job losses. But we anticipate muted impact on the labor market vis-à-vis previous slowdowns in the economy because of the ongoing pronounced labor shortage. Companies will likely continue to hoard workers to avoid having to rehire and retrain them when the economy reaccelerates. Wage growth should slow over the latter half of the year, but remain above inflation, giving workers real wage growth and purchasing power.

Inflation and Interest Rates

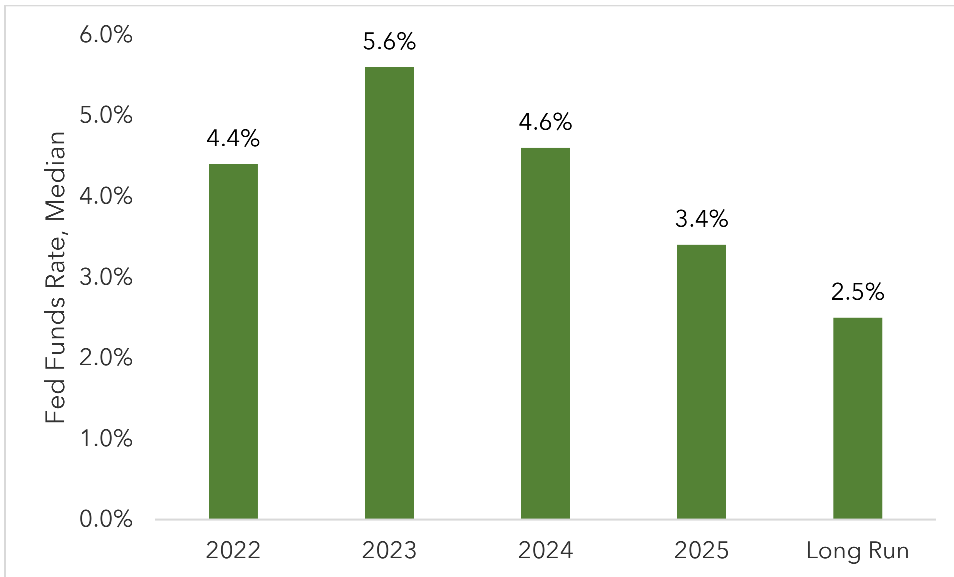
Across indexes, intervals, and methods of measurement, inflation has slowed considerably over the last year. The major headline and core indexes show this notable development. But as we have highlighted multiple times, inflation is getting overstated because of the notable lag effects associated with shelter costs. Excluding shelter costs, inflation is growing weakly. If we modify the consumer price index (CPI) to reflect current shelter costs without the lag, prices likely declined over the last year. Why has inflation slowed so significantly? In short, because supply chain disruptions have largely abated over the last year while excess demand for goods and services is slowing along with the overall economy.

Inflation Index (as of 6/2023)	1-Month Annualized	Year-Over-Year
PCE	2.0%	3.0%
Core PCE	2.0%	4.1%
CPI	3.9%	3.0%
Core CPI	3.2%	4.8%
Modified CPI	2.9%	-1.1%
Modified Core CPI	2.8%	-0.5%

Sources: BLS, BEA, Penn State, BGO Research

The upshot is that inflation should continue to slow over the balance of the year as the lagged decline in shelter costs filter through to the major inflation indexes. Inflation will likely still sit above the Fed's target rate by the end of the year, but we expect it to draw closer.

Will that stop the Fed from additional rate hikes? While impossible to know, the probability of another hike in the Fall has declined significantly in recent weeks. Either way, we do not expect the Fed to cut rates in 2023, but in the first half of 2024 at the earliest. That would leave the fed funds rate still in the mid-5% range by the end of the year. Thereafter, the Fed will likely cut rates as the economy slows, but gradually. In the short run, the long end of the curve will take its cues from the Fed. While the Fed continues to hold the line on rates, the 10-year Treasury yield should remain elevated near 4%. As the economy slows, inflation cools, and the Fed cuts rates, the long end of the curve will ease. But over the medium run we expect Treasury yields to remain above 3% and above levels from the last business cycle.



Sources: Federal Reserve, BGO Research

CRE and the Economy

Typically, an economic environment characterized by positive economic growth, an incredibly tight labor market, slowing inflation, and the prospect for lower interest rates would represent a clear positive for the commercial real estate (CRE) market. But the Fed's short-term agenda is superseding all of that. Until the market receives clearer direction from the Fed, it will remain in a holding pattern, with market participants keen to avoid making a mistake. Already, several key transaction-oriented firms are pushing off forecasts for a meaningful recovery in their businesses (both capital markets and leasing) to late 2023 if not 2024. Our forthcoming CRE overview and

outlook will discuss in further detail, but for now we note that the Fed remains the main headwind and source of uncertainty for the market.

Risks and Closing Thoughts

At this juncture, the main risks to the economic outlook stem from potential policy mistakes. First, the balance of monetary policy risks has shifted from doing too little to doing too much. The Fed remains fixated on driving inflation down to its target, trying to achieve its price stability mandate. While this mandate has a target rate, it does not have a timeframe. If inflation expectations had become unmoored, we could understand the Fed's desire to keep tightening at this juncture. But notably expectations have not changed much. If anything, slowing inflation has brought expectations down in recent months. Importantly, the slowdown in inflation is occurring without the Fed explicitly having to sacrifice the other main part of its mandate, full employment. The Fed's fear that a tight labor market could produce a wage-price spiral seems overblown since that rarely occurs, and wage growth continues to cool. The idea that inflation can only return to target with a recession seems increasingly suspect during such a unique business cycle. As we noted, by some measures, inflation might have already returned to target. And the well-known lag between raising rates and their subsequent impact on real economic activity means that more slowing in the economy, the labor market, and inflation likely lies ahead, just from the hikes that have already occurred. The Fed can afford to wait at this juncture, but will it?

The second key risk concerns fiscal policy. Fiscal policy's boost to the economy is already slated to lessen over time with little appetite left for purely stimulative spending bills and the spending cuts that lie ahead as part of the debt-ceiling deal from earlier this year. But that negotiation serves as a bit of a warning. We remain concerned that political rancor could sacrifice the health of the economy. When Congress returns from August recess, it will have to pass a spending bill by September 30. But the situation in Washington suggests that reaching a deal will be a challenge and a government shutdown is possible. Shutdowns have occurred multiple times over the last decade, ultimately damaging the economy and the credibility of the U.S. government. And we are not alone in our concerns. Recently, Fitch downgraded U.S. government debt because of similar concerns. A shutdown would risk the economic expansion. Avoiding such a self-inflicted wound remains paramount.

If the economy can avoid such policy mistakes, our base case scenario suggests a period of slowing economic growth but not an outright recession. At a minimum the risk of a recession is decreasing as inflation slows without collateral damage. The economy needs cool, well-reasoned policy making. Will it get it?

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