

# **U.S. Economic Pulse: October 2022**

## A Harder Landing Now Looks More Likely

Preston Caldwell  
Head of U.S. Economics

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# **Forecast Update:** Stickier Inflation and More Hawkish Fed Means We're Reducing Our Near-Term GDP Forecasts

# We Still Expect Inflation To Plummet, Allowing the Fed To Cut Rates and Jump-Start GDP Growth

## We Expect Growth to Trough in 2023 and Then Accelerate in 2024

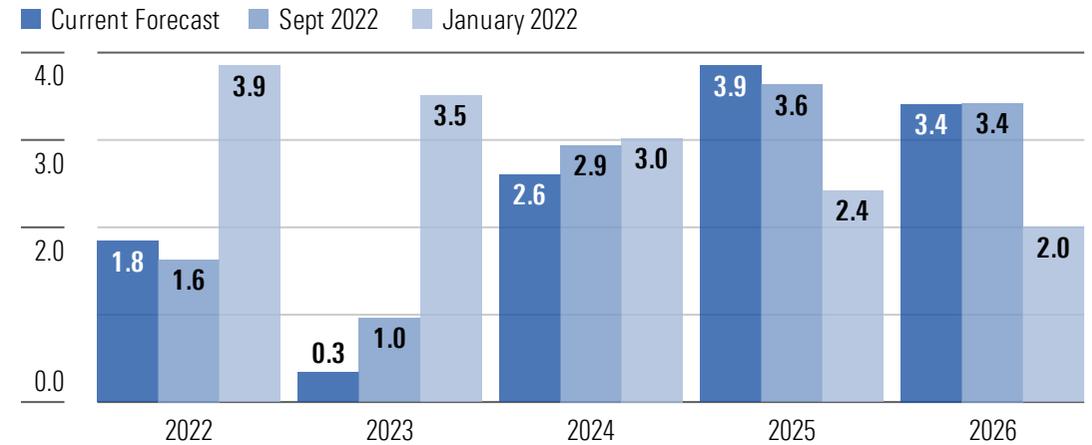
Since our last update ([U.S. Economic Pulse: September 2022](#)), we've reduced our 2023 and 2024 GDP forecasts owing to our increased expectations of monetary policy tightening. We now expect a 2023 average federal-funds rate of 4% compared with 3.15% previously.

Our forecasts are consistent with roughly 50% odds of a formal recession being declared between now and the end of 2023. But we've consistently argued that the binary question "Will there be a recession?" misses the point; any recession should be relatively mild and short-lived, in our view. We expect growth to reaccelerate in 2024 as the Federal Reserve lifts off the brakes and pivots to monetary easing.

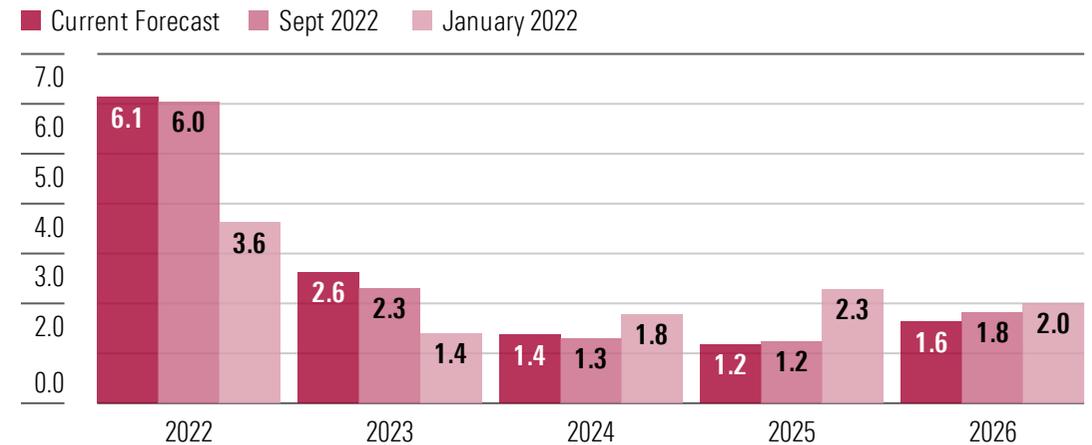
## Inflation Should Return to Normal in 2023

The last few months have shown increasing signs of inflation's stickiness, with core Consumer Price Index inflation remaining high despite decelerating economic activity and easing supply constraints. This impact will carry into 2023, so we've increased our inflation forecast accordingly. A hawkish response from the Fed means that our forecasts in later years are mostly unchanged. Inflation will still come under control, but at greater cost to near-term economic activity.

GDP Forecast Revisions



Inflation (PCE) Forecast Revisions



Source: Bureau of Economic Analysis, Morningstar. Data as of Oct. 18, 2022.

# We Remain More Optimistic Than Consensus on Strong GDP Growth and Mild Inflation

## We're More Bullish Than Consensus on Long-Run GDP

Our GDP forecasts for 2022 and 2023 are roughly in line with consensus. But starting in 2024, we become far more optimistic. Altogether, we expect a cumulative 250 basis points more real GDP growth through 2026 than consensus does.<sup>1</sup>

Consensus remains overly pessimistic on the recovery in the labor supply and has mistaken short-term supply shocks for a downtrend in productivity, in our view. We expect a growth rebound in 2024 as the effects of supply shocks fade, with the Fed facilitating on the demand side by backpedaling on monetary tightening.

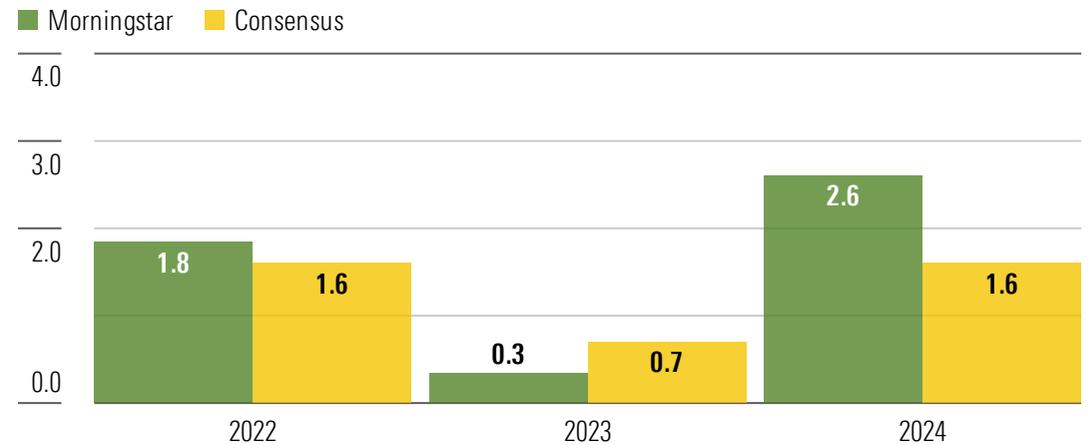
## We Expect Inflation to Fall Much Faster Than Consensus

On inflation, our views diverge sharply from consensus. Bond market breakevens imply a similar view as consensus on inflation. While consensus has largely given up on the “transitory” story for inflation, we still think most of the sources of the postpandemic bout of high inflation will unwind in impact over the next few years. This includes energy, autos, and other durables. Aggressive monetary tightening from the Fed will quell broader inflationary pressures in the economy.

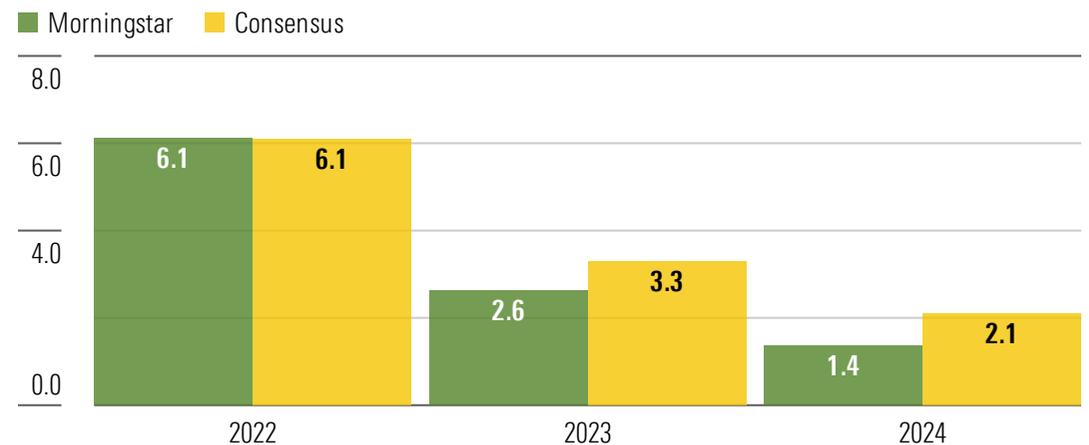
<sup>1</sup> This is based on those forecasts that extend out to 2026. Consensus averages typically end just two to three years ahead, which is why we don't display 2025 and 2026 on the chart.

Source: Bureau of Economic Analysis, Bloomberg, Morningstar. Data as of Oct. 18, 2022.

Real GDP Forecast Comparison



Inflation (PCE) Forecast Comparison



# **Economic Data Recap:** Economic Activity Still Trending Up for Now, but More Headwinds From Fed Tightening Are Coming

# Activity Data: No Signs of a Recession Yet, Although Growth Is Clearly Slowing

## All Economic Indicators Still Trending Up

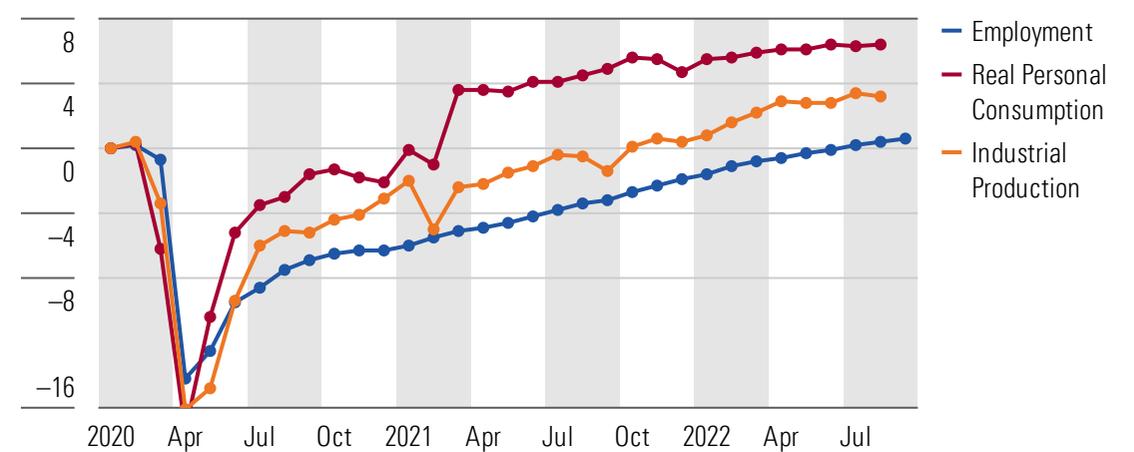
The U.S. economy is still showing no signs of contracting, with employment, real consumption, and industrial production all still trending up through September as in the first half of the year. As we argued in our [U.S. Economic Outlook: Third Quarter 2022](#), the slight drop in real GDP in the first half of 2022 was driven by the noisiest components of GDP (inventories and net exports) and very likely did not constitute a genuine economic slowdown.

A recession has certainly not occurred yet. This shouldn't be surprising, given the usual lag between monetary tightening and impact on economic activity. Headwinds to growth will peak in 2023, when the impact of Fed tightening crests.

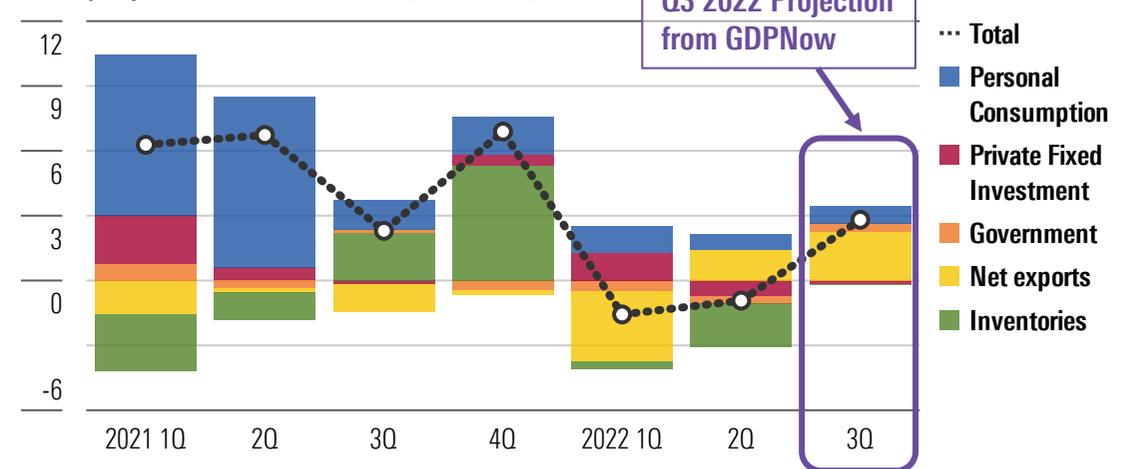
## Atlanta Fed's Nowcast Showing a Q3 GDP Rebound, but This Will Be Temporary

The Atlanta Fed's [GDPNow](#) projection of third-quarter 2022 real GDP growth now stands at a seemingly robust 2.8%. But this expected rebound is accounted for mainly by net exports and inventories, which are a poor guide to the underlying growth trend. Consumption growth is running at only about 1% annualized and will likely move lower in coming quarters owing to slowing job gains, falling asset prices, and consumers' delayed response to the decline in real wages in 2022.

Key Economic Indicators, % Cumulative Growth Since Jan 2020



GDP by Expenditure, % QoQ Growth (Annualized)



Source: Bureau of Economic Analysis, Atlanta Fed, Morningstar. Data as of Oct. 18, 2022.

## Labor Market: Further Slowdown in Job Growth to Come

### Across Industries, Employers Still Hiring at a Brisk Pace

Growth in nonfarm payroll employment has averaged about 0.25% per month in the three months through September. Representing about a 3% annual rate, this is still faster than employment growth in normal times (see the 1.5% average over 2015-19), much less than during a quasirecessionary period.

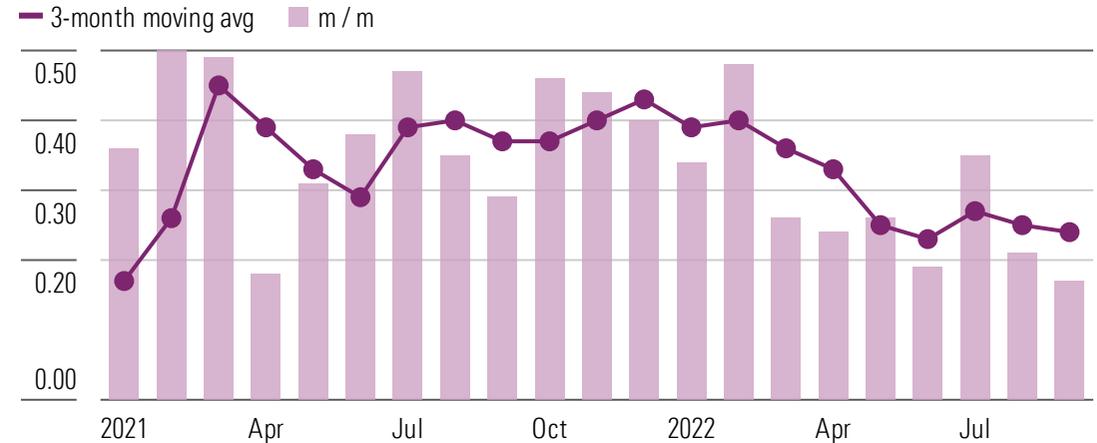
We expect job gains to slow markedly in coming quarters as employers gear up for weakening economic growth. The Fed's tightening has had little impact on the labor market thus far, as even industries that will be especially hard hit by monetary tightening (like residential construction) have continued to see job growth throughout 2022.

### Fall in Job Openings Rate Means That Labor Demand Is Cooling

The fall in the job openings rate (job openings divided by employment) signals a drop in labor demand among employers. The job openings rate since mid-2021 has been extremely high compared with prepandemic levels, which has led some economists to fear that the labor market is far too overheated and will require much more Fed tightening to avert a wage-price spiral. The fact that job openings have already fallen sharply even though unemployment is still near its trough of 3.5% is very encouraging, as it signals that labor markets may be able to eventually normalize without severe job losses.

Source: Bureau of Labor Statistics, Morningstar. Data as of Oct. 18, 2022.

Nonfarm Payroll Employment. % Growth



Job Openings Rate (%)



# Consumer Spending: Growth Remaining Low Despite Inflationary Relief

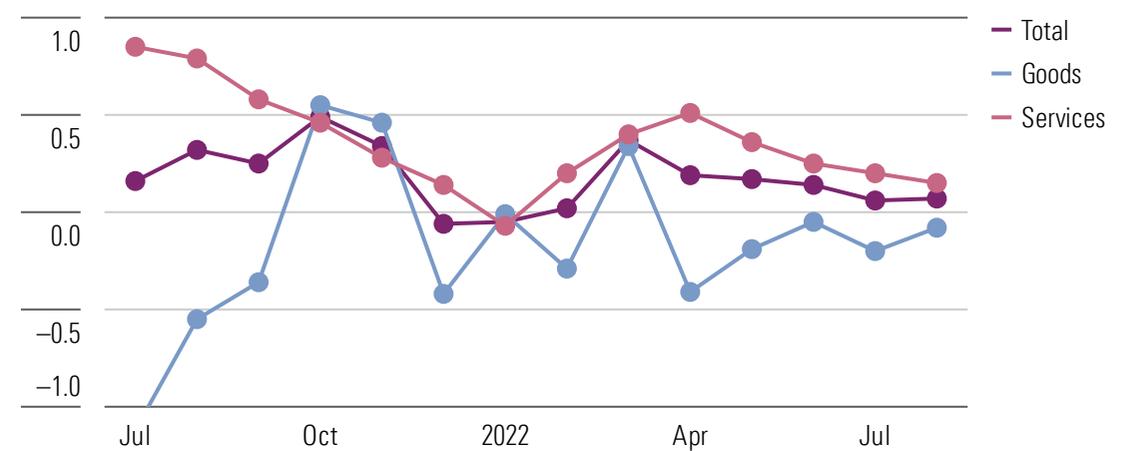
## Return to Prepandemic Spending Patterns Has Slowed

Growth in real personal consumption slowed to 0.1% per month on average over June through August. The runup in inflation put a dent in household spending, as inflation exceeded wage growth and entailed a redistribution of income from wages to profits. The meager consumption growth that occurred required households to dip into savings in order to fund consumption.

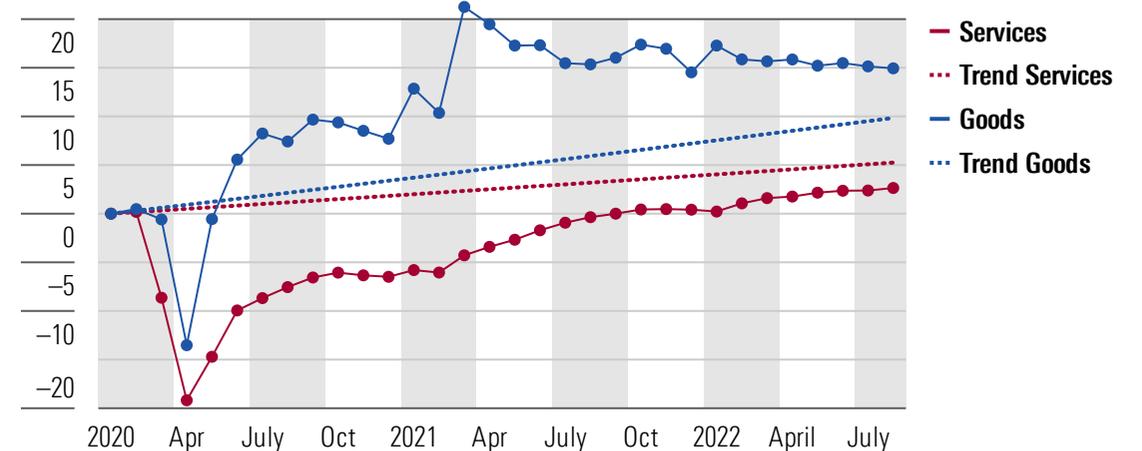
Relief from inflation came in July and August with falling energy prices, but households didn't appear to spend the savings on other goods. Retail sales (excluding gas stations) for September increased just 0.1% month over month, indicating another tepid month for consumption growth.

Growth in services consumption has been lackluster following an uptick over February through April from the decline of the COVID-19 omicron variant. Services consumption isn't quite yet back to its prepandemic trend, but it's close enough that the "return to normal" is now set to proceed at a much slower pace. Goods consumption is still quite elevated relative to its prepandemic trend. Dimming near-term economic prospects along with saturation from previous large expenditures will continue to weigh on goods consumption growth.

Real Personal Consumption, % Growth 3-Month Moving Avg



Real Personal Consumption, % Cumulative Growth Since Jan 2020



Source: Bureau of Economic Analysis, Morningstar. Data as of Oct. 18, 2022.

# Financial Data: Rate Hike Expectations Have Risen, but We Still Expect the Fed to Begin Cutting in Mid-2023

## Fed Rhetoric and Inflation News Have Pushed Rates Higher

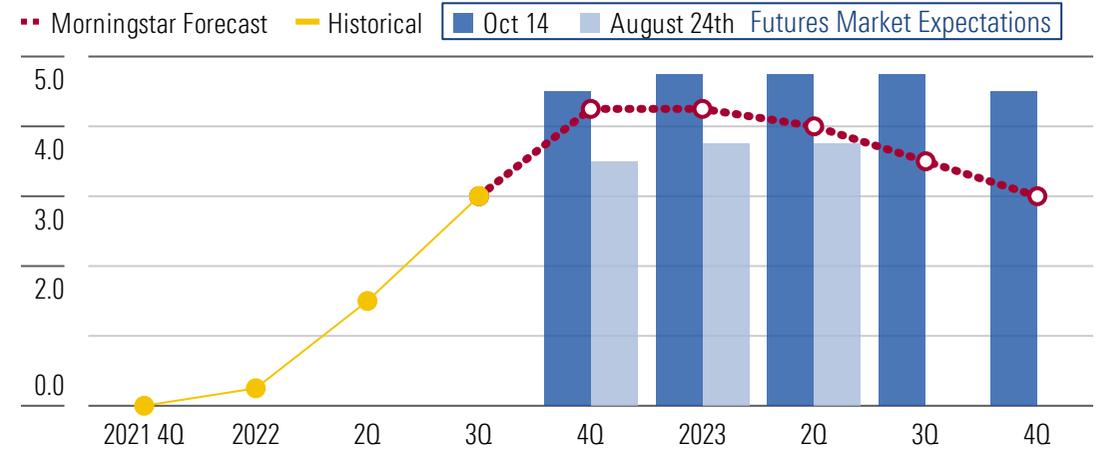
Expectations of monetary policy tightening have soared yet again, with futures market expectations for the path of the federal-funds rate having risen about 100 basis points in the past six weeks.

We've also increased our expectations for rate hikes. Disappointing near-term inflation data leaves little room for the Fed to slow the pace of rate hikes in the next couple of meetings (November and December). However, we still expect the Fed to begin reversing course in mid-2023 as inflation eases substantially and the need to shore up economic growth comes to the fore. We expect a year-end 2023 fed-funds rate of 3%, while futures markets imply a rate of 4.5%.

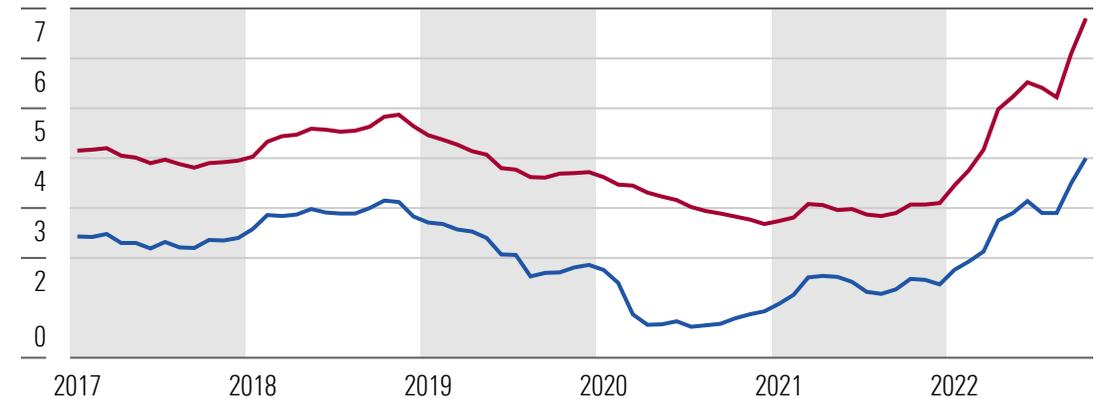
## Rise in Borrowing Rates Will Further Hit Housing and Other Areas

Increased rate hike expectations have filtered into longer-term bond yields, which matter more than the federal-funds rate in terms of impact on the real economy. The 10-year U.S. Treasury yield has jumped about 0.5% over the past month, and the 30-year mortgage rate is up around 1%. This means that the downturn in housing markets in 2023 is likely to be much more severe than previously anticipated.

Fed Funds Rate (%) - Median Futures Market Expectation for Quarter End



10-YR Treasury (blue line), 30-YR Mortgage Rate (red line)



Source: Federal Reserve, Freddie Mac, Morningstar. Data as of Oct. 18, 2022.

# Inflation: Energy Prices Make a Dent in Headline CPI, but Lack of Progress in Core Inflation Is Discouraging

## Inflation Still Running Much Too High

In year-over-year terms, CPI inflation has dipped from a peak of 9% in June to 8.2% in September on the back of energy price declines. Year-over-year inflation will continue to be driven lower by energy, based on current futures prices.

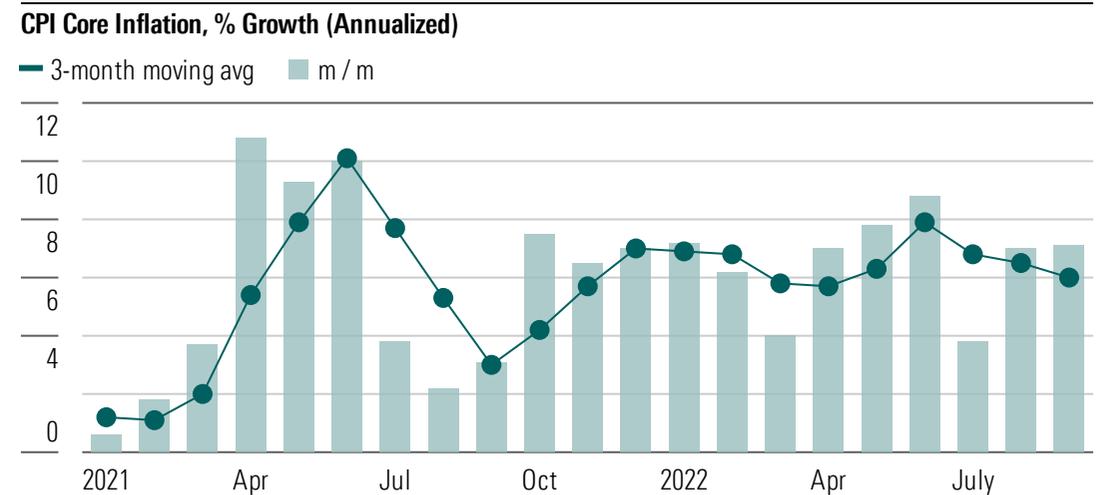
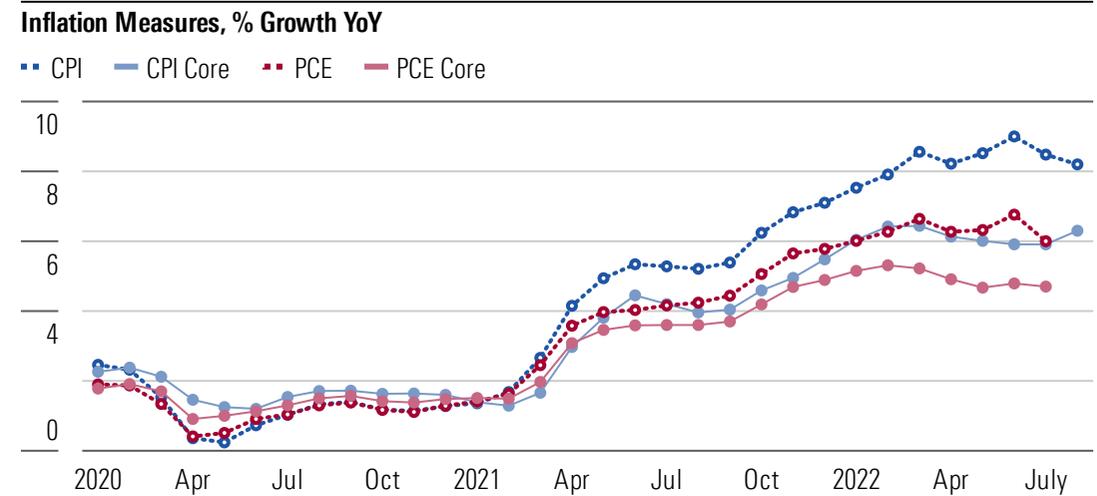
Compared with the CPI, the inflation situation is not quite as dire when looking at the Personal Consumption Expenditures Price Index, which looks at a broader basket of spending and therefore is less affected by the runup in prices in energy, food, autos, and related areas. The PCE was at 6.2% year over year in August, though still much too high compared with the Fed's 2% target.

## Core Inflation Still Trending Around 6%-7%

Year-over-year numbers are heavily affected by the runup in prices earlier in 2022, so economists are focusing more on the monthly numbers to gauge whether a downward shift in inflation could be occurring. In particular, core inflation (which strips out food and energy) is held to be a better predictor of underlying inflationary pressure in the economy.

CPI core inflation has averaged around 6%-7% annualized since the start of 2022, thus far defying hopes that easing supply constraints and Fed tightening would begin to push inflation down. This has been the primary driver of soaring expectations for rate hikes along with falling asset prices in recent months.

Source: Bureau of Economic Analysis, Morningstar. Data as of Oct. 18, 2022.



# Inflation: No Reason to Panic About Core Inflation Remaining High for Now

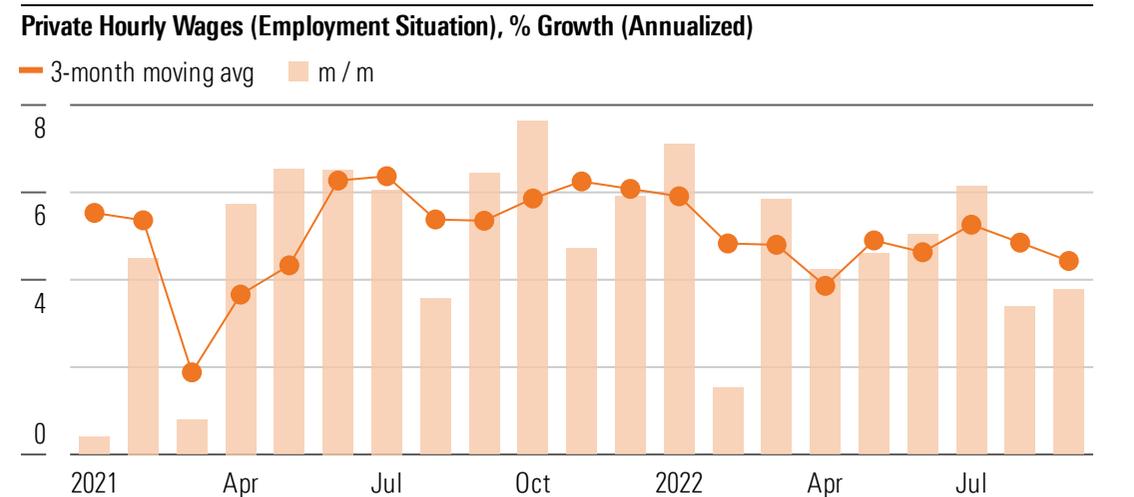
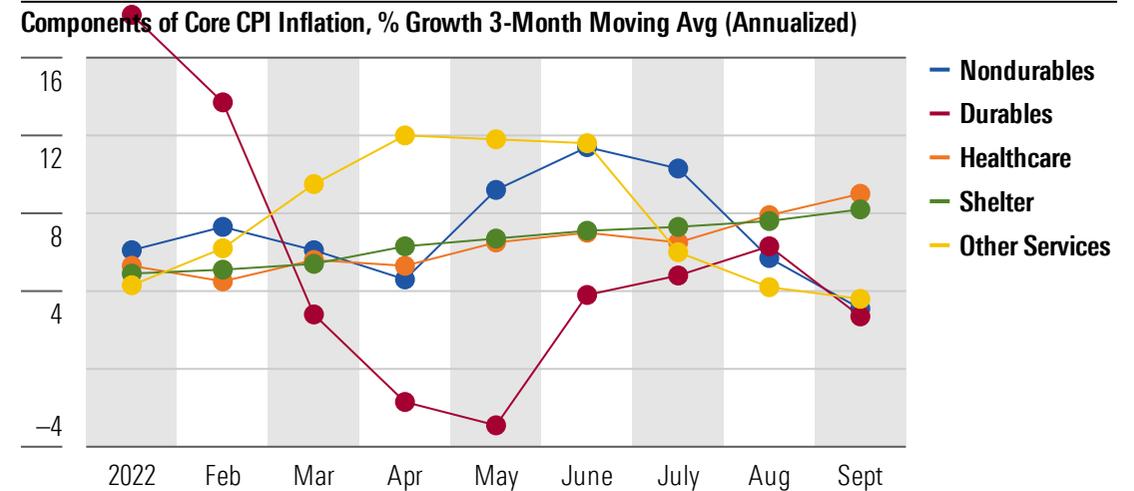
## Supply Chain Relief Should Eventually Push Down Core Goods Inflation

Among the components of core CPI, we have seen some progress in prices for durable and nondurable goods along with services excluding shelter and healthcare. Easing supply constraints should eventually push goods inflation into negative territory.

Shelter price inflation has continued to trend up as a lagged response to the runup in housing prices, but the incipient housing downturn should reverse that trend within the next year. The acceleration in healthcare inflation largely reflects the quirks in the CPI's methodology (its focus on out-of-pocket costs leads to excessive volatility). The PCE uses a different methodology and shows much more subdued healthcare inflation.

## Wage Growth Indicates a Lower Path for Core Inflation

Private hourly wage growth has averaged just 4.4% in the last three months. Assuming productivity growth of 1.5% and a constant labor share of GDP, this is consistent with inflation running about 3%. Even considering alternative measures showing wage growth closer to 5%-6%, wage growth indicates a far more benign inflationary environment than the recent 6% average for core CPI. Furthermore, wage growth should slow as labor demand slows in response to slowing economic growth.



Source: Bureau of Economic Analysis, Morningstar. Data as of Oct. 18, 2022.

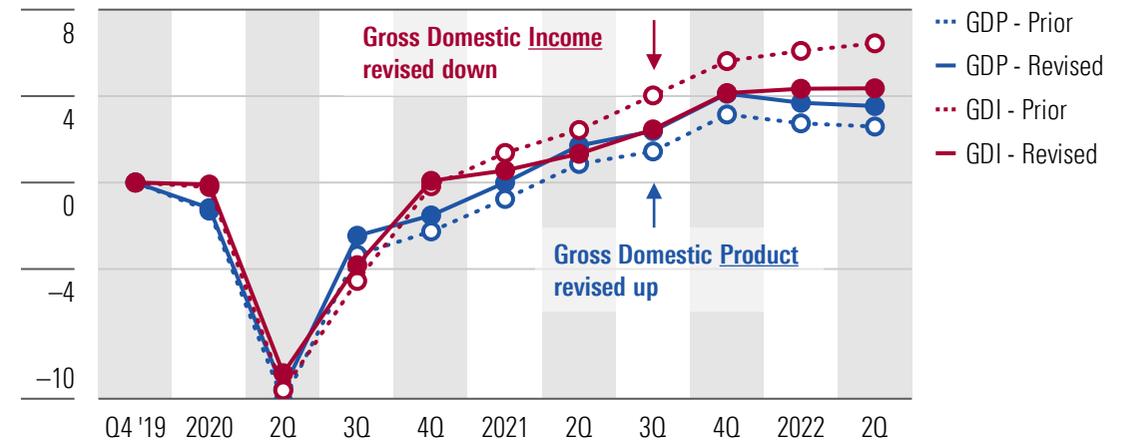
# Revised Economic Data Solves a Mystery and Shows Households to Be Far More Overstretched Than Thought

## Mysterious Divergence in Economic Data Has Been Resolved

Over the past year, economists had been puzzled by the divergence of GDP and gross domestic income. Theoretically, the two measures should be equal, but in practice they can diverge owing to differing source data. GDP sums up total expenditure in the economy, while GDI sums up total income. With the prior data, growth in GDI exceeded GDP by about 4 percentage points as of the second quarter of 2022.

Revised data has mostly closed the gap between GDP and GDI, with some interesting consequences for our map of the economic situation over the past year or so. GDP has been revised up about 1%, owing mainly to increased estimates of consumption. GDI has been revised down about 2%, due largely to reduced estimates of labor income.

GDP and GDI Revisions, % Cumulative Growth Since Q4 2019

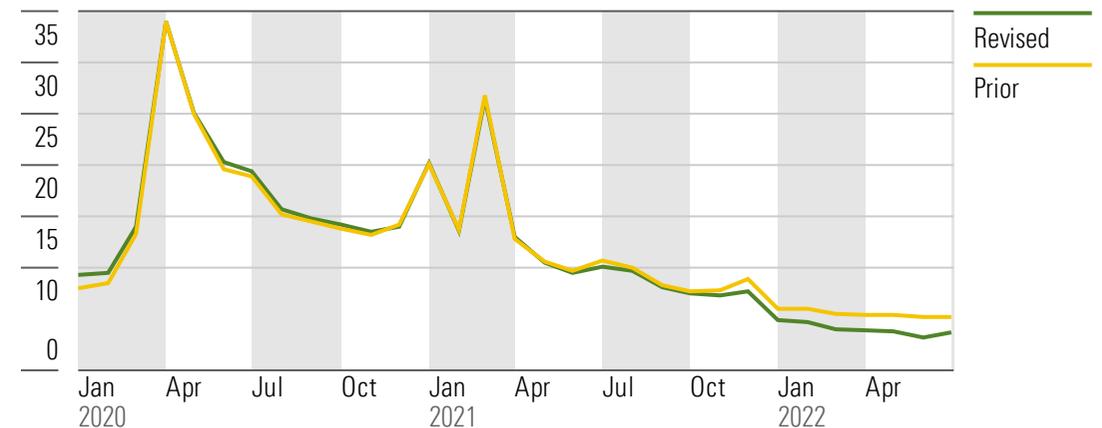


## Households Are Dipping Into Savings Far More Aggressively Than Thought

With the revised data, it's now clear that the personal saving rate has moved far lower than previously estimated. This follows logically from the increased estimates of consumption in conjunction with decreased estimates of labor income. Now, the personal saving rate is estimated at an average 3.5% in the past six months, compared with a prepandemic (2019) average of about 9%.

It seems that households have been more aggressively dipping into the excessive savings accumulated during the pandemic. But with most remaining "excess savings" likely to be in the hands of very-high-income households, it seems very likely that the saving rate will head back up in the near term.

Personal Savings Rate (%) - Revisions



Source: Bureau of Economic Analysis, Morningstar. Data as of Oct. 18, 2022.

# Appendix

Morningstar - U.S. Economics Dashboard

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021 E	2022 E	2023 E	2024 E	2025 E	2026 E	CAGR:	
																2014-19	2019-26
<b>U.S. Real GDP by Expenditure (% Growth)</b>																	
Personal Consumption	1.4%	1.5%	2.7%	3.3%	2.5%	2.4%	2.9%	2.0%	-3.0%	8.3%	2.6%	0.7%	2.6%	3.4%	2.7%	2.6%	2.4%
Residential Investment	13.0%	12.4%	3.8%	10.2%	6.6%	4.0%	-0.6%	-1.0%	7.2%	10.7%	-7.0%	-7.6%	0.9%	6.8%	8.4%	3.8%	2.5%
Business Investment	10.5%	5.7%	6.0%	4.3%	-3.1%	4.1%	7.4%	3.7%	-9.1%	7.8%	9.2%	0.5%	1.9%	3.7%	3.7%	3.2%	2.4%
Government Spending	-2.1%	-2.4%	-0.9%	1.8%	2.0%	0.4%	1.7%	3.3%	2.6%	0.6%	-1.0%	1.3%	2.0%	2.0%	2.0%	1.8%	1.3%
Exports	4.0%	3.0%	3.9%	0.3%	0.4%	4.3%	2.8%	0.5%	-13.2%	6.1%	6.0%	1.0%	3.0%	5.5%	5.0%	1.6%	1.7%
Imports	2.4%	1.2%	5.2%	5.2%	1.5%	4.5%	4.2%	1.1%	-9.0%	14.1%	8.5%	1.0%	1.0%	1.5%	1.5%	3.3%	2.5%
<b>GDP Growth %</b>	<b>2.3%</b>	<b>1.8%</b>	<b>2.3%</b>	<b>2.7%</b>	<b>1.7%</b>	<b>2.2%</b>	<b>2.9%</b>	<b>2.3%</b>	<b>-2.8%</b>	<b>5.9%</b>	<b>1.8%</b>	<b>0.3%</b>	<b>2.6%</b>	<b>3.9%</b>	<b>3.4%</b>	<b>2.4%</b>	<b>2.1%</b>
<b>Nominal GDP - \$ Trillion</b>																	
	<b>16.3</b>	<b>16.8</b>	<b>17.6</b>	<b>18.2</b>	<b>18.7</b>	<b>19.5</b>	<b>20.5</b>	<b>21.4</b>	<b>21.1</b>	<b>23.3</b>	<b>25.3</b>	<b>26.1</b>	<b>27.0</b>	<b>28.4</b>	<b>29.9</b>	<b>4.0%</b>	<b>4.9%</b>
% Growth	4.2%	3.6%	4.2%	3.7%	2.7%	4.2%	5.4%	4.1%	-1.5%	10.7%	8.7%	2.8%	3.8%	5.2%	5.0%		
<b>Inflation (% Growth)</b>																	
GDP Deflator	1.9%	1.8%	1.9%	1.0%	1.0%	1.9%	2.4%	1.8%	1.3%	4.5%	6.7%	2.5%	1.1%	1.3%	1.6%	1.6%	2.7%
PCE	1.9%	1.4%	1.5%	0.2%	1.0%	1.8%	2.1%	1.5%	1.1%	4.0%	6.1%	2.6%	1.4%	1.2%	1.6%	1.3%	2.6%
PCE - Core	1.8%	1.5%	1.6%	1.3%	1.6%	1.7%	2.0%	1.7%	1.3%	3.5%	4.8%	3.3%	2.2%	1.9%	2.0%	1.6%	2.7%
<b>Labor Market</b>																	
Unemployment Rate (%)	8.1%	7.4%	6.2%	5.3%	4.9%	4.4%	3.9%	3.7%	8.1%	5.3%	3.6%	4.3%	4.6%	4.0%	3.5%		
Labor Force Participation (%)	63.7%	63.2%	62.9%	62.7%	62.8%	62.9%	62.9%	63.1%	61.7%	61.7%	62.4%	62.4%	62.2%	62.4%	62.6%		
LFP % - Prime Age	81.4%	81.0%	80.9%	80.9%	81.3%	81.7%	82.1%	82.5%	81.4%	81.6%	82.4%	82.5%	82.6%	82.9%	83.2%		
<b>Supply Side (% Growth)</b>																	
Potential Hours Worked	1.0%	0.8%	0.7%	1.0%	0.9%	0.3%	0.8%	0.7%	0.0%	0.1%	0.3%	0.4%	0.4%	0.4%	0.3%	0.7%	0.3%
+ Actual Hours/Potential	0.8%	0.5%	1.2%	1.1%	0.4%	1.1%	1.1%	0.1%	-5.9%	4.3%	2.4%	-0.4%	-0.2%	1.4%	1.2%	0.8%	0.2%
= Hours Worked	1.8%	1.2%	1.9%	2.1%	1.3%	1.3%	1.9%	0.8%	-5.9%	4.4%	2.7%	0.0%	0.2%	1.8%	1.5%	1.5%	0.5%
Labor Productivity	0.5%	0.6%	0.4%	0.6%	0.4%	0.9%	1.0%	1.5%	3.3%	1.5%	-0.9%	0.3%	2.4%	2.0%	1.9%	0.9%	1.5%
<b>Output Gap (% Potent. GDP)</b>	<b>-5.4%</b>	<b>-5.4%</b>	<b>-4.9%</b>	<b>-4.3%</b>	<b>-4.6%</b>	<b>-3.8%</b>	<b>-2.8%</b>	<b>-2.3%</b>	<b>-6.5%</b>	<b>-2.5%</b>	<b>-2.4%</b>	<b>-4.0%</b>	<b>-3.3%</b>	<b>-1.5%</b>	<b>0.0%</b>		
<b>Other</b>																	
Govt Budget Balance (% GDP)	-9.3%	-5.9%	-5.3%	-4.7%	-5.4%	-4.4%	-6.1%	-6.7%	-14.9%	-12.1%	-4.4%	-4.9%	-5.4%	-5.8%	-5.4%		
Net Exports (% GDP)	-3.4%	-2.8%	-2.9%	-2.9%	-2.7%	-2.8%	-2.9%	-2.7%	-3.0%	-3.7%	-4.0%	-4.1%	-4.1%	-3.5%	-3.1%		
<b>Market (Year Avg)</b>																	
Fed Funds Rate	0.14%	0.11%	0.09%	0.13%	0.40%	1.00%	1.83%	2.16%	0.38%	0.08%	1.60%	4.04%	2.23%	1.63%	1.88%		
10-Year Treasury Yield	1.80%	2.35%	2.54%	2.14%	1.84%	2.33%	2.91%	2.14%	0.89%	1.44%	3.00%	3.60%	2.25%	2.25%	2.75%		

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