Preliminary data on the third quarter suggest that the economic growth topped 5%, its fastest pace since 2021. That is despite the most aggressive credit tightening by the Federal Reserve since the 1980s. It is nothing less than stunning.

Employment accelerated in September, with revisions for the two previous months moving to the upside for the first time this year. Those shifts, coupled with a sharp upward benchmark revision to personal income, mean that consumers entered the fourth quarter with much more of a cushion in savings than previously thought. Our own estimates of the excess savings amassed as of August nearly doubled with that revision; this was before the upward revisions to income that are likely to result from the acceleration in hiring over the summer.

What was supposed to be the Federal Reserve’s hardest mile in its marathon against inflation has morphed into a relay race. Sectors that drove employment gains on the heels of ultralow rates at the start of the recovery handed the baton to sectors that lagged earlier on. Sectors that benefited from ultralow rates and the push to buy homes and fill them early in reopening are yielding ground to less interest-rate sensitive sectors.

Nearly two-thirds of hiring over the summer was driven by gains in just three sectors: leisure and hospitality, healthcare and social assistance and government. Employment at restaurants, which has suffered chronic labor shortages, finally matched the peak it hit in February 2020. That is more than a year after overall employment crossed the previous peak. Employment in accommodations and public education is still well below previous peaks, while job openings in healthcare remain well above the level of new graduates. Burnout in healthcare is still high.

The Fed left the door open to another hike and kept its trajectory for rates even higher in 2024. The strength in the economy has increased the risk of backsliding on inflation, while stronger growth in and of itself justifies higher rates. That last point gets lost in translation. The 2010s, with subdued growth and inflation, were the anomaly, not the norm. Ultralow rates were needed to repair balance sheets in the wake of the subprime crisis; now they are not.

The wild card is the recent volatility in the Treasury bond market. Yields have ricocheted between surging in response to stronger growth and the dysfunction in Washington to falling as investors sought safety with the onset of yet another war in the Middle East. Those rates set everything from mortgage rates to corporate and municipal bond yields and could have a much larger effect on access to credit than rate hikes by the Fed alone. Where they end up could affect the Fed’s decision on whether to raise rates again.

This edition of Economic Compass takes a closer look at the resilience of the economy, how revisions have reshaped our understanding of that resilience and how a government shutdown could distort growth. Special attention will be paid to the recent volatility in the Treasury bond market and how that could affect the Fed’s decisions going forward. The good news is that short-term rates have likely peaked. The bad news is that rates across the yield curve are now expected to be much higher.

Government deficits and debt suddenly matter again. We are both overspent and under taxed, given the promises we have made to retirees for Social Security and healthcare. Few in Congress are willing to make tough decisions on both sides of our budget ledger to get on a more sustainable budget path.
I recently attended an annual bipartisan dinner with members of Congress; they are willing to reach across the aisle and negotiate a more sustainable budget. The number of people in the room has shrunk considerably over time; it was truly depressing.

**An slowdown**

**Two scenarios**

We have two scenarios for the economic outlook:

1. The base case assumes that our elected officials bridge their differences and, in a Kumbaya moment, pass another continuing resolution before the current one expires in mid-November. The war in Israel has changed the calculus a bit, as Congress is more united on aid for Israel than Ukraine; funding for those two wars and the crisis at the border with Mexico is expected to be in the stop-gap package. The majority of the two chambers of Congress agree that a shutdown is bad for the country and political suicide in an election year. A recent Pew poll revealed that unfavorable views of Congress were already within spitting distance of the 73% record hit during the last full government shutdown in 2013; it was taken before the recent malaise in Congress.

2. The downside scenario includes a failure of governance with Congress unable to bridge its differences and a government shutdown that spans mid-November to just before the Christmas holiday. We have not included a situation where the war in Israel is less contained for oil prices, as Israel has stronger regional ties than it did when OPEC invoked the oil embargo in 1973. However, risks on the outlook for a government shutdown are to the downside. Treasury bond yields could spike and cause an even broader tightening of credit conditions, which could wreak havoc on financial markets and cause lingering economic problems.

**Base case**

Chart 1 shows our base case outlook for growth in late 2023 and early 2024. Real GDP is expected to slow from an average pace of 2.4% in 2023 to 1.7% in 2024. Quarterly growth rates dip below the economy’s potential at the start of the year, which means unemployment rises, but only modestly. The increases are more due to a rise in the number of people in the labor force and the landing of jobs by new entrants than a surge in layoffs.

**Consumer spending is expected to slow but not collapse.** Recent benchmark revisions revealed that income growth was revised up in 2021 and 2022. That was before upward revisions to employment over the summer, which will further bolster savings and provide a larger cushion to blunt the blow of tighter credit and a resumption of student loan payments in October.

Recent Treasury data on remittances to the Education department revealed the student loan payments surged in August, two months before they were due. That provides testimony to how much household balance sheets have healed in recent years. Add changes to repayments for lower income households, a year grace period on defaults and student loan repayments are no longer expected to be the drag on growth that many expected.

A headwind is financial market volatility. That hits high-income households harder than the rest of the economy; they are better positioned to weather the storm but will put a damper on spending going forward.

A larger drag on overall growth will come from the pivot away from spending on goods, notably big-ticket items that need to be financed, toward services. Spending on most goods, except vehicles, exceeded their pre-pandemic trend in recent years. That is a fancy way of saying we have already bought a lot of stuff, and don’t need or desire as much going forward.
The outlier is vehicles, where pent-up demand remains substantial. The problem is affordability, which has evaporated with price hikes and high financing rates. The pool of consumers who can afford cash for a vehicle is limited.

Credit defaults have picked up but from exceedingly low levels. Low-income households are much more stressed than high-income households. Student loans were the primary driver of defaults in the past but changes to loan payments and delays on delinquencies the first year suggest they will not be an immediate stressor.

Debt service burdens remain extremely low, despite the rise in rates as many locked into ultralow mortgages rates. Those moves should temper the increase in defaults and loss in access to credit.

**Housing retracts its steps.** New home construction got a boost over the summer, as builders moved downscale to build smaller, less expensive homes and offered discounts to buoy first-time buyer demand. That shift means that housing activity added to the overall economy for the first time in nine quarters over the summer.

Those gains will be short-lived. The surge in rates, which has been amplified by the bump in bond yields, is making it harder for builders to offering deals to keep first-time buyers.

Higher rates, tighter lending standards, escalating insurance costs and cooling rents are taking a toll on the multifamily market. Backlogs have ballooned, which will keep supply coming on line. The key is to keep those projects financed. Many developers are turning to private investors – home offices and private equity — to get the funding they need. That is expensive.

**Business investment weakens.** Business investment has been bolstered by government incentives to build chip and electric vehicle plants and the spillover effects associated with the ramping up of infrastructure investment. Those gains will dissipate after the initial surge.

Higher rates are the largest drag on investment in 2024. Corporate debt that was locked in at low rates earlier in the recovery is due to reset in 2024. Higher interest expenses and elevated wage gains are expected to put a crimp on corporate cash flow.

This is in addition to tighter bank lending standards, which have already moved into recession territory. The resetting of office leases has yet to show up as a drag on bank balance sheets. Small and mid-sized firms are much more reliant on that credit than larger firms.

Inventories are particularly expensive to finance, given the rise in rates and increase in insurance costs. This is one of many reasons retailers have been reluctant to stock up as much as usual for the holiday season. You may want to take advantage of October promotions.

The outliers are investments in cyber security and generative AI (GenAI). The KPMG U.S. CEO Outlook survey revealed that CEOs were eager to leverage the new technology to boost productivity growth and contain costs. They also express concern and the need to guard themselves more aggressively from cyber-attacks and the theft of intellectual property enabled by GenAI.

**Government spending becomes a drag on growth.** Much of the stimulus passed during the pandemic has been spent. The boost to Social Security payments, which was the largest single contributor to federal spending in 2023, is expected to moderate on cooler inflation figures in January. The increase in spending associated with wars and the border pales when compared to outlays for Social Security and Medicare. Much of the rise in the federal deficit in 2023 was due to a shortfall in tax revenues; capital gains taxes plummeted in 2022 relative to 2021, which curbed government revenues in fiscal 2023.

State and local government receipts have slowed, with the exception of real estate and sales tax revenues. That accounts for the lion’s share of government spending and will exacerbate the moderation in growth in 2024.

“Households have a much larger savings cushion to weather the storm of tighter credit conditions.”

Pending home sales continued to lose ground in August as housing affordability plummets. Mortgage applications for existing home purchases dropped to their lowest levels since 1995 in recent weeks.

Prices are the sticking point. Supply remains well below demand as millennials age into their prime home buying years. Prospects for the single-family market improve again in late Spring and Summer 2024, after mortgage rates start to come down but winter will be chilly for the housing market.
The trade deficit widens. Exports are expected to grow slower than imports, as a strong dollar and weaker growth abroad work their way through to trade. The International Monetary Fund (IMF) lowered its forecast for global growth in early October; it tends to be more optimistic than private forecasters. Synchronous rate hikes and the spillover effects of higher rates in the U.S. on currencies abroad were cited as reasons. Depreciating currencies abroad stoke inflation, add to deficits and weaken growth. They require central banks to raise rates and to head off the price increases that accompany a weakening currency.

Indeed, the IMF issued a warning with its most recent reports. It fears that central banks are becoming too complacent on inflation by declaring a peak in rates too soon. They may need to raise rates much more than previously expected to fully derail inflation.

The Fed moves to the sidelines. The leadership of the Fed has made clear that the threshold to raise rates again is higher than the threshold to stay where it is, given the recent surge in bond yields. We would need to see a very large drop in yields to make the Fed raise rates in November.

That said, stronger growth and concerns that the economy could be more prone to bouts of inflation post-pandemic have delayed the timing and magnitude of rate cuts in 2024. We now expect the Fed to cut rates in July instead of May and only cut by a quarter instead of a half of one percent at that meeting.

Central banks around the world are worried that the post-pandemic economy will be more susceptible to bouts of inflation than the world we left. Escalating geopolitical tensions, climate change and a rethinking of supply chains are all adding to frictions in the flow of goods and services across borders, which makes the global economy more vulnerable to supply shocks.

“A government shutdown would exacerbate weakness in the fourth quarter and... have a lingering effect on growth.”

A government shutdown

Chart 2 shows the impact of a shutdown that lasts from mid-November until just before the Christmas holiday. A shutdown of that duration is expected to shave at least 0.7% from growth in the fourth quarter and give it back in the first quarter, once the government is up and running again.

Downside risks: That may be too optimistic. This would be the first government shutdown to occur amidst an aggressive credit tightening cycle, which includes reductions in the Fed’s bloated balance sheet. That means that the Fed, along with other major central banks – including the People’s Bank of China and the Bank of Japan – are no longer the primary buyers of Treasury bonds. Private investors, who are more skittish and prone to external shocks, have stepped in. Those shifts, widening budget deficits and a surge in Treasury bond issuances have added to volatility in the bond market.
Add the dysfunction we have seen, and it is little surprise that two of the three major rating agencies have already downgraded the credit worthiness of U.S. debt. One cited “an erosion in governance” among its reasons. The last remaining holdout has said it would downgrade if a shutdown occurred. That could add to the upward pressure on rates and take a larger toll on the economy in 2024. Interest rate sensitive sectors, from real estate to finance, would be hit hardest.

A shutdown of that magnitude would jeopardize the Fed’s ability to gauge the course of the economy. All data releases by the government would be suspended if a shutdown were to occur, while some could be lost entirely. Surveys on economic data in December could be suspended if the government goes into a full shutdown. That didn’t happen in 2018-2019, as the shutdown was only partial.

This is in addition to the collateral damage to agencies that are forced to work with skeletal unpaid staff. In early 2019, unpaid TSA agents and airport controllers staged sickouts as the shutdown wore on. Approvals and payments to hospitals for Medicare could also be delayed.

To add insult to injury, most federal employees are precluded from getting side jobs when the government goes into a shutdown. Congress will continue to be paid, even as these employees struggle to make ends meet.

**Bottom Line**

The economy has proven remarkably resilient, with accelerating growth, in spite of the most aggressive credit tightening cycle by the Fed since the 1980s. Recent revisions to the data only shore up that narrative; they suggest that households have much more savings than we previously thought to weather the storm of tighter credit conditions.

The sand in the gears is a government shutdown. That would exacerbate weakness in the fourth quarter and could have more of a lingering effect on growth than it did in the past. Every time I think the bar for political discourse can’t go any lower, it does. I would like to be surprised on the upside for a change. I say this in the most positive of ways. Congress, make my day.
# Economic Forecast — October 2023

## National Outlook

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## Inflation

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## Special Indicators

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<td>612</td>
<td>445</td>
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## Vehicle Sales

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## Interest Rate/Yields

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<tr>
<td>Federal Funds</td>
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<td>3.8</td>
<td>3.6</td>
<td>3.8</td>
<td>4.1</td>
<td>4.7</td>
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<td>Corporate Bond BAA</td>
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<td>5.8</td>
<td>6.1</td>
<td>6.6</td>
<td>6.5</td>
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## Exchange Rates

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<tbody>
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<td>Dollar/Euro</td>
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<tr>
<td>Yen/Dollar</td>
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<td>145.0</td>
<td>140.0</td>
<td>137.0</td>
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</tbody>
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<sup>1</sup> in 2022, GDP was $21.8 trillion in chain-weighted 2017 dollars.

<sup>2</sup> Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

<sup>3</sup> Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change. Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.