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The U.S. Economic Outlook for 2024–2025

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Executive Summary

Bottom Line

With trend inflation converging to normal, we expect the Fed to pivot soon to focus on preserving full employment. We believe that it will succeed. We project the quarterly pace of economic growth to moderate in the near term, decelerating to about 1.5 percent annualized in 2024Q2. Growth accelerates thereafter, ramping back up above 2.0 percent by 2025Q2. The unemployment rate is projected to creep up through 2025Q2, reaching 4.0 percent. We do not expect inflation to re-accelerate meaningfully, facilitating the start of cuts to the fed funds rate by mid-year.

American Consumer Keeps Going

Real GDP grew at an annualized pace of 3.3 percent in the fourth quarter of 2023. Although the pace of expansion cooled off from the red-hot 4.9 percent rate in the third quarter, it still surprised on the upside. The American consumer continues to defy predictions of imminent belt-tightening, with consumption adding 1.9 percentage points to real GDP growth in 2023Q4. Real compensation grew strongly in the second half of 2023, thanks to the robust labor market and the rapid recent disinflation, helping to fuel the ongoing strength of consumption.

Recent payroll employment gains have surprised to the upside. The labor market averaged 255,000 new jobs per month in 2023, less than 2022's 377,000 monthly pace, but much stronger than 2019's average of 166,000. This year got off to a hot start with 353,000 new jobs added in January. We expect job gains to continue to decelerate, however. The unemployment rate rose from 3.4 percent in January 2023 to 3.8 percent in August before stabilizing at 3.7 percent from November through January.

Rapid Disinflation with a January Question Mark

Core PCE inflation, a key metric for forecasting future inflation, decelerated sharply during the second half of 2023, declining from 4.3 percent year over year in June to 2.9 percent in December. The annualized pace of monthly core PCE inflation has registered at or below the 2.0 percent rate in six of the past seven months. Monthly PCE Inflation in core non-housing services is almost down to the pre-pandemic level.

PCE housing inflation has been stuck at a higher level, however, averaging about a 5.7 percent annualized pace since June 2023. We are still expecting markedly slower new tenant rent inflation to exert further downward pressure on the PCE housing price index. The January 2024 CPI report came in hotter than expected, with shelter inflation re-accelerating. The PCE price index is closely related to the CPI, but the share of housing in the PCE basket is much lower. It remains to be seen whether the January CPI report turns out to be just a blip.

Housing Rollercoaster

The 30-year conventional fixed rate mortgage rate has averaged about 6.7 percent so far this year after climbing to nearly 7.8 percent in late October 2023. The NAHB's Housing Market Index, which measures builders' sentiment in the market for new single-family homes, improved from December through February after plummeting from July through November 2023 as mortgage rates spiked. The new home market is still working through the supply overhang that developed in 2022. However, we remain cautiously optimistic about the single-family residential construction market. It stands to benefit from the ongoing decline in mortgage rates and constrained supply of existing homes for sale.

Monetary Policy Easing Is Here

Our forecast is consistent with a Fed that is done hiking for the current cycle, given that inflation has come down sharply while the labor market remains tight. We project the Fed to start cutting rates slowly by mid-2024. By that time, we expect unemployment to be on a gradual ascent with inflation running near the Fed's target. With the fed funds rate around 5.3 percent, maintaining the implied short-term real interest rate of above 3.0

percent will jeopardize the full employment mandate. Policy loosening has effectively started already, as expectations of future Fed policy have shifted substantially since last fall. Once actual cuts begin, we expect the Fed to proceed slowly—by 25 basis points at roughly every other meeting.

Six Percent Deficits to Linger

We believe that the November 2024 elections are likely to yield a divided government in one form or another. We therefore expect the status quo to persist in fiscal policy. The ultimate fiscal policy path for fiscal 2024–25 is likely to feature a robust increase in defense spending, with some spending restraint for discretionary non-defense spending.

The federal deficit widened from 4.4 percent of GDP in fiscal 2022 to 5.8 percent in fiscal 2023. With elevated interest rates and no significant revenue-raising reforms in sight, the federal deficit hovers around 6.0 percent over our forecast horizon. The privately held debt-to-GDP ratio is poised to increase from 79.3 percent in 2023Q4 to 86.1 percent in 2025Q4.

The 2024–25 Outlook

Our baseline forecast is that the recent decline in inflation will persist, and the Fed will be able to follow through on its plans to begin cutting short-term interest rates this year. While residential construction is expected to expand, we anticipate consumers to pull back on their spending as the unemployment rate creeps up slightly. Consequently, quarterly real GDP growth decelerates to slightly below trend in 2024Q2–Q4. We expect growth to rebound to a 2.0 percent pace by 2025Q1 and stay in that range through yearend. On a Q4-to-Q4 basis, real GDP grows by 1.8 percent during 2024 and 2.2 percent during 2025.

We expect PCE inflation to continue to converge towards the Fed's 2.0 percent goal over the next year (with CPI running slightly ahead), as shelter costs decelerate and consumer goods inflation stays muted. Core CPI inflation registers 3.4 percent year over year in 2024Q1 before slowing to 2.4 percent by 2024Q4, where it remains for the rest of the forecast. Core CPI inflation outpaces the headline throughout the forecast, as gasoline price increases remain subdued and food inflation slows.

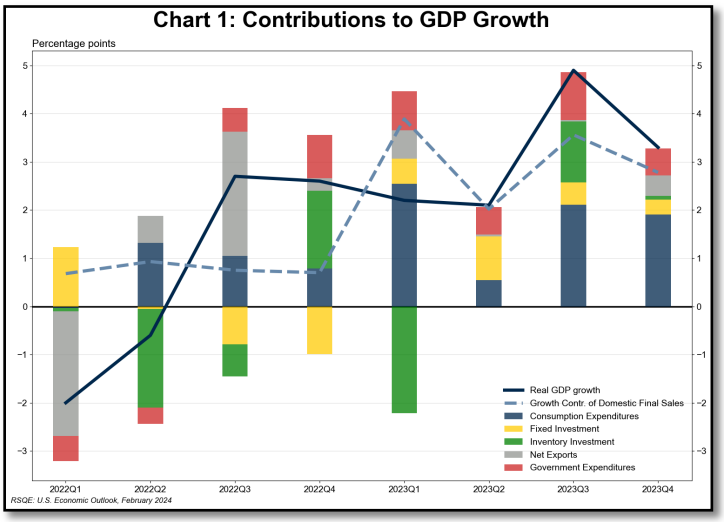
After a brief upswing in 2024Q1, the slowing trend in job gains continues in the forecast through 2025Q1. Monthly job gains bottom at around 90,000 jobs but improve only modestly in 2025Q2–Q4. On a calendar-year basis, the economy adds 2.5 million jobs in 2024 and 1.3 million in 2025. The unemployment rate edges up from 3.7 percent in 2024Q1 to 4.0 percent in 2025Q1. It then ticks down slightly beginning in mid-2025 as monetary conditions ease.

High prices, limited inventory, and ongoing declines in mortgage rates all help to spur activity in the residential construction market over our forecast period. Single-family housing starts take a breather to begin 2024 but then climb in every quarter of our forecast. They climb by 140,000 units from 2023 to 2024. Multi-family starts are forecast to grow modestly from their recent levels as a robust economy drives rental demand growth. A hefty decline during 2023, however, means that the 2025 calendar-year average remains 40,000 units lower than in 2023. Total housing starts climb from 1,415,000 units last year to 1,439,000 this year and 1,516,000 in 2025.

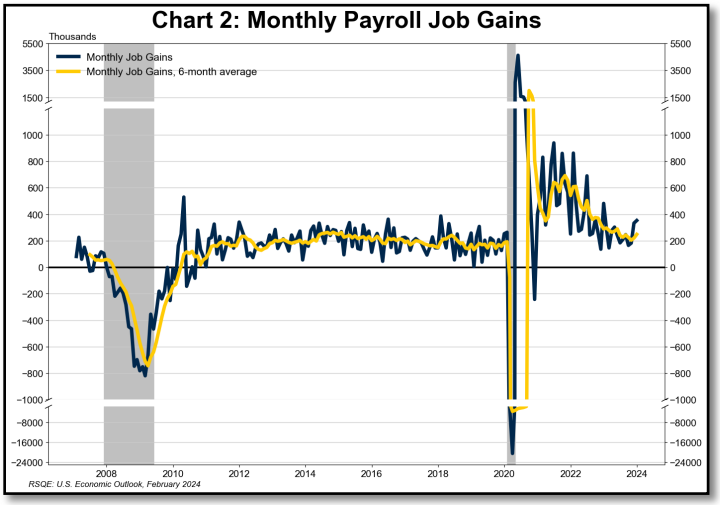
	Actual		RSQE Forecast	
	2022	2023	2024	2025
GDP (billions of current $)	25744.1	27356.4	28601.5	29757.5
Real GDP (billions of 2017 $)	21822.0	22375.3	22930.6	23372.3
% change: year-over-year	1.9	2.5	2.5	1.9
% change: 4th-qtr-to-4th-qtr	0.7	3.1	1.8	2.1
Nonfarm payroll employment (millions)	152.5	156.1	158.6	159.9
Civilian unemployment rate (%)	3.6	3.6	3.8	4.0
Capacity utilization, total industry (%)	80.3	79.3	78.5	78.4
Inflation (private nonfarm GDP deflator, % change)	7.1	3.6	2.0	2.1
Inflation (CPI-U, % change)	8.0	4.1	2.4	2.2
Inflation (core CPI, % change)	6.1	4.8	2.8	2.4
Light vehicle sales (millions)	13.8	15.5	16.0	16.4
Private housing starts (thousands)	1551.3	1414.8	1439.4	1516.2
3-month Treasury bill rate (%)	2.0	5.1	5.0	4.1
10-year Treasury note rate (%)	3.0	4.0	4.0	3.8
Conventional mortgage rate (%)	5.3	6.8	6.2	5.6
Real disposable income (billions of chained 2017 $)	16116.9	16796.0	17189.3	17557.2
% change	-6.0	4.2	2.3	2.1
Corporate profits after tax (billions of current $)	2980.5	2987.3	3349.4	3417.6
Value of U.S. $ (FRB broad index), % appreciation	6.7	-0.2	-0.4	0.0
Current account balance (NIPA basis, billions of current $)	-985.8	-832.7	-803.3	-805.0
Federal surplus (FY, NIPA basis, billions of current $)	-1114.8	-1564.2	-1769.1	-1729.7

The Current State of the Economy

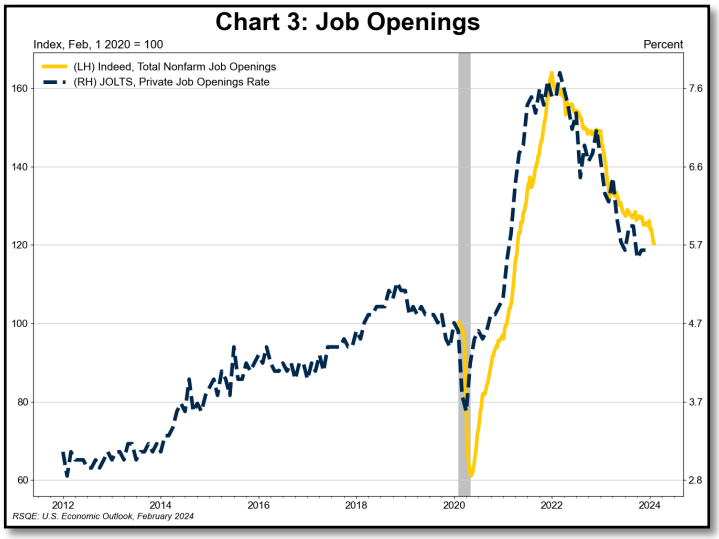
Real GDP grew at an annualized pace of 3.3 percent in the fourth quarter of 2023. Although the pace of expansion cooled off from the red-hot 4.9 percent rate in the third quarter, it still surprised on the upside. Chart 1 shows the growth rate of real GDP and the growth contributions of its major components since the beginning of 2022. A step down in the contributions of the volatile inventory investment and net exports components accounted for 0.8 percentage points of the 1.6 percentage point deceleration in topline GDP growth. Slower growth of government spending and private fixed investment accounted for a further 0.6 percentage points of the slowdown. The American consumer continues to defy predictions of imminent belt-tightening, with consumption adding 1.9 percentage points to real GDP growth in 2023Q4. Consumption of goods remains at a high level relative to disposable incomes. Many observers had therefore expected the downward trend in this share from 2022Q2 to 2023Q2 to continue. Instead, it rebounded in the second half of 2023.

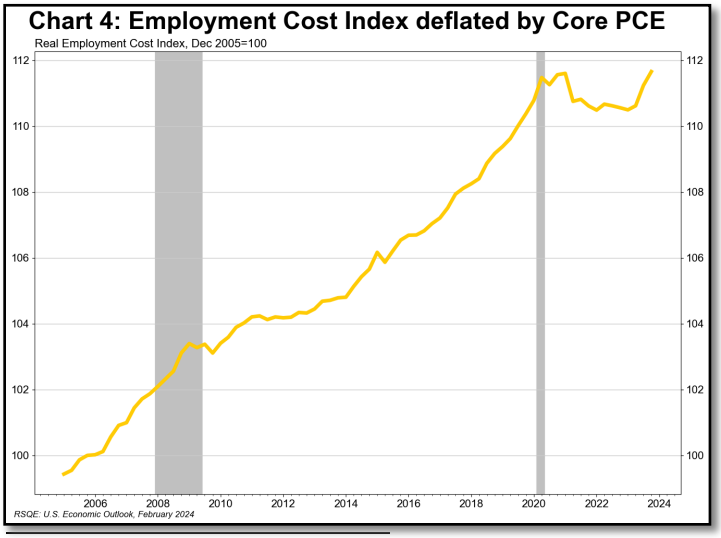


Consumers' resilience likely has multiple legs to stand on. First, equity values improved considerably over the course of 2023 after the considerable declines in 2022. Revolving consumer credit—largely comprised of credit card debt and unsecured revolving lines of credit—continues to expand at a brisk pace despite much higher interest rates, the considerable tightening in the terms of credit reported by the Federal Reserve's survey of loan officers, and rising delinquency rates. Finally, real wages are rising again thanks to the robust labor market and the rapid disinflation.



Monthly job gains slowed during most of 2023, and as of November 2023 the six-month average of job gains stood at 205,000. Payroll job gains jumped back over 300,000 in December 2023 and January 2024, though, suggesting the labor market has not run out of steam yet. The unemployment rate rose from 3.4 percent in January 2023 to 3.8 percent in August before stabilizing at 3.7 percent from November through January. The private job openings rate remains far above its pre-pandemic level, despite trending down for almost two years. Likewise, the data from Indeed.com show about 20 percent more job openings than four years ago, with payroll counts rising only about 3.7 percent over the same time. While the pace of nominal wage increases has slowed somewhat over the past year, the rapidly slowing rate of price inflation has resulted in measurable real compensation growth, as shown in chart 4.[1] As inflation accelerated in mid-2021, real compensation took a hit and then stagnated through 2023Q2. The rapid disinflation in the second half of last year, however, resulted in a 0.9 percent non-annualized increase in real compensation.

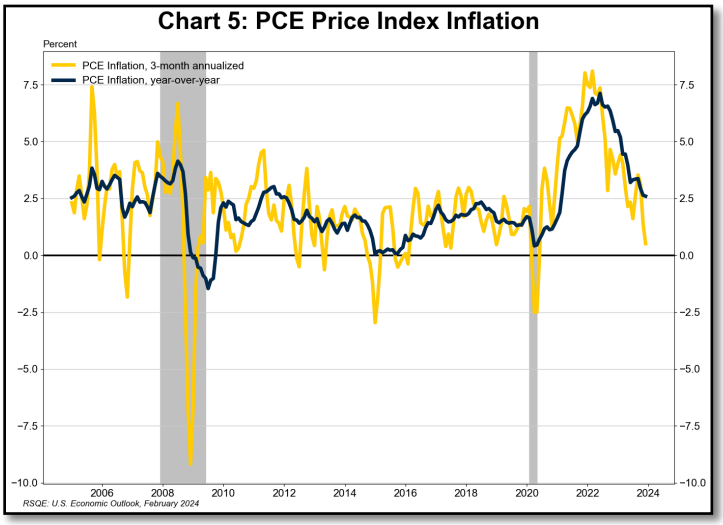




[1] We chose the employment cost index for civilian workers to abstract from pandemic-driven shifts in the composition of jobs in the economy, and we deflated the index by the core personal consumption expenditures (PCE) price index to look beyond the spikes in energy and food prices, which have since abated.

Our outlook depends critically on what inflation will do in the near term. The Fed targets PCE inflation at an average pace of 2.0 percent per year. As of December 2023, year-over-year PCE inflation had declined to 2.6 percent, with the 3-month annualized pace sliding well below 2.0 percent in recent months. While energy and food price dynamics are responsible for some of that deceleration, core PCE price index inflation dipped to 2.9 percent year over year in December 2023, with the pace during the fourth quarter running at 1.5 percent.

Chart 5: PCE Price Index Inflation



Goods prices have been largely flat since mid-2022, a return to the pre-Covid pattern that we largely expect to continue. Hence, the bulk of the recent disinflation has been due to the prices of services. Housing accounts for about a quarter of all personal consumption expenditures on services. PCE housing services price index inflation continues to moderate, but from a very high level. That measure, which reflects average housing costs in the economy, has diverged considerably from measures of rent inflation for new tenants.

Chart 6: Shelter Inflation

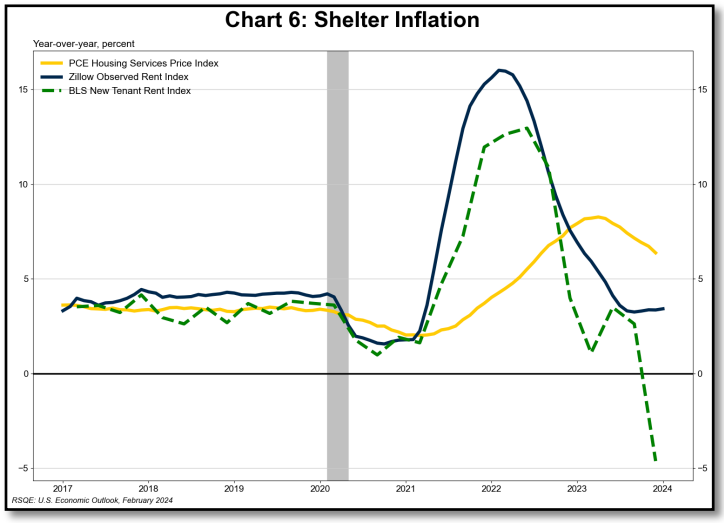
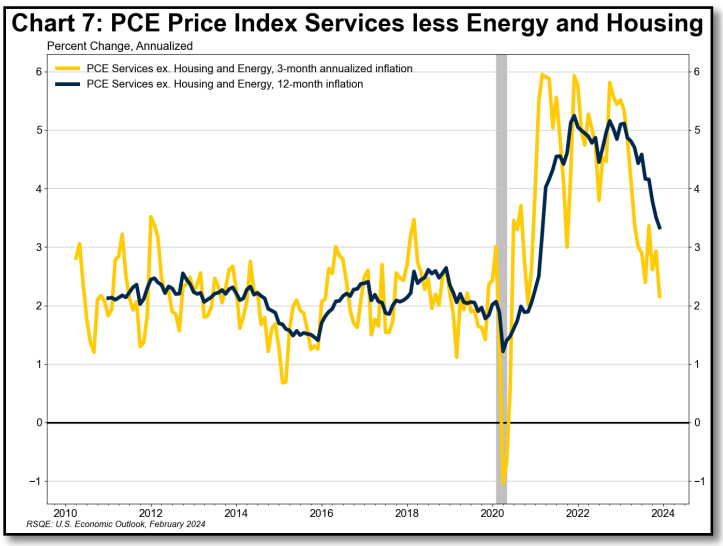
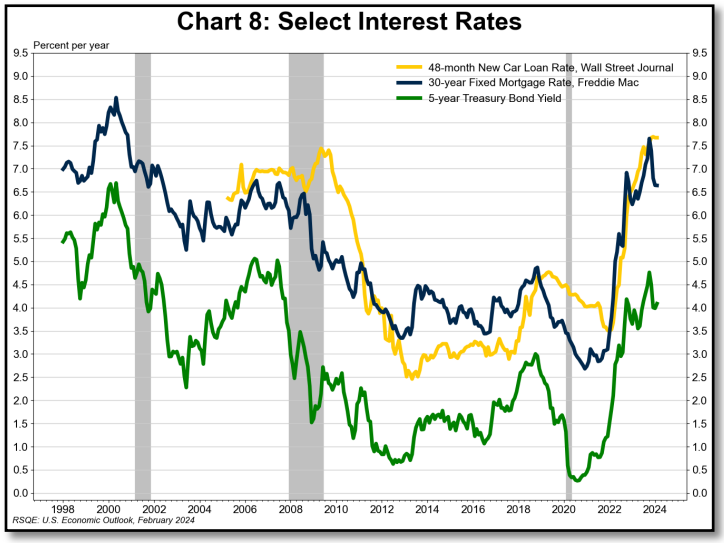


Chart 6 shows two such measures, Zillow's observed rent index and BLS's experimental new tenant rent index. Both indices peaked in mid-2022 and dropped below their pre-Covid readings by mid-2023. Year-over-year PCE housing services inflation, however, peaked only in March 2023. The downward progress since then has been slow. In the second half of 2023, monthly housing inflation averaged about a 5.7 percent pace annualized, far outside of its pre-Covid range of 3.3–3.5 percent. Still, we expect shelter inflation to keep decelerating gradually.



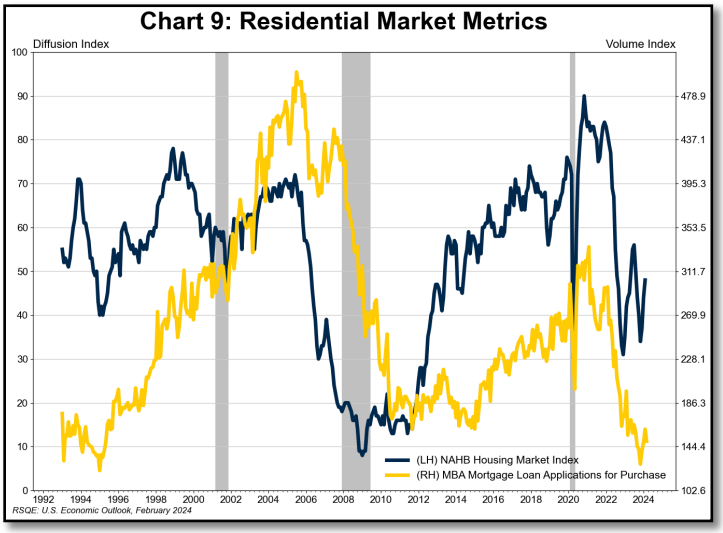
Outside of housing, there has been a very substantial disinflation in the rest of the core services sector since mid-2023. The 12-month pace of inflation dropped from 4.6 percent in July 2023 to 3.3 percent in December. The 3-month annualized inflation rate has slowed even further, falling to just 2.2 percent for October–December 2023, around its pre-pandemic range.

Although a mild near-term reacceleration is possible, we believe that PCE inflation is likely to remain near the Fed's 2.0 percent target while nominal wage gains run ahead. As a result, further real compensation growth will help fuel ongoing growth of consumption expenditures.

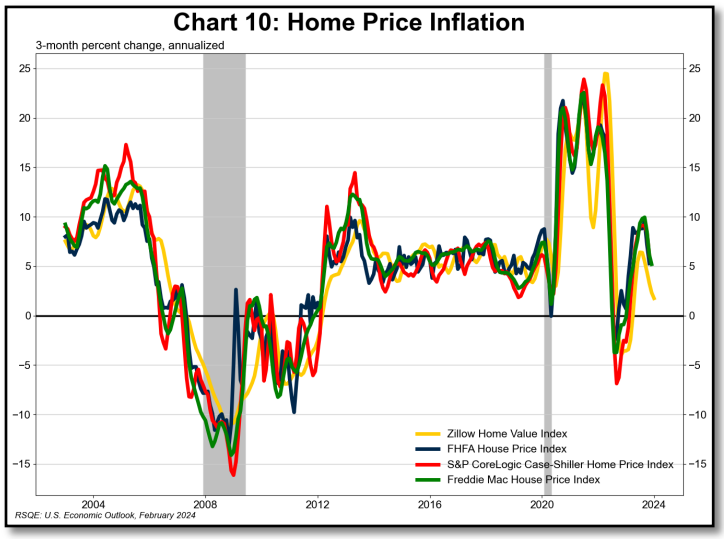


This recent dramatic disinflation has led to a considerable shift in expectations of future Fed policy toward a less restrictive stance, resulting in the easing of current financial conditions. Between late October 2023 and early February 2024, the yield on 5-year Treasury debt came down by more than 80 basis points (bps). Many consumer and corporate interest rates followed Treasury yields lower, with a few exceptions such as the 48-month new car loan rate reported by the Wall Street Journal and Bankrate.com. The 30-year fixed mortgage rate has declined by about 120 bps since late October, falling to around 6.6 percent as of early February.

Chart 9 shows the National Association of Home Builders' (NAHB's) Housing Market Index and the Mortgage Bankers Association's index of loan applications for purchases. The steep fall-off in homebuilder sentiment and mortgage application activity during 2022 is clearly visible, as is the short-



lived recovery in early 2023, which was driven by a temporary respite in mortgage rates. Recent improvements in both metrics due to the latest declines in mortgage rates have been quite modest so far. However, we remain cautiously optimistic that residential single-family construction activity will continue ramping up from here, helping to fill the large void in the overall housing market left by existing homeowners choosing to hold on to their low interest rate mortgages instead of selling their homes.



This shortage of new listings of existing homes for sale led to a re-acceleration of home price inflation in 2023 despite sharply higher mortgage rates. By the fall of 2023, the pace of new listings stabilized, and the impact of higher mortgage rates took over once again, resulting in slowing home price inflation toward the end of the year. Most housing price index values for a particular month are constructed to reflect contracts signed over the several prior months. As a result, home price indices will likely not receive a boost from recent declines in mortgage rates for at least a few more months.

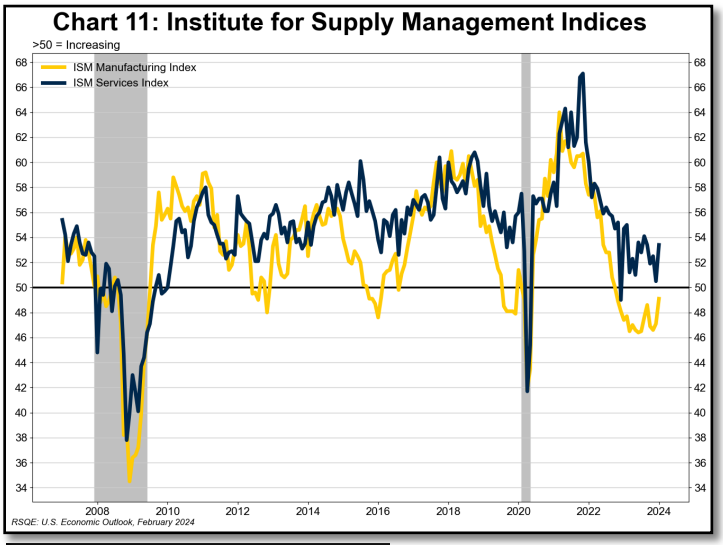
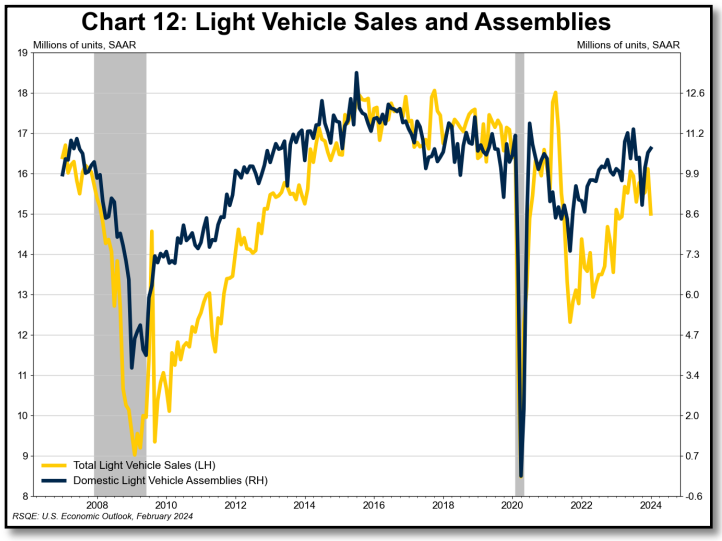


Chart 11 shows the Institute for Supply Management's (ISM's) Purchasing Manager Indices for manufacturing and services.[2] The

[2] Readings below 50 are consistent with slowing business activity.

index for manufacturing has been indicating slowing activity since November 2022. The index rebounded to 49.1 in January 2024, however, suggesting that a recovery in manufacturing could start soon. More importantly, the ISM services index rebounded to a respectable 53.4 reading in January 2024, up from a near-stall level of 50.5 in December 2023.



The light vehicle market appears to be stuck in low gear. New vehicle loan interest rates have not followed Treasury yields down, possibly reflecting rising newly delinquent auto loan balances. In fact, as of early February, 48-month loan rates for new vehicle purchases stood at a 52-week high of 7.9 percent. The annualized vehicle sales pace jumped to 16.1 million units in December 2023, only to dip to 15.0 million in January. The pace of sales appears to be stuck in the neighborhood of 15.5 million units per year once smoothed through the recent (possibly weather-driven) volatility. The pace of domestic light vehicle assemblies had largely recovered from the impact of last fall's strike by December. With the dealer inventory situation gradually improving and consumer incentives making a comeback, we still expect light vehicle sales to climb meaningfully in 2024.

Overall, the state of the economy remains noisy and challenging to interpret. Several key government surveys have suffered non-trivial declines in response rates in recent years, complicating our task further. We believe that the current picture is consistent with the pace of economic growth slowing modestly from the recent readings, but remaining healthy throughout our forecast window.

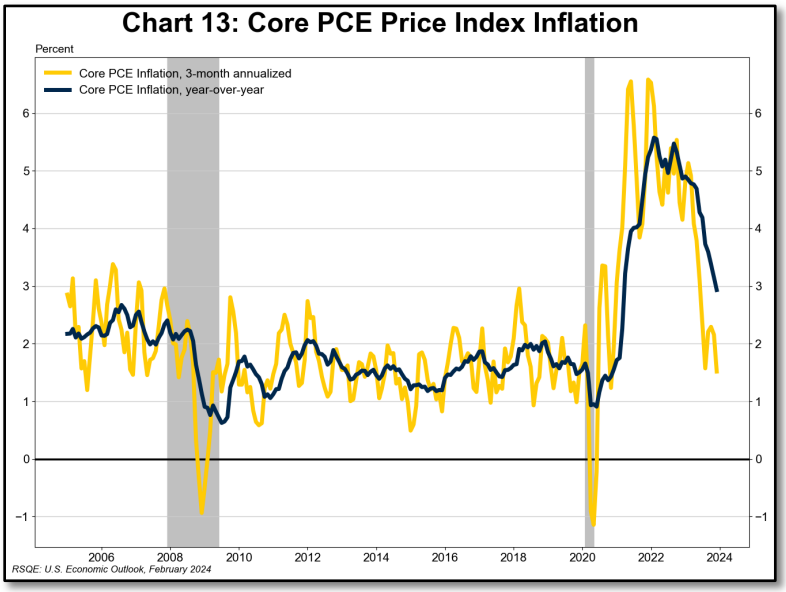
Next, we outline several key policy and economic assumptions underlying the forecast.

Monetary Policy

The Federal Open Market Committee (FOMC) remains committed to bringing inflation down to its 2.0 percent objective. After hiking the federal funds rate by 25 basis points in each of its first three meetings of 2023, the Committee decided to forego a rate hike at its June meeting. The FOMC raised the target range by 25 further basis points in July to 5.25–5.5 percent and has opted to hold at that range in each of the past four meetings, including January 2024.

After the January meeting, FOMC members signaled an end to the current hiking cycle, judging "that the risks to achieving its employment and inflation goals are moving into better balance." This comment was followed by "The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent." We interpret this language as signaling that the Fed will not cut rates at its next meeting in March, and it is not planning to cut quickly once it starts.

The median economic projection for the federal funds rate among December FOMC meeting participants also indicated that the current 5.25–5.5 percent target range was the expected peak of this hiking cycle. The median Committee member saw three cuts in 2024, and no individual member projected a future hike through 2026. The Committee maintained its belief that inflation would continue to normalize, with the participants' median projection of year-over-year PCE price index inflation falling to 2.4 percent by the end of this year and 2.1 percent by the end of 2025. At the same time, the median projection saw the unemployment rate rising to 4.1 percent this year and holding at that level through 2026.



Core PCE inflation, a key metric for forecasting future inflation, stood at 2.9 percent year over year in December. This metric has been slowing consistently since the September 2022 reading of 5.5 percent. The 3-month

average (annualized) rate currently sits at 1.5 percent, the lowest reading since December 2020. The pace of monthly core PCE inflation has registered at or below the 2.0 percent level in six of the last seven months. This rapid deceleration of trend inflation provides support for the Fed's decision to take further hikes off the table. Non-housing services (roughly a 50-percent slice of private consumption) has been one of the remaining sectors displaying stubbornly high inflation, but it has been showing signs of sustained slowing recently (as shown on chart 7 in the previous section).

The Fed's statutory dual mandate requires a balanced approach to promoting maximum employment alongside price stability. The labor market held up remarkably well in 2023 in the face of tightening monetary conditions, including a strong end to the year, but job growth has generally followed a decelerating trend. Total nonfarm payroll employment increased by 182,000 jobs in November, 333,000 in December, and 353,000 in January. Those gains were below 2022's monthly average of 377,000, but they show that labor demand remains strong. This resilience gives the Fed a longer runway to ensure above-target inflation is extinguished prior to pivoting toward lower rates.

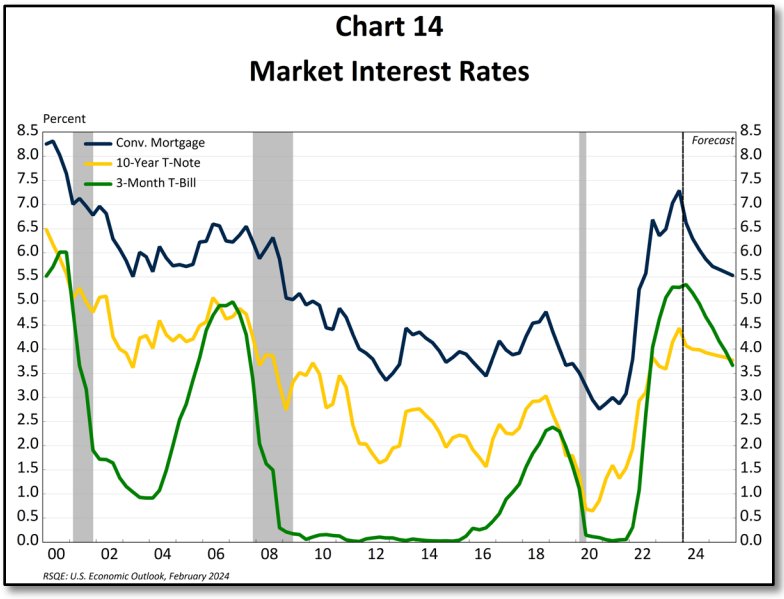
Keeping longer-term inflation expectations in check is important for maintaining economic stability. The economic costs of reining in inflation would likely be much larger if high inflation were to become engrained in long-term plans and contracts. Fortunately, most measures of inflation expectations have remained reasonably well-anchored in 2023 and early in 2024. The 5-year-to-10-year inflation expectations measure from the University of Michigan's Surveys of Consumers remained around 3 percent throughout 2023 and into February 2024.

The Fed has been reducing the size of its balance sheet since May 2022, though the pace of the sell-off has been somewhat slower than initially announced. The Fed's current path is to shrink its balance sheet by over 70 billion dollars per month. The Fed is expected to begin deliberations on slowing the pace of run off this year as its tightening campaign ends, which will likely leave the balance sheet larger relative to the size of the economy than prior to the pandemic.

We believe that our forecast is consistent with a Fed that is done hiking in the current cycle. We project the Fed to start cutting rates slowly by mid-2024. At that time, we expect unemployment to start edging up slightly and the quarterly pace of core PCE inflation to be running around 2.1 percent. With the

fed funds rate still around 5.3 percent, the implied short-term real interest rate of above 3.0 percent will likely appear overly restrictive given the softening labor market and normalizing inflation. We expect the Fed to cut rates slowly, however, by 25 basis points at roughly every other meeting throughout our forecast horizon.

Chart 14 shows our projections for selected key interest rates. The 3-month Treasury bill rate declines from 5.3 percent in 2024Q1 to 4.7 percent in 2024Q4 and 3.7 percent in 2025Q4. The 10-year Treasury rate falls from 4.4 percent in 2023Q4 to 4.1 percent in 2024Q1, 3.9 percent in 2024Q4, and 3.8 percent in 2025Q4, leading to a nearly flat yield curve by the end of 2025. Mortgage rates decline more quickly than longer-term government bond yields as the excess spread that has developed between them shrinks toward more normal levels. The 30-year conventional fixed-rate mortgage rate falls to 6.6 percent in 2024Q1, 5.9 percent in 2024Q4, and 5.5 percent by 2025Q4.



Fiscal Policy

This past January proved that one of the few ways to get a divided Congress to work together is to introduce a bill proposing sizable tax breaks coupled with spending that address distinct priorities for both parties. The Tax Relief for American Families and Workers Act, which passed in the House with an unusually large margin of 357-50, is one example. Given the wide bipartisan support in the House, we believe that this bill will likely become law with some adjustments. We expect some delays, though, because the Senate's next day in session is not until February 26th.

The current bill includes increases in refundable child tax credits, an expansion of low-income housing financing, and an extension of the 100-percent bonus depreciation from the Tax Cuts and Jobs

Act of 2017 until the end of 2025. In addition, it also reinstates the immediate write-off on research expenditures retroactively to 2022. If enacted, we anticipate a temporary drag on government revenues in fiscal 2024 along with a gradual impact on federal transfers to persons. Estimates from the Congressional Budget Office and the Joint Commission on Taxation suggest that this bill would add an additional 44.7 billion dollars to the federal budget deficit from FY2024–28. If the tax incentives were to expire as scheduled, revenues would rise, leading to only slightly higher cumulative deficits by the end of FY2033.

Other than this rare recent bipartisan effort in the House, Congress has been struggling to fund the government for more than a few months at a time, despite being nearly halfway through the current fiscal year. So far, only defense spending has been enacted for fiscal 2024, toplined at 883.7 billion dollars with a 3.0 percent increase from 2023. With the next funding deadline on March 1st, the Senate and the House have fewer than seven business days combined to cook up a continuing resolution. Given that contentious fights have become the norm, the ultimate fiscal policy path for fiscal 2024 is likely to feature a robust increase in defense spending, with some spending restraints for discretionary non-defense spending. We do not expect the currently looming sequestration cuts to be triggered on April 30th, as we expect Congress to finally approve full fiscal year appropriations before then.

Table 1 contains fiscal year data and our projections for the federal budget on a National Income and Product Accounts (NIPA) basis from fiscal years 2022 to 2025. In fiscal 2023, the 3.1 percent decline in current receipts was driven primarily by lower capital gains tax revenue due to the abysmal stock market performance in 2022. Looking ahead, we project modest gains in receipts in fiscal 2024, as we anticipate that the restoration of the deduction for research expenditures and other business tax breaks subject to the Senate's approval will put a dent in the

Table 1
Federal Budget, NIPA Basis
(Billions of Dollars)

			FY Forecast	
	2022	2023	2024	2025
Current receipts	4899.6	4747.6	4782.9	5078.5
% change	16.1	-3.1	0.7	6.2
Current expenditures	6014.4	6311.8	6552.0	6808.2
% change	-15.0	4.9	3.8	3.9
Consumption	1215.2	1306.1	1386.2	1447.0
% change	1.1	7.5	6.1	4.4
Transfer payments	3954.9	4004.4	3991.4	4110.4
% change	-17.6	1.3	-0.3	3.0
Federal subsidies	172.9	102.7	96.0	84.5
% change	-66.8	-40.6	-6.5	-11.9
Interest payments	671.3	898.6	1078.4	1166.2
% change	21.8	33.8	20.0	8.1
Surplus (+) or deficit (-)	-1114.8	-1564.2	-1769.1	-1729.7
Percent of GDP	-4.4	-5.8	-6.2	-5.9

RSQE: U.S. Economic Outlook, February 2024

near-term corporate tax collections. In fiscal 2025, with no new tax cuts expected, revenue growth accelerates to 6.2 percent.

On the other hand, we expect the growth of federal expenditures to slow down over the next two years, from 4.9 percent in 2023 to 3.8 percent in 2024 and then to 3.9 percent in 2025. Transfer payments are set to grow again after a pause in 2024, rising by 3.0 percent by fiscal 2025, owing to the extension of the pandemic-era Affordable Care Act credits and the expected expansion of the child tax credits. Additionally, we project federal subsidies to continue shrinking toward their pre-pandemic levels through fiscal 2024–25. Interest payments on the federal debt, however, rose by over one-third in fiscal 2023 due to sharply higher interest rates, marking the largest surge since 1947. The growth of interest payments will decelerate to 20.0 percent in 2024 and 8.1 percent in 2025.

The federal deficit widened from 4.4 percent of GDP in fiscal 2022 to 5.8 percent in fiscal 2023. With elevated interest rates and no significant revenue-raising reform in sight, the federal deficit hovers around 6.0 percent over our forecast horizon, reaching 6.2 percent of GDP in fiscal 2024 and edging down to 5.9 percent in fiscal 2025. While our baseline forecast assumes that the Fed will taper the pace of its sales of Treasury security holdings starting from 2024Q2, the privately held debt-to-GDP ratio is poised to increase from 79.3 percent in 2023Q4 to 86.1 percent in 2025Q4 as large federal deficits continue unabated.

The Housing Market

Mortgage rates have declined by more than a percentage point since last October, bringing some much-needed relief to prospective homebuyers. The 30-year conventional fixed rate mortgage rate, as reported weekly by Freddie Mac, has hovered round 6.6 percent since late December 2023 after climbing to nearly 7.8 percent in late October. The decline in mortgage rates has led home purchases to become more affordable relative to incomes, and we expect further improvement in the years ahead. Still, we project housing purchases to remain significantly less affordable in the years to come than they were in the era of three-percent mortgages.

Our preferred measure of house prices, the seasonally adjusted S&P CoreLogic Case-Shiller National Home Price Index, currently extends only through November 2023, so it is too early to assess the effects of the decline in rates on prices. The academic literature suggests that movements in house prices tend not to fully offset the impact of changes in mortgages rates on monthly mortgage payments.[3] We therefore expect the recent decline in rates to translate to at least some improvement in affordability.

More timely indicators of activity in the housing market are already showing signs of stabilization following the decline in mortgage rates. The Mortgage Bankers Association's index of loan applications for purchases has recently displayed some faint signs of life, returning to summer 2023 levels after nosediving last fall. The University of Michigan Survey of Consumers' sentiment indices of conditions for buying and selling a home both improved slightly in January–February, although they remain at much lower levels than prior to the run-up in mortgage rates. Existing home sales hovered at a very slow sales pace of around 3.4 million per year in the fourth quarter of 2023, but they appear to have arrested their descent from earlier in the year. Seasonally adjusted months' supply of single-family existing homes rose from under 3.0 months in February–July 2023 to 3.7 in November–December, indicating a slightly looser market. We believe that high mortgage rates continue to lock potential sellers into the low-rate mortgages they secured in the past. Further declines in mortgage rates should help to unlock inventory and allow for the return of healthier activity in the market for existing homes.

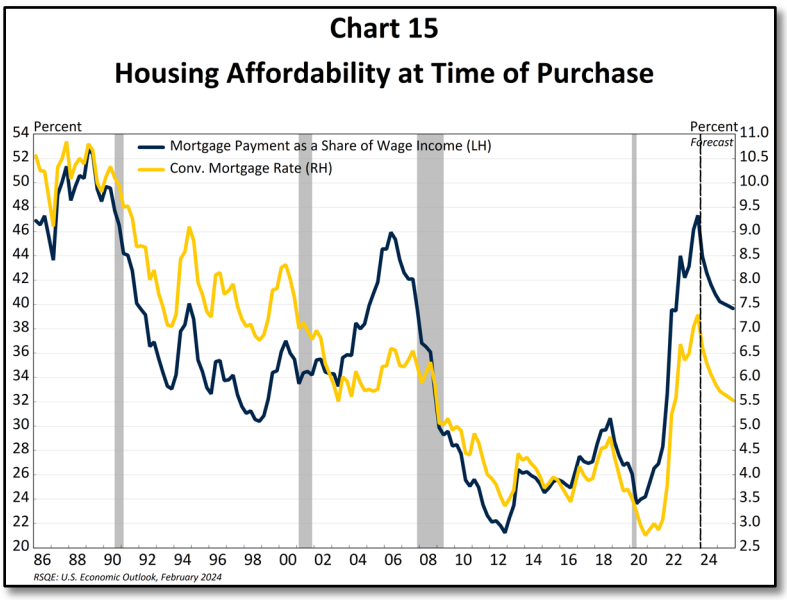


Chart 15 plots our preferred measure of affordability, our calculation of the ratio between a mortgage payment on a newly bought home and the average wage income per worker. We estimate that this ratio climbed to 47.3 percent in the fourth quarter of 2023, the highest since 1990. As mortgage rates decline

[3] See, for instance, Sean Campbell, Morris Davis, Joshua Gallin, and Robert Martin, "What Moves Housing Markets: A Variance Decomposition of the Rent-Price Ratio," *Journal of Urban Economics*, 2009, 66(2).

over our forecast period, we project the affordability ratio to dip below 40 percent by the end of 2025. That would be welcome relief for prospective homebuyers, but house purchases will remain much less affordable than in the years prior to the pandemic. We estimate that from 2010 through 2019, the mortgage payment on a newly purchased home averaged just over one-quarter of average wage income per worker.[4]

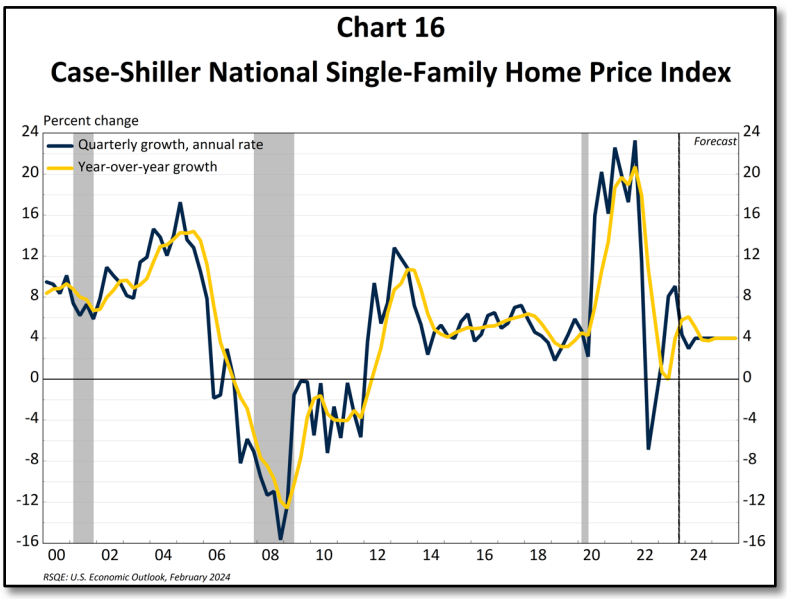
The market for newly built homes features more margins for price adjustment than the existing-homes market. Homebuilders can adjust lot and house sizes, finishes, appliances, and other features to compensate partially for the spike in mortgage rates. The market for new construction has accordingly held up better than the existing homes market recently. The low inventory level in the existing homes market has also cushioned the blow from higher mortgage rates to new construction activity.

Annualized sales of new single-family homes dipped from 693,000 in the third quarter of 2023 to 652,000 in the fourth quarter, but we expect a rebound in the first quarter of 2024. Single-family housing starts climbed to an annualized pace of 1,051,000 in the fourth quarter of 2023, about 25 percent higher than in the first quarter. Months' supply of new single-family homes for sale stood at 8.2 in December 2023. That level was down from the recent peak of 10.1 months' supply in July 2022, but above the 7.1 months' supply in July 2023. We believe that a balanced market is likely to feature under 6 months' worth of supply. The market is working through the supply overhang that developed in 2022 in fits and starts. We remain cautiously optimistic about the single-family residential construction market, which should benefit from the ongoing decline in mortgage rates.

Multi-family housing starts retreated in 2023 after a banner performance in 2022. The 547,000 multi-family starts in 2022 were the most since 1986. The influx of new product as those starts reached completion combined with higher financing costs, flatlining new tenant market rents, and climbing vacancies to put a chill on the multi-family construct market. Still, the total of 477,000 multi-family starts last year was the second highest since 1986.

[4] The mortgage payment is computed assuming no down payment using the contemporaneous average conventional mortgage rate. As a proxy for mortgage size, we index the median home price in 2012 to cumulative house price growth since that time as measured by the Case-Shiller Home Prices Index. Average wage is computed by dividing total wage income by employment level in the BLS' household survey.

Chart 16 shows the historical and forecast paths of year-over-year and quarterly annualized rates of home price appreciation, as measured by the seasonally adjusted Case-Shiller Home Price Index. Based on our internal nowcasting model and other incoming data, we have penciled in annualized increases of 4.3 percent for national house prices in 2023Q4 and 3.0 percent in 2024Q1. Prices then appreciate by a steady 4.0 percent per year over the remainder of our forecast period. In year-over-year terms, we are forecasting the index to rise by 3.7 percent in 2024Q4 and by 4.0 percent in 2025Q4.



Energy Markets

Oil prices have come down significantly since spiking in September–October 2023. Since early November 2023, the price of a barrel of WTI crude has only strayed outside of the 70–80-dollar range on a handful of days. The price of WTI has averaged about 74 dollars per barrel so far this year. Domestic oil prices have remained stable despite the Organization for Petroleum Exporting Countries and its allies (OPEC+) adding a further 2.2 million barrels per day (bpd) to their previously announced voluntary cuts and production targets for early 2024. Nor has the price of WTI reacted much to the news flow from the Middle East.

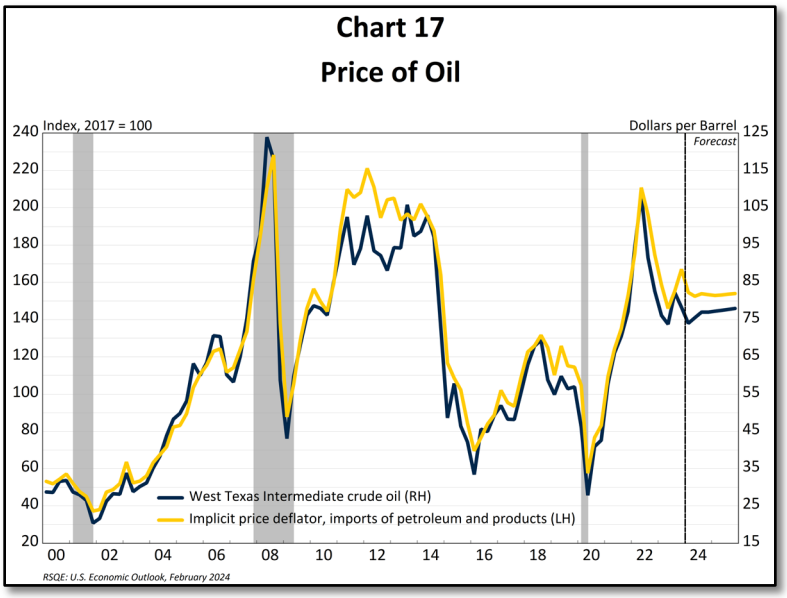
The spread between the Brent and WTI oil benchmarks, however, has been pushed higher in recent months, likely reflecting increases in transportation costs due to the disruption of the Red Sea shipping route. The Brent–WTI spread has widened from 4.4 dollars in 2023Q3 to 5.4 dollars in Q4 and to 6.3 in January 2024. We expect the spread to stay elevated in the near term, shrinking back to 4.5 dollars by the end of this year.

Absent severe disruptions driven by geopolitical conflicts, we expect the oil market to stay in balance over the coming years. We judge that OPEC+ will likely be able and willing to respond to unexpected increases in demand by dialing back its cuts. The International Monetary Fund has recently revised its global growth projections upward for 2024, reflecting more optimistic outlooks for the U.S. economy and for several large developing economies. As inflation decelerates in many developed countries, it is likely that global growth projections could be revised further upward, boosting the outlook for oil demand growth.

Crude oil production from the non-OPEC+ countries continues to increase, driven by the United States. The Energy Information Administration (EIA) projects that domestic oil production will increase by about 0.6 million barrels per day (bpd) over 2024–25, a deceleration from about a 1.0 million bpd increase in 2023. This slowdown in production growth reflects significant declines in exploratory rig counts relative to 2022, which are so far being offset by increases in per-well output.

The relatively warm 2023–24 heating season and elevated pre-existing natural gas storage stocks have combined to drive the price of natural gas down below 2.0 dollars per million British thermal units (MMBTu) early in February, under the 2.5-dollar average in 2023. Domestic production of natural gas has increased to 113.1 billion cubic feet per day (bcfpd) in 2023, rising from 108 bcfpd in 2022. The EIA projects that in 2024–25 production growth will total a further 3.2 bcfpd, but extra new liquefied natural gas (LNG) net exports will soak up 2.6 bcfpd of that total. More normal future heating seasons underlie our projection for natural gas prices rising toward the 3.0 dollar per MMBTu range by late 2024. The impact of the recently announced pause on approvals for new LNG export terminals is unlikely to be felt over our forecast horizon. The U.S. LNG export capacity has doubled in recent years and is projected to almost double again by 2028 due to the approved projects already under construction.

Chart 17 shows our forecast for WTI prices in blue and the implicit price deflator for imports of petroleum in yellow. We expect the price of WTI to stay in the 74–80-dollar range throughout the forecast. For most of that period, oil will be getting cheaper relative to the overall price level in the economy. The implicit price deflator for imported petroleum products, which is driven by global oil price benchmarks

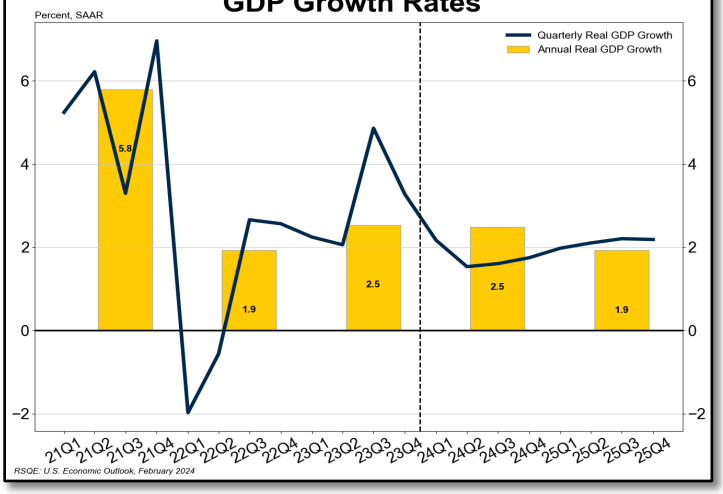


other than WTI, has historically been a more relevant metric for domestic gasoline prices. The price of U.S. petroleum imports is likely to increase a bit by this summer, as Canada's Trans Mountain oil pipeline expansion goes online and diverts some 590,000 bpd from Alberta to Pacific ports, raising prices for oil imports from Canada.

The Forecast for 2024–2025

Last year concluded with a sharp deceleration in inflation coupled with continued healthy growth in the labor market, an outcome that came as a pleasant surprise. Our baseline forecast is built on the expectation that the recent normalization of inflation, particularly in the service sector, reflects the economy's momentum more accurately than the recent jump in job gains. We believe the Fed will be able to follow through on its telegraphed plans to begin cutting short-term interest rates this year. However, we acknowledge that there is currently much uncertainty about the timing and scale of the pivot. If the Fed misjudges the appropriate policy path, the economy's recent strength could dissipate quickly. Moreover, even though the Fed's quest for a soft landing appears to be proceeding successfully to date, there are risks that inflation might stabilize above 2 percent, making the last mile on inflation seem longer than it looks from the present moment. First, any return of supply disruptions could reignite inflationary pressures, given the helpful role that supply chain normalization has played recently. Second, measured housing services inflation continues to run stubbornly high, despite the rapid deceleration of new-tenant rents. Both factors could contribute to more persistent measured inflation, delaying the highly anticipated start of the rate-cutting cycle. Our forecast balances these risks against the undeniable momentum in the recent economic data.

Chart 18
GDP Growth Rates



- Real GDP grew by 2.5 percent last year, a number that would have surprised many a year ago. Robust consumer spending and government hiring both boosted growth.
- While residential construction is expected to expand with a less restrictive monetary policy ahead, we anticipate consumers to pull back on their spending as the unemployment rate creeps up slightly. Consequently, quarterly real GDP growth decelerates slightly below trend and stays there through yearend.
- By 2025Q2, quarterly real GDP growth rebound above the 2.0 percent pace, owing to a healthy gain in nonresidential fixed investment and the recovery of consumption.
- Calendar-year GDP growth registers 2.5 percent again in 2024 and notches down to 1.9 percent in 2025.

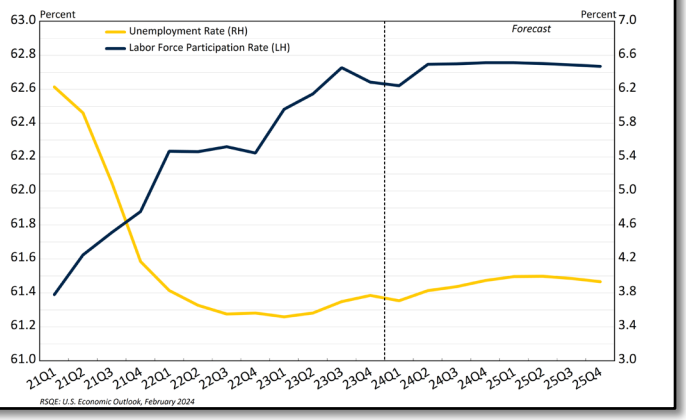
Table 2
Contributions to the Growth of Real GDP
(Average quarterly contributions, percentage points at annual rate)

	'23Q4	'24Q1	'24Q2	'24H2	'25
Real GDP (% change, AR)	3.3	2.2	1.5	1.7	2.1
Contributions to real GDP growth					
Final sales to domestic purchasers	2.8	2.6	1.8	1.9	2.2
Consumption	1.9	1.9	1.0	1.2	1.3
Nonresidential fixed investment	0.3	0.2	0.4	0.2	0.4
Residential investment	0.0	0.0	-0.0	0.2	0.3
Government purchases	0.6	0.4	0.4	0.3	0.2
Net exports	0.4	0.2	-0.2	-0.1	-0.1
Inventory investment	0.1	-0.6	-0.1	-0.1	0.1

RSQE: U.S. Economic Outlook, February 2024

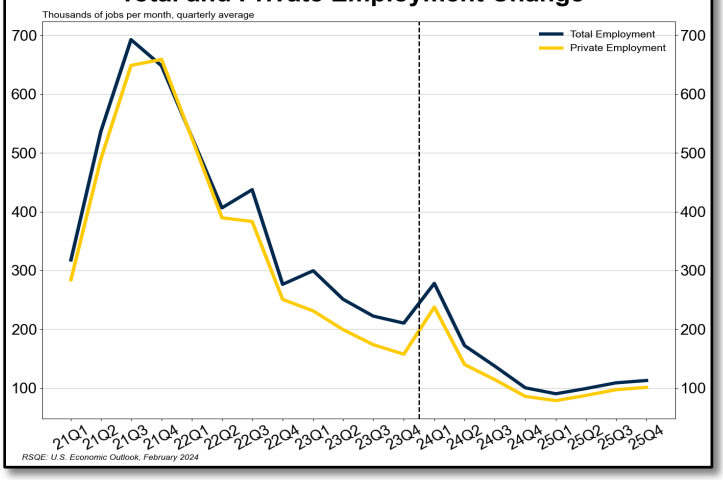
- With sizeable gains in durable goods, nondurable goods, and services, consumption expenditures contributed 1.9 percentage points to real GDP growth of 3.3 percent at an annual rate in 2023Q4.
- Durable goods consumption is set to take a breather as high interest rates bite and unemployment ticks up. Therefore, the growth contribution from consumption will decline to 1.2 percentage points in 2024H2.
- Residential investment picks up in 2024H2 as mortgage rates moderate, while business fixed investment continues to grow steadily thanks to steady increases in equipment and intellectual property products investment.
- The government sector's average growth contribution slows down from 0.6 percentage points in 2023Q4 to 0.2 percentage points in 2025, edging towards its pre-pandemic average.

Chart 19
Labor Force Participation Rate
and Unemployment Rate



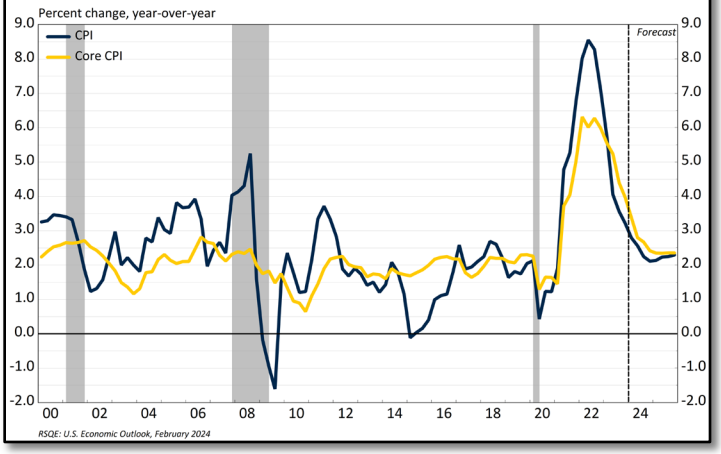
- The labor market has been cooling off, but it remains strong by historical standards. The headline unemployment rate has hovered at 3.7 percent since November 2023 after reaching a 50-year low of 3.4 percent earlier in the year.
- After trudging upwards to 62.8 percent in August, the labor force participation rate dropped to 62.5 percent in December. Participation edges up from 62.6 percent in 2024Q1 to 62.7 percent in 2025H2. The lack of significant progress in participation reflects a cooling labor market that is no longer able to fully offset the ongoing retirements of the baby boom generation.
- The cumulative effects of previous monetary tightening are projected to continue to work their way through the labor market. The unemployment rate edges up from 3.7 percent in 2024Q1 to 3.9 in 2024Q3 and 4.0 in 2025Q1. The unemployment rate then ticks down slightly in 2025H2 as monetary conditions ease.

Chart 20
Total and Private Employment Change

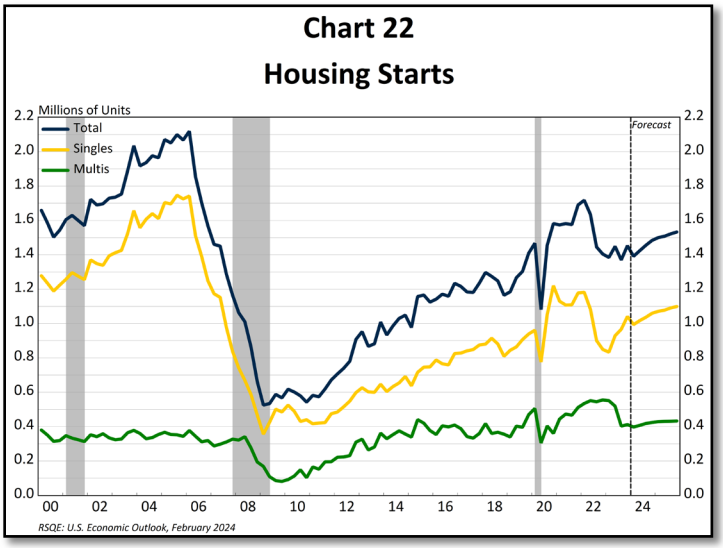


- Recent payroll employment gains have surprised to the upside. The labor market averaged 255,000 new jobs per month in 2023, less than 2022's 377,000 monthly job pace, but much stronger than 2019's average of 166,000. This year got off to a hot start with 353,000 new jobs added in January.
- After a brief upswing in 2024Q1, the slowing trend in job gains continues in the forecast through 2025Q1. Job growth ticks up in 2025. Several years of a tight labor market are likely to spur faster productivity growth over the next two years. As a result, recovery in job growth in 2025 is muted.
- The economy adds 2.1 million jobs during 2024 and 1.2 million during 2025.
- The government sector keeps adding jobs throughout the forecast, albeit at a much slower pace compared to 2023, as local government employment tops its pre-pandemic count.

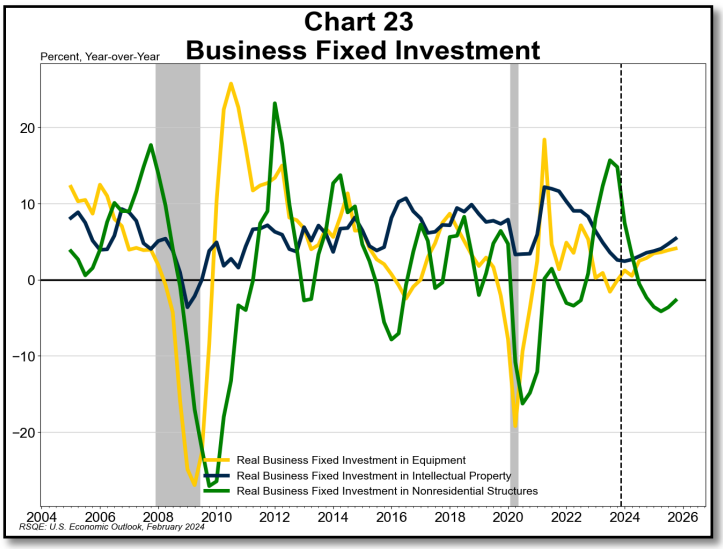
Chart 21
Consumer Price Index



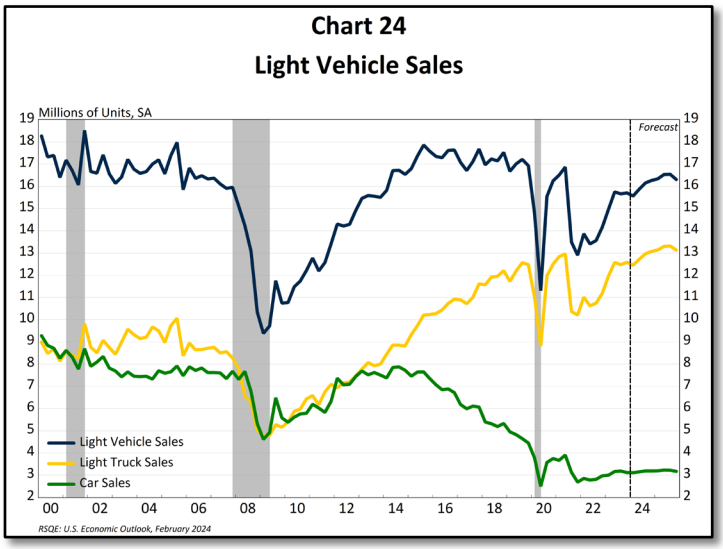
- All-items CPI inflation came in at a 2.8 percent annualized pace in 2023Q4, while core inflation registered a 3.4 percent pace. Energy prices declined in the quarter, while housing and other services continued to be the main drivers of CPI inflation.
- We expect PCE inflation to continue to converge towards the Fed's 2.0 percent goal over the next year (with CPI running slightly ahead) as shelter costs decelerate and consumer goods inflation stays muted.
- Core CPI inflation registers 3.4 percent year over year in 2024Q1 before slowing to 2.8 percent in 2024Q2 and 2.4 percent by 2024Q4, where it then remains.
- Core CPI inflation outpaces the headline throughout the forecast, as gasoline price increases remain subdued and food inflation slows.
- The year-over-year change in the PCE deflator, the Fed's preferred inflation measure, slows from 2.7 percent in 2023Q4 to 1.7 percent in 2024Q3, before settling at 2.0 percent in 2025Q2–Q4.



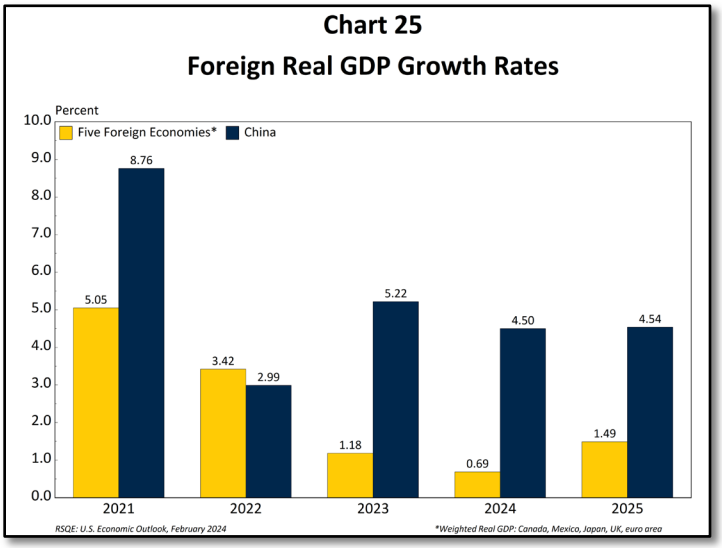
- Single-family housing starts take a breather to start 2024, dipping from an annualized pace of 1,042,000 in 2023Q4 to 994,000 in 2024Q1. The pace of single-family construction then climbs in every quarter of our forecast, reaching 1,060,000 starts by 2024Q4 and 1,100,000 by 2025Q4.
- Multi-family starts also dip from an annualized pace of 412,000 in 2023Q4 to 398,000 in 2024Q1. Multi-family starts recover to 424,000 units at an annual pace in 2024Q4, and 433,000 in 2025Q4, as a robust economy drives rental demand growth.
- Total housing starts climb from 1,415,000 units last year to 1,439,000 this year and 1,516,000 in 2025. High prices, limited inventory, and ongoing declines in mortgage rates all help to spur activity in the residential construction market over our forecast period.



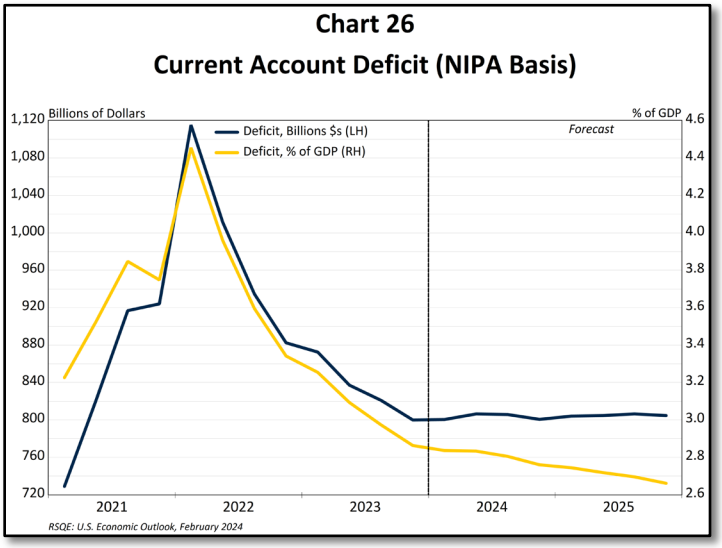
- Real business investment in equipment fell by 0.1 percent during 2023, largely driven by reductions in industrial and information processing equipment investment. We project a rebound to year-over-year growth of 2.8 percent in 2024Q4 and 4.1 percent in 2025Q4 as information processing equipment investment picks up.
- The rush of microchip factory construction drove the nonresidential structure investment growth to 14.8 percent year-over-year in 2023Q4. In the forecast, microchip plant investment begins to retreat from its lofty 2023 level, contributing to year-over-year declines in overall nonresidential construction investment of 2.3 and 2.7 percent in 2024Q4 and 2025Q4, respectively.
- Investment growth in intellectual property retreated to 2.6 percent in 2023Q4 due to a slowdown in research and development activities. The year-over-year pace of growth bottoms at 2.4 percent in 2024Q1, then ramps up to 5.4 percent by 2025Q4.



- The annualized pace of light vehicle sales fell from 16.1 million units in December 2023 to 15 million units in January 2024. Weather patterns, poor affordability, and limited inventory levels are partially responsible for this decline. Despite stubbornly high vehicle financing rates, dealers remain focused on stocking higher-priced vehicles.
- Light vehicle sales are expected to recover from January's sluggish pace to reach an average of 16.2 million units in 2024H2, as financing rates retreat and income growth outpaces vehicle prices.
- As interest rates continue to fall, light vehicle sales are expected to climb to 16.4 million units in 2025, with light trucks accounting for over 80 percent of light vehicle sales.
- During our forecast, car sales stall out as vehicle manufacturers continue to abandon low-profit-margin models in favor of light trucks, luxury sedans, sports cars, and electric vehicles.



- To forecast demand for U.S. exports, we construct a trade-weighted index of real GDP for five of our major export markets: Canada, Mexico, Japan, the United Kingdom, and the euro area. We also track China's growth, but chart it separately since it runs much faster.
- Real GDP growth in the five-country composite outpaced growth in China in 2022 for the first time in decades.
- Economic growth in China ramped up to 5.2 percent in 2023. In the United Kingdom and the eurozone, however, growth nearly stalled last year, which pushed the five-country growth rate down to just 1.2 percent.
- In 2024, a projected slowdown of growth in Canada, Japan, and Mexico lowers the five-economy growth pace further, to 0.7 percent. In 2025, growth accelerates in four of the economies, yielding a 1.5 percent expansion pace for the five-country aggregate.
- In China, property sector troubles and slowing external demand growth will result in 2024–25 real GDP growth stepping down to a 4.5 percent annual pace.



- The current account deficit registered 2.9 percent of GDP in 2023Q4, continuing its retraction from its post-pandemic high of 4.5 percent in 2022Q1 driven by waning imports and growth of exports.
- Nominal exports grew at a moderate 3.1 percent annual pace in 2023Q4. Although growth in China sputters going forward, the pace of exports is propped up by an improving global economic outlook and rising business fixed investment. Nominal exports grow at an annualized rate of 3.7 percent in 2024Q4 and 3.4 percent in 2025Q4.
- Nominal import growth cooled to 2.7 percent in 2023Q4 owing to a deceleration in goods imports. We expect nominal import growth to pick up to an annual pace of 3.1 percent in 2024Q4 and 3.4 percent in 2025Q4 as industrial production revs up.
- Consequently, the current account deficit edges down to 2.8 percent of GDP by 2024Q4 and 2.7 percent by 2025Q4, still elevated relative to pre-pandemic readings.

Risks to the Forecast

Our forecast is subject to several uncertainties. The first risk is that we may be misinterpreting the economy's current strength, as the data stream continues to present conflicting narratives. The next set of risks concerns inflation and monetary policy. Third, the fiscal environment is also quite uncertain and poses a few risks as we move closer to another election cycle. Finally, the geopolitical situation remains volatile.

Perhaps the broadest-based risk to our forecast is that we may have significantly overestimated the economy's current momentum. We have certainly been surprised by the economy's resilience to date in the face of higher interest rates. However, the economic data has not been telling a uniform story. Since the beginning of the pandemic, both the Current Employment Statistics and the Current Population Survey programs have seen declining response rates, leading many analysts to wonder if the signals from those surveys are becoming noisier. In the past six months, the number of employed U.S. residents has decreased by 60,000, while the number of jobs at establishments has risen by nearly 1.5 million. Although these surveys have significant conceptual differences, particularly regarding the treatment of multiple job holders and self-employment, they have undoubtedly depicted contrasting pictures of the national labor market in recent months. Additionally, the discrepancy between total expenditures and incomes in the economy has widened to 2.4 percent of GDP in 2023Q3, which is currently the third largest discrepancy on record.

Inflation's retreat from its recent peak brought a sense of relief to consumers, but also to economic forecasters. It is crucial, however, to acknowledge the potential risks that could challenge its return to target. Inflation could re-accelerate due to factors such as unexpected disruptions to shipping routes or other escalations in geopolitical tensions, a surprise in the shelter component of inflation, or economic activity running persistently above trend. Conversely, an upside risk to our forecast is that inflation may continue to decelerate well below target while the labor market remains resilient. That would allow the Federal Reserve to cut rates without a noticeable moderation in the pace of economic growth. Although these scenarios are not features of our baseline outlook, they hold significant potential to influence the future trajectory of monetary policy and fiscal policy, which in turn would have a direct impact on our economic forecast.

Even though economic forecasting is our chosen opportunity for experiencing public ridicule, predicting the next president of the United States is an equally formidable challenge, and it has direct economic implications through the power of the executive branch. We continue to believe that the most likely outcome of the November 2024 elections, is that the United States will continue to feature divided government in one form or another. We therefore expect the status quo to persist in fiscal policy. A budget

standoff resulting in a prolonged government shutdown or debt crisis could result in a measurable level of fiscal consolidation, dampening our outlook. Of course, if the November elections produce a single-party government, the fiscal trajectory could be very different than we have projected.

Finally, the geopolitical situation remains quite volatile, with two major active wars and many ongoing economic confrontations. We do not anticipate the wars in Ukraine or Gaza to have first-order effects on our baseline economic outlook at this point in time. Yet the wars present significant tail risks. One major downside risk is that the current war between Israel and Hamas might evolve into a broader regional conflict, which could constrain the global oil supply, disrupt popular trade routes, and reinvigorate stress in supply chains. The geopolitical situation writ broadly could certainly get worse, but it could also improve. A significant de-escalation of the war in Ukraine or the economic tensions with China, for instance, would relieve some external pressure on inflation and reduce the urgency of reconfiguring supply chains.

We consider the balance of risks to the outlook to be broadly neutral because of our judgment that the Federal Reserve now has space to loosen monetary policy to offset many of the potential negative shocks we have described.