Executive briefing

Macroeconomic outlook and impact on businesses

February update
Week of February 19, 2024

EY Parthenon
Building a better working world

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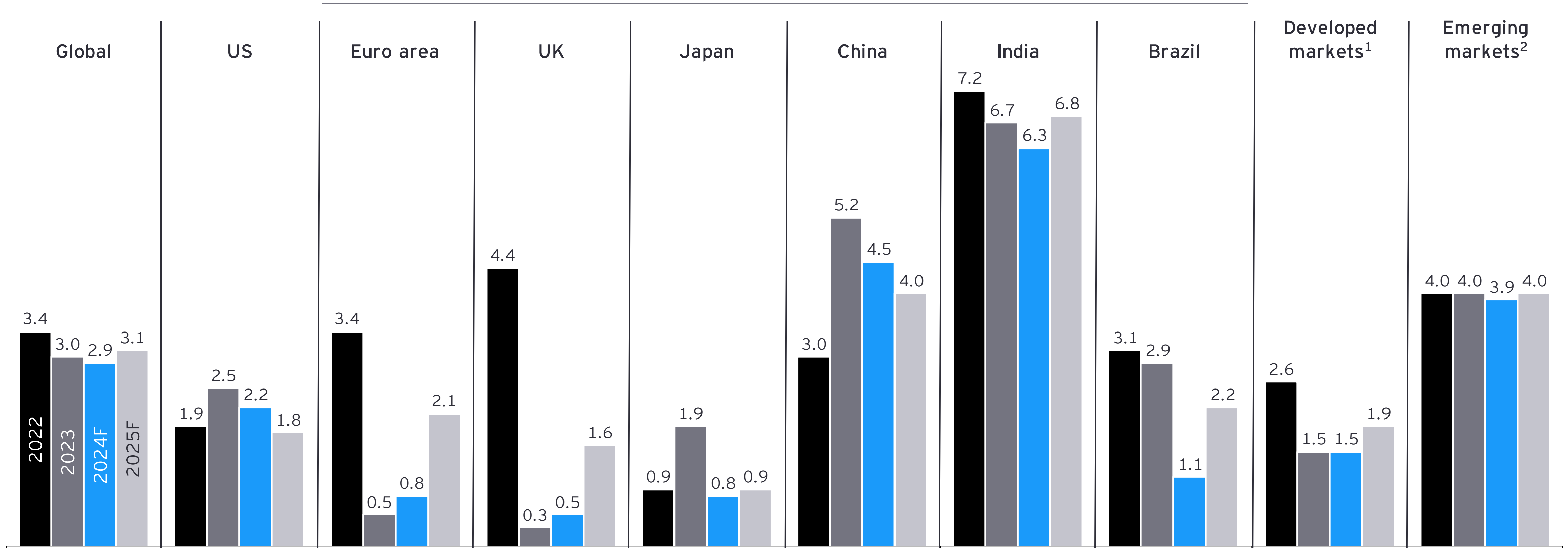
The global economy will remain on a soft growth trajectory in 2024, with developed markets likely to see modest growth while emerging markets stay on a firmer growth path

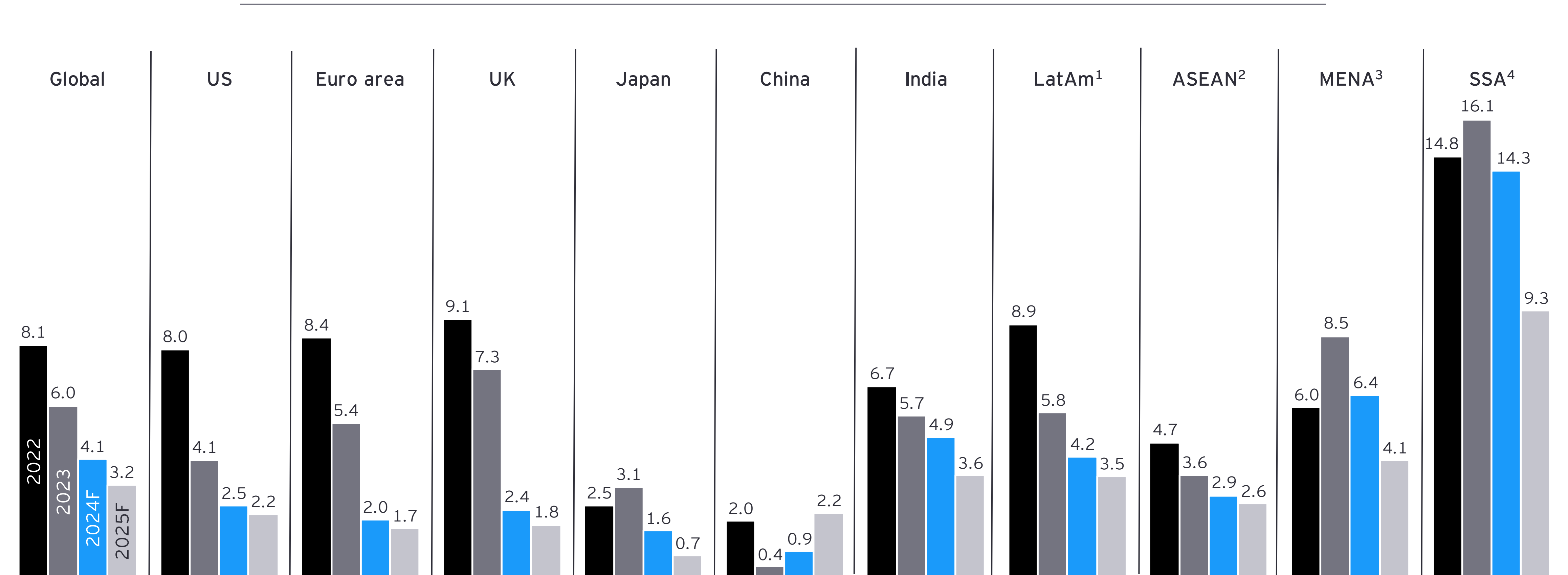


1. Includes G7, euro area, as well as Australia, Czech Republic, Denmark, Hong Kong SAR, Iceland, Israel, South Korea, New Zealand, Norway, Singapore, Sweden, Switzerland and Taiwan.
2. Includes China Mainland, India, Indonesia, Malaysia, Philippines, Thailand, Russia, Poland, Turkey, and most economies in Latin America and the Caribbean, Middle East, Central Asia, and Sub-Saharan Africa.

Source: EY-Parthenon

EY Parthenon

Assuming mildly softer final demand growth and continued favorable supply conditions, we expect disinflationary momentum to continue across most economies



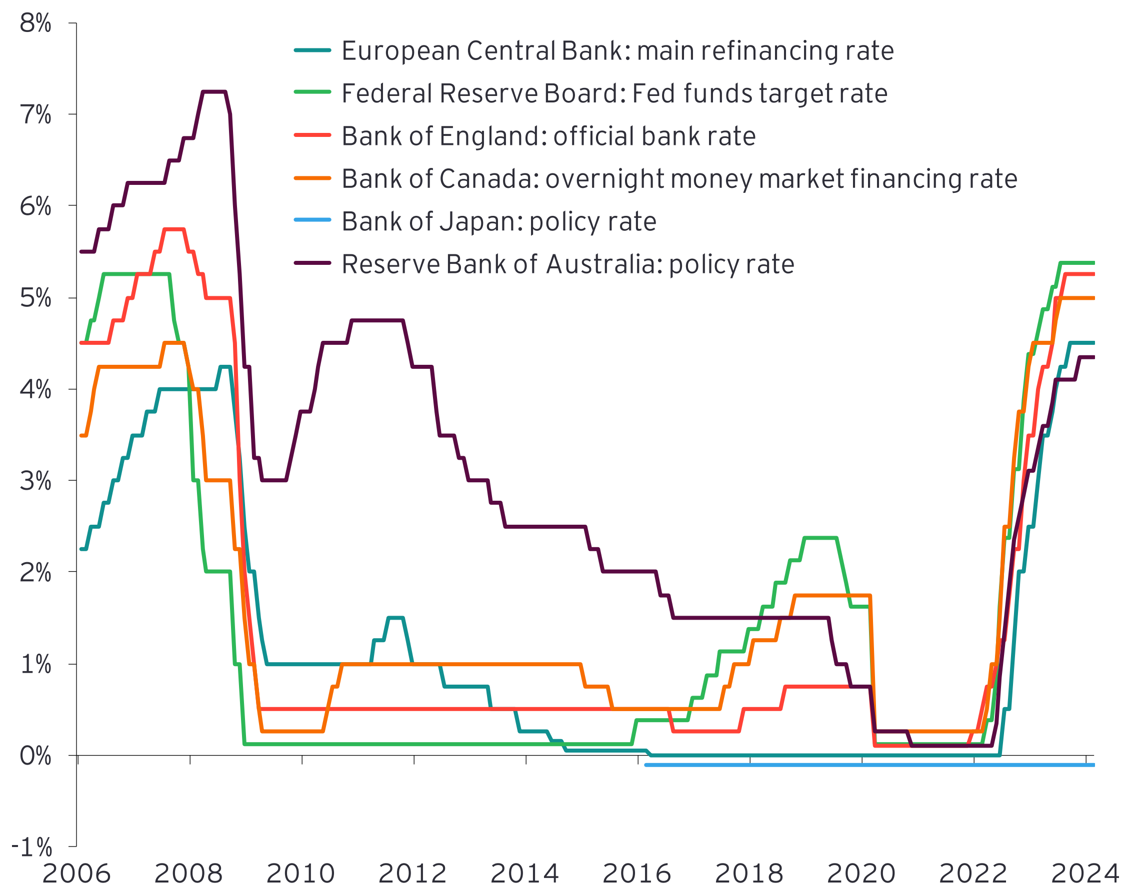
1. LatAm includes 12 countries.
2. ASEAN includes Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam.
3. MENA include Algeria, Bahrain, Egypt, Iraq, Israel, Kuwait, Morocco, Oman, Qatar, Saudi Arabia and the UAE.
4. SSA (Sub-Saharan Africa) includes Angola, Botswana, Ghana, Kenya, Mauritius, Mozambique, Namibia, Nigeria, Seychelles, South Africa, Tanzania, Uganda, Zambia and Zimbabwe.

Source: EY analysis

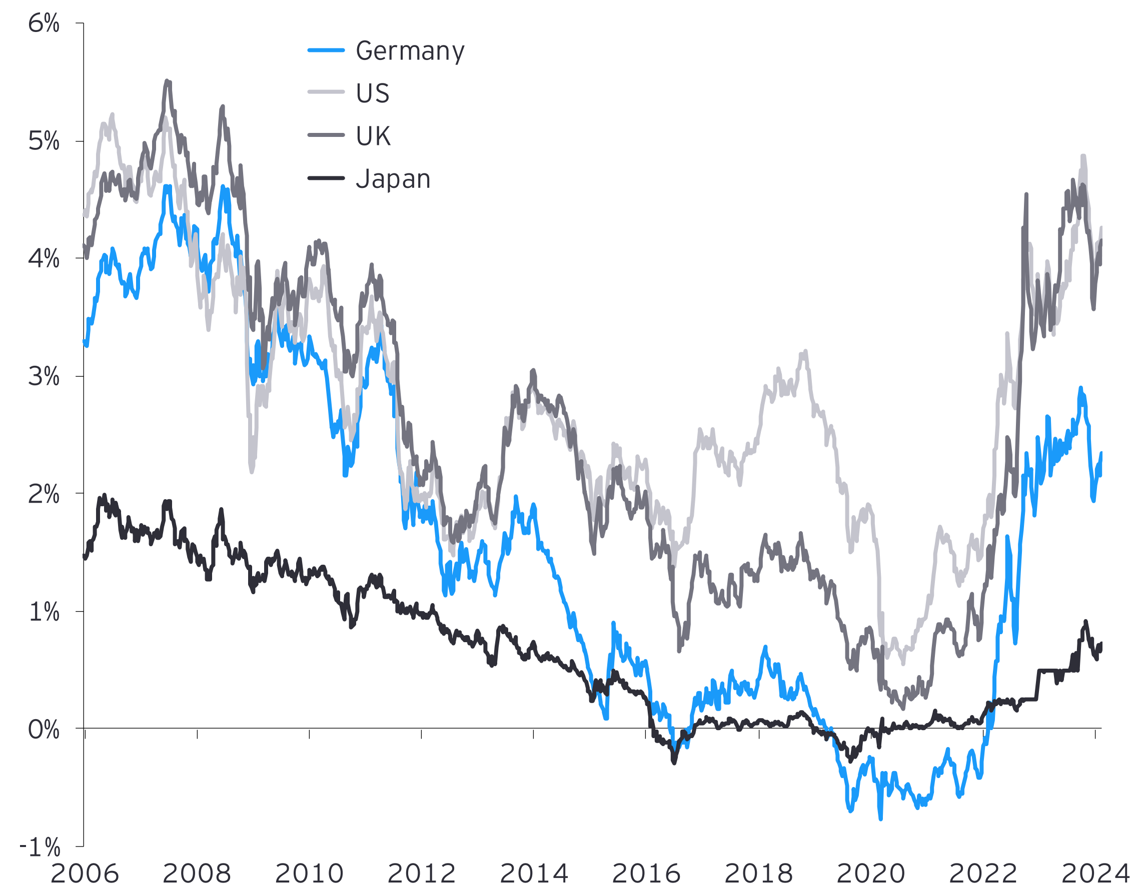
EY Parthenon

Central banks will carefully consider easing policy this year, but policymakers won't rush to cut rates until they are confident lower inflation will be sustained

Central bank rates
January 2006–February 2024



Long-term interest rates
January 2006–February 2024[1]



1. Long-term interest rate data as of February 9, 2024, for all countries listed.

Source: Respective countries' central banks

EY Parthenon

A brightening US outlook to start 2024 but the economy isn't devoid of risks — from elevated interest rates and tight credit conditions to elevated geopolitical uncertainty

Finding the signal amid noisy data: While the US economy entered 2024 with solid momentum, noisy economic data at the start of the year has made the outlook more difficult to assess. We believe the inflation picture is likely not as hot as the latest Consumer Price Index (CPI) and Producer Price Index (PPI) reports suggest, while the labor market picture is likely not as rosy as painted by the strong January jobs report. But neither is the state of housing, consumer spending and industrial production as weak as the January data seemingly indicates.

Outlook: Our view remains that a soft landing is likely as economic conditions gently cool and inflation gradually reverts to the Fed's 2% target. Consumers will show more caution with their outlays as "cost fatigue" gradually curbs willingness to spend, but ongoing disinflation should support positive real household income growth. And business leaders will continue to exercise more scrutiny with their investment and hiring decisions amid still-elevated interest rates and softer final demand growth. They will also look to drive stronger productivity growth via more efficient production and organization processes as well as via the integration of GenAI. We now see the US economy growing 2.2% in 2024, partly reflecting the strong carryover from 2023, following real GDP growth of 2.5% last year.

Labor market enduring strength: The labor market started the year on a very strong note, with the economy adding 353k jobs in January and the unemployment rate remaining steady at 3.7% while wage growth reaccelerated. While the hiring strength was likely overstated due to large positive seasonal adjustments, the report indicated that the labor market remains on solid ground. Yet we continue to anticipate a mild softening of labor demand in the coming months. This will mostly come in the form of reduced hiring, strategic resizing decisions and wage growth compression. We see the unemployment rate rising toward 4.2% by year-end.

Consumers take a breather: The January retail sales report showed a larger-than-expected pullback in spending in January as consumers rested after the holiday shopping season. We continue to expect a solid consumer spending performance in 2024, but momentum will be a little more subdued than the robust 2.2% advance in 2023. Indeed, softer employment conditions will likely translate into more modest income momentum, while cost fatigue weighs on consumer wallets in the early part of the year. We project that real consumer spending will grow around 2.0% in 2024.

Bumpy disinflation: Consumer price inflation showed some notable stickiness in January as headline inflation cooled less than expected to 3.1% year-over-year (y/y). And core CPI inflation remained disappointingly steady at 3.9% y/y — its slowest pace since May 2021. Looking ahead, disinflationary impulses from cooling economic momentum, reduced pricing power, continued labor market rebalancing, and receding shelter cost inflation will help further ease inflation pressures this year. We foresee headline and core CPI inflation around 2.2% y/y in Q4 2024 barring any significant geopolitical, commodity price or recessionary shock. The Fed's favored inflation gauge, the deflator for core personal consumption expenditures, will likely reach the critical 2.5% y/y threshold in early 2024 — within striking distance of the 2.0% target.

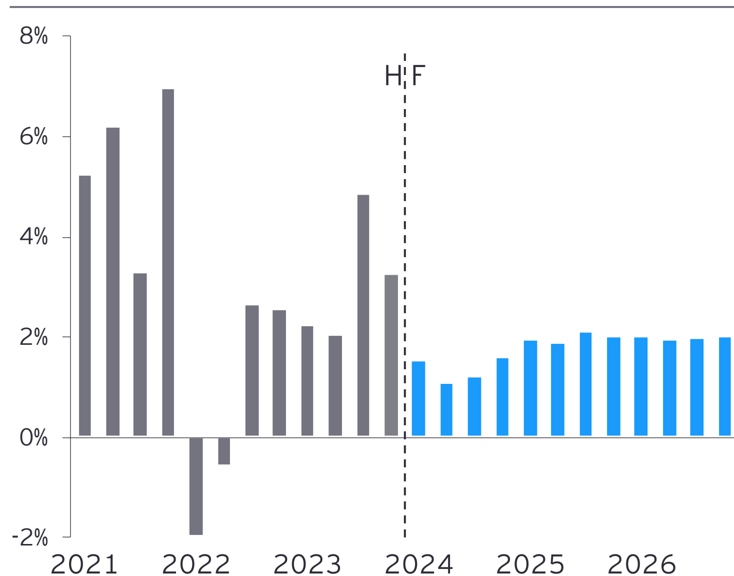
A careful Fed: The Fed kept the federal funds rate unchanged at 5.25%–5.50% at the January Federal Open Market Committee (FOMC) meeting and dropped its tightening bias in the policy statement. However, Fed Chair Jerome Powell stressed that the FOMC would need more "good" disinflation evidence over the coming months in assessing when to start easing policy. Our long-standing view has been that the Fed would start cutting rates in May, but recent upside surprises in economic and inflation data increase the odds of a June onset. We still expect a total of 100 basis points (bps) of rates cuts this year.

Risks to watch for: We see two prominent downside risks heading into 2024. The first stems from an inflation flare-up and collapsing economic activity. This features prominently in a context where geopolitical tensions remain elevated, fragmentation has become a reality and supply shortages, a close memory, return. The second risk is that monetary policy remains overly restrictive against a slower growth backdrop, leading to tighter financial conditions and private sector activity retrenching. On the upside, noninflationary growth supported by a robust labor market, consumer resilience and stronger productivity growth from efficiency improvements and technological innovations would represent the ideal scenario coming out of this unique pandemic shock.

Source: EY-Parthenon

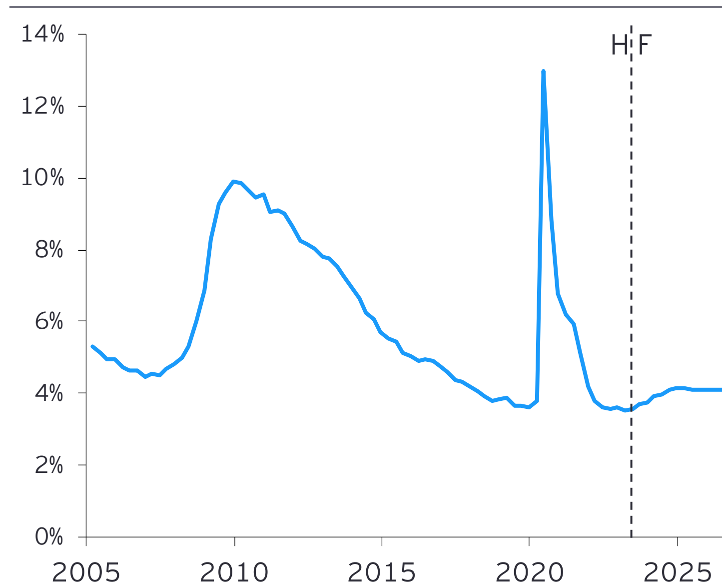
We foresee cooler economic dynamics in 2024 in the US with slower private sector activity and a modest rise in unemployment, but cooling inflation favoring Fed rate cuts

US real GDP growth (q/q annualized rate) 2021-26F



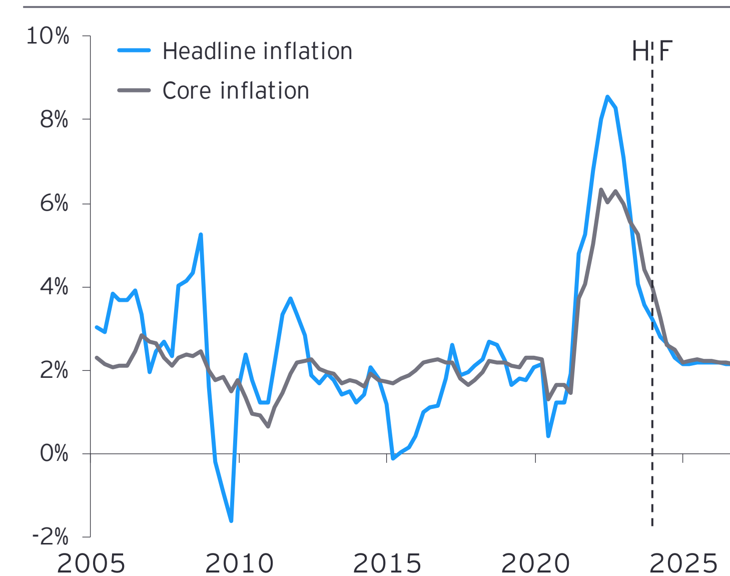
GDP growth
2024F: 2.2%
2025F: 1.8%
2026F: 2.0%

US unemployment rate 2005-26F



Unemployment rate
Q4 2024F: 4.2%
Q4 2025F: 4.1%
Q4 2026F: 4.1%

US y/y percentage change in CPI 2005-26F



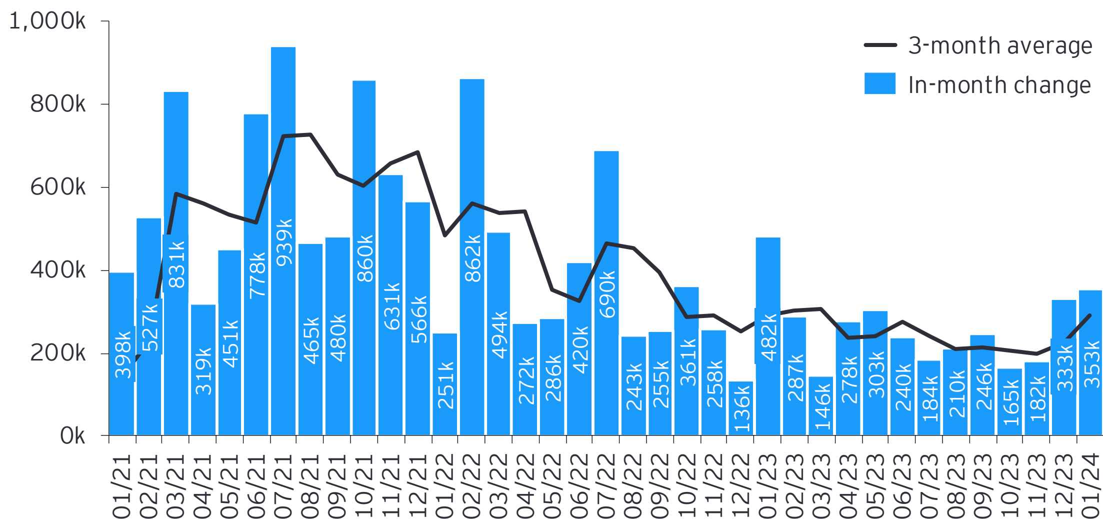
Core CPI inflation (y/y)
Q4 2024F: 2.2%
Q4 2025F: 2.1%
Q4 2026F: 2.2%

Key risks: financial market stress and geopolitical tensions

Source: EY-Parthenon

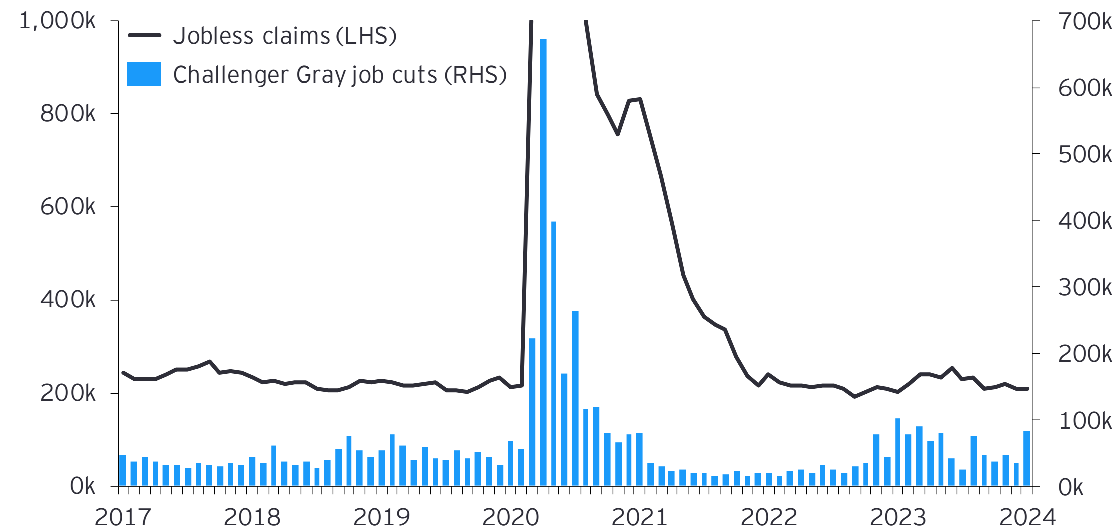
The labor market remains robust, but more discerning hiring, performance reviews and resizing decisions by employers will lead to cooler momentum in 2024

US m/m change in total nonfarm employment
January 2021-January 2024



- The labor market started the year with remarkable vigor as nonfarm payrolls rose a whopping 353k in January, well above the consensus estimate. While noisy seasonal factors explain part of the strength in payrolls, revisions added 126k jobs to December and November figures, raising the three-month nonfarm payroll growth average to 286k, the highest since April 2023.
- Hiring strength was likely overstated due to large positive seasonal adjustments, but jobs gains were broad based in January, with the private sector adding 317k jobs and the government sector adding 36k jobs. The service sector added an impressive 289k jobs – the most since January 2023 – led by significant hiring in health care, professional and business services, and retail. And employment in the goods sector rose 28k jobs on broad-based gains in construction and manufacturing.

US jobless claims and cuts
January 2017-January 2024

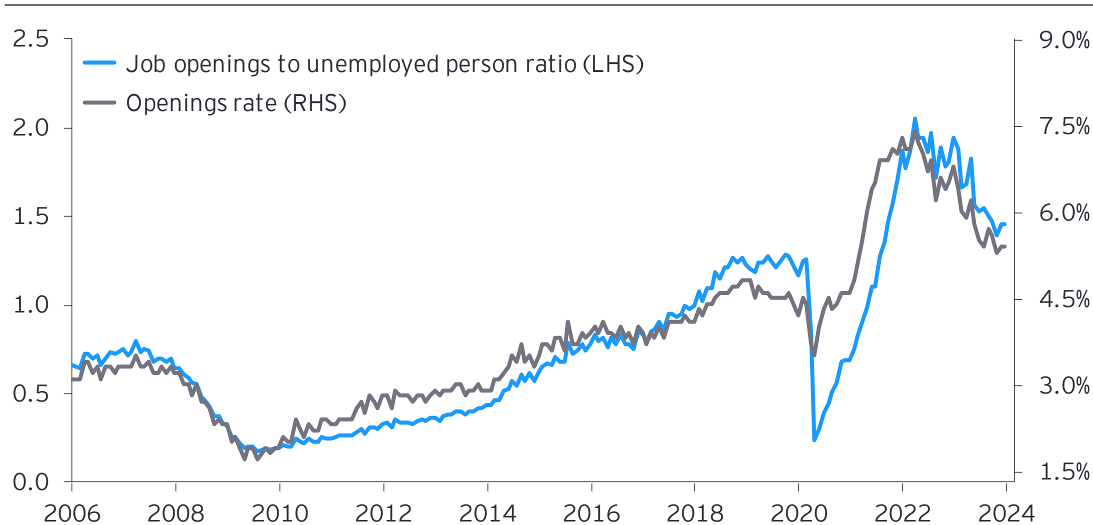


- The employment diffusion index – an indicator of the proportion of private sector industries generating jobs – rose to 65.6%, the highest since January 2023.
- Joblessness also remained low with the unemployment rate steady at 3.7% in January. Moreover, new weekly jobless claims for unemployment benefits remain historically low, underscoring the labor market's resilience despite a recent spike in announced layoffs, predominantly in the technology industry.
- Looking ahead, we expect job growth will continue to move forward, albeit at a slower pace. We expect the unemployment rate to drift slightly higher toward 4.1% by year-end.

Source: Challenger, Gray & Christmas; Bureau of Labor Statistics; Department of Labor; EY-Parthenon

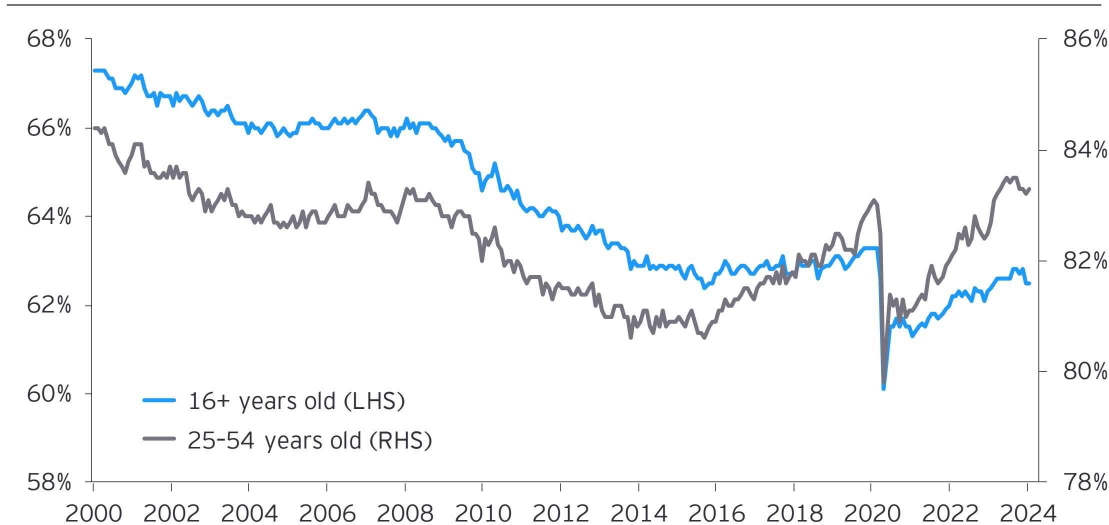
Slower labor demand and reduced churn indicate that labor market conditions are better balanced; this should favor gradually cooling wage growth momentum

US job opening rate and openings to unemployed persons ratio
January 2006–December 2023



- The latest Job Openings and Labor Turnover Survey (JOLTS) in December points to less labor market churn and signaled that supply and demand in the labor market has returned to a better balance. Job openings remain 29% above their pre-pandemic level but have reverted half of their post-pandemic surge.
- Workers feel less confident about quitting their jobs amid slower hiring. The quits rate was unchanged at 2.2% in December, slightly below the pre-pandemic rate of 2.3%. Meanwhile, companies are reluctant to let go of their valuable talent pool. The layoffs and discharge rate, a measure of involuntary separations, remained at a low level of 1.0% for a fourth consecutive month in December.
- The ratio of job openings to unemployed workers – an indicator of labor market tightness closely watched by Fed officials – slightly edged up to 1.44 in December but remains well below its peak level of 2.1 reached in early 2022.

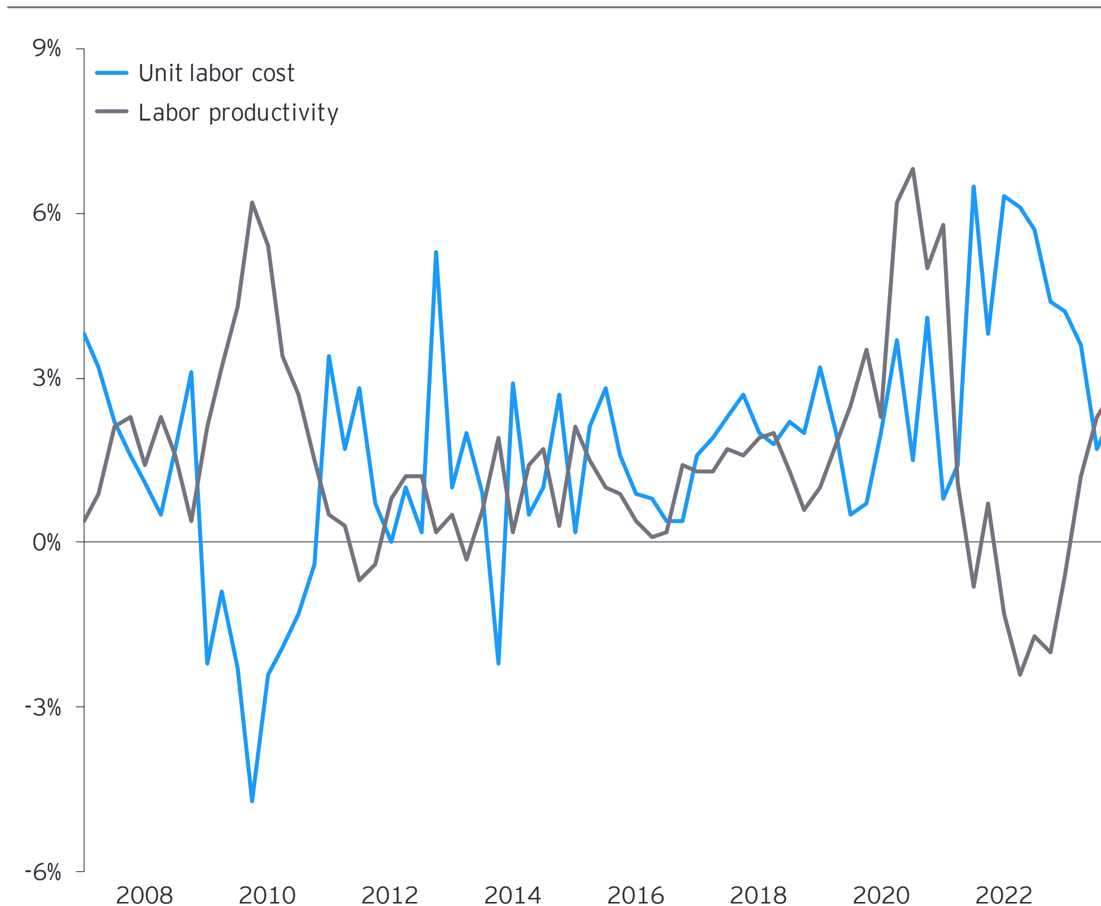
US labor force participation rates
January 2000–January 2024



- On the supply side, labor force participation among the key prime-age cohort (25- to 54-year-olds) inched up 0.1 percentage point (ppt) to 83.3% in January. Meanwhile, the overall participation rate remained steady at 62.5% for a second consecutive month.
- This year, the economy will likely experience below-trend but positive job growth with the unemployment rate likely to be in a slight uptrend but remain relatively low overall.
- Employers will become increasingly strategic when it comes to attracting and hiring the talent they need, and wage compression will continue to be used as a lever to keep a lid on overall labor costs.

Source: Bureau of Labor Statistics; EY-Parthenon

Robust productivity growth is acting as a welcome buffer against still elevated compensation growth, pushing down unit labor costs and easing inflation pressures



Source: Bureau of Labor Statistics; EY-Parthenon

- Nonfarm business sector labor productivity posted another solid advance in Q4 2023, rising 3.2% (annualized), as economic output rose 3.7% and hours worked increased a more modest 0.4%. This represents the third consecutive quarterly gain of more than 3.0% – a feat that occurred once in the decade that preceded the pandemic (in 2019).
- Encouragingly, the annual trend in productivity growth continues to firm, with growth accelerating to 2.7% y/y in Q4 2023. Excluding the recession-induced distortions (when productivity surges because labor is cut more rapidly than output), this is the strongest reading since Q4 2019 and before that the strongest reading since 2005.
- Stronger productivity helped offset solid growth in compensation. While compensation increased a solid 3.7% in Q4, unit labor costs only rose 0.5%. This is the perfect illustration of how stronger productivity can lead to noninflationary growth. Unit labor costs are now rising at a modest 2.3% y/y clip, down from a peak of 6.5% in 2022 and in line with the pre-pandemic pace of inflation.
- As we have been stressing for the past eight months, the revival in productivity is encouraging for the broader inflation and economic outlook. If companies can generate strong productivity growth, they will be able to control costs and protect margins without sacrificing talent in an environment of still-elevated wages and fading pricing power.
- We see four key factors behind the productivity revival: (1) with inflation easing and more cautious final demand, business executives are focusing on investments that enhance productivity; (2) higher capital costs are leading to more efficient capital allocation; (3) increased R&D and labor mobility are accelerating innovation diffusion; and (4) government initiatives like the Infrastructure Investment and Jobs Act, CHIPS and Science Act, and Inflation Reduction Act have encouraged – not crowded out – private investment.

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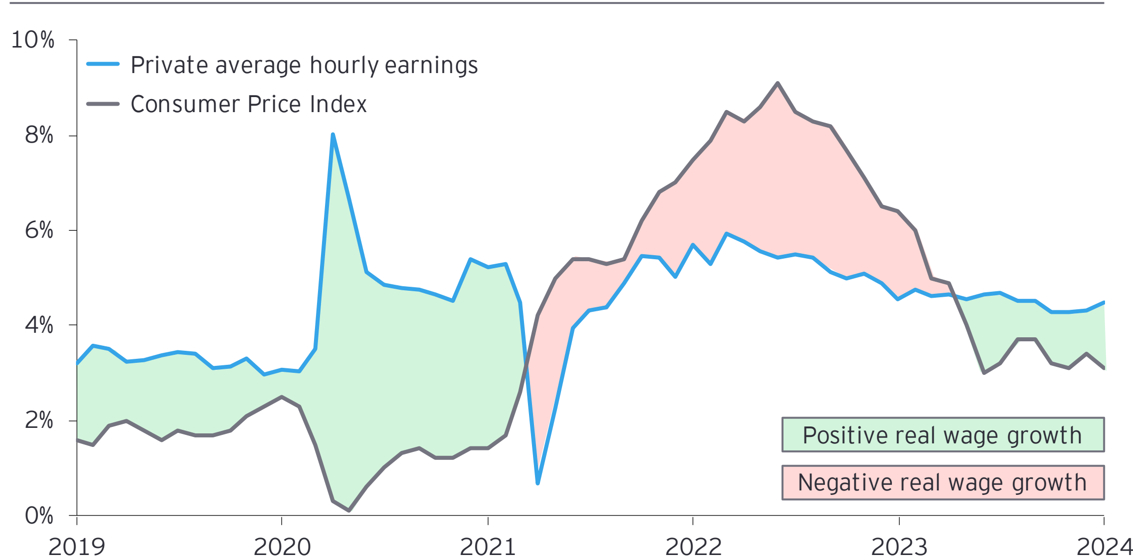
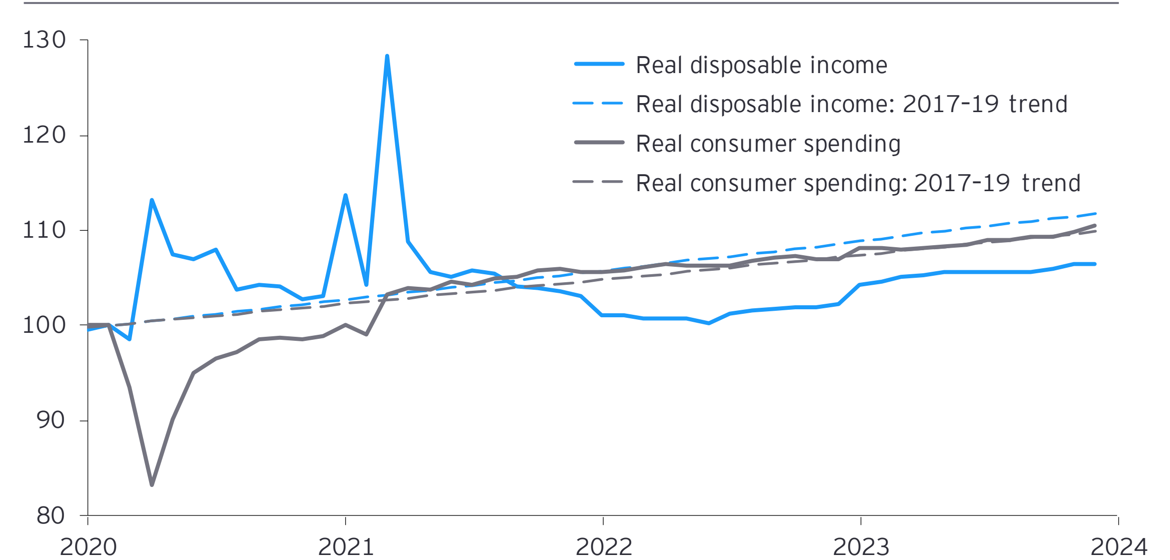
Continued growth in real disposable income is keeping consumer spending on a positive track; this tailwind should persist even as the labor market cools

US y/y average hourly earnings and inflation
January 2019–January 2024



- Wage pressures strengthened with hourly earnings rising a hot 0.6% month over month (m/m) in January, partly reflecting a pullback in hours worked amid inclement weather. As a result, wage growth rose 0.2ppt to 4.5% y/y, the highest since September 2023. As labor demand and supply continue to rebalance in the coming quarters, we see wage growth converging toward 3.5% this year – a pace consistent with the Fed's 2.0% inflation target.
- On the bright side, wage growth ran ahead of inflation for a ninth straight month in January, with real average hourly earnings rising 0.4ppt to 1.4% y/y, the strongest since July 2023. The ongoing recovery in households' purchasing power is preventing a retrenchment in consumer spending despite cost fatigue from still elevated prices for goods and services.

US real consumption expenditures and disposable income
January 2020–December 2023 (February 2020 = 100)



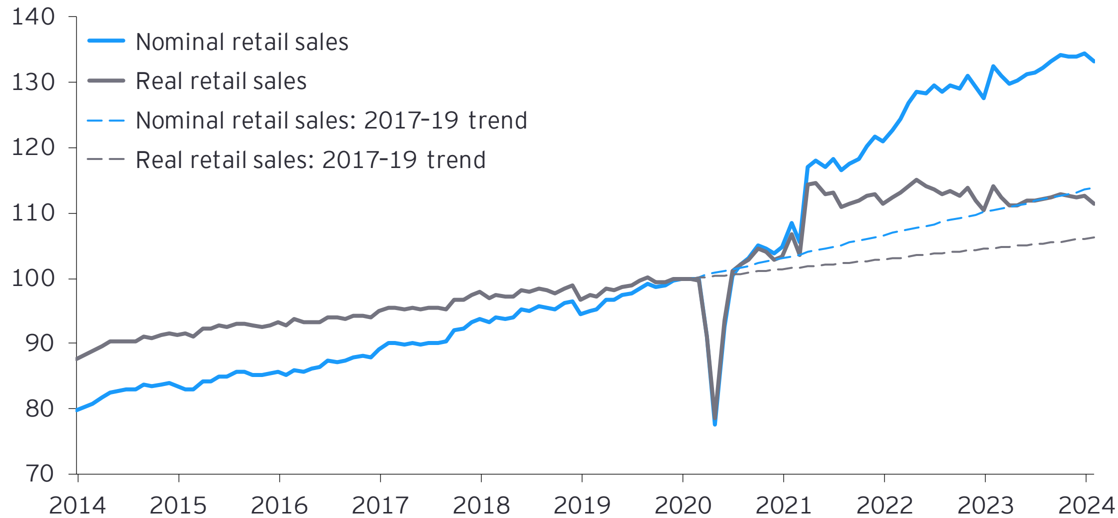
- Personal income rose 0.3% m/m last month as favorable labor market dynamics led to a 0.4% bump in wages and salaries. Encouragingly, slower inflation supported ongoing momentum in households' purchasing power as real disposable personal income rose 0.1% m/m and 4.2% y/y.
- Still, with spending outpacing income in December, the personal savings rate ticked 0.4ppt lower to 3.7% last month.
- While we anticipate more moderate real disposable income momentum, we believe growth will still average 2% in 2024, leading consumers to spend with more scrutiny.

Source: Bureau of Labor Statistics; Bureau of Economic Analysis; EY-Parthenon

EY Parthenon

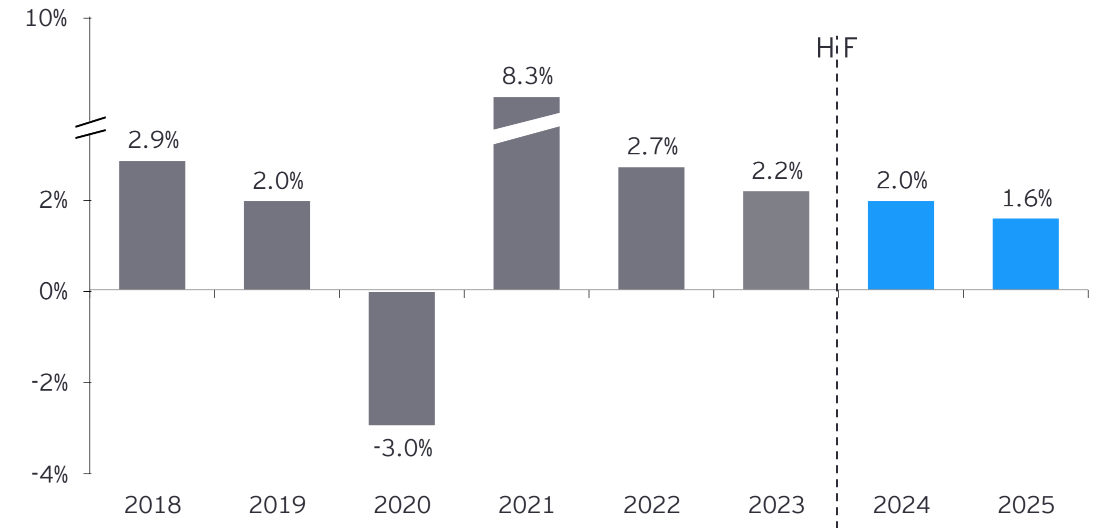
Consumers slowed their spending at the start of the year, and more moderation is likely in coming quarters amid cost fatigue and softer employment trends

US nominal and real retail sales indexes
January 2014–January 2024 (December 2019 = 100)



- A noisy report showed retail sales fell more than expected in January, down 0.8%, while the December gain was revised lower to 0.4% from 0.6% previously. One-off factors, including shifting seasonal adjustment dynamics and the unusually harsh winter weather, likely help explain the disappointing performance. When adjusting for inflation, the volume of sales fell 1.1% given the 0.3% increase in consumer prices.
- The weakness was broad based across retailers. As anticipated, purchases of motor vehicles were a drag on top-line retail sales. They fell by the most in a year, down 1.7%, as the cold winter weather likely kept consumers away from auto dealerships. In January, consumers spent less at gasoline stations (reflecting lower gas prices) and building materials stores and cut back on personal care products, clothing and sporting goods.

US y/y percentage change in real personal consumer expenditures
2017–25F



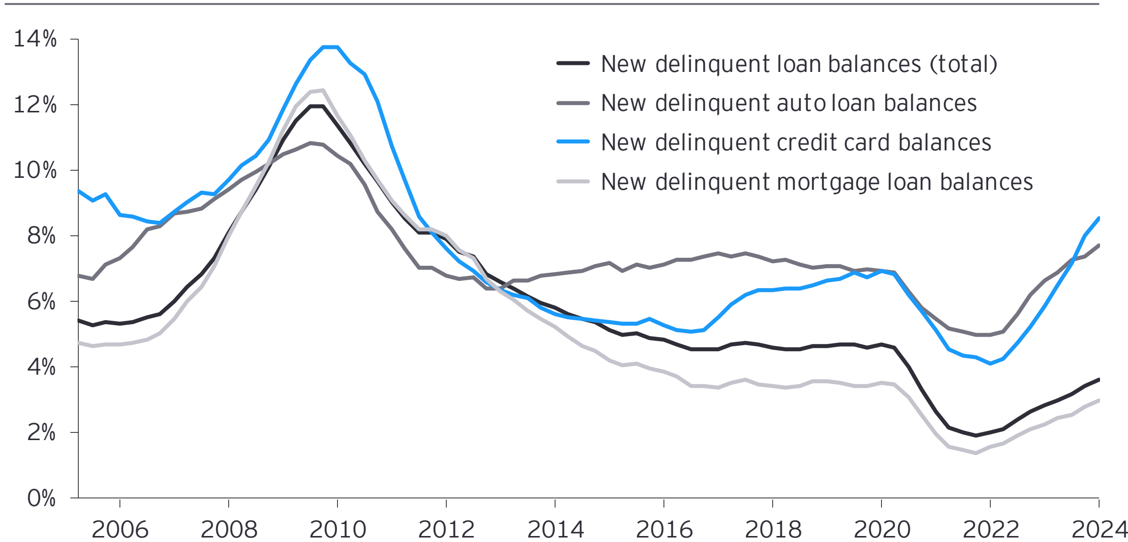
- Control retail sales – a key gauge of broader consumer spending trends that strips out the volatile components – declined 0.4%, the first decline since March 2023 and a notable reversal from the 0.6% increase in the prior month. The latest data, along with the downward revisions to the December figures, point to softer consumer spending momentum at the start of the year, though continued moderate real income gains should put a robust floor under growth in the first quarter.
- We continue to expect a solid consumer spending performance in 2024, but momentum will be a little more subdued than the robust 2.2% advance in 2023. Indeed, softer employment conditions will likely translate into more modest income momentum, while cost fatigue weighs on consumer wallets in the early part of the year. We project that consumer spending will grow around 2.0% in 2024.

Source: Census Bureau; Bureau of Economic Analysis; EY-Parthenon

EY Parthenon

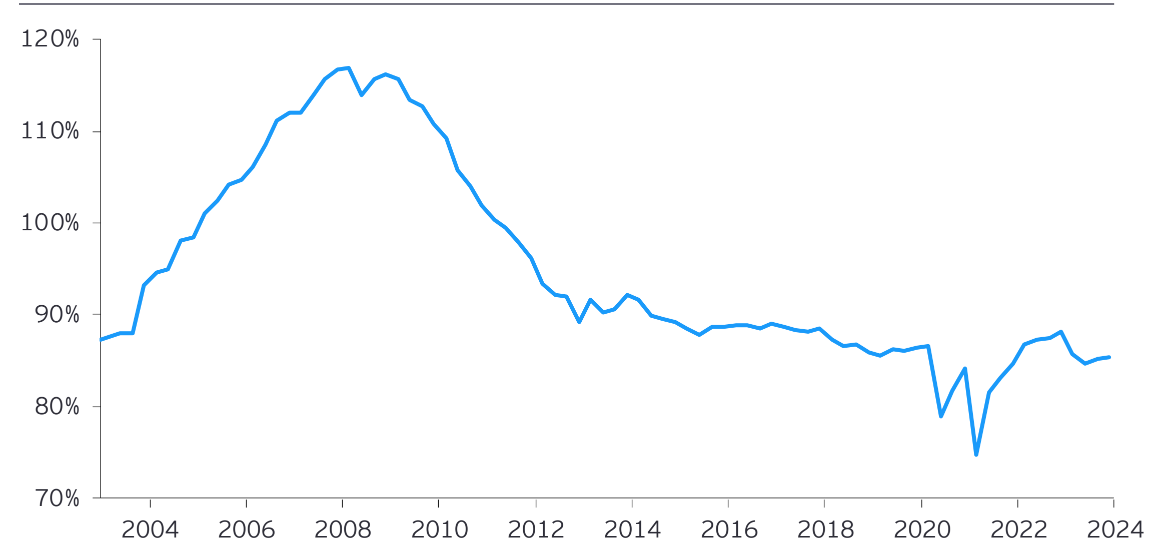
Rising delinquencies on consumer loans point to some pockets of strain in the consumer sector, but households' balance sheets and overall debt show no cause for alarm

US new delinquent loan balances, 30+ days (percentage of current balance) 2005 Q1-2023 Q4



- After a period of historically low delinquency rates observed during the pandemic, new delinquencies (over 30 days) and new serious delinquencies (over 90 days) for credit card balances and auto loans have risen to their highest levels since 2011.
- The new delinquency rate on credit cards reached 8.5% in Q4 2023, up from 8.0% in Q3 and the highest level since Q2 2011. The new delinquency rate on auto loans has also risen markedly and, at 7.7%, is now well above their pre-pandemic level.
- The lower-income and younger tranches of the population are the ones showing the most significant increase in new delinquencies.

Total household debt as a percentage of disposable income 2003 Q1-2023 Q4

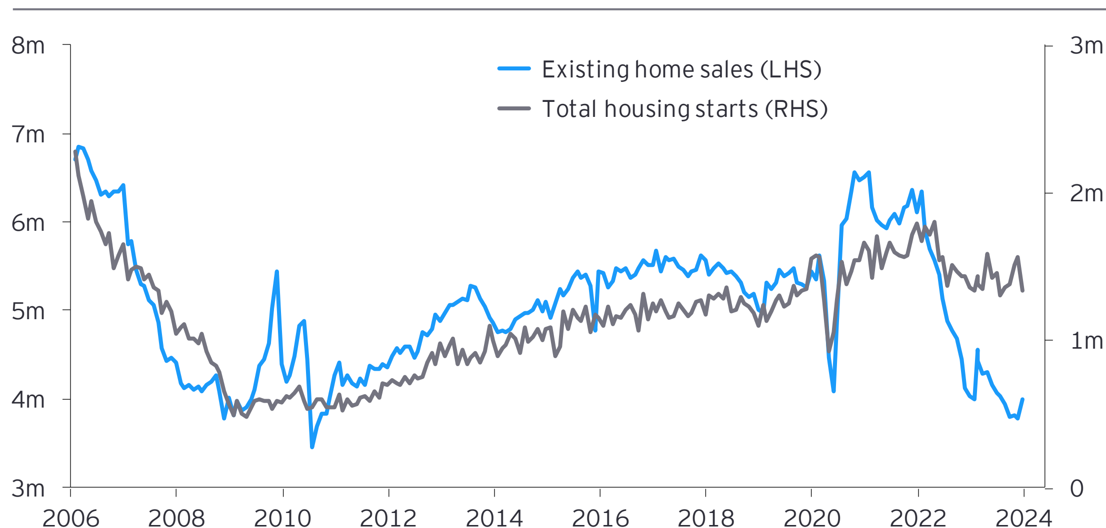


- Total consumer household debt rose $212b in Q4 2023 to a record $17.5t. Still, consumer credit growth is slowing materially, with consumer loans largely unchanged from last year and revolving credit growth having slowed from 15% y/y in December 2022 to 8% y/y in December 2023.
- Despite the prevailing narrative, households are not more reliant on credit. Total household debt relative to disposable income currently stands at 85%, down from 87% pre-pandemic. Excluding mortgages, outstanding revolving and nonrevolving credit relative to disposable income is at its lowest since 2014. And the debt-servicing ratio on consumer loans is on par with its pre-pandemic level.
- Looking ahead, we anticipate consumers' debt-servicing ratio and delinquency rates will gradually deteriorate, but resilient income growth should prevent a rapid deterioration in credit conditions.

Source: Federal Reserve Bank of New York Consumer Credit Panel; Federal Reserve Board

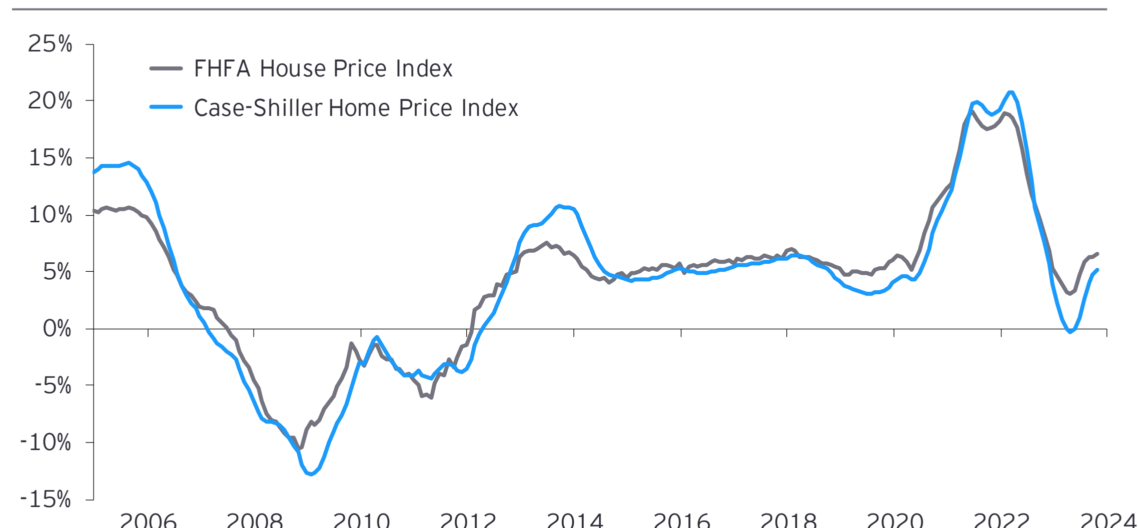
Reduced affordability is still constraining sales, but construction activity remains supported by tight supply conditions, while easing interest rates should support demand

US existing home sales and housing starts
January 2006-January 2024



- Existing home sales rebounded 3.1% to 4mn in January, the strongest pace of sales since August 2023. Meanwhile, housing starts tumbled 14.8% m/m, falling to a 1.33m annual pace from December's upwardly revised estimate. While this marked the largest decline seen since April 2020, starts were likely impacted by the harsh winter weather.
- The drop in starts was largely driven by a 35.8% m/m fall in multifamily starts, while single-family starts also fell 4.7%. On an annual basis, housing starts are down by 0.7%, yet building permits have risen by 8.6%.
- Looking ahead, we expect new and existing homes sales to remain sluggish in H1 before gradually recovering into 2025, supported by lower mortgage rates and positive income growth. On the construction front, limited supply should support growth, but tight lending conditions along with higher cost of construction will limit the upside.

US y/y home price indexes
January 2005-November 2023



- Home prices have rebounded in recent months, reflecting the mismatch between demand and supply. The S&P CoreLogic Case-Shiller Home Price Index increased 0.2% m/m in November 2023 – the smallest gain since February 2023 – while the Federal Housing Finance Agency (FHFA) House Price Index climbed 0.3% m/m for a second consecutive month.
- As a result, annual home price growth has reaccelerated, with the S&P CoreLogic Case-Shiller index up 0.4ppt to 5.1% y/y in November and the FHFA index up 0.3ppt to 6.6% y/y. We expect home price growth will remain positive given tight supply conditions in 2024.

Source: Mortgage Bankers Association; Census Bureau; National Association of Realtors; EY-Parthenon

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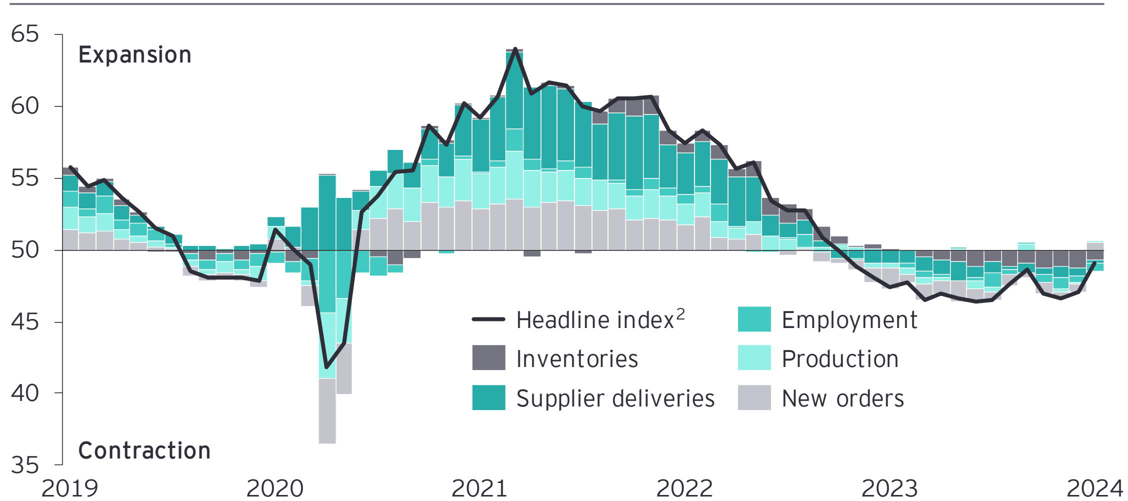
Manufacturing activity remains constrained by high costs, soft global demand and higher interest rates, but momentum should gradually pick up in 2024

US ISM manufacturing index by component contribution[1]
January 2019–January 2024



- The Institute for Supply Management (ISM) manufacturing index outperformed expectations in January but remained in contraction territory, rising by 2 points to 49.1. While this marked the 15th consecutive month of contraction in the index, the latest reading was the slowest pace of contraction in over a year.
- Within the details, two of five subindexes entered expansion territory last month. The forward-looking new orders index jumped from 47.0 in December to a more robust 52.5 in January. Meanwhile, the production subindex saw a marginal increase from 49.9 to 50.4 in the same period. Supplier deliveries also experienced a jump from 47.0 to 49.1; an index below 50 denotes faster deliveries.

US industrial production indexes
January 2007–January 2024 (2017 = 100)

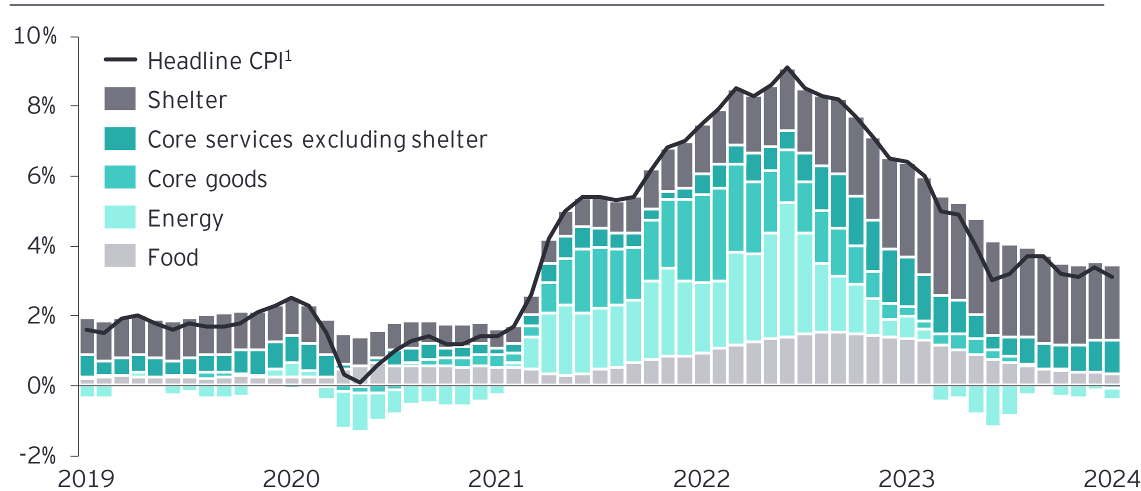
- Momentum in industrial activity was depressed by winter weather in January as industrial production fell 0.1% following a flat reading in December. The slowdown was primarily driven by a significant 0.5% drop in manufacturing output — the largest in three months. A 2.3% decline in mining output also contributed to the weakness.
- With factors such as high interest rates, stringent credit conditions and slow global demand prevailing, the manufacturing sector is likely to continue facing challenges in the short term. However, we anticipate a steady resurgence in the sector later this year facilitated by improvements in both global and domestic demand and a reduction in interest rates.

1. The Institute for Supply Management measures PMI (Purchasing Managers' Index) by surveying manufacturing and service firms on their orders, production, employment, deliveries and inventories. The index indicates business activity in both sectors. This is a diffusion index, with readings above 50 indicating expansion and readings below 50 indicating contraction in activity.
2. Includes manufacturing as well as mining and electric and gas utilities.

Source: Federal Reserve; Institute for Supply Management; EY-Parthenon

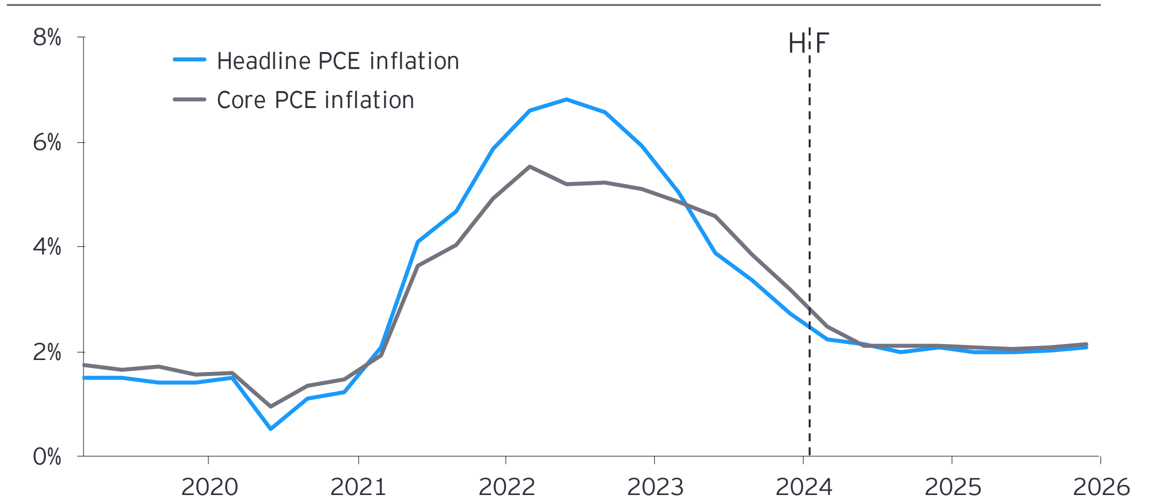
The path from 3% inflation to 2% will be bumpy, but increased price sensitivity and reduced pricing power mean inflation is on track to reach the Fed's target in H2 2024

US y/y percentage change in CPI, contribution by category
January 2019–January 2024



- The path may prove bumpy, but disinflation has more room to run in 2024. Headline CPI rose more than expected in January, up 0.3% m/m, despite lower energy and core goods prices. However, January CPI readings tend to be volatile, so the latest data should be taken with a pinch of salt.
- Core CPI also rose faster than anticipated, up 0.4% m/m. This was the strongest print in nine months owing to a hot reading for core services driven by broad-based gains in shelter costs as well as transportation and medical care prices.
- As a result, headline CPI inflation eased less than anticipated, falling 0.3ppt to 3.1% y/y, while core inflation was flat at 3.9% y/y — the lowest since May 2021.

US y/y percentage change in PCE deflators
2019–2025F



- While this report will undoubtedly spark a wave of inflation pessimism, five key elements should still form the perfect mix for disinflation through 2024: cooler consumer demand growth, declining rent inflation, narrower profit margins, moderating wage growth, and stronger productivity growth.
- We expect headline personal consumption expenditure (PCE) and core PCE inflation will ease further toward the Fed's 2.0% target by year-end, at around 2.0%–2.2% y/y in Q4.

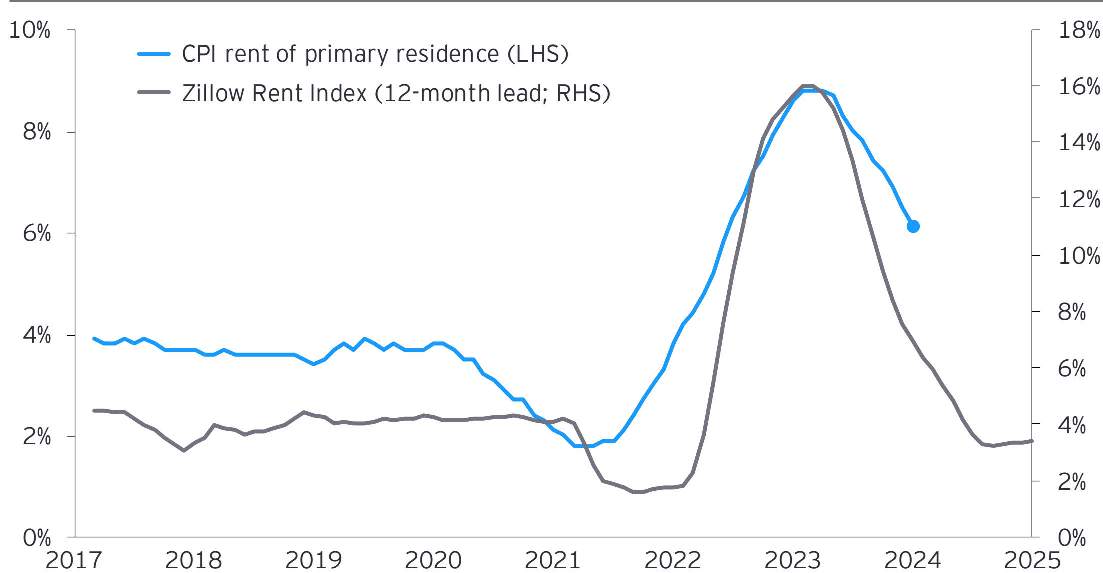
1. Headline CPI includes the prices on a fixed basket of goods. Core CPI removes the CPI components that can exhibit large amounts of volatility from month to month, such as food and energy.

Source: Bureau of Labor Statistics; EY-Parthenon

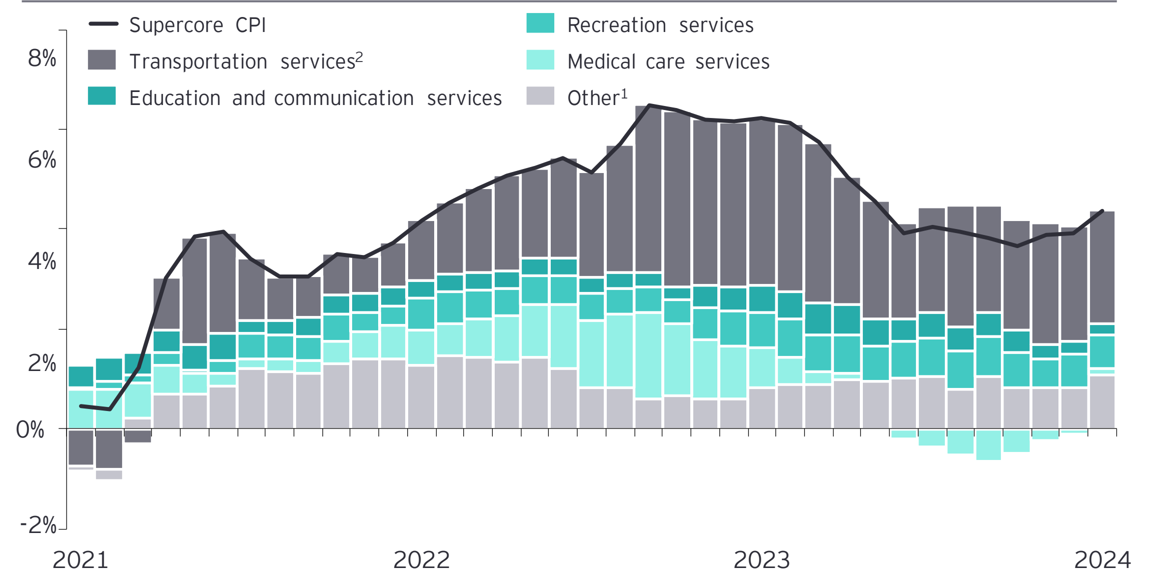
EY Parthenon

Services inflation is likely to ease as rent disinflation speeds up and wage pressures soften amid a continued labor market rebalancing

US y/y growth in rent
March 2017-January 2025F



US y/y growth in core CPI services, excluding shelter
January 2021-January 2024



- Shelter costs, which represent the largest component of services inflation, rose more than expected in January by 0.6% m/m. Rents grew 0.4% m/m – consistent with the two preceding months – but owners' equivalent rents (OER) posted a 0.6% increase, the highest since April 2023. On annual basis, shelter inflation remains in a downtrend and was up 6.0% y/y in January.
- The Zillow Observed Rent Index, which leads the CPI rent component by about 12 months, and the Bureau of Labor Statistics' experimental New Tenant Rent Index suggest considerable moderation in shelter costs in the forthcoming period.
- Assuming shelter inflation gradually reverts towards its pre-pandemic pace this year, with rent inflation declining from 6.1% to 4.0% and OER inflation declining from 6.2% to 4.0%, this would reduce headline CPI inflation by 0.75ppt and core inflation by 0.9ppt.

- The Fed's favored supercore CPI measures (i.e., core services excluding shelter costs) experienced a sharp rise of 0.85% in January – the strongest since April 2022. While this sparked some concerns about the disinflation momentum for core services, we stress that seasonal factors, a "January reset" effect and unusual momentum in the OER index relative to the rent index likely explain the strong monthly momentum.
- Looking into the services details, transportation costs climbed 1.0% m/m, largely due to a 1.4% m/m rise in motor vehicle insurance prices – the 27th consecutive monthly gain – reflecting the impact of increased vehicle prices and repair costs.

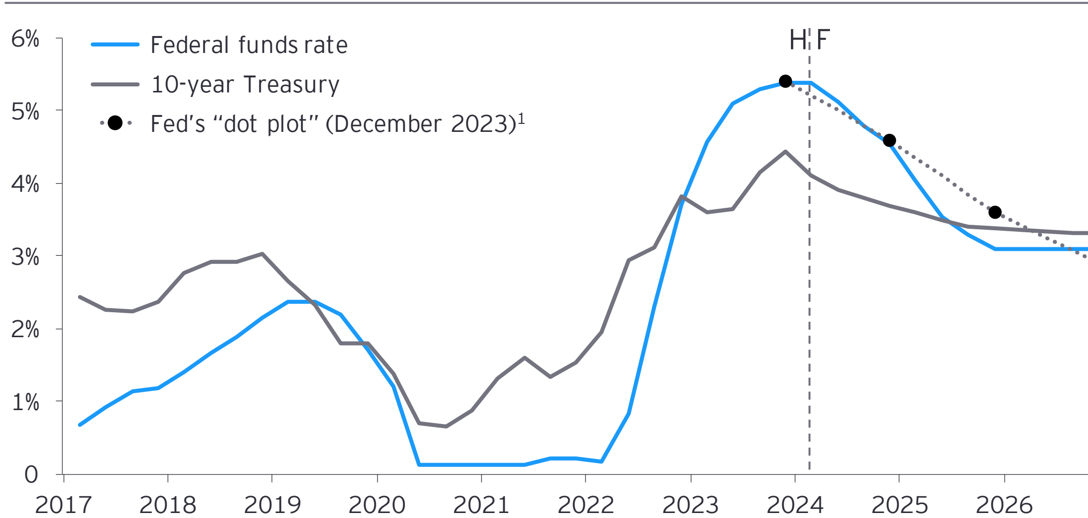
1. Includes water, sewer and trash collection services; household operations; and other personal services.
2. Includes leased vehicles, vehicle rental, vehicle maintenance and repair, vehicle insurance, vehicle fees, and public transportation (including airline fares).

Source: Bureau of Labor Statistics; EY-Parthenon

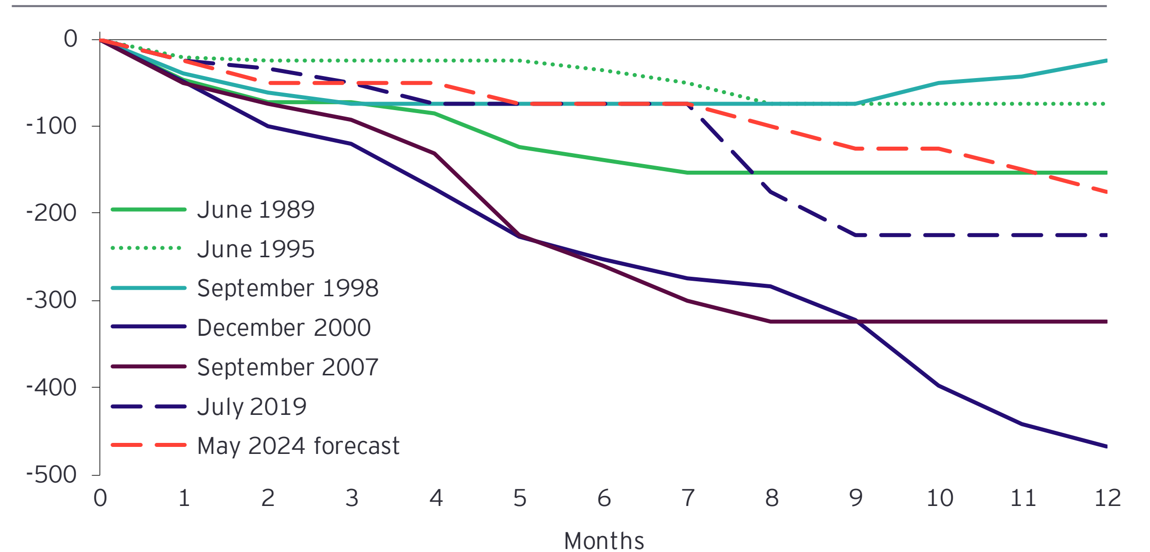
EY Parthenon

The Fed signaled that a March rate cut is not the "base case," suggesting patience is required; we anticipate 100bps of rate cuts in 2024 starting in May

US interest rate forecasts, federal funds rate and 10-year Treasury yield Q1 2017–Q4 2026F



US federal funds rate across loosening cycles: basis points change



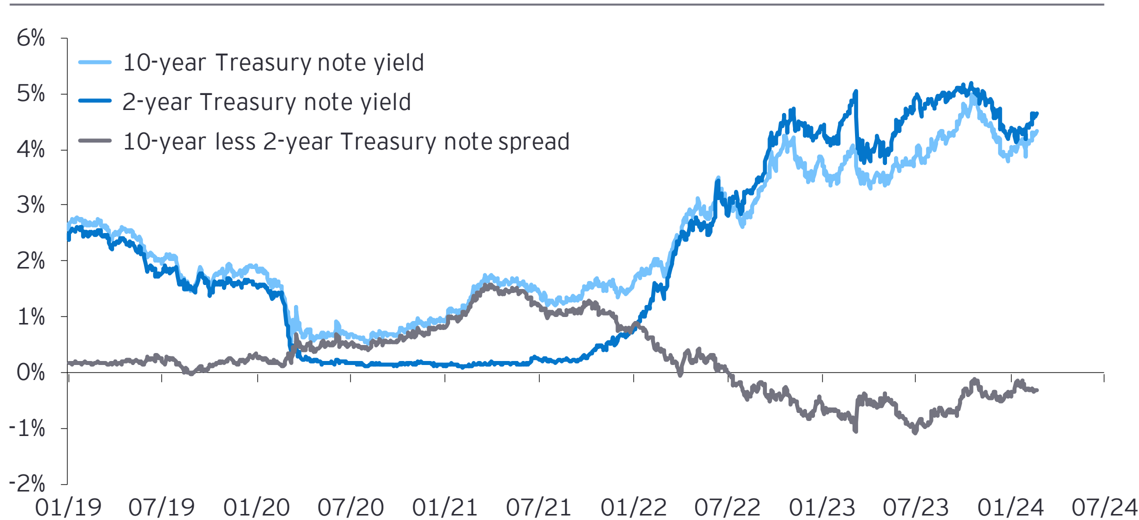
- The Federal Open Market Committee's unanimous decision to hold the federal funds rate at 5.25%–5.50% in late January wasn't surprising. As anticipated, by eliminating the phrase "any additional policy firming," the Fed's tightening bias was removed from the FOMC statement. Instead, the statement favored a hawkish negative statement, saying the FOMC "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."
- During the press conference, Powell clarified what "greater confidence" entails. He noted that officials were encouraged by the strong disinflation progress over the past six months, especially as it has occurred without any notable economic pain. But he stressed that the FOMC needed more disinflation evidence over the coming months.
- The minutes of the January Federal Open Market Committee (FOMC) meeting reaffirmed the Fed's careful approach to monetary policy with most participants noting the risks of "moving too quickly" in cutting the federal funds rate. The minutes also highlighted the notion that officials want more confidence that inflation is moving down sustainably to 2%, by emphasizing the "importance of carefully assessing incoming data."
- Overall, we maintain our long-standing view that the Fed will start cutting rates in May with 100bps of rate cuts this year. We believe the Fed will start tapering its quantitative tightening process in the second half of the year, after the first rate cut.

1. "Dot plot" charts the median interest rate projection from the FOMC. The projections for the federal funds rate are the values at the end of the specified calendar year.
Source: Federal Reserve Board; EY-Parthenon

EY Parthenon

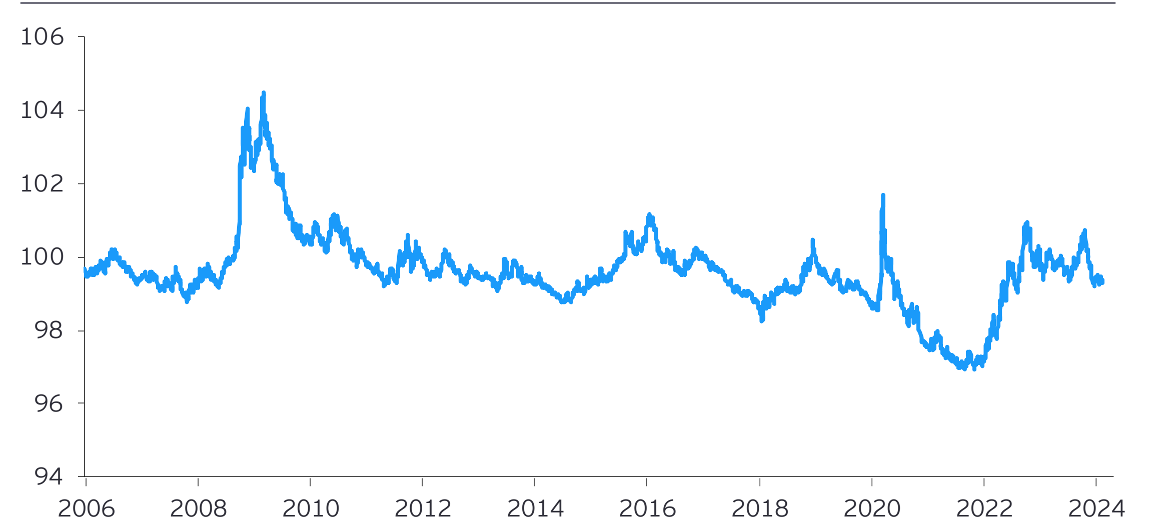
Bumpy inflation data and strong labor market gains have curbed expectations of imminent rate cuts and pushed Treasury yields higher

US 10-year, 2-year, and 10-year less 2-year Treasury note spreads
January 1, 2019–February 21, 2024



- Signs of robust economic activity at the turn of the year and the Fed's pushback against market expectations of imminent rate cuts have pushed the 2-year note 50bps higher since mid-January to around 4.6%. The S&P 500 notched a record-high close in late January, as investors' growing skepticism that the Fed would cut interest rates in March was offset by robust earnings and optimism around economic momentum and artificial intelligence (AI) technologies.
- The yield curve, measured as the spread between the 2-year and 10-year Treasury yields, has remained inverted since early July 2022. However, over the past six months, the negative spread has been shrinking as markets have been pricing Fed rate cuts.

Goldman Sachs US Financial Conditions Index
January 1, 2006–February 21, 2024

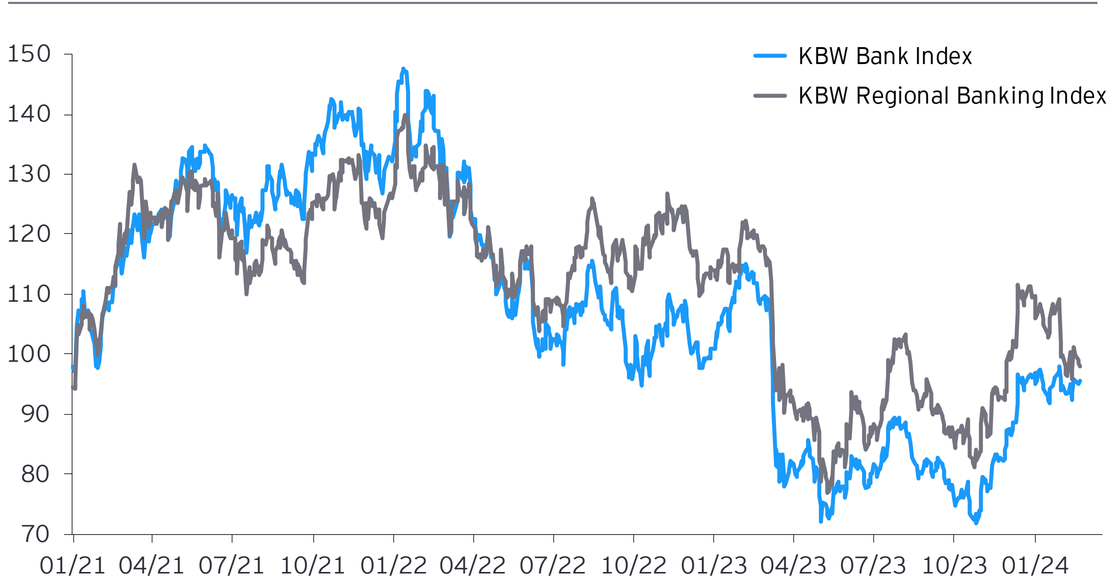


- The Goldman Sachs Financial Conditions Index has traded sideways since late December 2023 after a marked easing from its October high.
- A rapid tightening in financial conditions remains a key risk to the economic outlook. This could emerge suddenly from pressures in the banking sector (potentially related to commercial real estate debt), corporate refinancing pressures or a sudden repricing of Fed policy easing.

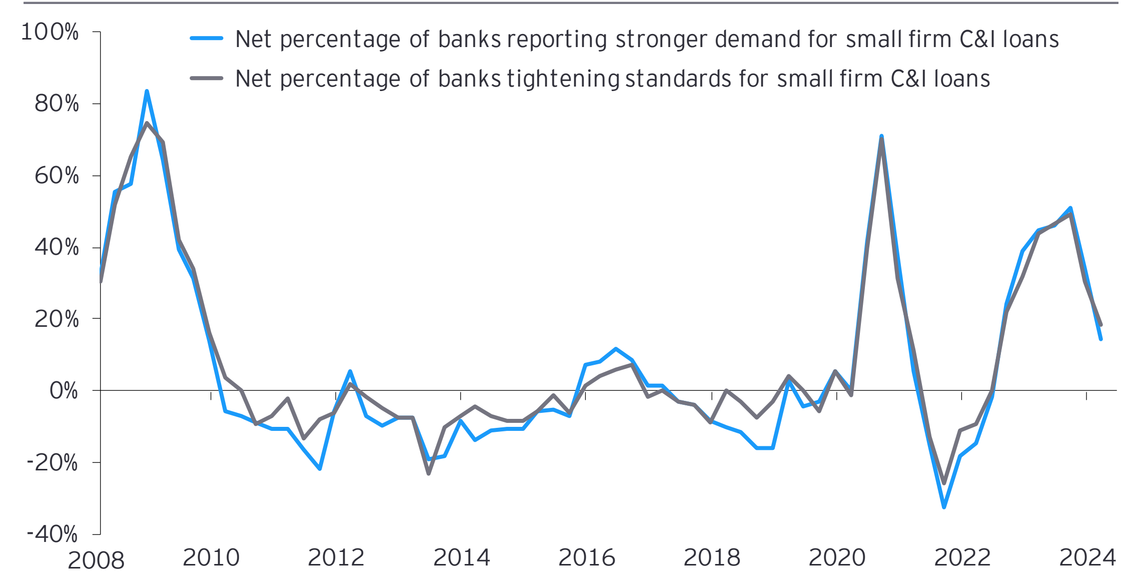
Source: Federal Reserve Board; Bloomberg; EY-Parthenon

US regional banks have come under renewed pressure amid lingering CRE-related vulnerabilities, but the risk of contagion to the broader financial system remains limited

Nasdaq bank stock indexes
January 1, 2021-February 22, 2024



US lending conditions for businesses
Q1 2008-Q4 2023



- Recent renewed stress in regional banking following disappointing earnings report from a New York-based bank holding company highlighted that the tight monetary environment continues to place pressure on some vulnerable corners of the banking system.
- Regional banks face a challenging backdrop, with higher interest rates pressuring loan demand and deteriorating asset quality — especially in the commercial real estate (CRE) segment — putting downward pressure on revenues.
- Looking ahead, increased bank funding costs and deposit volatility will keep pressure on small and midsized banking institutions, leading to tighter credit conditions and lingering effects on private sector activity. Though not our baseline, a sudden tightening of credit and financial conditions remains a downside risk to the outlook.

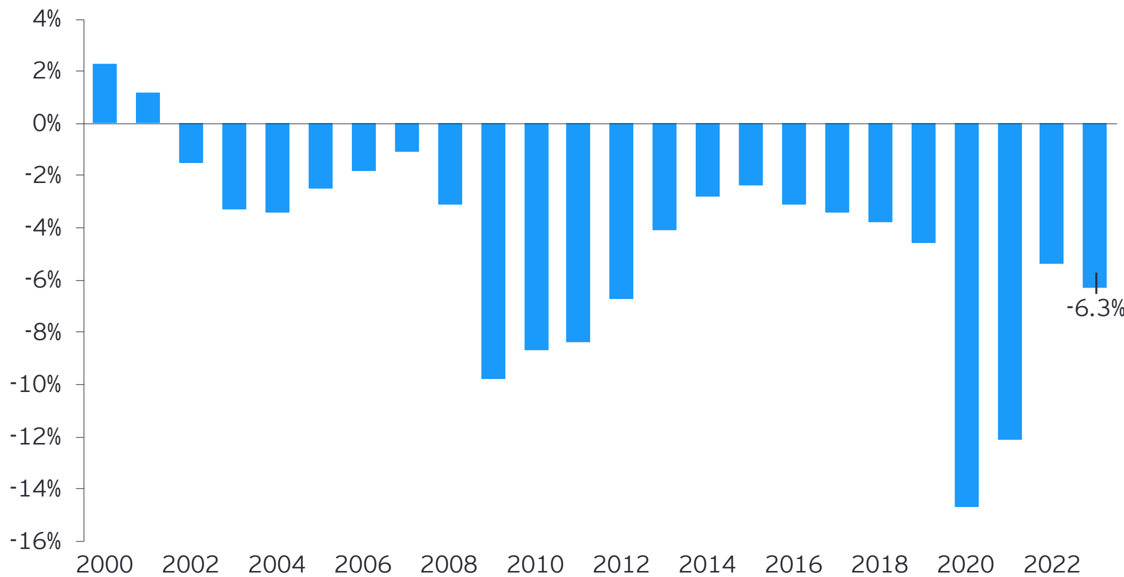
- Encouragingly, the latest Federal Reserve Board's Senior Loan Officer Opinion Survey (SLOOS) showed a smaller share of banks reporting tighter credit conditions. Fewer banks tightened lending standards in Q4 2023, with a net 19% reporting tightening standards on commercial and industrial (C&I) loans to small firms, down from 30% in Q3 2023 and a peak of 49% in Q2 2023.
- Lending conditions to large and medium-sized firms also remained stringent, though the net percentage of banks tightening standards continued to fall. In Q4 2023, a net 15% share of banks reported tightening standards for C&I loans — half the share in the prior survey.

Source: Federal Reserve Board; Bloomberg; EY-Parthenon

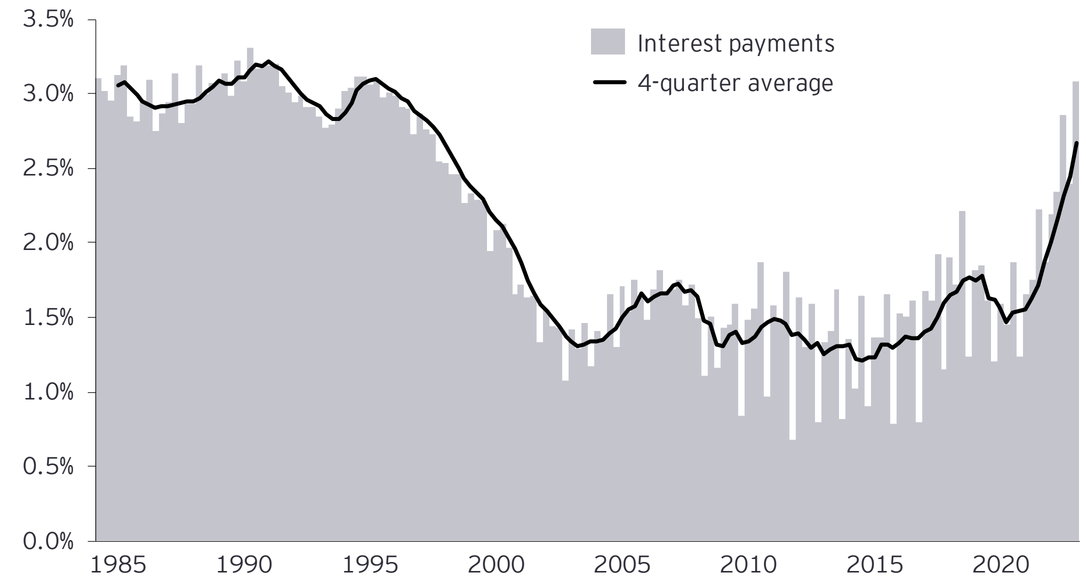
EY Parthenon

Debt sustainability concerns are rising as surging debt burdens and interest payments threaten to crowd out private investment, limit fiscal space and weigh on future growth

US federal budget: deficit or surplus (percentage of GDP) FY2000-FY2023



US interest payments on government debt (percentage of GDP) 1985-2023



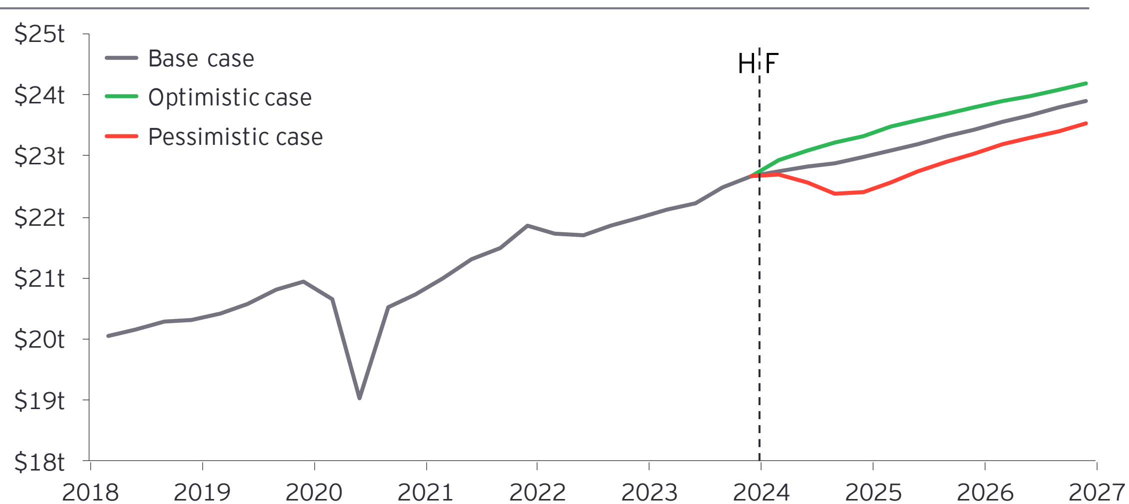
- **Higher cost of debt:** Investors demand higher rates to compensate for the increased risk of default (risk premium). This increases the cost of borrowing for the government and favors the potential for a further acceleration in debt costs.
- **Crowding out private sector investment:** Excessive government borrowing also pushes up borrowing costs for the private sector, leading to reduced business investment, residential investment and consumer spending growth.
- **Impact on currency and treasuries:** Persistent and uncontrolled budget deficits could lead to a decrease in the global appetite for US Treasuries and dollar-denominated assets. If investors begin to question the ability of the US to service its debt, it could lead to reduced demand for these assets, potentially weakening the dollar and increasing borrowing costs. This scenario could have ripple effects across the global economy, given the central role of the US dollar and Treasuries in the world financial system.

Source: Haver Analytics; EY-Parthenon

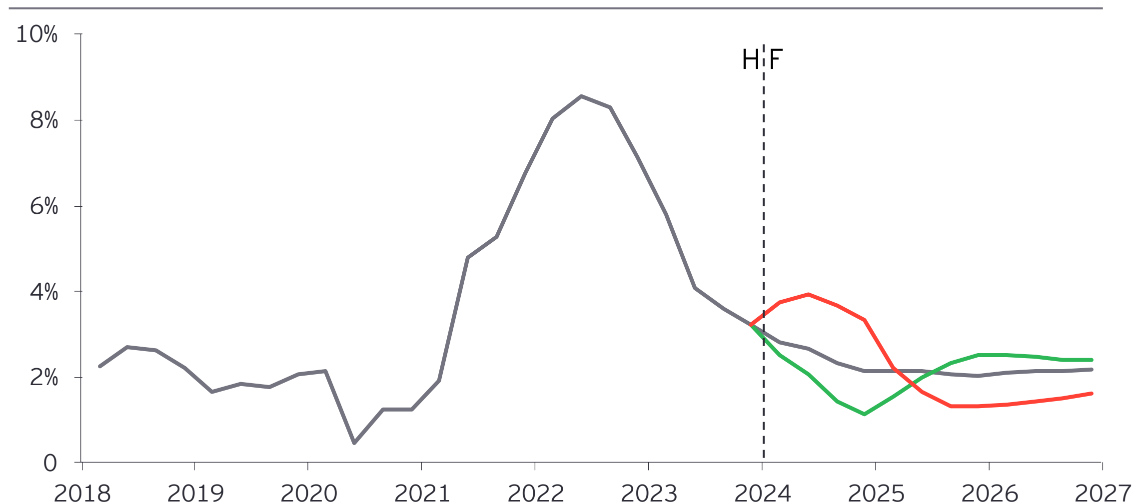
EY Parthenon

Inflation resurgence, restrictive monetary policy and geopolitical tensions are key downside risks to growth, while stronger productivity growth represents an upside risk

US real GDP 2018–25F



US y/y percentage change in headline CPI 2018–25F



Characteristics of a potential optimistic case:

- The labor market comes into better balance, with labor force participation continuing to rise and productivity growth accelerating, driven by a combination of firm-level efficiency gains and tech-driven innovation led by generative AI adoption.
- Real GDP growth picks up, as the US consumer shows resilience supported by more robust disposable income growth while businesses turn more optimistic about the outlook, focusing on long-term investment and hiring decisions.
- Amid a noninflationary growth environment, the Fed pivots to a less hawkish stance. Less restrictive monetary policy leads to easing global financial conditions, thereby supporting stronger economic and markets transactions activity.

Characteristics of a potential pessimistic case:

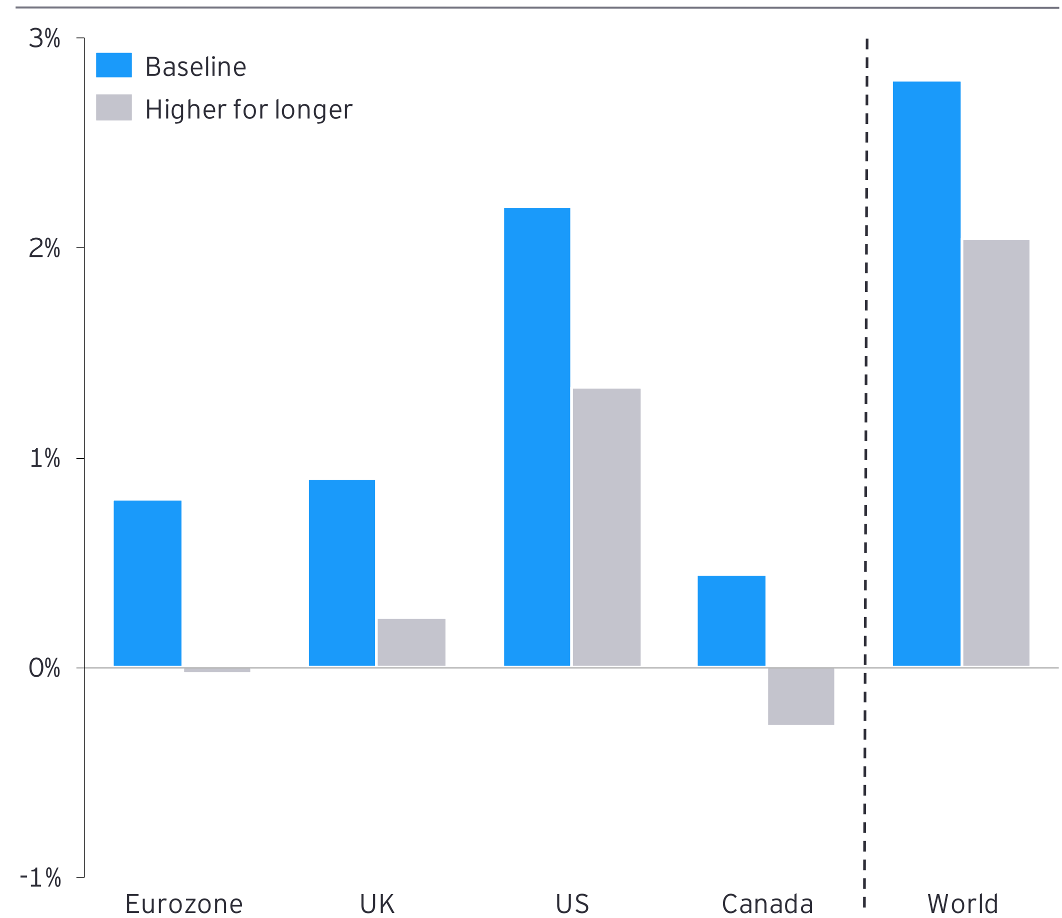
- A surge in inflation amid rising geopolitical tensions puts upward pressure on the cost of goods and services, while constrained labor force participation keeps wage growth elevated and pressures companies' margins.
- Elevated inflation and rising inflation expectations force the Federal Reserve to tighten monetary policy further, pushing the Fed funds rate well above 6% and leading to a severe tightening of global financial conditions and plunging stock prices.
- Consumers grow increasingly reluctant to spend amid persistently high inflation and unrelenting efforts from central banks to tame inflation. Continued cost pressures and elevated uncertainty erode business sentiment and prompt firms to implement broader layoffs. Labor market conditions deteriorate rapidly, with the unemployment rate rising sharply.

Source: EY-Parthenon

EY Parthenon

A "higher for longer" scenario: A delayed easing cycle by central banks amid sticky inflation trends could lead to recessionary conditions in key advanced economies

- Although 2023 saw a significant deceleration in inflation, a scenario where underlying inflation remains elevated remains a key risk to our baseline. Slower disinflation could be the result of renewed upward pressures from energy prices or transportation costs due to intensifying geopolitical tensions.
- Slower progress towards central banks' inflation targets would lead to delayed rate cuts and result in a "higher for longer" cost-of-capital environment.
- To assess the economic impact of such a scenario, we assumed that the Fed, the European Central Bank, the Bank of England and the Bank of Canada maintain a restrictive policy stance and keep policy rates steady throughout 2024, rather than starting their policy easing cycle by midyear. As a result, credit conditions tighten further, with banks maintaining stringent lending standards to both consumers and businesses.
- Financial market volatility increases and investors' sentiment deteriorate markedly as market participants reassess the inflation and interest rate outlook.
- Persistently high borrowing costs strain corporate and households' balance sheets, reducing their ability to service and refinance their debt. The vulnerability of borrowers, already in precarious financial positions, is amplified, leading to a rise in defaults among corporates and households. The higher cost of borrowing dampens housing market activity and puts further downward pressure on consumer demand.
- Elevated interest rates and tightening financial conditions would push the global economy into a recession, with the weakness concentrated in advanced economies. As a result, global growth is 0.8ppt lower in 2024, with the US experiencing stall-speed growth, the eurozone contracting and the UK stagnating.



Source: EY analysis

EY Parthenon

Sector considerations: GenAI in focus

Industry and sector	Perspectives
Consumer and health	▸ Generative AI (GenAI) has the potential to revolutionize early-stage drug discovery and development in the pharmaceutical industry, saving both time and costs. Key applications for GenAI in drug discovery include target identification, target validation, hit generation and lead optimization, while in drug development, GenAI can assist in preclinical testing, study design, administrative processes and regulatory submissions. To formulate a successful GenAI strategy, organizations must understand the software landscape, decide on whether to develop their own GenAI applications or to purchase them, and then execute a comprehensive change management plan. Despite its potential, organizations must be prepared for significant governance to ensure the ethical and effective use of GenAI. However, with its potential to accelerate discovery, enhance product diversity, cut costs and improve approval rates, GenAI is seen as a key future tool in drug discovery and development.[1]
Financial services	▸ The financial services sector is navigating uncertainties with a growing trend toward mergers and acquisitions (M&A), viewing it as a strategic opportunity to gain a competitive advantage. Particularly, increased activity is anticipated in 2024, with 90% of financial service CEOs planning to engage in M&A and 72% planning to increase their investments in acquisitions. Private equity (PE) firms, sitting on significant capital, are also expected to lean more into the M&A market. Meanwhile, there is a prominent focus on generative AI, as 69% of these CEOs see an immediate need to integrate the technology to avoid falling behind competitors. However, banks will need to overcome several challenges, including lack of expertise, budget constraints and data privacy concerns, to leverage GenAI effectively. Emphasis is also placed on establishing infrastructure and talent for GenAI integration.[2]
Industrials and energy	▸ The energy sector is poised for an increase in deals in 2024, with decarbonization and consolidation being substantial motivators. Although oil and gas consolidation has driven significant deal value, other energy segments like power and utilities, mining and metals, and alternative and renewable energies are also predicted to see heightened activity due to the ongoing energy transition and supportive policies. Looking ahead to 2024, we can expect utilities to continue shedding noncore assets and even parts of their transmission and distribution portfolios to fortify their balance sheets for prospective investments. Traditional energy companies are set to leverage incentives offered by local, state and federal legislation, such as the Infrastructure Investment and Jobs Act and the Inflation Reduction Act. These incentives make investments and potential acquisitions in renewable and alternative energy more economically viable, allowing companies to advance their carbon reduction objectives while also producing returns.[3]
Private equity	▸ Generative AI is transforming the private equity industry, with 74% of PE-backed corporations either integrating or experimenting with AI solutions in their business dealings. Moreover, GenAI has led to a sevenfold surge in venture capital funding in the first half of 2023 vs. the entirety of 2022. To optimize the use of GenAI, PE firms are aiming for a balance between immediate tactical maneuvers and smart strategic actions. These include enhancing their understanding of GenAI technologies, investigating how these technologies can be amalgamated into day-to-day operations, assessing the influence on valuations and performance, conducting specific pilot test programs, and building collaborations with AI specialists. In addition, firms must reconsider investment approaches, design plans for turning AI pilots into scalable solutions and manage potential AI-associated risks such as data bias. Given the ever-evolving AI regulations, firms need to stay well informed and maintain their regulatory compliance.[4]

1. Life science source link.
2. Financial services source link.
3. M&A in industrials and energy source link.
4. AI in private equity source link.

Source: EY-Parthenon

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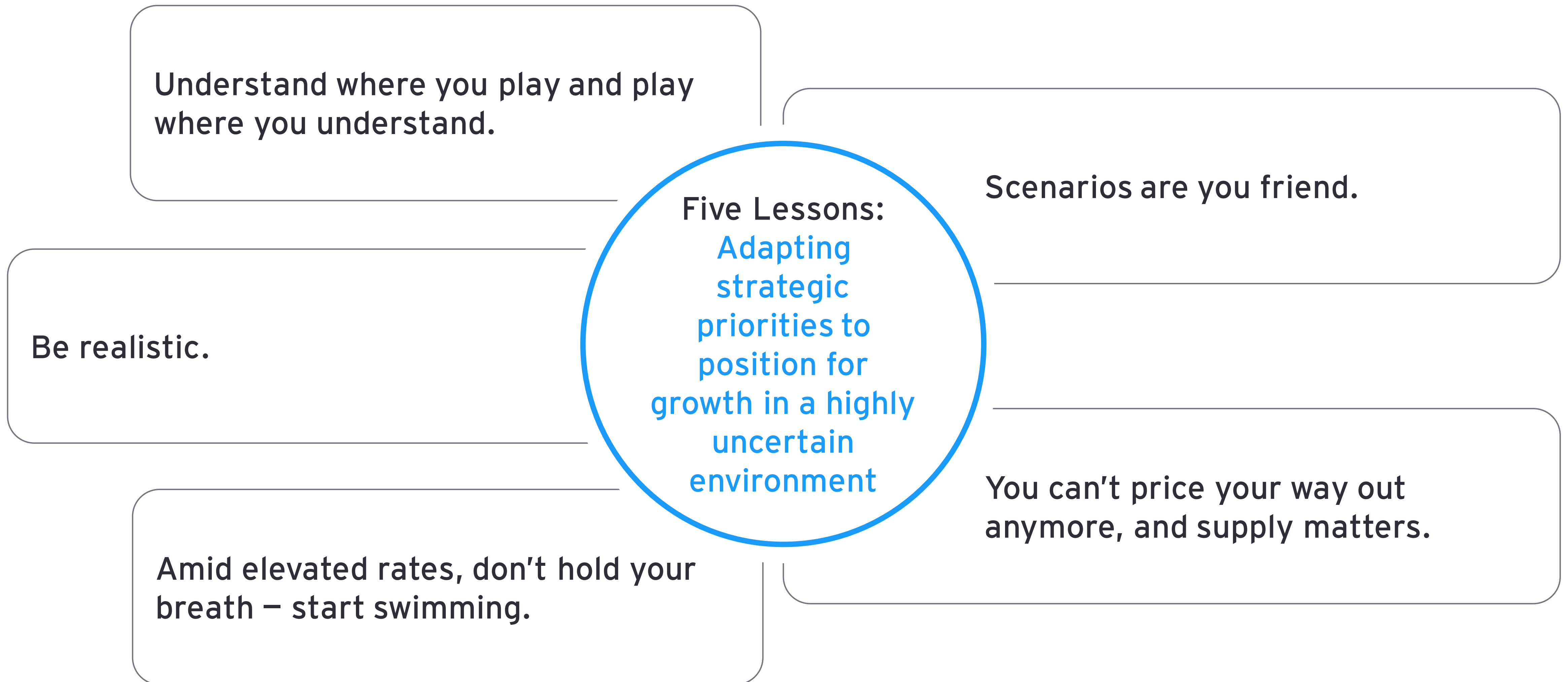
Slower growth; a higher cost of doing business; shifting preferences; and rising trade, geopolitical and regulatory uncertainty underscore the importance of being proactive



Source: EY-Parthenon

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