Executive briefing

Macroeconomic outlook and impact on businesses

September update
Week of September 25, 2023
## Table of contents

<table>
<thead>
<tr>
<th>Topics and EY-Parthenon perspectives</th>
<th>Page(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global snapshot: global growth remains sluggish and uneven with notable soft spots in China and Europe</td>
<td>3-6</td>
</tr>
<tr>
<td>US outlook: entering a turbulence zone as near-term headwinds emerge, but a soft landing remains within reach</td>
<td>7-9</td>
</tr>
<tr>
<td>Employment: softening labor market trends will extend into 2024 as companies turn more conservative with hiring and pay</td>
<td>10-11</td>
</tr>
<tr>
<td>Consumer behavior: the consumer engine will lose some steam as the labor market and excess savings tailwinds fizzle out</td>
<td>12-14</td>
</tr>
<tr>
<td>Housing and real estate: activity will remain under pressure from depressed affordability and ebbing households’ income prospects</td>
<td>15</td>
</tr>
<tr>
<td>Business activity: a higher cost of capital, slower global and domestic demand, and a strong dollar will limit capex growth</td>
<td>16</td>
</tr>
<tr>
<td>Inflation: core inflation will cool markedly and likely fall below 4% by year-end, while headline inflation will be pressured by higher oil prices</td>
<td>17-18</td>
</tr>
<tr>
<td>Federal Reserve: the Fed is likely done tightening monetary policy but is strongly committed to keeping rates “higher for longer”</td>
<td>19</td>
</tr>
<tr>
<td>Financial conditions: the bond market has embraced the “higher for longer” interest rate paradigm</td>
<td>20-22</td>
</tr>
<tr>
<td>Risks and opportunities: higher energy prices could delay the inflation descent and add pressure on central banks to raise rates further</td>
<td>23-25</td>
</tr>
<tr>
<td>Sector considerations and implications of the macroeconomic outlook</td>
<td>26</td>
</tr>
<tr>
<td>Meet the team</td>
<td>27-28</td>
</tr>
</tbody>
</table>

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Global snapshot

The global growth slowdown is set to extend into 2024; the US outlook has improved, but Europe and China remain notable soft spots in the global economy.

Y/y percentage change in real GDP
2020-24F

Global

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Global growth is projected to slow to 2.8% in 2023 and see a muted recovery to 2.9% in 2024. Below-trend growth is expected across most advanced economies, with localized recessions in Europe, modest growth in the US and Japan, and moderate growth momentum across most emerging markets. Risks to the global outlook remain tilted to the downside, with disappointing growth in China risking exacerbating the current slowdown in global growth. A surge in global interest rates and financial market volatility could also adversely affect global economic activity.

Inflation has declined markedly in many economies thanks to falling commodities prices, easing supply chain disruptions and slower demand for manufactured goods. Cooling inflation trends have allowed most central banks to slow the pace of interest rate hikes, and we expect most major central banks will have reached the end of their tightening cycle by year-end. But with core inflation (excluding food and energy) still excessively elevated across many regions and renewed upward pressure on headline inflation from higher energy prices, advanced economies' central bankers will display a hawkish bias towards higher-for-longer interest rates and will be unlikely to consider rate cuts until Q2 2024. Meanwhile, some emerging markets' central banks have already started cutting rates.
A growth scare in China with financial market spillovers would have severe global implications, but a modest slowdown would have limited direct consequences for the US.

- China's economic trials have emerged as a key risk. Economic activity in China has weakened in recent months, and stress in the property sector has resurfaced, posing downside risks to the global macroeconomic and business outlook.

- Accordingly, authorities have launched fiscal and monetary policy stimulus measures to support the economy in the short term. Early indications are that these measures are supporting final demand. As such, we believe excessive pessimism around the economic outlook is misguided.

- Still, it is important to examine key contagion channels. We find that a worsening of China's economic outlook would have a limited adverse effect on the US economy given the relatively small direct trade and financial linkages. However, a potential tightening in global financial conditions associated with a “China growth scare,” such as in 2015-16, would significantly magnify the impact.

- The US economy’s direct trade exposure to China is rather small, as the country accounts for only 7% of American exports—a mere 0.6% of GDP. As such, financial conditions and confidence effects are arguably more important transmission channels through which a worsening slowdown could be transmitted to the US economy.

- Importantly, economies that are more heavily reliant on China for trade, investment and tourism activity would experience a disproportionately larger drag on activity. Additionally, the longer economic growth and financial markets disruptions would linger, the more severe the impact would be.

- Our modeling shows that if China GDP growth were to surprise on the downside and fall one percentage point (ppt) below baseline in 2023 and 2024, weaker trade and investment flows along with tighter financial conditions would impose a cumulative drag of 0.3ppt on US real GDP in 2024, with growth averaging 1% compared with 1.3% in our current baseline. Global GDP growth would fall 0.5ppt below our baseline to 2.4% in 2024.

Source: Census Bureau; EY-Parthenon
Global inflation continues on a downward trajectory, but rising energy prices and persistent service sector inflation could slow the disinflation process in the near term.

Headline Consumer Price Index (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.

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2. Euro area includes 20 countries.

Source: OECD; EY Parthenon
Global snapshot

The end of the global tightening cycle is near, but central bankers and investors are embracing a “higher for longer” paradigm, pushing long-term yields to multiyear highs.
US outlook

While a US recession isn’t on the near-term horizon, economic activity is poised to downshift entering 2024 as the economy faces a set of new and old headwinds.

- **Outlook**: High-frequency data indicates the economy is experiencing a controlled landing, with healthy but cooling labor market conditions, moderating wage growth, and increasingly conservative consumer and business spending. With real GDP on track to grow robustly in Q3, a recession isn’t on the near-term horizon, but the economy faces imminent risks. The triple threat from the resumption of student loan payments, a government shutdown and a strike by auto union workers could significantly weigh on GDP growth in Q4 and add to downside risks already impacting the economy including elevated prices, interest rates and tighter credit conditions. We see real GDP growing 2.2% in 2023 and expanding at a muted 1.3% pace in 2024, though a gradual rebound in economic momentum is expected in the second half of next year.

- **Labor market cooling**: The August jobs report brought more evidence that labor supply and demand are coming into better balance and that labor market tightness is easing. Job growth surprised on the upside in August with a solid 187k jobs gain, but significant downward revisions to payroll gains in June and July point to softer hiring trends. The unemployment rate edged up to 3.8%, due in part to a rise in labor force participation, while wage growth cooled to 4.3% year over year (y/y). We continue to expect further hiring freezes and strategic resizing decisions along with some continued moderation in nominal wage growth in the coming months, but we don’t anticipate a severe employment pullback. We see the unemployment rate stabilizing rising toward 4.0% by year-end and rising to around 4.4% by the end of 2024.

- **Consumer crosswinds**: Consumers are spending more conservatively as they continue to face a trifecta of headwinds: elevated inflation, higher interest rates, and slowing labor market and income gains. The restart of student loan payments on October 1, the near depletion of excess savings and tight credit conditions will further weigh on consumers’ ability to spend going into next year. We anticipate consumer spending will advance 2.5% in 2023 and register muted growth of 1.3% in 2024.

- **En-core disinflation**: While the free disinflationary lunch is over, the slowdown in core inflation momentum remains encouraging. Factoring less favorable annual comparisons, headline inflation rose 0.5ppt to 3.7% y/y in August, but core inflation moderated a notable 0.4ppt to 4.3% – its slowest pace since September 2021. Looking ahead, easing demand for goods and services, the pass-through from softer home and rent price inflation, and cooling wage growth should lead to further disinflation. We see headline inflation easing to 3.2% y/y in December, while core CPI inflation is likely to ease toward 3.8% y/y by year-end.

- **Higher for longer**: The Fed left the policy rate unchanged in a range of 5.25%-5.50% at its September policy meeting but maintained a hawkish bias by preserving the optionality for further tightening this year and strongly signaling that interest rates will stay high for longer over the coming years. We continue to believe the Fed’s tightening cycle is complete, and while there will likely be chatter around an additional rate hike before year-end, we believe this will prove to be noise. Still, given the increased Fed hawkishness, we have pushed back our first rate cut expectation of 25 basis points (bps) to Q2 2024, and we anticipate 75bps of rate cuts in 2024 (down from 100bps previously).

- **Risks**: Labor market resilience is undoubtedly the main upside risk to the economy. Paradoxically, though, stronger economic activity and less easing of labor market tightness would prompt the Federal Reserve to raise interest rates higher and maintain a restrictive stance for longer. This overtightening of monetary policy would increase recession risks. Rising odds of a government shutdown and associated policy uncertainty, along with the resumption of student loan repayments and the UAW strike, are additional downside risks to the outlook. Slower growth in Europe and China, rising energy prices, and a strengthening dollar are other important risks to monitor.

Source: EY-Parthenon
The economy is on track to grow strongly in Q3, but the triple headwinds of a UAW strike, a looming shutdown, and student loan repayments will weigh on Q4 GDP growth.

US real GDP growth (quarter over quarter annualized rate) 2021-2024F

While the economy is currently on track to grow above 3% annualized in Q3, real GDP growth in the fourth quarter is set to downshift substantially partly due to three key developments:

1. The restart of student loan repayments on October 1 for about 20m borrowers, which we estimate represents about 0.4% of disposable income, will curb households’ spending power and will likely lead to some deterioration in household finances into 2024. That said, the launch of the new income-driven repayment (IDR) program could reduce monthly payments and alleviate the pressure on households’ budgets.

2. The pressing obligation for Congress to pass legislation to fund the government in fiscal year 2024 could lead to a government shutdown if a budget (partial or full-year) isn’t passed before the September 30 deadline. We estimate that each week of government shutdown will cost the US economy $6b and shave GDP growth by 0.1 percentage points (ppt) in Q4 (in annualized growth terms). The drag on growth reflects the reduction in pay for furloughed federal workers, delays in government spending on goods and services, and the resulting decrease in final demand. Importantly, the economic impact of any shutdown within a quarter would be partially offset by retroactive pay for furloughed workers and the resumption of economic activity.

3. The UAW targeted strike, which is impacting major US auto manufacturers, is likely to weigh on auto production and could have ripple effects through the economy if it were to last. Notably, it could lead to renewed supply disruptions in the auto sector and put renewed upward pressure on auto prices. We estimate that every week of strike by all 140k auto union workers would weigh on GDP growth by 0.1ppt. Currently, 13k workers are on targeted strikes.
Key risks: Fed policy tightening, tighter credit conditions, financial market volatility, China's economic challenges

Source: EY-Parthenon
The labor market is slowing, but layoffs remain low; higher interest rates and softer domestic demand will lead to more conservative hiring and strategic job cuts into 2024.

The labor market continues to move into better balance. The pace of hiring slowed further in August, with the economy adding 187k jobs. Moreover, net revisions to the prior two months showed 110k fewer jobs than previously reported, bringing the three-month moving average for payroll growth down to 150k in August, the slowest since payroll growth plunged at the start of the pandemic.

Details of the report showed that employment in services industries expanded 143k, little changed from July, while hiring in goods producing industries rose by 36k. Overall, employment gains were a little more broad-based, as the employment diffusion index – a measure of how many private sector industries are adding jobs – rose to 63.8 in August, its highest since January 2023.

The unemployment rate rose by 0.3ppts to 3.8% in August – its highest level since February 2022 – but the increase mostly reflected a rebound in labor force participation. Indeed, measures of layoff activity remain historically low, suggesting that executives are still reluctant to let go of their valuable talent pool after having put so much effort into hiring and training over the past two years.

Looking ahead, we foresee softer labor market conditions with further hiring freezes and strategic resizing decisions along with some continued moderation in nominal wage growth. But we don’t anticipate a severe employment pullback. We see the unemployment rate rising from 3.8% toward 4.0% by year-end and around 4.4% by the end of 2024.
One encouraging development pointing to a continued labor market rebalancing is the rebound in the labor supply. After holding steady for five straight months (reflecting the constraint of an aging workforce), the labor force participation rate edged up 0.3ppt to 62.8 in August. Participation among the key prime-age cohort (25- to 54-year-olds) also ticked up 0.1ppt to 83.5%—a level reached in June and a 15-year high.

The strong recovery in prime-age labor force participation is a sign that robust (albeit slowing) labor demand is pulling workers back into the labor force. Reduced labor supply pressures could also help alleviate excessive wage inflation pressures.

Job openings continued their downward trajectory in July, falling by 338k from downwardly revised 9.2m in June to 8.8m, their lowest level since March 2021. Even so, openings remain roughly 2m above pre-pandemic levels. The hiring rate decreased 0.1ppt to 3.7%, while the quits rate, which reflects workers’ confidence in the jobs market, fell back to 2.3%, same as its pre-pandemic level.

The ratio of job openings per unemployed worker, which is closely watched by Fed officials, edged down to 1.51 in July, its lowest level since September 2021.

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1. Labor force participation rate.
Source: Bureau of Labor Statistics; EY-Parthenon
Nominal wage growth has recently outpaced inflation, providing support to household income and spending; but slower income momentum is expected heading into 2024.

- Loosening labor market conditions have led to a gradual moderation in wage growth. Average hourly earnings have moderated from a peak of 5.9% in February 2022 to 4.3% in August. Other measures of wage growth, such as the Atlanta Fed Wage Growth Tracker, also point to cooling compensation trends. The index slowed to 5.3% y/y in August from 5.7% in July and a peak of 6.7% in August 2022.

- Importantly, wage growth has been moderating at a slower pace than inflation, which has led to a rebound in real wage growth. After contracting for two years, real average hourly earnings have turned positive in May, suggesting that households’ purchasing power has been regaining some ground.

- Indeed, the rebound in real disposable income has been a key source of consumer resilience over the past year. However, real disposable income fell 0.2% in August, as stronger inflationary pressures during the month led to the first monthly decline in real disposable income since June 2022.

- With employment growth expected to moderate, the disposable income tailwind from slower inflation will be largely offset by slower labor income growth. As such, we believe a downshift in consumer spending is poised to materialize in the latter part of the year.

Source: Bureau of Labor Statistics; Bureau of Economic Analysis; EY-Parthenon
The tailwinds bolstering consumer spending capacity are fizzling out; credit conditions are tightening and excess savings are likely to be depleted by year-end.

Consumers are facing increasingly challenging credit conditions. The Federal Reserve’s latest survey of bank-lending conditions showed that a net 36% share of banks reported tightening standards for credit cards over the last three months, compared to 30% in the prior survey. Lending standards on auto loans and other consumer loans have also become more stringent.

Credit has also become more expensive, as interest rates on consumer loans have risen sharply since 2022, leading to a decline in demand for consumer credit. Momentum in bank loan growth to consumers has slowed sharply from 11% y/y at the start of the year to 5.7% y/y in August.

While remaining excess savings along with a resilient labor market help explain consumers’ staying power in the face of higher inflation and interest rates, the impetus is rapidly fading, as excess savings are nearly depleted.

We estimate that US households have drawn down 75% of their excess savings, with only about $500b left at the aggregate level. However, excess savings for lower-income families have likely already been exhausted. As such, excess savings should not be viewed as a key source of income supporting a steady pace of spending going forward.

1. Data for auto and other loans are only available starting in Q2 2021
2. Excess personal savings is defined as the cumulative stock of savings above what consumers would have saved if income and spending would have maintained their pre-pandemic pace.

Source: Federal Reserve Board; Bureau of Economic Analysis; EY-Parthenon
Consumer spending has remained on a firm trajectory, but it will come under pressure in coming months as student loan payments restart and labor market conditions soften.

Retail sales rose more than expected in August, but the strength mostly reflected higher prices. Retail sales increased 0.6% over the month, but the volume of sales fell 0.1% after adjusting for the robust 0.6% increase in consumer prices. Beneath the headline print, the details of the report revealed that consumers spent less on some discretionary items and took a breather from online shopping to allow for more spending on pricier essentials such as gasoline.

Importantly, control retail sales — a key gauge of consumer spending trends that strips out volatile retail segments — posted a muted 0.1% increase following a downwardly revised 0.8% gain in July. Looking at the broader trend, retail sales momentum slowed to 2.5% y/y in August compared with 2.6% y/y in July and 7.4% y/y in January. And in inflation-adjusted terms, retail sales are 1.2% lower relative to last year.

Consumers are becoming more conservative with their spending as they continue to face a trifecta of headwinds: elevated inflation, higher interest rates and slowing labor market gains. The restart of student loan repayments on October 1 and the near depletion of excess savings will further weigh on consumers’ ability to spend going into next year.

Slower employment and disposable household income growth in the coming months and the resumption of student loan repayment will likely mean ongoing consumer cautiousness, though we do not anticipate a consumer pullback. Overall, we project that consumer spending will grow 2.5% in 2023 and around 1.3% in 2024. Averages are somewhat misleading, however, as spending momentum is expected to reaccelerate through 2024.

Source: Census Bureau; Bureau of Economic Analysis; EY-Parthenon
Mortgage rates above 7% are putting continued downward pressure on home sales, but tight supply conditions should support construction activity, especially for multifamily units.

After showing some signs of stabilization in recent months, housing activity has come under renewed pressure from surging mortgage rates. Ground-breaking activity fell more than expected in August, as housing starts plunged 11.3% to 1.28m. However, the weakness was concentrated in the volatile multifamily segment, which plunged 26%. The more forward-looking housing permits rose 6.9% with a 15% surge in the multifamily sector.

Existing home sales fell 0.7% in August and were running 15% below last year at 4.04 million units. Amid tight supply conditions, the median home price rose by 3.9% y/y.

Low affordability is keeping buyers and sellers who are locked into lower fixed mortgage rates on the sidelines. The average mortgage rate on a 30-year fixed loan climbed above 7% in mid-August and reached 7.23% in September, the highest level since December 2000. And the average monthly mortgage payment on a median-priced existing home has surged over 120% since January 2019, or $1,230.

We expect new and existing homes sales to remain sluggish over the remainder of the year, while tight supply conditions should continue to support a floor under housing starts and constructions activity. Low inventories of homes, limited housing mobility and gradual construction should maintain upward pressure on home prices.

Source: Census Bureau; National Association of Realtors; EY-Parthenon
Factory activity has stalled and sentiment remains depressed, but ongoing efforts to boost supply in sectors such as auto and electronics should keep a floor under activity.

1. The Institute for Supply Management (ISM) manufacturing index edged up 1.3 points in August, but at 47.6, it remained below the 50-mark for expansion. Purchasing manager sentiment remains depressed with activity contracting for a tenth straight month.

2. The details of the survey revealed that every subcomponent was below the 50 threshold for expansion, except the production index which came in at 50. The forward-looking new orders index and inventories continued to contract at a faster pace. The employment index increased 4.1ppt to 48.5, though the weakness has yet to translate to manufacturing employment.

3. Industrial production grew 0.4% m/m in August following a downwardly revised 0.7% gain in July. However, the gain was mostly driven by growth in mining output, which rose 1.4% – the strongest gain in seven months. Overall, manufacturing momentum has slowed markedly with output 0.7% below its year-ago level.

4. Along with higher interest rates, slower global demand for manufactured goods and weak manufacturing sector activity in China offer a soft external backdrop for factory activity in the months ahead. These headwinds will continue to limit business spending activity, though a retrenchment appears unlikely.
Headline CPI (Consumer Price Index) rose 0.6% month over month (m/m), inline with expectations and the largest monthly gain since June 2022. The rise was primarily driven by higher energy prices, which increased 5.6% on the month due to a 10.6% spike in gasoline prices accounting for more than half of the increase in headline CPI. Meanwhile, core CPI prices (excluding food and energy) saw a moderate 0.3% m/m rise in August, after rising 0.2% for two straight months.

Despite the monthly increase, a disinflationary trend remains in place. On an annual basis, headline CPI inflation rose 0.5ppt to 3.7% y/y in August as base effects turned less favorable. Meanwhile, core CPI inflation fell 0.3ppt to 4.4% y/y – its slowest pace since September 2021.

Looking ahead, restrictive monetary policy, easing demand for goods and services, the pass-through from softer home and rent price inflation, and cooling wage growth should lead to further disinflation. Cooler wholesale price inflation, reflecting profit margin compression, along with import price deflation, subdued inflation expectations and easing wage growth should also contribute favorably.

In December, we foresee headline and core CPI inflation easing to around 3.2% y/y and 3.7% y/y, respectively. Meanwhile, headline and core PCE inflation should close the year around 3.1% and 3.5%, respectively.

Higher energy prices will likely put temporary upward pressure on headline inflation, but core inflation should continue its descent and fall below 4% before year-end.
Inflation

Services are now the main driver of core inflation, but we foresee slower shelter and transportation price inflation in the coming months, leading to disinflation

Services inflation remains elevated but showed further signs of cooling in August, with prices rising 5.9% y/y after a 6.1% increase in July. Encouragingly, housing disinflation is gaining momentum. Shelter costs inflation inched down 0.1ppt to 0.3% m/m in August, with rent prices rising 0.5% m/m, and owners’ equivalent rent rising 0.4% m/m.

Shelter cost inflation is now clearly easing. It slowed from 7.7% y/y in July to 7.3% y/y in August. And housing disinflation is set to pick up further momentum in the coming months. The Zillow Rent Index, which captures rents of units currently advertised on the open market, continues to point to a rapid cooling in CPI inflation towards 5%-6% by year-end.

With the strong disinflationary impulse from commodity and goods prices now over and housing disinflation underway, further moderation in core services inflation excluding shelter costs will be needed to bring inflation closer to the Fed’s 2% target. This ‘supercore’ measure closely watched by the Fed rose 0.5% m/m in August after a 0.2% increase in July but remained in a downtrend.

Transportation services prices will be particularly important to watch in the months ahead. They have accounted for about half of supercore inflation over the past year, with price increases concentrated in travel and auto-related services such as car insurance and repair.
The Fed has likely reached the end of its hiking cycle; policymakers will now proceed “carefully” while cementing a “higher for longer” monetary policy paradigm.

There was no surprise in the Federal Reserve’s decision to hold the federal funds rate at 5.25%-5.50%. The Federal Open Market Committee (FOMC) statement was little changed, with policymakers unanimously voting to hold the federal funds rate steady while preserving the conditional optionality for further tightening should it be necessary.

The median dot plot stole the limelight, as the Fed’s median rate expectations revealed a terminal rate still at 5.6% in 2023 – signaling optionality for another rate hike in November or December. The Fed’s “higher for longer” policy stance was shown in the median rate projection for the end of 2024 being raised by 50bps to 5.1%, signaling only 50bps of rate cuts next year.

The summary of economic projections (SEP) revealed three key dimensions of the Fed’s latest thinking. First, the Fed is in the “strenuous last inflation mile” camp. While core inflation projections were revised down in near term, they were revised mildly higher in medium term, despite more restrictive policy. Second, policymakers are all-in on a soft landing. Third, policymakers no longer anticipate an overshoot of the neutral unemployment rate but, instead, see the labor market gently cooling.

Despite the Fed’s hawkish lean, we still believe the Fed’s tightening cycle is complete. We have nonetheless revised our expectations for rates cuts next year to 75bps (from 100bps previously), with the first cut unlikely before June 2024.

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
Higher interest rates and slower growth are weighing on companies’ and consumers’ balance sheets; profit margins are shrinking and consumer delinquencies are rising.

- Profit margins have compressed markedly amid softer demand domestically and abroad and as companies find it harder to pass on elevated input costs onto consumers.
- Before-tax profits fell $11bn following deeper contractions of $61b and $121b in Q4 2022 and Q1 2023, respectively. In the details, lingering weakness in domestic profits was partially offset by a rebound in foreign profits. Profit margins fell 0.1ppt to a new cycle low of 10.5% of GDP, 1.6ppt below their Q2 2021.
- Looking ahead, we expect corporate profit margins will remain under pressure as sales conditions soften further and pricing power continues to wane.

On the consumer side, balance sheets remain relatively healthy but fragilities are also appearing. The 30-day delinquency rate (new delinquencies) on consumer loans is still low, but it has rebounded markedly from its pandemic trough in mid-2021.

- In the latest quarterly report from the NY Fed, the most notable upticks were reported for delinquencies in credit card and auto loan balances. The delinquency rate on credit cards reached 7.20% in Q2, up from 4.76% the year before. Delinquencies on auto loans have also risen markedly and are now above their pre-pandemic level amidst higher interest rates and elevated used car prices.
As investors price a higher-for-longer interest rate paradigm, long-dated Treasury yields are hovering at multiyear highs amid continued economic resilience.

1. Weighted average of riskless interest rates, the exchange rate, equity valuations and credit spreads.

Source: Federal Reserve Board; Bloomberg; EY-Parthenon

- Long-term Treasury yields have remained closed to multiyear highs in August amid resilient economic activity and as investors pared back their rate cut expectations. The 10-year Treasury yield has risen 30 basis points so far in September and hit a 16-year high of 4.41% on Sep 20, its highest level since 2006.

Beyond the US economy’s resilience and the Fed’s ‘high for longer’ paradigm, other factors have contributed to the bond market selloff in recent weeks. The Bank of Japan loosened its yield curve control policy in late July, pointing to potentially weaker demand from Japanese investors for foreign bonds. And higher-than-expected debt issuance plans from the Treasury and Fitch’s downgrade of US sovereign debt rating amid rising concerns over larger budget deficits also helped push longer-dated yields higher.

- The US economic outperformance relative to the rest of the world and the resilience of the US economy compared to the rest of the world continue to fuel the dollar strength.

- The DXY dollar index is up 5.6% from its July 13 low and should see continued upward pressure in coming weeks as the US economy continues to show resilience compared to sluggish economic performance elsewhere.
Regional banks remain under renewed pressure as a series of credit downgrades underscored lingering vulnerabilities in the banking sector

Recent credit downgrades by Moody’s and S&P of 10 and five regional banks, respectively, highlighted that some vulnerabilities in the banking system remain and put renewed downward pressure on bank stocks. The KBW Bank Index, which tracks the performance of 24 major banks, is down 9% since late July, while the KBW Regional Banking Index is down 14% from its early August peak.

In another sign of lingering stress, banks continue to rely on the Fed’s new liquidity facility, though lending through the discount window has faded. In the week of September 20, banks tapped $108 billion from the Federal Reserve’s BTFP program, near the highest level since the beginning of the banking turmoil.

Regional banks are facing a challenging backdrop, with higher interest rates pressuring loan demand and deteriorating asset quality—especially in commercial real estate segment—putting downward pressure on revenues.

Looking ahead, increased bank funding costs and deposit volatility will keep pressure on small and midsize banking institutions, leading to tighter credit conditions and lingering effects on private sector activity. But a more sudden tightening of credit and financial conditions remains a downside risk to the outlook.
Oil prices have risen markedly amid tight supply conditions; surging energy costs could delay the disinflationary process, especially if they filter into core prices.

Tight supply conditions in the oil market with falling US oil output and extended oil production cuts from Russia and Saudi Arabia have propelled oil prices sharply higher in recent weeks. Brent oil prices reached a 10-month high of $95/barrel in mid-September. And gasoline prices have rapidly followed suit, surging towards $3.90 per gallon.

In the US, the number of active oil rigs has declined by 106 so far this year amid softer commodity prices. However, the recent rebound in oil prices should lead to a gradual rebound in oil production later this year, as rig counts tend to follow energy prices with a lag.

While higher oil prices hurt consumer spending through higher cost at the pump, they can also provide a boost to the economy via higher energy investment. However, it is worth noting that domestic shale producers have shown reluctance to significantly ramp up oil production in this cycle even as oil prices surged in the wake of the Russia-Ukraine war.

Renewed upward momentum in energy prices and potential pass-through into core inflation pose upside risks to the inflation outlook. In August, energy prices in the CPI report surged 5.6% m/m reflecting a 10.6% surge in prices at the pump. While policymakers at the Fed tend to look through temporary increases in energy prices, a persistent rise would reinforce the Fed’s hawkish posture.
Overtightening of monetary policy is key downside risk, while economic resilience, stronger productivity growth and lower inflation represent an upside risk.

Characteristics of a potential pessimistic case:
- Repeated supply-side shocks and slumping productivity keep upward pressure on the cost of goods and services, while constrained labor force participation keeps wage growth elevated.
- Elevated inflation and rising inflation expectations lead the Federal Reserve to implement further rate hikes, pushing the Fed funds rate well above 6% and leading to a severe tightening of global financial conditions, with surging bond yields and plummeting stock prices.
- High inflation and tighter credit conditions dampen business and consumer confidence and lead to a sharp private-sector retrenchment. Labor market conditions deteriorate rapidly, with the unemployment rate rising sharply.

Characteristics of a potential optimistic case:
- Supply-side pressures rapidly abate, and the labor market comes into better balance with labor force participation continuing to rise and productivity rebounding. This leads to cooler wage growth and a more rapid slowdown in inflation.
- 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 sharp deceleration in inflation, the Fed gradually pivots to a less hawkish stance, managing a so-called “soft landing” of the economy.

Source: EY-Parthenon
In the current environment, firms must look to transform uncertainty into opportunity, which requires a holistic strategy framework factoring multiple alternative scenarios.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Maintain a holistic pricing strategy</td>
</tr>
<tr>
<td>2</td>
<td>Reinforce talent resilience and productivity growth</td>
</tr>
<tr>
<td>3</td>
<td>Understand the supply-side drivers</td>
</tr>
<tr>
<td>4</td>
<td>Adapt to the new cost of capital</td>
</tr>
<tr>
<td>5</td>
<td>Align strategies with stakeholder priorities</td>
</tr>
</tbody>
</table>

Five “no-regret” actions to build resilience amid elevated uncertainty

Source: EY-Parthenon
### Sector considerations and implications of the macroeconomic outlook

<table>
<thead>
<tr>
<th>Industry and sector</th>
<th>Perspectives¹</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consumer and health</strong></td>
<td>- Resilient consumer activity has been instrumental in staving off a recession in the US. While higher interest rates have put downward pressure on housing and industrial sectors, the consumer-led economy still reports a robust standing. Still, there are signs that momentum is slowing. The combination of high prices, elevated interest rates, softer labor market trends, tighter credit conditions and the resumption of student loan payments will likely dampen consumption going forward.</td>
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<td><strong>Government and infrastructure</strong></td>
<td>- Interest rates for 30-year mortgages breached 7% and moved past recent highs from roughly a year ago. Given that a large share of homeowners refinanced at lower rates in prior years, higher mortgages rates are keeping a tight lid on the supply of homes for sale, which, in turn, is keeping a floor under home prices. For July and August, new listings declined by 20.8% and 7.5% from a year ago, respectively. We expect the supply pressure to gradually ease in the coming year, as a large number of homes will get completed reflected by the high number of housing units under construction, especially on the multifamily front. In August, housing units under construction for single- and multifamily units amounted to 1.68m in aggregate.</td>
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<td><strong>Industrials and energy</strong></td>
<td>- In the near term, the United Auto Workers strike at the three major car manufacturers will have a visible but limited impact on industrial production. Production of motor vehicles represents roughly 10% of total factory output in the US. Should negotiations fail and the strike be prolonged, the hit to production would be more pronounced, weighing on GDP growth and impact tier 1 suppliers adjacent to the automotive industry. More broadly, a cooling consumer outlook coupled with a restrictive credit environment will continue to weigh on final demand and restrain industrial activity and investment.</td>
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<td><strong>Private equity</strong></td>
<td>- Activity in the private equity space continues to be anemic in 2023, as has been the case since central banks began lifting interest rates to lower inflation. Uncertainty about the trajectory of the economy has put buyers and sellers on the sidelines since mid-summer of last year and suppressed dealmaking, which is also reflected by the record-high global stock of dry powder (uncalled capital) at around $3.7t. However, we believe activity has found a bottom, and dealmaking volumes will trend up beginning in 2024.</td>
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<td><strong>Technology, media and telecom</strong></td>
<td>- Market participants are convinced that the disruptive force of generative AI is akin to the introduction of the internet with tech stocks supporting equity market gains. The ratio of the Nasdaq 100 to the Russell 2000 breached an all-time high at 8.3, eclipsing the peak value of 8.2 during the dot-com bubble. As AI matures into commercial relevance, we see the emerging technology having the potential of greatly enhancing the productivity and economic growth.</td>
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¹. Tailwind/headwind indicator references bulleted text for associated sector and does not represent an overall perspective as to the health or outlook for a given sector.

Source: EY-Parthenon
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