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Global growth has downshifted to a slower gear, and a worsening economic slowdown in China casts a cloud over an already conservative global outlook.

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. Economic activity in China has weakened significantly in recent months, and stress in the property sector has resurfaced, posing downside risks to the global outlook. A worsening of China’s economic slowdown and a surge in global interest rates and financial market volatility could 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. Germany is now experiencing producer price deflation, while China is grappling with growing deflationary pressures stemming from weak domestic demand. 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, policymakers will display a hawkish bias toward higher-for-longer interest rates and will be unlikely to discuss rate cuts until 2024.

Source: EY-Parthenon
Global inflation continues on a downward path, but core inflation remains well above central banks’ comfort zone and won’t fall below 3% in the US and Europe before 2024.

1. 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.
2. Euro area includes 20 countries.

Source: Respective countries’ central banks
The end of the global tightening cycle is near, but interest rates will stay higher for longer; this new paradigm is lifting long-term government yields to 2007-10 highs.
A US recession is no longer our base case, but risks from elevated interest rates and prices, tighter credit conditions, and slower global growth continue to cloud the outlook

**Outlook:** Our outlook for the US economy has improved materially, as unique post-pandemic economic dynamics appear to be making a soft-landing scenario more plausible. The labor market is gently cooling, with the unemployment rate still sitting near all-time lows while inflation has rapidly declined. With real wage growth turning positive, this has led to a gradual slowdown in consumer spending despite ongoing headwinds from elevated prices and interest rates and tightening credit conditions. The latest GDP figures showed the economy continued to grow at a healthy clip in Q2, and high-frequency data confirms a recession isn’t on the near-term horizon. Against this backdrop, we have further reduced our probability of a recession over the next 12 months to 40%. Still, we continue to see downside risks to growth from tighter credit conditions, the restart of student loan payments, uncertainty regarding the lagged economic impact of monetary policy and a weak global economic backdrop. We see real GDP growing 2.1% in 2023 and expanding at a muted 1.2% pace in 2024.

**Labor market rebalancing:** The labor market continues to show signs of rebalancing, with cooler labor demand leading to a gradual moderation in wage growth. The economy added 187k jobs in July (fewer than anticipated), and job openings fell to their lowest level in over two years in June. While layoffs remain low, job creation has become significantly less broad-based as businesses take a more conservative approach toward hiring and pay. 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 rising from 3.5% toward 3.8% by year-end and around 4.3% by the end of 2024.

**Consumer endurance:** Consumers are still willing to spend, judging by the strong July retail sales, but they are increasingly acting with financial prudence and reshuffling their spending budget month to month amid elevated prices and interest rates. 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, as the buffer from excess savings shrinks, student loan repayments restart, credit conditions remain tight and household finances deteriorate. We anticipate consumer spending will advance 2.3% in 2023 and register muted growth of 0.9% in 2024.

**Core disinflation is coming:** The latest Consumer Price Index data confirmed that a disinflationary environment remains in place. Headline inflation ticked up 0.2 percentage points (ppt) to 3.2% year over year (y/y) as base effects turned less favorable and core inflation fell 0.1ppt to 4.7% y/y. We see headline inflation easing to 3.0% y/y in December, while core CPI inflation is likely to ease toward 3.8% y/y by year-end.

**A higher-for-longer Fed bias:** The Fed raised the federal funds rate range by 25 basis points to 5.25%-5.50% at the July Federal Open Market Committee (FOMC) meeting, more than likely marking the end of a historic tightening cycle. Given our outlook for continued disinflation and softer economic momentum, we remain of the view that the Fed will keep the federal funds rate unchanged throughout the remainder of the year. While we do not anticipate rate cuts in 2023, we foresee the Fed starting to discuss policy recalibration in the winter. The first rate cut is unlikely before March 2024, and we expect the process will be gradual, with rate cuts of only 125 basis points (bps) through 2024.

**Risks:** Increased labor market and economic resilience raise the risk that inflation could reaccelerate and lead the Federal Reserve to raise interest rates to a higher level than currently anticipated. 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, are additional downside risks to the outlook. China’s economic slowdown, financial market volatility and real estate turmoil represent important global risks to monitor, especially against a delicate geopolitical backdrop.

Source: EY-Parthenon
The US economy sailed into the second half of the year on a solid note, with real GDP on track to grow around 2.5% annualized in Q3, after averaging growth of 2.2% in H1.

**US real final demand to domestic purchasers (q/q annualized rate)**

- Real GDP growth outpaced expectations in Q2 and posted a 2.4% annualized gain following a 2% advance in Q1. Faster inventory accumulation added 0.1ppt to GDP growth, while net international trade subtracted 0.1ppt. Final sales to domestic purchasers, representing the contributions from consumer spending, private fixed investment and government consumption, pointed to ongoing resilience in domestic demand, with growth of 2.3%.

- Consumer spending rose a modest 1.6%, after a strong 4.2% gain in Q1, but sequential monthly momentum in spending points to a reacceleration in consumption growth in Q3. Residential investment fell 4.1%, marking its ninth consecutive quarterly decline.

**US real GDP growth (q/q annualized rate)**

- Business investment rose a healthy 7.7% in Q2 supported by solid advances across intellectual property investment (+3.9%), equipment investment (+10.8%) and structures (+9.7%) — an encouraging sign that business executives are still driving growth despite lingering recession concerns.

- Looking ahead, economic momentum is expected to lose steam heading into 2024 amid a persistent drag from higher interest rates, tighter credit conditions and a weak global economic backdrop. But given the strong start to the year, we have upgraded our real GDP growth forecast from 1.9% to 2.1% in 2023 and now see the economy growing a muted 1.2% in 2024, with real GDP growth likely to linger below potential for several quarters.

Source: Bureau of Economic Analysis; EY-Parthenon
Slower business and consumer spending, softer labor market conditions, and cooler inflation trends are expected as we move into 2024, but a retrenchment isn’t foreseen.

Key risks: Fed tightening, tighter credit conditions, financial market volatility, China’s economic challenges.
Job growth continues to gradually cool, and the slowdown will extend into next year as higher interest rates and a softer domestic demand take a toll on hiring

The labor market continues to show signs of cooling. The pace of hiring slowed further in July with the economy adding 187k jobs, in line with the June gain. Moreover, net revisions to the prior two months showed 49k fewer jobs than previously reported, bringing the three-month moving average for payroll growth down from 228k to 218k in July, the slowest since January 2021.

Employment in services rebounded by 154k after a sluggish 97k increase in June, while hiring in goods-producing industries rose by 18k after a 31k gain the prior month. Overall, employment gains were less broad-based, as the employment diffusion index – a measure of how many private sector industries are adding jobs – narrowed from 58.8 to 57.2 in July – the second lowest level since April 2020.

Despite the slower pace of hiring, the labor market remains tight. The unemployment rate ticked 0.1ppt lower to 3.5% in July – a touch above the 54-year low reached in January and April of this year. New weekly filings for jobless claims, a proxy for layoffs, had been on a slight uptrend since the start of the year but have fallen back modestly in recent weeks, confirming that layoff activity remains low.

We expect labor market conditions to soften further in coming months with slower hiring, strategic resizing decisions and wage growth compression. We foresee the unemployment rate rising toward 3.8% by year-end and 4.4% in mid-2024.
The post-pandemic labor market rebalancing via easing labor demand and a sustained rebound in labor supply is very encouraging, as it should help ease wage-cost pressures.

- Job openings were down modestly in June, falling by 34k to 9.58m, their lowest level since April 2021. Even so, openings remain more than 2m above pre-pandemic levels. The hiring rate decreased 0.2ppt to 3.8%, while the quits rate, which reflects workers' confidence in the jobs market, fell back to 2.4%, just above its pre-pandemic level.

- The ratio of job openings per unemployed worker, which is closely watched by Fed officials, remained unchanged at 1.61 in June, its lowest level since October 2021. Overall, the data suggest that while conditions have moderated slightly, labor market tightness persists.

- One encouraging development pointing to a continued labor market rebalancing is the rebound in the labor supply in recent months. The labor force participation rate held steady for a fifth straight month at 62.6% in July (reflecting the constraint of an aging workforce), and participation among the key prime-age cohort (25- to 54-year-olds) ticked down 0.1ppt to a still-elevated 83.4% in July after reaching a 15-year high in June.

- 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.

Source: Bureau of Labor Statistics; EY-Parthenon
Retail sales posted a stronger-than-expected 0.7% gain in July as consumers spent more online, at sports and clothing stores, and on dinner and bar outings. Still, they exercised more discretion on furniture, electronics and cars.

Control retail sales—a key gauge of consumer spending trends that strips out volatile retail segments—posted a strong 1.0% increase following an upwardly revised 0.6% gain in June.

Looking at the broader trend, consumer spending has decelerated, but not collapsed. Momentum in retail sales picked up from 1.6% y/y to 3.2% in July, but this largely reflects base effects from a weak July in 2022. More broadly, the pace of sales has slowed from 7.4% y/y in January, and in inflation-adjusted terms, retail sales are 0.1% lower relative to last year.

There is a greater sense of optimism regarding the economy and inflation, but consumers are still acting with financial prudence amid elevated prices and interest rates. Slower employment and disposable household income growth in the coming months will likely mean ongoing consumer cautiousness, but we don’t foresee a retrenchment.

Reduced excess savings, the resumption of student loan payments and tight credit conditions will further weigh on households’ budgets, even if falling inflation should provide a tailwind to real wages. We project that consumer spending will grow just 2.3% in 2023 and a muted 0.9% in 2024. Averages are somewhat misleading, however, as spending momentum is expected to reaccelerate through 2024.
While slower inflation is lifting real wages, wage growth compression and slower employment growth will likely lead to a slowdown in consumer spending momentum.

The ongoing rebound in real disposable income — reflecting still-solid wage gains amid cooling inflation — has been a key support to consumer spending. Real disposable income rose 0.2% m/m in June and was up in 11 of the past 12 months, supporting consumers’ purchasing power as they continue to face elevated prices.

Cooling inflation and robust labor markets have supported a rebound in consumer sentiment in recent weeks, even if absolute levels of confidence remain depressed in early August. Weak sentiment points to cautious consumer spending amid elevated prices and rapidly dwindling excess savings.

After building up savings at an unprecedented rate during the pandemic, households have been drawing down on these funds rapidly over the past 18 months. We estimate that excess savings have declined about 70% to $600b on aggregate and that excess savings for lower-income families have largely been depleted.

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 such, excess savings should not be viewed as a key source of income supporting a steady pace of spending going forward.

1. 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: US Census Bureau; Bureau of Economic Analysis; EY-Parthenon
Tight supply conditions have prevented a more severe pullback in housing construction, but a sustained recovery remains elusive, given affordability is at a four-decade low.

- Groundbreaking activity rebounded in July as housing starts rose 3.9% to 1.45m, but they remained about 20% below their April 2022 peak. The gain was concentrated in single-family starts, as a tight supply of existing homes for sale is supporting activity. In July, existing homes sales were running 17% below last year at 4.07m units – the third slowest pace since 2010.

- The National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index (HMI) fell 6 points to 50 in August, after rising for seven consecutive months. The three subindexes – current sales, expected sales, and buyer traffic – deteriorated in the latest survey, as the surge in mortgage rates in recent weeks likely weighed on builder sentiment.

- Low affordability is keeping prospective buyers and existing homeowners who are locked into lower fixed mortgage rates on the sidelines. The average mortgage rate on a 30-year fixed loan reached 7.02% in mid-August, the highest level since April 2002. And the average monthly mortgage payment on a median-priced existing home has surged nearly 120% since January 2019, or $1,200.

- We expect existing home sales and housing starts to remain sluggish over the remainder of the year, while tight supply conditions should continue to support a floor under new home sales and construction activity. Home price growth is likely to slip further into negative territory, but a sharp correction is unlikely given tight supply conditions.

1. The NAHB Housing Market Index is a gauge of builder opinion on the relative level of current and future single-family home sales. The maximum reading is 100. Source: eMBS; Mortgage Bankers Association; US Census Bureau; National Association of Realtors; Wall Street Journal; Federal Housing Finance Agency; EY-Parthenon
Factory activity has stalled and sentiment remains depressed, but the need to rebuild supply in sectors such as automobiles and electronics is keeping a floor under activity.

On the surface, the July industrial production report provided a more upbeat picture, with output growing 1.0% m/m following declines in the prior two months. However, the gain was mostly driven by a rebound in auto production and strong utilities as high temperature raised demand for cooling. Overall, manufacturing momentum has slowed markedly, with output 0.7% below its year-ago level.

The ongoing manufacturing slump is the most visible consequence of the Fed’s tightening campaign. Along with higher interest rates, slower global demand for manufactured goods and worsening China’s economic situation offer a weak external backdrop for factory activity in the months ahead. These headwinds will continue to limit business spending activity, though a retrenchment appears unlikely.

The US manufacturing sector saw activity contract for a ninth straight month in July with the Institute for Supply Management (ISM) manufacturing index edging up 0.4 points but remaining below the 50 mark at 46.4. The latest report marked the longest stretch of contracting activity since 2009.

The details of the survey revealed that every subcomponent was below the 50 threshold level of expansion. Production contracted for the second consecutive month, supplier delivery times got longer, and inventories and new orders continued to contract (albeit at a slower rate compared to the previous month). The employment index fell 3.7ppt to 44.4, the lowest reading since July 2020, though the weakness has yet to translate into a pullback in manufacturing hiring.

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
Nonresidential structures have emerged as a bright spot in an otherwise soft business investment landscape, driven by a supportive policy environment.

Direct government funding and tax incentives provided by recent legislations – the Infrastructure Investment and Jobs Act (IIJA; signed November 2021), the Inflation Reduction Act (IRA; signed August 2022) and the CHIPS Act (signed August 2022) – are supporting a surge in public and private investments in new facilities and infrastructures.

The IIJA is mostly targeted toward infrastructure, allocating approximately $550b of new federal spending over the first five years to roadways and bridges, power, rail, broadband, water infrastructure, and similar projects. The IRA and CHIPS Act are intended to bolster innovation and capabilities in disruptive technologies such as renewable energy, electric vehicles (EVs) and semiconductors.

These supportive policies have spurred a marked rebound in spending on nonresidential construction over the past year. Monthly Census data shows that real total nonresidential construction spending was up by an impressive 17% y/y in June, with both private and public sector construction spending rising in tandem. Encouragingly, public spending appears to have increased without crowding out private investment.

Beneath the surface, the surge in manufacturing construction (particularly computer and electronics) stands out, but other segments of construction spending have also seen growth. Spending on water supply projects has soared by 23% since the start of 2022, while spending on highway and streets has grown by 15% over the same period.

1. Percentage growth from January 2022 to June 2023 on an absolute basis.
Source: Census; EY-Parthenon
Growth in manufacturing construction has been particularly buoyant over the past year. Real construction spending on new factories (adjusted for the increase in construction costs) has grown 91% since the beginning of 2022 and now accounts for about 10% of all construction spending, compared to 5% in early 2022.

This boom has largely been driven by new construction of computer, electronic and electrical manufacturing facilities, which has more than quadrupled since the beginning of 2022. This stands in sharp contrast with growth in the remainder of the manufacturing segment, which has been sluggish over the same period.

While there is no doubt that the CHIPS and Science Act has spurred the resurgence, the rise in spending began months before the legislation was approved. Some projects began in anticipation of CHIPS Act funding, while others likely came in response to severe supply chain disruptions during the pandemic. Overall, more than 50 new semiconductor projects have been announced since the CHIPS Act was enacted.

Once completed and absorbed into the economy, these new manufacturing facilities should strengthen domestic semiconductor production and competitiveness and boost the resilience of supply chains to future shocks. Looking beyond the semiconductor sector, the increase in public and private infrastructure spending points to moderate positive spillovers to the economy that will materialize in the coming years with a positive lift to employment and productivity.

Source: Census; Bureau of Labor Statistics; Semiconductor Industry Association; EY-Parthenon
The July CPI report offered more evidence that inflation pressures are abating. Headline CPI (Consumer Price Index) rose 0.2% month over month (m/m) for a second consecutive month in July, in line with expectations. Encouragingly, core CPI prices (excluding food and energy) also rose 0.2% m/m in July for a second straight month—the smallest back-to-back increase in core CPI since February 2021. On an annual basis, headline CPI inflation rose slightly, up 0.2ppt to 3.2% y/y in July as base effects turned less favorable. Core CPI inflation fell 0.1ppt to 4.7% y/y—its slowest pace since October 2021—and rose at a 3.1% annualized pace over the past three months, compared to 5% and 4.1% in May and June, respectively.

In the near term, the temporary uptick in headline CPI inflation should extend into August amid higher energy prices and unfavorable base effects, but headline inflation should ease back down later this year. Core CPI inflation, meanwhile, is likely to ease further toward the low 4% in August and September.

Softer demand for goods and services, the pass-through from slower housing inflation, and cooling wage growth should lead to continued disinflation in H2, especially for the core measure. By December, we foresee headline and core CPI inflation easing to around 3.0% y/y and 3.8% y/y, respectively. However, renewed upward momentum in energy prices and potential pass-through into core inflation pose upside risks to the inflation outlook.

Source: Bureau of Labor Statistics; EY-Parthenon
Elevated services inflation is now the main core inflation driver, and moderating shelter and transportation prices should lead to further disinflation.

Services inflation remained elevated in July, rising 5.7% y/y for a second consecutive month with housing inflation accounting for 75% of the monthly gain. Encouragingly, housing disinflation is gaining momentum. Shelter costs rose a moderate 0.4% m/m for a second consecutive month in July, with rent prices rising 0.4% m/m – their lowest print since March 2022 – and owners’ equivalent rent rising 0.5% m/m.

We’re clearly past peak inflation on the housing front, with shelter cost inflation showing a gentle easing from 8.2% year over year (y/y) in March to 7.7% y/y in July. Housing disinflation will pick up momentum in the coming months. The Zillow Rent Index, which captures rents of units currently advertised on the open market, points to a rapid cooling in CPI inflation toward 5% by year-end.

Given the expected decline in rent inflation, the trajectory of core services inflation excluding shelter costs, which makes up a quarter of the CPI basket, will be critical to the inflation outlook. This “supercore” measure, which is closely watched by the Fed, rose 0.2% m/m in July – slightly faster than in June but still down from the 0.4%-0.5% pace at the start of the year. Importantly, we believe this measure isn’t as good at capturing the pass-through from wage pressures as the Fed has indicated.

With the strong disinflationary impulse from commodity and goods prices now over, further disinflation in supercore inflation will be needed to bring inflation closer to the Fed’s 2% target. Transportation services prices will be particularly important to watch. 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.

1. Includes water, sewer and trash collection services; household operations; and other personal supercore 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; Zillow; EY-Parthenon
While wage growth remains well above the Fed’s comfort zone, the latest ECI data points to a gentle moderation in labor cost pressures amid signs of labor market rebalancing. The Employment Cost Index (ECI) posted a 1.0% quarter-over-quarter (q/q) advance in Q2 – the slowest pace in two years and much lower than the 1.2% average gain over the past four quarters.

Encouragingly, headline ECI compensation fell 0.3ppt to 4.5% y/y, its slowest pace since Q1 2022, though still well above the 3% pre-pandemic pace. Meanwhile, private sector wage growth fell a notable 0.5ppt to 4.6% y/y – its lowest since Q3 2021 and 1.1ppt below its Q2 2022 peak of 5.7%. Looking ahead, we continue to expect a moderation in wage gains in the coming months, as labor market conditions soften and the demand for workers comes closer into balance with a rebounding labor supply.

Productivity bounced back strongly in Q2, rising at a stronger-than-expected 3.7% annualized clip. The trend in productivity growth climbed back in positive territory for the first time since 2021, up 1.3% y/y in Q2. When accounting for the stronger productivity trend, unit labor costs rose a modest 1.6% annualized in Q2, pointing to an environment where labor cost pressures are gradually easing.

The revival in productivity growth echoes anecdotal evidence we are picking up from our conversations with business executives. With the increasing value and cost of labor and the higher cost of capital, we have seen several examples of businesses focusing on ways to boost labor productivity and process efficiency via greater retention efforts, long-term training programs and the incorporation of new technologies, including generative AI, machine learning and quantum computing.
The Fed has likely reached the end of its hiking cycle, but it will maintain a hawkish lean in considering how long to maintain a restrictive stance; cuts are unlikely before March.

As widely anticipated, the Fed raised the federal funds rate range by 25 basis points to 5.25%-5.50% at the July FOMC meeting, more than likely marking the end of a historic tightening cycle. Still, Fed Chair Jerome Powell maintained a hawkish posture during the press conference to avoid an undesired easing of financial conditions.

The hawkish language from the June statement was maintained, noting that “in determining the extent of additional policy firming that may be appropriate,” the Committee would factor the 500bps of rate hikes so far and the long and variable lags of monetary policy effects on economic activity and inflation.

During the post-meeting press conference, Powell reiterated that core inflation remained elevated and that policy had not been restrictive enough for long enough to have its full desired effects. He noted that a more gradual pace of tightening did not entail the Fed going at every other meeting, but instead that it could be two out of three meetings, thereby ensuring the perception that September could be “live.”

The FOMC July meeting minutes revealed that almost all participants favored raising the federal funds rate by 25bps to 5.25%-5.50%, with only a couple of participants indicating that they favored leaving the target range unchanged. Most participants continued to see “significant” upside risks to inflation, which could require further tightening of monetary policy.

Interestingly, FOMC participants continue to view a period of below-trend GDP growth and softening labor market conditions as necessary to bring inflation down toward the 2% target. This echoes Powell’s remarks that while a path to a soft landing was possible, he didn’t believe in so-called “immaculate disinflation.”

Given our inflation and employment outlook, we remain of the view that the Fed will keep the federal funds rate unchanged in September and that, by the November FOMC meeting, there will be ample evidence that headline and core personal consumption expenditures (PCE) inflation should close the year around 3.1% and 3.5%, respectively. While we believe most voting policymakers will favor holding monetary policy in restrictive territory rather than tightening it further, unanimous votes may become a relic of the past.
Latest survey of banks’ lending standards points to a continued tightening of credit conditions; this should pose a moderate drag on economic activity in coming quarters.

Recent survey evidence suggests that banks continue to tighten their lending standards for businesses and consumers. The Federal Reserve’s survey of bank-lending conditions showed that a net 49% reported tightening standards on commercial and industrial (C&I) loans to small firms over the last three months, up from about 47% in the prior survey. Moreover, banks widely reported expecting to tighten lending standards further over the rest of the year.

Lending standards on credit card and other consumer loans have also become more stringent. A net 36% share of banks reported tightening standards for credit cards, compared to 30% in the prior survey.

Surveyed banks cited “a less favorable or more uncertain economic outlook” and “reduced tolerance for risk” as top reasons for tightening credit standards.

Apart from tighter standards, reduced credit demand is also driving the slowdown in lending activity, as the more challenging economic environment and increased economic uncertainty curb businesses’ willingness to invest.

Historically, swings in lending standards typically lead credit growth in the overall economy by about 12 months. This points to some lingering effect of the recent tightening of credit conditions on the economy in coming quarters.
Financial conditions

Long-dated Treasury yields reached a 16-year high as a resilient economy has led investors to position for a higher-for-longer interest rate paradigm; the dollar is rallying.

- Long-term Treasury yields have surged to multiyear highs in August, with the upward move led by real yields as resilient economic activity is challenging investors’ view that the Federal Reserve will cut rates aggressively next year. The 10-year Treasury yield has risen nearly 40 basis points so far in August and hit an intraday high of 4.35% on August 21, its highest level since 2007.

- Other factors contributed to the bond market sell-off 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. 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 pushed longer-dated yields higher.

- With the Fed slowing its tightening cycle earlier than other advanced economies’ central banks and growth differentials narrowing, the US dollar had depreciated markedly since the fall of 2022. However, the US growth outperformance in H1 2023 against a weak global backdrop and increased safe-haven flows amid a risk-off sentiment are fueling a rebound in the greenback.

- The DXY (US Dollar Index) dollar is up 3.8% 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 for the rest of the world.

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

Source: Federal Reserve Board; Bloomberg; EY-Parthenon
Recent credit downgrades by Moody's and S&P of ten and five regional banks, respectively, highlighted that there remain some vulnerabilities in the banking system and put renewed downward pressure on bank stocks. The KBW Bank Index, which tracks the performance of 24 major banks, is down 11% since late July, while the KBW Regional Banking Index is down 12% 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 August 23, banks tapped $107 billion from the Federal Reserve’s Bank Term Funding Program (BTFP), the most since the beginning of the banking turmoil.

Smaller banking institutions play an important role in the US economy, as they are a key source of bank lending to businesses and consumers. They account for about 40% of total bank loans outstanding and nearly 70% of all outstanding commercial real estate (CRE) loans. And small business loans represent a larger share of small banks’ portfolios than that of larger institutions.

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. But a more sudden tightening of credit and financial conditions remains a downside risk to the outlook.
On August 1, Fitch downgraded the United States’ credit rating from AAA to AA+, the second such downgrade by a rating agency in the nation’s history. The move reflected concerns over a high and growing debt burden and some erosion of governance amid repeated debt-limit standoffs. The downgrade had been telegraphed by Fitch and had no significant impact on financial markets.

The downgrade is, however, bringing the important issue of fiscal sustainability back to the fore at a time when the budget deficit is rising. The federal government registered a budget deficit of $1.61b for the fiscal year to date in July, more than twice the cumulative deficit recorded during the same period in fiscal year 2022.

The US will face serious fiscal challenges in the longer term with rising debt and interest cost burdens, which will likely put upward pressure on Treasury yields. According to the latest CBO estimates, the debt-to-GDP ratio is projected to rise to 115% of GDP by 2033 and reach 181% in 2053.

In the long run, a high government debt burden weighs on economic growth by crowding out public and private investment and constraining the government’s ability to respond to potential economic shocks. To be sure, fiscal policymakers can’t afford to be complacent about rising debt levels and will be pressured to act in coming years to put government debt on a sustainable path.

In the near term, however, the attention will turn to the need for Congress to pass a spending bill to avoid a government shutdown at the end of September. Our estimates show that every week of government shutdown would reduce real GDP growth by about 0.1 percentage points in Q4.

Source: US Department of the Treasury; EY-Parthenon
Overtightening of monetary policy remains a key downside risk, while economic resilience, stronger productivity growth and lower inflation represent an upside risk.

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.

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

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

1. Maintain a holistic pricing strategy
2. Reinforce talent resilience and productivity growth
3. Understand the supply-side drivers
4. Adapt to the new cost of capital
5. Align strategies with stakeholder priorities
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