U.S. Economic Outlook

The Fed's tightrope walk begins

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Since our last update, the tragic events in Ukraine began playing out. As social scientists, we try to never lose sight of the fact that economics is about real people together driving change in an economy. Our thoughts are with the people of Ukraine and we hope for a fast and peaceful resolution to the conflict.

Beyond the obvious humanitarian issues created from the conflict, there are also global economic consequences. Elevated commodity prices such as grain and oil as a result of the conflict may soon feed into already elevated inflation rates here in the U.S. In light of recent data and developing events, we now see the Consumer Price Index ending this year at 5.8 percent year-over-year (YoY)—3.2 percentage points above our February forecast. The persistence of inflation pressures will also likely begin to dampen real economic activity in our view. Consumer spending, adjusted for inflation, is likely to grow just 3.2 percent (annualized) this year, down from 7.9 percent in 2021. The downshift in consumer spending may also lead to softer real GDP growth. We now expect real GDP growth to expand at a 3.0 percent pace both this year and next, and the Fed to begin hiking interest rates this month. It will likely continue hiking rates to tamp down inflation, with the federal funds rate reaching 1.5 percent by the end of this year and 2.5 percent by the end of 2023. The combination of slower real growth and a tightening of monetary policy creates greater risks in our outlook, including that the Fed responds too aggressively to rising rates. Finally, we are monitoring financial market volatility closely. Should equity markets continue to sell-off, there could be adverse effects on both consumer wealth and confidence.

Key Points:

- GDP to contract in Q1
- First Fed rate hike likely this month
- Sharp upward revisions to the inflation outlook

Fig. 1 Real gross domestic product (GDP)
(SA, CAGR and YoY* percent change)

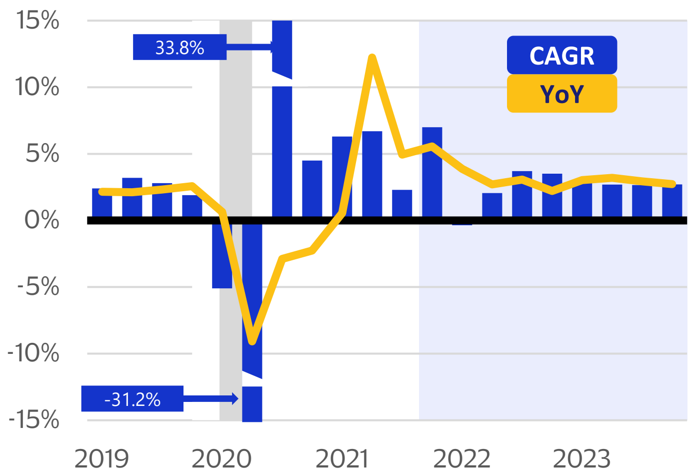
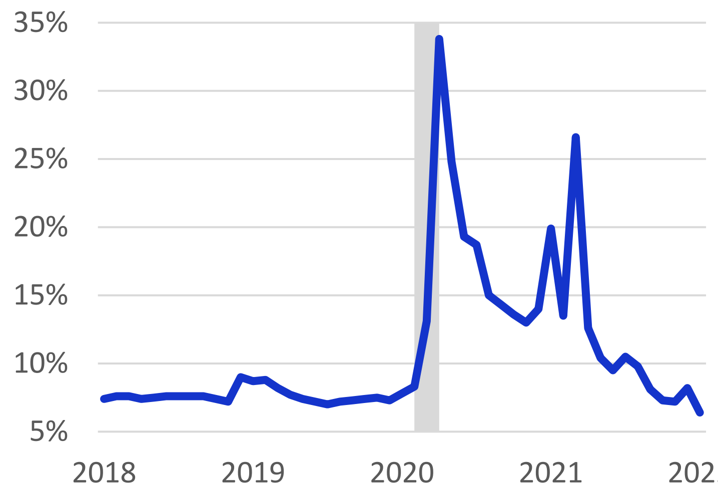


Fig. 2 Saving rate as a percent of disposable personal income (SA, percent)



*Seasonally adjusted (SA), compound annualized growth rate (CAGR), year-over-year (YoY). Sources: Visa Business and Economic Insights and U.S. Department of Commerce.

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Consumer spending pressures emerging

Robust employment growth continued in February, with 678,000 jobs added and upward revisions to January's job gains. Income growth in January also held up much better than expected even in light of the expiring Child Tax Credit payments. For now, it seems that the tight labor market and higher wage growth are helping to offset the pullback in fiscal support. There are signs, however, that household incomes may face some pressure in the months ahead. For starters, the saving rate, which has been elevated throughout the pandemic, has now fallen below the pre-recession average (Fig. 2). While the absence of fiscal support may have played a role in the lower saving rate, inflation is also starting to take a bite out of consumers' wallets.

Among the largest changes this month to our outlook is a significant upward revision to the inflation outlook for this year. We now expect the Fed's preferred measure of inflation, the PCE deflator, to average 6.2 percent this year and 2.3 percent next—2.2 and 0.7 percentage points higher, respectively, than last month's forecast. Candidly, there is likely further upside risk to our inflation outlook. Additionally, we have kicked up our oil price forecast to reflect the view that Brent crude prices will average $115 per barrel in Q2 of this year before slowly coming back down. The ongoing conflict and resulting persistent inflation pressures may hold back consumer confidence this year as real (inflation-adjusted) incomes come under pressure. While nominal consumer spending will remain elevated this year at 9.6 percent due to higher prices, real spending growth is set to moderate to 3.2 percent.

Yield curve shape worth watching

With geopolitical tensions rising, Treasury markets have responded with some repricing. The benchmark 10-year Treasury rate had been steadily climbing until global investors began buying with the onset of the conflict. The result was a decline in the 10-year rate. In addition, the shape of the yield curve began to flatten as investors priced in higher short-term rates, reflecting the impending rate hikes from the Fed, and slower economic growth. This put downward pressure on longer-term rates such as the 10-year Treasury rate. With these changes, we have revised our outlook for interest rates to reflect this much flatter yield curve. The spread between the three-month and 10-year Treasury rates is now expected to fall to 1.24 percentage points by the end of this year. The most dramatic flattening has occurred in the spread between the two-year and 10-year rates, likely to be just 0.14 percentage points by the end of this year.

Risks to the outlook

Over the course of the last few weeks, pandemic risk has given way to geopolitical risk. Should the situation in Ukraine escalate, the result on inflation and real economic growth would be more negative than we are currently forecasting. Another key risk is the possibility of stagflation, where economic growth stalls and inflation remains high. There is also a risk the Fed hikes rates quickly to slow inflation but ends up tipping the economy into a recession. The outlook is certainly more cloudy than last month.

	Actual 2021				Forecast 2022				Actual		Forecast	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2020	2021	2022	2023
Gross Domestic Product (CAGR)	6.3	6.7	2.3	7.0	-0.4	2.0	3.7	3.5	-3.4	5.7	3.0	3.0
Personal Consumption	11.4	12.0	2.0	3.1	2.7	2.2	3.3	2.9	-3.8	7.9	3.2	2.5
Business Fixed Investment	12.9	9.2	1.7	3.1	13.8	11.3	9.8	9.3	-5.3	7.4	8.7	8.5
Equipment	14.1	12.1	-2.3	2.4	15.2	14.4	11.3	10.5	-8.3	13.0	9.3	9.4
Intellectual Property Products	15.6	12.5	9.1	10.6	9.7	11.7	10.9	10.1	2.8	10.2	10.5	9.2
Structures	5.4	-3.0	-4.1	-9.4	1.7	1.3	2.0	3.3	-12.5	-8.1	-1.5	3.5
Residential Construction	13.3	-11.7	-7.7	1.0	4.9	-0.1	1.1	1.9	6.8	9.1	-0.2	1.7
Government Purchases	4.2	-2.0	0.9	-2.6	0.2	1.1	1.2	1.5	2.5	0.5	0.0	1.6
Net Exports Contribution to Growth (%)	-1.6	-0.2	-1.3	-0.1	-1.1	-0.4	-0.4	-0.3	-0.3	-1.4	-0.7	-0.4
Inventory Change Contribution to Growth (%)	-2.6	-1.3	2.2	4.9	-1.1	-0.9	0.0	0.0	-0.5	0.3	0.6	0.0
Nominal Personal Consumption (YoY % Chg.)	3.9	20.7	11.7	12.9	11.6	9.3	9.3	8.2	-2.6	12.1	9.6	4.8
Nominal Personal Income	16.1	1.6	5.3	7.2	-3.6	2.7	2.6	2.7	6.5	7.4	1.0	4.0
Retail Sales Ex-Autos	11.5	28.5	15.8	18.8	12.5	8.1	7.2	5.4	0.3	18.4	8.2	3.3
Consumer Price Index	1.9	4.8	5.3	6.7	7.8	7.3	6.7	5.8	1.2	4.7	6.9	2.6
Federal Funds Rate (Upper Bound)	0.25	0.25	0.25	0.25	0.50	1.00	1.25	1.50	0.25	0.25	1.06	2.13
Prime Rate	3.25	3.25	3.25	3.25	3.50	4.00	4.25	4.50	3.54	3.25	4.06	5.13
10-Year Treasury Yield	1.74	1.45	1.52	1.52	1.74	2.26	2.44	2.49	0.89	1.45	2.23	2.65

Forecast as of: March 10, 2022

Interest rates presented are end of quarter rates

Note: Annual numbers represent year-over-year percent changes and annual averages

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Accessibility notes

Fig. 1

GDP CAGR ranges from 2.4% in Mar-2019, to a low of -31.2% in Jun-2020, a high of 33.8% in Sep-2020, and the latest reading of 7.0% in Dec-2021, with the GDP CAGR forecast to finish 2022 at 3.5% and 2023 at 2.7%. YoY GDP growth ranges from 2.2% in Mar-2019 to a low of -9.1% in Jun-2020, a high of 12.2% in Jun-2021, and the latest reading of 5.6% in Dec-2021, with YoY GDP growth forecast to finish 2022 at 2.2%, and 2023 at 2.7%.

Fig. 2

Saving rate as a percent of disposable personal income ranges from 7.4% in Jan-2018 to a high of 33.8% in Apr-2020, and has been steadily declining since then to a new four-year low of 6.4% in January of this year.