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The U.S. Economic Outlook for 2024–2026

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Executive Summary

To Sum Up: Not Calling a Recession

With the labor market cooling a touch too quickly, we expect the Fed to jump into action soon, which will help stabilize the unemployment rate at 4.6 percent by mid-2025. Over the near term, we project a modest deceleration of economic growth to accompany the cooling labor market. We expect the solid momentum of private domestic final demand in the first half of 2024 to cushion the impact of the labor market slowdown, though, preventing a decline in real GDP. The annualized real GDP growth rate bottoms at 1.3 percent in 2024Q4 and rebounds above 2.0 percent in 2025Q2.

Labor Market Scare

The headline unemployment rate rounded up to 4.3 percent in July, up 0.7 percentage points on the 2023 average. That increase triggered a well-known recession indicator—the so-called "Sahm rule." However, we judge that recent immigration flows could explain part of the run-up in unemployment, representing a quick increase of supply rather than reduced demand for labor. Still, the labor market is clearly slowing. In July, monthly payroll job gains decelerated to 114,000, down by 65,000 from June and marking the second-lowest increase since January 2021. We will be alarmed if these labor market metrics continue to deteriorate at the recent pace much longer.

Outside of the labor market, the economy is looking resilient. The annualized pace of real GDP growth averaged 2.1 percent in 2024H1, and the combined growth contribution of private fixed investment and consumption has exceeded 2.0 percentage points for four consecutive quarters. In addition, according to the most recent Federal Reserve's survey of senior loan officers, banks have largely stopped tightening credit standards for commercial loans. That trend should help sustain the flow of business investment even if consumption growth slows somewhat.

Inflation Slowing Again, For Real This Time?

Most key measures of inflation have cooled consistently in recent months. The year-over-year pace of core CPI inflation slowed from 3.8 percent in March to 3.2 percent in July, while core PCE inflation slowed from 2.8 percent in March to 2.6 percent in June. The 3-month averages of month-to-month inflation rates are also coming down. Of course, we were in a similar spot late in 2023, only to see monthly inflation readings shoot up again early this year. This time, though, we believe that the preponderance of hard and soft data points to a more enduring slowdown in inflation.

Housing Blues

Although mortgage rates have moderated from their recent highs, the housing market is significantly stressed. The boost that the dearth of existing homes for sale gave to new home construction appears to have waned. The NAHB's Housing Market Index slid into contractionary territory yet again for May–July. The yield premium mortgages command over the 10-year Treasury rate remains very high. We do expect that the prospect of considerably lower mortgage rates will bolster housing construction eventually. Yet it will likely take a few quarters for uncertainty about the near-term economic trajectory to resolve and clear out the existing overstock of new homes for sale.

Soft Data

Many survey-based economic metrics remain downbeat. The University of Michigan Survey of Consumers' sentiment index has been trending down from an already weak average level in 2024Q1. Except for a brief recovery in March, the ISM index for manufacturing has been signaling slowing activity since November 2022. However, the ISM index for the service sector, arguably the larger source of growth over recent years, recovered in July to show a moderate expansion, after indicating shrinking activity for April and June.

Rate Cut Imminent, Again

Just like in December 2023, the start of the rate-cutting cycle appears imminent. The spike in inflation at the beginning of this year forced the Fed to hold off on cuts. But the recent disinflation and a measurable cooling of the labor market have cleared the way for cuts to begin in September. The pace of cuts to follow is likely to depend on the incoming data. Our forecast of ongoing disinflation and continued deterioration in the labor market leads us to expect the Fed to keep reducing the fed funds rate range at every meeting through May 2025. By then, the labor market is expected to have stabilized, and we expect the pace of rate cuts to slow.

Averaging Diverging Fiscal Paths

The outcome of the November elections remains highly unpredictable at this stage. It is almost certain, however, that fiscal 2025 will start under a continuing resolution. Beyond that, the fiscal path could diverge substantially depending on the outcome of the elections. Our forecast averages major government consumption, transfers, revenues, and import tariff trajectories under different election outcome scenarios, albeit with a common thread of a slowdown in discretionary nondefense spending growth and continued expansion of defense spending. Over our forecast horizon, we do not expect any major reforms to address the longer-term sustainability of the federal fiscal trajectory, regardless of the election outcome.

The 2024–2026 Outlook

We project that real GDP growth will slow from its 2.8 percent annualized pace in 2024Q2 to 2.1 percent in 2024Q3 and just 1.3 percent in 2024Q4. We expect looser monetary policy to work through the economy enough to lift quarterly growth to a 2.4 percent pace in 2025Q3. It stays at that level or above from then through the end of 2026.

The unemployment rate continues its upward climb from 4.3 percent in 2024Q3 to 4.4 percent in 2024Q4, stabilizing at 4.6 percent in 2025Q2–Q3 and then declining to 4.3 percent by 2026Q4. Monthly job gains bottom at around 100,000 in 2025Q1. The recovery of job gains proceeds slowly afterwards. The economy adds 1.4 million jobs in 2025, and 1.5 million in 2026.

We expect the PCE deflator to continue its decline toward the Fed's 2.0 percent target, as shelter cost increases continue to decelerate and consumer goods inflation stays muted. Year-over-year core CPI inflation slows to 3.2 percent in 2024H2 before settling around 2.3 percent in 2026. Core CPI inflation slightly outpaces the headline rate throughout the forecast, as gasoline price increases remain largely subdued and food inflation slows.

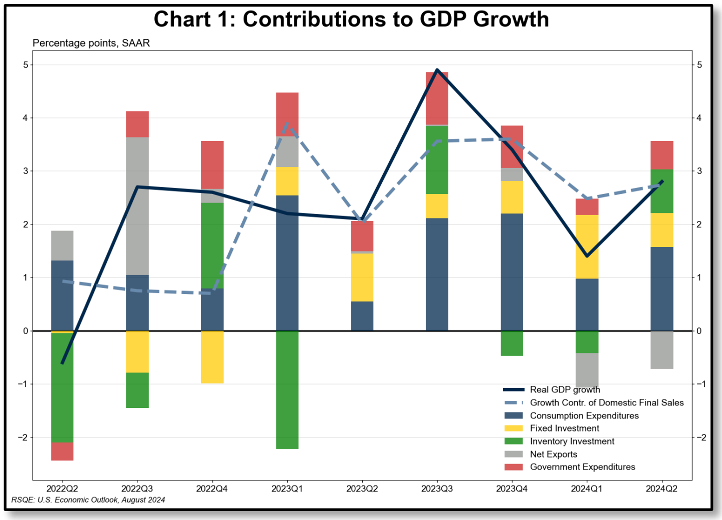
With plenty of supply for sale, new single-family home construction starts remain soft in 2024H2, averaging a pace of 975,000 units. The pace of single-family housing starts bottoms in 2024Q4 before rebounding to 1,130,000 units by 2026Q4. We expect multi-family starts to edge up to 355,000 units in 2024H2 and to recover to 440,000 by 2026Q4 as financing costs drop.

Auto loan interest rates remain stable while the CPI for new light vehicles has decreased in recent months. Hence, vehicle affordability has been improving relative to incomes, a trend we expect to continue. As a result, we project that the annualized pace of sales will edge up to 15.8 million 2024H2. Vehicle sales total 16.0 million in 2025 and 16.2 million in 2026.

	Actual	**RSQE Forecast**		
	2023	2024	2025	2026
GDP (billions of current $)	27360.9	28745.1	29908.4	31306.2
Real GDP (billions of 2017 $)	22376.9	22956.2	23391.3	23968.0
% change: year-over-year	2.5	2.6	1.9	2.5
% change: 4th-qtr-to-4th-qtr	3.1	1.9	2.1	2.5
Nonfarm payroll employment (millions)	156.1	158.6	160.0	161.5
Civilian unemployment rate (%)	3.6	4.1	4.6	4.4
Capacity utilization, total industry (%)	79.0	78.2	77.7	77.7
Inflation (private nonfarm GDP deflator, % change)	3.6	2.4	2.1	2.2
Inflation (CPI-U, % change)	4.1	3.0	2.4	2.4
Inflation (core CPI, % change)	4.8	3.4	2.5	2.3
Light vehicle sales (millions)	15.5	15.7	16.0	16.2
Private housing starts (thousands)	1421.4	1353.7	1381.3	1533.0
3-month Treasury bill rate (%)	5.1	5.0	3.7	3.3
10-year Treasury note rate (%)	4.0	4.1	3.7	3.6
Conventional mortgage rate (%)	6.8	6.6	5.7	5.3
Real disposable income (billions of chained 2017 $)	16784.0	16981.0	17321.1	17854.4
% change	4.1	1.2	2.0	3.1
Corporate profits after tax (billions of current $)	2974.5	3274.1	3358.7	3513.6
Value of U.S. $ (FRB broad index), % appreciation	-0.2	1.9	0.6	0.0
Current account balance (NIPA basis, billions of current $)	-831.2	-942.6	-948.9	-995.7
Federal surplus (FY, NIPA basis, billions of current $)	-1561.2	-1601.7	-1659.8	-1755.9

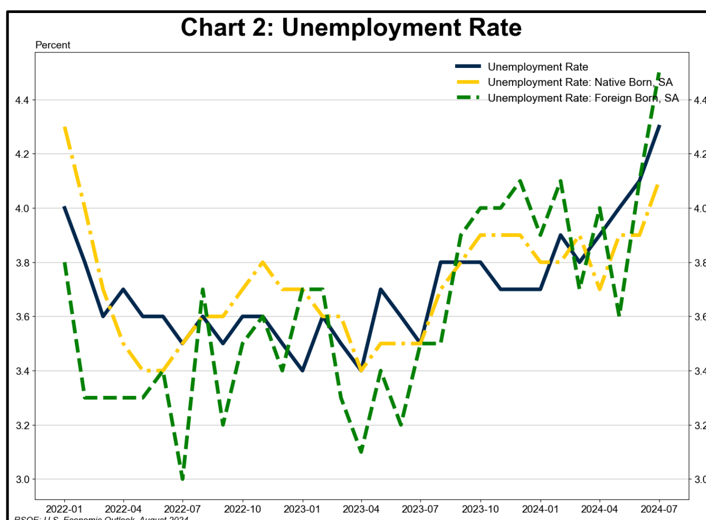
The Current State of the Economy

The pace of economic growth appears to remain robust, but concrete signs of a slowdown in the labor market have started to emerge recently. Real GDP expanded at an annualized pace of 2.8 percent in the second quarter of 2024. Chart 1 shows the growth rate of real GDP and the growth contributions



of its major components over recent quarters. Consumption expenditures contributed 1.6 percentage points to the headline growth reading in 2024Q2. The government sector's contribution poked up again, adding 0.5 percentage points to real GDP growth. Inventory investment, which tends to display significant volatility, added a hefty 0.8 percentage points. Nevertheless, we believe that the underlying momentum in the economy is still solid, since the combined growth contribution of private fixed investment and consumption has now exceeded 2.0 percentage points for four consecutive quarters.

The labor market has shown more deterioration than overall economic growth. Chart 2 shows the



national unemployment rate and unemployment rates by nativity since 2022.[1] The headline unemployment rate rounded up to 4.3 percent in July, triggering the so-called "Sahm rule," which is a well-known early indicator of recession onset.[2] Despite the Sahm rule's accuracy identifying past

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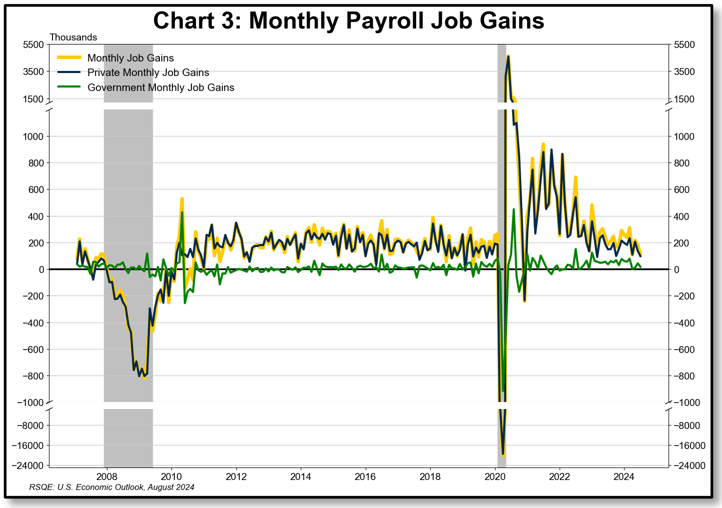
[1] The Bureau of Labor Statistics does not publish seasonally adjusted unemployment rates by nativity, so we have adjusted those ourselves.

[2] The Sahm rule was originally developed in Sahm (2019), "Direct Stimulus Payments to Individuals," in *Recession Ready: Fiscal Policies to Stabilize the American Economy*, edited by Heather Boushey, Ryan Nunn, and Jay Shambaugh, chap. 3: Brookings Institution. It is triggered when the three-month moving average of the national unemployment rate rises by at least 0.5 percentage points relative to the moving average's lowest level in the previous year.

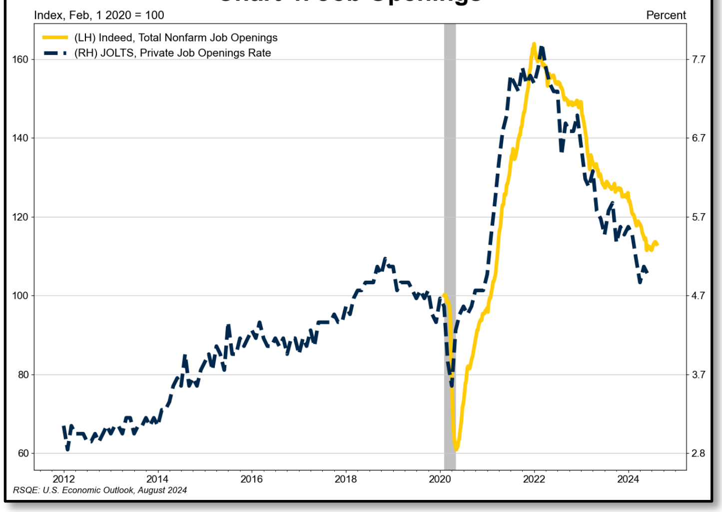
recessions since World War II, we are not about to make a recession call yet. We judge that recent immigration flows, coupled with higher unemployment rates observed for foreign-born workers in the past few months, suggest that the run-up in the unemployment rate could potentially be explained in part by numerous new immigrants facing more challenges finding jobs. Still, the recent increase in the unemployment rate is an important piece of evidence of a labor market slowdown compared to the past quarter, and it would be alarming if the run-up continues at its recent pace.



In July, monthly payroll job gains slowed to 114,000, down by 65,000 from June and marking the second-lowest increase since January 2021. Recent downward revisions revealed more cracks in the labor market than we previously perceived. For instance, payroll job gains in April were revised down from a healthy 175,000 jobs, as of the first reading, to a much weaker final number of 108,000. July's slowdown reflected a stepdown in job gains both in private service-providing industries and in the government sector. Private service-providing job additions retreated from 125,000 in June to 72,000 in July, while government job gains slowed from 43,000 to 17,000 during that time. We are less worried about the sharp deceleration in government job gains, since we were expecting those gains to taper off now that the level of government employment caught up to its pre-pandemic trend. Instead, we are more concerned with the relatively broad-based slowdown in the private services industry. Along with the downward revisions, the recent numbers represent a much more muted momentum in the labor market.

After three and a half years of seemingly insatiable demand for labor, private job opening rates have finally softened to near pre-pandemic levels (which corresponded to a pretty tight labor market already). Chart 4 illustrates two measures of labor demand we track. Data from Indeed.com is a timely

Chart 4: Job Openings



leading indicator of the official private sector job openings rate from the Job Openings and Labor Turnover Survey (JOLTS). While the latest data indicate some stabilization in both series, it would become worrisome if job openings continue to slide.

Chart 5 shows the Institute for Supply Management's (ISM's) Purchasing Manager Indices for manufacturing and services. Except for a brief recovery in March, the manufacturing index has been stuck below 50 since November 2022, a reading consistent with slowing business activity. However, the service index bounced back in July after briefly dipping below 50 in both April and June. The latest reading suggests that the service sector, arguably the larger source of growth over recent decades, is currently expanding at a moderate pace, despite the potential warning signs in the labor market.

Chart 5: Institute for Supply Management Indices

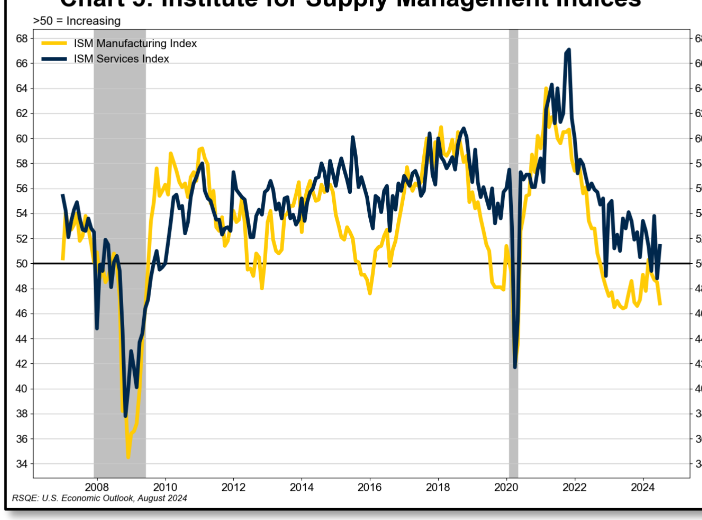
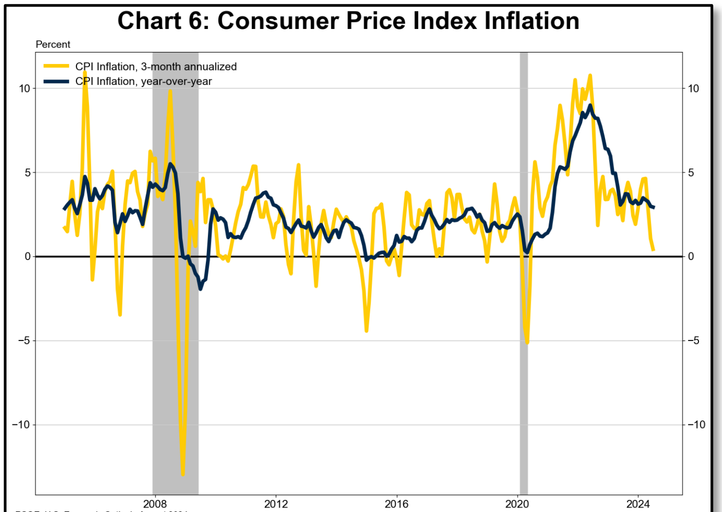
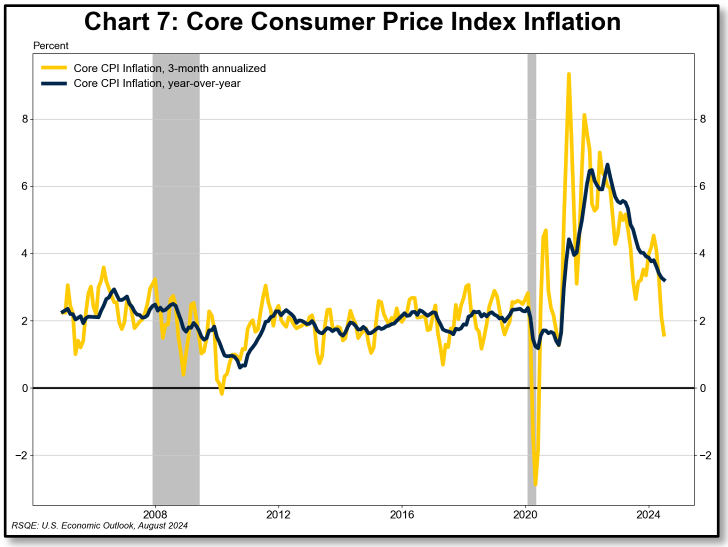


Chart 6: Consumer Price Index Inflation

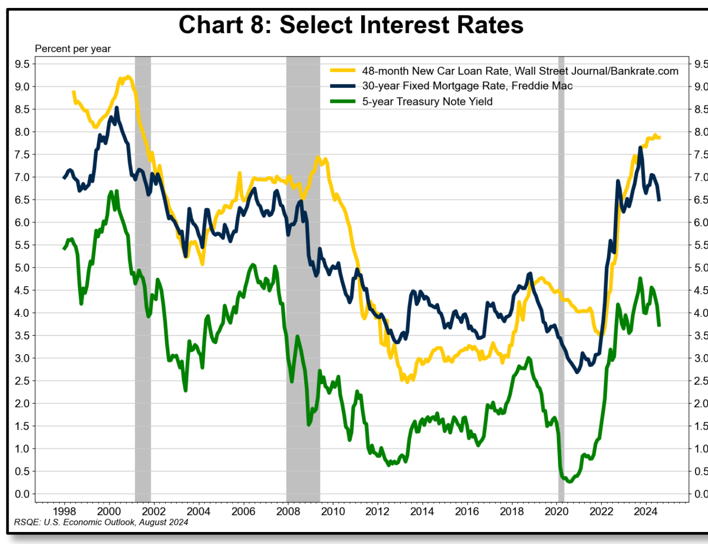


On the other hand, most measures of inflation improved consistently over the past several months. Chart 6 shows the 3-month annualized and year-over-year rates of headline Consumer Price Index (CPI) inflation. The year-over-year rate dipped below 3.0 percent in June–July, the slowest readings since March 2021. Core CPI inflation, which



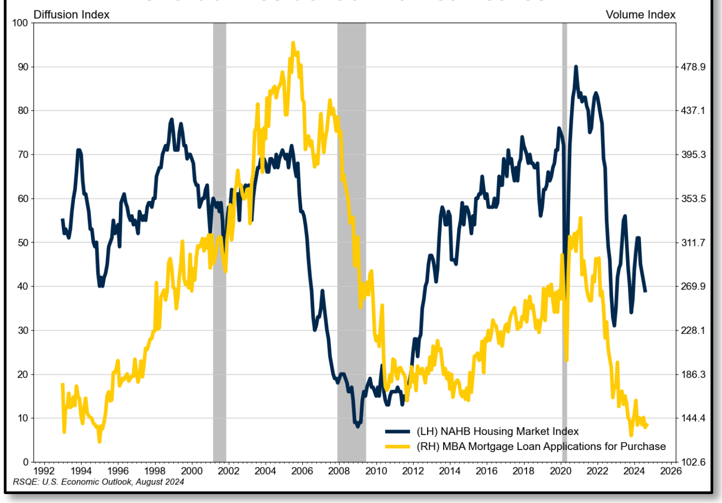
excludes the volatile food and energy components of the index, has also been moving in the desired direction after some setbacks in the first quarter. The year-over-year pace of core CPI inflation slowed from 3.8 percent in March to 3.2 percent in July, while the 3-month annualized pace registered just 1.6 percent in July. Overall, we believe that the recent deceleration in inflation, combined with the cooldown in the labor market, should pave the way for the Federal Reserve to pivot to short-term interest rate cuts in the upcoming months.

As the financial market has settled on the expectation of the first cut in the federal funds rate in September, both the 30-year fixed mortgage rate and the 5-year Treasury note yield have declined. The 30-year mortgage rate came down from a recent level of 7.2 percent in early May to 6.5 percent in mid-August. The yield on the 5-year Treasury note had already dropped by more than 70 basis points from late April before the market was rattled by the disappointing July jobs report. In contrast, the 48-month new car loan rate has been hovering around 7.8 percent since late December 2023, likely due to rising credit quality concerns. We expect all three rates to decline as the Fed begins to cut short-term interest rates.



Although mortgage rates have moderated, the housing market remains significantly stressed. Chart 9 shows the National Association of Home Builders' (NAHB's) Housing Market Index alongside the Mortgage Bankers Association's (MBA's) volume index of loan applications for purchases. The NAHB's index, which measures builders' sentiment on concurrent and six month forward single-family sales as

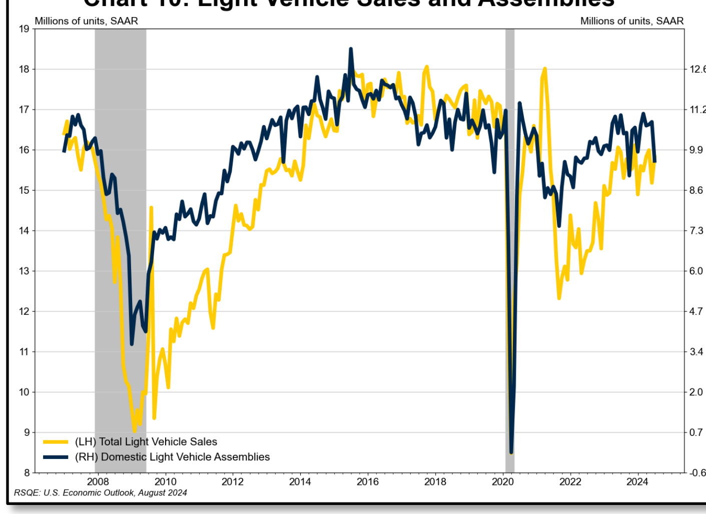
Chart 9: Residential Market Metrics



well as traffic of prospective buyers, has slid into contractionary territory since May. We expect high mortgage rates to continue to restrain residential single-family construction activity in the near term. Moreover, existing homeowners are also likely to hold on to their mortgages originated in the 2010s for some time longer, as mortgage rates are still coming down from a 15-year high.

The pace of light vehicle sales has likewise been stuck in second gear recently, hampered by expensive financing costs. Smoothing through month-to-month volatility, light vehicle sales have been stuck around the 15.6-million-unit annualized pace for about a year. On the other hand, the rate of domestic light vehicle assemblies has been trending up over the first half of 2024, notching an annualized rate of 11.3 million units in June. We remain optimistic that the light vehicle sales pace will average 15.8 million in the second half of the year, as lower short-term interest rates are set to work their way through to vehicle financing rates in the months to come.

Chart 10: Light Vehicle Sales and Assemblies



Overall, the state of the economy remains noisy and challenging to interpret. We believe that the current picture is consistent with a moderate near-term slowdown in economic growth, albeit from a healthy initial state. Although we forecast the labor market to continue cooling off through the first half of next year, we believe that the Fed's pivot to looser monetary policy will arrive in time to forestall a recession. If the Fed does not pivot decisively to rate-cutting mode at its next meeting, though—watch out below!

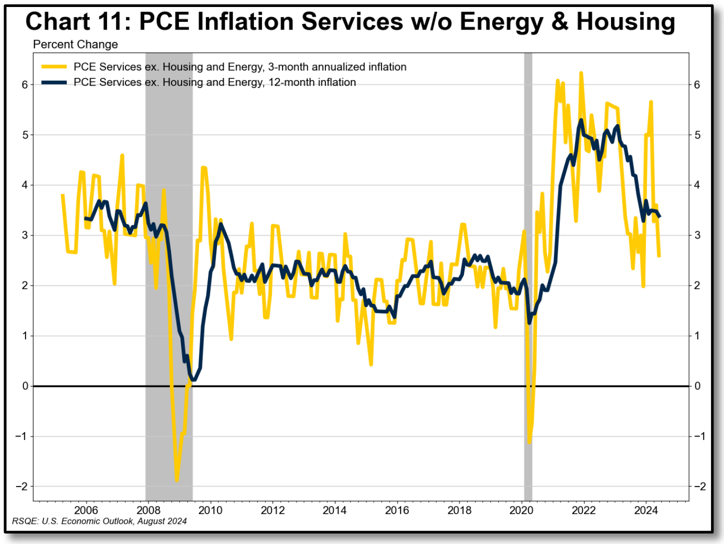
Next, we outline several key policy and economic assumptions underlying the forecast.

Monetary Policy

The Federal Open Market Committee (FOMC) remains committed to its dual mandate of bringing inflation down to its 2.0 percent objective while maintaining full employment. The FOMC has held the federal funds rate steady in the 5.25–5.5 percent range since July 2023. FOMC members have recently been signaling that cuts will start soon, though. Members have repeatedly noted that "that the risks to achieving its employment and inflation goals have moved toward better balance." In July, one member remarked, "evidence is mounting that… the effects of tighter monetary policy have corralled high inflation" and "we are getting closer to the time when a cut in the policy rate is warranted." We interpret this language as signaling that the Fed was ready to start cutting rates at its next meeting in September even prior to the weak jobs report released early in August. A first cut in September now seems set in stone, while the pace of cuts going forward will likely be moderate, absent rapid deterioration of labor market conditions.

The median economic projection for the federal funds rate among June FOMC meeting participants envisioned one cut in 2024 and four more in 2025. The Committee maintained its belief that inflation would continue to normalize, with the participants' median projection of year-over-year PCE price index inflation falling to 2.6 percent by the end of this year and 2.3 percent by the end of 2025. At the same time, the median projection foresaw the unemployment rate rising to 4.0 percent this year and 4.2 percent in 2025. Year-over-year PCE inflation sat at 2.5 percent in June, and the unemployment rate rose to 4.3 percent in July, likely adding urgency to the Fed's pivot to rate-cutting mode.

Core PCE inflation, a key metric for forecasting future inflation, stood at 2.6 percent year over year in June. This metric has been slowing consistently since the September 2022 reading of 5.5 percent, but progress has slowed in early 2024. The 3-month average (annualized) rate spiked to 4.5 percent in March after reaching 1.6 percent in December 2023, but it had declined back to 2.3 percent as of June. The spike in inflation at the beginning of this year forced the Fed to hold off on cuts, but the recent disinflation has re-cleared the way for cuts to begin later this year. Core non-housing services, also known as the "supercore" (roughly a 50-percent slice of private consumption), was one of the final sectors to



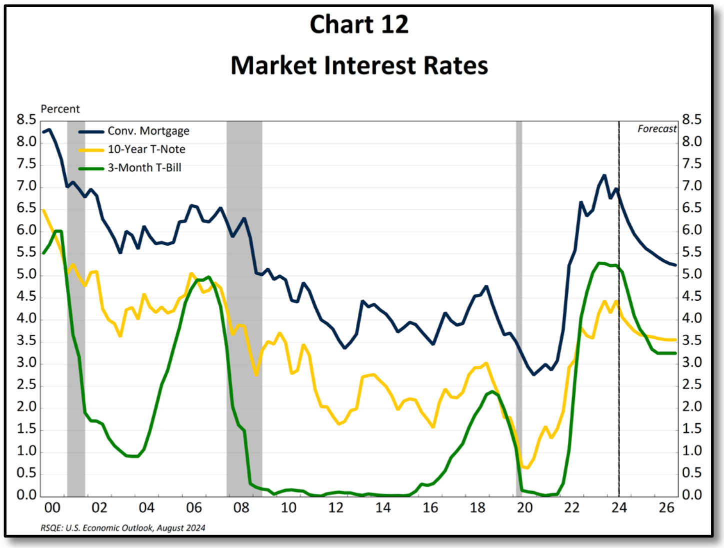
experience disinflation. As shown on Chart 11, however, it was a significant driver of the recent spike and subsequent decline.

The Fed's statutory dual mandate requires a balanced approach to promoting maximum employment alongside price stability. The labor market is still near full employment, but it is showing definite signs of cooling off. The recent pace of payroll job gains, at 154,000 jobs per month over the past four months, is a step down from the 2023Q1–24Q1 average of 254,000 and is much slower than 2022's monthly average of 377,000. The slowdown in the labor market alongside close-to-target inflation gives the Fed room to move rates lower.

The Fed has been reducing the size of its balance sheet since May 2022. At that time, the Fed announced a 95 billion dollar-per-month redemption cap for its securities holdings, and it has been shrinking its balance sheet by around 80 billion dollars per month since then. On May 1st of this year, the Fed announced that it would slow the pace of decline by establishing a new redemption cap of 60 billion dollars per month beginning on June 1st, a small step towards a more accommodative policy. As the rate-cutting cycle commences, we expect the pace of balance sheet reduction to slow to 30 billion dollars per month.

We believe that our forecast is consistent with a Fed that is entering a cutting cycle. We project the Fed to start cutting rates at the September FOMC meeting. By that time, we expect unemployment to still round to 4.3 percent and the annualized pace of core PCE inflation to dip to around 2.4 percent, down from 3.7 percent in 2024Q1. With the fed funds rate around 5.3 percent, the implied short-term real interest rate of nearly 3.0 percent will appear too restrictive, especially given the softening labor market. We expect the Fed to cut rates at a steady pace, with three 25 basis point cuts by the end of 2024, five total in 2025, and one more in 2026, reaching the terminal rate range for this cycle of 3.00–3.25 by March of 2026.

Chart 12 shows our projections for selected key interest rates. The 3-month Treasury bill rate falls from 5.1 percent in 2024Q3 to 4.6 percent in 2024Q4 and 3.3 percent in 2025Q4, before holding around that level through 2026. The 10-year Treasury rate dips from 4.1 percent in 2024Q3 to 3.9 percent in 2024Q4 and then declines gradually to 3.6 percent by the end of 2025, where it stays through 2026. Measured by the 10 year–3 month spread, the yield curve thus un-inverts in the second half of 2025 for the first time since late 2022. Mortgage rates decline more quickly than longer-term government bond yields as the excess spread between them shrinks in the face of subsiding policy rate, inflation uncertainty, and default risk. The 30-year conventional fixed-rate mortgage rate falls from 7.0 percent in 2024Q2 to 5.5 percent in 2025Q4 and 5.2 percent by 2026Q4.



Fiscal Policy

The outcome of the November elections remains highly unpredictable at this stage. Despite the uncertainty surrounding the election, it is reasonably clear that the fiscal 2025 budget is unlikely to be finalized before the putative September deadline. We expect a continuing resolution to be reached in time, though, as both parties would prefer to avoid blame for a government shutdown ahead of the elections. With the latest debt ceiling deadline approaching on January 2nd, 2025, the nation will be reminded yet again that the federal debt is on an unsustainable path, with no clear solutions in sight.

Election uncertainty escalated after President Biden ended his reelection bid less than a month prior to the Democratic National Convention. We currently judge that the probability that Republicans will reclaim the Senate is high enough to make it our base case, but the election outcomes for President and for the House of Representatives look close to a coin flip.

We have some idea of how the second Trump Administration might play out based on the first one and on his campaign platform. We have also made several assumptions about policies a potential Harris Administration could focus on based on her record as a Senator, and on the expectation of a fair amount of continuity with the path that President Biden has established.

Some aspects of the fiscal path may remain relatively certain regardless of who controls the White House and Congress in January. We anticipate that several provisions from the Tax Cuts and Jobs Act (TCJA) currently set to phase out or expire in 2025 are likely to be extended. A permanent doubling of the maximum child tax credit (CTC), for instance, is included in the Republican National Convention's platform, a proposal that is likely to garner bipartisan support. The TCJA's personal income tax cuts also have a high chance of sticking around, although they will come with a great fiscal cost. The Joint Committee on Taxation estimated that an extension of the TCJA's personal income tax rates and CTC provisions would increase the primary deficit by a cumulative 3.3 trillion dollars from 2025 to 2034, on top of a baseline primary deficit of an estimated cumulative 7.4 trillion dollars.

The Biden Administration's budget for fiscal 2025 proposed to restore the pre-TCJA top marginal tax rate of 39.6 percent for single filers earning over 400,000 dollars and married couples earning over 450,000 dollars a year. That proposal, along with a further expansion of the CTC, would be likely to remain on the table under a hypothetical Harris Administration, but the likelihood of its enactment will depend on who controls Congress come January 2025.

The fiscal impact of the business tax provisions in the TCJA is moderate compared to the personal income tax provisions, but it is not negligible. We believe that the 21-percent corporate tax rate is likely to endure even if Democrats win a trifecta in November. On the other hand, a further reduction in corporate tax rates would remain in the picture if Republicans gained undivided control of the government. Additionally, there is also a chance that the reinstatement of the immediate write-off on research expenditures and an extension of 100-percent bonus depreciation would make a comeback to Congress after the lame-duck session if Republicans sweep the election.

Along several other margins, however, fiscal policy could diverge substantially depending on the outcome of the elections. One of the most significant differences would be in clean energy policy. Tax incentives introduced by the Inflation Reduction Act are likely to be phased out earlier if Republicans take full control of the government. Import tariffs, which are under control of the executive branch, are also a wildcard, particularly in a potential second Trump Administration. Revenue accruals from tariffs surged by 50 billion dollars during the start of the trade war with China from 2017Q4 to 2018Q4, marking a 37 percent increase year over year.

We expect the Treasury to begin deploying extraordinary measures to cover government obligations using cash on hand prior to the reinstatement of the debt ceiling in January. The Bipartisan Policy Center estimates that the "X date" when the Treasury Department exhausts all of its resources and the U.S. government would risk default would likely arrive in later 2025 in the absence of a deal.[3] The combination of the presidential transition and unresolved fiscal 2025 appropriations could intensify the upcoming debt ceiling battle.

Overall, the fiscal picture remains noisy with a close election ahead. Our forecast averages the various election outcome scenarios mentioned above, with a common thread of the slowdown in discretionary nondefense spending growth and continued expansion of defense spending.

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

		FY Forecast		
	2023	2024	2025	2026
Current receipts	4750.6	5021.6	5241.0	5441.4
% change	-3.0	5.7	4.4	3.8
Current expenditures	6311.8	6623.4	6900.7	7197.3
% change	4.9	4.9	4.2	4.3
Consumption	1306.1	1381.5	1440.2	1501.5
% change	7.5	5.8	4.3	4.3
Transfer payments	4004.4	4073.2	4221.7	4411.7
% change	1.3	1.7	3.6	4.5
Federal subsidies	102.7	95.3	85.0	86.0
% change	-40.6	-7.2	-10.8	1.2
Interest payments	898.6	1073.4	1153.7	1198.1
% change	33.8	19.5	7.5	3.8
Surplus (+) or deficit (-)	-1561.2	-1601.7	-1659.8	-1755.9
Percent of GDP	-5.8	-5.6	-5.6	-5.7

RSQE: U.S. Economic Outlook, August 2024

Table 1 shows the data and our projections for the federal budget on a National Income and Product Accounts (NIPA) basis for fiscal years 2023 to through 2026, broken down by receipts and major expenditure categories. Federal tax revenue is set to grow by more than 82 billion dollars in 2024Q2, before slowing down in the second half of the year. We expect the annual growth pace of federal receipts to shrink from 5.7 percent in fiscal 2024 to 3.8 percent in fiscal 2026 as nominal GDP growth decelerates.

[3] Bipartisan Policy Center. "2025 Debt Limit Looms: Cash on Hand Expected to Last Only Until the First Half of the Year." Bipartisan Policy Center. Published April 16, 2024. https://bipartisanpolicy.org/press-release/2025-debt-limit-cash-on-hand/.

The growth rate of federal expenditures remains steady over the next two years, averaging 4.5 percent throughout our forecast period. Strong defense spending supports overall federal consumption growth. Transfer payments are expected to rise by 4.5 percent in fiscal 2026, as Medicaid's federal contribution settles into its post-pandemic trajectory. Federal subsidies remain on track to shrink toward their pre-pandemic levels through fiscal 2024–25 before leveling off in fiscal 2026. Interest payments on the federal debt, however, rose by over one-third in fiscal 2023 due to sharply higher interest rates. As the Fed enters its rate-cutting cycle, the growth rate of interest payments decelerates from 19.5 percent in fiscal 2024 to 3.8 percent by fiscal 2026.

With moderate growth in revenue and robust growth in spending, we anticipate the federal deficit to stay elevated over the next three years, hovering around 5.6–5.7 percent of GDP through fiscal 2026. The privately held debt-to-GDP ratio is poised to increase from 80.9 percent in 2024Q2 to 87.8 percent in 2026Q4. As Fed tapers the pace of its rundown of Treasury security holdings, a large stash of Treasury debt stays on the Fed's balance sheet and not in the hands of the public.

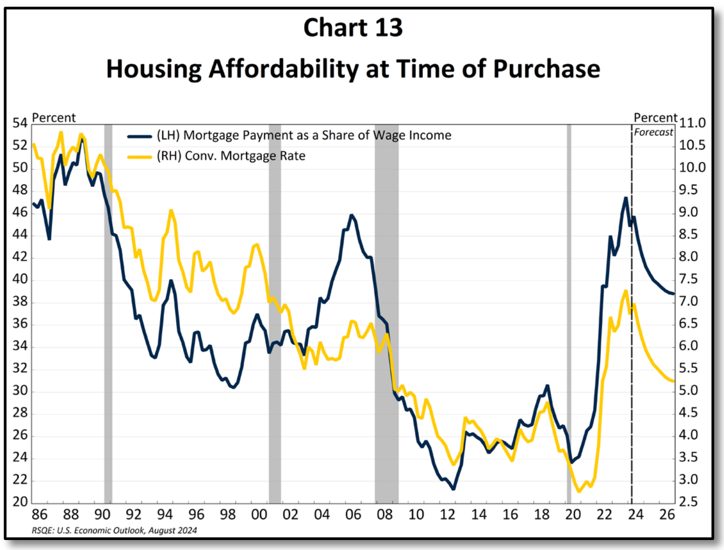
The Housing Market

Supply and demand in the market for existing single-family homes came into better balance in the first half of 2024, even as mortgage rates remained elevated. The 30-year conventional fixed rate mortgage rate, reported weekly by Freddie Mac, hovered around 7.0 percent in the second quarter, greatly hampering housing affordability. Inventory edged higher yet remained below pre-pandemic levels, while sales stabilized around 2018–19 levels.

Our preferred measure of house prices, the seasonally adjusted S&P CoreLogic Case-Shiller National Home Price Index, continued to rise slowly in the first half of the year. With modest growth in home prices and lower mortgage rates on the horizon, we project housing to become gradually more affordable in the next couple of years, although in absolute terms, affordability will remain poor.

Indicators of activity and sentiment in the housing market have sent mixed signals amid elevated prices and tepid sales. The Mortgage Bankers Association's index of loan applications for purchases has turned upward from its low point in 2023 but has remained at a relatively depressed level. Refinancing applications jumped in early August as mortgage rates eased. The University of Michigan Survey of Consumers' index of conditions for buying a home deteriorated significantly since May due to high mortgage rates, while the sentiment index of conditions for selling remained low, if stable. Existing single-family home sales moderated for a fourth consecutive month to a 3.5-million-unit pace in June after registering about 4.0 million in February. The seasonally adjusted months' supply of existing single-family homes rebounded from 3.0 in February to 3.8 in June. While there has been a measurable improvement in the number of active for-sale listings, we believe that high mortgage rates continue to lock many potential sellers into the low-rate mortgages they secured in the past. The decreases in mortgage rates should allow for healthier activity in the market for existing homes.

Chart 13 plots our preferred measure of affordability, our calculation of the ratio between a mortgage payment on a newly bought home and the average wage income per worker. We calculate that this ratio decreased early this year from its high point in late 2023 but rebounded to 45.8 percent in the second quarter of 2024 due to the brief increase in mortgage rates. As mortgage rates decline, we project the affordability ratio to ease to 42.4 percent by the end of 2024, before further declining to 39.7 percent by 2025Q4 and 38.8 percent by 2026Q4. Although this decline will bring some relief to prospective homebuyers, house purchases will remain much less affordable than in the years prior to the pandemic. We estimate that from 2010 through 2021, the mortgage payment on a newly purchased home averaged just over one-quarter of average wage income per worker.[4]



The market for newly built homes has more room for price adjustment in the face of high mortgage rates than the existing-homes market. Homebuilders can adjust lot and house sizes, finishes, appliances,

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

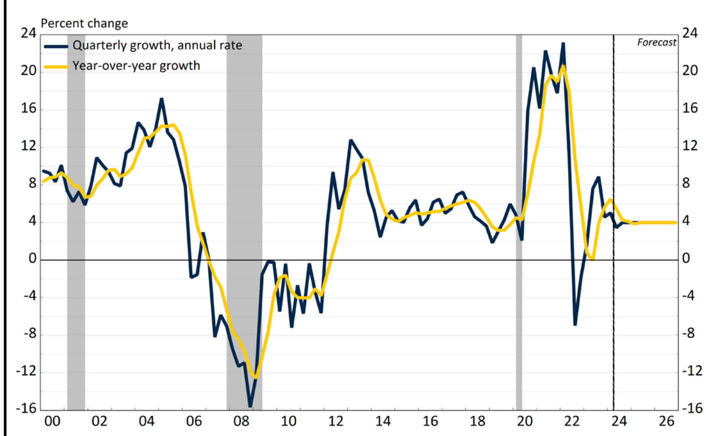
and other features to compensate partially for the spike in mortgage rates. The low inventory level in the existing homes market also cushioned the blow from higher mortgage rates to new construction activity. As a result, new residential construction was holding up better to high mortgage rates than activity in the existing homes market until recently.

Annualized sales of new single-family homes slowed from 663,000 in the first quarter to 656,000 in the second quarter. Within the second quarter, though, sales jumped to 730,000 in April and dipped to 617,000 in June. As economic growth slows, we expect the moderation to continue over the second half of 2024 before sales rebound in 2025. The sales pace reaches 755,000 by 2026Q4, helped by markedly cheaper mortgages.

Single-family housing starts have exhibited the same pattern as sales recently, slipping to 1,006,000 annualized units in the second quarter from the 1,062,000 pace in the first quarter. The months' supply of new single-family homes for sale jumped back up to 9.3 months in June as sales dropped, after coming down to 7.7 in April. Construction activity will continue to be restrained in the near term as the market works through the supply overhang that has developed since 2022. However, we remain cautiously optimistic about the single-family residential construction market in the medium run, which should benefit from the renewed decline in mortgage rates.

Multi-family housing starts continued to retreat as rental vacancies grew. The pace of starts stood at 342,000 in the second quarter, after a gradual slowdown from the almost 40-year high of 546,000 in 2022. This pace was the slowest since the depths of the pandemic recession. We believe delays in off-campus leases related to technical difficulties affecting financial aid application marginally contributed to the subdued demand over the summer. The influx of starts that are close to completion is also set to put a chill on multi-family starts. However, the recent uptick in permits and

Chart 14
Case-Shiller National Single-Family Home Price Index



starts, easing financial conditions in the near term, and the ongoing inflow of immigrants should help sustain demand for rentals in 2025–26.

Chart 14 shows the historical and forecast paths of year-over-year and quarterly annualized rates of home price appreciation, measured by the seasonally adjusted Case-Shiller Home Price Index. Incoming data averaged an annualized increase of 4.3 percent in the first half of 2024, inclusive of our nowcast for June. Prices appreciate by a steady 4.0 percent per year over the remainder of our forecast period. In year-over-year terms, we forecast the index to climb by 4.1 percent in 2024Q4 and 4.0 percent in 2025–26.

Energy Markets

The price of West Texas Intermediate (WTI) crude oil jumped from 68 dollars per barrel in 2021 to almost 125 dollars per barrel in early March 2022, amid Russia's invasion of Ukraine. Prices then fell to roughly 75 dollars per barrel by the end of 2022. Since then, the price per barrel has largely hovered around 80 dollars. Exceptions occurred in September 2023, when oil supply risks were notably high, and in early April 2024, when Israel struck the Iranian embassy in Syria.

As the situation abroad remains volatile, we turn our focus to another major risk to our energy outlook: China's demand for oil. Oil consumption in China has contracted recently and stood marginally below year-earlier levels in 2024Q2. Concerns about demand in China and the strength of the U.S. economy led the price of WTI to fall to 73–76 dollars per barrel as of the first week of August.

On August 1, 2024, the Organization for Petroleum Exporting Countries and its allies (OPEC+) decided to maintain their current path of output cuts, unwinding some of them starting in October. We expect this to leave OPEC+ with enough spare capacity to help minimize oil supply disruptions, which will help to support our modest WTI price forecast. Without a large increase in supply from OPEC+ countries, though, the bulk of crude production growth to satiate global demand will have to originate elsewhere. The Energy Information Administration (EIA) estimates that U.S. production growth will increase by 0.8 million barrels per day between 2023 and 2025, which is almost half of the global increase.

Natural gas prices, as measured by the Producer Price Index (PPI) for natural gas fuels, eased by 6 percent in 2024Q1 and another 11.3 percent in 2024Q2, due to record U.S. natural gas production during 2023 and mild winter weather reducing demand for space heating. Low natural gas prices led to reduced drilling and production cuts, but not before natural gas inventories were restocked. By the end of June 2024, natural gas inventories stood almost 20 percent higher than the five-year average from 2019–23. The EIA predicts a decrease in natural gas injections into storage due to relatively flat production in the second half of 2024 and that inventories will draw down closer to the five-year average by the end of the injection season in October. Over the next few years, we expect normal future heating seasons to return along with upward pressure on domestic prices from rapidly growing liquefied natural gas exports. We therefore expect natural gas prices to ramp up throughout our forecast, but still to reach only the relatively low levels seen in 2017 and 2018.

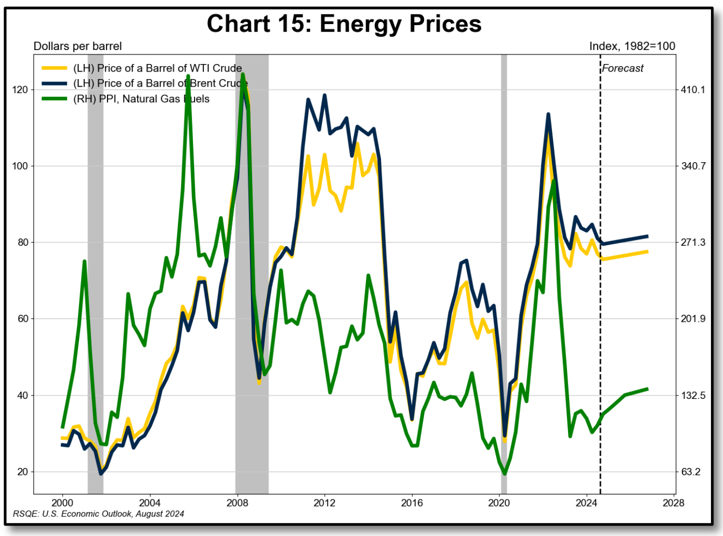


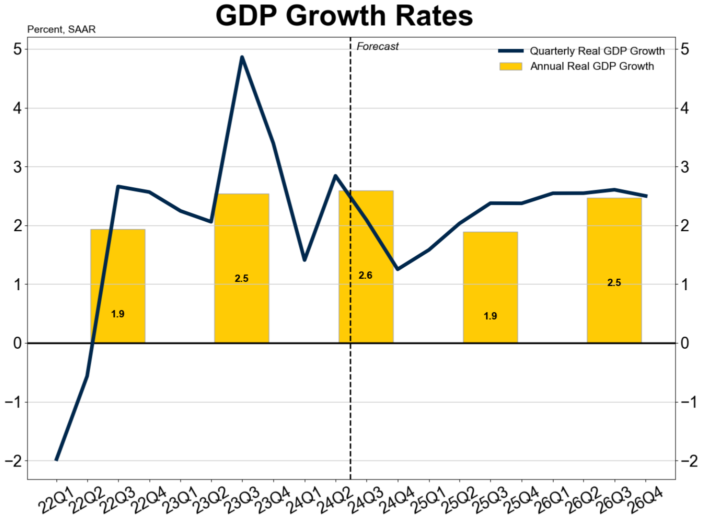
Chart 15: Energy Prices

Chart 15 shows our forecast for WTI and Brent crude prices in maize and blue, as well as the PPI for natural gas fuels in green. We expect the price of WTI to tick up from 77 dollars in the second half of 2024 to a little over 79 dollars by the end of 2026. The Brent–WTI spread used to be sensitive to tensions in the Middle East, but the inclusion of U.S. WTI-Midland crude in the Brent index appears to have tamed that volatility. We project that the Brent–WTI spread will remain relatively stable around 4 dollars per barrel through 2026.

The Forecast for 2024–2026

The gradual cooldown of the previously overheated labor market accelerated in July, raising the question of whether the process has tipped into an unhealthy and self-reinforcing deterioration. The unemployment rate registered 4.3 percent in July, up 0.6 percentage points relative to its average in the second half of last year. The Sahm rule metric exceeded 0.5 percent. In historical data, that level has signaled the onset of a recession. Despite this warning sign, we are not on recession watch yet. There are several reasons to believe that at least part of the recent increase in unemployment does not reflect weakening economic conditions. Most prominently, the significant inflow of new immigrants has been increasing labor supply at the lower end of the wage distribution, where unemployment rates are historically higher. Even taken at face value, the recent run-up in unemployment is still too small to cause much trouble given the considerable momentum of private demand growth. An estimated Okun's law relationship suggests that the 0.8 percentage point increase in the unemployment rate we project for 2024Q1–25Q1 should subtract about 0.8 percent off real GDP growth over that period. Our outlook loosely fits this historical pattern, with a significant slowdown in growth but no outright contraction.[5]

Chart 16
GDP Growth Rates



RSQE: U.S. Economic Outlook, August 2024

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

	'24H1	'24Q3	'24Q4	'25	'26
Real GDP (% change, AR)	2.1	2.1	1.3	2.1	2.5
Contributions to real GDP growth					
Final sales to domestic purchasers	2.6	2.2	1.6	2.2	2.7
Consumption	1.3	1.7	1.1	1.2	1.5
Nonresidential fixed investment	0.6	0.3	0.3	0.5	0.6
Residential investment	0.3	-0.2	-0.2	0.1	0.3
Government purchases	0.4	0.4	0.4	0.3	0.3
Net exports	-0.7	-0.0	-0.1	-0.1	-0.3
Inventory investment	0.2	-0.1	-0.3	0.0	0.1

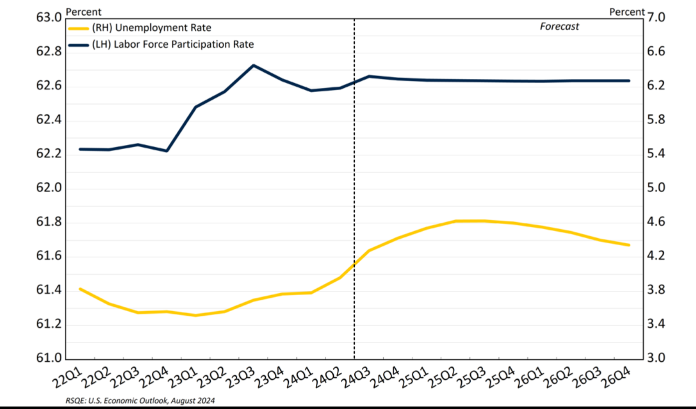
RSQE: U.S. Economic Outlook, August 2024

- We project that real GDP growth will slow from its 2.8 percent annualized pace in 2024Q2 to 2.1 percent in 2024Q3 and to just 1.3 percent in 2024Q4. This significant deceleration reflects the continued labor market softening from the prior monetary tightening.
- Expectations that the rate cutting cycle is about to begin are already easing financial conditions. We expect looser policy to work through the economy enough to lift quarterly growth to about a 2.4 percent pace in 2025H2.
- The ongoing immigration wave has lifted estimates of potential GDP growth over the next several years above the 2.0 percent pace.
- Calendar year GDP growth registers 2.6 percent in 2024, then moderates to 1.9 percent in 2025 and rebounds to 2.5 percent in 2026.

- Consumption expenditures remain strong in 2024Q3, contributing 1.7 percentage points to growth. Their contribution averages 1.1 percentage points in 2024Q4–25Q2, as compensation growth slows.
- Slowing growth of investment in vehicles and other equipment is behind the dip in the growth contribution of nonresidential fixed investment in 2024H2. Investment in structures edges down through mid-2026, coming off a spike driven by a slew of new microchip factories.
- Residential investment does not start adding to growth until 2025, as housing affordability is slow to improve even with cheaper mortgages.
- Government consumption expenditures' contribution to growth edges down from 0.4 percentage points in 2024H2 to 0.3 in 2025–26, largely due to slowing government employment growth.
- The combined drag of net exports and inventory investment on real GDP growth averages about 0.2 percentage points over 2024Q3–26Q4.

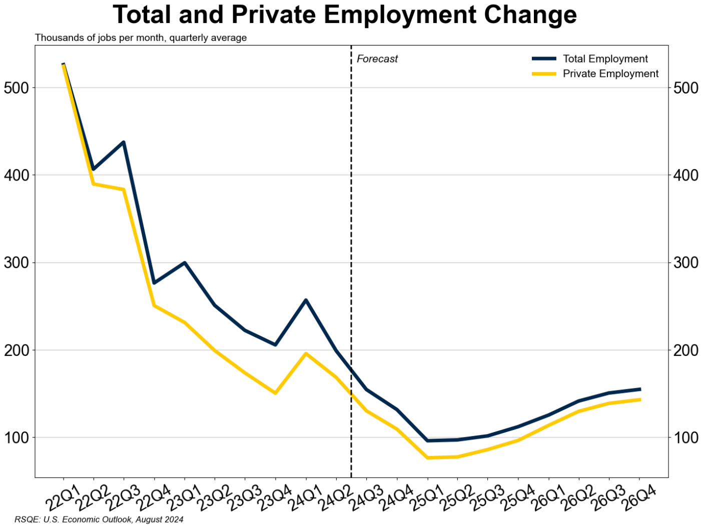
[5] Okun's law is the empirical relationship between the change of the unemployment rate and real GDP growth; the estimates above come from the 1987Q1–2019Q4 period.

Chart 17
Labor Force Participation Rate and Unemployment Rate



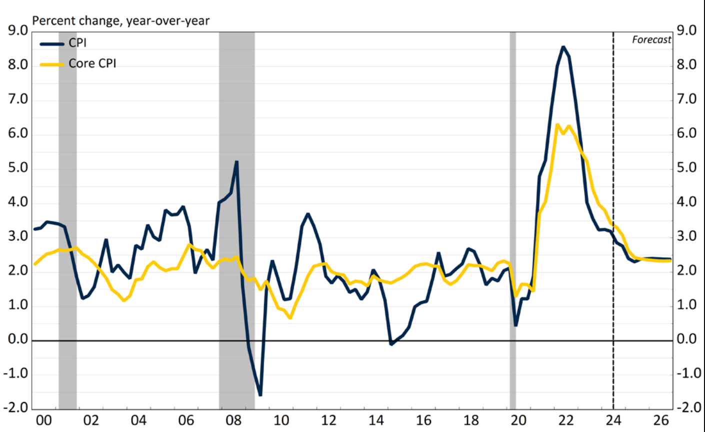
- The labor market is starting to show signs of cooling off substantially. The headline unemployment rate climbed to 4.3 percent in July after averaging 3.8 percent from August 2023 to February 2024.
- The labor force participation rate has hovered in the range of 62.5 to 62.8 percent since February 2023 and was at 62.7 percent in July. Participation edges down to 62.6 percent at the beginning of 2025, where it stays for the rest of the forecast window. The flat participation rate reflects the opposing forces of ongoing retirements and of rising participation rates of recent and forthcoming immigrants.
- The cumulative effects of previous monetary tightening continue to make their way to the labor market. The unemployment rate continues climbing upward from 4.3 percent in 2024Q3 to 4.4 percent in 2024Q4, peaking at 4.6 percent in mid-2025 and then declining to 4.3 percent by 2026Q4 as looser monetary policy propagates through the economy with a lag.

Chart 18
Total and Private Employment Change

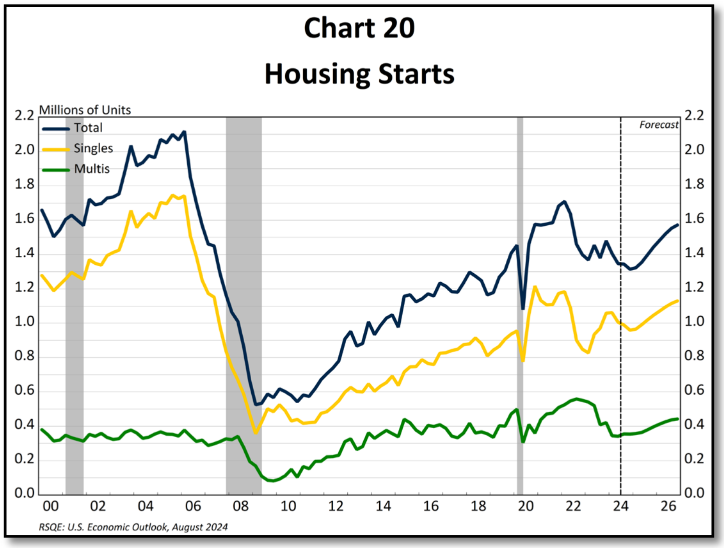


- Payroll employment gains have continued to slow in 2024. The labor market has averaged 154,000 job gains per month from April to July 2024, weaker than the 251,000 pace in 2023, but still near 2019's average of 166,000.
- The slowing trend in job gains continues through 2025Q1, bottoming at about 100,000 jobs per month. Job growth in 2025H2 remains moderate. Growth ramps up again by 2026 as interest rate cuts feed through to the labor market.
- The economy adds 2.2 million jobs during 2024, 1.2 million during 2025, and 1.7 million during 2026.
- The government sector adds jobs throughout the forecast, albeit at a much slower pace compared to 2023, as local government employment tops its pre-pandemic count.

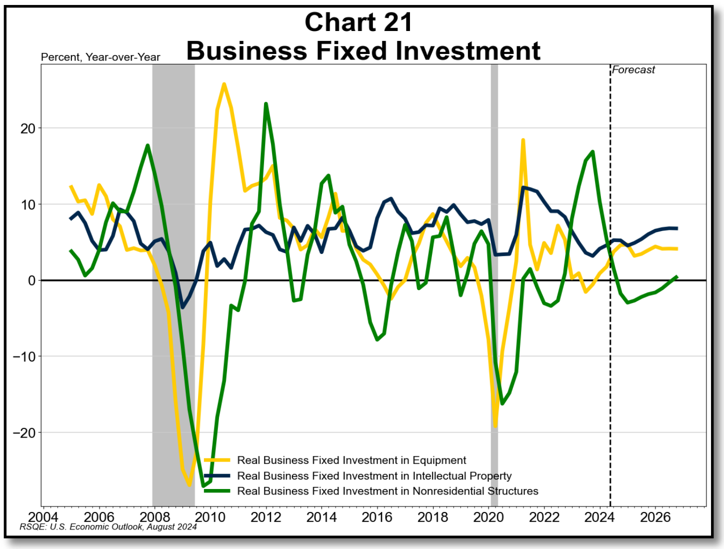
Chart 19
Consumer Price Index



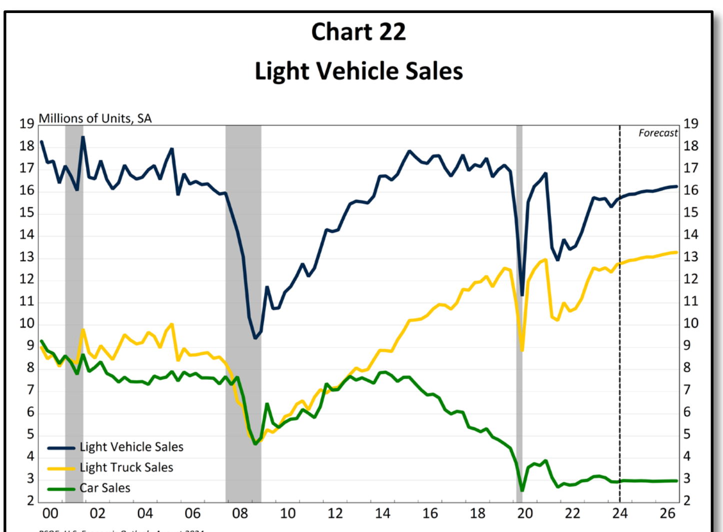
- All-items CPI inflation slowed to 3.2 percent year-over-year in 2024Q2 with decreases in energy prices, while core CPI inflation registered a 3.4 percent pace with slower price increases in housing and other services.
- We expect the PCE price index, the Fed's preferred inflation measure, to decline toward the Fed's 2.0 percent goal over the next few quarters, as shelter costs continue to decelerate and consumer goods inflation stays muted. The year-over-year PCE inflation slides to 2.5 percent in 2024Q4 and decelerates further to 2.1 percent by the end of 2025 and throughout 2026.
- CPI inflation runs slightly hotter than PCE. Year-over-year core CPI inflation slows to 3.2 percent in 2024H2 and eases further to 2.4 percent in 2025Q4 and 2.3 percent in 2026Q4.
- Core CPI inflation slightly outpaces the headline rate throughout the forecast, as gasoline price increases remain largely subdued and food inflation slows.



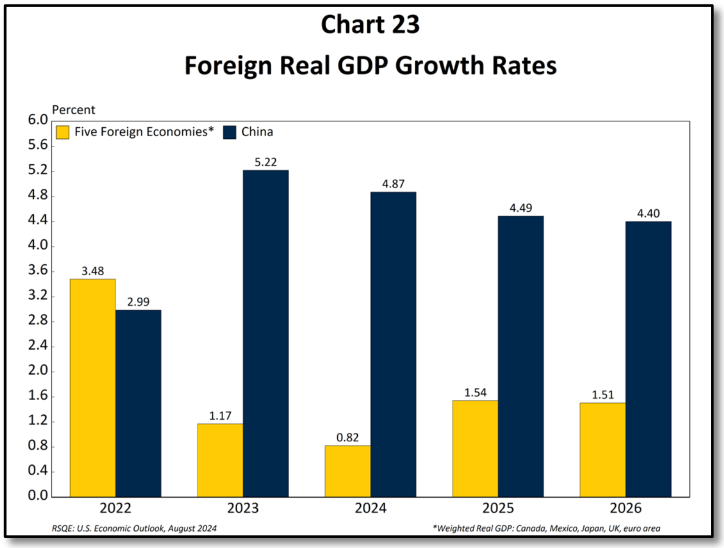
- The 30-year fixed mortgage rate edged below 7.0 percent in early August, but it remained elevated relative to the 2010s. With plenty of supply for sale, new single-family home construction remains soft in 2024H2, averaging a pace of 975,000 units. The pace then builds up to 1,130,000 units by 2026Q4.
- Multi-family starts remained below 350,000 in 2024H1, with a considerable number of units under construction and moderate rental vacancies. We expect multi-family starts to edge up to 355,000 units in 2024H2, and to recover to 440,000 by 2026Q4 as financing costs drop.
- Total housing starts dip from 1,348,000 units in 2024Q2 to 1,315,000 in 2024Q4 due to short-term uncertainty before recovering toward the pre-pandemic trend by 2026Q4.
- We are generally optimistic on new construction.



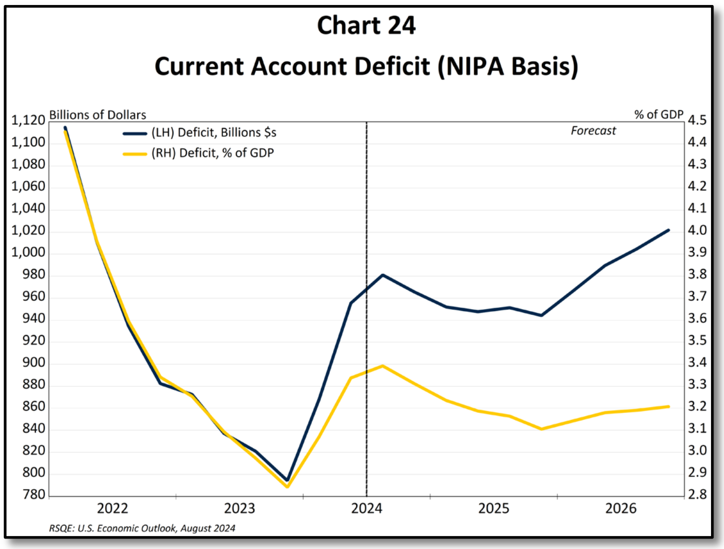
- Real investment in equipment grew by 1.8 percent year over year in 2024Q2, reflecting a continued ramp-up in information processing equipment investment and a recovery in truck sales to businesses. As lower interest rates begin to take effect, the growth of equipment investment is expected to remain strong, reaching a year-over-year growth rate of 4.1 percent by 2026Q4.
- Intellectual property investment expanded by 4.6 percent year over year in 2024Q2. We project that robust growth in software and research development investment will persist throughout our forecast, boosting the pace of growth to 6.8 percent year over year by 2026Q4.
- Year-over-year growth in nonresidential structure investment cooled to 5.3 percent in 2024Q2 as microchip factories' construction activity growth likely peaked. We expect investment in this category to take a breather for 2024–25 falling by 1.8–1.9 percent during each year before leveling off during 2026.



- The annualized pace of light vehicle sales rebounded in July to 15.8 million units following a temporary dip in June partly due to a cyberattack affecting dealers, but make-up sales did not materialize. Expensive financing, economic uncertainty, and limited availability of cheaper trim levels have been constraining sales.
- Vehicle affordability relative to incomes is likely to keep improving, as auto loan interest rates come down while dealers lose pricing power and manufacturers increase incentives due to rising inventories. As a result, we project that the pace of sales will rise to 15.9 million by 2024Q4 and continue to climb slowly to 16.3 million by 2026Q4.
- All the sales gains are in the light truck category, which includes pickups, SUVs, and crossovers.
- As manufacturers increase incentives and consumers go for cheaper vehicle trims, the contribution of vehicle sales to real GDP will be smaller for the same number of units sold.



- To forecast demand for U.S. exports, we construct a trade-weighted index of real GDP for five of our major export markets: Canada, Mexico, Japan, the United Kingdom, and the euro area. We also track China's economy, but we show it separately because it tends to grow more quickly.
- After relatively weak growth of 3.0 percent in 2022, China's real GDP expanded by 5.2 percent in 2023 as it lifted most pandemic curbs on economic activity. The pace of growth slides to 4.4 percent by 2026 on constrained demand for Chinese exports.
- The five-economy composite calendar year growth rate fell to 1.2 percent in 2023 as a consequence of central banks' inflation-fighting policies and of the Russia–Ukraine war. Weakness in Mexico and Japan pushes the calendar year average to just 0.8 percent in 2024 despite improved growth in the United Kingdom and the euro area. In 2025–26, five-economy growth is projected to rebound to 1.5 percent per year.



- The current account deficit declined from its pandemic-era high point to more usual levels in 2022–23 as consumption patterns rotated back from goods toward services.
- In recent quarters, import growth has outpaced exports, which were likely held down by weak economic growth in our key export markets. As a result, the current account deficit increased from 2.8 percent of GDP in 2023Q4 to 3.3 percent in 2024Q2.
- Export growth slightly outpaces imports in 2025, as economic growth in our export markets accelerates while domestic consumption growth eases. The current account deficit improves to 3.1 percent as a share of GDP by 2025Q4.
- In nominal terms, the current account deficit stays around 950 billion dollars in 2025. The deficit then widens to more than 1.0 trillion dollars at an annual rate by 2026H2.

Risks to the Forecast

Economic uncertainty remains elevated. We believe the key known risks fall into three broad categories. The first set of risks, related to data quality and misinterpretation, has become more prominent since the pandemic. Even the highest quality data releases, such as the payroll jobs report, are subject to considerable revisions, which could alter both estimates of recent economic conditions and perceptions of trends over the past few years. For example, over 2023, the employment count in the Quarterly Census of Employment and Wages—the primary source for the annual benchmarking of the payroll employment level—has been lagging behind monthly nonfarm payroll jobs numbers. As a result, many analysts believe that the BLS' birth-death adjustment model produces inflated estimates of jobs at new businesses, incorrectly boosting the reported monthly payroll job gains. The soon-to-be-released preliminary estimate of the benchmark revision of the March 2024 payroll employment count should shed some light on this hypothesis. The implied revisions could filter widely into economists' and policymakers' estimates of the current slack in the labor market.

The Fed's goal recently has been to engineer a gentle loosening of labor market conditions in order to tame inflationary pressures. As currently reported, the past few data points suggest that the pace of softening may have gotten a touch too fast for the Fed's liking. Should this faster pace persist, the Fed may have to cut rates more precipitously than we currently anticipate. Upward revisions and reversals of the recent trends in the data are also plausible, however, with the opposite implications for policy.

At the end of September, the annual NIPA update will revise GDP data for 2019Q1–24Q1, potentially shifting our understanding of the underlying economic momentum outside of the labor market. For example, a significant upward revision to GDP growth during 2023 could make the recent real GDP growth contributions of domestic private demand appear less robust. PCE inflation over the same period will also be revised.

While the raw CPI data is not usually revised, the seasonal factors used to produce seasonally adjusted monthly inflation readings are updated every year. Big recent movements in the data, such as those witnessed since 2020, can become embedded in seasonal factors and echo in later years. As a result, reading inflation trends from patterns in monthly seasonally adjusted data is a risky proposition. It currently appears that monthly inflation trends are very near the finish line, similar to the trend late last year. However, the year-over-year readings remain elevated, a statistic that should be relatively unaffected by seasonal factors. Interpreting the data in light of these tricky seasonal patterns creates risks on both sides of the Fed's inflation target.

One final question of data interpretation relates to consumption. Our forecast relies on the continued resilience of consumption expenditures, which have weathered sharply higher interest rates and prices remarkably well. Our reading of the tealeaves suggests a modest slowdown of consumption growth ahead, largely reflecting a slower pace of job gains and moderating wage growth, despite some help from lower interest rates. But a more dramatic consumer retrenchment is also possible. Stress has been building in vehicle and credit card finance. Anecdotally, households with incomes below median have been cutting back for some time now. And consumer confidence remains at depressed levels, suggesting that consumers are ready to sharply curtail spending if need be. Of course, consumer spending could also defy our expectations of a slowdown, as it has repeatedly both before and during the current expansion.

The second set of risks covers policies and policymakers. On the monetary policy side, members of the FOMC have to work with the same data constraints that we do. They also have to balance the risks of doing too much versus falling behind the curve and needing to catch up later. When all is said and done, it is unlikely that the Fed will get policy exactly right in any given episode. On the fiscal policy side, the results of the upcoming election remain highly uncertain. For this forecast, we have plugged in middle-ground assumptions between the possible outcomes, but the actual election results will necessarily drift away from our projected tax, expenditure, and trade policies.

The international political environment remains fraught with risks to the domestic outlook. A broad resolution of international tensions remains a positive tail risk to the outlook, but negative developments remain more likely. The war in Ukraine is not getting any closer to a diplomatic resolution, raising the prospect of a dramatic escalation that could draw more European countries into the conflict. Such an escalation would likely result in scrambled supply chains, higher domestic defense spending and production, and higher energy prices, to name a few consequences.

The war in Gaza and the Iran–Israel confrontation continue and risk triggering a broader war in the Middle East, which would almost surely send shocks through global energy markets. A disruption of the flow of energy commodities from the region would likely hit European economies the hardest given that they have dramatically increased their reliance on non-Russian energy imports. Europe is the major export market for U.S. energy, so knock-on effects on the domestic energy market would also be likely to ensue.

Tensions with China are unlikely to ease anytime soon, but the pace of further escalation is uncertain. We have assumed a modest increase in import tariffs over our forecast horizon regardless of who wins the upcoming election, but the range of possible scenarios and their economic implications is large.

The final group of significant risks comprises financial vulnerabilities. The recent violent moves in global stock price indices following an unexpected policy rate decision from the Bank of Japan highlighted the degree of fragility in the international financial system. Domestically, many sectors that rely on debt finance have been under stress for a couple of years. Commercial real estate has been facing a refinancing crisis, especially in the office and downtown retail space markets. The economic impact has been limited so far, and some relief in rates appears to be coming. But the possibility of broader turmoil in mortgage-backed securities backed by commercial real estate spilling into broader financial stress remains real, especially if other sectors of the economy also slow and prospects of a full-blown recession rise.

Domestic stock markets have recorded outsized gains since the start of 2023, with the S&P 500 up almost 40 percent. The gains have been driven largely by the stocks of a few large corporations likely to benefit from advances in AI software and technology. Should the modest recent retrenchment in the degree of enthusiasm for all things AI continue, domestic equity prices may suffer a considerable correction. While a stock market decline alone is usually not sufficient to push the U.S. economy into a recession, it could do so in conjunction with other negative shocks.

Overall, we consider the balance of risks to the outlook to be tilted only somewhat to the downside, since we believe that the Federal Reserve should be able to offset many of the potential negative shocks we have described. Some shocks, however, could require joint monetary and fiscal action, which may delay the necessary response.