Has the U.S. economy achieved a soft landing?

After nearly two years of uncertainty, the U.S. economy seems to be taking a turn toward stability. Consumer confidence is moderating above levels that typically foreshadow recession, unemployment remains low despite slowing job growth, and forecasters are reporting that the Federal Reserve’s July interest rate hike may be the last of the current round. Still, predictions for the fourth quarter of 2023 anticipate slower growth, and many questions remain. Can the economy maintain its resilience through a period of stable-but-high interest rates, contraction in the manufacturing sector, a tighter lending environment, and looming distress in the commercial real estate markets? While fears of recession have somewhat abated, it would not take much for a single shock to rekindle them.

Overview: The beginning of recovery?

U.S. GDP increased 2.4% in the second quarter of 2023 following a 2% gain in Q1. The economy’s continued expansion is one of several factors driving a more optimistic outlook among economists, alongside a resilient job market, falling inflation, consistent consumer spending, and an expected pause in interest rate hikes. As of early September, the Fed’s forecast probability of a recession within the next 12 months is close to 60%, but there is a wide range of disagreement among economists. For example, The Conference Board forecasts that later this year, economic growth will gradually buckle under mounting headwinds, likely leading to a very short and shallow recession. At the same time, other forecasters estimate the possibility of recession to be lower than 20%.

Figure 1: Graph of U.S. GDP from Q1 2021 to Q2 2023

Sources: BAE, Moody’s
Looking ahead, Moody’s Consensus forecast (an average of numerous forecasts) anticipates real GDP growth of 2% in 2023, falling to 0.8% in 2024. If the economy continues on this trajectory and inflation is on track to reach the Fed’s target rate of 2%, the Fed could begin to slowly lower interest rates in mid-to late 2024.

While recent indicators paint a picture of an economy on the upswing, certain developments could darken the outlook quickly, such as an unforeseen financial shock (similar to the bank failures that took place earlier this year), a stock market crash, a spike in oil prices, or any other unexpected event that would cause consumers and businesses to pull back on spending and investment. Additionally, some indicators continue to suggest the possibility of recession in the coming months. For example, the U.S. Leading Economic Indicator (LEI) has been in decline for fifteen months — the longest streak of consecutive decreases since 2007–08, during the runup to the Great Recession.

Businesses navigate inflation, receding supply chain challenges and a shifting labor market

The U.S. Consumer Price Index (CPI) rose 0.6% in August on a seasonally adjusted basis, after increasing 0.2% in July. The non-seasonally adjusted consumer price index (CPI) was up 3.7% from a year ago, and the non-seasonally adjusted core CPI was up 4.3%.

In particular, higher energy prices boosted U.S. headline inflation in August and likely contributed to the upside surprise in core inflation. Within energy, the CPI for gasoline surged 10.6%. In this case, cuts to oil production by Saudi Arabia and Russia, which will be extended through December, have boosted energy prices. However, U.S. gasoline futures, a leading indicator of the CPI, are falling and suggest that gasoline will weigh on the CPI in September. This in and of itself should not alter the assumption that the Federal Open Market Committee has reached or is close to reaching an end to rate increases. The central bank will likely look past energy’s big contribution to August’s CPI and instead focus on the slowdown in the labor market, which will be key to bringing down service-sector inflation.

In addition, after three years of pandemic-related disruptions and headaches, supply chain pressures have eased considerably, giving businesses greater confidence in shipment dates and revenue projections. That said, lessons learned during COVID-19, as well as ongoing trade conflicts with China, have long-term implications for procurement professionals. Businesses will face pressure to increase domestic production, reduce their dependence on risky sources, and rethink strategies of lean inventories and just-in-time replenishment, which can be crippling in the event of material shortages.

When it comes to the labor market, employment has proven far more durable than expected, but job growth appears to be slowing. Payroll employment rose by 187,000 in August, beating expectations — however, June and July employment figures were revised lower by a combined 110,000. Job growth has now averaged just 150,000 over the last three months, compared with a pre-revision average of 218,000 in July. The unemployment rate jumped to 3.8%, partly because an influx of job seekers entered the labor force. This is welcome news to the Fed, as an orderly slowing of job growth is essential to its goal of a soft landing.
However, looking ahead, U.S. demographic shifts that are already underway will put increased pressure on the labor market and exacerbate worker shortages in some industries. One of the main drivers of these challenges is the aging of the baby boomer generation. The U.S. Census Bureau reports that the median age in the U.S. has risen to 38.8 years. This represents an increase of 3.4 years since 2000, including the largest single-year gain on record (0.3 years in 2021). As the population gets older, the proportion of working-age people shrinks.

In 2021, the share of working-age people in the U.S. was 64.9%, compared to 67.3% in 2007. These demographic trends will affect U.S. businesses and the overall economy in a number of ways, primarily in terms of the makeup of the American workforce, but also with regard to the solvency of Social Security benefits and the strain on the U.S. healthcare system created by a surge of older individuals needing higher levels of care.

As members of the baby boomer generation retire in larger numbers, the combination of a smaller Generation X and a younger, less experienced millennial and Gen Z cohort may lead to a shortage of available workers to fill the baby boomers’ open jobs. As a result, companies in some industries may need to pay higher wages to compete for limited talent, which could have broader economic implications — including the possibility of reflation.

Other business-related concerns include the ongoing contraction in the manufacturing sector and troubling weaknesses emerging in the commercial real estate industry. Purchasing managers at U.S. manufacturing firms were pessimistic in July, and the ISM manufacturing index has remained below its neutral threshold of 50 for the ninth consecutive month. Meanwhile, the ISM services index continues to reflect tepid but positive growth, with a reading of 52.7%.

In the commercial real estate space, the balance of distress in the U.S. commercial real estate market increased for the fourth consecutive quarter to $71.8 billion at midyear. Commercial property prices are still falling, with the second-quarter RCA CPPI National All-Property Index down 10.2% from a year earlier. However, the steepest declines occurred in the fourth quarter of 2022 and the first quarter of 2023, suggesting that prices may be on the road to recovery.

Consumers continue to spend despite a dip in confidence

U.S. consumer confidence blasted past expectations in July, and then dipped in August. The Conference Board’s Consumer Confidence Index declined from a downwardly revised 114 (previously reported at 117) in July to 106.1 in August, an even sharper decrease than the modest pullback to 115.2 predicted by the consensus forecast. The dip in confidence reflects a less favorable assessment by consumers of current and near-term business and labor market conditions, as well as a deterioration of their near-term outlook on income. Despite this decline, consumer sentiment remains above the levels typically observed preceding a recession. And given that the FOMC often views consumer resilience as justification for increasing interest rates, the recent decline in consumer confidence could help reduce the likelihood of further rate hikes in 2023.

Interest rates continue to play a major role in the housing market. The current spread between the effective mortgage rate (the average rate on all outstanding mortgages) and the current mortgage rate is 200 basis points. This incentivizes homeowners who locked in ultra-low interest rates over the past three years to stay in their homes, which results in fewer homes on the market. With approximately three months’ supply of existing single-family homes currently for sale, inventory remains well below its pre-pandemic level and the four to six months of inventory that represents a balanced housing market. At the same time, mortgage delinquency rates fell to a seasonally adjusted 3.37% in the second quarter — the lowest reading on record.

Consumer spending has stabilized, and retail sales continue to grow gradually. Core sales, excluding vehicle dealers and gasoline stations, rose 1% in July, exceeding expectations. Year-over-year growth remains modest at 3.2%, but is now outpacing retail prices as inflation eases. Modest growth is likely to continue for the remainder of the year, as most consumers who still want jobs can get them, and pandemic-era savings have not yet been fully depleted.
A welcome shift toward stability approaching year-end

Throughout 2023, the U.S. economy has displayed remarkable resilience. Despite persistent uncertainty, the recession that many economists were predicting has not come to pass, and the possibility of a significant downturn in the near future seems to be diminishing. At the same time, the economy has yet to absorb the full impact of the Federal Reserve’s unprecedented interest rate hikes to rein in inflation, and shocks to the system could reanimate fears of a recession. Weaknesses emerging in some parts of the economy are likely to intensify and grow more diffuse over the coming months, leading to flat to slightly negative growth at the end of the year, but still falling short of recession. Overall, the economic big picture approaching the final quarter of the year is much brighter and steadier than many anticipated.

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About Benjamin E. Demko

Ben Demko manages the economic research and analytics team focused on macroeconomic, industry, and market risks that impact KeyBank’s varied loan portfolios. He is responsible for proprietary, forward-looking perspectives on the economy and real estate markets that are used across the bank for stress testing, loss estimation, asset management, resource allocation, and profit planning. Ben joined KeyBank in 2005 and has nearly 20 years of business analytics, economic research, and risk management experience.