Economy

FOMC's Goldilocks projections overlook impending fiscal drag, especially from student-loan repayments

We expect US real GDP to grow above 4% QoQsaar in Q3CY23, inducing a further 25bp hike in the Fed Funds rate at the FOMC's meeting on 1st Nov'23. At this week's meeting, the FOMC's median projections suggested a Goldilocks economy in CY23, with real GDP growing 2.1% (vs the projection of 1% in Jun'23) while core PCE inflation was projected to end CY23 at 3.7% (vs 3.9% previously). But the US economy has benefited from a persistent fiscal stimulus over recent quarters. This will be abruptly withdrawn in Q4CY23, with a cap on non-defense discretionary spending coming into force as part of the debt ceiling deal agreed in May'23, and student loan interest payments set to resume on 1st Oct'23. The consequent decline in personal consumption is still likely to tip the US into recession in Q4CY23-Q1CY24.

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Resumed student-loan repayments to erode PCE from Q4CY23

The debt ceiling deal ended the moratorium on student-loan interest payments (which had been in place since Mar'20 as a form of covid relief). President Biden's plan to write-off some student loans (estimated to total USD440bn) was deemed unconstitutional by the US Supreme Court at end-Jun'23. So, interest began accruing on the entirety of the USD1.6trn of student loans from this month, and interest payments will resume on 1st Oct'23. These are estimated to reduce the average individual's disposable income by 8-9% in Q4CY23, thus eating into private consumption expenditure (the key pillar of US economic strength in recent quarters).

Inverted yield curve will win, helped by strong USD

The USD is likely to continue rallying in nominal effective terms, gaining against the EUR and GBP as those central banks face less pressure to raise rates as headline inflation abates. While a weakening USD boosted the US economy in H1CY23, the stronger USD will be a drag on net exports in Q4CY23 – helping tip the US economy into the recession that has been telegraphed by the persistently inverted yield curve since Jul'22. We expect the recession, combined with the YoY decline in M2 throughout CY23, to finally help rein-in core PCE inflation to 3% YoY by Mar'24, allowing the Fed to resume cutting its policy rate in Q2FY24.

Goldilocks economy implies smaller and later rate cut projections

The rate-setting Federal Open Market Committee (FOMC) chose to keep its policy rates unchanged at its Sep'23 meeting (as widely expected), but the committee's median projections for the economy were revised substantially upwards. In particular, the real GDP growth projection for CY23 was revised up from 1% (in Jun'23) to 2.1%, while the CY24 projection was also raised to 1.5% (from 1.1% in Jun'23). Despite the much higher projections for growth, the core PCE inflation projection was lowered slightly, to 3.7% for end-CY23 (from 3.9% in Jun'23) and unchanged at 2.6% for end-CY24.

This Goldilocks scenario ('not too hot, not too cold') would result in a soft-landing for the US economy, defying the persistent prediction of a recession indicated by the inverted yield curve. While the median FOMC projection remains for the Fed Funds rate to end CY23 at 5.6% (implying one more 25bp rate hike this year), the projection for end-CY24 has been raised to 5.1% (implying a 50bp reduction during next year, or just 25bp lower than the current Fed Funds rate).

Exhibit 1: FOMC's Goldilocks projections: Faster growth, slower inflation, but smaller and later rate cuts

Percent

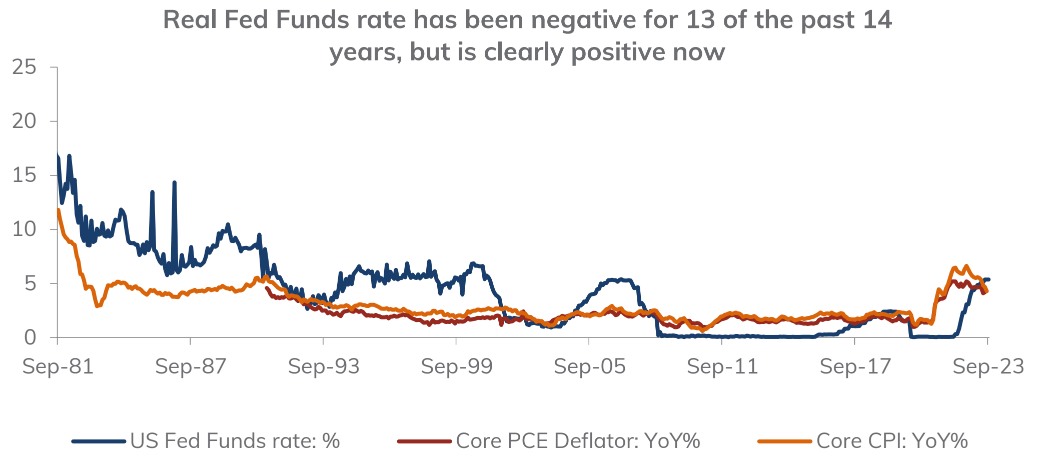
Variable	Median[1]					Central Tendency[2]					Range[3]				
	2023	2024	2025	2026	Longer run	2023	2024	2025	2026	Longer run	2023	2024	2025	2026	Longer run
Change in real GDP	2.1	1.5	1.8	1.8	1.8	1.9–2.2	1.2–1.8	1.6–2.0	1.7–2.0	1.7–2.0	1.8–2.6	0.4–2.5	1.4–2.5	1.6–2.5	1.6–2.5
June projection	1.0	1.1	1.8		1.8	0.7–1.2	0.9–1.5	1.6–2.0		1.7–2.0	0.5–2.0	0.5–2.2	1.5–2.2		1.6–2.5
Unemployment rate	3.8	4.1	4.1	4.0	4.0	3.7–3.9	3.9–4.4	3.9–4.3	3.8–4.3	3.8–4.3	3.7–4.0	3.7–4.5	3.7–4.7	3.7–4.5	3.5–4.3
June projection	4.1	4.5	4.5		4.0	4.0–4.3	4.3–4.6	4.3–4.6		3.8–4.3	3.9–4.5	4.0–5.0	3.8–4.9		3.5–4.4
PCE inflation	3.3	2.5	2.2	2.0	2.0	3.2–3.4	2.3–2.7	2.0–2.3	2.0–2.2	2.0	3.1–3.8	2.1–3.5	2.0–2.9	2.0–2.7	2.0
June projection	3.2	2.5	2.1		2.0	3.0–3.5	2.3–2.8	2.0–2.4		2.0	2.9–4.1	2.1–3.5	2.0–3.0		2.0
Core PCE inflation[4]	3.7	2.6	2.3	2.0		3.6–3.9	2.5–2.8	2.0–2.4	2.0–2.3		3.5–4.2	2.3–3.6	2.0–3.0	2.0–2.9	
June projection	3.9	2.6	2.2			3.7–4.2	2.5–3.1	2.0–2.4			3.6–4.5	2.2–3.6	2.0–3.0		
Memo: Projected appropriate policy path															
Federal funds rate	5.6	5.1	3.9	2.9	2.5	5.4–5.6	4.6–5.4	3.4–4.9	2.5–4.1	2.5–3.3	5.4–5.6	4.4–6.1	2.6–5.6	2.4–4.9	2.4–3.8
June projection	5.6	4.6	3.4		2.5	5.4–5.6	4.4–5.1	2.9–4.1		2.5–2.8	5.1–6.1	3.6–5.9	2.4–5.6		2.4–3.6

Source: FOMC

Core MoM inflation has eased, but needs to abate more

The Fed Funds rate remains at 5.25-5% (i.e., a central rate of 5.375%), well above both the core PCE inflation rate (4.2% YoY in Jul'23) and the core CPI inflation rate (4.3% YoY in Aug'23). Crucially, both core CPI (+0.3% MoM, or 3.6% annualised) and core PCE (+0.2% MoM, or 2.4% annualised) grew at a more moderate MoM pace than the headline YoY growth pace in the latest month, implying that the momentum of core inflation has begun slowing slightly. But, MoM changes need to abate further if core inflation is to be brought closer to the 2% YoY target – having consistently remained above 4% YoY since Oct'21.

Exhibit 2: Real policy rate positive now, despite core inflation exceeding 4% YoY for nearly 2 years

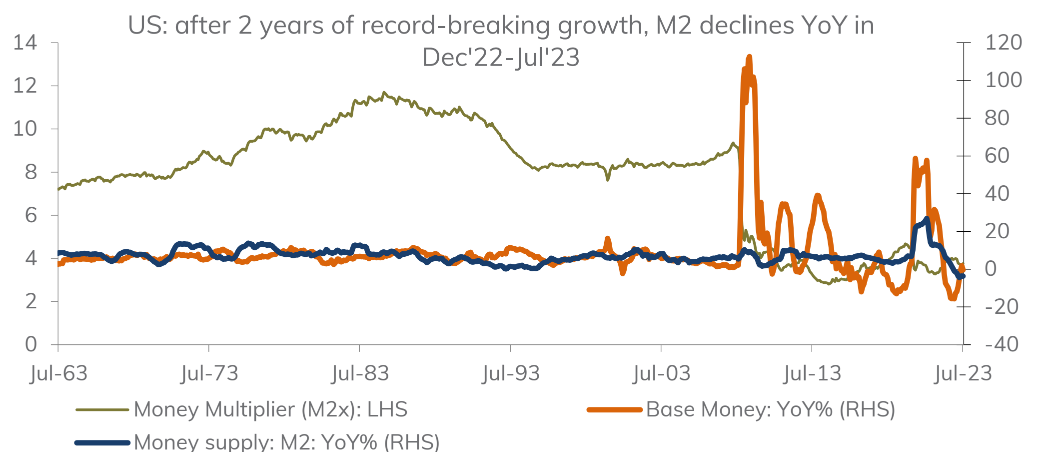


Source: I-Sec, based on data from FRB, Bureau of Economic Analysis, Bureau of Labor Statistics

Eight months of M2 contraction haven't sufficed to rein in core inflation much

Our view since the beginning of CY22 has been that the excessively rapid money supply (M2) growth in Mar'20-Feb'22 (averaging 18.2% YoY over the period, vs an average of 6.8% YoY and a peak of 10.4% YoY in the 60 years preceding covid) would inevitably keep inflation high, force rapid hikes in the Fed Funds rate and result in a recession by CY24 (see Monetary Policy errors have raised the risk of recession by 2024, 7th Apr'22). Since Dec'22, M2 has had to contract YoY (for the first time since 1945) declining 3.7% YoY in Jul'23 as quantitative tightening resumed after a two-month hiatus. But this has not yet sufficed to bring core inflation anywhere near the Fed's 2% YoY target.

Exhibit 3: Resumption of QT, and M2 contracting 3.7% YoY, but core inflation still too high



Source: I-Sec, based on data from FRB and CEIC

With real GDP likely growing over 4% in Q3CY23, expect a 25bp hike in Nov'23

Aided by a large fiscal stimulus, which has taken the US fiscal deficit to 8.6% of GDP in the year to Jun'23 (with a large deficit still likely in the current quarter), US real GDP growth is likely to stay strong in Q3CY23, accelerating to above 4%QoQsaar growth for the quarter. The Atlanta Fed's GDPNow estimate for the quarter is 4.9% growth. Given such rapid growth, and the persistence of excessively high core inflation, the Fed is likely to raise the Fed Funds rate by another 25bp (to a range of 5.5-5.75%, or a central rate of 5.625%) at its next FOMC meeting (ending 1st Nov'23). We have maintained a steady forecast since the beginning of CY23 of the Fed Funds rate peaking at 5.5%, so this represents a slight increase in our forecast target for the Fed Funds rate.

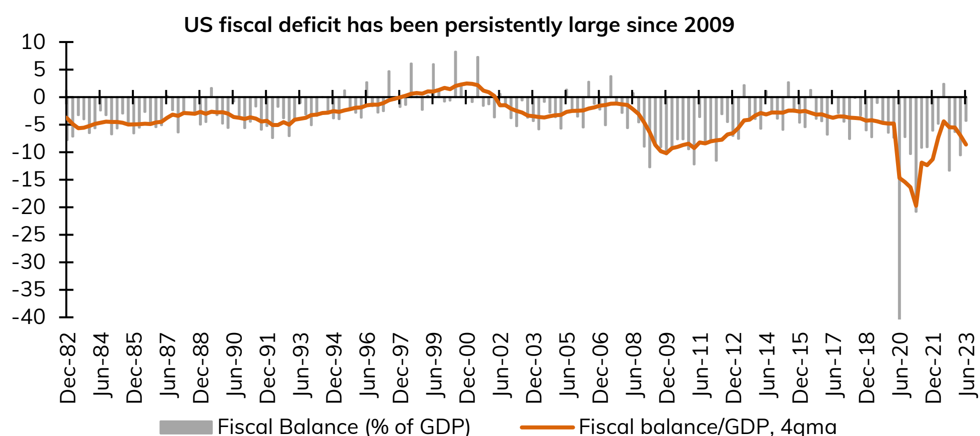
Exhibit 4: US yield curve remains severely inverted, still predicting recession ahead

Source: FRB-St. Louis

Fiscal impulse to weaken as spending restraints and student loan repayments kick-in from Oct'23

The US 10-year minus 2-year yield spread has remained consistently inverted since 5th Jul'22. Although (at -0.63pp currently) the inversion is less severe than at its worst point (-1.08pp on 3rd Jul'23), it continues to signal a recession ahead. We expect that the persistence of high interest rates across maturities will begin to weigh on domestic demand, particularly private consumption. The ongoing fiscal stimulus will diminish as the deficit narrows from Q4CY23, particularly since the spending restraints kick-in at the start of the next fiscal year (Oct'23). And, with President Biden's massive student-loan forgiveness program deemed unconstitutional by the Supreme Court (at the end of Jun'23), at least USD440bn of student-loans, which the Biden administration had sought to forgive, will need to be serviced from 1st Oct'23 onwards. Since Mar'20, there was a moratorium on student-loan repayments as part of the US policy response to the covid pandemic – benefitting 27mn Americans – but that moratorium ended as part of the debt-ceiling deal. As of Sep'23, interest has started accruing on all USD1.6trn of student loans, and repayments must resume from 1st Oct'23. Although US households still have excess savings built up via the three stimulus cheques they received in Apr'20-Mar'21, the additional student-debt service payments are expected to account for 37% of the excess savings of individuals outside the top-20% of income earners, and reduce monthly personal disposable income by 8-9% on average. There will clearly be a significant negative impact on personal consumption (the key driver of the US economy in recent quarters).

Exhibit 5: US fiscal deficit at 8.6% of GDP in the year to Jun'23; to decline from Q4CY23



Source: I-Sec, based on data from US Bureau of Economic Analysis

Stronger USD reining in net external demand, plus fiscal contraction, to still tip the US into recession in Q4CY23-Q1CY24

We expect the USD's NEER (DXY) to continue the rebound that began in the third week of Jul'23. There will be less pressure on the ECB and BoE to tighten policy as headline inflation moderates (since they target headline rather than core inflation), so the yield differential will begin to favour the USD. Thus net exports will be more of a drag on growth in Q4CY23. We expect the combination of a reduced fiscal impulse and a strengthening USD to sufficiently weaken aggregate demand to tip the US into recession in Q4CY23 and Q1CY24, thereby also contributing to further reducing core PCE inflation as M2 contracts YoY through the rest of CY23. The earliest possibility of a US rate cut continues to be in Q2CY24, after core PCE inflation has moderated below 2.5% YoY.

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