Review & Preview
February 12, 2024

US Economy: Soft Landing May Experience a Bumpy Road

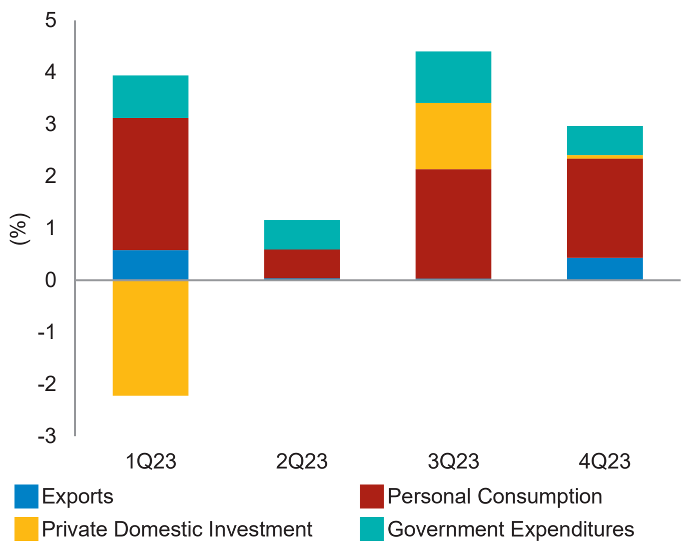
The economy performed well in 2023, but there are signs of a potential slowdown ahead

Principal Takeaways

- The US economy performed better than expected in 2023, owing to strong domestic consumption and government spending.
- The strong labor market and the rise in real wages fueled consumer spending in 2023. However, consumer spending may be slowing down as revolving credit and delinquencies rise.
- The labor market also appears to be moderating, with the number of non-farm jobs declining by almost 2 million from 2022.
- Inflation is down markedly, averaging 4.2% for the year, from its 8.9% peak in June 2022.

The US economy performed better than expected in 2023, growing 2.5%, despite the significant monetary tightening that had taken place over the last few years. Strong domestic consumption led US GDP growth, aided by a tight labor market, growth in real incomes, and positive wealth effects from the housing and stock markets. Government spending has also contributed to economic activity, owing to the passage of the Inflation Reduction Act and the Chips and Science Act, which boosted federal spending. Both private investment and exports had mixed results, but the economy still ended on a positive note, growing by an annualized 3.3% on a fourth quarter basis and bringing positive momentum into 2024 (**Exhibit 1**).

Exhibit 1
US Economy – Components of GDP, 2023



Source: US Bureau of Economic Analysis

To date, both consumers and corporations have been less interest-rate sensitive than in previous tightening cycles. Both consumers and corporations took advantage of the low interest rate environment. Approximately 80% of homeowners have fixed rate mortgages under 5%, shielding them from the mortgage rate spike. Businesses pushed out the duration of debt maturities, alleviating the immediate pressures from higher interest rates. But the ongoing resilience of the US economy may be tested.

Analytical Contact:
Ann Modica, Oldwick
+1 (908) 882-2127
Ann.Modica@ambest.com

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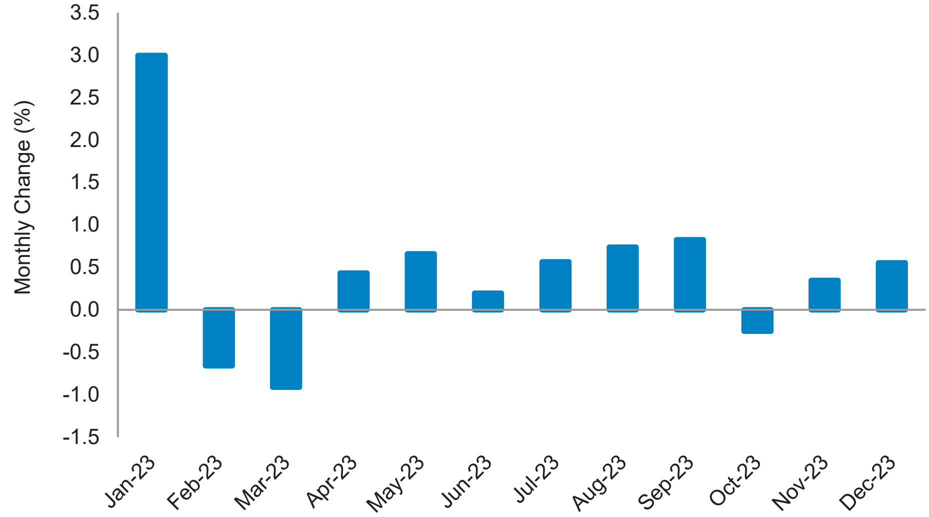
Exhibit 2

US Economy – Retail Sales End Year on High Note



Source: US Census Bureau

Interest rates may be at or near their peak, but the delay in monetary policy transmission could still have a negative impact on growth. Although the Fed is projecting three rate cuts in 2024, monetary policy may remain somewhat restrictive especially as the lagged effect impacts both consumer spending and business decisions. Estimates of the delayed transmission vary, but most place the lag at between one and two years. Recessions tend to occur about eight quarters following an initial Fed rate hike. In this most recent tightening cycle, the Fed first raised rates in March of 2022, bringing the US economy to the two-year mark following the initial hike.

However, the risk of recession—the likelihood that the US will enter recession within the next 12 months—has declined from the previous year. According to the *Wall Street Journal*'s most recent economic survey, there is a 39% probability of the US entering a recession over the next year. Last year, the probability of recession was at 61%. Although the US is not expected to enter recession over the next 12 months, growth is set to slow due to a variety of headwinds including a slowdown in global growth, a mature business cycle, geopolitical tensions, economic uncertainty about the upcoming elections, and the Federal Reserve's timing on interest rate cuts.

Consumers on Solid Footing but Showing Signs of Slowing Down

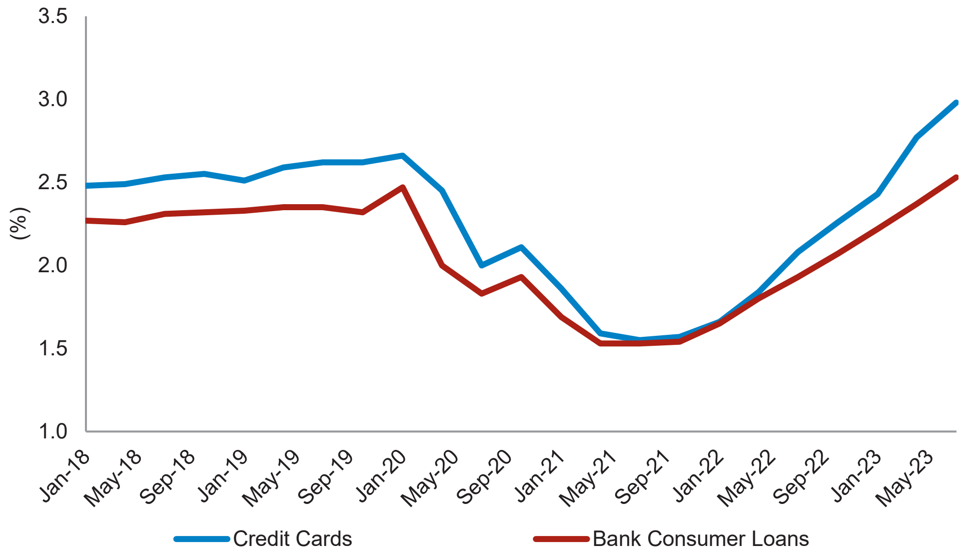
Consumer spending remains the main driver of US economic activity, accounting for almost 70% of GDP. To varying degrees, unprecedented fiscal stimulus, cooling inflation, positive real wage gains, and tight labor markets have all supported domestic demand the last few years. Retail sales numbers throughout the year were relatively strong, and ended the year on a high note, growing by 0.6% in December (**Exhibit 2**).

However, there are signs that consumer spending will moderate in 2024. An expected economic slowdown, dwindling savings, rising debt levels, and a weaker employment outlook could lead to a decline in domestic consumption. There are signs that recent consumption is being partly fueled by revolving credit. According to the most recent Federal Reserve Consumer Credit release, revolving credit was up by more than USD 1.1 trillion from November 2022 to November 2023, an increase of 9.5%. Although the report does not note whether the outstanding balances are being paid off before interest is due, there is some cause for concern. Credit card and auto loan delinquencies, which began rising in 2022, now exceed pre-pandemic levels, particularly for lower-income households (**Exhibit 3**).

Increased delinquencies are occurring at a time when consumer savings are being depleted and consumer loans/credit are likely being used, at least partly, to fund consumption (**Exhibit 4**). Another balance sheet pressure on millions of households is the resumption of student loan payments in October 2023, after three years of reprieve. According to the Department of Education, approximately 43 million borrowers owe over USD 1.5 trillion in student loan debt, with the average debt at approximately USD 37,000. Although the impact on total growth will be only slightly negative on the margin, it is another headwind for consumer spending.

Exhibit 3

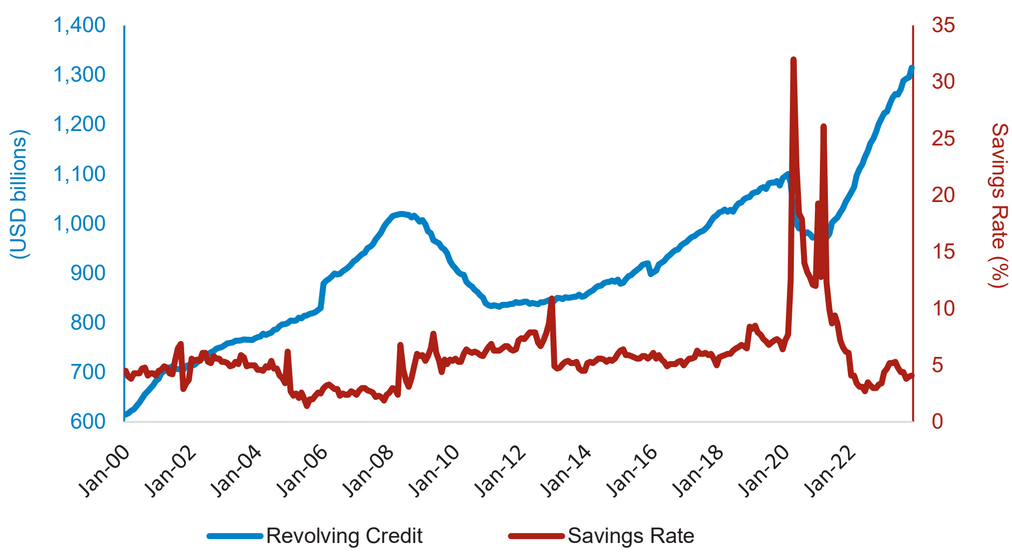
US Economy – Consumer Deliquencies Above Pre-Pandemic Levels



Source: Board of Governors of the Federal Reserve System

Exhibit 4

Credit Increasing as Savings Decline



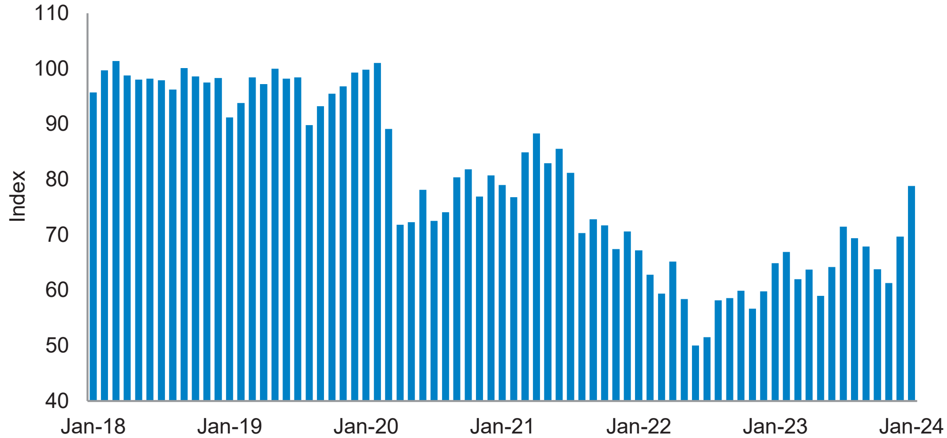
Source: US Bureau of Economic Analysis

On the bright side, consumer sentiment continues to improve. At the end of 2023, consumer sentiment had risen due to dwindling concerns about high inflation and the expectation that inflation would continue to moderate. In January 2024, consumer sentiment reached its highest level since July 2021, as consumers believed that inflation would continue to moderate and that incomes would increase over the next 12 months. However, sentiment is still well below rates seen prior to the pandemic (**Exhibit 5**).

Labor Market Appears to be Moderating, But Is There a Long-term Structural Issue on the Horizon

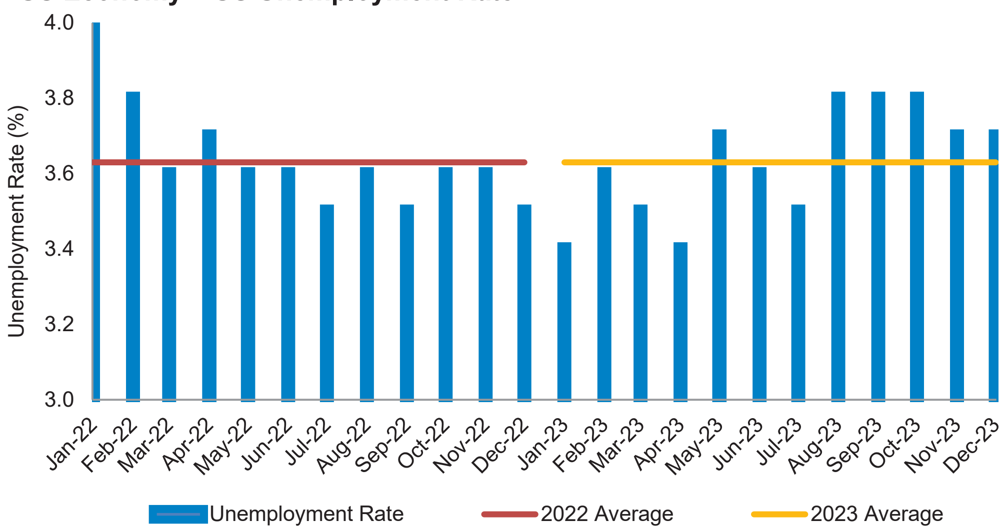
The labor market has also been another bright spot for the US economy and consumers. At the end of 2023, the unemployment rate was 3.7%, with the number of unemployed persons at 6.3 million, although both metrics had deteriorated slightly from 2022. In December 2022, the unemployment rate was 3.5% and the number of unemployed people, 5.7 million.

Exhibit 5
US Economy – Consumer Sentiment Improves



Source: University of Michigan

Exhibit 6
US Economy – US Unemployment Rate

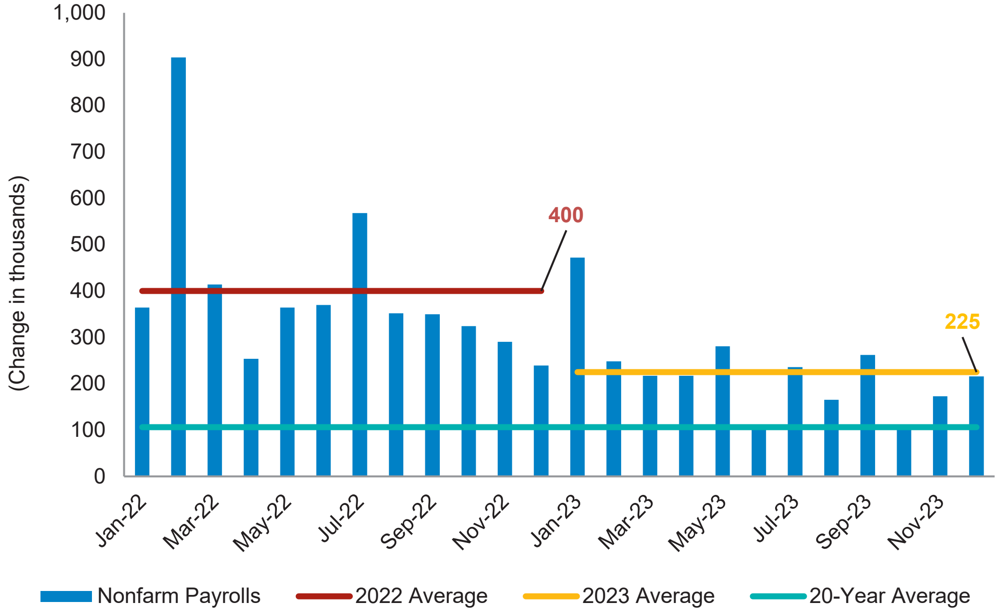


Source: AM Best data and research

Although the unemployment rate ended the year slightly higher than in 2022, the annual average unemployment rate was 3.6% in both 2022 and 2023 (**Exhibit 6**). The average number of nonfarm payrolls added each month declined significantly year over year, to 225,000 from 400,000 in 2022. A total of 4.8 million jobs were added in 2022, versus 2.7 million jobs added in 2023. Job gains have been largely concentrated in sectors (health care, government, construction, and social assistance) with large job losses during the pandemic. Still, although the labor market has moderated somewhat, with the unemployment rate up marginally and the number of jobs added down slightly, it remains relatively strong from a historical perspective (**Exhibit 7**).

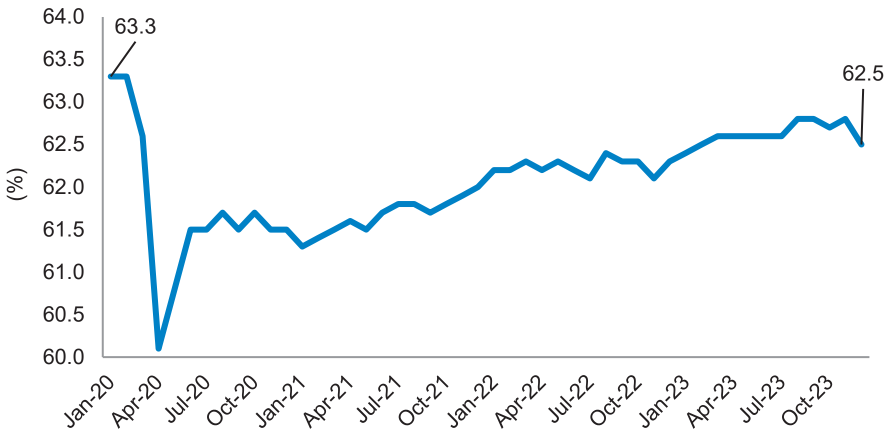
The decline in labor participation was already an issue before the pandemic, but COVID exacerbated this trend, with current participation rates still below pre-pandemic levels. In January 2020, just prior to the start of the pandemic, labor participation was 63.3% but then dropped precariously to a low of 60.1% as the economy shut down at the start of the pandemic. Thousands of people have subsequently entered the workforce, but the current labor participation rate of 62.5% is still well below the pre-

Exhibit 7
US Economy – Monthly NonFarm Payrolls



Source: US Bureau of Labor Statistics

Exhibit 8
US Economy – Labor Participation Rate



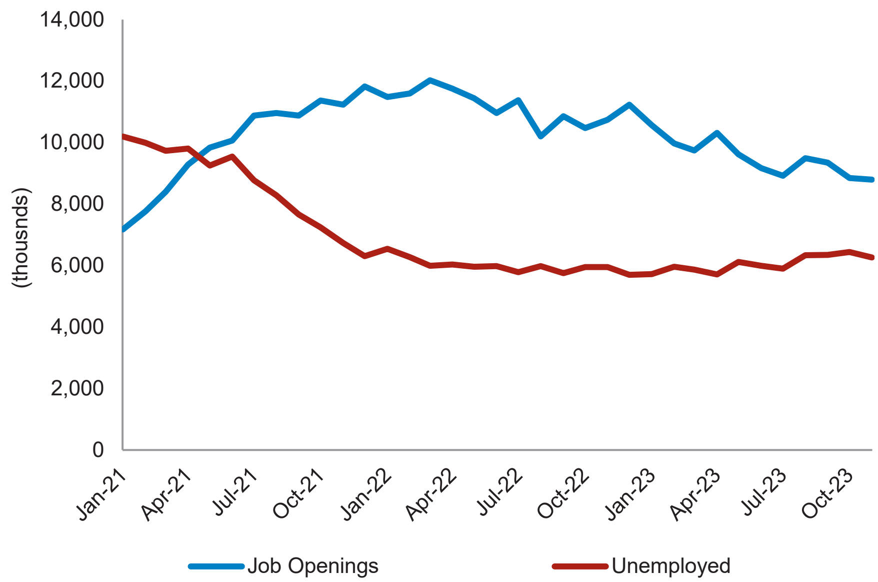
Source: US Bureau of Labor Statistics

pandemic level, (**Exhibit 8**). According to the US Department of Commerce, nearly every industry is feeling the impact of fewer workers, as an estimated two million workers are missing from the labor force when compared with the start of the pandemic. The gap has been narrowing, but the number of open jobs is still higher than the number of unemployed individuals (**Exhibit 9**).

The shortage of laborers has many causes, but decreased immigration and early retirements were two of the major causes during the pandemic. Despite some improvement in rising immigration levels in recent years, the aging of the US population and fewer laborers constitute a longer-term structural issue. And the issue is not expected to get any better, as baby boomers continue to retire and birth rates continue to fall (**Exhibit 10**). If the shortage cannot be addressed by technological improvements to improve productivity or by increasing the labor force, labor shortages could lead to an ongoing rise in wages over the longer term, which would have inflationary and economic growth implications.

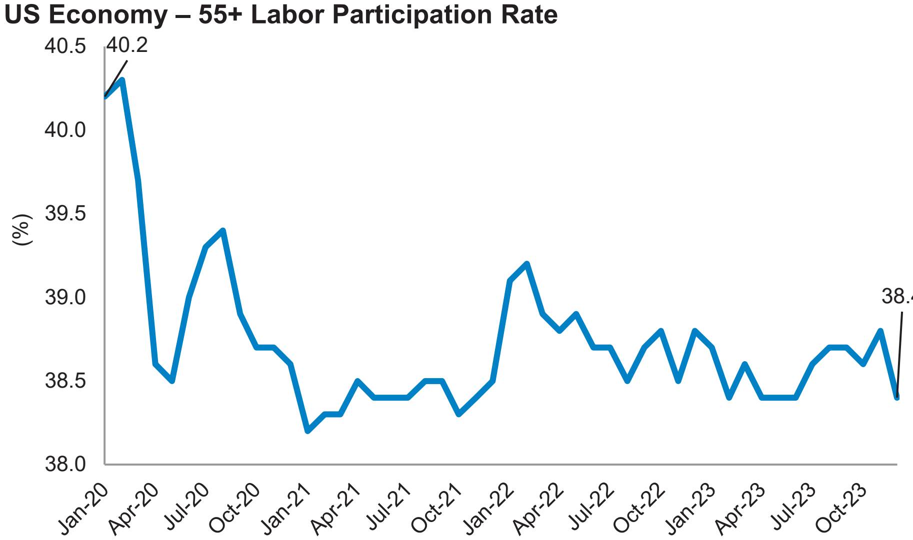
Real wage growth turned positive in the second half of 2023. Real wage growth had turned negative in April of 2021 about a year after the start of the pandemic, as inflation rose, reaching a peak of almost 9.0% in June 2022. Although inflation has been declining from the peak, real wage growth remained negative through May 2023, before turning positive again in June 2023 (**Exhibit 11**). Wage growth averaged approximately 4.3% for the year, and employers are projecting average salary increases of 4.0% in 2024.

Exhibit 9
US Economy – Job Openings versus Unemployed



Sources: US Bureau of Labor Statistics, AM Best calculations

Exhibit 10
US Economy – 55+ Labor Participation Rate



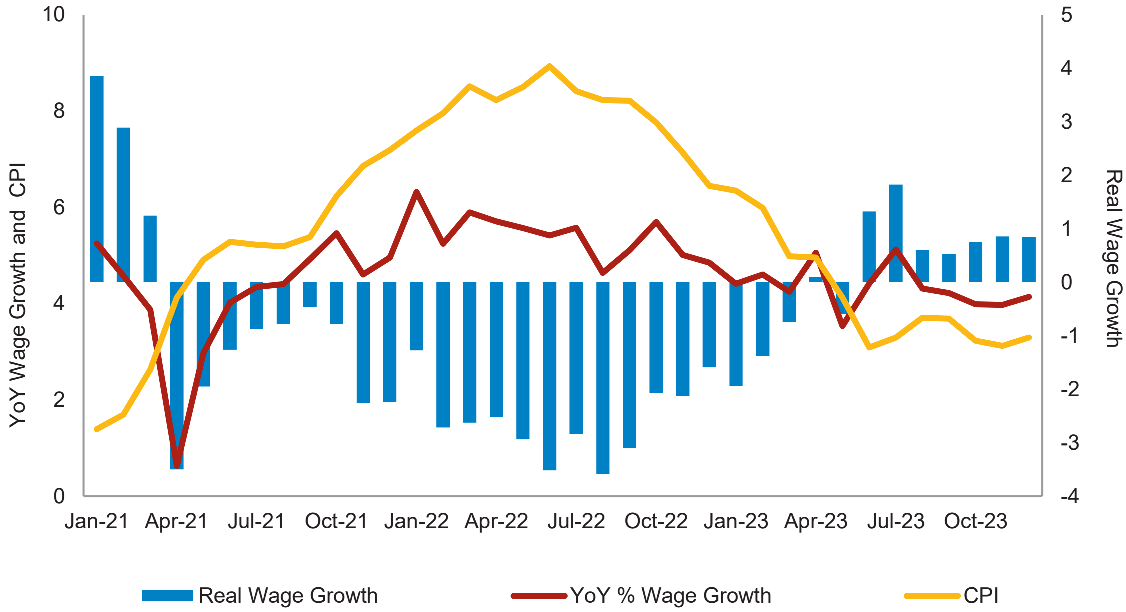
Source: US Bureau of Labor Statistics

Inflation Moving Towards Fed's Target

Inflation continues to move down towards the Federal Reserve's target of 2.0% and is likely to continue to fall in the upcoming year, as economic growth is expected to slow and prices continue to return to equilibrium. Headline inflation started the year at 6.3% and ended at 3.3%, averaging 4.2% for the year. Core inflation, which strips out volatile energy and food prices, also declined, although it was a bit stickier. Core inflation started the year at 5.5% and ended it at 3.9%, averaging 4.8% for the year. PCE (personal consumption expenditures) inflation, the Federal Reserve's preferred measure of inflation, also declined in 2023. All inflation measures are trending down towards the Fed's 2.0% target. Significant progress has been made from the peak inflation rates of almost 9.0% (headline inflation) in June 2022 and 6.7% (core inflation) in September 2022 (**Exhibit 12**).

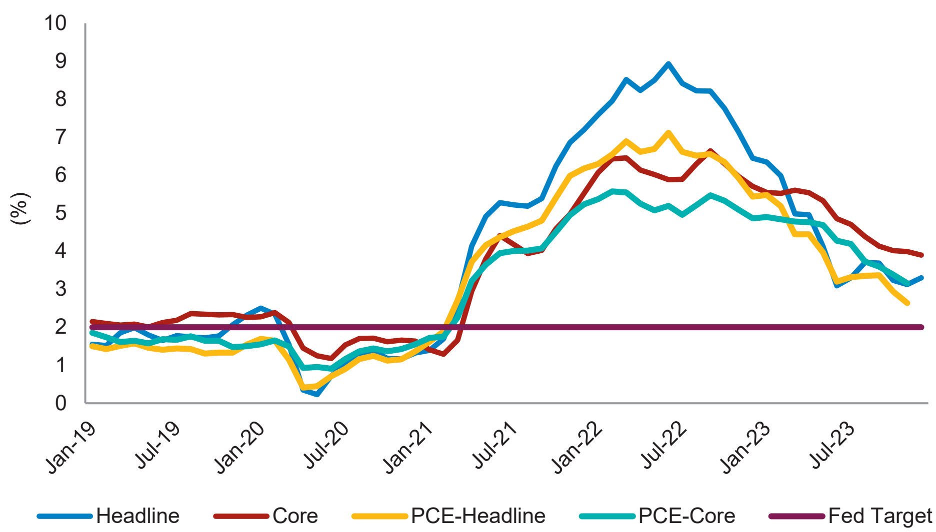
Inflation for goods, which skyrocketed during the pandemic, moderated last year, and turned disinflationary in 2023, as supply chain disruptions and the demand for goods eased. Service

Exhibit 11
US Economy – Real Wages



Sources: US Bureau of Labor Statistics, AM Best calculations

Exhibit 12
US Economy – Inflation Continues Towards Fed's Target

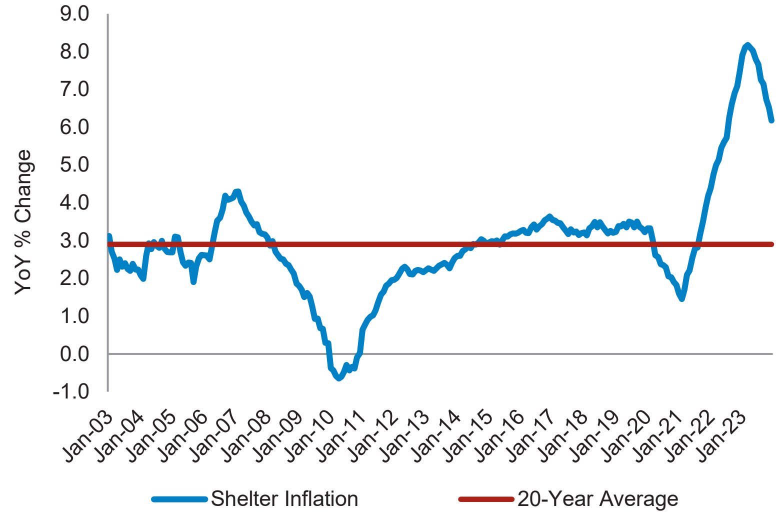


Source: US Bureau of Economic Analysis

inflation peaked in January 2023 at 7.6% but trended downward throughout the year. However, the largest component of the index, shelter inflation, remained well above the 20-year historical average of approximately 3.0%, registering at 6.2%, more than double the historical average, despite declining from the highs earlier in the year. Rents are a lagging indicator (renters tend to renew leases annually so price changes take longer to cycle through), so shelter inflation should fall during the year, putting further downward pressure on inflation (**Exhibit 13**). Inflation expectations remain anchored, with medium- to long-term expectations in the range of expectations seen just prior to the start of the pandemic.

Exhibit 13

US Economy – Shelter Inflation



Source: US Bureau of Labor Statistics

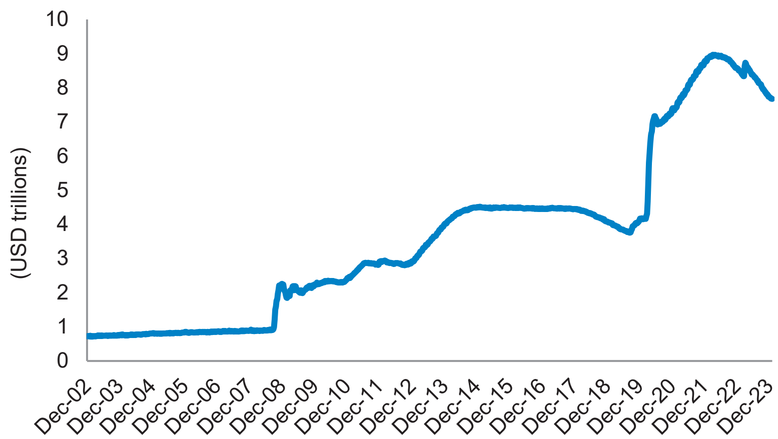
Over the short term, however, inflationary risks are tilted to the downside given the precarious geopolitical environment. Various conflicts around the world have the potential for supply chain disruptions and commodity price shocks, which would increase costs and cause higher inflation. Medium- to longer-term trends also appear to be tilted to the downside and will be harder for central bankers to address. Supply constraints (particularly for housing and labor), deglobalization, and higher fiscal deficits could all result in above trend inflation over the longer term.

Federal Reserve Takes Dovish Pivot in December 2023

The Fed raised the federal funds rate by a total of 100 basis points in 2023, with the last hike in July. Since March 2022, the Fed has increased rates by 500 basis points, bringing the federal funds rate to a range of 5.25% to 5.50%. However, the Fed appears to have reached a peak in the hiking cycle and has signaled that rate cuts are on the horizon for 2024.

Exhibit 14

US Economy – Federal Reserve Balance Sheet



Source: Board of Governors of the Federal Reserve System

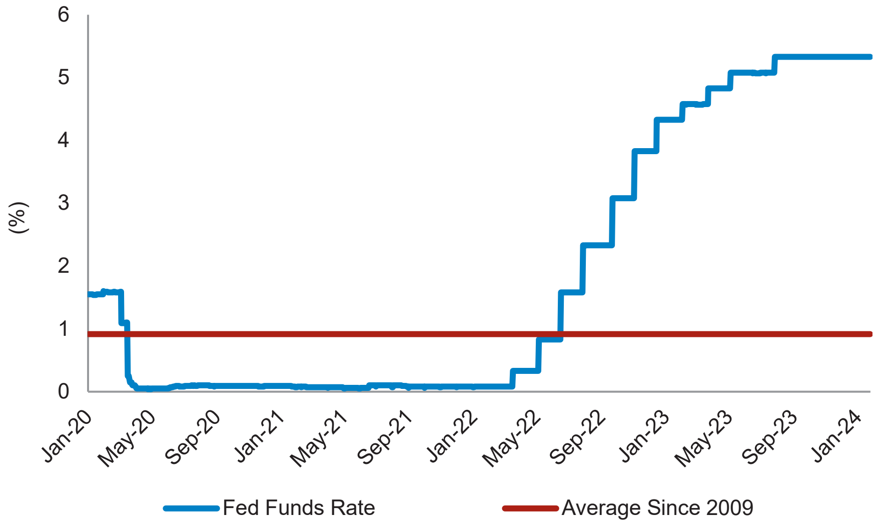
The Fed appears to have pivoted in December 2023, when it revised its projections with a more "dovish" stance, projecting three 25 basis point cuts to the fed funds rate in 2024. This would bring the current fed funds rate of 5.375% to 4.625% by the end of 2024. During the pivot in December, market expectations were double those of the Fed, pricing in cuts amounting to 150 basis points. Markets have recently pulled back somewhat on their expectations owing to macroeconomic data and Fed remarks.

The central bank also continues to tighten financial conditions by shrinking its balance sheet. At the start of the pandemic, the Fed held approximately USD 4 trillion in assets on its balance sheet, which ballooned to a high of almost USD 9 trillion in mid-2022. From the peak to the end of 2023, the balance sheet has shrunk by over USD 1.2 trillion, bringing it to USD 7.7 trillion (**Exhibit 14**).

Although interest rates are expected to come down this year, there have been discussions about the potential for a higher neutral rate (an interest rate that neither restricts nor stimulates economic growth). Since 2009, the fed funds rate has averaged slightly under 1.0%. Currently, the Federal Reserve is forecasting a long-term fed funds rate of 2.5% (**Exhibit 15**). Although it's too early to determine if the rate will trend higher, there are reasons for the potential neutral rate increase.

One is the surprising resilience of the US economy during this current period of monetary tightening. Richmond Federal Reserve President Tom Barkin has stated that, "If the economy is running above potential at 5.25% (nominal interest rates, then that suggests to me that the neutral rate might be higher than we've thought," while noting it is still too early to tell.

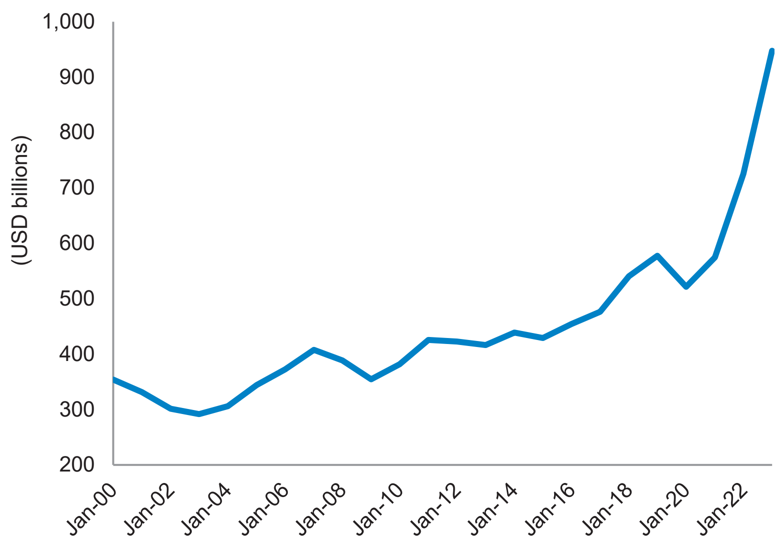
Exhibit 15
US Economy – Federal Funds Rate



Sources: Board of Governors of the Federal Reserve System, AM Best calculations

Looser fiscal policy could also cause a higher long-term neutral rate. Over the last few years, monetary policy and fiscal policy have been working against each other. While the Fed was tightening policy to rein in inflation, the government undertook expansionary fiscal spending with fiscal deficits running approximately 7%-8% of GDP (which, all else being equal, is known to be inflationary). If the government continues to spend, and fiscal deficits continue to grow, policy rates are likely to remain higher due to the inflationary impact. Additionally, public debt is becoming a larger concern, with interest payments almost twice as much as they were three years ago (**Exhibit 16**). A recent negative outlook change on the US credit rating, coupled with its rising debt, may have markets requiring a high-risk premium to fund future government spending.

Exhibit 16
US Economy – Government Interest Payments



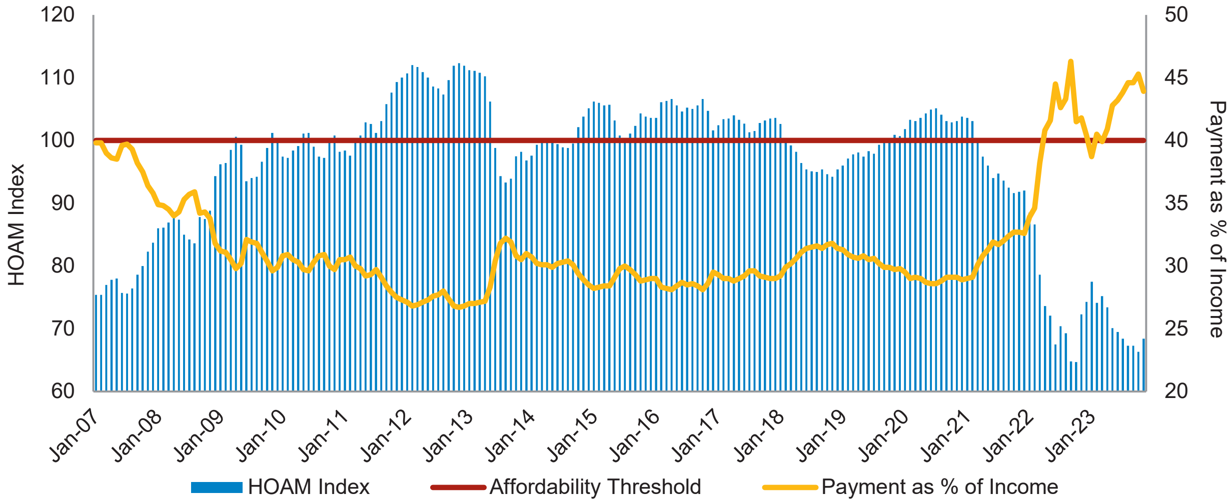
Source: US Bureau of Economic Analysis

One of the Worst Housing Markets in Decades, But Is There Light at the End of the Tunnel?

High interest rates and elevated home prices continue to negatively impact the housing market, with sales hitting just over four million units, the lowest number in nearly three decades. Home prices increased modestly in 2023, but prior appreciation kept home prices high. As a result, home affordability remains at near-record low levels. The Federal Reserve Bank of Atlanta's Home Ownership Affordability (HOAM) Index tracks the affordability of housing by looking at interest rates, median home prices, and median income, and to what degree these metrics affect housing affordability. The index uses the Housing and Urban Development (HUD) standard 30% share of

Exhibit 17

US Economy – Housing Affordability (HOAM) Index



Source: Federal Reserve Bank of Atlanta

income threshold spent on housing to measure affordability. A HOAM index lower than 100 would indicate that median household income would be insufficient to cover the cost of owning a median-priced home, when the housing cost is greater than 30% of income, while one greater than 100 would indicate that housing costs are lower than the 30% income threshold.

In the most recent national affordability survey in November 2023, both the HOAM Index and the percentage of income used for housing had improved from October 2023 (one of the worst months for affordability on record). In October 2023, 45.3% of the national median income would have been necessary to pay for a median-priced home. That fell slightly to 43.9% in November 2023, still well above HUD's affordability threshold of 30% (**Exhibit 17**).

The large increase in mortgage rates has played a significant role in the run up of housing affordability. Since the start of 2022, interest rate hikes have led to 30-year mortgages more than doubling. In 2022, the 30-year fixed mortgage rate started the year at 3.2% and ended 2023 at 6.6%. In 2023, mortgage rates hit a high of 7.8% in October, before coming down at the end of the year. Mortgage rates are expected to come down in 2024 once the Federal Reserve begins cutting interest rates (**Exhibit 18**).

The large differential in mortgage rates over the last few years has been one of the contributing factors to the lack of homes for sale. Many existing homeowners are "rate locked"—in mortgages with mortgage rates much lower than the currently prevailing rate. This creates a disincentive for homeowners to move from their current home if they need to move and finance the new home (at a higher mortgage rate). Currently an estimated 80% of mortgages have mortgage rates under 5.0% (**Exhibit 19**).

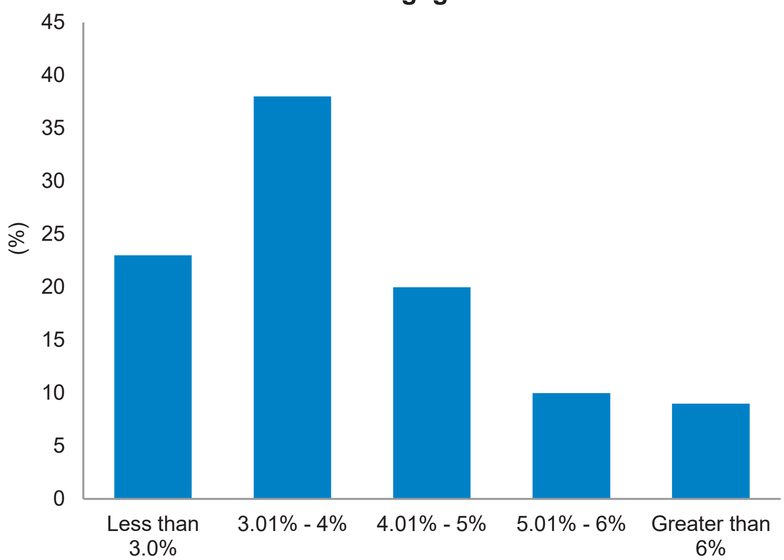
Exhibit 18

US Economy – 30-Year Fixed Mortgage Rate

Source: Freddie Mac

Exhibit 19

More than 60% of Current Mortgages Under 4.0%



Source: Freddie Mac

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A.M. Best Company, Inc.
A.M. Best Rating Services, Inc.
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY
A.M. Best América Latina, S.A. de C.V.
Av. Paseo de la Reforma 412, Piso 23,
Col. Juárez, Alcadía Cuauhtémoc, C.P. 06600, México, D.F.
Phone: +52 55 1102 2720

EUROPE, MIDDLE EAST & AFRICA (EMEA)

LONDON
A.M. Best Europe - Information Services Ltd.
A.M. Best Europe - Rating Services Ltd.
12 Arthur Street, 8th Floor, London, UK EC4R 9AB
Phone: +44 20 7626 6264

AMSTERDAM
A.M. Best (EU) Rating Services B.V.
NoMA House, Gustav Mahlerlaan 1212, 1081 LA Amsterdam, Netherlands
Phone: +31 20 308 5420

DUBAI*
A.M. Best Europe - Rating Services Ltd. - DIFC Branch*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780
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ASIA-PACIFIC

HONG KONG
A.M. Best Asia-Pacific Ltd
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
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