Visa Business and Economic Insights

U.S. Economic Outlook

The Fed tightens the screws

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As we have been indicating for months now, we expect first quarter gross domestic product (GDP) growth to contract. This has nothing to do with how consumers and businesses are spending and investing, but rather the wild swings in inventory building over the previous two quarters. In the fourth quarter of last year, inventories added a whopping 5.3 percentage points to GDP, accounting for the bulk of growth during the quarter. However, these gains were quickly countered by Omicron-related supply chain disruptions. We estimate that the subsequent downshift in inventory building reduced GDP growth in Q1 by 1.5 percentage points.

Looking beyond the volatility of the last two quarters, we see economic growth expanding 2.6 percent this year. Among the key changes to our forecast this month is a downward revision to our outlook for real consumer spending, as inflation and significantly higher interest rates throttle back the pace of real spending activity. While real consumption growth began the year on solid footing (rising an estimated 3.9 percent), we see it moderating at an annualized pace of between 2 and 2.5 percent over the coming quarters. We are also less optimistic on the housing front. Much higher housing prices combined with surging mortgage rates will likely keep a lid on residential investment in the second half of this year. Another considerable change to the outlook is the pace of the Federal Reserve's rate hikes. We now expect 50 basis point hikes in the next two meetings before the Fed reverts to 25 basis point hikes each quarter through the rest of this year and the first three quarters of 2023. The result will be higher rates across the yield curve and economic growth that bounces back to the boring 2.0-2.5 percent growth rates experienced before the pandemic.

Key Points:

- GDP expected to bounce back in Q2
- More aggressive Fed rate hikes coming
- Recession not likely in our view

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

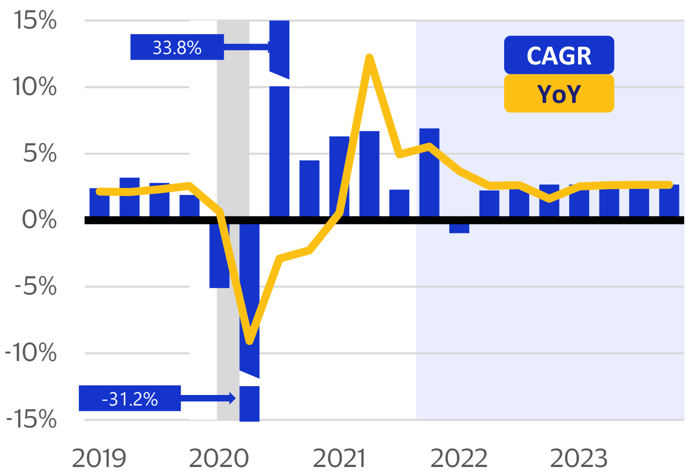
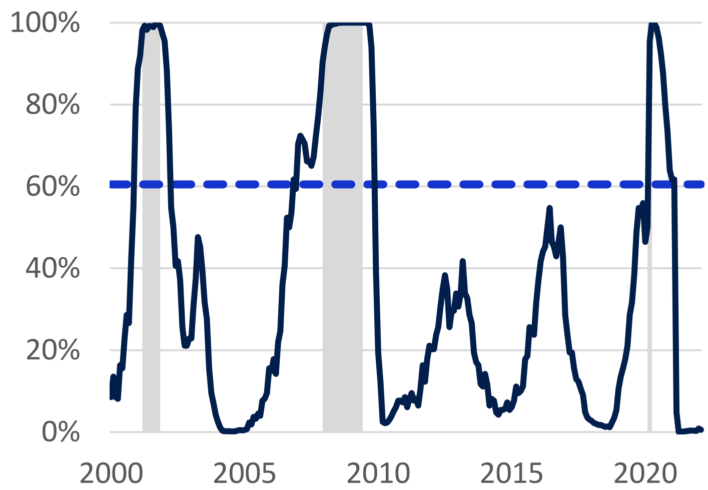


Fig. 2 BEI recession probability in the next 12 months** (SA, percent)



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

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Inflation continues to chip away at spending

On the surface, consumer spending looks solid. Job gains have been robust and average hourly earnings are growing to the tune of 5.6 percent on a YoY basis. Under the surface, however, signs of softness are emerging. While nominal consumer spending has held up, month-over-month gains in real (inflation-adjusted) spending have been negative for three of the last four months. Continued, elevated inflation pressures that erode consumer purchasing power remain the dominant narrative. There is reason to believe that consumer spending growth will face even more headwinds in Q2. Fiscal stimulus effects from last year will weigh on YoY income and spending growth as we lap the strong spending growth. Outside of fiscal policy changes, the Fed has begun the process of hiking interest rates, thus raising the cost of borrowing. Finally, in our view, inflation has not yet peaked, which indicates that the worst is yet to come in terms of price pressures on consumers.

In this month's outlook, inflation (as measured by the PCE deflator) is likely to top out at 6.4 percent YoY in Q2. While some categories of inflation—namely oil and home prices—are expected to moderate later this year, others, such as apartment rents and other services, will likely keep headline inflation well above the Fed's 2 percent target through the middle of next year. While we do not expect an outright contraction in consumer spending, we do expect more modest growth ahead, on par with pre-pandemic levels.

Don't believe the hype

One of the major headlines to emerge recently is the inversion of the yield curve: this occurs when the two-year Treasury rate moves above the 10-year rate. When looking at the history, we found that while it is true that such an inversion has happened before a downturn, the track record is mixed. Since 1980, the inversion of the 10s/2s part of the yield curve has predicted 12 of the last five recessions—in other words, it raises a lot of false alarms. Rather than relying on one metric such as the yield curve, we leveraged the Conference Board's Leading Economic Index and constructed our own in-house model. Using this index constructed of a broad range of economic and financial market variables, we see the risk of recession as less than 5 percent over the next 12 months (Fig. 2). If recessions are defined as broad-based slowdowns in economic activity, then current economic data do not support the case for recession.

Risks to the outlook

Geopolitical uncertainty poses the main risk to this month's outlook. Should a cease-fire or peace agreement be reached in Ukraine, oil and other commodity prices could stabilize faster than expected, which would add downside risk to our inflation forecast and upside risk to GDP growth. On the downside, it remains to be seen how consumers will respond to ongoing high inflation and rapidly increasing borrowing costs as the Fed hikes rates. Given the rapidly changing rate environment, we also expect greater uncertainty around business investment.

	Actual				Forecast				Actual		Forecast	
	2021				2022				2020	2021	2022	2023
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Gross Domestic Product (CAGR)	6.3	6.7	2.3	6.9	-1.0	2.2	2.5	2.7	-3.4	5.7	2.6	2.6
Personal Consumption	11.4	12.0	2.0	2.5	3.9	2.1	2.4	2.3	-3.8	7.9	3.2	2.3
Business Fixed Investment	12.9	9.2	1.7	2.9	13.6	11.3	8.0	7.5	-5.3	7.4	8.2	7.6
Equipment	14.1	12.1	-2.3	2.8	15.2	14.4	8.3	7.5	-8.3	13.1	8.8	7.9
Intellectual Property Products	15.6	12.5	9.1	8.9	9.4	11.5	9.8	9.1	2.8	10.0	9.9	8.8
Structures	5.4	-3.0	-4.1	-8.3	1.9	1.5	2.0	2.8	-12.5	-8.0	-1.2	3.2
Residential Construction	13.3	-11.7	-7.7	2.2	4.3	-0.9	0.4	0.2	6.8	9.2	-0.4	0.6
Government Purchases	4.2	-2.0	0.9	-2.6	0.5	1.1	1.2	1.5	2.5	0.5	0.1	1.6
Net Exports Contribution to Growth (%)	-1.6	-0.2	-1.3	-0.2	-2.1	-0.4	-0.4	-0.3	-0.3	-1.4	-1.0	-0.4
Inventory Change Contribution to Growth (%)	-2.6	-1.3	2.2	5.3	-1.5	-0.6	-0.2	0.0	-0.5	0.4	0.6	-0.1
Nominal Personal Consumption (YoY % Chg.)	3.9	20.7	11.7	12.8	11.7	9.2	8.8	7.4	-2.6	12.1	9.2	4.6
Nominal Personal Income	16.1	1.6	5.3	7.2	-3.4	2.9	2.7	2.7	6.5	7.4	1.2	3.8
Retail Sales Ex-Autos	11.6	28.5	15.8	18.7	13.0	7.4	6.4	4.6	0.3	18.4	7.7	2.7
Consumer Price Index	1.9	4.8	5.3	6.7	7.9	7.3	6.5	5.3	1.2	4.7	6.7	2.9
Federal Funds Rate (Upper Bound)	0.25	0.25	0.25	0.25	0.50	1.50	1.75	2.00	0.25	0.25	1.44	2.56
Prime Rate	3.25	3.25	3.25	3.25	3.50	4.50	4.75	5.00	3.54	3.25	4.44	5.56
10-Year Treasury Yield	1.74	1.45	1.52	1.52	2.32	2.44	2.68	2.85	0.89	1.45	2.57	3.05

Forecast as of: April 7, 2022

Interest rates presented are end of quarter rates

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

Forward Looking Statements

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Accessibility notes

Fig. 1

GDP CAGR ranges from 2.4% in Mar-2019, to a low of -31.2% in Jun-2020, a high of 33.8% in Sep-2020, and the latest reading of 6.9% in Dec-2021, with the GDP CAGR forecast to finish 2022 at 2.7% and 2023 at 2.7%. YoY GDP growth ranges from 2.2% in Mar-2019 to a low of -9.1% in Jun-2020, a high of 12.2% in Jun-2021, and the latest reading of 5.0% in Dec-2021, with YoY GDP growth forecast to finish 2022 at 1.6%, and 2023 at 2.7%.

Fig. 2

BEI recession probability model results, which range from 8.6% in Jan-2000 to a high of 100% in Oct-2000, May-2008 and April 2020. Historically, when the model results climb above 60.5%, a recession follows.