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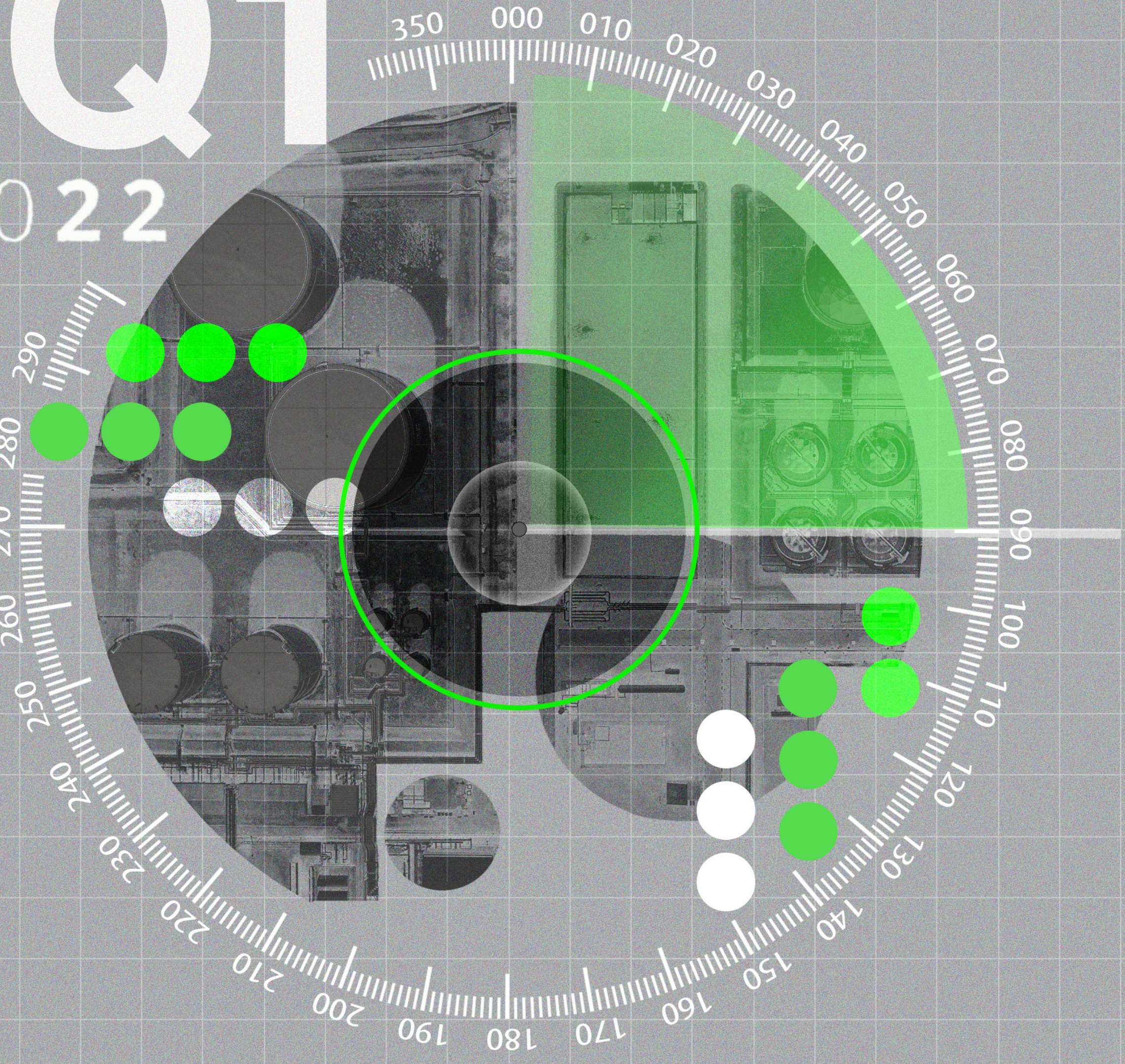
2022



United States Economic Forecast

The Q1 2022 forecast examines the impact of the Ukraine crisis, persisting inflation, and the lingering effects of COVID-19 on the US economy

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The Russia-Ukraine war won't derail the recovery

THE US ECONOMY'S performance in the past few months has been better than what most people expected—or even realized. While Omicron took infection rates to a new high, little trace of it appeared in economic data. Inflation and related problems, such as tangled supply chains, may continue to challenge business leaders and policymakers—but the US economy is performing well by most measures:

- The unemployment rate is already back to the full employment level.
- The labor force participation rate has started to pick up, as some of the folks who left the labor force are coming back to work.
- Corporate profits are more than satisfactory. Profits in Q3 2021 were 21% above the prepandemic level. That's much better than many businesses had reason to expect when the pandemic first hit in March 2020.
- Strong profits have supported business investment. The pandemic shifted investment away from buildings and toward equipment and information products.[1] But the willingness to invest suggests that businesses are surprisingly optimistic about the future.
- The pandemic drove the adoption of technology and—as a consequence—appears to have accelerated labor productivity growth. Previous Deloitte forecasts assumed that trend productivity was less than 1%. But productivity growth has remained surprisingly strong during the recovery from the pandemic, about 2% over the four quarters to December 2021. If productivity growth remains high, many of the long-term issues facing the US economy—such as financing social security—will likely become considerably easier to solve.

But just as Omicron's potential to impact the economy waned, geopolitical tensions increased. The Russian invasion of Ukraine is not likely to derail the US recovery, but it will push up inflation in the short run.

The US economy is likely to feel the impact of a continuing Ukraine crisis through two main channels.

- Most importantly, the price of oil is likely to remain higher than it would have otherwise—although how much higher is an open question. Russia produces about 12% of global crude oil supplies. Sanctions may remove some of this oil supply, as the United States (and possibly some European countries) reduce or end purchases of Russian oil.

  However, oil is a global, fungible commodity and Russia can still sell oil to nonboycotting nations. That would release other oil for shipment to boycotting countries without affecting the global price of oil. Of course, payments may be more difficult, and Russia may need to sell its oil at a discount. But the size of the supply shock may be more limited than that 12% figure suggests.

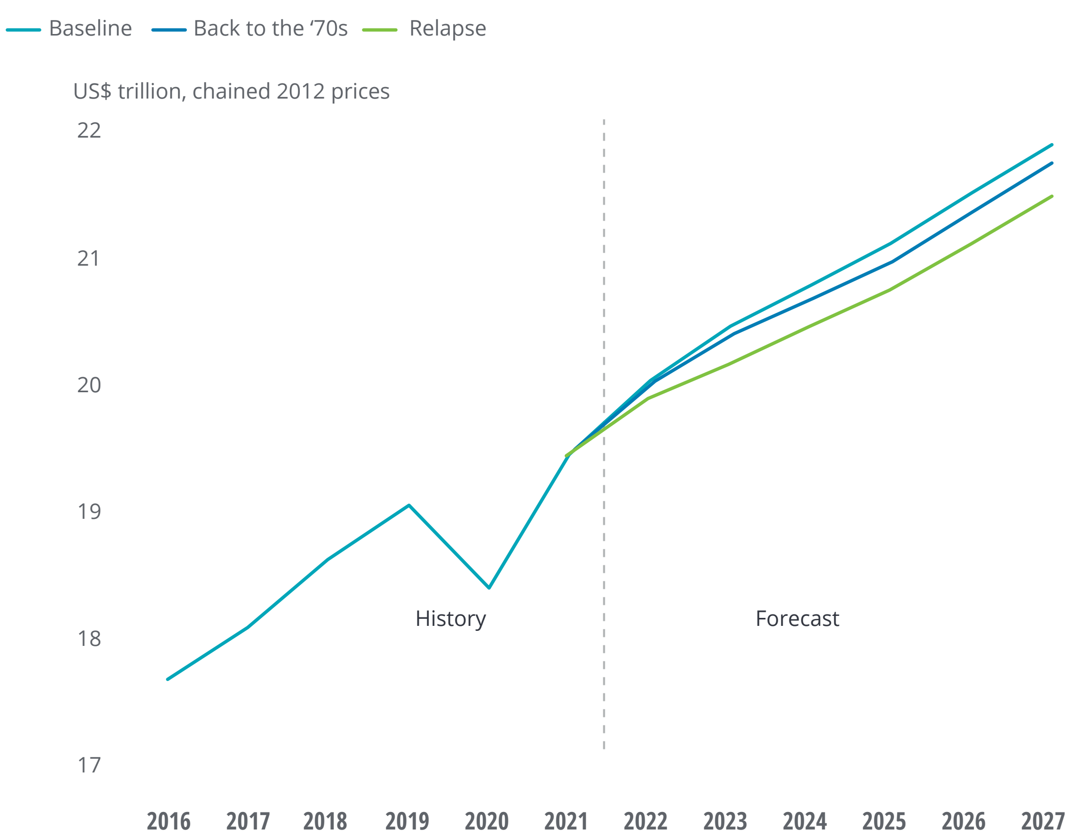
- Europe's heavy dependence on Russian natural gas suggests that the European Union's economy will experience slower growth—or, in the extreme case, a recession. The EU is a major trading partner of the United States, accounting for more than 15% of US exports. On top of a direct decline in demand, dollar appreciation reflecting the relative safety of the United States will make US goods less competitive. Both would reduce the contribution of exports to US GDP growth.

The combined impact is not large enough to generate a recession in the United States—but growth could slow down. And inflation would pick up, at least in the short term. Our baseline forecast assumes a US$15 per barrel rise in the price of oil, which leads to an extra half-a-percentage-point rise in the consumer price index (CPI) in 2022 (with most of the rise occurring in the second quarter). That's not huge, but during a period when the Fed is struggling to control inflation, it presents policymakers with a big problem.

Before the invasion, we had penciled in five 25-basis-point Fed hikes in 2022, starting in March. Despite this bump in inflation, we don't think the Fed's interest-rate trajectory is likely to change. Our reasoning: The Fed knows that the extra inflation is (to use that banished word) "transitory." And the extra inflation will be associated with some additional unemployment, which would call for the Fed to ease. In our forecast, the reasons for easing offset the reasons for raising rates, leaving policy unchanged from the preinvasion path.

FIGURE 1

Real GDP, US$ trillion



Source: Deloitte analysis.

We've also assumed a small impact on exports. First, growth in Europe is likely to take a hit of as much as half a percentage point, even if natural gas deliveries from Russia aren't interrupted. Second, any geopolitical crisis pushes investors to buy safe assets, mainly US dollars. The dollar's appreciation will make US exports less competitive.

And keep in mind: COVID-19 hasn't gone away. While the probability of the disease becoming both less deadly and endemic is rising, new mutations could change things quickly. We continue to carry a scenario in which COVID-19 once again slows the economy.

Scenarios

Baseline (55%): Growth continues in 2022 as the impact of COVID-19 wanes, although some slowing occurs as the economy reaches full employment, monetary policy becomes tighter, COVID-19–era fiscal impulse reverses, and the Ukraine crisis raises energy prices and the dollar temporarily. Households continue to increase spending on pent-up demand for services such as entertainment and travel. However, spending on durable goods stalls as consumers switch back to prepandemic patterns. Business investment continues to grow rapidly, particularly in information-processing equipment and software. Investment in nonresidential structures remains weak, however, as the oversupply of office buildings and retail space weighs on the market. The infrastructure spending bill raises the level of government spending modestly for most of the forecast period. All of this helps elevate demand above the pre–COVID-19 trend for several years. Inflation remains above the Fed's target in 2022, but gradually settles back to the 2% range as demand for goods falters and businesses solve their supply chain issues. The pandemic jump-starts the widespread adoption of new technology, leading to faster productivity growth. The unemployment rate gradually falls back to below 4%. The Fed raises rates at a relatively fast pace in 2022 out of concern for inflation, then slows rate hikes as inflation falls back to the normal range.

Relapse (15%): The discovery of the Omicron variant underlines the risks that COVID-19 continues to pose to the US economy. New variants are constantly being found.[2] In this scenario, the current vaccines are not as effective against one or more new variants. People return to social distancing and cut back on purchasing services that are perceived as "risky." This slows growth substantially. A muted government response results in financially stretched businesses failing, and weakened balance sheets create the conditions for a more traditional, slower recovery from the recession. After continued outbreaks, consumers permanently reduce spending on travel, entertainment, food, and accommodations, requiring a painful readjustment of the economy.

Back to the '70s (30%): Households and businesses see price hikes from pandemic-related shortages and react by raising prices and wages. The reaction, and consequent rise in inflationary expectations, creates an inflationary spiral. Consumer prices are rising at a steady rate of over 5% by the end of 2022, causing the Fed to raise interest rates to limit demand. In 2023, inflation continues, but a "growth recession" causes the unemployment rate to rise. The Fed is reluctant to engineer an actual recession, and inflation settles in at a 4% rate over the five-year forecast horizon.

Sectors

Consumer spending

The near-term outlook for consumer spending turns on two big questions:

1. Will consumers spend down all those pandemic-era savings?

In 2020, during the height of the pandemic, households saved about US$1.6 trillion more than we forecasted before the pandemic. Some of that went into investments, but many households have a lot more cash on hand now than they normally would want. How much of that will they spend as the pandemic impact wanes? One possibility is that many consumers will remain cautious and hold on to those savings even as they are able to go out and spend. Another possibility: Spending booms for a while longer as the impact of COVID-19 continues to wane. The baseline Deloitte forecast assumes a modest decline in the savings rate below its long-term level, and that's enough to support continued growth in consumer spending. But spending could be even stronger this year if households decide to cash in more of those savings.

2. When consumer services recover, what happens to durable goods?

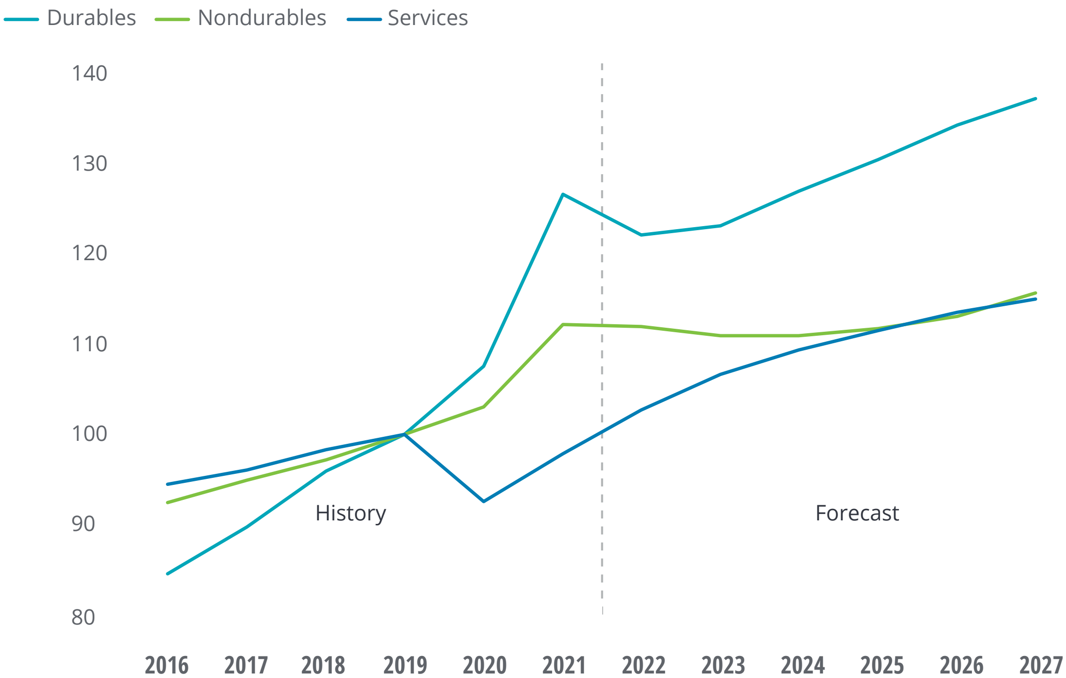
The pandemic sparked a remarkable change in consumer spending patterns. Spending on durable consumer goods jumped US$103 billion in 2020, while spending on services fell US$556 billion over the same period. Households substituted bicycles, gym equipment, and electronics for restaurants, entertainment, and travel. Once households can again purchase services, will they begin buying fewer goods? That may be happening, as by December 2021, durables spending was down 14% from the peak in March 2021.

Deloitte's forecast assumes that durable goods spending continues to fall over the next few years as consumer spending "renormalizes" and consumers resume spending on services. For a more detailed consumer spending forecast, see Deloitte's consumer spending forecast, *Consumer spending forecasts: Services find their way back after a forgettable 2020.*

In the longer term, we expect the pandemic to exacerbate some existing problems. It has thrown the problem of inequality into sharp relief, straining the budgets and living situations of millions of lower-income households. These are the very people who are less likely to have health insurance—especially after layoffs—and more likely to have health conditions that complicate recovery from infection. And retirement remains a significant issue: Even before the crisis, fewer than four in 10 nonretired adults described their retirement as on track, with a quarter of nonretired adults saying they had no retirement savings.[3] The stock market boom will have little impact on most people's balance sheets, leaving many people still unable to afford retirement as they age.[4]

FIGURE 2

Consumer spending, index, 2019 = 100



Source: Deloitte analysis.

FIGURE 3

Consumer spending growth

	History						Forecast					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Real consumer spending	2.5	2.4	2.9	2.2	-3.8	7.9	2.8	1.7	1.5	1.5	1.6	1.7
Real consumer spending, durable goods	5.4	6.3	7.0	4.3	7.7	18.0	-3.6	0.8	3.2	2.9	2.9	2.2
Real consumer spending, nondurable goods	2.5	2.7	2.5	2.9	3.1	9.0	-0.2	-1.0	0.1	0.7	1.3	2.3
Real consumer spending, services	2.0	1.8	2.4	1.7	-7.5	5.9	5.0	3.9	2.5	2.0	1.9	1.3
Net household wealth (US$ trillion)	95	103	104	117	130.9	154	156	153	152	153	155	156
Unemployment rate (percent)	4.9	4.4	3.9	3.7	8.1	5.4	4.1	4.0	4.0	3.8	3.6	3.6
Consumer price index	1.3	2.1	2.4	1.8	1.2	4.7	5.5	1.9	2.0	2.3	2.5	2.3

Source: Deloitte analysis.

Housing

The housing sector has outperformed the broader economy in the wake of the pandemic, as buyers and sellers found ways to navigate the pandemic's restrictions. A host of factors combined to boost housing demand over the past year:

- Continued strong economic position of high-wage remote workers
- Growing expectations that remote work will persist after the pandemic
- Historically low mortgage rates
- Millennials moving into prime home-buying age

Even as the Fed has reduced its purchases of mortgage-backed securities, demand for houses remains high, and homebuilder confidence remains above pre–COVID-19 levels. The spread of the Delta and Omicron variants could potentially strengthen the case for remote work, therefore boosting housing demand. More vacant developed lots of land could be available for homebuilding, driving an uptick in short-term housing supply to meet the strong demand.

Deloitte expects demand to cool due to reduced affordability in the medium term. Nominal home price increases and rising mortgage rates will both slow the interest of potential homebuyers. Despite the slowdown, demand is likely to exceed supply in the medium term as builders continue to grapple with supply chain issues and land-use restrictions. The Deloitte baseline forecast expects house prices to rise faster than inflation through the forecast horizon.

Demographics suggest that housing is not likely to become a key driver of economic growth in the foreseeable future. Population growth has slowed to about 0.5% per year (compared to over 1% during the 2000s' housing boom). The baseline forecast assumes that housing starts will gradually fall over the five-year horizon to 1.5 million starts in 2026. Faster medium-term growth would require faster population growth, most likely from immigration. Otherwise, the current heightened demand for housing is likely to be a short-term phenomenon.[5]

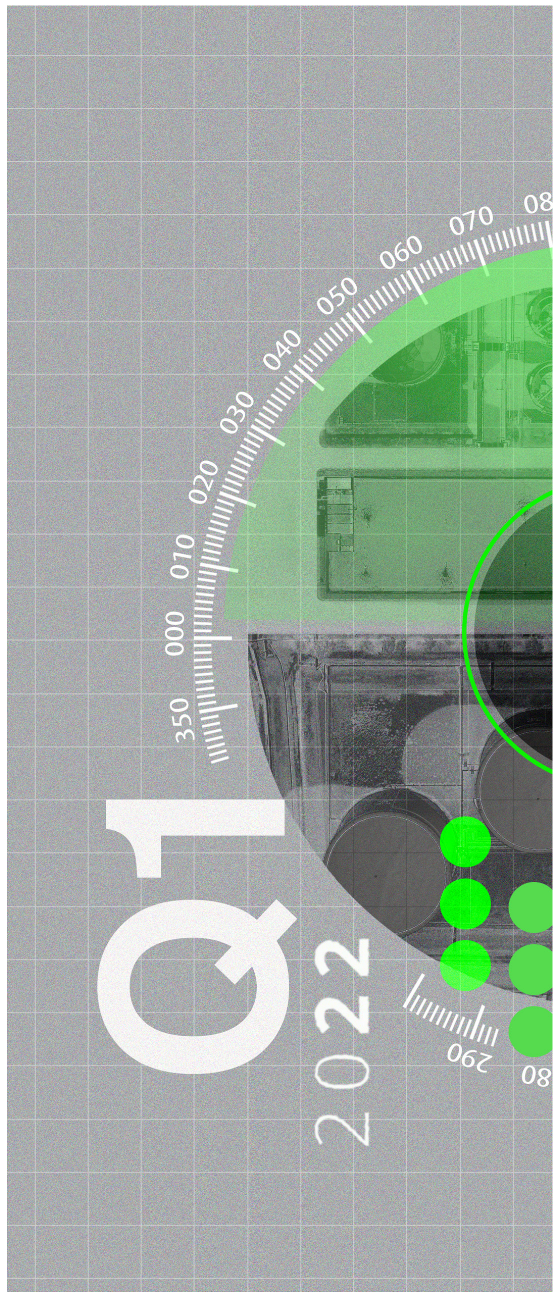
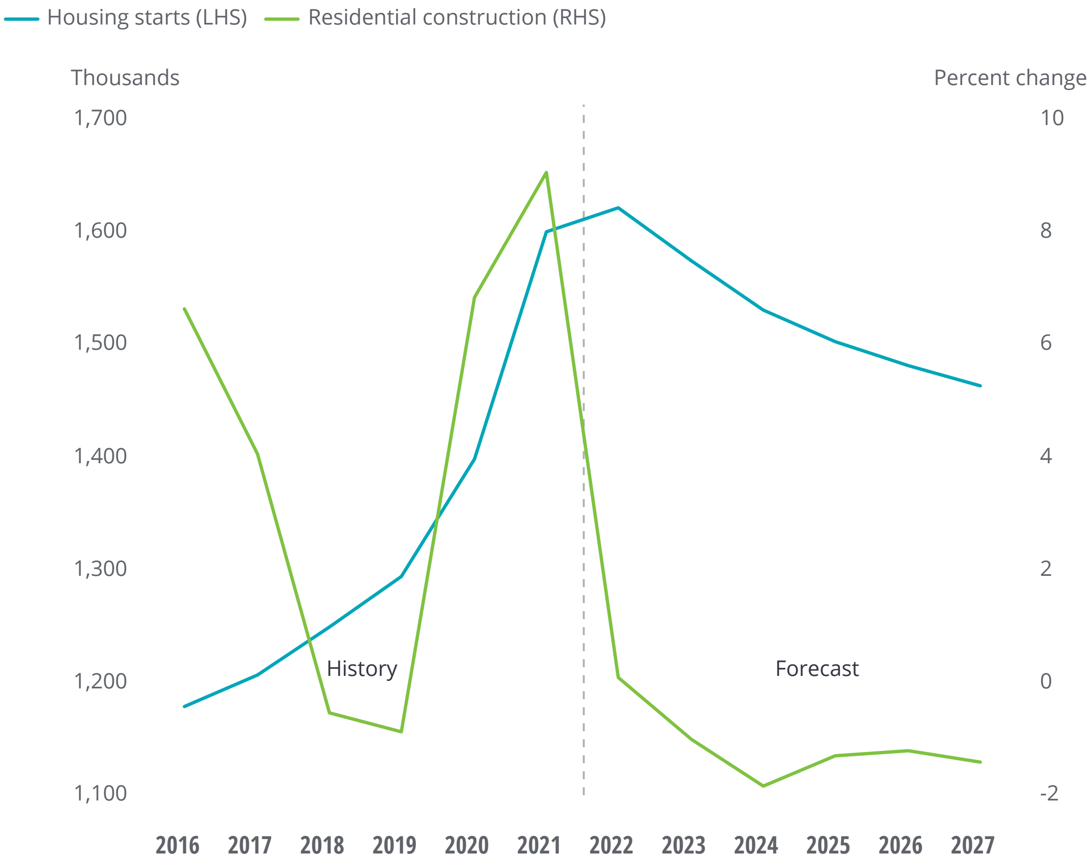


FIGURE 4

Housing



Source: Deloitte analysis.

FIGURE 5

Housing

	History						Forecast					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Real investment in private housing	6.6	4.0	-0.6	-0.9	6.8	9.0	0.1	-1.0	-1.9	-1.3	-1.2	-1.4
Housing starts (million)	1.18	1.21	1.25	1.29	1.40	1.60	1.62	1.57	1.53	1.50	1.48	1.46
Stock of houses (million)	136.2	137.2	138.3	139.5	140.7	142.0	143.3	144.8	146.2	147.6	149.0	150.4
30-year fixed mortgage rate (percent)	3.6	4.0	4.5	3.9	3.1	3.0	4.2	5.0	5.5	5.7	5.7	5.6

Source: Deloitte analysis.

Business investment

Businesses have ramped up investment since the initial impact of the pandemic, but they have been selective about what they are investing in.

Investment in nonresidential structures continues to be down (more than 20%) from the prepandemic level. Most likely, the business case for office buildings and retail space collapsed with online shopping and the shift toward working at home. Mining structures also took a big hit because of the decline in oil prices earlier in the pandemic. There are signs that construction of mining structures has begun to reverse, which may help boost the sector temporarily. However, the overall recovery of the nonresidential construction is likely to be limited by the continued low demand for office and retail space.

Investment in equipment has been growing at a fast rate. The Deloitte forecast assumes continued growth, as the need for transportation equipment (to move goods) and information-processing equipment (to support telework) is likely to remain strong.

Investment in intellectual property accelerated during the pandemic (after dropping in the first quarter of 2020). That's mostly because of investment in software, and likely reflects the investments needed for telework. We expect this category to remain strong over the next few years as businesses continue to require software to accompany their investments in information-processing equipment.

Financing investment should remain easy, despite concerns about the Fed raising short-term interest rates. Nonfinancial businesses are sitting on a pile of cash, and even as they rise, interest rates remain at low levels. In our baseline forecast, the corporate bond rate rises to a relatively low (by historical standards) 4.7% and stays there through the end of the forecast horizon. Even adding in the potential for a corporate tax hike, the cost of capital is likely to remain very low. That will boost businesses' ability to pay for all those new computers and servers, not to mention the software to run them. But even with such easy financing terms, office and retail space will be unable to generate sufficient returns to entice businesses to increase capacity.

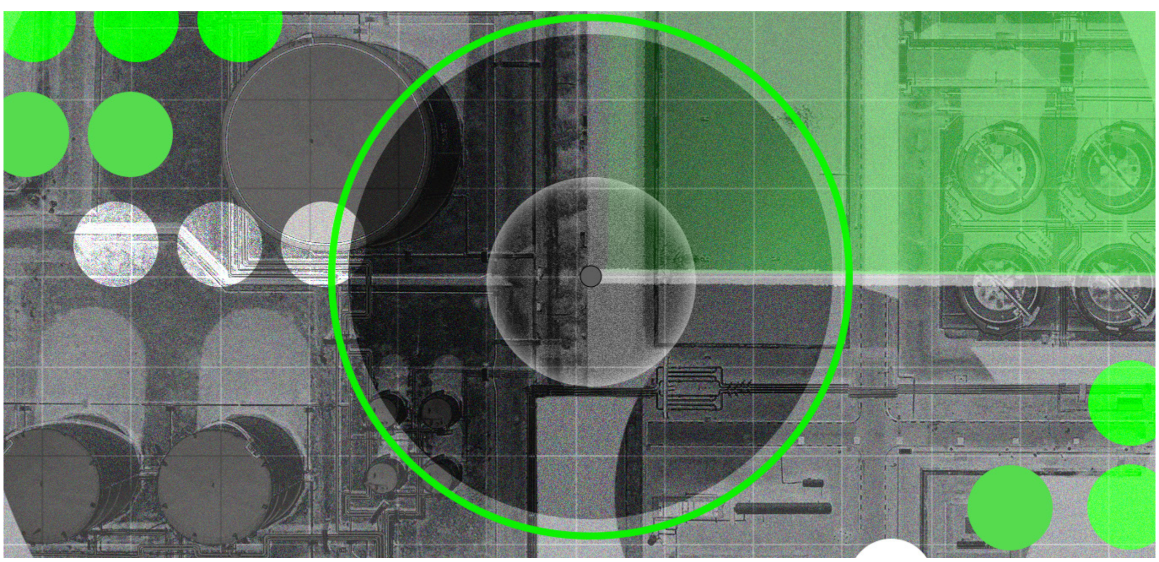


FIGURE 6

Business sector

Source: Deloitte analysis.

FIGURE 7

Business sector

	History						Forecast					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Real fixed business investment	0.9	4.1	6.4	4.3	-5.3	7.3	3.0	3.0	2.3	2.5	2.7	2.7
Real inventory investment (US$ billion)	35.7	33.6	65.7	75.2	-42.3	-37.5	165.6	123.9	91.3	40.4	52.7	51.5
Employment cost index	2.2	2.4	2.8	2.7	2.6	3.3	3.7	3.1	3.0	3.1	3.3	3.3
Corporate profits before tax	-1.1	4.5	8.3	2.7	-5.2	22.6	-5.6	2.7	3.3	2.7	3.4	2.6
Yield on 10-year Treasury note	1.8	2.3	2.9	2.1	0.9	1.4	2.7	3.7	4.1	4.1	4.1	4.1

Source: Deloitte analysis.

Foreign trade

The Ukraine crisis is likely to make things more difficult for US exporters. Lower demand from Europe (market for 15% of US exports) and a higher dollar will create some short-term challenges.

Beyond the Ukraine crisis, things look more positive. Real US exports remain substantially below the prepandemic level, and real imports are now higher than they were in late 2019, but that could translate into opportunities for the United States as global financial and economic conditions normalize. Deloitte's baseline forecast assumes that exports will grow more quickly than imports. More normal financial conditions will create more opportunities for investment outside the United States and less desire to hold dollars to avoid risk, lowering the dollar and making the United States more competitive globally. As a result, there is a modest improvement in the current account deficit over the forecast horizon. Of course, much depends on how trade policy develops, and whether businesses actually follow through on talk about "reshoring" in response to supply chain disruptions.

Over the past few years, many analysts have begun to face the possibility of deglobalization. Global exports grew from 13% of global GDP in 1970 to 34% in 2012. But then the share of exports in global GDP started to fall as globalization began to stall, and opponents of freer trade have gained political influence. All this points to an unraveling of the policies that fostered the earlier globalization.

COVID-19 may have accelerated this trend. Although the pandemic is a global phenomenon, leaders have made major decisions about how to fight it—in both health and economic policy—on a country-by-country basis. The most striking examples of this are the US withdrawal from cooperation in the World Health Organization—although President Biden rescinded the move on his first day in office—and the unilateral decisions of both China and Russia to deploy their own vaccines before the completion of phase 3 trials. And countries with vaccine-manufacturing facilities rushed to vaccinate their own citizens rather than cooperating on a global vaccination plan.

On top of this, the United States-China trade conflict continues. The White House has shown some interest in returning to a multilateral approach to trade—for example, by supporting Ngozi Okonjo-Iweala for the World Trade Organization director-general. However, US Trade Representative Katherine Tai has made a point of stating that trade policy should be aimed at helping US workers.[6] And many of the Trump-era tariffs remain in place, with little prospect that the tariffs on China, in particular, will be withdrawn.

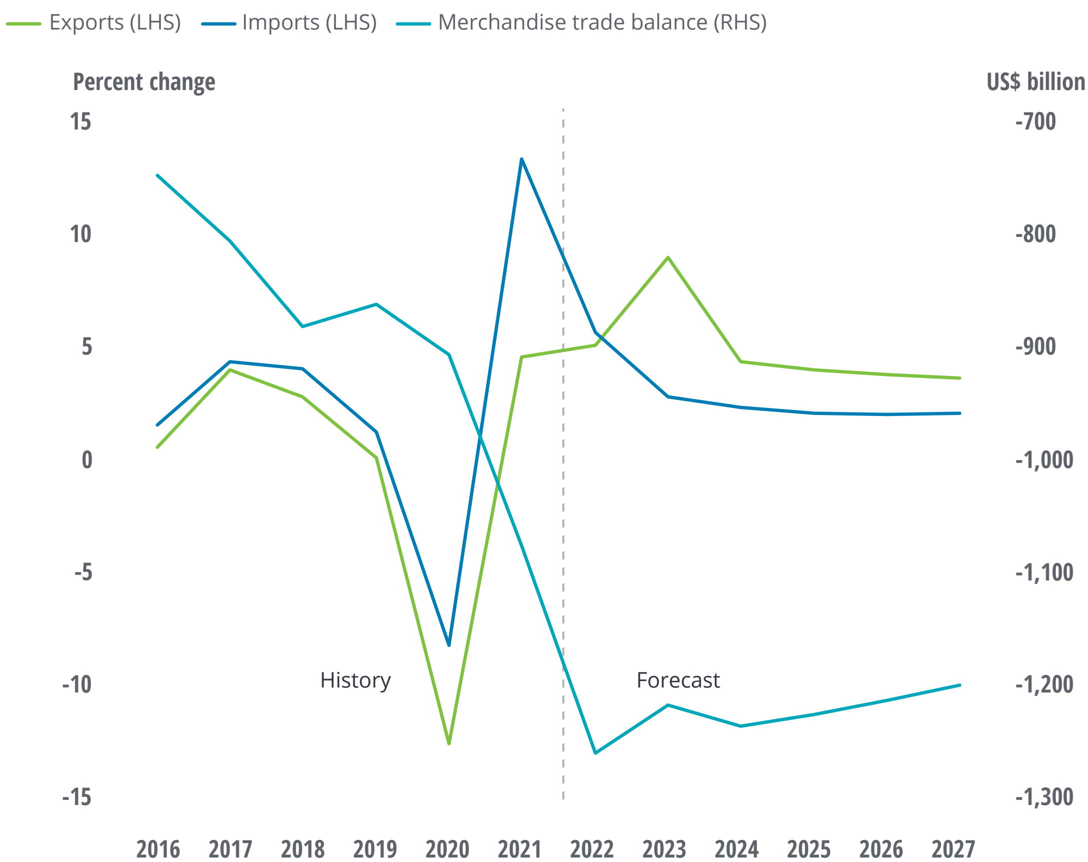
Many businesses have been considering rebuilding their supply chains to create more resilience in the face of unexpected events such as the pandemic and changes in US trade policy. The imperative for such changes has become stronger with the increasing supply chain issues and port delays facing importers of key components and consumer goods. It's impossible, of course, to simply and quickly refashion supply chains to reduce foreign dependence. American companies will continue to source from China in the coming years. But companies will likely accelerate attempts to reduce their dependence on China (a process they had begun before the pandemic). Building more robust supply chains may mean moving production back to the United States, or perhaps to Mexico or some other, closer source. Or it may mean a portfolio of suppliers rather than a single source—even if the single source is the cheapest.

Reengineering supply chains will inevitably mean a rise in overall costs. Just as the "China price" held inflation in check for years, an attempt to avoid dependency on China might create inflationary pressures in the later years of our forecast horizon. And if markets won't accept inflation, companies will have to accept lower profits to diversify supply chains. Globalization has offered a comparatively painless way to improve most people's standard of living; deglobalization will involve painful costs and may limit real income growth during the recovery.

Meanwhile, short-term trade flows are hostage to the virus. Port shutdowns, container shortages, and other supply chain woes will continue to increase month-to-month volatility in trade—and perhaps provide business executives more reason to find more robust (and more expensive) alternatives.

FIGURE 8

Foreign trade



Source: Deloitte analysis.

FIGURE 9

Foreign trade

	History						Forecast					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Real exports of goods and services	0.4	4.1	2.8	-0.1	-13.6	4.6	5.2	9.4	4.4	4.1	3.8	3.7
Real imports of goods and services	1.5	4.4	4.1	1.1	-8.9	14.0	5.9	2.8	2.3	2.0	2.0	2.0
Current account balance (share of GDP)	-2.1	-1.9	-2.1	-2.2	-3.0	-3.6	-3.9	-3.4	-3.4	-3.2	-3.0	-2.8
Merchandise trade balance (US$ billion)	-735	-797	-878	-857	-905	-1,084	-1,280	-1,235	-1,255	-1,243	-1,230	-1,216
Relative unit labor costs (index, 2008 = 100)	100.7	101.6	100.6	105.2	109.9	106.3	107.2	105.5	103.0	100.9	99.9	99.6

Source: Deloitte analysis.

Government policy

President Biden's Build Back Better plan appears unlikely to pass at this point. But if it does pass, it will likely be considerably smaller than originally planned. That leaves federal budget policy on a much more modest path than what might have been expected six months ago.

It's true that the infrastructure spending bill—already in place—will boost government spending over the next 10 years. This spending will increase the capacity of the economy and likely help to drive some additional productivity growth. Much of this additional spending comes toward the end of our forecast horizon, however. And it's relatively modest compared to the economy as a whole. According to the Congressional Budget Office, in 2026, the peak year of spending, the bill will add about US$61 billion to the federal deficit.[7] That amounts to about 0.2% of projected GDP. The infrastructure bill is likely to have a positive and significant impact on public capital in the United States, but it's not a large fiscal stimulus by any means.

Meanwhile, Congress and budget politics have returned to prepandemic norms. In this case, it's not a good thing, as the prepandemic norm was difficulty passing the basic legislation to fund the government. So far this year, at least five months of continuing resolutions leave federal government agencies uncertain about what they can expect to do, and little time to do it once the appropriate bills do pass.

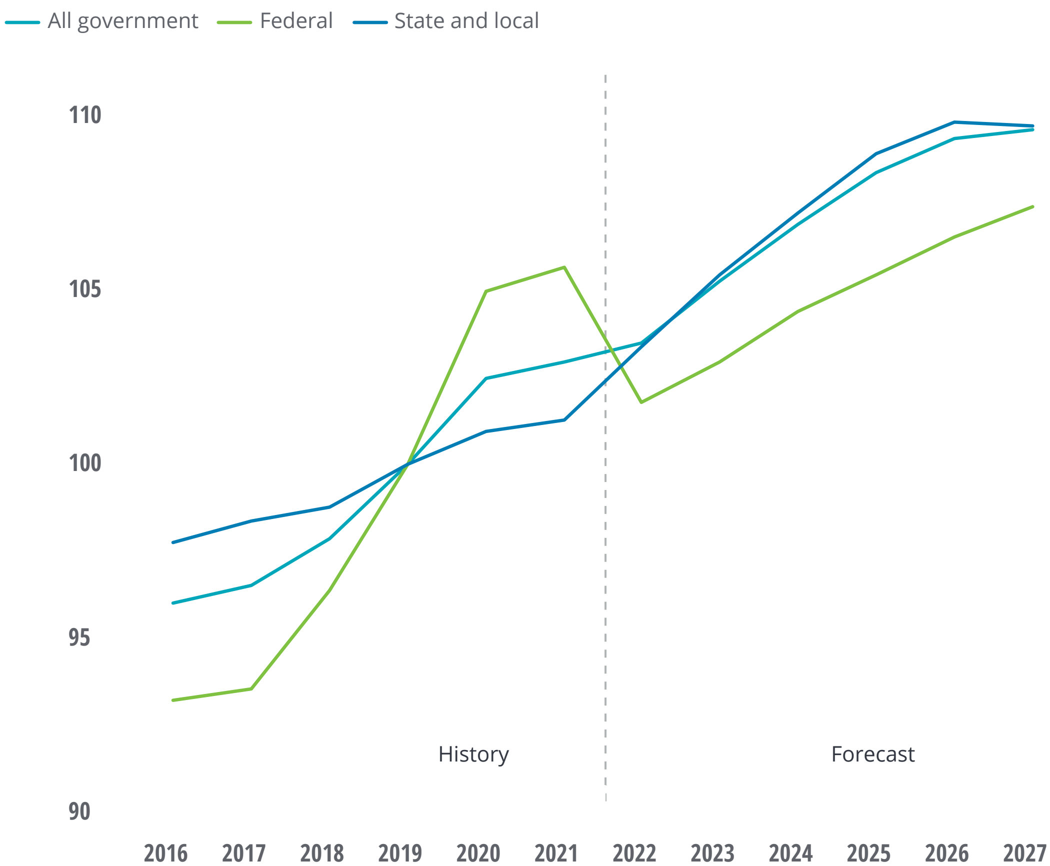
Meanwhile, the disappearance of pandemic-era income support is creating a significant fiscal drag. In the second half of 2021, household income from employee compensation rose over half a billion dollars, but a decline in personal transfer receipts from the federal government offset about a quarter of that additional income. This is weakening demand and is one of the reasons why the baseline forecast does not expect inflation to continue into the second half of 2022. Essentially, the federal government is adopting a restrictive policy that is likely to dampen demand, while at the same time the Fed raises interest rates. That's not a policy recipe for strong economic growth.

Our baseline forecast assumes deficits will fall by 2022 to below US$1.4 trillion per year, and then rise slowly. That's a hefty amount, one that inevitably raises the question of whether the US government can continue to borrow at such a pace. The answer is that it can—until investors lose confidence. At this point, most investors show no sign of concern about US debt. In fact, very low interest rates on US government debt indicate the world wants more, not less, American debt. We anticipate no problem over the forecast horizon.

But the government will face a crisis if it does not eventually find ways to reduce the deficit and consequent borrowing. The crisis may be many years away, and current conditions argue for waiting. It would, however, be a bad idea to wait too long once those conditions lift.

FIGURE 10

Government sector, index, 2019 = 100



Source: Deloitte analysis.

FIGURE 11

Government

	History						Forecast					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Real government consumption and investment	2.0	0.5	1.4	2.2	2.5	0.5	0.5	1.7	1.6	1.4	0.9	0.2
Real federal government consumption and investment	0.5	0.3	3.0	3.8	5.0	0.6	-3.6	1.1	1.4	1.0	1.0	0.8
Real state and local government consumption and investment	2.8	0.6	0.4	1.3	0.9	0.3	2.0	2.0	1.7	1.6	0.8	-0.1
Federal budget balance, unified basis (share of GDP)	-2.9	-3.5	-3.9	-4.5	-12.5	-13.8	-6.2	-5.5	-6.0	-6.1	-6.1	-5.7

Source: Deloitte analysis.

Labor markets

The conversation about labor markets has switched—and fast. Not long ago, employment was about 10 million below the prepandemic level and the main question was how difficult it would be to get all those workers back on the job. Now business commentary is full of talk about labor shortages and stories about employers struggling to find workers. That seems a bit odd since employment is still lower than the prepandemic level.

Many pundits have seized on several reasons why businesses are experiencing so much trouble hiring workers:

Generous government benefits kept people out of the labor force. This explanation makes some sense, but there are reasons to doubt that it is the whole story or, perhaps, even a major part of the story. Some economic research suggests that the original US$600 weekly supplement to unemployment insurance did not affect businesses' ability to rehire workers during the earlier part of the recovery.[8] However, anecdotal evidence is strong enough to suggest that the unemployment insurance supplement may have contributed to the problem. The last of these benefits ended in September, however. The only possible impact in 2022 would be because some people saved money and are therefore able to remain selective about the jobs they are willing to take.

Child care has prevented a significant number of people from reentering the labor force. The Bureau of Labor Statistics (BLS) estimates that the labor force participation among parents of children under 18 years fell about 1 percentage point in 2020. The good news is that this problem is on its way to being solved, with schools having reopened. Day cares, however, still face enrollment limits in some states, and are among the businesses that have the most trouble finding staff, which limits the ability of parents of small children to reenter the labor force.

Health remains a concern for people who are at risk of COVID-19, particularly those who cannot be vaccinated due to a high risk of complications.

About half of the decline in the labor force is among people 55 years and older. Many of these people have probably retired, in the sense of expecting to remain permanently out of the labor force, but some can likely be enticed back with the right compensation packages and flexible working hours and conditions.

As is the case in many areas, the pandemic accelerated trends that were evident before it started. Slow labor force growth and continued high demand had already created conditions that required companies to offer higher wages to lower-skilled workers and to be more imaginative about hiring.[9] In the post–COVID-19 world, companies that make extra effort to find the workers they need and provide conditions to attract those workers will have an important competitive advantage.

Deloitte's baseline forecast assumes that job growth is strong over the next two years as employers do, in fact, find and rehire those missing workers. However, labor force participation rises over the next year as potential workers become more comfortable returning—or are forced to return because of lack of income. As a result, we see the unemployment rate remaining at around the 4% level in the next year, and only falling consistently below that once temporary rise in labor participation ends.

But most important is this: Over the longer horizon, labor force growth slows to just 0.2% per year, presenting continuing challenges for employers. It's a demographic fact that employers will have to learn to live with.

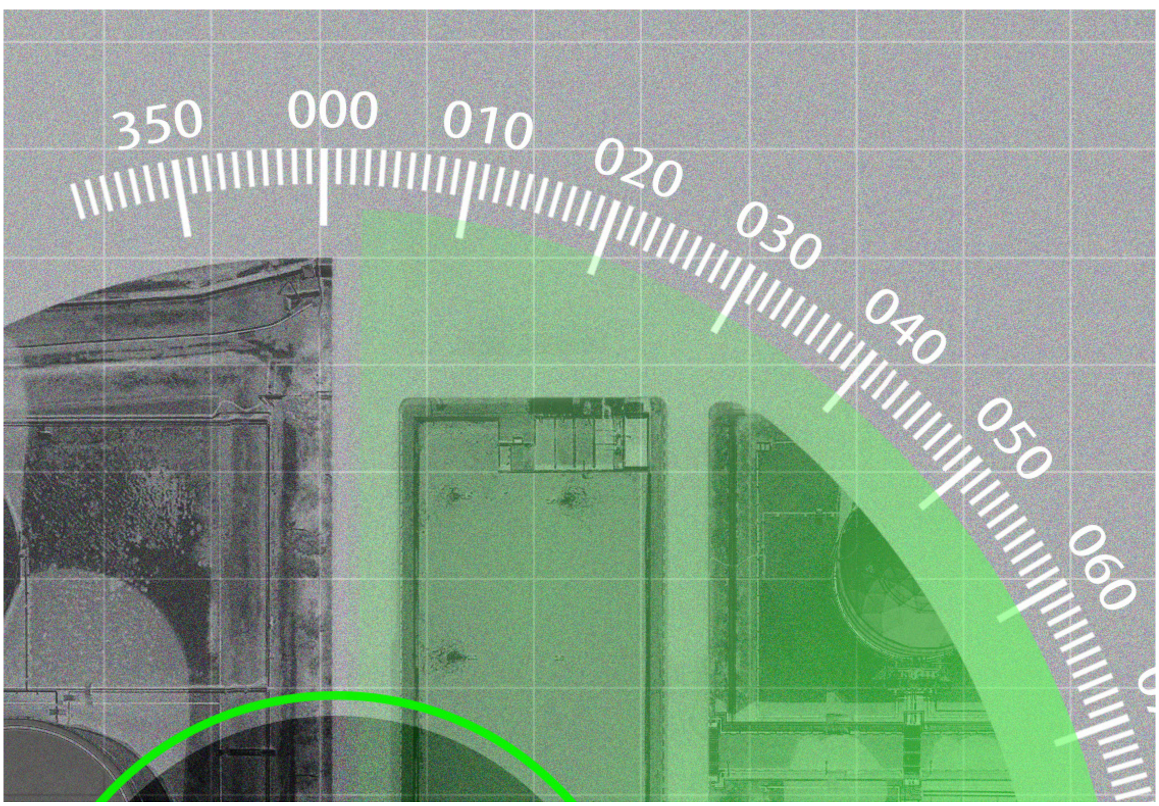


FIGURE 12

Labor market

Source: Deloitte analysis.

FIGURE 13

Labor markets

	History						Forecast					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Average monthly change in employment (thousand)	211	189	191	166	-729	329	326	104	52	61	65	51
Unemployment rate (percent)	4.9	4.4	3.9	3.7	8.1	5.4	4.1	4.0	4.0	3.8	3.6	3.6
Employment-to-population ratio (percent)	59.7	60.1	60.4	60.8	56.8	58.4	59.7	59.7	59.5	59.4	59.3	59.1
Employment cost index	2.2	2.4	2.8	2.7	2.6	3.3	3.7	3.1	3.0	3.1	3.3	3.3

Source: Deloitte analysis.

Financial markets

The Fed's actions have been one of the bright spots of the US response to the pandemic. When the virus first began spreading, there was a significant possibility that a financial market meltdown would exacerbate the country's economic problems. The Fed's prompt and strong actions kept financial markets liquid and operating, preventing that additional level of pain.

With GDP now above the prepandemic level, strong employment growth, and some signs of incipient inflation, the Fed has started to unwind its pandemic response. "Tapering" purchases of long-term assets ("quantitative easing" or QE) began at the early November 2021 FOMC meeting, and are set to finish at the March 2022 meeting. That would be a fast reversal of the policy. The end of QE, however, will not end questions surrounding the Fed's policy. It will still own more than US$7 trillion in long-term assets (both Treasuries and mortgage-backed securities). The Fed may eventually actively sell these, or it may elect to let them "run off" by not replacing them as they mature. Discussions about the Fed balance sheet will continue for some time.

At the same time, the pressure on the Fed to begin raising the funds rate has intensified. In November 2021, Fed officials were suggesting that the first rate hike would occur in late 2022. By February, Fed watchers considered a hike at the March meeting very likely, and there was some discussion of a 50-basis-point hike to send a signal to markets (The Fed normally raises the funds rate about 25 basis points each time, so that the impact of higher interest rates occurs gradually).

The baseline forecast assumes that the Fed hikes the funds rate 25 basis points at each of the three meetings in the spring of 2022 (March, May, and June), and continues to raise rates 25 basis points at every other meeting after that. This is consistent with our assumption that inflation will decline in the second half of 2022, which would take a lot of pressure off the Fed. We expect the Fed to stop hikes when the funds rate is a bit above 2.5%, leaving real short-term interest rates in (just barely) positive territory.

We expect long-term rates to rise as well, reflecting the global economic recovery and the rise in short-term rates. By 2026, the 10-year Treasury stands at 3.9%. That may seem high today, but is, in fact, low in the historical context. It would imply a spread between long- and short-term rates that is only about half the level the economy normally experiences in full employment. The possibility that, in a booming economy, long-term interest rates might rise by even more should not be dismissed.

Of course, interest rates are always the least certain part of any forecast: Any significant news could, and will, alter interest rates significantly.

FIGURE 14

Financial markets

Source: Deloitte analysis.

FIGURE 15

Financial markets

	History						Forecast					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Federal funds rate	0.39	0.97	1.78	2.16	0.42	0.13	0.71	1.76	2.57	2.63	2.63	2.63
Yield on 10-year Treasury note	1.84	2.33	2.91	2.14	0.89	1.44	2.66	3.71	4.06	4.06	4.06	4.06
Interest rate on 30-year fixed-rate mortgage	3.65	3.99	4.54	3.94	3.11	2.96	4.19	5.04	5.46	5.67	5.67	5.65
Net household wealth (US$ trillion)	95	103	104	117	131	154	156	153	152	153	155	156

Source: Deloitte analysis.

Prices

The news media has been flooded with reports about inflation for some time. Before the Ukraine crisis, that commentary tended to underplay how much of the rise in prices was due to specific supply chain problems that were likely to be alleviated over time. Businesses were already finding ways around some of these shortages, and the rotation of consumer spending from goods to services is also removing some pressure on supply chains. The possibility of a significant bump in prices in Q2 from higher oil prices complicates, but does not negate, that picture. There are some other likely impacts on prices (such as a rise in food prices as Ukrainian and Russian wheat exports disappear this year). These may add to short-term price pressures. The real question, however, remains the same as before the Ukraine crisis: whether inflation becomes baked into the economy. We have increased the probability of our "Back to the '70s" scenario for this reason.

CPI inflation first accelerated in March 2021, although the March increase was mainly due to higher energy costs. The next three months—April to June—saw much higher core inflation. Most of the acceleration, however, was due to a few specific pandemic-related categories. And then, inflation decelerated back to acceptable levels for three months,[10] although the news media ignored this. However, many economists understood that the signals were consistent with the "transitory" inflation story the Fed was describing.

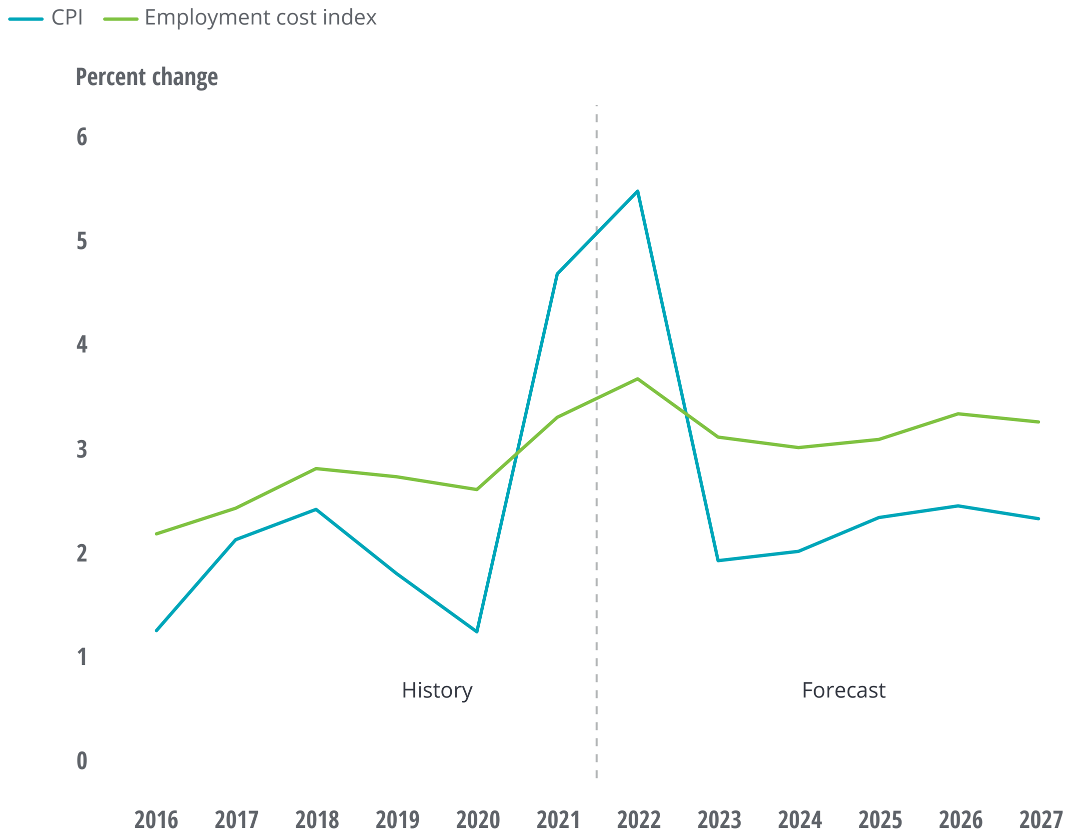
In October, inflation accelerated again and has remained higher since then. The overall level of inflation (6–7% on a year-over-year basis) is still relatively mild compared to inflation in the early 1980s (about twice that rate) or in many other countries that have experienced inflationary problems. But more important, inflation looks odd. It's still heavily driven by a few unusual categories such as used cars. And goods inflation has accelerated much more than services inflation. That's very unusual, since goods inflation has been lower than services inflation for the entire post–World War II period. Economists have long understood that this is to be expected because of long-term technological changes.[11] Simply put, services production is much harder to automate than goods production. The high level of goods inflation is, therefore, unlikely to continue unless services inflation also accelerates.

But there are some warning signs. Among them are the spread of inflation to some areas that are not recovering from a postpandemic price decline (apparel, for example), and the rise in shelter prices. Shelter, and its subcomponent that measures the implicit rise in housing prices for homeowners ("owners' equivalent rent of residences") appears to respond with a lag to higher housing prices. And housing prices by the widely used Federal Housing Finance Agency (FHFA) measure are up 27% from the prepandemic level, while owners' equivalent rent is up just 5.2%. We may see elevated readings for the CPI over the next year as the CPI for shelter catches up with housing prices.

The Deloitte forecast continues to assume that the current inflation is "transitory" in the sense that it will dissipate over time. Companies are already finding ways around many of their supply chain problems, as evidenced by high factory utilization and growing industrial production. And our forecast of declining demand for consumer durables suggests that the need for expanded production will gradually decline, reducing the bottlenecks that are currently frustrating producers and leading to higher prices. Our baseline forecast shows inflation remaining at around 3.5% in 2022 before falling back to the 2% range.

FIGURE 16

Prices



Source: Deloitte analysis.

FIGURE 17

Prices

	History						Forecast					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Chained GDP price index	1.0	1.9	2.4	1.8	1.3	4.2	4.0	1.7	2.0	2.4	2.4	2.3
Consumer price index	1.3	2.1	2.4	1.8	1.2	4.7	5.5	1.9	2.0	2.3	2.5	2.3
Chained price index for personal consumption expenditures	1.0	1.8	2.1	1.5	1.2	3.9	4.6	1.9	2.0	2.3	2.4	2.3
Employment cost index	2.2	2.4	2.8	2.7	2.6	3.3	3.7	3.1	3.0	3.1	3.3	3.3

Source: Deloitte analysis.

Appendix

FIGURE 18

Baseline (55%)

	History						Forecast					
% year over year unless mentioned otherwise	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
GDP and components												
Real GDP	1.7	2.3	2.9	2.3	-3.4	5.7	2.9	2.1	1.6	1.5	1.9	1.8
Real consumer spending	2.5	2.4	2.9	2.2	-3.8	7.9	2.8	1.7	1.5	1.5	1.6	1.7
Real consumer spending, durable goods	5.4	6.3	7.0	4.3	7.7	18.0	-3.6	0.8	3.2	2.9	2.9	2.2
Real consumer spending, nondurable goods	2.5	2.7	2.5	2.9	3.1	9.0	-0.2	-1.0	0.1	0.7	1.3	2.3
Real consumer spending, services	2.0	1.8	2.4	1.7	-7.5	5.9	5.0	3.9	2.5	2.0	1.9	1.3
Real investment in private housing	6.6	4.0	-0.6	-0.9	6.8	9.0	0.1	-1.0	-1.9	-1.3	-1.2	-1.4
Real fixed business investment	0.9	4.1	6.4	4.3	-5.3	7.3	3.0	3.0	2.3	2.5	2.7	2.7
Real inventory accumulation	36	34	66	75	-42	-38	166	124	91	40	53	52
Real exports of goods and services	0.4	4.1	2.8	-0.1	-13.6	4.6	5.2	9.4	4.4	4.1	3.8	3.7
Real imports of goods and services	1.5	4.4	4.1	1.1	-8.9	14.0	5.9	2.8	2.3	2.0	2.0	2.0
Real government consumption and investment	2.0	0.5	1.4	2.2	2.5	0.5	0.5	1.7	1.6	1.4	0.9	0.2
Real federal government consumption and investment	0.5	0.3	3.0	3.8	5.0	0.6	-3.6	1.1	1.4	1.0	1.0	0.8
Real state and local government consumption and investment	2.8	0.6	0.4	1.3	0.9	0.3	2.0	2.0	1.7	1.6	0.8	-0.1
Prices												
Consumer price index	1.3	2.1	2.4	1.8	1.2	4.7	5.5	1.9	2.0	2.3	2.5	2.3
Chained price index for personal consumption expenditures	1.0	1.8	2.1	1.5	1.2	3.9	4.6	1.9	2.0	2.3	2.4	2.3
Chained GDP price index	1.0	1.9	2.4	1.8	1.3	4.2	4.0	1.7	2.0	2.4	2.4	2.3
Employment cost index	2.2	2.4	2.8	2.7	2.6	3.3	3.7	3.1	3.0	3.1	3.3	3.3
Labor markets												
Average monthly change in employment (thousand)	211	189	191	166	-729	329	326	104	52	61	65	51
Unemployment rate (percent)	4.9	4.4	3.9	3.7	8.1	5.4	4.1	4.0	4.0	3.8	3.6	3.6
Employment-to-population ratio (percent)	59.7	60.1	60.4	60.8	56.8	58.4	59.7	59.7	59.5	59.4	59.3	59.1
Income and wealth												
Real disposable personal income	1.8	2.8	3.4	2.3	6.2	2.2	-4.6	1.7	0.9	1.4	1.6	1.7
Net household wealth (US$ trillion)	95	103	104	117	131	154	156	153	152	153	155	156
Personal saving rate (percent of disposable income)	7.0	7.3	7.6	7.6	16.4	12.0	5.4	5.4	4.7	4.5	4.5	4.4
Corporate profits before tax (with inventory valuation and capital consumption adjustments)	-1.1	4.5	8.3	2.7	-5.2	22.6	-5.6	2.7	3.3	2.7	3.4	2.6
Housing												
Housing starts (thousand)	1,177	1,205	1,247	1,292	1,397	1,598	1,620	1,573	1,528	1,500	1,480	1,462
Total housing stock (million)	136	137	138	140	141	142	143	145	146	148	149	150
Interest rate on 30-year fixed rate mortgages (percent)	3.65	3.99	4.54	3.94	3.11	2.96	4.19	5.04	5.46	5.67	5.67	5.65
Foreign trade												
Current account balance, share of GDP (percent)	-2.1	-1.9	-2.1	-2.2	-3.0	-3.6	-3.9	-3.4	-3.4	-3.2	-3.0	-2.8
Merchandise trade balance (US$ billion)	-735	-797	-878	-857	-905	-1,084	-1,280	-1,235	-1,255	-1,243	-1,230	-1,216
Relative unit labor costs (index, 2008 = 100)	100.7	101.6	100.6	105.2	109.9	106.3	107.2	105.5	103.0	100.9	99.9	99.6
Financial												
Federal funds rate (percent)	0.39	0.97	1.78	2.16	0.42	0.13	0.71	1.76	2.57	2.63	2.63	2.63
Yield on 10-year Treasury note (percent)	1.84	2.33	2.91	2.14	0.89	1.44	2.66	3.71	4.06	4.06	4.06	4.06
Government												
Federal budget balance, unified basis (share of GDP, percent)	-2.9	-3.5	-3.9	-4.5	-12.5	-13.8	-6.2	-5.5	-6.0	-6.1	-6.1	-5.7

Source: Deloitte analysis.

FIGURE 19

Back to the '70s (30%)

	History						Forecast					
% year over year unless mentioned otherwise	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
GDP and components												
Real GDP	1.7	2.3	2.9	2.3	-3.4	5.7	2.7	1.9	1.3	1.4	1.9	1.8
Real consumer spending	2.5	2.4	2.9	2.2	-3.8	7.9	2.8	1.4	1.0	1.1	1.4	1.6
Real consumer spending, durable goods	5.4	6.3	7.0	4.3	7.7	18.0	-3.5	0.3	2.1	2.2	2.6	2.1
Real consumer spending, nondurable goods	2.5	2.7	2.5	2.9	3.1	9.0	-0.3	-1.2	-0.3	0.4	1.1	2.1
Real consumer spending, services	2.0	1.8	2.4	1.7	-7.5	5.9	5.0	3.6	2.1	1.6	1.7	1.1
Real investment in private housing	6.6	4.0	-0.6	-0.9	6.8	9.0	-0.1	-1.2	-2.0	-1.4	-0.9	-1.3
Real fixed business investment	0.9	4.1	6.4	4.3	-5.3	7.3	2.0	2.3	2.3	2.2	2.7	2.7
Real inventory accumulation	36	34	66	75	-42	-38	150	115	83	36	53	53
Real exports of goods and services	0.4	4.1	2.8	-0.1	-13.6	4.6	5.3	9.1	4.1	3.9	3.8	3.7
Real imports of goods and services	1.5	4.4	4.1	1.1	-8.9	14.0	5.4	2.2	1.5	1.1	1.2	1.3
Real government consumption and investment	2.0	0.5	1.4	2.2	2.5	0.5	0.5	1.7	1.6	1.4	0.9	0.2
Real federal government consumption and investment	0.5	0.3	3.0	3.8	5.0	0.6	-3.6	1.1	1.4	1.0	1.0	0.8
Real state and local government consumption and investment	2.8	0.6	0.4	1.3	0.9	0.3	2.0	2.0	1.7	1.6	0.8	-0.1
Prices												
Consumer price index	1.3	2.1	2.4	1.8	1.2	4.7	6.8	4.4	4.4	4.5	4.5	4.5
Chained price index for personal consumption expenditures	1.0	1.8	2.1	1.5	1.2	3.9	5.8	4.4	4.3	4.5	4.4	4.5
Chained GDP price index	1.0	1.9	2.4	1.8	1.3	4.2	5.1	4.0	4.1	4.3	4.3	4.4
Employment cost index	2.2	2.4	2.8	2.7	2.6	3.3	5.3	6.1	5.9	5.7	5.7	5.6
Labor markets												
Average monthly change in employment (thousand)	211	189	191	166	-729	329	293	81	20	32	47	35
Unemployment rate (percent)	4.9	4.4	3.9	3.7	8.1	5.4	4.4	4.4	4.6	4.7	4.6	4.7
Employment-to-population ratio (percent)	59.7	60.1	60.4	60.8	56.8	58.4	59.5	59.4	59.0	58.8	58.6	58.4
Income and wealth												
Real disposable personal income	1.8	2.8	3.4	2.3	6.2	2.2	-4.7	1.7	0.9	1.4	1.9	1.9
Net household wealth (US$ trillion)	95	103	104	117	131	154	153	142	139	143	149	154
Personal saving rate (percent of disposable income)	7.0	7.3	7.6	7.6	16.4	12.0	5.4	5.6	5.2	5.2	5.5	5.6
Corporate profits before tax (with inventory valuation and capital consumption adjustments)	-1.1	4.5	8.3	2.7	-5.2	22.6	-6.4	0.7	3.2	3.1	3.9	3.4
Housing												
Housing starts (thousand)	1,177	1,205	1,247	1,292	1,397	1,598	1,619	1,568	1,518	1,487	1,472	1,457
Total housing stock (million)	136	137	138	140	141	142	143	145	146	148	149	150
Interest rate on 30-year fixed rate mortgages (percent)	3.65	3.99	4.54	3.94	3.11	2.96	4.47	6.65	7.67	7.86	7.91	8.04
Foreign trade												
Current account balance, share of GDP (percent)	-2.1	-1.9	-2.1	-2.2	-3.0	-3.6	-3.8	-2.9	-2.6	-2.2	-1.9	-1.6
Merchandise trade balance (US$ billion)	-735	-797	-878	-857	-905	-1,084	-1,277	-1,225	-1,223	-1,172	-1,120	-1,074
Relative unit labor costs (index, 2008 = 100)	100.7	101.6	100.6	105.2	109.9	106.3	106.3	104.9	102.8	100.6	99.3	98.5
Financial												
Federal funds rate (percent)	0.39	0.97	1.78	2.16	0.42	0.13	0.93	3.25	4.57	4.63	4.63	4.63
Yield on 10-year Treasury note (percent)	1.84	2.33	2.91	2.14	0.89	1.44	2.91	5.22	6.18	6.22	6.36	6.57
Government												
Federal budget balance, unified basis (share of GDP, percent)	-2.9	-3.5	-3.9	-4.5	-12.5	-13.8	-6.2	-5.6	-6.2	-6.5	-6.7	-6.5

Source: Deloitte analysis.

FIGURE 20

Relapse (15%)

	History						Forecast					
% year over year unless mentioned otherwise	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
GDP and components												
Real GDP	1.7	2.3	2.9	2.3	-3.4	5.7	2.3	1.3	1.4	1.4	1.8	1.8
Real consumer spending	2.5	2.4	2.9	2.2	-3.8	7.9	2.3	1.3	1.3	1.2	1.4	1.6
Real consumer spending, durable goods	5.4	6.3	7.0	4.3	7.7	18.0	-3.7	0.8	3.3	2.6	2.5	2.0
Real consumer spending, nondurable goods	2.5	2.7	2.5	2.9	3.1	9.0	-0.8	-1.4	-0.2	0.4	1.2	2.2
Real consumer spending, services	2.0	1.8	2.4	1.7	-7.5	5.9	4.2	2.8	2.0	1.8	1.7	1.3
Real investment in private housing	6.6	4.0	-0.6	-0.9	6.8	9.0	-0.7	-1.4	-1.7	-1.4	-1.6	-1.6
Real fixed business investment	0.9	4.1	6.4	4.3	-5.3	7.3	2.2	0.9	1.8	2.3	3.3	3.3
Real inventory accumulation	36	34	66	75	-42	-38	147	77	41	14	19	19
Real exports of goods and services	0.4	4.1	2.8	-0.1	-13.6	4.6	3.6	7.6	4.5	4.2	3.7	3.6
Real imports of goods and services	1.5	4.4	4.1	1.1	-8.9	14.0	4.6	1.7	1.7	2.1	2.1	2.0
Real government consumption and investment	2.0	0.5	1.4	2.2	2.5	0.5	0.5	1.7	1.6	1.4	0.9	0.2
Real federal government consumption and investment	0.5	0.3	3.0	3.8	5.0	0.6	-3.6	1.1	1.4	1.0	1.0	0.8
Real state and local government consumption and investment	2.8	0.6	0.4	1.3	0.9	0.3	2.0	2.0	1.7	1.6	0.8	-0.1
Prices												
Consumer price index	1.3	2.1	2.4	1.8	1.2	4.7	5.5	1.9	2.1	2.3	2.3	2.2
Chained price index for personal consumption expenditures	1.0	1.8	2.1	1.5	1.2	3.9	4.5	1.9	2.0	2.2	2.2	2.1
Chained GDP price index	1.0	1.9	2.4	1.8	1.3	4.2	3.9	1.8	2.2	2.3	2.2	2.1
Employment cost index	2.2	2.4	2.8	2.7	2.6	3.3	3.6	3.1	3.0	2.9	3.0	3.0
Labor markets												
Average monthly change in employment (thousand)	211	189	191	166	-729	329	262	69	67	69	71	72
Unemployment rate (percent)	4.9	4.4	3.9	3.7	8.1	5.4	4.3	4.4	4.4	4.3	4.1	4.0
Employment-to-population ratio (percent)	59.7	60.1	60.4	60.8	56.8	58.4	59.4	59.2	59.1	59.0	58.9	58.9
Income and wealth												
Real disposable personal income	1.8	2.8	3.4	2.3	6.2	2.2	-5.0	1.6	1.0	1.3	1.5	1.6
Net household wealth (US$ trillion)	95	103	104	117	131	154	164	157	154	151	152	154
Personal saving rate (percent of disposable income)	7.0	7.3	7.6	7.6	16.4	12.0	5.6	5.8	5.5	5.6	5.6	5.6
Corporate profits before tax (with inventory valuation and capital consumption adjustments)	-1.1	4.5	8.3	2.7	-5.2	22.6	-6.8	-1.5	2.2	3.0	4.5	2.8
Housing												
Housing starts (thousand)	1,177	1,205	1,247	1,292	1,397	1,598	1,616	1,563	1,514	1,487	1,468	1,451
Total housing stock (million)	136	137	138	140	141	142	143	145	146	148	149	150
Interest rate on 30-year fixed-rate mortgages (percent)	3.65	3.99	4.54	3.94	3.11	2.96	3.57	4.01	4.14	4.40	4.40	4.36
Foreign trade												
Current account balance, share of GDP (percent)	-2.1	-1.9	-2.1	-2.2	-3.0	-3.6	-4.1	-3.8	-3.7	-3.5	-3.3	-3.1
Merchandise trade balance (US$ billion)	-735	-797	-878	-857	-905	-1,084	-1,265	-1,208	-1,209	-1,195	-1,190	-1,174
Relative unit labor costs (index, 2008 = 100)	100.7	101.6	100.6	105.2	109.9	106.3	106.7	105.8	103.3	101.4	100.1	99.8
Financial												
Federal funds rate (percent)	0.39	0.97	1.78	2.16	0.42	0.13	0.25	1.11	1.18	1.18	1.18	1.18
Yield on 10-year Treasury note (percent)	1.84	2.33	2.91	2.14	0.89	1.44	2.05	2.57	2.73	2.77	2.79	2.79
Government												
Federal budget balance, unified basis (share of GDP, percent)	-2.9	-3.5	-3.9	-4.5	-12.5	-13.8	-6.2	-5.7	-6.2	-6.2	-6.2	-5.7

Source: Deloitte analysis.

Endnotes

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