Soft Landing Outlook: No Dice in 2024, But Maybe in 2025

Labor Market Outlook

The Burning Glass Institute

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Introduction

In the first quarter of 2024, inflation significantly accelerated. With inflation already nowhere near the 2% target of the Federal Reserve, reaching that target in 2024 is increasingly unlikely. The labor market is still tight, keeping wage growth elevated. And both rent growth and inflation expectations—other key determinants of inflation—remain above pre-pandemic levels, though they're down from their peaks. While the extreme conditions of the pandemic and its immediate aftermath are behind us, economic and labor market conditions are still not consistent with a 2% inflation rate. In other words, a "soft landing"—when the Federal Reserve brings inflation back to target without triggering a recession—is unlikely this year.

But with the underlying determinants of inflation gradually improving, inflation could reach the Fed's target in 2025.

Why?

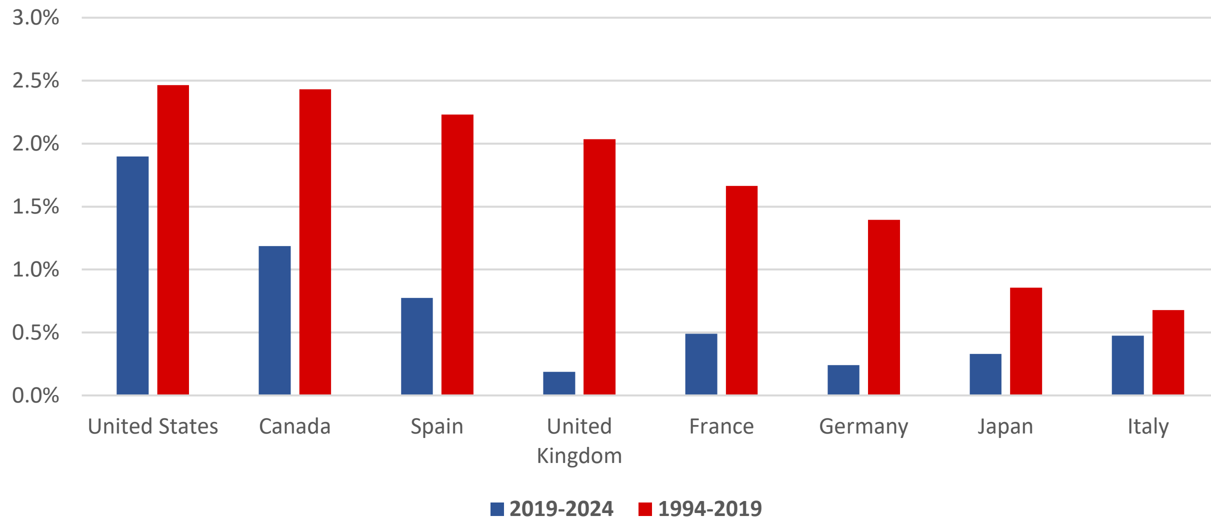
The labor market, while still tight, is gradually loosening. A substantial increase in immigration has boosted workforce numbers, providing businesses with a broader pool of labor. Expanded labor supply can help moderate wage growth pressures, which, in turn, can contain inflationary forces. Apprehensions at the southern border are up, and a shrinking share of these results in expulsions. A lag between entering the US and joining the labor force means the impact on the US labor market is likely to play out over the next year.

Second, the rapid integration of Generative AI into the economy has started to usher in a transformative shift in productivity and operational efficiencies across numerous sectors. This technological leap expands aggregate supply by making it possible to produce more and better goods and services with the same or fewer workers—helping dampen inflationary pressures by lowering production costs and enhancing the economy's overall output capacity.

These two factors—the immigration surge and the integration of Generative AI—function as critical levers expanding the US labor force and its productive capacity. Thus, it is feasible for the economy to experience solid growth through 2025 while inflation falls back toward the Federal Reserve's target.

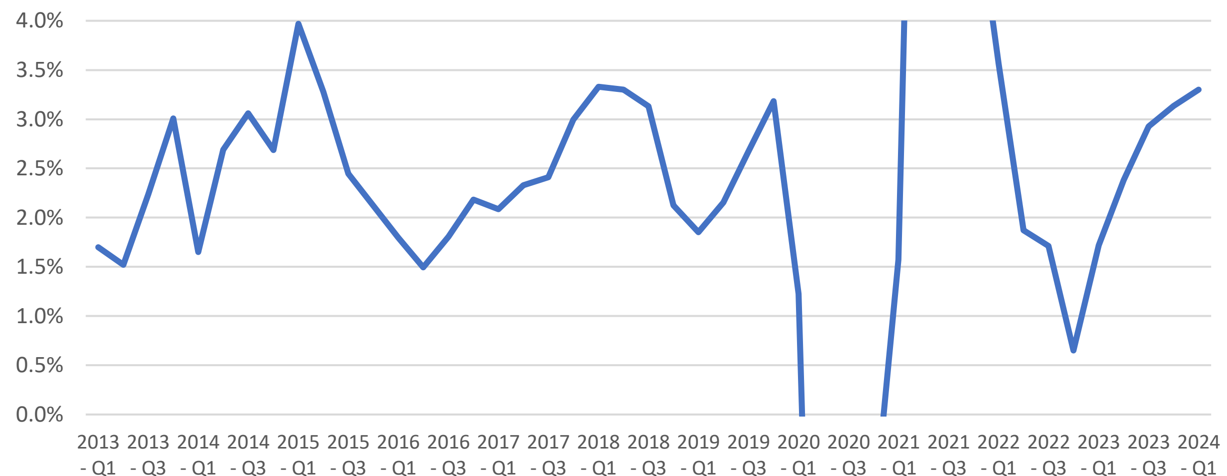
Growth Accelerates

The US has been growing much faster than other advanced economies since 2019.



Source: International Monetary Fund

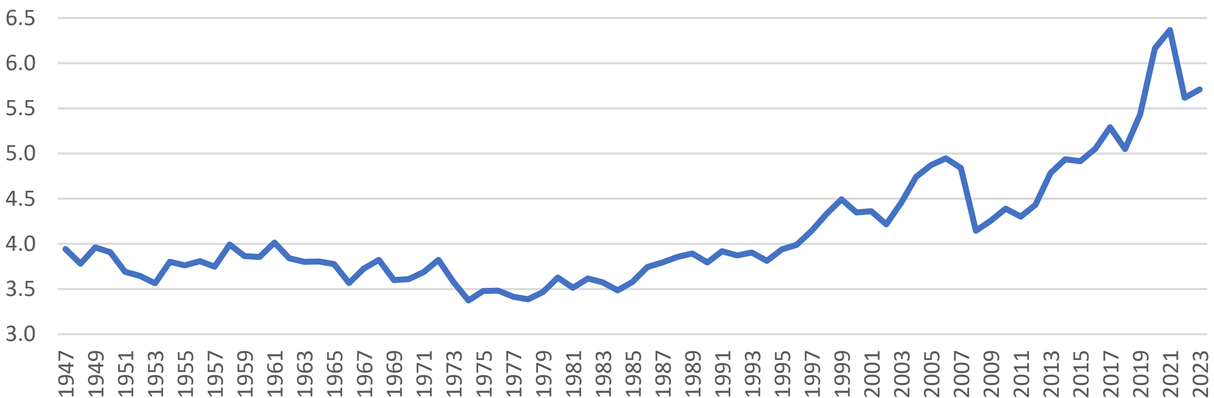
Not only is the economy expanding, but it appears to be doing so at a faster rate than many economists had forecasted—and there are signs that this momentum is building. The official gross-domestic product figures for the first quarter haven't yet been published. However, my estimates, which are based on projections from the Federal Reserve Bank of Atlanta's GDPNow model, suggest that the economy accelerated last quarter.



Sources: Bureau of Economic Analysis and Federal Reserve Bank of Atlanta

A pivotal, yet often underestimated, driver of US growth over the past decade is the remarkable surge in household net worth. Rising household wealth tends to translate to broader economic strength. And indeed, recent gains in home and stock prices—driven in part by the proliferation of generative AI technologies—have likely boosted perceived wealth among individuals and households, encouraging consumer spending. Although the accompanying chart concludes in 2023, the upswing in stock prices in 2024 suggests that this dynamic will continue this year—and may have accelerated significantly.

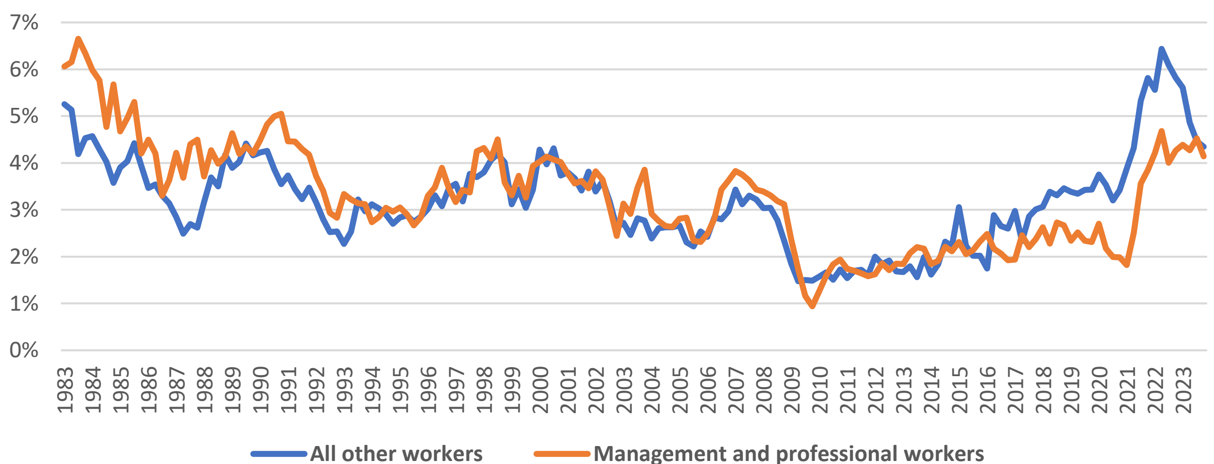
Ratio: Household Net Worth to GDP



Source: Federal Reserve Board

Overall wage growth has gradually moderated though it remains well above pre-pandemic rates, according to the Employment Cost Index. However, the slowdown in wage growth is driven predominantly by roles that do not necessitate a bachelor's degree—for example, manual services, blue-collar work, and sales and office support. Spending likely remains strong despite decelerating overall wage growth in part because of the steady pace of wage increases for highly educated management and professional workers. This group constitutes approximately 40% of the workforce and accounts for most of the overall cost of labor across the US economy.

Growth in Salaries and Wages (Employment Cost Index)



Source: Bureau of Labor Statistics; Burning Glass Institute

Inflation: No Soft Landing Yet

In recent months, the notion of a "no landing" scenario, where inflation remains well above the Fed's target rate, has become increasingly plausible in 2024. The fundamental factors driving inflation—such as economic and job growth, a tight labor market, rental price growth, and inflation expectations—are failing to align with a further reduction to a 2% inflation rate this year.

Firstly, the economy remains strong and may even have accelerated in the second half of 2023, buoyed by household and government spending.

As a result, the labor market remains tight, a condition that appears poised to persist given the economy's strength. Despite a noticeable slowdown in wage growth since 2022, it remains well above pre-pandemic levels. Moreover, the deceleration has been primarily driven by low-paying occupations. Wage growth for managerial and professional occupations, which have a more significant impact on overall labor costs, has been stable or declined only slightly.

Inflation expectations remain well above pre-pandemic levels, according to various measures, making it hard for actual inflation to come down to 2%. These play a crucial role in shaping actual inflation: when businesses anticipate that inflation will remain low in the future, they are more inclined to restrain from increasing prices in the present.

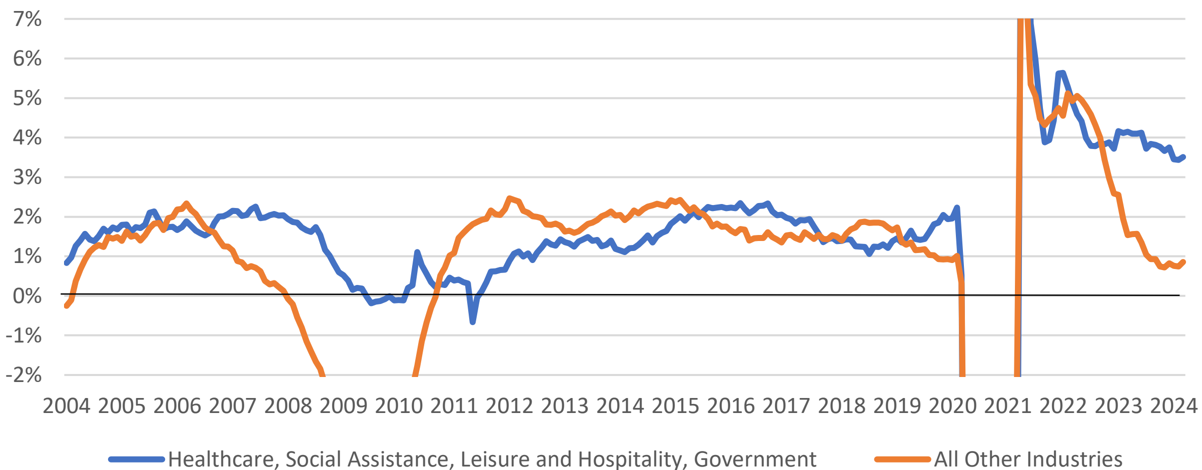
Inflation measures in the US incorporate a large category called "Owners' Equivalent Rent of Residences" (OER), which is intended to estimate the rental value homeowners would pay to rent their own homes in a competitive market. A surge in OER in 2022 and early 2023 contributed heavily to high inflation; an anticipated snapback in the measure had encouraged optimism for a potential soft landing last year. However, the decrease in OER growth rates has been more modest and gradual than many economists predicted. Consequently, inflation within this segment continues to be almost double pre-pandemic levels, keeping overall inflation elevated.

Alternative inflation measures also point to persistently higher inflation. Smoothed inflation measures, such as median inflation and trimmed-mean inflation—both developed to capture the underlying inflation trends more accurately—remain significantly above their pre-pandemic rates. Most critically, they are showing no signs of a sustained downshift.

This adjustment underscores how challenging the "last mile" in the battle against inflation is and suggests that a "no landing" scenario is more probable than a "soft landing" for 2024. Indeed, in recent weeks, markets have adjusted their expectations, scaling back predictions of imminent Fed rate cuts, leading to a surge in market interest rates.

Disinflation in 2025?

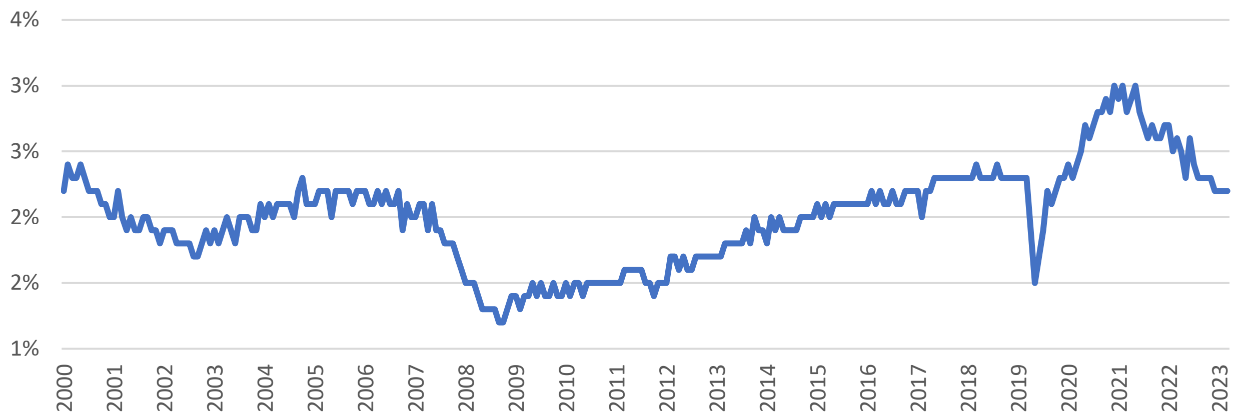
Strong job creation of late obscures what is increasingly a two-track labor market. On one level, hiring in health care, social assistance, and leisure and hospitality is booming. Government hiring is also elevated. This vigorous growth in part reflects the ongoing rebound from the downturn in these sectors caused by the pandemic. However, employment in other sectors is expanding at a more subdued pace. As hiring gradually normalizes in the first group, overall job creation should converge toward a slower pace of growth.



Source: Bureau of Labor Statistics

Meanwhile, the quits rate is another signal of labor-market loosening. Over the past two years, the quits rate has fallen from its peak during the Great Resignation to levels significantly lower than one might anticipate given current labor market conditions. Despite strong job growth and a still-tight labor market, why are fewer people leaving their jobs?

A plausible explanation is that many who left their positions during the Great Resignation have since found employment more in tune with their career goals, salary expectations, work-life balance preferences, and personal values. When individuals secure jobs that more closely match what they seek in their professional lives, they are less inclined to leave, leading to a decrease in turnover rates.

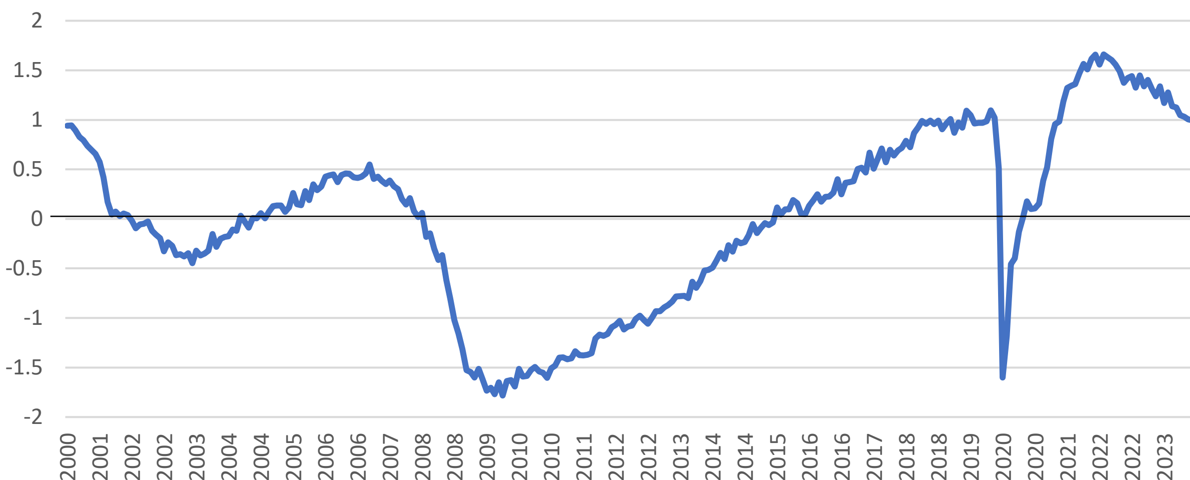


Source: Bureau of Labor Statistics

The crosscurrents of these dynamics suggest that job growth this year will likely slow somewhat but remain solid. Though the labor market remains relatively tight, this gradually loosening should take pressure off inflation. While we don't expect inflation to reach the Fed's 2% target in 2024, the outlook for 2025 is more optimistic—in particular, because of two other factors that should add to labor supply meaningfully in the coming year.

Immigration Is Loosening the Labor Market

Despite accelerating growth and strong job creation, the labor market has, counterintuitively, been loosening. Over the past two years, our Labor Market Tightness Index has shown a gradual decrease, indicating that the labor market's current tightness is back to 2019 levels, though that is still the tightest labor market since the late 1990s, outside the pandemic.



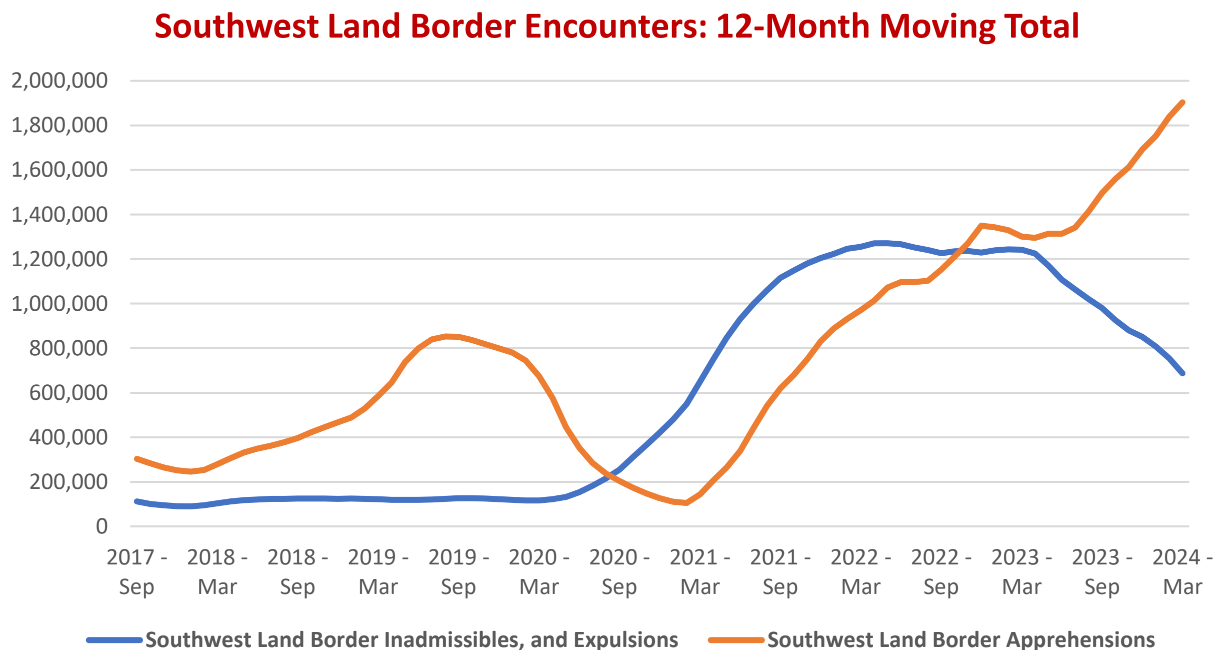
Source: Burning Glass Institute

The main reason for this unexpected dynamic is the significant surge in immigration. While this influx has been going on since 2022, it was not reflected in official government statistics, and therefore its impact on the labor market has been underreported. Recent reports from the Congressional Budget Office (CBO) and the Brookings Institution have sought to bridge this data gap. While the CBO estimates a net inflow of 3.3 million immigrants in 2023, compared with the Census' latest projection of 1.1 million. This discrepancy is partly due to CBO's incorporating data from the latter half of 2023, a period of intense inbound migration at the southern border.

The biggest driver of the increase is a category of individuals with nonlegal or pending statuses, including those awaiting immigration court decisions, humanitarian parolees, and those who crossed the border undetected. Net migration by this group was 2.4 million in 2023—accounting for nearly three-quarters of the total.

This large immigrant influx and its impact on the labor market in 2023 is due in part to the growing share of border encounters that end up in apprehensions alongside a decline in expulsions. Apprehended individuals—particularly asylum seekers—may enter the labor market, depending on their legal status and the host country's policies. While some are granted work permits during their legal proceedings, others may find work informally.

CBO's recent estimates imply a bigger increase in the noninstitutionalized population and, therefore, the labor force compared to data reported by the Bureau of Labor Statistics, whose calculations are based on Census population figures. The discrepancy between BLS's published population estimates and those adjusted for recent immigration data helps explain how job creation has remained strong despite a falling quits rate and slow labor-force growth in the official statistics.



Source: Customs and Border Protection

The large influx of less-educated immigrants is also one of the reasons for the recent divergence in wage growth trends. Less-educated immigrants tend to be eligible to fill manual services, blue-collar work, and sales and office support occupations, which may be alleviating labor shortages and helping wage growth cool.

If these immigration trends hold up—and the CBO projects a similar volume of net inflows in 2024 as in 2023—these dynamics should continue to boost labor supply and help wage growth cool, easing inflationary pressure in the process.

A Boost from Generative AI

AI adoption could add to the disinflationary dynamic by lowering labor costs in some industries in 2025. In the past year, generative AI has seen remarkable advances, leading to its adoption across a diverse range of applications. The surge in interest has also fueled a boom in AI-focused startups, attracting significant venture capital investments. Innovations in AI will continue, propelled by collaborations between academia, industry, and open-source communities.

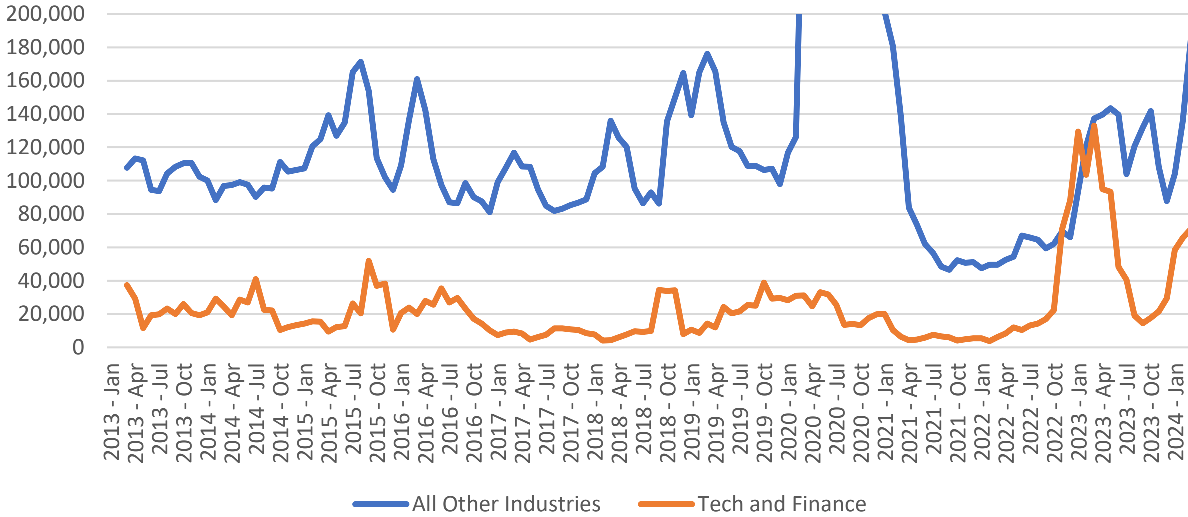
Although the overall fraction of firms using AI remains modest, the share has increased markedly—from approximately 3.7% in September 2023 to about 5.4% by the end of February 2024, with expectations to increase to around 6.6% by Fall 2024, according to the Business Trends and Outlook Survey. The adoption of AI varies significantly across sectors, ranging from 1.4% in construction and agriculture to 18.1% in the information sector. The primary uses of AI in businesses include marketing automation, virtual agents, natural language processing, and data/text analytics.

AI adoption will likely be disinflationary for two main reasons: First, it enhances worker efficiency, allowing companies to increase production without a corresponding increase in labor costs. As labor costs decrease relative to sales due to AI-driven efficiencies, companies may engage in aggressive price competition. Lower operational costs will allow companies to reduce prices in a bid to capture market share from competitors. Price competition should contribute to disinflationary pressure in the economy, as businesses pass on cost savings to consumers in the form of lower prices.

Second, inflation measures changes in the price level of a basket of consumer goods and services. Quality adjustment is made to account for changes in the quality of products over time. If generative AI leads to improved products and services—such as more efficient appliances, better software, or more effective medical treatments—then these quality improvements can be accounted for in the inflation calculations. This would lead to a lower reported inflation rate for the same nominal price because the real value received by consumers has increased.

This may not be purely hypothetical. One potentially ominous sign for the economy is that announced job cuts tracked by Challenger, Gray & Christmas rose markedly earlier this year—driven primarily by the finance and technology sectors, the two sectors that are most exposed to generative AI. This upswing may reflect an embrace of technology or, in the case of the tech sector, a realignment of focus towards AI-driven initiatives and away from other areas. Notably, despite an increase in announced job cuts, stock prices in tech and financial have gained during this period.

However, this otherwise worrying rise in announced layoffs probably does not signal a downturn because, so far, these impacts remain relatively contained within just two sectors.



Source: Challenger, Gray, and Christmas