Hard Landing? Soft Landing? Why the Year Ahead Will Bring

No Landing

Labor Market Outlook

The Burning Glass Institute

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The Path Ahead In 2024

The recent combination of robust economic growth and notable decrease in inflation has fueled optimism for a "soft landing" in 2024, with inflation aligning with the Federal Reserve's 2 percent target without triggering a recession. However, we hold a different view. While a soft landing is more likely now than it seemed even a few months ago, our analysis of labor market dynamics suggests that a more plausible scenario is that inflation will fail to drop down to the 2-percent target in 2024, leading to a 'no landing' scenario.

The rapid expansion of the U.S. labor force in 2023 was driven by temporary factors, such as an influx of immigration and high labor force participation rates, which are unlikely to continue through 2024. With immigration rates slowing down and labor force participation rates already at peak levels with limited potential for further increase, we can expect a significant slowdown in labor force growth in the year ahead. This shift could stabilize or even reverse the recent rise in unemployment rates.

This is significant because this expansion in the workforce has been a major factor in loosening the labor market over the past several months. However, as workforce growth slows, the labor market will remain tight, leading to sustained upward pressure on wages and, consequently, inflation. In such a scenario, it seems likely that the inflation rate will stay above 2 percent in 2024 – what we refer to as “no landing”.

What are soft and hard landings?

A soft landing occurs when the Federal Reserve raises interest rates sufficiently to decelerate the economy and decrease inflation towards its 2 percent target without instigating a recession. This is the optimal economic scenario and it is one that few believed was possible a year ago. A hard landing is when the economy enters a recession in consequence of efforts to lower the inflation rate – for example if high interest rates stifle spending to the point that economic growth dips into the negative. No landing means that the inflation rate did not reach the Fed’s target rate of 2 percent.

Why haven’t we achieved a soft landing already?

On the one hand, the prospects for a soft landing appear more likely than 12 or even 6 months ago. On the one hand, the economy continues to grow, that growth may even be accelerating, and employment is rising solidly. Yet, even as there has been a notable reduction in inflation and wage growth, inflation remains notably above the Federal Reserve's 2 percent target. The lingering question is whether inflation will continue its descent to the 2 percent target, or if it will plateau at a higher level while the economy keeps expanding. A soft landing, and the continued reduction in inflation that underpins it, therefore depends on reaching pre-pandemic wage growth rates and inflation expectations. As our analysis will show, that is not the most likely scenario.

Why There Won't Be a Soft Landing

The economy shows no signs of recession

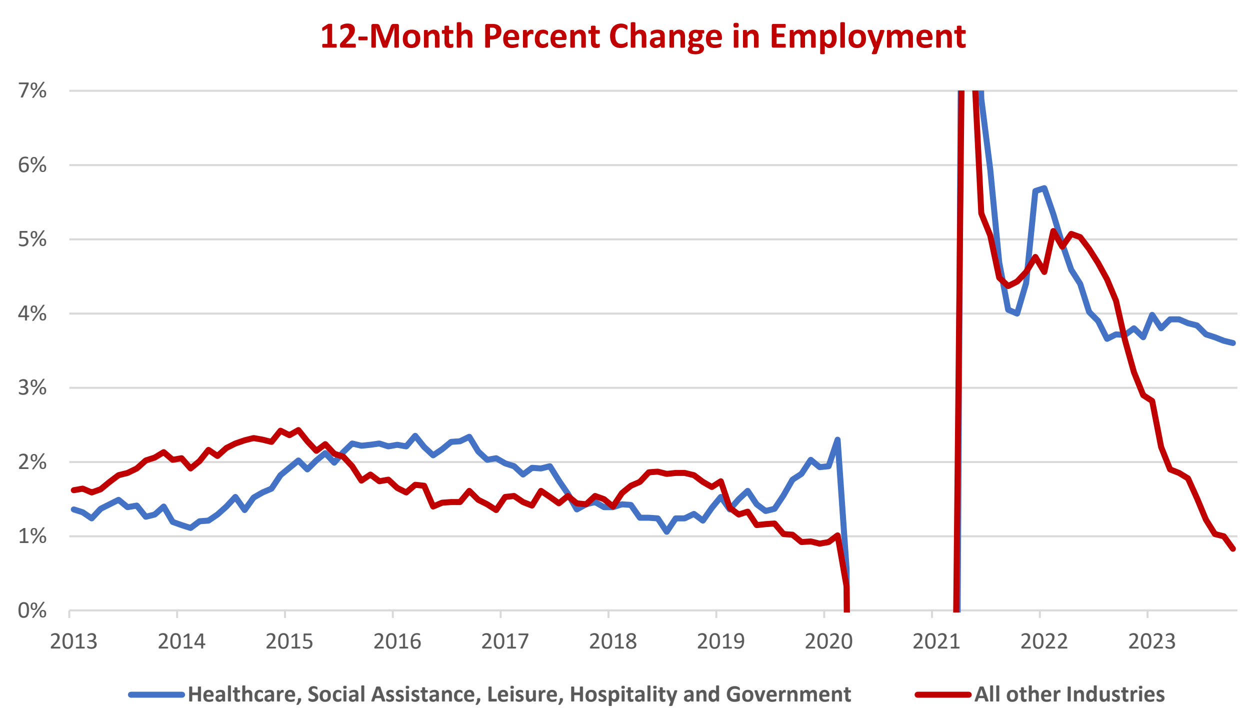
Despite the Federal Reserve's aggressive tightening over the past 1.5 years, the US economy has grown without slipping into a recession. In fact, the economy has accelerated in recent quarters. This strength predominantly stems from the American consumer, whose spending habits remain steadfast. Strong growth in government spending has also contributed to the overall economy.

The economy may slow down in 2024. Some of the sectors still recovering from the pandemic will reach their new normals. Nevertheless, consumer demand would have to fall both considerably and quickly for the economy to dip into negative growth, making a recession seem unlikely.

Employment growth is slowing, but remains solid

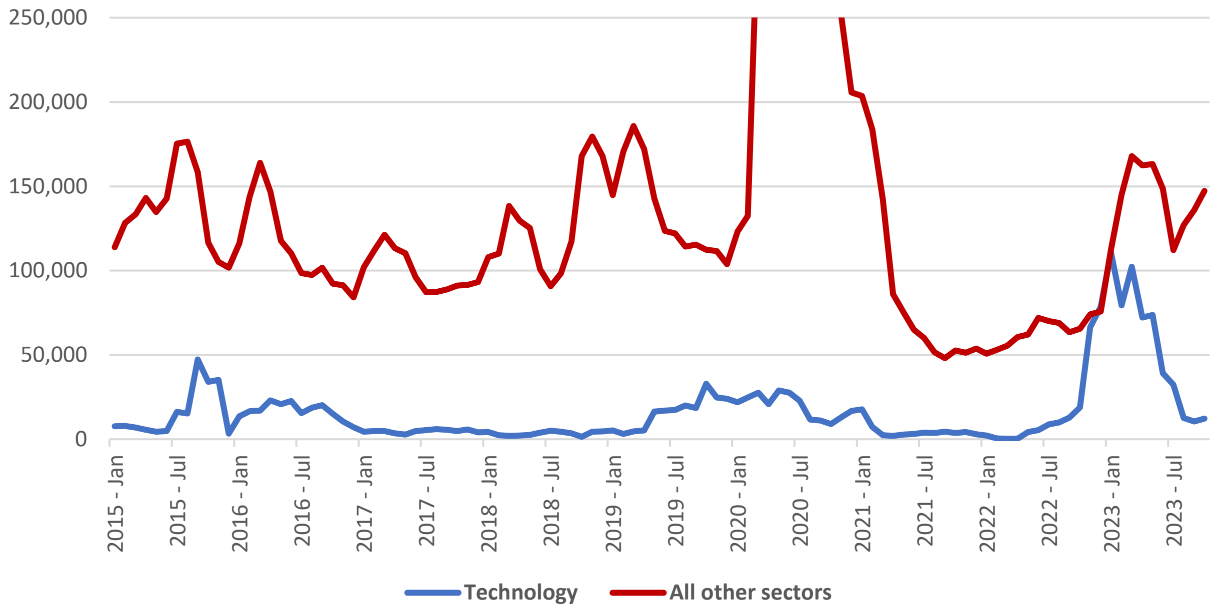
Job growth is showing signs of deceleration, yet remains robust. Importantly, there is substantial variation across industries. Sectors that offer in-person services — such as healthcare, social assistance, leisure, hospitality, and government sectors — are still rebounding from the pandemic and exhibiting particularly significant growth. Meanwhile, most other industries are experiencing more moderate increases in employment. We expect job growth to slow from its rapid pace in 2023, but will continue to trend positively nevertheless.

If the US economy is facing any decline, it is not reflected in layoff figures. Last year's surge in technology sector layoffs has concluded, and layoff rates in other sectors appear to be at normal levels.



Source: Bureau of Labor Statistics

Announced Job Cuts: 3-Month Moving Total

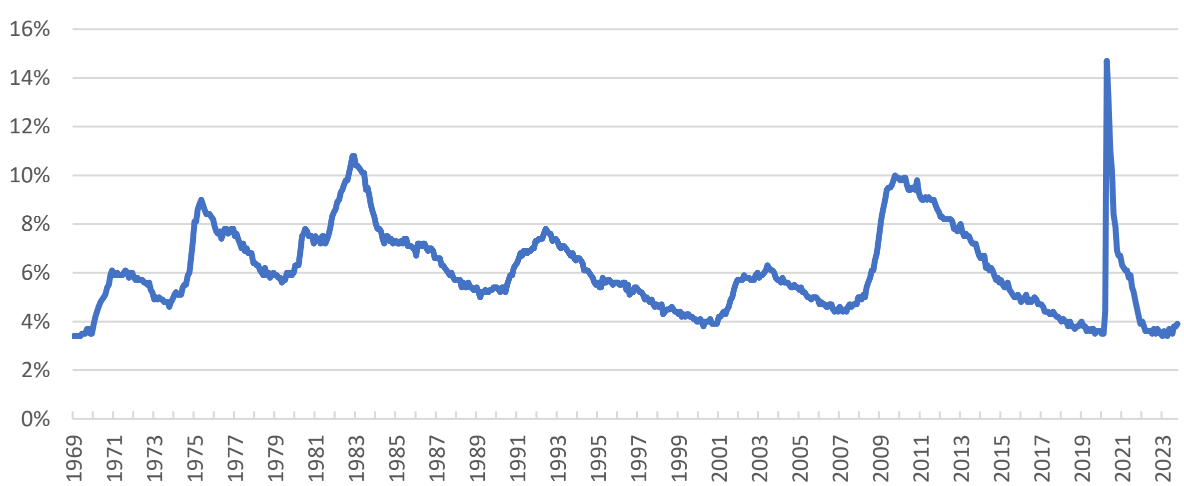


Source: Challenger, Gray, and Christmas

Our historically tight labor market is loosening – but only very gradually

In 2023, despite vigorous job growth and a wave of baby boomer retirements, the unemployment rate has edged upward, and the labor market has shown signs of easing.

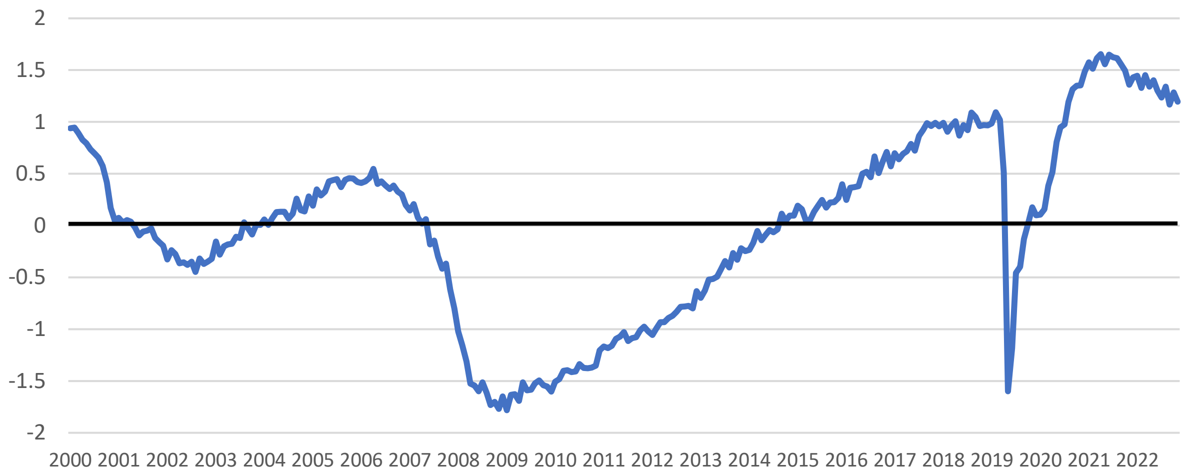
US Unemployment Rate



Source: Bureau of Labor Statistics

The Burning Glass Institute's Labor Market Tightness Index reveals that, while the US labor market is easing up, it still registers as tighter than at any period in the half-century prior to the pandemic.

Burning Glass Institute Labor Market Tightness Index



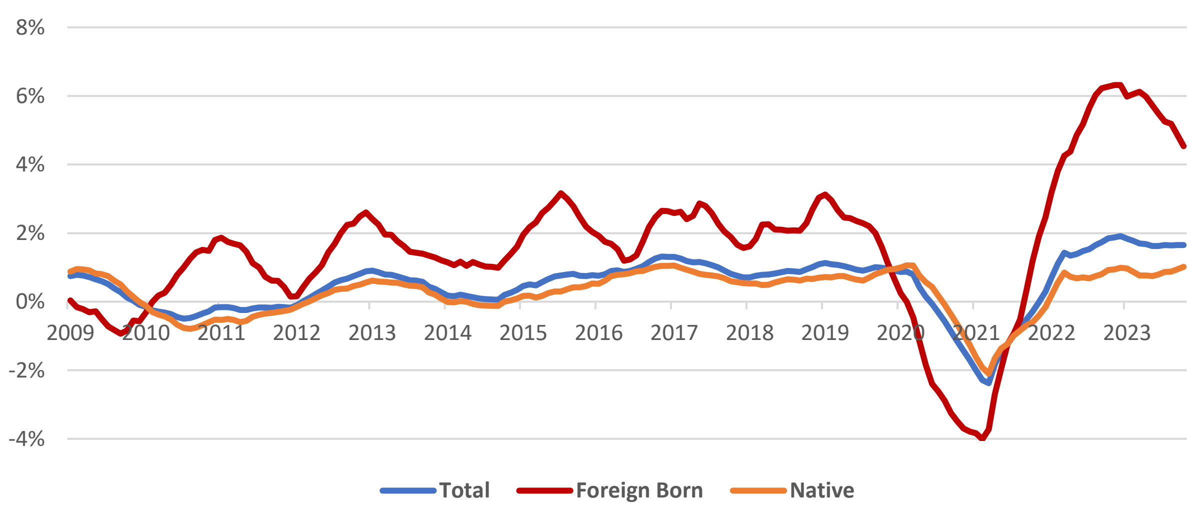
Source: The Burning Glass Institute

But why then is the unemployment rate going up?

First, the labor force is expanding swiftly, outpacing any period in the past two decades, even amidst the mass retirement of the baby boomer generation, with approximately 10,000 Americans turning 65 each day. A notable portion of this growth is attributed to a surge in the number of foreign-born workers, particularly since 2021. The number of immigrants is unusually large, making up for a slump during the COVID-19 pandemic, which saw some of the lowest levels in decades.

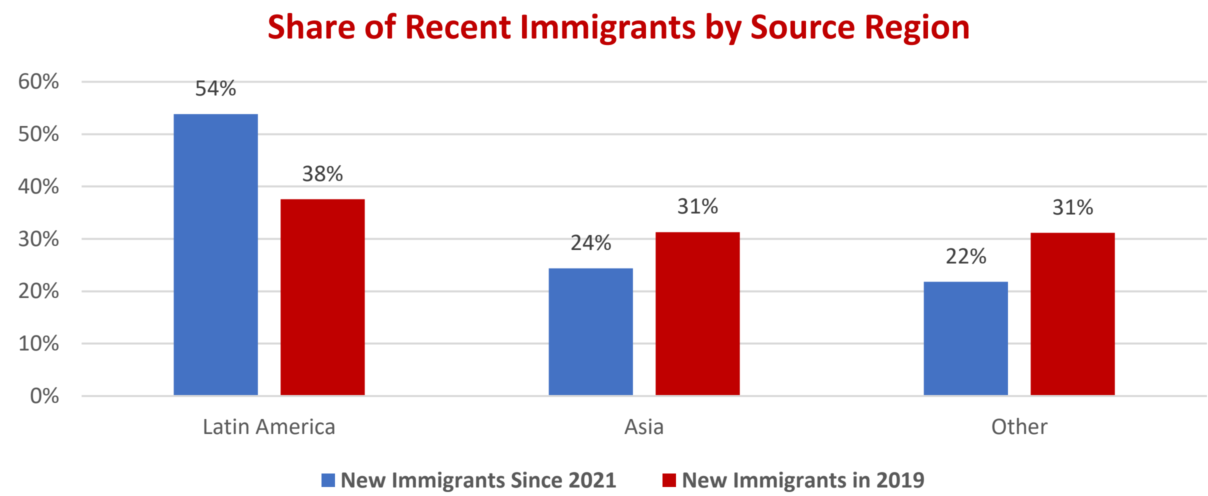
Percent Change in the Labor Force

Last 12 Months versus Previous 12 Months



Source: Bureau of Labor Statistics

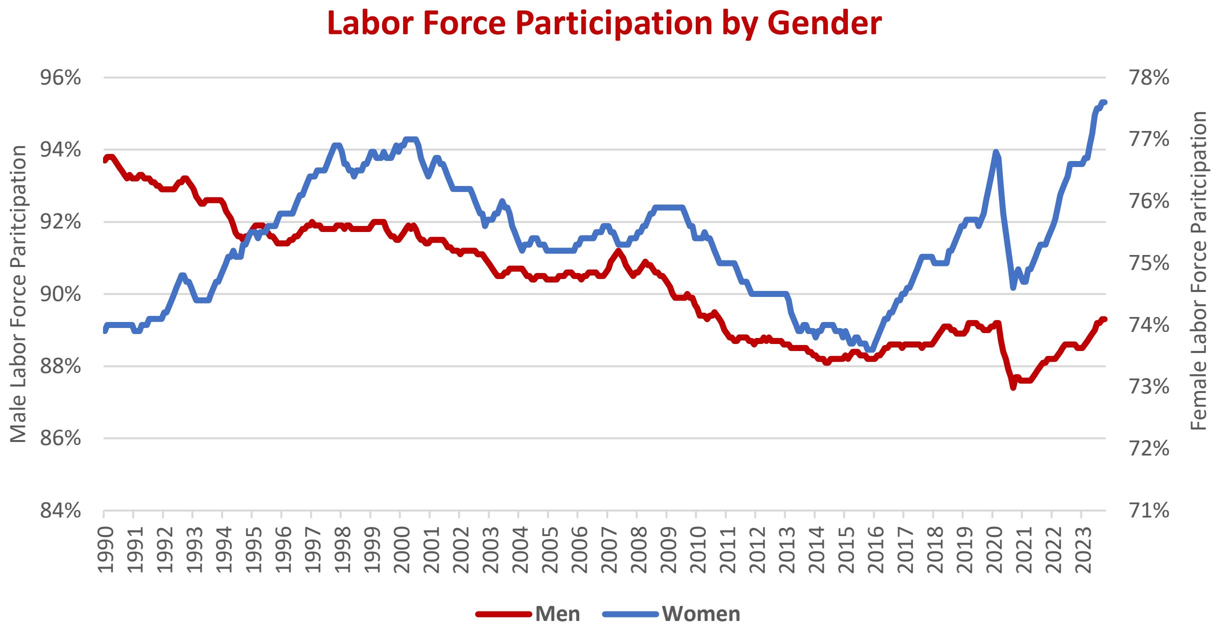
Data reveal that 54 percent of new immigrants have arrived from Latin America since 2021, a significant increase from the 38 percent in pre-pandemic times. This trend reflects how the border crisis and the rise in asylum seekers are contributing to significant labor force expansion.



Source: Bureau of Labor Statistics

Moreover, the recent wave of immigration has had its greatest impact in certain occupations such as construction, maintenance, food service, and repair jobs, which historically have disproportionate representation of Hispanic workers. These are some of the occupations that have seen the greatest talent shortages – and the highest wage growth during the pandemic recovery. The loosening labor market in blue-collar and manual service occupations can be partially attributed to this immigration.

The labor force's rapid expansion also owes much to a robust recovery in labor force participation rates which have reached unprecedented highs. That has been especially true among working age women. Over the past decade, the labor force has benefited from a marked increase in the labor force participation of Black and Hispanic women, introducing nearly 1.5 million additional workers to the US economy. A strong labor market tends to attract groups traditionally on its margins.



Source: Bureau of Labor Statistics

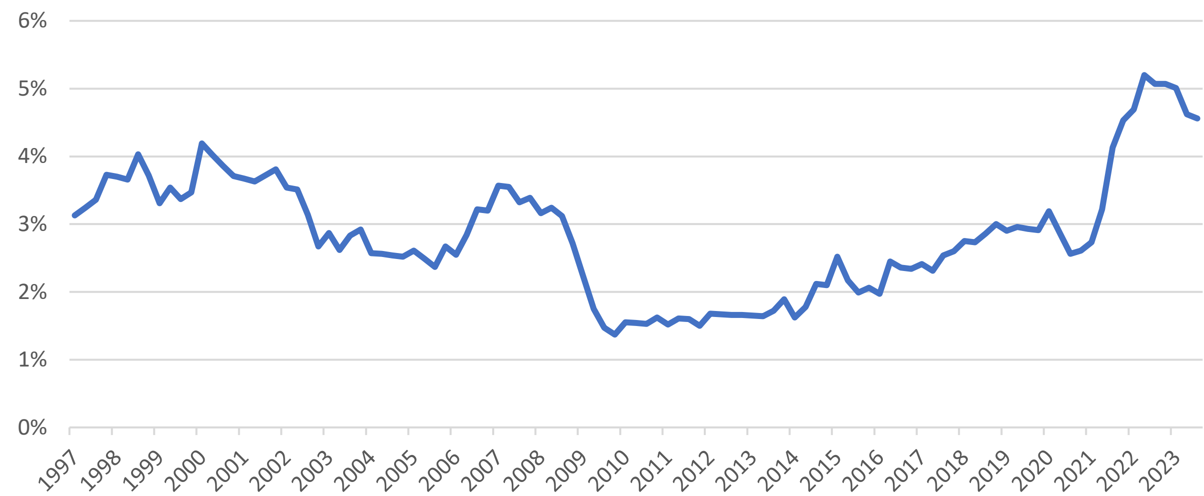
Yet, while the significant expansion of the labor force has been so strong as to yield a rising rate of unemployment despite both notable job growth and extensive baby boomer retirements, the forces behind this rapid expansion appear to be transient. Immigration rates are already decelerating, and labor force participation rates, currently at historic highs for many demographics, have scant room for further escalation. Consequently, we can anticipate a marked deceleration in labor force growth in 2024, which could stabilize or even reverse the upward trend in the unemployment rate.

Wage growth is strong and slow to decline

The Employment Cost Index, a highly reliable barometer of wage trends, indicates that wage growth is decelerating gradually. However, at still roughly 50 percent above its levels just before the pandemic (albeit down from its peak of 75 percent above pre-pandemic levels), it is still far too early to predict a reversion to historical norms in the near future.

US Employment Cost Index - Wages

4 Quarter Rolling % Change

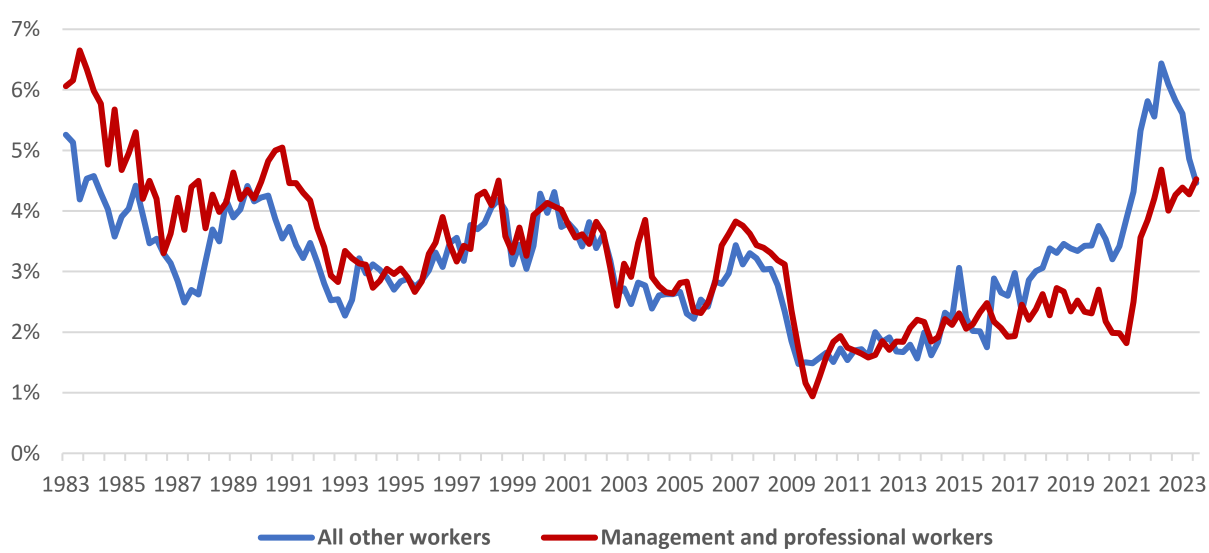


Source: Bureau of Labor Statistics

Delving deeper, the data show considerable disparities across job categories. Notably, wage growth for the highly educated management and professional sector—which represents around 40 percent of the workforce and commands the majority share of earnings—shows no signs of abatement. In fact, the slowdown in wage increases is almost exclusively seen in roles that do not demand a bachelor's degree. Wages for these positions spiked during the pandemic even after accelerated wage growth in the three to four years preceding the pandemic. The pandemic brought about unique labor market conditions that temporarily boosted wages for this segment, but these factors are now diminishing.

Growth in Salaries and Wages

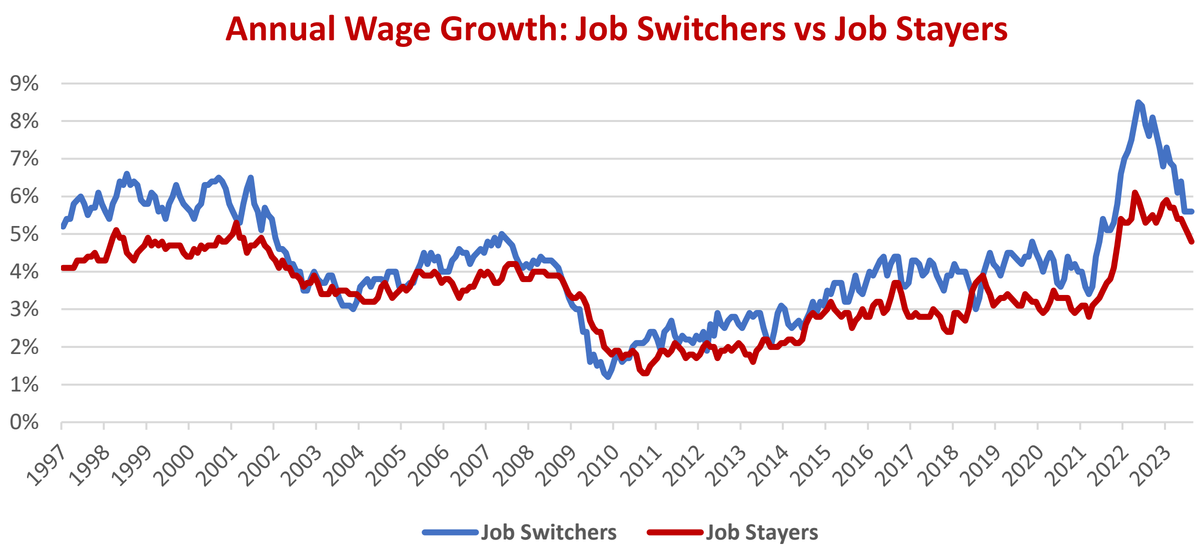
Year-over-year percentage change



Source: Bureau of Labor Statistics and The Burning Glass Institute

The current wage growth trends in the labor market demonstrate a notable degree of 'stickiness,' meaning that, even when wage growth for new hires cools down, overall wage growth is slow to decrease. This characteristic is accentuated by the pattern of annual salary raises, which typically lag behind shifting labor market conditions and inflation rates.

The Atlanta Fed Wage Growth Tracker indicates that job changers are seeing wage growth slow more than those who stay in their jobs. Corroborating this, the [Conference Board's survey] shows that 2023 salary budgets were the largest since 2001, highlighting a trend where annual wage increases are more influenced by past wage trends and are less reactive to immediate labor market dynamics.



Source: Federal Reserve Bank of Atlanta

In late 2023, auto worker unions negotiated new contracts that included significant wage increases. These substantial increases, set through collective bargaining, not only benefit the auto workers directly but also set a precedent that can influence wage expectations in other sectors. Such substantial wage hikes in union contracts contribute to the overall 'stickiness' of wage growth, ensuring that even as the labor market evolves, the foundation for ongoing wage increase remains robust, supporting a continued upward trend in wages across various industries.

Looking ahead to 2024, The Conference Board survey indicates that total salary increase budgets will grow by an average of 4.1 percent, signifying the third consecutive year of growth exceeding 4 percent, still a full point above the pre-pandemic rate. High continued levels of annual salary adjustment, plus a still-tight labor market, set an elevated floor for overall wage growth through 2024.

Why There Won't Be a Hard Landing

Over the past year and a half, the United States economy has demonstrated remarkable resilience in the face of the Federal Reserve's aggressive monetary tightening policies. Typically, such measures can lead to an economic slowdown or even a recession. However, contrary to these expectations, the US economy has not only avoided a recession but has shown signs of acceleration in recent quarters. This robustness is largely attributed to the strength of the American consumer, whose spending habits have remained robust.

Several factors have contributed to bolstering consumer confidence and spending. Firstly, many Americans accumulated significant savings during the pandemic, partly due to reduced spending on categories like travel, dining out, and entertainment. Secondly, various government incentives designed to support individuals and businesses through the pandemic period injected additional liquidity into the economy. Additionally, surging home prices have increased household wealth for homeowners, and gains in the stock market further contributed to a sense of financial well-being among consumers.

Government spending has also played a crucial role in supporting economic growth. Increased expenditure in various sectors has provided a stimulus to the economy.

When compared to other advanced economies, the recovery and growth of the US economy have been notably strong. In fact, the size of the US economy now surpasses the predictions made by the International Monetary Fund (IMF) in 2019, despite the unprecedented global pandemic of 2020-2021. This indicates not only a robust recovery but also an expansion beyond pre-pandemic expectations.

Looking ahead to 2024, the economy might slow down. However, for a recession to occur, there would need to be a significant and rapid decline in consumer demand, a scenario that currently seems unlikely. The sustained consumer spending, supported by the factors mentioned earlier, acts as a buffer against negative growth.

No Landing: Why Inflation Won't Return to 2% in 2024

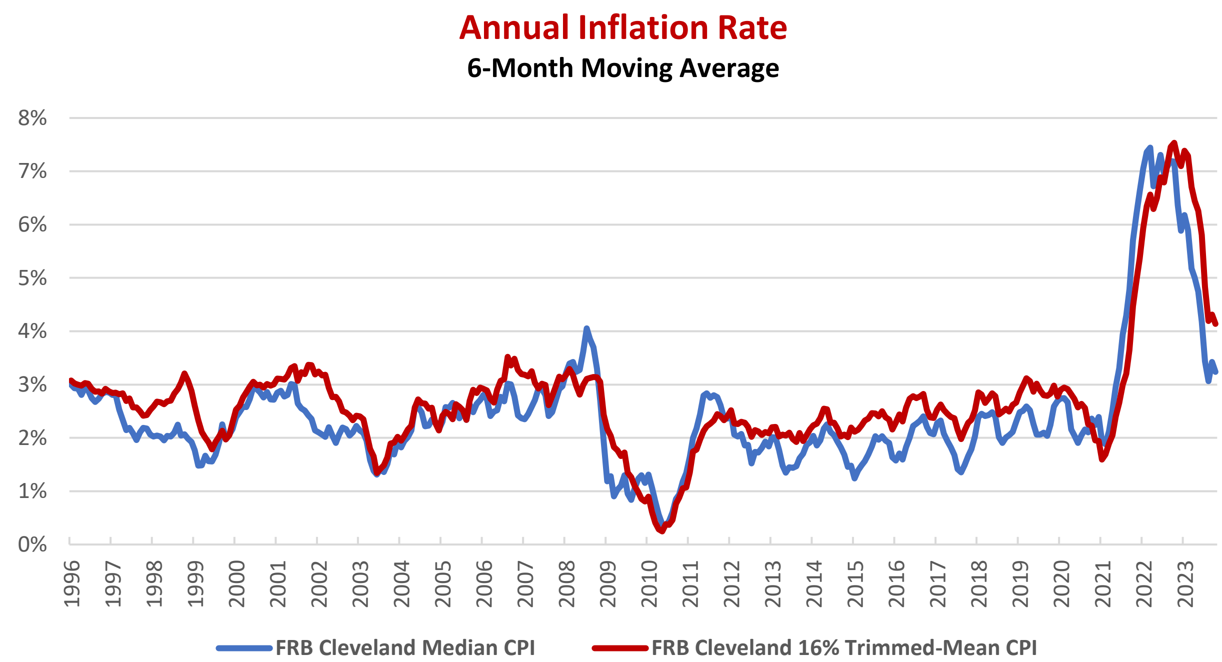
As the economy and job market continue to ascend, the critical component for a 'soft landing' is the tempering of inflation. Over the past year, inflation has indeed retreated substantially but still far exceeds the Federal Reserve's 2 percent objective. The pivotal question is whether inflation will descend further to meet this target or whether it will stabilize at a higher rate amidst ongoing economic expansion, with the outcome largely hinging on the labor market conditions.

Changes in the inflation rate are the product of two main drivers: foundational market dynamics and events that cause deviations from the normal rise of prices. Labor market tightness, rising wages, and public expectations of inflation are all core market dynamics that support continued inflation. By contrast, the pandemic and its associated supply disruptions such as soaring rent and used vehicle prices, have yielded short-term deviations that pushed inflation, and inflation expectations, upward outside of the normal course of business.

As these latter influences begin to ebb, their impact will inevitably diminish. Once this process concludes, the direction of inflation will depend on the labor market's level of tightness, wage growth, and the recalibration of inflation expectations. As discussed above, we expect elevated rates of wage growth to continue through 2024. At the same time, inflation expectations are still well above pre-pandemic rates.

As a result, the most likely scenario is for overall inflation to remain well above the 2% Fed target rate.

Hence, no landing.



Source: Federal Reserve Bank of Cleveland

If inflation stays higher than expected in 2024, contradicting current market predictions of Federal Reserve rate cuts, long-term interest rates could rise significantly. This adjustment would occur as markets realign expectations with the Fed's actions to control inflation. Higher long-term rates would increase borrowing costs, especially in the housing market, potentially slowing economic growth. Additionally, these changes could lead to greater volatility in financial markets.

All this is part of the bigger narrative of the coming decade: a tight labor market will continue to create wage and price pressures, which will force the Fed to slow down the economy.