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Looking Back on the US Economy in 2024 and its Outlook for 2025

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With 2024 now at a close, eager market eyes turn to 2025. The US will ring in the new year and a new Administration in a strong but increasingly uncertain position. Inflation is yet again hitting a tenacious snag on the journey to 2%, while growth continues to surprise on the upside. Both suggest the real neutral rate of interest might be even higher than the 1% median estimate in the latest Federal Reserve Summary of Economic Projections. This question will be paramount in 2025. Other federal policies will also loom large over the 2025 outlook, including the possibility of tariffs and a major shift in immigration.

2024 in the Rearview Mirror: more growth than expected, but also more inflation

Table 1:

Forecasts of 2024 US Economic Outcomes

	Survey of Professional Forecasters		FOMC Summary of Economic Projections	
	Nov 2023	Nov 2024	Dec 2023	Dec 2024
Real GDP (Q4-Q4%)	1.3	2.4	1.4	2.5
Unemployment Rate (Q4)	4.2	4.2	4.1	4.2
PCE Inflation (Q4-Q4%)	2.4	2.4	2.4	2.4
Core PCE Inflation (Q4-Q4%)	2.4	2.8	2.4	2.8
Payroll Growth (Thous. per month)	91K	161K**		
Business Investment (Q4-Q4%)	1.5	3.6		
Ten-year Yield (Q4)	4.03	4.16*		

* Actual Q4 average of daily data
** Incorporates preliminary benchmark revision

Source: FRBPHL, FRB, Haver, BLS, BEA, author's analysis.

Private sector expectations going into 2024 were not nearly as dire as they were going into 2023 when recessionary calls were common and real growth was expected to be near 0%. Nevertheless, in late 2023, forecasters saw a rocky descent-but-not-quite-landing for the US economy in 2024 (see Table 1 above). Forecasters surveyed in the Philadelphia Fed's Survey of Professional Forecasters (SPF) broadly expected a sharp slowdown in real GDP growth over 2024, with a median SPF forecast of 1.3% growth in 2024 Q4-Q4 (left columns). The median Federal Open Market Committee (FOMC) participant likewise saw growth cooling to 1.4% (right columns of Table 1). Both expected inflation to cool to 2.4% and the unemployment rate to rise to around 4.1-4.2%.

How accurate were they? While data for 2024 is not yet finalized, with only Q4 outstanding the SPF now projects 2024 growth to come in at 2.4%, an outcome that was in the 94th percentile of SPF forecasts back in late 2023, while the December FOMC Summary of Economic Projections (SEP) has median GDP growth for 2025 of 2.5%. Even these median forecasts might prove to be too pessimistic in the end: both of them implicitly assume 2024 Q4 growth comes in at roughly 2% annualized, but some nowcasting models are more optimistic. At the time of publication, GDPNow is currently predicting 3.2% real GDP growth, which if true would imply 2024 growing at 2.7% Q4-Q4. That would also mean 9 out of the last 10 quarters grew at 2.5% annualized or greater, an impressive run. Either way, it appears that forecasters underestimated growth again for 2024, though not as egregiously as they did for 2023.

Year-ago 2024 growth forecasts were off for several reasons but primarily because forecasters underestimated business investment and employment growth. The November 2023 SPF foresaw a 1.5% expansion in real business investment over 2024; the current forecast incorporating actual data through Q3 is 3.6%. Likewise, a year ago, forecasters assumed employment growth would essentially converge back to a breakeven trend. The SPF assumed payroll growth would come in at 91,000 a month on average for the year. The actual data so far (incorporating the preliminary benchmark revision through March 2024) suggests that 2024 averaged 161,000 jobs a month. The fact that forecasters were generally correct on the unemployment rate suggests that the miss on employment growth may have been driven by an underlying underestimate of labor supply growth; since the unemployment rate is a ratio of the two, these errors would have been offsetting for the unemployment rate forecast.

Forecasters, in contrast, have been almost exactly on point on headline inflation but, more importantly, for monetary policy, they underestimated core inflation by 0.4 percentage points. Combined with the growth surprise, this suggests that observers misunderstood the US economy a year ago. Indeed, in December 2023, the median FOMC participant still penciled in a long-run real R* of 0.5%; in the intervening 12 months, that estimate has risen a full half a point.

The 2025 Outlook: Third Time's a Charm for the Not-Quite-Landing?

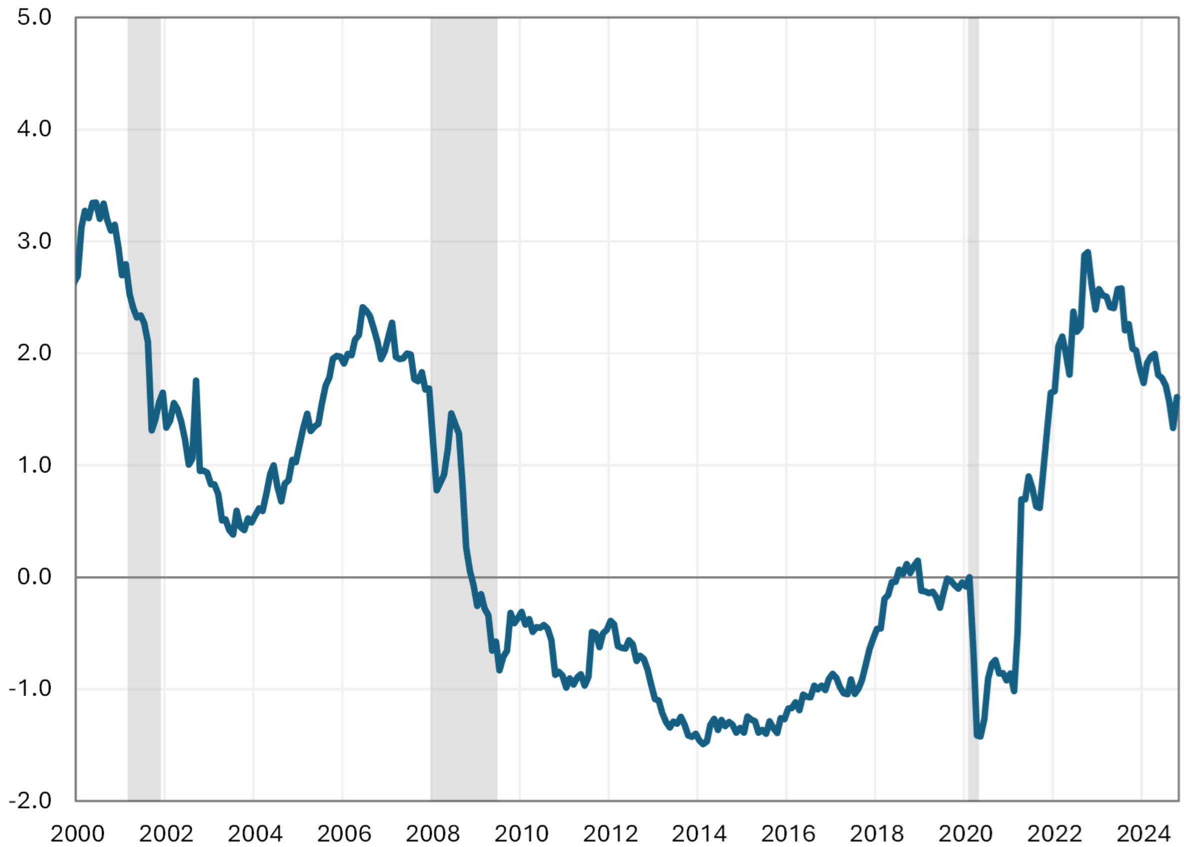
For 2025, the Fed and markets once again see growth cooling (to 2.0-2.1%), inflation moderating (albeit not all the way to target, with core reaching 2.2% in the November SPF and 2.5% in the December SEP), and the unemployment rate roughly staying stable. Of course, the December SEP in particular still involved major shifts in the outlook, with the Fed postponing two cuts they had previously signaled for 2025.

On many measures, the US economy remains the best-placed in the advanced world, and markets should not lose perspective that the uncertainties facing the US in 2025 are ones coming in the context of an economy that has consistently outperformed forecasts and the rest of the G7.

Still, there are several risks to the outlook in 2025 that bear watching.

- **R*.** The level of the neutral rate, or R*, will be the most consequential economic question of 2025. A major fundamental risk is that the Fed has misjudged the neutral interest rate. Indeed, this tension was on display in the December SEP, with an implied median real R* estimate of 1%, yet a rate path that, under a conventional Taylor rule, suggested the FOMC really had an R* closer to 1 ¼ % in mind. It may even be higher; the 5Y5Y TIPS, a market-based proxy for medium-run real R*, is currently running at ~2.2%. Meanwhile, my previously published model of shorter-run R* is at 1.6% (see Figure 1 below). Models aside, the strongest reason to suspect R* might be higher than thought is simply because of the incoming data: R* conceptually measures the interest rate at which the economy grows at trend, yet we have seen consistent upside surprises on GDP growth coupled with unanticipated tenaciousness on inflation. A higher R* would also be consistent with the deteriorating fiscal outlook that has come into increasing clarity.

Figure 1



The short-run risk from a higher R* is two-fold. On the one hand, the Fed may commit a dovish policy error, cutting too far and reaccelerating inflation. Those risks have been diminished thanks to the Fed's shift in the dot plot at the December meeting. On the other hand, even if the Fed doesn't commit an error, there's a risk that they postpone or cancel even more rate cuts, which would spark more of the type of market sell-off we saw in the wake of the December meeting.

- **The labor market.** The challenge for the Fed is that all is not on firm ground with the employment side of their mandate either. While the unemployment rate has appeared to stabilize over the past several months, it has still risen half a point over the past year, the type of rise normally associated with a recession. While employment levels like the prime-age employment-population ratio are near historic highs, measures of momentum like hires, quits, and job openings are weakening and back to levels more consistent with 2016 or 2017 rather than 2019 (the JOLTS hires rate is now back down to 2013 levels). Given how the weather has skewed recent data, and given the magnitude of downward benchmark revisions to the payroll survey through this past March, there is a real risk that the US labor market is, in fact, more vulnerable than it looks and that overly tight monetary or fiscal policy (see below) might exacerbate its weakness.

- **Federal policy.** The key undertone to the 2025 US outlook is a series of federal policy debates. Foremost among them is the outcome of tariffs. On the campaign trail, President-elect Trump proposed a dramatic shift in US customs duties that, taken literally, would involve raising tariffs across the board by 10-20% and by 60% on China. That could raise the price level to an extra percentage point next year, on average, depending on the breadth of the final policy. In fact, Federal Reserve Chair Powell hinted that some FOMC participants had incorporated tariff expectations into their SEP forecasts (that said, Fed officials have previously signaled they would look through the one-time price level effects of a tariff hike, though they might have to respond to any ancillary macroeconomic effects to demand and supply). It could also be a meaningful drag on consumer demand. On the other hand, if tariffs are used as a budgetary payfor to extend the 2017 tax cuts, long-run yields, and term premia may fall.

  The other major federal policy to keep tabs on in 2025 is immigration. While the main driver of the US growth surprise over the last few years has been productivity, labor supply, driven by immigration, has also been a contributing factor. The policies that would have the greatest potential to damage growth are deportations and curbing of future highly-educated immigration flows. Both policies are still uncertain.

A related question is: How accurate have year-out forecasts been in the past? It turns out that, like the statisticians hunting for bears in the old joke (one misses right, one misses left, the third exclaims "Nailed it!"), private forecasters have clustered around the correct answers on inflation, GDP growth, and the unemployment rate a year out, but they can still miss widely in both directions. The figure below (Figure 2) shows the year-ahead error rates for SPF forecasts in Q4 every year since 1969. Positive numbers indicate the median SPF forecast was an overestimate, while negative means the SPF came up short. The boxes show the interquartile range (25th-75th percentile, or middle 50%), the middle lines show the median error, the dots the average, and the brackets the full range of the errors. I have divided the sample into the full sample (left) and just the years when CBO's unemployment gap was negative, as it is now (right).

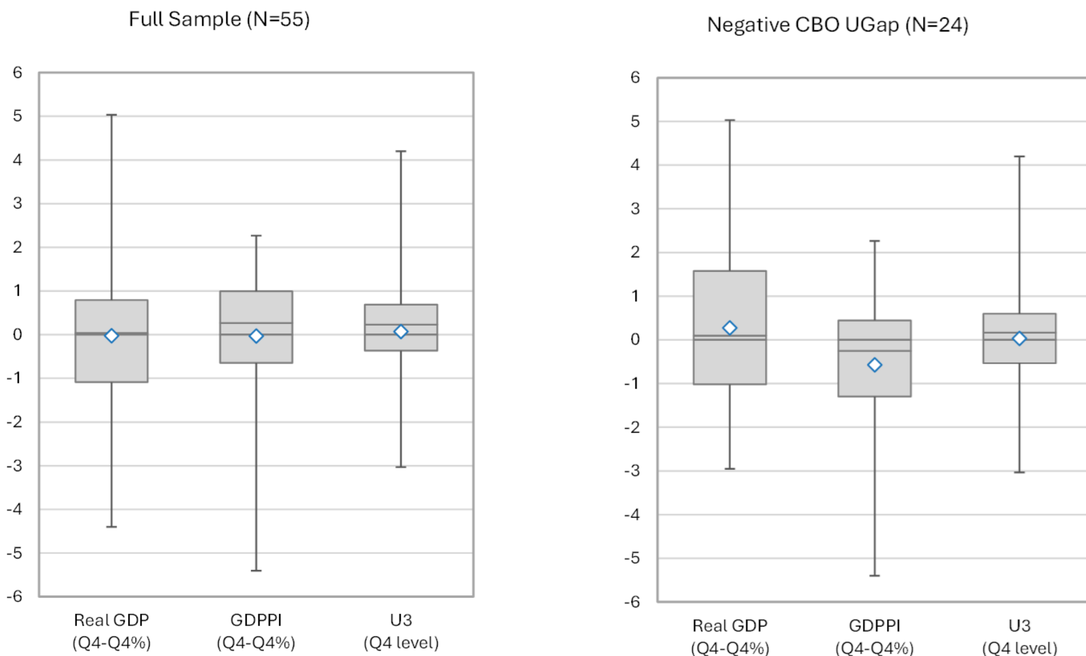
As you can see, the median SPF errors a year out are close to zero in both samples, especially for growth. When the economy is at full employment (right panel), forecasters nevertheless tend to overestimate growth (middle 50% of real GDP errors skewed positive) and underestimate inflation (middle 50% of errors skewed negative). The middle 50% of unemployment errors a year out are relatively symmetric.

Figure 2

Survey of Professional Forecaster Year-Ahead Errors Since 1969 Q4

Q4 year-ahead forecasts

Positive = median SPF overestimate



Source: FRBPHL, BEA, BLS, author's calculations.

Taken at face value, then, in a strong economy like the present, one might want to discount forecasters' growth assumptions and add a premium to their inflation projections based on

historical experience. On the other hand, the labor market was at full employment in late 2023 as well (measured by a negative CBO unemployment gap), and as already discussed, making those adjustments would have *increased*, not decreased, the forecaster error!

Conclusion

The US economy has had a remarkable pandemic recovery. It's still far from clear that this remarkable recovery is even over. But massive uncertainty hangs over 2025, even after the happy surprises of, first, 2023, and then 2024. The perennial question of whether the Fed will nail a soft landing remains; the progress that seemed to be made throughout 2024 was called into question with a flattening of inflation at the end of 2024 and continued growth robustness. Both of these, along with a worsening federal debt trajectory, hint that R* might be higher than originally thought. Risks on the labor market side loom as well, especially around slowing measures of churn and momentum that could eventually feed into a rising unemployment rate. For 2025, the Fed and private forecasters see growth moderating and inflation cooling some but not all the way to 2%. This could be right but is also the mean-reversion forecast made at the end of 2022 and again in 2023 that proved wrong two years in a row. Overarching all of this is the potential for federal policy to significantly alter the outlook through a major shift in tariffs and immigration.

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