U.S. Outlook for Interest Rates, Inflation, and Monetary Policy

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This is a summary of our 64-page report.

Key Takeaways

- Interest Rates
  We expect the U.S. Federal Reserve to pivot to easing monetary policy in 2023 as inflation falls back to its 2% target and the need to shore up economic growth becomes paramount. Our 2026 and long-run projection for the federal-funds rate and 10-year Treasury yield is 1.75% and 2.75%, respectively, though we expect rates to dip below these levels in 2024 and 2025 as monetary policy leans accommodative. We're expecting interest rates to fall much more than consensus in the near term, with our projected year-end 2023 federal-funds rate at 1.75% compared with 3.25% for consensus. Likewise, near-term Treasury yields are too high—implying much tighter monetary policy than we're expecting.

- Inflation
  We're projecting price pressures to swing from inflationary to deflationary by 2023, owing greatly to the unwinding of price spikes caused by supply constraints in durables, energy, and other areas. This will make the Fed's job of curtailing inflation much easier. In fact, we think the Fed will overshoot its goal with inflation averaging 1.4% over 2023-26. Our inflation analysis is critical to our near-term projections for the gross domestic product and interest rates. If inflation becomes much more entrenched, then the Fed will have to engineer a sharp short-run recession by hiking interest rates much higher than we expect.

- GDP and Recession Risk
  For now, we think the Fed is slowing the economy enough to help cool off inflation without provoking a major slowdown. We're projecting annual growth rates to remain in positive territory. A technical recession is a possibility, but we don't think it would be a quantitatively significant slowdown. As long as the Fed is allowed to shift to easing in 2023, GDP should continue trending upward and then accelerate in 2024 and 2025. Housing, which is the most interest-rate sensitive major component of the GDP, will drive much of the fluctuation in GDP growth. Lower rates in 2024 and 2025 will be needed to improve housing affordability and thereby resuscitate housing demand.

- Long-Run Interest Rates
  Long-term forces (far outside of the control of the Fed) have acted to push down interest rates in the U.S. and other major economies for decades. In economic parlance, the natural rate of interest has shifted downward because of demographics and slower productivity growth, among other factors. These factors will keep interest rates lower for longer.

- Monetary Policy Primer
  We provide an overview of how monetary policy seeks to calibrate interest rates in order to balance out its goals for GDP and inflation. Such a framework is essential for projecting the course of interest rates.

Forecast Update: Growth Slowdown Is Materializing Sooner Than Expected

Near-Term Headwinds Are Increasing, but Our Long-Term Optimism on GDP and Inflation Is Largely Unchanged

We Expect a More Delayed Recovery Owing to Supply Shocks and the Fed

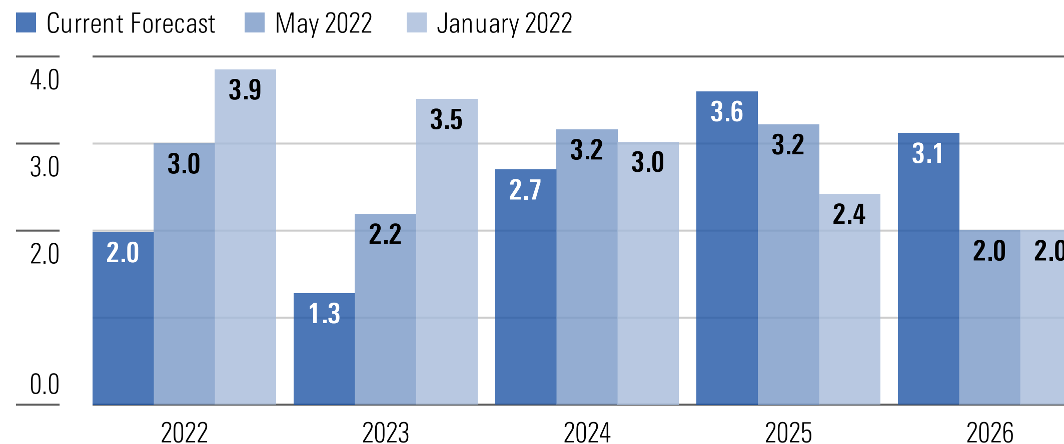
Since our last update, we've further lowered our near-term GDP forecasts. Near-term measures of economic activity have come in weaker than expected in recent months, with the Atlanta Fed's GDPNow currently projecting a sequential decline in second-quarter 2022 real GDP. Altogether since the start of the year, our near-term GDP forecasts have come down substantially owing to supply shocks (especially the Ukraine war) and a heightened determination from the Fed to fight inflation with tighter monetary policy.

We expect GDP growth will bounce back starting in 2024 as the Fed pivots to easing. Resolution of supply constraints should facilitate an acceleration in growth without inflation becoming a concern again. Increases to our GDP growth forecasts for 2025-26 partially make up for our downward revisions for 2022-23.

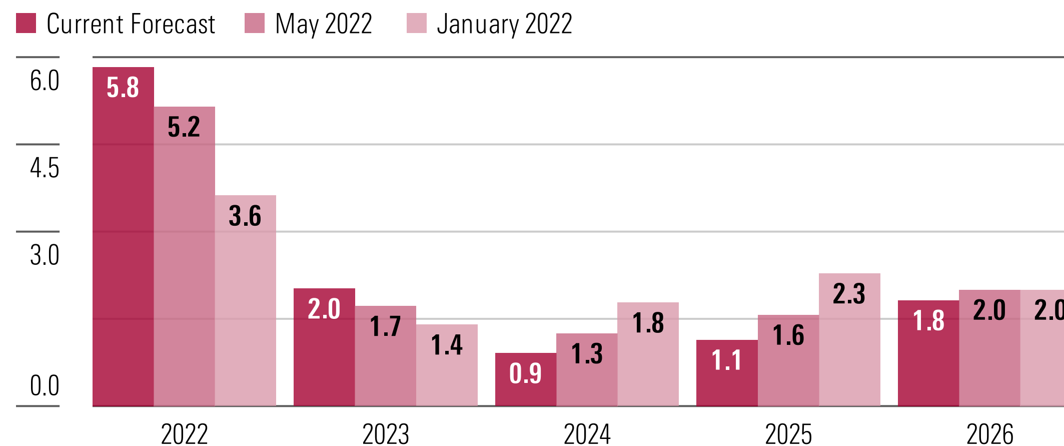
Inflation in 2022 Staying Hotter for Longer Than Expected

Our inflation forecasts for 2022 have edged higher, mainly because of oil prices shooting up higher in May and June. We're still expecting inflation to come down dramatically in 2023 and later years as supply constraints affecting durables, energy, and other areas are resolved. The downward revisions to our GDP forecast also mean a more negative output gap in the near term than we expected, which will cool off inflation further.

GDP Forecast Revisions



Inflation (PCE) Forecast Revisions



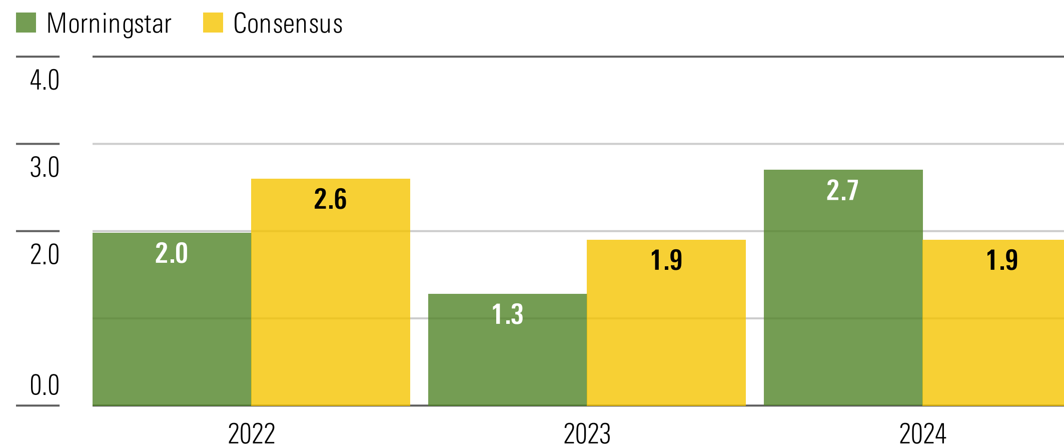
Source: U.S. Bureau of Economic Analysis, Morningstar. Data as of July 6, 2022.

FORECAST UPDATE

We Remain More Optimistic Than Consensus on Strong GDP Growth and Mild Inflation

We're More Bullish Than Consensus on Long-Run GDP

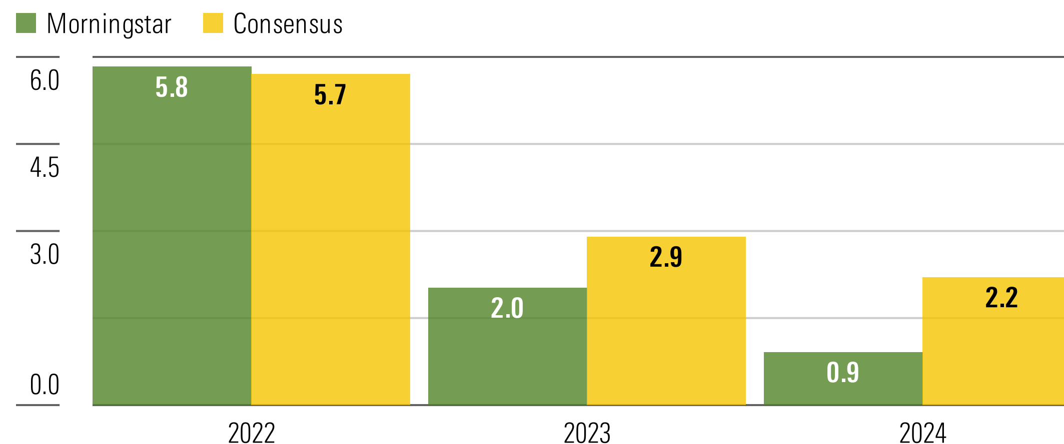
Our GDP forecasts for 2022 and 2023 are slightly more bearish than current consensus, although we expect consensus forecasts to be revised down soon. In the longer run, we're far more bullish than consensus. Based on available long-run forecasts, we're expecting about 2.5% more cumulative GDP growth than consensus through 2026. Consensus remains overly pessimistic on recovery in the labor supply and has generally overreacted to near-term headwinds. Our five-year GDP forecasts are driven by our detailed analysis of the labor market and the other supply-side building blocks of the economy. See our U.S. Economic Outlook: Second-Quarter 2021 for more details.



We Expect Inflation to Fall Much Faster Than Consensus

On inflation, our views diverge sharply from consensus after 2022. Bond market breakevens imply a similar view as consensus on inflation.

While consensus has greatly given up on the "transitory" story for inflation, we still think most of the sources of today's high inflation will abate (and even unwind in impact) over the next few years. This includes energy, autos, and other durables. Combining these factors with monetary policy tightening, we expect inflation to undershoot 2% in 2023 and 2024. Worries about inflation broadening out into the rest of the economy (including via high wage growth) look overblown.



Source: U.S. Bureau of Economic Analysis, Bloomberg, Morningstar. Data as of July 6, 2022.

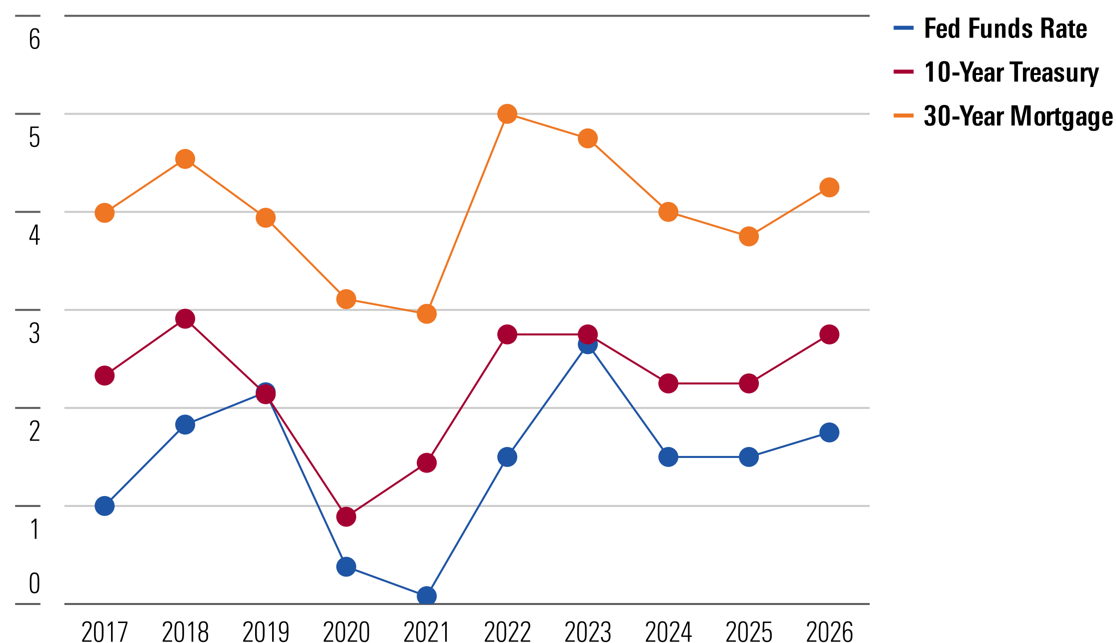
Interest-Rate Forecast Summary

We Expect the Fed to Shift Back to Easing in 2023

Interest rates have soared over the past year as expectations of monetary policy tightening have built up and begun to play out. However, we think the Fed will receive the green light from falling inflation to pivot back to easing in mid-2023. GDP growth will be running up against severe headwinds into 2023, owing especially to a sharp drop in housing activity in response to housing affordability deteriorating to its worst since 2007. The Fed will need to lower interest rates to avert a greater fall in housing activity and eventually lead to a rebound. Monetary easing should also provide for more benign financial conditions, supporting the broader economy. This should allow GDP growth to reaccelerate in 2024 and 2025, as we expect. By 2026, we expect monetary policy with a neutral stance, with the federal-funds rate and the 10-year Treasury yield in line with our assessment of their long-run natural levels.

We're expecting easing to proceed far more rapidly than consensus, with our expectation of a year-end 2023 federal-funds rate of 1.75% compared with consensus at 3.25%. Likewise, near-term interest rates implied by bond markets look too high. The five-year Treasury yield is at 3% as of July 2022, implying an average federal-funds rate of 2.5%-3%, depending on one's term premium assumption. By contrast, we're expecting an average federal-funds rate of about 1.75% over the next five years. On the other hand, the long end of the yield curve looks more reasonable. The current 10-year Treasury yield is at 3%, which is close to our long-run projection of 2.75%.

Interest Rate Forecasts (Average Annual % Rates)



	2022	2023	2024	2025	2026
Federal-Funds Rate	1.50%	2.65%	1.50%	1.50%	1.75%
10-Year Treasury	2.75%	2.75%	2.25%	2.25%	2.75%
30-Year Mortgage	5.00%	4.75%	4.00%	3.75%	4.25%

Source: U.S. Bureau of Economic Analysis, Morningstar. Data as of July 6, 2022.

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