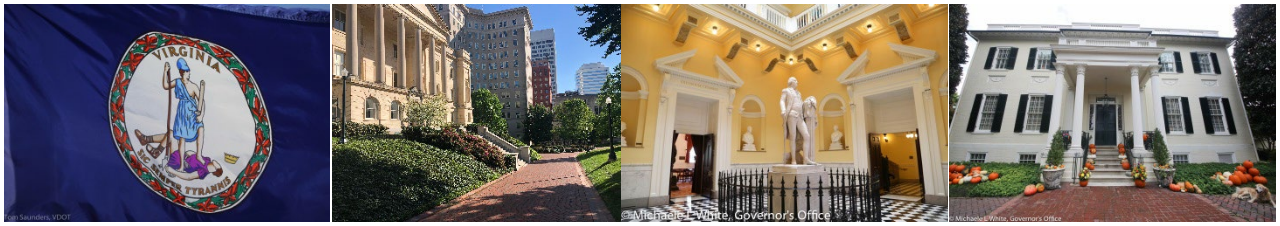
Economic Forecast



The US Economy - Review of FY 2023

The FY 2023 U.S. economic forecast was based on the October 2022 IHS Market standard scenario. As IHS Markit prepared the October 2022 forecast, the consensus among economists was that the Federal Reserve's action to bring down inflation by raising interest rates would cause the economy to contract and enter a mild recession lasting three quarters. Seventy percent of economists polled in the November 2022 *Blue Chip* economic consensus thought a recession would occur in calendar year (CY) 2023. At the November Governor's Advisory Council on Revenue Estimates meeting, a majority of members concurred that a recession would happen in CY 2023. Compared to the October IHS forecast, the timing of the recession was thought to begin later, and the December post-GACRE forecast pushed the start of the recession back to the end of the first quarter of CY 2023.

The Fed raised interest rates seven times during FY 2023, increasing the federal funds rate by 350 basis points. Eventually, the Fed's actions along with some alleviation of global supply chain issues, caused increases in the consumer price index to moderate. Over the fiscal year ending June 2023, consumer prices increased 3.0 percent, after increasing 4.0 percent over the year ending in May 2023. The June 2023 increase was the smallest 12-month increase since March 2021. A year earlier, in June 2022, the 12-month increase in overall prices was 9.1 percent and had been 7.0 percent or higher in the preceding 6 months.

U.S. job growth was unexpectedly strong throughout FY 2023 but did begin to cool near the end of the year. Nonfarm payrolls increased 209,000 in June 2023 and the unemployment rate was 3.6 percent. The total, while still solid from a historical perspective, marked a considerable drop from May's downwardly revised total of 306,000 and was the slowest month for job creation since payrolls fell by 268,000 in December 2020.

Over the course of the fiscal year, economic data largely surprised to the upside. Labor market and retail spending data showed an economy that continued to be resilient despite the Fed's rate increases. There were some shocks, with the banking crisis in March setting off fears of a credit contraction, and the showdown over the debt ceiling also threatening to disrupt the economy. These downside risks to the economy appear to be contained for now.

US Economic Forecast

Baseline US Forecast: Mild Recession

Our baseline assumption is for a "mild recession." In this scenario, the combination of a federal government shutdown, elevated inflation and interest rates, reduced credit accessibility, and rising geopolitical tensions cause the economy to fall into a shallow recession in the second quarter of CY 2024 (fourth quarter of State FY 2024). The recession lasts through the fourth quarter of CY 2024 (second quarter of State FY 2025), with a peak to trough decline of 1.0 percent in GDP and the unemployment rate rising to 6.5 percent in the third quarter of CY 2024.

In this scenario, the risk of an extended federal government shutdown results in a drop in consumer and business confidence. The stock market falls by 22 percent from the third quarter of CY 2023 through the second quarter of CY 2024.

Key Assumptions and Risks in the "Mild Recession" Scenario

- Because the Fed remains concerned about inflation, it keeps the fed funds rate elevated in the fourth quarter of 2023 despite the weakening economy.
- Despite the temporary deal in Congress, the risk of an extended federal government shutdown increases, causing consumer and business confidence to decline.
- The crisis caused by Russia's invasion of Ukraine persists longer than expected.
- Worries grow that the attack by Hamas on Israel will lead to a wider conflict.
- Concerns increase that China might block the Taiwan Strait, limiting the supply of semiconductor chips from Taiwan and raising fears of a wider war. Business and consumer confidence declines.
- Recent bank failures reduce consumer confidence and cause banks to tighten lending standards more than expected.
- The stock market falls by 22 percent from the third quarter of 2023 through the second quarter of 2024.
- Declines in European economies hurt U.S. exports and also corporate earnings from European subsidiaries.

The economy returns to full employment by the fourth quarter of 2025.

The Virginia Economy - Review of FY 2023

Payroll employment growth exceeded expectations in FY 2023. In the official forecast, total nonagricultural employment was projected to increase by 2.5 percent and actual growth was 2.7 percent. Employment growth was driven largely by lower paying sectors of the economy such as Leisure and Hospitality, and Education and Health Services, which grew by 6.8 percent and 4.4

percent, respectively. Industry sectors with the largest positive variances to forecast were Construction, Financial Activities, and Professional & Business Services. The forecast for employment growth in Professional & Business Services assumed a reduction in temporary workers that did not occur as the economy continued to grow, avoiding a downturn in this highly cyclical subsector.

Virginia Economic Forecast

Baseline Virginia Forecast: Mild Recession

In our baseline forecast, we anticipate a mild two- to three-quarter recession in the U.S. economy beginning at the end of the third quarter of State FY 2024, with recovery beginning in the second quarter of FY 2025. The economic downturn is driven by a combination of a federal shutdown, political tensions, still-high inflation, sustained higher interest rates, and reduced credit availability. Virginia's economy experiences contractions in most of its key indicators during the same period. The mild recession forecast is based on the Moody's October U.S. Downside 75th Percentile Scenario, modified by staff for timing and severity.

- Real GSP grows at 1.4 percent in FY 2024 compared to the actual growth of 1.7 percent in FY 2023. It is projected to fall to 0.8 percent in FY 2025 and rise to 2.7 percent in FY 2026.
- Other major economic indicators used in our analysis, e.g., personal income, employment, and wages and salaries, show softening in growth rates starting in FY 2024 through FY 2025, and then experiencing an upturn in FY 2026.
- The unemployment rate is projected to rise to 3.6 percent in FY 2025. Compared to FY 2023 rate of 3.0 percent, it increases to 3.3 percent in the fourth quarter of CY 2023 and rises to a peak of 4.9 percent in the third quarter of CY 2024.
- Total nonfarm employment is expected to have slightly positive growth in FY 2024 followed by a slightly negative growth in FY 2025, a 0.1 percent rise and 0.1 percent decline, respectively.
- The mild recession forecast has personal income growing 3.9 percent in FY 2024, followed by 3.2 percent growth in FY 2025. Income from wages and salaries is expected to grow 4.6 percent in FY 2024 and 3.5 percent in FY 2025.

Average wages grow at 5.0 percent and 3.6 percent during FY 2024 and FY 2025, respectively, followed by 3.7 percent growth in FY 2026.