KPMG Economics

We're not in Kansas anymore
The view from Washington

Diane C. Swonk, Chief Economist
KPMG US
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Dorothy's iconic line to Toto, upon realizing she was no longer on her family's farm in *The Wizard of Oz,* resonated given the turbulence of the last four years. The pandemic was the twister that transported us from the slow moving and subpar economy of the 2010s into the rapidly changing, less predictable 2020s.

I spent the better part of the first half of February in on- and off-the-record meetings with economists, policy makers, diplomats, political analysts and former heads of state in Washington. The meetings simultaneously bolstered my optimism about the prospects for a soft landing, while adding to my unease over escalating geopolitical tensions.

Globalization played the unfortunate role of the Wicked Witch of the East in the meetings, who was crushed by Dorothy's house. What was once heralded for its ability to integrate economies, boost market reforms and spread democratic ideals was now the villain.

To hear a former head of state and world renowned economists openly worry about the problems it had unleashed was sobering. Trade, without enforceable guardrails on how countries compete, had consequences. Consumers and corporations benefited from cheap goods, while the costs to workers displaced by trade were untenable. We failed to make good on promises to transition those hit hardest. Inequality across country borders narrowed, while inequalities within borders widened.

It was as if my entire childhood, coming of age in the Detroit area in the 1970s and 1980s, had come home to roost. I bore witness to what the economic research later confirmed. Those who lost jobs to offshoring, notably men, experienced a deterioration in their mental and physical health. Children suffered as families deteriorated.

Consumer might drives gains

Real GDP growth grew a revised 3.2% annualized pace in the fourth quarter. Consumers played a key role in supporting the economy. A rebound in inflation-adjusted wages, ongoing employment gains and a cushion from savings amassed and debt paid down earlier in the cycle blunted the blow of higher interest rates. The housing market struggled but showed signs of green shoots. Business investment remained subdued, except for the construction of electric vehicle and chip plants. Inventories were rebuilt and government spending remained strong. The deficit narrowed slightly, with exports outpacing imports.

Real GDP is forecast to slow to a 2.0% annualized pace in the first quarter. Consumer spending is expected to moderate, while the housing market stabilizes. Business investment is expected to contract. Inventories outside of the vehicle sector are building. (Incentives are back; affordability is improving.) Federal government spending is poised to weaken in response to the continuing resolution. State and local government spending remains solid. The trade deficit has begun to widen; the volume of imports is expected to outpace that of exports.

Fed holds off until mid-year. The Federal Reserve is expected to start rate cuts in June and cut a total of three times in 2024. The Fed is expected to begin to taper the pace it allows assets to mature off its balance sheet in late summer. The concern is the functioning of the Treasury bond market. Liquidity has never returned to pre-pandemic norms.

The Fed funds rate is not expected to dip below 3% until early 2026. The good news is that the Fed is no longer willing to risk a recession to dampen inflation, given how far we have come in the battle against inflation. The Fed would cut to stimulate if unemployment spiked.

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Episodic periods of unemployment became permanent. Idled factories rusted, while industrial meccas symbolized generational losses.

My best friend's family slipped into poverty when we were in our teens. Her siblings quit college, returned home and dug up their backyard to plant vegetables to keep food on the table. The smell of freshly baked bread still leaves me with a sense of melancholy, as it was the only bread her family could afford.

I thought about that a lot during the last few weeks. Few have seen what I saw; even fewer link it to the political polarization we are enduring. There is a natural path from those displaced by free trade and the 2008-09 global financial crisis to deepening political divisions.

This edition of *Economic Compass* lays out what I gleaned from recent meetings. The economic fundamentals for a soft landing in the US remain good. The Federal Reserve looks poised to join other central banks and begin the process of cutting rates, albeit cautiously. The worst mistake a central bank can make is to cut prematurely and stoke a more persistent bout of inflation or worse, stagflation; the Fed would also like to keep its record of avoiding recession. The stakes on getting policy right couldn't be higher given the tinderbox that economic inequality has become.

The hype surrounding generative AI (GenAI) entered our discussions. Would it make our problems worse or cure what ails us? **Spoiler alert:** It depends on how we leverage it. The potential to boost the middle class is great. So is its ability to spread misinformation, sow the seeds of discontent and intensify cyber attacks.

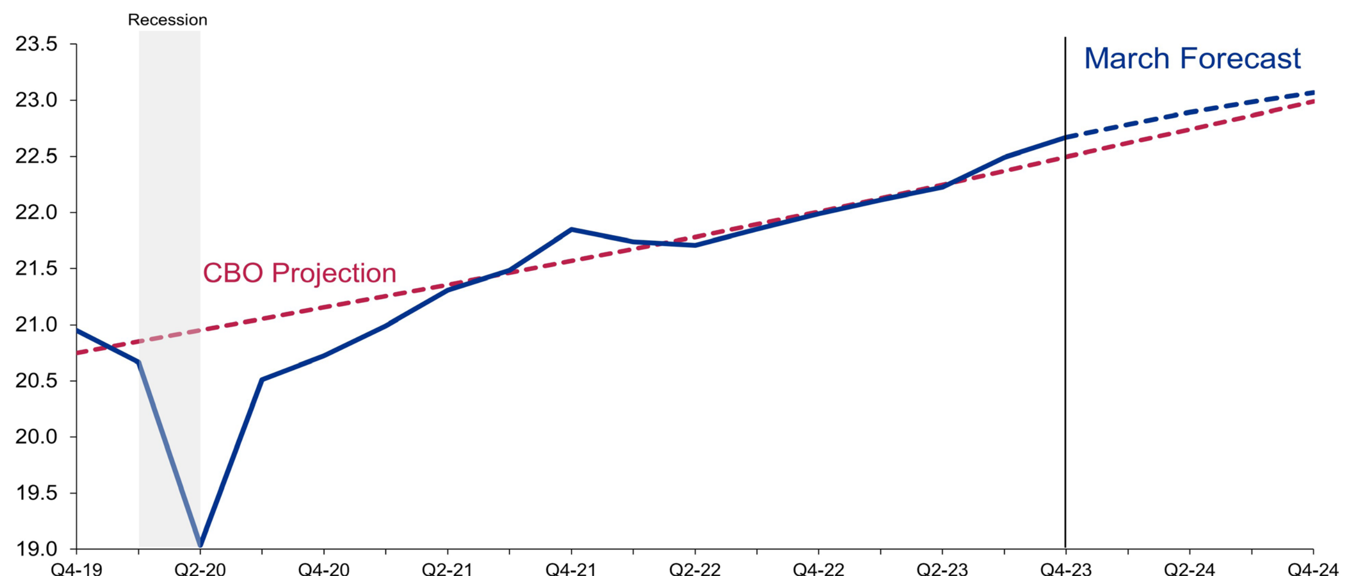
Escalating geopolitical tensions posed the greatest threat to the near-term outlook. Political polarization is a close second. It has entered every facet of life, right down to lenses through which we assess the economy and personal relationships. One consumer behavioral expert noted that women cite partisan differences as the number one reason that they break up with their romantic partners; men cite weight gain. That is sad.

Prospects for soft landing improve

Discomfort in our comfort

The stunning performance of the economy in 2023 and the momentum with which we entered the year shored up confidence that the economy could achieve a soft landing in 2024. By the end of 2023, the US economy was above its pre-pandemic trend forecasted by the Congressional Budget Office (CBO) in 2020. The consensus was that the economy would continue to post solid, if not spectacular, gains in 2024 and 2025. (See Chart 1)

Chart 1



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Consumer spending is expected to slow but remain a driver of gains. Hiring is expected to moderate, not add to unemployment. The surge in retirements is taking a toll on participation in the labor market, which will keep unemployment unusually low.

The mortgage winter is expected to thaw, but the housing market is not expected to post strong gains until the second half of the year. Mortgage rates need to stay below 7% to unleash the pent-up demand due to millennials aging into their prime home-buying years. Roughly 12,000 young adults are turning 35 every day, which has supercharged demand as supply remains constrained. New home construction is picking up but underbuilding in the wake of the subprime mortgage crisis exacerbated shortages.

Business Investment is forecast to weaken. New office construction, which was still coming on line in many major cities is coming to a halt. Shale production is slowing, while renewable energy projects are being delayed in response to high rates and the hurdles due to domestic content rules. The exception is electric vehicle and chip plants, which are still being built.

Inventories outside of the vehicle sector are expected to be rebuilt. Vehicle inventories are bloated, even as incentives have picked up. New vehicle purchases have become a luxury for the two top income quintiles.

Federal government spending is poised to slow in response to the continuing resolution but should pick up if an omnibus bill can be passed. Congress was able to avert a shutdown in early March, which is a low threshold given we are six months into the fiscal year.

We currently do not have the additional spending from an omnibus in the forecast. It would mirror the bill that the former Speaker of the House of Representatives negotiated in June 2023 to avoid a debt default, except that it now includes more than 600 pages of earmarks.

State and local governments have more resources; 46 of 50 states ended fiscal year 2023 with a surplus. Most states expect to exceed or meet their revenue targets in fiscal 2024.

The trade deficit is expected to widen, with the US outperforming its trading partners. The volume of imports is expected to outpace exports. Mexico has eclipsed China as our largest import partner due to its proximity to the US and guaranteed access to our market via the USMCA trade agreement. Foreign direct investment to Mexico surged, including from China.

Humility is the better part of valor; there was little comfort in the optimism that we shared. Most of the same economists were convinced that the economy would slow, if not slip into recession, in 2023. No one expected the economy to accelerate in the wake of the most aggressive credit tightening cycle by the Fed since the 1980s.

Much depends upon the ability to keep generating jobs. The bulk of the bite of higher rates showed up as a drop in job openings, not a surge in layoffs. Job openings have slipped from a peak of 12.2 million in March 2022 to 8.9 million at the end of January 2024. That compares with 7.0 million in February 2020. Employers let go of temporary workers and cut back on hours worked, instead of doing wholesale layoffs.

Reports of layoffs at publicly traded companies, largely in tech and finance, were flagged as a warning signal to policy makers that the slowdown in employment might cut deeper. They were not having it, with some surmising that much of what was slated to be cut would be absorbed. That was especially true of jobs in tech.

Financial conditions eased in late 2023 and early 2024, as financial markets attempted to front-run the Fed on rate cuts. That triggered a pickup in some pockets of the economy. Fed Chairman Jay Powell cited reports of a pickup in activity at year-end by some contacts at his press conference following the January meeting.

What was expected to be the Fed's hardest mile in its marathon against inflation morphed into a relay race. The most interest rate sensitive sectors suffered layoffs, while less interest rate sensitive sectors picked up the slack in the second half of 2023.

The sectors that drove employment have room to run. Healthcare and social assistance is chasing a moving target due to aging demographics. Leisure and hospitality finally crossed the peak hit in February 2020 and, if TSA throughput is any indicator, travel remains robust. Job openings for state and local governments, excluding public education, remain elevated.

Payroll employment gains re-accelerated after a lull due to strikes over the summer and fall of 2023. That does not usually happen before a recession. However, response rates to the survey have been extremely low and revisions large. If the unemployment rate holds at 3.9% or rises in March, that could trigger what is known as the Sahm Rule, an early recession indicator. A modest increase in unemployment is consistent with the Feds definition with a soft landing - the key is to keep the rise small.

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Risks. The largest near-term threat to the outlook is a spike in oil prices. Those closest to the sector were surprised at how well behaved prices have been in recent months. Shale production is expected to rise at the slowest pace since 2016 in 2024, as producers focus on returning more of their profits to investors.

Escalating geopolitical tensions exacerbate those risks. As the war in the Middle East continues, OPEC+ is still expected to keep its production cuts in place.

Oil analysts were divided over whether OPEC nations would cheat, which would cap a rise in oil prices. One geopolitical expert even surmised that OPEC might cut production to sway the outcome of the US election.

Separately, many voiced their concerns about the latent effects of rate hikes on the economy. Public credit markets are much more transparent than private markets. No one was exactly sure how much dry powder firms would have left in their arsenals, once loans reprice in 2024.

The losses associated with an overhang of office space were expected to hit much harder in 2024 than 2023. Many loans had been postponed in hopes that rates would come off of their highs. Rates can't fall enough to make some of the emptiest buildings viable. The losses are dispersed and not seen as a systemic threat but would nonetheless be a headwind.

Middle-market companies were tentative, despite improving assessments of the economy. They were hedging investment decisions, signing contracts that enabled them flexibility in reacting to economic conditions. This was true across the board and started to show up as a drawdown in deposits, a slowdown in loan demand and delays to big investment decisions.

On the upside is the ramp-up associated with GenAI. Many see a bubble forming. That is common with such a consequential innovation. Investors bet on the sector before they know how the technology will be fully deployed. We saw a similar phenomenon with utilities, rail and the internet. Bubbles helped finance the infrastructure needed to adopt new technologies.

A productivity miracle?

Optimists vs pessimists

Debate over the outlook for productivity growth was heated. Productivity growth is notoriously volatile; it surged as we went into lockdowns, plummeted when the economy reopened and rebounded in 2023.

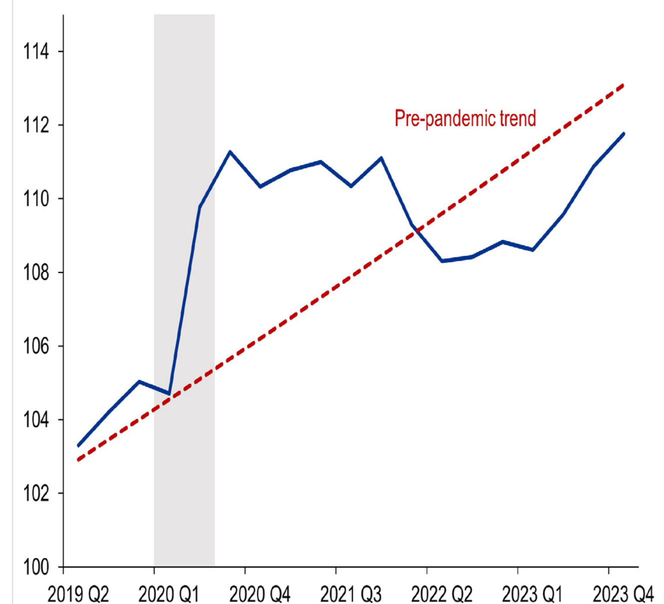
The most recent productivity gains are getting us close to the pre-pandemic trend. (See Chart 2.) The question is whether recent gains can be sustained.

Optimists argue that the recent catch-up in productivity growth reflects the pickup in investment earlier in the recovery and the learning of older versions of AI. The pandemic was a catalyst, much like the Y2K threat (Google it) in the 1990s, to make leapfrog investments and more quickly adopt new technologies.

Those shifts enabled inflation to decelerate, even as labor markets tightened and wages accelerated in the late 1990s. However, globalization also played a role as it spurred competition and lowered inflation with a jump in cheap imports.

Optimists posit that we still have room to run on productivity gains before the effects of GenAI kick in. Pilots on the boost to productivity by GenAI are remarkable and warrant watching. Some firms are already seeing a boost but lacked the critical mass to show up in the overall economic data.

Chart 2



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The lags between innovation and commercialization can be a decade or longer. Most expect GenAI to be adopted faster than previous open use technologies. The largest hurdle is cost. Unlike other open use technologies, the costs of the data and the energy needed to run the GenAI models rise with usage.

Energy costs are so large that the tech behemoths are working to secure their own designated energy sources to limit the costs of adoption. One major player has contracted its own nuclear plant to support its energy needs. Startups are trying to counter the funding bias large firms have in running GenAI models by increasing the energy efficiency of the models themselves.

The high costs of everything from curating firm-specific data to the energy needed to run the models make what some see as theoretically possible but not economically feasible. The reduction of the costs to run GenAI models is considered a necessary prerequisite to broader adoption.

Recent research suggests that widespread deployment across firms is more likely to occur via "AI as a service model." This is one of the reasons that we are seeing partnerships form to deliver ways to curate and customize data for a broader set of firms. Many firms are front-running potential disruptions to their business model by choosing to lean into the new technology.

The cost threshold on the most transformative aspects of GenAI was expected to slow the dispersion of the technology, even though it was expected to be adopted faster than other technologies. That left many skeptical of shifts to pie-in-the sky forecasts for productivity growth.

More of those improvements are expected to be felt in the 2030s rather than the 2020s. Wealthier countries are expected to adopt the technology faster than emerging economies. That could reverse the improvement in inequality between countries and add to the setback emerging economies suffered as a result of the pandemic.

More of the focus was on how the technology would change the nature of work, not just displace workers. Historically, large innovations fueled jobs not yet imagined while displacing existing jobs. GenAI appears unique in how it can augment skills and change the nature of work all along the educational spectrum.

One recent paper by labor economist David Autor of MIT posits that GenAI could expand the size of the middle class by up-skilling a larger swath of workers. That would help to narrow instead of widen income inequalities.

Separately, many worry that AI models perpetuate the biases that they have literally learned from us. I have a more nuanced view. It is easier to remove bias from a program than it is to remove it from our own hardwiring. The challenge is to identify it.

Cyber security and the risk posed by bad actors is a larger concern. One tech expert outlined how the CEO of a company he worked with was almost fooled by a phishing email that learned from his profile and attempted to hack his company with a near perfect replica of his favorite charity; it failed, but only because the CEO was forrwarned on what could happen.

Pessimists see much of the recent improvement in productivity as a catch-up on earlier losses. Productivity growth picked up as supply chains healed and workers shifted to more productive companies, which paid them a premium for their skills.

A better balance between the supply and demand for workers put downward pressure on quit rates. That enabled workers to learn the jobs they had and firms to implement training delayed by the pivot online. The recent plateau in educational attainment, notably among women, could slow productivity growth.

Ongoing supply-chain fragilities, as evidenced by recent attacks in the Red Sea, are another hurdle. Those shifts are delaying deliveries and boosting costs, especially on goods between Europe and Asia. Shipping costs across the board have risen.

Central banks are "cautious"

The Fed will be slow to cut

The Federal Reserve worries that much of the low hanging fruit in response to supply chain healing and the drop in goods prices, including oil prices, has been plucked. Meanwhile, it fears that service sector inflation, which is more sensitive to wage costs, is getting sticky. Preliminary data for January and February suggest those fears may be warranted. Service sector inflation accelerated both months, while increases in prices were more broad based.

Recent research by the Federal Reserve Bank of San Francisco suggests that the rise in prime-age (25–54-year-olds) participation may be another hurdle. Much of the improvement and related increase in entrants into the labor market we saw in 2023 could be coming to an end. That could stop wages from cooling to a pace to more consistent with the 2% inflation target.

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A loss in prime-age participation is worrisome on multiple levels. It reduces the ratio of workers to retirees, which stresses government finances, and leaves large swaths of the population on the sidelines.

Prime-age participation among women hit a new record in 2023, but still lags all of our major competitors in the developed world. Prime-age participation among men regained ground lost to the recession but is still low. Prime-age participation among men peaked in the late 1950s. (Yes, you read that right.)

That is one of many reasons the Fed was so focused on getting the economy back to the low unemployment we saw in 2019. It hoped that would enable more workers to return to the labor force, without fueling inflation.

Workers who saw their wages leveled up as they went from being invisible to essential, finally had a moment in the sun. Then they were burned by inflation. Hence, the Fed's commitment to restoring price stability, even if it meant "pain," a euphemism for unemployment.

What is price stability? It is when inflation no longer distorts decision making. The 2% target is somewhat arbitrary. It doesn't mean that prices fall after skyrocketing during the pandemic, although some have come off their peaks. It means that inflation cools more rapidly than wages and purchasing power is restored. Eventually, consumers recoup what was lost to inflation and then feel improvements in living standards.

Normalizing rates after a bout of inflation without a deep recession is not the same as cutting to stimulate. The urgency isn't there, while the risks of cutting prematurely remain high. History is littered with examples of central banks which cut only to stoke a more corrosive and persistent bout of inflation. Negative supply shocks, from armed conflicts to climate change, exacerbate the upside risks to inflation.

We are still forecasting the first cut in rates to occur in June, with a total of three cuts by year-end 2024. However, debate over whether to wait longer than June at the March meeting will be heated. The fed funds rate is expected to drop to a 2.75%-3% target range in early 2026. That is well above the February 2020 target of 1.5%-1.75%.

What would prompt the Fed to cut more aggressively? A much weaker economy than we currently have. The Fed is not willing to suffer a **deep** recession to get inflation down, given the progress made. The Fed has been walking a tightrope; trying to keep financial markets from front-running them on rate cuts and risk an acceleration in inflation, while not overshooting with restrictive policies.

"What is price stability? It is when inflation no longer distorts decision making."

Too close to call?

Veteran election forecasters take their pick

Most Americans do not want a rematch of 2020, but that appears all but a done deal. The outcome of the election remains too close to call, with a high probability that the results will be contentious, given how deeply divided the electorate remains.

As noted in last month's report, that is why we expect the election itself to have an impact on the economy, before the outcome of the election is determined. Anxiety leading up to and in the aftermath of a hotly contested election fuels policy uncertainty, which acts as a tax and dampens overall economic activity. That negative effect is already showing up in reports from lenders and businesses.

Veteran political analyst Charlie Cook re-upped his 2020 prediction that the presumptive Republican nominee would win the White House in 2024. He expects Republicans to take the Senate but sees the House of Representatives as a toss-up.

Economic models of the outcome of the race point to a different outcome. (I moderated a heated exchange between Charlie and Mark Zandi of Moody's back in February 2020.) Zandi's model is still forecasting a narrow victory for the presumptive Democratic nominee. Ray Fair of Yale University laid out his economic model and its findings; it supports Zandi's conclusions but both forecasters admitted that the election outcomes remain a very close call.

Recent research by Pew suggests that we have all grown fatigued by our divisive politics. However, that is not new. We were similarly fatigued in 2020.

Research by University of Maryland was more encouraging. It suggests the gap in beliefs and policy solutions narrowed substantially when discussion was preceded by facts, not ideological arguments. It found overwhelming policy agreement, even when discussing some of the country's thorniest issues, such as Social Security, immigration and the federal debt.

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How do we bridge those differences? Sporting events are seen as a big plus because they get people cheering for a common team. Talking with instead of at one another is also undervalued. Once we spend time relating to people as human beings, sharing stories about our families and personal challenges, the tribal barriers we erect tend to break down. The biggest challenge in an election year is to get us all out of our echo chambers.

Bottom Line

That brings me back to where I started: *The Wizard of Oz*. The pandemic and the chaos of the last four years were not unlike Dorothy's journey along the Yellow Brick Road. Her success in her journey was not in magically being transported home but in discovering her own inner strength, which she found in the bonds she built along the way. That is not unlike the resilience we have seen in the economy through the challenges posed by the pandemic, reopening, inflation and a rise in armed conflicts.

The story is a cautionary tale, reminding us to look behind the curtain and avoid being misled by unsound economic policies that play to our fears instead of our strengths. Globalization has faults and strengths.

Some of our greatest challenges – from climate change to escalating geopolitical tensions and inequality – cannot be solved by turning inward. They require cooperation and allies, much like Dorothy found in her companions.

Ultimately, it is a story of hope instead of despair, which is why I was drawn to it. I believed in my best friend as she believed in me; we are still close all these years later. She beat the odds of her childhood much like the economy beat the odds of a recession. That is in and of itself a win along with the prospect that unemployment is likely to remain relatively low in the year ahead.

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Economic Forecast — March 2024

	2023	2024	2025	2023:3(A)	2023:4(A)	2024:1	2024:2	2024:3	2024:4	2025:1	2025:2	2025:3
National Outlook												
Chain Weight GDP[1]	2.5	2.5	1.6	4.9	3.2	2.0	1.9	1.6	1.5	1.5	1.5	1.9
Personal Consumption	2.2	2.4	2.0	3.1	3.0	2.5	2.2	1.9	1.9	1.9	2.0	1.9
Business Fixed Investment	4.4	2.1	2.7	1.5	2.4	-0.5	3.0	3.5	2.6	2.6	2.2	2.6
Residential Investment	-10.6	2.7	1.7	6.7	2.9	4.9	1.9	-0.7	0.1	1.0	3.7	3.2
Inventory Investment (bil $ '17)	47	81	77	78	66	79	80	84	83	79	69	82
Net Exports (bil $ '17)	-927	-959	-1032	-931	-915	-928	-947	-971	-990	-1008	-1024	-1041
Exports	2.7	3.8	3.8	5.4	6.4	4.7	3.3	4.6	4.0	3.5	3.6	3.7
Imports	-1.6	3.7	4.8	4.2	2.7	5.0	4.6	6.2	5.1	4.5	4.4	4.5
Government Expenditures	4.0	2.4	0.7	5.8	4.2	1.0	1.3	1.0	0.7	0.6	0.6	0.6
Federal	4.2	1.4	0.5	7.1	2.3	-1.0	1.0	0.7	0.4	0.4	0.4	0.6
State and Local	3.9	2.9	0.8	5.0	5.4	2.2	1.5	1.1	0.8	0.7	0.6	0.7
Final Sales	2.9	2.3	1.6	3.6	3.5	1.8	1.9	1.5	1.5	1.6	1.7	1.7
Inflation												
GDP Deflator	3.6	2.3	2.4	3.5	1.4	2.6	2.3	2.3	2.3	2.6	2.3	2.5
CPI	4.1	3.1	2.3	3.3	2.8	3.4	3.0	3.1	2.2	1.6	1.9	2.5
Core CPI	4.8	3.4	2.7	2.9	3.4	3.8	3.2	3.1	2.8	2.8	2.4	2.5
Special Indicators												
Corporate Profits[2]	2.0	5.9	1.0	-0.6	2.0	8.4	11.1	7.4	5.9	1.4	-1.0	-0.1
Disposable Personal Income	4.2	2.5	3.3	0.5	2.2	2.7	2.8	3.4	3.7	4.3	2.6	2.6
Housing Starts (mil)	1.42	1.41	1.41	1.37	1.48	1.40	1.43	1.42	1.40	1.40	1.41	1.42
Civilian Unemployment Rate	3.7	3.8	3.8	3.7	3.8	3.8	3.8	3.8	3.7	3.7	3.8	3.9
Total Nonfarm Payrolls (thous)[3]	2950	1660	496	667	631	754	306	300	300	141	157	130
Vehicle Sales												
Automobile Sales (mil)	3.1	3.2	3.3	3.3	3.0	3.2	3.3	3.2	3.2	3.2	3.3	3.3
Domestic	2.3	2.3	2.3	2.3	2.2	2.2	2.3	2.3	2.2	2.2	2.3	2.3
Imports	0.9	1.0	1.0	1.0	0.8	1.0	1.0	0.9	1.0	1.0	1.0	1.0
LtTrucks (mil)	12.5	12.8	12.9	12.5	12.5	12.5	12.7	12.8	13.0	13.0	13.0	13.1
Domestic	9.8	9.9	10.0	9.6	9.8	9.7	9.8	9.9	10.0	10.0	10.0	10.1
Imports	2.7	2.9	3.0	2.9	2.7	2.8	2.9	2.9	3.0	3.0	3.0	3.0
Combined Auto/Lt Truck	15.6	16.0	16.2	15.7	15.5	15.7	16.0	16.0	16.2	16.2	16.3	16.4
Heavy Truck Sales	0.5	0.4	0.4	0.6	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.5
Total Vehicles (mil)	16.2	16.4	16.6	16.3	16.0	16.2	16.4	16.4	16.6	16.6	16.7	16.9
Interest Rate/Yields												
Federal Funds	5.0	5.2	4.2	5.3	5.3	5.4	5.3	5.1	4.8	4.6	4.3	4.1
10 Year Treasury Note	3.9	3.9	3.7	4.1	4.4	4.2	3.9	3.8	3.8	3.8	3.8	3.6
Corporate Bond BAA	5.9	5.8	5.7	6.0	6.2	5.8	5.7	5.6	6.0	5.8	5.8	5.7
Exchange Rates												
Dollar/Euro	1.08	1.09	1.10	1.09	1.08	1.08	1.08	1.09	1.09	1.10	1.10	1.10
Yen/Dollar	140.5	143.3	133.8	144.5	147.8	149.0	145.0	141.0	138.0	137.0	135.0	133.0

[1] in 2023, GDP was $22.4 trillion in chain-weighted 2017 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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