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The economy surged 4.9% in the third quarter. But is a recession still looming?

Paul Davidson October 26, 2023

Is it a last hurrah? Or just another strong showing from an economy that continues to defy the doomsayers?

The U.S. economy shifted into a higher gear in the third quarter as a surge in consumer spending offset a dip in business investment.

The nation's gross domestic product, the value of all goods and services produced in the U.S., expanded at a seasonally adjusted annual rate of 4.9% in the July-September period, the Commerce Department said Wednesday. That's up from solid growth of 2.1% in the second quarter and above with the 4.5% rise predicted by economists in a Bloomberg survey.

It also marks the fastest pace since late 2021, when the nation was climbing out of the COVID-induced recession.

For nearly two years, the economy has shrugged off high inflation, rapidly climbing interest rates and persistent recession forecasts thanks to splurging consumers. Many economists believe growth is finally poised to slow markedly in the months ahead -- and possibly slip into recession - amid an armada of threats, including higher long-term rates, the resumption of student loan payments and a potential government shutdown.

Is consumer spending rising?

Consumer spending grew 4% following a modest 0.8% increase in the second quarter. Such purchases make up about 70% of economic activity.

Households have benefitted from $2.7 trillion in pandemic-related savings and vibrant job and wage growth. Employers have been reluctant to lay off workers following widespread COVID-related worker shortages and instead pushed annual pay raises above 5% to lure job candidates and hold onto existing staffers.

Although pay increases have been gradually slowing, they finally started outpacing inflation in recent months, giving workers more purchasing power.

Yet low- and moderate-income Americans have depleted much of their excess cash reserves and taken on more credit card debt even as borrowing costs are rising and banks are tightening their lending standards, says economist Bernard Yaros of Oxford Economics.

The Federal Reserve has raised its key interest rate to a 22-year high of about 5.4% and the 10-year Treasury bond hit 5% last week, highest since 2007. The latter development is likely to discourage business borrowing, hiring and investment and further nudge up 30-year mortgage rates that are approaching 8%, battering the struggling housing market, economists say.

The resumption of student loan repayments that were frozen during the health crisis poses yet another hurdle to consumers, Yaros says.

A slowdown in consumption is expected to dampen growth substantially in coming months. Forecasters surveyed by Wolters Kluwer Blue Chip Economic Indicators predict the economy will expand at a 0.7% pace in the current quarter and 1.1% next year.

"The staying power of this growth spurt is questionable going forward," says economist Olu Sonola of Fitch Ratings. "Above trend economic growth cannot sustainably co-exist alongside an increasingly restrictive interest rate environment."

How likely is a recession in 2024?

In September, the economists surveyed reckoned there was a historically high 48% chance of recession over the next 12 months, though that's down from 61% odds in May.

Barclays is forecasting a mild downturn that features about 375,000 job losses by mid-2024. But Barclays economist Jonathan Millar say he wouldn't be surprised if the nation leaned on a financially healthy consumer and continued to flout predictions of an imminent slump.

Will the Fed increase rates again in 2023?

Fed Chair Jerome Powell has said strong economic growth could spur higher inflation, possibly forcing the central bank to raise interest rates again.

The good news is that Thursday's report shows an underlying measure of inflation eased last quarter. That could prompt the Fed to hold rates steady despite the impressive rise in economic output, says **Bernard Baumohl, chief global economist of the Economic Outlook Group.**

How other parts of the economy fared:

Housing bolsters growth for first time in nearly 3 years

Housing construction and renovation grew 3.9% after nine straight quarterly declines.

The Federal Reserve's sharp interest rate hikes have pushed mortgage rates near 8% and clobbered existing home sales. Homeowners are reluctant to put their houses up for sale because they don't want to be a saddled with a much higher mortgage rate for their new home.

The limited supply of homes on the market has finally prodded builders to put up more new inits. But some economists believe the spurt will be short-lived as high rates dampen new home sales as well.

Business stockpiling adds to growth

Businesses replenished inventories, adding 1.3 percentage points to growth. Early this year, companies drew down their bloated stocks, posing a big drag on the economy.

Such stockpiling has been volatile and doesn't typically reflect the economy's underlying health. Companies heavily stocked up in 2021 in response to supply chain snarls and product shortages, leading to big swings in recent months.

The beefed up industries over the summer will likely lead to drawdowns, hurting growth in the current quarter, says economist Paul Ashworth of Capital Economics.

Government spending increases

Government outlays rose for the fifth straight quarter, climbing 4.6% following a 3.3 advance in the previous quarter. Federal spending increased by 6.2% and state and local purchases rose by 3.7% amid a wave of infrastructure and clean energy projects spurred by sweeping federal legislation.

Business investment edges down

Business investment increased slipped 0.1% after rising 7.4% the prior quarter.

Outlays for computers, delivery trucks, factory machines, and other equipment dropped 3.8% amid higher borrowing costs.

Spending on buildings, oil rigs and other structures rose 1.6%.

Trade curbs growth slightly

Trade was a slight drag on growth as imports and exports both rose significantly after falling the prior quarter.

Exports climbed 6.2% while imports rose 5.7% on strong demand by U.S. consumers.

Since the nation imports far more than it exports, the two developments widened the trade gap and modestly reduced growth.

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