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Beyond the Portfolio – Economic Outlook: Growth, Jobs, and Inflation

Henray Cohen:

Welcome back to Beyond the Portfolio, the podcast from BMO Wealth Management. I'm Henray Cohen, US head of investments, and today we're stepping back from the markets to focus on the bigger picture of the current economy.

Where are we headed on growth? What happens to the job market in an age of automation? And to what extent is inflation really behind us? And to help make sense of it all, I'm thrilled to be joined by Doug Porter, chief economist here at BMO. Doug leads our economics team and brings decades of experience trying to make sense of the macro forces at play. Doug, welcome to the pod.

Doug Porter:

Well, thanks for having me, Henray. It's an honor to be here.

Henray Cohen:

So today I was thinking we would touch on three big areas. The first would be the state of the US economy, the second is the future of the jobs market, and the third is your outlook for inflation. How does that sound?

Doug Porter:

That sounds wonderful.

Henray Cohen:

Okay, great. Well, then let's start with talking about the size of the pie itself. In other words, do you see the economy continuing to grow at this current pace? And how would you handicap the odds of a recession here in the US?

Doug Porter:

Yeah, the short answer is yes, I do see the economy still growing at a fairly robust pace over the next year. And just if we stand back for a moment, I know we're always faced with lots of ebbs and flows in the data, but if we look at how much has the economy grown after inflation in the last year, it's been 2.7%. That's a little bit above its long run average of closer to 2%. And of course, a lot of that has to do with just the terrific amount of money being spent on the AI backbone. That's really been a big factor in driving the US economy to grow a little bit faster than normal.

And the short answer is yes, we see relatively robust growth continuing through 2026. In terms of what kind of odds I would put on a recession, first of all, I would start off by saying it takes a lot to drive the US economy into a recession. It takes a really mighty blow. And when you think about some of the shocks we've been hit with just in the last couple years, the big run-up in interest rates in the wake of the inflation that we faced in 2022, and of course the trade war last year, and the conflict with Iran this year, that's a lot of shocks that the US economy has been able to roll right through.

And barring some mega shock that really none of us see coming at this point, it's tough for me to see the conditions that would really drive the US economy in an outright downturn. It just so happens that the blue chip consensus of forecasters gets asked this very question every month, "What odds do you put on a US recession over the next 12 months?" And at present, the blue chip consensus is saying a little bit less than 30%.

I would put it a wee bit lower than that. We can never rule it out, of course. You can always be hit with some big surprise. But I think given the kind of momentum the economy has, the amount of spending that's going into AI, the strength of the financial markets right now, I would put the odds of a recession at lower than normal at this point, at least over the next 12 months. What's the one big risk that's staring us right in the face right now that could upset it? Of course it's the conflict in Iran, and the possibility that oil prices could really meaningfully flare higher again, but provided oil prices stay below $100 a barrel, and they're closer to 70 as we speak, I think that's very manageable for the US economy.

Henray Cohen:

Well, that's certainly comforting to hear. I know that's a question that a lot of clients are thinking about, and a question that I get asked a lot, but it is nice to put things in perspective around just how resilient the economy has been, especially over the past few years, given what we've endured.

Maybe now let's turn to jobs. On the surface, the labor market still looks pretty healthy, but there's real anxiety bubbling underneath, and a lot of it comes down to AI and robotics. Maybe the AI doomer scenarios are overblown, but in a world where we're headed, with very capable LLMs and humanoid robots, how high do you think the unemployment rate will peak over the next few years?

Doug Porter:

So first of all, I think we all have to be humble on this question. There are a lot of moving parts here. The technology is moving very quickly. This is the speed of a major technology being unrolled like we've rarely seen before. So I think we all have to admit that none of us know for sure.

But I will say from a bigger standpoint, I've always been on the side that thinks that the doom scenario is just not right. I often like to say that the greatest job killer that we've ever dealt with in the last couple centuries was the tractor, which basically removed many, many agricultural jobs. And around the turn of the century, last century that is, almost half of the American workforce was in agriculture. Now about 1% is. We managed through that. After World War II, 40% of the workforce worked in factories, now less than 9% does.

Those were two massive changes that the economy dealt with relatively smoothly over time. And I'm a big believer that yes, this technology will disrupt some professions, to be sure, it will eliminate some jobs, but there are many jobs we can't even imagine right now that I think will step in. And I tend to be the view that AI will help people do their jobs better, in many cases, and not eliminate jobs on a massive scale.

So I'm just not in the camp that sees this as a major job killer. So that's a long, roundabout way of saying I actually do not see the unemployment rate rising much in the next couple years. In fact, the other side of the coin that we haven't talked about yet is, at the same time as we've got all these concern about AI taking out jobs, the size of the labor force, the number of people who are actually, either have a job or are looking for a job, has actually shrunk over the last year. It's come down.

And between a lot of baby boomers retiring, and a fairly notable slowdown in immigration, it really doesn't look like we're going to get much pressure in terms of new labor force supply. I think there's the possibility that the unemployment rate could actually drop over the next year. It's interesting, when we look back over the last 12 months, as I mentioned before, we've been dealing with all the uncertainty on the trade file first, on the trade tiff with a number of nations, the Iran conflict, the run-up in oil prices. The unemployment rate has barely budged over the last 12 months, even amid all this massive uncertainty that we've been dealing with. So I happen to think the unemployment rate's going to stay fairly close to 4%, if not even come down a bit in the next couple of years.

Henray Cohen:

Well, I hope you're right on that. If that's the case, or maybe just thinking bigger-picture about what's actually going on, where people are actually becoming more productive and these tools are helping people be better at their jobs, what impact do you think that will have on wage growth? And what do you think we might see as far as real wage growth over the next one or two years?

Doug Porter:

So this is the potentially good news story of any kind of productivity gains we get from AI, is what we've seen over time is the way to get real wage gains is to have strong productivity growth. That's what ultimately can finance companies to pay more in terms of wages, if they actually are getting productivity gains behind that.

And there are some early tantalizing hints that all this investment in AI, all the spending in AI is starting to produce some results. Now, it could be something that's not related to AI at all, but we have actually seen fairly robust productivity growth in the last year, and arguably in the last three years, in the US economy.

What does it all mean for wage growth? Well, we've seen, and there's lots of different measures of wages, but the one we like to look at is growing about 3.5% a year. Admittingly in the last 12 months, that's been a bit below inflation, headline inflation, because it's popped up as a result of the run-up in oil prices. But presumably as energy prices hopefully come down or moderate over the next year, we're going to see headline inflation dial back somewhat. And we think 3.5% wage gains will look not bad in the future. And there's some possibility that if we start to see some real productivity gains from AI, that those wages can even nudge a little bit higher without causing inflation.

Henray Cohen:

Okay. Well, now that we're talking about inflation, I'd love to maybe expand to the bigger topic of broader inflation. The market has a certain path baked in, but I know you don't always agree with the consensus. So do you think broad inflation is going to come in higher or lower than what the market is expecting over the next year, and where do you see the disconnect, if there is one?

Doug Porter:

So I have to tell you right off the bat that I'm not really that far out of line with consensus in terms of where it sees inflation going over the next year. Just as a bit of background, during COVID and afterward, I was, not to toot my own horn, but I was definitely on the side of being early in terms of warning that that episode was really unusual, really different, putting strains on both supply and demand the likes of which we hadn't seen in decades.

So I was a bit of an inflationista coming out of COVID, but I think things are quite different from four years ago, and I'm not particularly concerned that this big run-up in energy that we saw through the spring is going to lead to a broader outbreak of inflation more generally. We have inflation moderating over the next year.

I am still a bit concerned that we're not going to get all the way back to 2% though. So our official call on US inflation for next year is an average of about 2.5%. Just to put that in perspective, the latest number we saw was 4.2 on headline inflation in May. Now, I do think that number's going to come down through the second half of the year, provided energy prices do cool a bit, but that's not that different from where consensus is at this point, that it is looking for something in the range of between two to 3% next year for headline inflation.

Henray Cohen:

2.5% inflation, a lot of people would be really happy with that number. I'm sure markets would be really happy for that number. What are the macro forces that you think are going to help us get there?

Doug Porter:

So if we look at core CPI, it's actually not that far away from that range. And usually core is not a bad way to judge where we're going to be on overall inflation a year from now. We do see some cool down in growth next year. So just to back up a little bit, we still see very heavy duty AI spending in 2027, but we think the growth rate of that new spending is going to cool a bit in 2027.

We also see government fiscal policy turning a little bit more restrictive in 2027, after we get through the midterms. We do see fiscal policy being a little less supportive. So with a slight moderation in economic growth in 2027, we think, alongside presumably tamer energy prices, we think that takes a little bit of steam out of headline inflation.

And I guess the last factor I would point to, of course, a big driver of overall US inflation is what's going on in the residential housing market.

And what we're seeing there is very mild price gains. And we do think that will weigh on shelter costs, which is a big component of CPI, and we are seeing some moderation on that front already. We think that will play a bigger role in 2027.

Henray Cohen:

Yeah. I guess one last question on the topic of inflation is, you mentioned a lot of things, but one thing you didn't mention was the money supply, or government spending, or government deficits. Been a couple of years since that has been in the headlines as much. But what are your thoughts? I mean, as you look at the state of our federal government, and forecasted deficits at just shy of $2 trillion a year for what seems to be the new run rate going forward, what impact, if any, do you see that having on inflation?

Doug Porter:

Yeah. And to be sure, when I think of the medium and longer-term risks for the economy, I do think the state of government finances is clearly one thing to be concerned about and to keep an eye on. I do think one way or the other, we do have to bring that deficit slowly but surely down, to cap the level of government debt. I don't think it's a problem that has to be dealt with today, but I do think over the next one to two years, we definitely have to start to bend the curve towards a lower deficit.

If there's a morsel of good news, the overall budget deficit has actually been tracking a little bit better than what many expected a year ago. I know the number that many people talk about is $2 trillion. In fact, over the last 12 months, the deficit's been a little bit less than 1.7 trillion. That's still an enormous number, make no mistake about it. But it actually has been coming in a wee bit better than expected.

And I think if there's just a bit of restraint, it doesn't have to be anything dramatic, just a bit of restraint on spending, and we continue to see the economy stay on track, and sure note the revenues start to get that deficit down, just headed in the right direction, that would be a big win, I believe.

In terms of its impact on inflation, the way I look at it is, is the deficit changing? Has it grown a lot in the last year? It hasn't, really. It's actually very similar in the last 12 months to what it was in the prior 12 months. So it's really not adding to growth, or it making inflation any worse at this point. That's the way an economist would judge it.

In other words, the way I would look at it is if the deficit is getting wider, is getting worse, that's when you start worrying about it adding pressure to inflation. And so I'm not concerned, or overly concerned, I should say, that the deficit is really making a bit of a tough situation on the inflation front any worse than it has been.

Henray Cohen:

All right. Well, thank you for that perspective. This has been a great conversation. I think listeners are walking away with much clearer picture of where BMO sees the economy headed, and what to watch for from here. So thank you, Doug. And to everyone listening, thanks for tuning in to Beyond the Portfolio. We'll catch you next time.

Mike Miranda:

Thank you for listening to Beyond the Portfolio. You could follow us on Apple Podcasts, Spotify, or your favorite podcast app. Until next time, I'm Mike Miranda.

Speaker 4:

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