FOCAL POINT

US: a not-so-soft landing, no rate cuts before Q2 2024

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Our Focal Point series explores topical issues on macro, markets and investment

- **After a strong H1, activity in Q3 looks healthier than expected thanks to increasing real income, low savings and fiscal support. Yet the economy will slow down and flirt with recession: growth will turn slightly negative in Q1 2024, followed by subpar growth thereafter. Risks are balanced: demand may prove more resilient than expected to high rates, but the full impact of tighter finance has yet to be felt and fiscal support will fade.**
- **How soft the landing will critically depend on the labour market. So far easing labour demand has coexisted with record low unemployment (3.6% in July), as employers prefer to hoard workers, but this may be tested in a case of more severe downturn.**
- **Employment cost growth is cooling, but at 4.5% yoy remains some 1pp higher than the level consistent with 2% inflation. Production and import prices are decelerating too, but robust demand will slow disinflation. Indeed, we see core PCE inflation still above 3% by Q1 2024.**
- **The July's rate hike was followed by overall hawkish communication. We think that the Fed is done hiking, but see no cuts before June next year. Only very negative inflation surprises might trigger another rise in November. Quantitative tightening should end by mid-2024.**

After a strong Q2, preliminary data for the summer point to still healthy demand; increasing hopes of a soft landing are supporting risk assets. We acknowledge that the latest data reduce the risk of a crash and therefore revise up our growth forecast. But we caution against complacency. Growth will slow markedly down in Q4 and GDP will eventually contract in Q1. Furthermore, the recovery will be rather sluggish, with GDP approaching trend growth only by end-2024. The Fed is likely done with raising rates, but due to a resilient labour market and a sluggish pace of disinflation it is unlikely to pivot before June 2024.

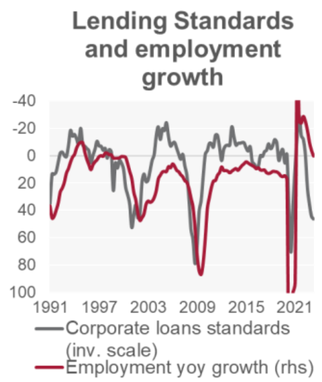
No signs of recession so far…

Hopes of a soft landing are being fuelled by early data for the summer, showing demand, especially consumption, defying inflation, and higher rates, while employment growth is moderating at a very gentle pace. Several tailwinds to growth were underestimated, like the stock of excess savings supporting recovering real income in boosting consumption, which is in turn tilted towards less interest rate sensitive services. The real surprise in the strong Q2 GDP report was the bounce back in non-residential investment. It was concentrated mostly in IT and helped a lot by the vast amount of funding obtained by firms at record low rates before the Fed started hiking. Another boon was fiscal policy as cost of living: adjustment in social security is supporting disposable income and the tax advantages legislated in the CHIPS and Inflation Reduction Acts are leading to a spike in the construction of manufacturing plants. Overall, we expect the contribution of investment to growth to fade, as profitability is declining, and debt is being rolled over at much higher rates.

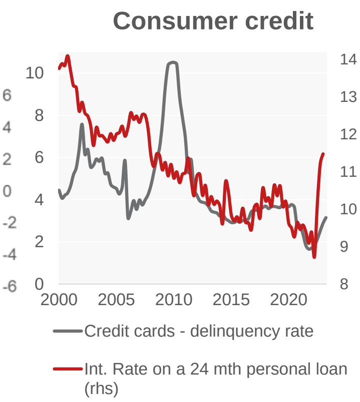
Source:BEA, GIAM

…but tighter financing will eventually take its toll

Even in our upwardly revised forecast, GDP will be flat or only slightly positive in Q4 and contract by -0.2% Q1 2024, after a still healthy Q3. Tighter financial conditions, operating with a longer lag than in the past, will be the key driver While the Fed is likely done with hiking, borrowing costs are not declining and we therefore expect the headwinds to domestic demand to intensify. Fiscal policy will become a drag too: the spending caps asked by the Republicans in exchange for the deal on the debt ceiling in May will compress nondiscretionary federal government spending during the coming months and in 2024. Moreover, the Supreme Court's decision to stop student loans forgiveness will impact disposable income. This and the end of pandemic-era student loan interest forbearance, in October, will cut disposable income and consumption. Back of the envelope calculations show that, if most cuts are frontloaded to Q4, those could dent consumption by 1.2pp and GDP by 0.8pp annualised. We estimate that excess savings will stop contributing meaningfully to consumption by the end of Q3. Estimates put forward by the Fed and other analysts vary widely, as they assume different values for the "normal" level against which excess savings are benchmarked. The strong recourse to consumer credit, despite record high interest rates and rising delinquencies, suggest to us that households' budgets are getting tighter. In our forecast, the saving rate will gradually climb from the current (Q2) 4.4% to 7% by the end of 2025 and stabilises at that level (which is broadly in line with the pre-pandemic average) thereafter. The slowdown of the European economy and the underwhelming performance of China will drag on exports. Most of the common early warning indicators (such the slope of the yield curve, credit standards, business surveys) are consistent with a forthcoming recession, but whether this will happen then a close call. Several factors, like solid balance sheets, recovering real wages and a tilt of expenditure towards less interest rate sensitive items like services and immaterial investment like property rights are likely to blunt or, more likely, delay the impact of the monetary policy squeeze,

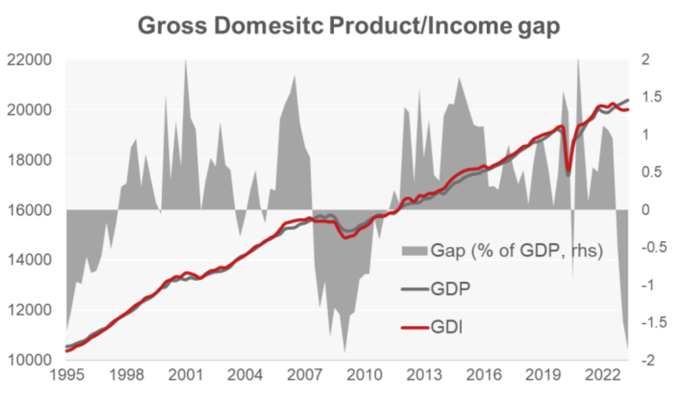


Source:Federal Reserve, BLS, Refinitiv, GIAM



Source:Fed. Reserve,

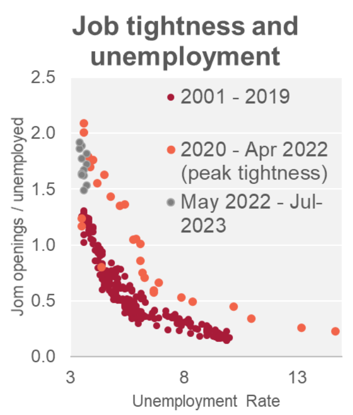
Therefore, after recording 2.1% growth in 2023, GDP will expand by just 0.8% in 2024. The rather weak figure for next year is mostly due to a sluggish H1 recovery burdened by still challenging financial conditions. We expect annualised growth to go back to near trend by Q4 2024. Risks around our forecast are broadly balanced: we are maybe still underestimating the strength of households' finances and the impact of strong corporate balance sheets on capex. If so, the economy may achieve a genuine soft landing. However, this would likely force the Fed to restart its hiking rates, risking an even sharper slowdown in 2024, and to further postpone rate cuts, exposing the corporate sector to a higher refinancing risk over the course of 2024 and afterwards. Regarding downside risks, the signs of stress, concentrated in the banking sector may intensify. This would deepen the capex and consumption contraction and make it longer lasting, preventing a significant upswing in 2024. Another risk to our forecast is due to the possibility of large downside revision to GDP figures. Normally the difference between GDP (which measures activity on the expenditure side) and Gross Domestic income (a gauge of the resources received by the economy) is not very large, but currently income is lower than estimated expenditure by around 2% a level last seen during the Great financial Crisis.



Source:BEA, Refinitv, GIAM

The labour market: is this time different?

The reaction of employment to the slowdown will be crucial in discriminating between a mild recession and a soft landing. The data so far show a gradual rebalancing between booming labour demand and adjusting supply. In August payroll growth cooled again and past data were revised slightly down, and the data for July showed that the quit rate is falling fast, approaching the 2019 levels, as workers turn less confident about the employment prospects. Moreover, the ratio of job openings to unemployment (an indicator of demand/supply imbalances) is gradually converging to levels more consistent with the current low unemployment rate. Surveys show that demand should cool further. Yet, a not so smooth rebalancing of the labour market remains a possibility. The job finding rate (% of people unemployed that finds a job the following month) is decreasing and the August reading of the Conference Board consumer confidence index was depressed by a jump in the share of respondents thinking that jobs are getting harder to find.



Source:BLS, Refinitiv GIAM

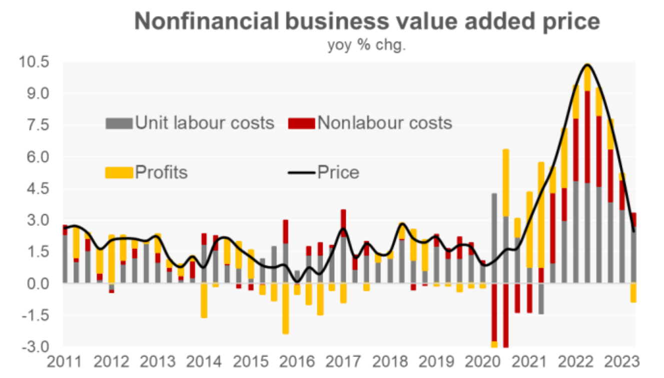
Source:BLS, NFIB, Refinitiv, GIAM

We expect the large supply/demand mismatch that has characterised the recovery to affect employers' attitude, leading them to temper the pace of dismissal when activity weakens. For this reason, the unemployment rate should peak at just below 5% by the end of 2025, higher than what the Fed expects (4.5%) but still low compared to the past periods of weakening activity. The employment cost index (the Fed's preferred wage inflation gauge) moderated from 4.8% yoy growth in Q1 to 4.5% in Q2. Labour hoarding may put a floor to wage growth and, weakening demand and will make it harder for firms to pass costs to consumers, which will in turn challenge a still declining profitability.

Inflation on a very gentle downward slope…

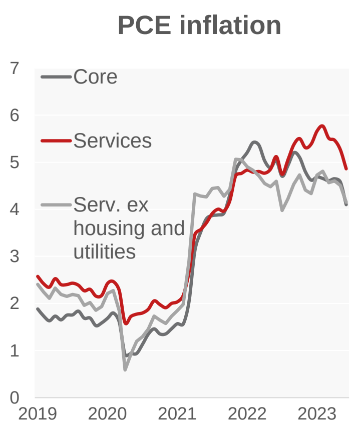
The gradual descent of core PCE inflation (4.1% yoy in July, compared with a peak of 5.4% yoy in February 2022) is set to continue. Deflating good prices are providing the bulk of the decrease, as supply chains are back to normal. Weakening services inflation has benefitted from the slowdown in house prices gradually feeding through to rents. After peaking at 20% in spring 2022, the Case-Shiller house price index has remained flat on a year on year basis in April and May, but has been increasing month on month since January, so the prospects for the evolution of rents over the next year are less clear. Finally, inflation for services excluding energy and housing continues to hover around 4%.

There is a fair amount of disinflation in the pipeline, not just from commodity ad production prices, but also from margins. Data on value added show that most of the year on year increase in prices is due to labour costs, with profits contributing negatively in Q2.



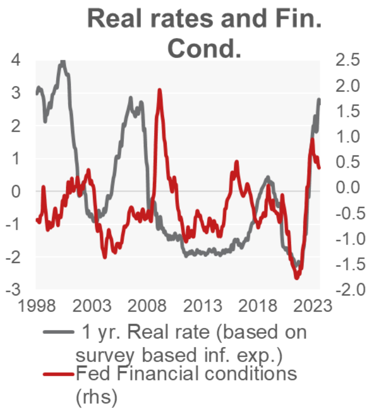
Source:BEA, GIAM

In In principle a cooler labour market will help bring down inflation even though recent research shows that the relationship between unemployment rate and ex shelter service inflation is rather weak. Inflation expectations by consumers and of pricing power by firms are also heading down. We expect disinflation to continue, but core PCE will still end 2023 at around 3.5%. Substantial upside risk remains, as the wage growth is sticky and spill-overs could turn out to be stronger. Also, emerging demand/supply imbalances could trigger a more material reacceleration in house prices.

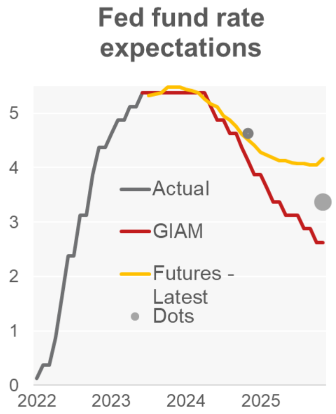


Source:BEA, Refinitiv, GIAM

Source:NFIB, U. Michigan, Refinitiv, GIAM



Source:Federal Res., Philadelphia Fed, GIAM



Source: Federal Reserve Board, Refinitiv, GIAM

…and rate cuts must wait until Q2 2024

At Jackson Hole, Chair Powell, reiterated the Fed's commitment to the 2% inflation target and that substantial upward risks to price pressure remain, but at the same time acknowledged that the risk of tightening too much has increased: he and other FOMC members reckoned that it is time for them to assess the evidence, hinting to no rate hikes at the September meeting. More broadly, we think that the Fed is done hiking and only large surprises in the coming CPI and employment reports might trigger a further rate hike in November. The still hawkish tone of the communication relates rather to steering expectations about the timing of the rate cuts. We expect the first cut late in Q2 2024: Given the past underestimation of inflation and a looser relationship between slower activity and job destruction due to labour hoarding, the central bank must and can wait with a pivot. We expect a total of 100bps Fed funds rate reduction in 2024, as monetary policy will need to prop up a recovery burdened by higher private sector borrowing costs and the lack of any fiscal support.

Quantitative tightening (QT) will likely end in Q2 in conjunction with the first rate cuts. In the July meeting, some FOMC members hinted at the possibility that the shrinking of the balance sheet could continue when the fed reduces the policy rate. We deem this unlikely: First, having the policy tools moving in opposite direction would send a confusing message. Second, the level of securities held reached by Q2 2024 would be consistent with a share of reserves to GDP of slightly above 8%, the pre-pandemic estimate of its steady state value stated by the NY Fed and some FOMC members. In a forthcoming Focal Point we will detail our thinking about the possible evolution of US monetary policy.

Imprint

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