Global Macro Research - Insight

29 February 2024

8.24 minute read | #US / #Growth / #Monetary policy

US outlook update: Coming in to land?

We now expect the US economy to achieve a soft landing this year. But the economy is not completely out of the danger zone, with the risk of a sharper slowdown higher than normal.

Key Takeaways

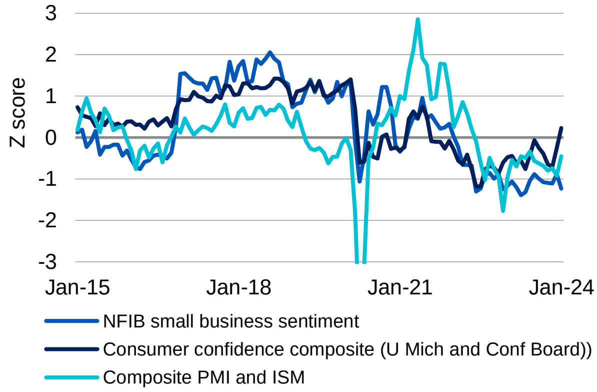
- There are few signs of distress in US economic data in early 2024, even if growth seems to be slowing from the rapid rates of last year.
- This reflects the continued boost from strong balance sheets and positive supply shocks, which have helped the economy weather the impact of high interest rates.
- While we expect these tailwinds to fade somewhat through 2024, the moderation in inflation pressure last year means the Fed should be able to ease policy this year, and there has already been a marked loosening in financial conditions.
- The combination of resilient activity, slower inflation and easing financial conditions should see growth slow but not turn negative. Our judgement is that a soft landing is now the most likely outcome for the US economy this year.
- However, the risk of a downturn is still significant and notably larger than normal.
- In fact, it is possible that the economy is more sensitive to high rates this year, as supply tailwinds recede or balance sheet dynamics deteriorate. Similarly, if inflation proves harder to squeeze out, it could limit the scope for policy easing, reigniting the risk of a hard landing.
- Alternatively, the improvement in supply growth could continue, helping maintain the favourable mix of strong growth and moderating inflation. This would imply a more durable increase in US potential growth and the interest rate structure.

Defying gravity

US data at the start of 2024 have been mixed, but overall activity remains resilient. In particular:

- The labour market looks solid, with payrolls gains exceeding consensus forecasts, few signs of stress in unemployment insurance claims, and vacancies still elevated.
- Manufacturing and services sector sentiment is improving, even if the former continues to lag. Consumer confidence has also picked up. The one fly in the ointment is small business sentiment, which dropped in January and remains at concerning levels (see Figure 1).

Figure 1: Consumer and business sentiment is improving



Source: Haver, abrdn, February 2024

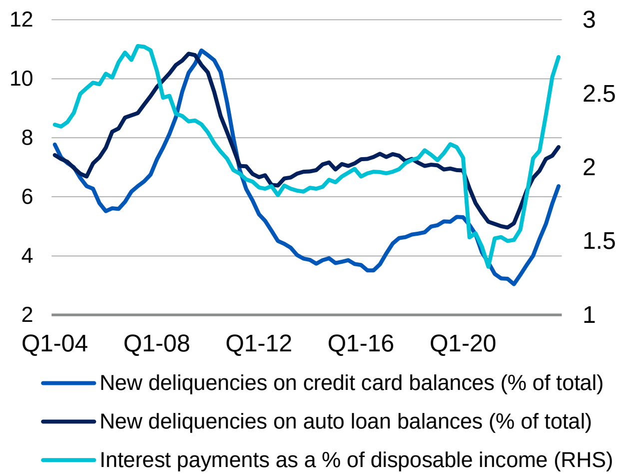
- Credit conditions, while still tightening, are doing so across a smaller share of banks, and loan demand was less negative across many categories too.

- Corporate profits rebounded over the second half of last year, and, on the whole, earnings reports have beaten analyst expectations. This could reflect less pressure on margins than we had feared, especially as wage growth eases.
- Finally, NBER recession indicators show few signs of imminent distress, and the Conference Board's leading indicator is no longer signalling a recession.

Admittedly, there are some cracks beneath this strong exterior. The latest retail sales report pointed to weak goods spending in January, while downward revisions make Q4 consumption growth look slightly less impressive than previously thought. Industrial production was also soft at the start of the year, despite improving sentiment in the sector.

Moreover, there are signs of stress in segments of the household sector, with delinquencies for auto and credit card loans increasing as financing costs reach multi-year highs (see Figure 2). These dynamics look relatively contained for now, but a broadening of this trend could be the start of a larger consumer retrenchment.

Figure 2: Delinquency rates point to some pockets of distress among consumers



Source: Haver, abrdn, February 2024

Finally, there are still puzzling signs in the data. GDI is painting a more subdued picture of momentum compared to GDP data. It would not be a surprise to see some downward revisions to 2023 GDP growth that narrow this gap. Similarly, payrolls growth looks noticeably stronger than reported in the household survey, so the risk of downward revisions to these data looks elevated as well.

These soft spots, or data irregularities, might be consistent with slower growth this year, but there are few signs of a more abrupt deterioration. To understand how likely the latter is, it is important to explore what is behind its resilience, and whether it can continue.

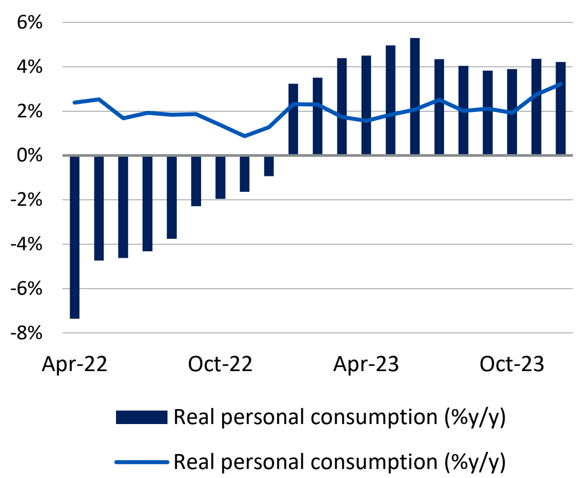
Demand side supports from balance sheets

Balance sheet dynamics helped underpin growth last year, with consumers able to draw down an estimated $600bn (2.4% of GDP) in excess saving to support spending.

These savings piles are now smaller, and likely concentrated among high-income households, making it harder to finance spending via this channel going forward.

However, improving real incomes might take some of the slack (see Figure 3), with slower inflation and strong total compensation growth helping shift spending to a slower, but more sustainable trajectory.

Figure 3: Improving real incomes should support spending



Source: Haver, abrdn, February 2024

At the same time, corporate margins have been insulated by the continued boost from low interest rates following the Covid pandemic. A relatively modest refinancing profile over the past 18 months means that borrowers have not needed to lock in rates that reached levels as high as 6.6% for BBB companies. As refinancing picks up this year and next, corporates will benefit from rates that are around 100bps off this peak, lessening the potential hit to margins.

The supply side strikes back

Meanwhile, several favourable supply shocks have helped support growth.

A recovery in global supply chains enabled a rebound in production and sales, particularly in the auto sector. However, this dynamic has now run its course, and disruptions in the Red Sea mean that the risks are tilted towards renewed stress.

In the labour market, stronger participation, alongside rising immigration, provided a material boost to the labour force and so potential growth in 2023.

We suspect the recovery in participation is over, with the prime worker rate close to multidecade highs.

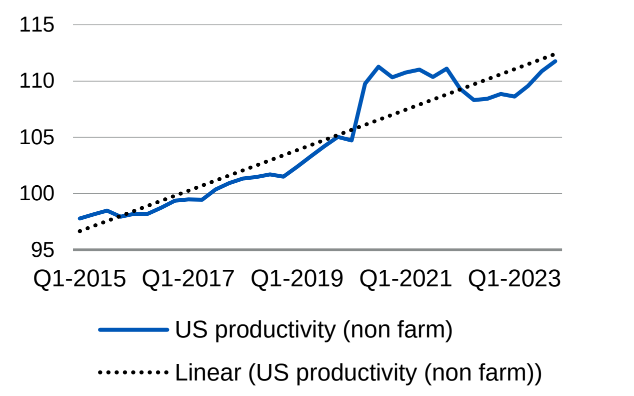
But there might be scope for continued strong immigration to boost labour supply, particularly given years of low immigration during the pandemic.

At the same time, labour market matching efficiency has improved significantly, reflected in vacancies falling sharply without unemployment also increasing. However, with the Beveridge curve – which can be thought of as representing labour market matching efficiency – having largely returned to pre-pandemic norms, this tailwind may now also have run its course.

Finally, productivity growth picked up sharply, surging to 2.7% year over year at the end of last year. This is the strongest reading since the early 2000s outside of recession distortions.

Productivity growth could remain strong in the short term, boosted by pandemic era R&D spending and public sector investment related to the Inflation Reduction Act (IRA) and Chips Act. But we are not convinced that this heralds the start of a multi-year acceleration in productivity growth, so much as a period of a catch up to the pre-pandemic productivity trend following a slump through 2021 and 2002 (see Figure 4).

Figure 4: Productivity is now growing strongly following huge swings through the pandemic



Source: Haver, abrdn, February 2024

That said, a more durable step change in productivity based on structural changes in the economy following the pandemic and capital deepening around artificial intelligence is possible. This is the most important source of upside risk for the US economy over the medium to long run.

Immaculate disinflation

Positive supply shocks have played an important role in cooling labour demand without layoffs, moderating nominal wage growth, pushing down labour costs for firms, and lowering inflation. All this has reduced the necessity for demand destruction to bring inflation back to target.

The results have been striking. Core PCE inflation in six-month annualised terms slowed to 1.9% over the second half of last year, at face value meeting the Fed's target.

Admittedly, there are lingering concerns over the sustainability of this decline. Falling goods prices have masked still hot core services inflation. Moreover, the January CPI and PPI data point to some reacceleration in sequential core PCE inflation in early 2024. So, it is certainly possible that the final mile of bringing inflation back to target will be bumpy.

But the big picture is that the US has made remarkable progress in lowering inflation. Moreover, the ongoing slowdown in wage growth points to further progress ahead, while inflation expectations have been well anchored over recent years.

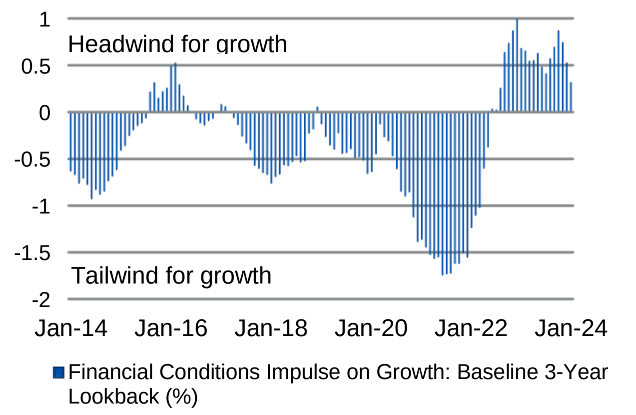
Fed taking its foot off the brake

The moderation in inflation means the Fed is likely to begin easing policy soon. It kicked off an effective policy pivot at its October and December meetings last year, shifting from a tightening to an easing bias, and signalling deeper interest rate cuts over 2024.

The impact of this shift on financial conditions has been striking, with longer term interest rates falling – albeit with considerable volatility – credit spreads tightening, and equities rallying.

The Fed's own financial conditions index gives a sense of the implications of this shift for growth. In October last year, the central bank's model suggested that changes in financial conditions over the past three years would lower GDP growth by 0.9ppts over the subsequent 12 months. Following the easing in financial conditions over recent months, this headwind has lessened to just 0.3ppts (see Figure 5).

Figure 5: Financial conditions now present a smaller headwind



Source: Haver, abrdn, February 2024

Soft landing incoming

Solid short-term growth shows that the US economy has been able to withstand the headwinds from high interest rates. And the economy may be moving past the peak of these headwinds as falling inflation allows the Fed to tolerate the recent easing in financial conditions.

We have been arguing for many months now that the runway for a soft-landing has been increasing. We now think that a soft landing is more likely than not. In other words, a US recession is no longer our base case.

We will have more to say about the specific details of our revised US baseline forecasts including the Fed rates path, in our forthcoming Global Economic Outlook.

Not out of the danger zone yet

Despite this shift, it is important to emphasise that recession risks remain elevated compared to a typical year in the business cycle.

In part this reflects heightened uncertainty around both the supply and demand sides of the economy in the aftermath of the pandemic.

It is possible that a more abrupt end to the favourable supply shock of the past 12 months means the economy struggles more than we anticipate. At the same time, balance sheet dynamics that have supported growth so far could evaporate more abruptly.

It is also possible that the last mile of bringing inflation back to target proves more difficult, or even that the rapid decline through the second half of last year gives way to a renewed increase perhaps because demand growth is too strong or because the supply environment turns more adverse.

An increase in inflation would limit the scope for the Fed to ease policy and could even prompt rate hikes if it is severe enough. In this scenario, a renewed tightening in financial conditions could cause a hard landing.

But it is equally important to note that there are upside risks to our forecast. A continued improvement in the supply side would sustain the mix of strong growth and slower inflation over the past year. Such a scenario would probably be consistent with higher equilibrium interest rates as higher potential growth pushed up the demand for investment spending. Indeed, in this scenario the Fed might conclude that policy was not as tight as thought and encourage it to leave rates on hold for longer, and ease policy less than planned.

What to watch

Important waymarks to watch over the coming months to test our new baseline view will be:

- The trend in personal consumption, which should slow but not stall;
- Core services PCE inflation, which should continue to drift lower in three- and six-month annualised terms despite some bumps over the coming months;
- Rate cuts starting in May or June, with further delays adding to risks of tighter financial conditions and weaker growth.

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AA-060324-175103-44