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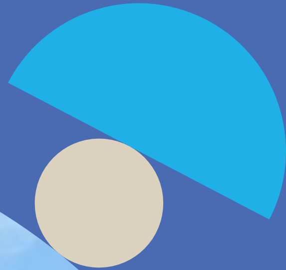
Topical Thoughts
February 2024

A US soft-landing comes within reach



The US economy continues to defy gravity. Despite one of the most aggressive tightening cycles in decades growth is holding up, supported by solid consumer spending. Having refinanced their mortgages at low rates many households have not felt the impact of higher interest rates, and a tight labour market keeps wage growth elevated. With inflation receding the Fed is now beginning to signal looser conditions ahead. While the risk of a more severe slowdown is still elevated, chances of a very rare soft-landing have risen in recent months.

The US economy continues to show remarkable resilience in the face of one of the most aggressive monetary tightening cycles over the past few decades. GDP grew at an annualised rate of 3.2% in the final quarter of 2023 and 2.5% over the whole year. In addition, recent data show that business activity remained healthy at the beginning of this year. Although manufacturing contracted for the fifteenth month in a row in January, it did so at the slowest pace since the downturn began in November 2022, while new orders expanded for the first time since August 2022. More importantly, service activity kept expanding all through 2023 and did so at an accelerating pace in January 2024, with new orders pointing at further strength.

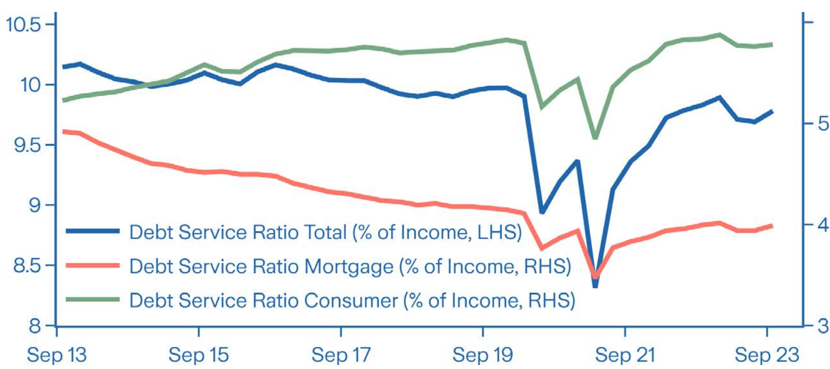
Service activity is holding up

Source: Bloomberg

Resilient consumers keep spending

Consumer spending continues to be a major driver of the robust shape of the US economy. Households shifted their expenditures from goods to services in the aftermath of the pandemic, but the overall pace of spending slowed only slightly last year. Consumption has been supported by remaining excess savings while the labour market has not weakened to a degree that would have triggered a significant setback in spending. Solid wage growth and falling inflation rates have helped to raise real wages and consumers' purchasing power. At the same time, households have not felt the full impact of higher interest rates and tighter financial conditions as many of them refinanced their mortgages at very low rates right after the pandemic. With the Fed now signalling looser financial conditions ahead households and corporates may be able to bridge the gap, avoiding refinancing at substantially higher interest rate levels.

Households are still not feeling the full impact of higher interest rates

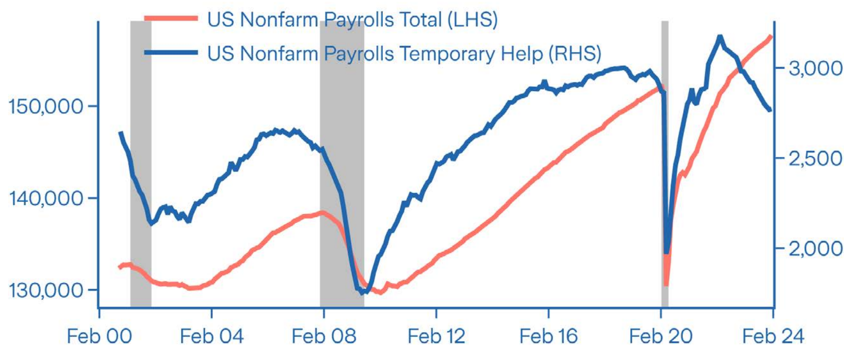


Source: Bloomberg

A weaker labour market is expected to weigh on wage growth

Given that interest rates are still significantly above pre-pandemic levels, overall financial costs for households are expected to increase further. At the same time, employment and wage growth are likely to soften. The unemployment rate remains close to the lowest levels in decades, but the broader underemployment rate, which includes persons that are marginally attached to the labour force and those that are employed part time for economic reasons, has risen to 7.2% from its post-pandemic low of 6.5%. Meanwhile, the demand for temporary workers does not confirm the strong growth in new nonfarm payrolls, which has been a reliable predictor of an economic slowdown in the past. Similarly, the quits rate of employees voluntarily quitting their job has recently ticked down below the pre-pandemic level, signalling a further slowdown in wage growth.

Falling demand for temporary workers is pointing at softer employment conditions



Note: Grey bars show US recession periods

Source: Bloomberg

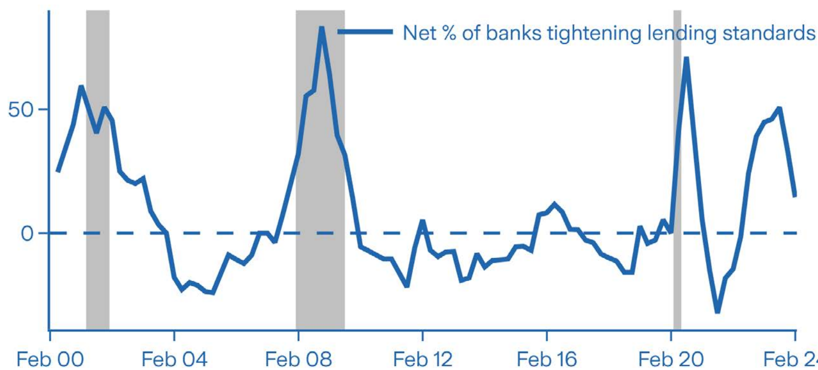
Chances for a rare soft-landing have improved

The coming months will be a tug-of-war between falling inflation rates, which bolsters consumers' purchasing power, and a weakening labour market that is expected to weigh on the wage outlook and consumer confidence. The fact that gasoline prices have fallen significantly from their peaks helps to lift both consumers' sentiment and their purchasing power although prices are still significantly above their pre-Covid levels and have started to rise again in recent weeks.

One of the major risks identified for 2024 is that the Fed will need to keep monetary conditions tight for longer than investors think. Although this risk seems to have diminished following the Fed's dovish tilt at the end of last year, recent push-backs from Fed Chair Powell and other members of the FOMC show that the threat is still very much present, particularly given that the labour market looks still very tight, at least at the surface.

So while the risk of a hard landing is still high, the economy has weathered the tighter monetary environment surprisingly well so far. Historically, an important leading indicator for the health of the corporate sector, the Fed's latest Senior Loan Officer Survey reveals a slowing pace of credit tightening in the final quarter of last year that should help ease headwinds to growth. Fading price pressure and the lack of substantial negative spill overs from tighter financial conditions to employment and spending increase the likelihood that the Fed will achieve a rare soft landing of the economy. Nevertheless, there are still significant risks of a more severe slowdown, particularly if elevated inflation rates and wage growth keep the Fed from cutting rates in the months ahead.

Improving lending standards are easing the pressure on the corporate sector



Note: Grey bars show US recession periods

Source: Bloomberg

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