FOCAL POINT

US: soft landing will require more patience on rate cuts

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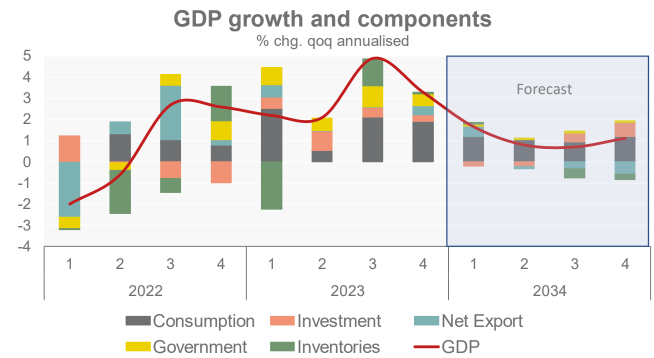
Our Focal Point series explores topical issues on macro, markets and investment

- **We significantly upgrade our 2024 US growth forecast from 1.5% to an above consensus 2.1%. Last year ended with a much stronger than expected demand, which is set to spill over into Q1. Strong real income growth is offsetting fading excess savings in driving consumption, while solid balance sheets are cushioning the impact of higher yields on corporate capex.**
- **The middle part of the year should then see a rather shallow downturn, followed by a Q4 recovery thanks to easier financial conditions. The unemployment rate is expected to peak at around 4.2% by then, while core PCE inflation should continue to moderate and end the year at 2.2% year on year.**
- **The Fed is unlikely to start cutting rates before May: the gradual downturn allows it to wait for firm data on disinflation. We see the Fed funds rate down by cumulated 100bps this year and to reach our estimate of the neutral range (2.75-3.0%) by the end of 2025. We expect the Fed to trim quantitative tightening (QT) in spring and stop it at the beginning of 2025.**

The US economy is proving much more resilient than many (including ourselves) expected in the wake of the historical steep policy rate increases. The economy enters 2024 with solid balance sheets and strong real disposable income growth, as the labour market rebalances without any increase in layoffs so far. The outcome looks like the soft-landing scenario the Fed has long been betting on, where inflation recedes very gradually down to target. This calls for patience, and the 75bps cuts pencilled in by the December dots look more realistic than current market expectations (-135 bps).

The upgrade to our growth forecast owes in part to a strong final quarter of 2023 that will also lift 2024 average growth: the first Q4 GDP release has it at a much better than expected 3.3% annualized, which provides a 1.3pp statistical carryover to 2024. We expect the positive momentum in demand to slow only gradually in Q1. GDP will decelerate in the middle of the year to around 0.8% annualised, but in Q4, the loosening in financial conditions will lead to a reacceleration. Consumption

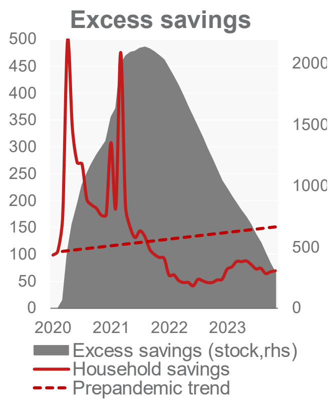


Source: BEA, GenAM

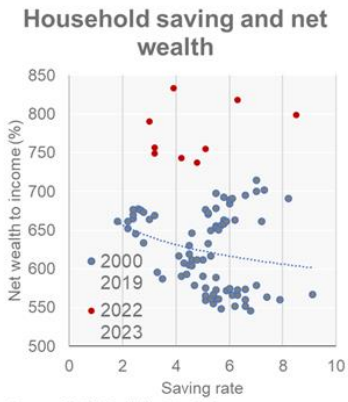
will drive growth in the first half of the year, with capex gradually catching up.

Strong balance sheets cushion the impact of high rates.

The role of one-off factors like excess savings in boosting disposable income is waning. But it is being replaced by real wage growth which importantly benefits lower income workers (who tend to show a higher propensity to consume) to a larger extent than in the past: While the gap in nominal wage growth between low and high earners has narrowed, the bulk in price disinflation has been concentrated in items like fuel and foods, while discretionary or financial services, consumed more intensively by higher income households, are still featuring high inflation. On top of that, net worth has increased as a share of income across the income spectrum. This should allow consumers to delay the increase in their depressed savings rate (currently at only 4%), which we do not expect to go back to the 2010-19 average of 6.1% before the second half of 2025. Of course, the outlook for



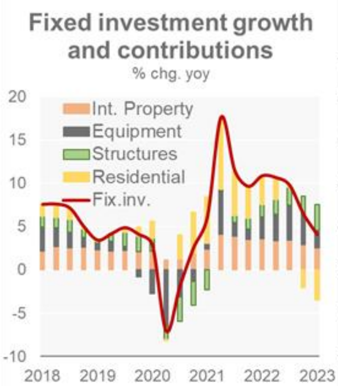
Source: BEA, SF Fed, GenAM



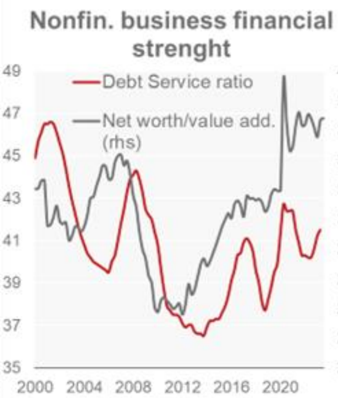
Source: BEA, Refinitiv, GenAM

consumption is not immune to risks, and the rapid surges in insolvencies (especially credit cards and auto loans) is a sign that tighter financial conditions are biting. Yet, we think households are more cushioned than in the past.

Residential investment has been hit hard by higher interest rates, but it seems to have bottomed. The most recent data on permits are positive, with those for single-family units at its highest level since May 2022, helped by the decline in mortgage rates. Non-residential investment continued to expand over 2023 despite the spike in borrowing costs thanks to three factors. First, corporate balance sheets proved solid and capable of withstanding the recent increase in debt servicing expenditure. As of mid-2023, non-financial corporates' debt service (interest plus amortization payments) was just above 40% of value added, roughly at the same level as the 2018 peak, but well below past peaks. Over 2024 and 2025, US corporations will have to roll over around 16% of debt, but given our assumptions on bond yield, the peak in corporate borrowing costs should be behind us. Preliminary evidence that bankruptcies are peaking at a rather muted level is consistent with this and encouraging. Secondly, post-COVID adaptation (e.g., the increase in working from home) spurred the demand for intellectual property products like software and the IT component of equipment, which are less sensitive to borrowing costs. Finally, fiscal policy is providing a strong boost too: the measures put in place by the federal administration to increase renewables production and re-shoring of strategic industries (like chips or electric vehicles) are triggering a surge of capex in production structures. Our forecast of a mild contraction in capex, followed by an acceleration in the final part of the year, is predicated on the continuation of these trends, helped by easier financial conditions. Uncertainty increases as presidential and congressional elections approach. This may moderate the acceleration, but looking at the last three decades, we haven't spotted a marked deceleration in capex in the quarters prior to elections.



Source: BEA, Gen AM



Source: BIS, BEA, Refinitiv, GenAM

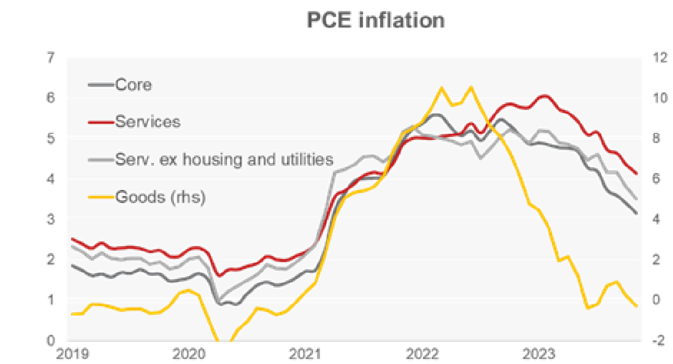
Our forecast considers the bill the Congress passed in mid-January to avert a shutdown (or better to delay it into March): it constrains expenditures to what is dictated by the Fiscal Responsibility Act approved last spring. Therefore, defence spending is set to increase by around 3%, while a series of deals between Congress and the White House will keep non-defence expenditure roughly flat in real terms. The slightly positive impact on growth will be broadly offset by higher taxes. However, some net expansionary fiscal impact could materialize if a bipartisan agreement in the Senate Finance Committee became law. It envisages expanding child tax credit and has a list of tax incentives that should induce firms to accelerate capex. This would induce some upside risks to growth, but at the cost of a further worsening in the fiscal outlook.

Slow disinflation amid low-pain job market rebalancing

A soft landing in activity means that job destruction will be mild: we expect the unemployment rate to peak at 4.3% in Q3.

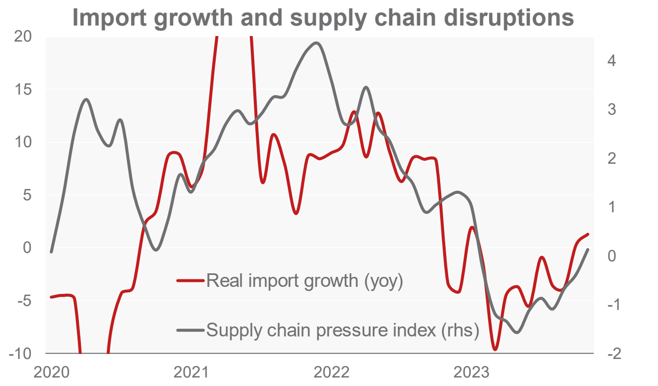
The ongoing rebalancing between labour demand and supply will continue; the ratio between job offers and unemployed people has dropped from a peak of 2 in the spring of 2022 to 1.41 in November.

The labour market remains tight: the pre-pandemic peak in the openings to unemployed ratio was 1.27, reached in Oct. 2019. But it is easing, as also shown by the drop of the quits rate, down to 2.3%, in line with what prevailed in the year before the COVID outburst. Consequently, wages are decelerating, with the employment cost index up by 4.4% yoy in Q3, down from a peak of 5.1% yoy in Q2 2022, and only marginally above the 3.5%-4% range the Fed deems consistent with the 2% inflation target. Even though the evidence of a causation chain between wage growth and core inflation is weak (actually, a recent paper by the Boston Fed shows that wages are just catching up with past high inflation, without adding to it), evidence of a decline could provide more reassurance on disinflation. Core inflation is increasingly driven by services, which have a tighter relation with domestic activity rather than internationally traded goods. They drove the initial phase of disinflation, as global supply bottlenecks eased, but their contribution is set to become minimal. For this reason, we expect the next leg of disinflation to be slower, with core PCE inflation easing from the current 3.2% yoy to 2.2% yoy by the end of 2024.



Source:BEA, Refinitiv, GenAM

Risks around our forecast are broadly balanced: the residual purchasing power from savings or the strength of wealth effect may be underestimated, and in that case, the economy might not land at all. Conversely, the full impact of higher rates may just be delayed rather than muted and would eventually show up in much weaker growth. However, we do not see political tensions as a major risk factor to our forecast: disruptions to shipping in the Red Sea affects mostly Asia and Europe. While the increase in trade costs may lift core goods inflation, we do not expect it to be anywhere near what happened in 2021. At that time, supply backlogs had to face (and were in part caused by) the surge in global goods demand following the post-pandemic reopening of the economy. Currently, not only do global supply chains show



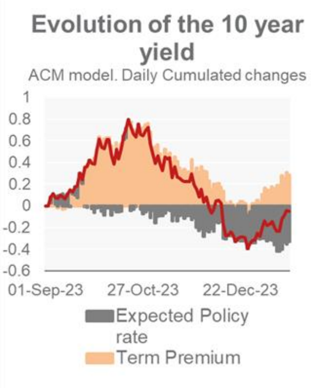
Source: Census Bureau, NY Fed, Refinitiv, GenAM

little evident gridlock, but imports have significantly slowed down.

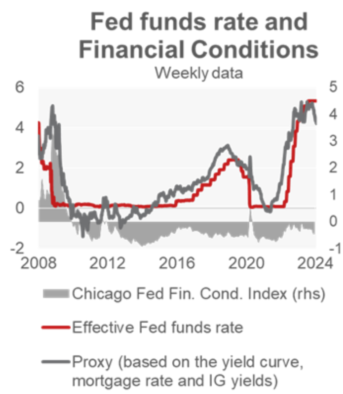
The November elections are clearly significant downside risk for the outlook for public finances and trade, which would materialize only in 2025. The tight race and the extreme positioning of the likely Republican candidate, Trump, may cause swings in sentiment as the election day approaches, but looking at evidence on past elections, the impact on consumer and business confidence should not be huge.

First rate cut in May, accompanied by QT tapering.

Overall, the latest developments leave the Fed in a more comfortable position than a few months ago, as its baseline scenario of below potential, but not tanking growth seems to be materialising. Over the last weeks the Fed's communication efforts concentrated in pushing back against expectations of a quick reduction in the key rate, which in turn were the key driver of the reduction in long term yields. This development is unwelcome as the Fed wants financial conditions not to loosen prematurely.



Source: NY, Fed, Refiniitv, GenAM

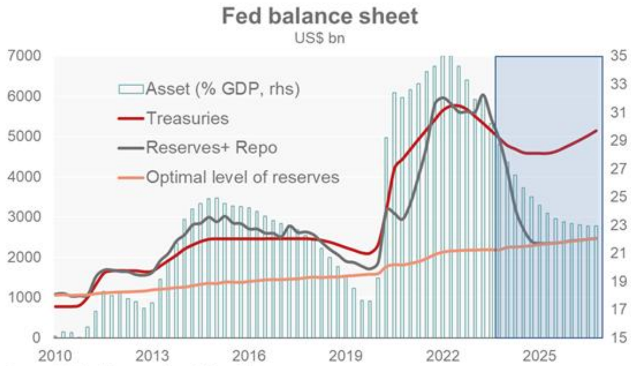


Source:Refinitiv, GenAM

The recent communication by FOMC officials opened the door for rate cuts but warned that this is likely to happen later and to a lesser extent than market currently hopes. The Fed needs solid evidence that inflation, especially in services is on a steady downward path and the absence of recession risks gives it the scope for a careful and patient assessment.

The tone of the January meeting will be consistent with this stance but should provide stronger guidance on the timing of the first cut. We expect it to happen at the May 1st meeting and see a total of four 25bps rate cuts this year, to the 4.25%-4.5% range, in line with a more cautious approach than those followed in past periods of loosening. Then a more confident Fed will implement a further loosening, bringing back rate to the 2.75-3% neutral range by YE 2025.

The January FOMC meeting may provide more clarity on the evolution of QT. Currently, each month the Fed leaves up to $95bn of maturing bonds (U$60bn UST, $35bn of agency debt) not reinvested. As reported in the minutes, at the December meeting several participants suggested to start the discussion on tapering this runoff well in advance. Early in January governor Logan added to the case for a slower reduction in the balance sheet by observing that while the level of reserves remains abundant, their distribution across banks is getting uneven, and this could create volatility in repo rates. A smoother runoff would give banks time to adjust reserves more smoothly. We slightly changed our prediction for QT and now expect the Fed will halve to US$30bn the monthly pace of UST runoff from Q2 onwards, further cut to 15bn in Q5 and end it by the first months of next year. We expect no changes in the speed of MBS runoff, in line with the Fed's stated willingness to speed up the composition of the portfolio towards Treasuries. We estimate that, in equilibrium, Fed asset would amount to around 23% of GDP.



Source: Federal Reserve Board, GenAM

Summing up: stronger growth will not derail disinflation.

Indications of very strong domestic demand and a smooth rebalancing in the labour market have dramatically increased the odds of a soft landing, which is what we now consider as the base case. Our forecast is now some 0.6% above consensus, a large part of this gap is because we include the carryover from the much better than expected Q4 2023 GDP reading. Yet we do see a deceleration in consumption that will allow disinflation to continue, albeit at a slower pace. With no sign of a forthcoming increase in unemployment, the Fed than can be patient in both the timing of the cuts and the pace of monetary easing.

Imprint

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