GlobalData. TS Lombard

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US Watch

OUTLOOK FOR 2024 – BALANCING RETRENCHMENT AND RENEWAL, INFLATION LURKS

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- Odds favour weaker growth near term followed by a rebound.
- Fed determines the outcome, biased to ease at first sight of the economy wobbling.
- Near-term, the lynchpin is equities, longer term the issue is inflation once the stored liquidity gets let out.

This USW is about 2024, what happens more immediately is implicit in my view of how the US economy and monetary policy evolve through the year. There is full awareness about how Friday's employment data could shift the narrative-of-the-moment, in either direction. My bias is towards weaker growth in the first half of 2024 followed by recovery. During the anticipated period of economic weakness, notions of a short-lived mild downturn, almost a "drive-by", followed by a solid recovery, will get buried by an avalanche of weak data and political biases wanting to portray the downturn as the second coming of the Great Depression. My confidence in renewal is built on the massive amount of liquidity that the Fed has locked into short-term financial assets by virtue of the high real rates being paid in money markets. If short rates drop quick enough (I believe that would happen should the economy begin to wobble) liquidity will subsequently flood into tangible assets and risk markets.

A lot can go wrong in 2024. Any combination of policy mistakes, global events, and domestic politics could turn a minor downturn into something more major or spur a renewal that quickly reverses progress on inflation. **To get a modest downturn followed by a modest recovery, the Fed will need to keep these opposing forces in check. The FOMC, however, is more biased to favour growth than let a real recession take hold and pull-down prices –no matter how much they are bellowing the opposite.** If need be, to help the economy along, Treasury will use whatever latitude it has to manage the TGA to "backdoor" fund the economy.

The forecast for the US in 2024 is straight forward – a short period of near recessionary growth (up 0.3% in the first half of the year), followed by recovery. Real GDP should end up 1.4% higher on a Y/Y basis (1% Q4/Q4), with core PCE up 3.2% on the year (rising 3% Q/Q in Q4), with unemployment topping out at 4.5% in Q2. I offer this outlook with better than a 50/50 probability without very strong conviction. Inflation could certainly come in lower, unemployment higher, or growth does not decelerate at all. What is outlined in Table 1 is, from my perspective, the correct starting point from which to assess risks and their potential impacts.

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Table 1: GDP, Inflation and Unemployment -- 2024 Forecast

		2022Q4	2023Q4	2024Q1	2024Q2	2024Q3	2024Q4
Real GDP Q/Q		2.6%	1.5%	0.2%	0.4%	1.5%	2.0%
	Q4/Q4	2.6%	2.7%				1.0%
	Y/Y	2.0%	2.4%				1.4%
Core PCE Q/Q		4.4%	3.8%	3.5%	3.2%	3.0%	3.0%
	Y/Y	4.8%	3.6%	3.2%	3.2%	3.4%	3.2%
Unemployment Rate*		3.7%	4.0%	4.3%	4.5%	4.5%	4.3%

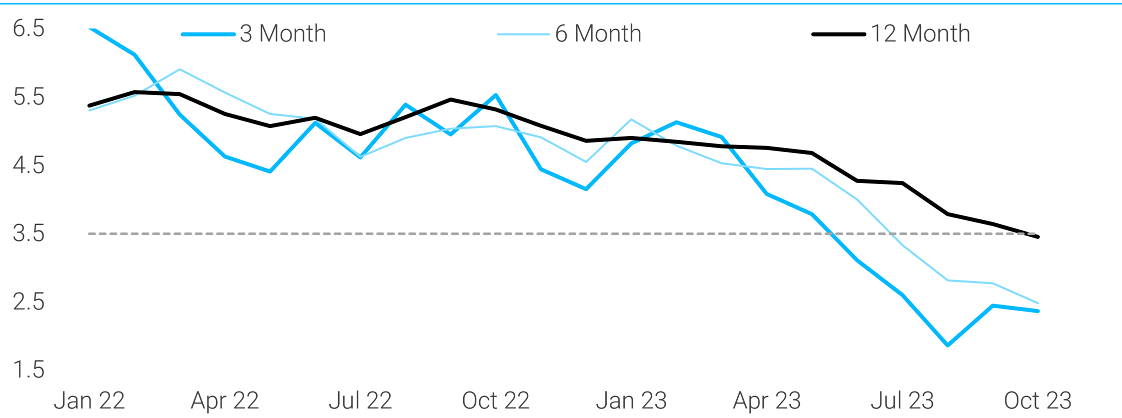
Source: BEA, BLS, GlobalData. TS Lombard

The forecast pattern of real growth allows for disinflationary trends to extend through the year (leads, lags, and all that). In response, I would expect the yield curve to normalize (short yields dropping faster than long yields) and that, in turn, should boost risk markets, presuming the downturn is kept in check. Underlying normalization is the market's understanding that the Fed will be on the shelf in 2024, happy with positive real growth and inflation trending under 4% -- with a distinct bias to ease just in case the wobbles get a bit too wobbly, or before that if inflation is trending at 3.5% or lower.

At 3.5%, the Fed could take 100BP off the funds rate and still claim they are "restrictive" based on Taylor Rule inputs -- core inflation 3.5% (Chart 1), neutral rate 0.50%, 2.5% target inflation, 4% NAIRU, and 3.9% unemployment rate. If we want to assume the current run rate for inflation is 3%, holding everything else constant, the funds rate could drop to a 3.75%-4.00% range.

Chart 1: Core inflation down to 3.5%, at least

Core PCE inflation, annualized



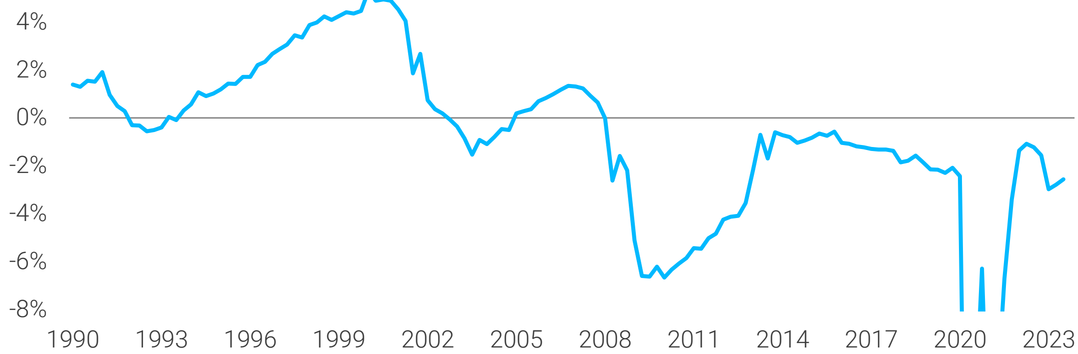
Source: BEA, GlobalData. TS Lombard

Politics will keep fiscal policy on the shelf in 2024, but the argument about the deficit is legitimate regardless of one's feelings about the various proposals (cut spending vs raise taxes). The deficit in fiscal 2024 will be generated by whatever the economic cycle produces for revenue and spending, aside from inflation indexing lowering tax rates 5.4%, and proposed increases in defence and border spending (Wall, Taiwan, Israel, Ukraine). Fiscal 2023 delivered a $1.7trn deficit, 6.3% of GDP, $320bn worse than fiscal 22 (5.4% of GDP), but better than 15% of GDP that was the 20 deficit, and 12% in 21. What made the deficit worse in 23 was the drop in revenue from indexing tax rates to inflation (42% of the increase), increased outlays for social security and Medicare/Medicaid (26%), the increase in net interest on the debt (16%) and increased outlays (16%).

Pick your increase to get worked up over, they are broad enough to feed all political biases, including interest on the debt. The 2020 and 2021 transfers turbo-charged the level of government debt and interest payments consequently shot up as well -- to 3.5% of GDP (correct way to look at payment is versus GDP), but that is still low than the peak 5% at the start of 1991. To the references about interest payments crowding out military spending, interest payments have been outpacing defence spending since 1974.

What is problematic about the budget is that the primary deficit (deficit excluding interest payments). This is the deficit that adds to debt. The primary deficit should trend back to balance as recovery takes hold (Chart 2). Since 2013, the primary deficit has instead leaked wider relative to GDP (Social Security and medical payments and 2018 Trump/Republican tax cuts are major reasons), moving from 0.5% of GDP to 2.4% of GDP just before COVID. Post-Covid, the percentage returned to 1.2% in 2022 but increased spending and reduced revenue pulled it back out to 2.6% of GDP and there is no reason to believe a cyclical reversion to 0% is underway. Heated arguments over the deficit will take over Congress, much it to bolster political/social aims in the guise of balance. Nothing will be accomplished, Wati'll next year, I suppose.

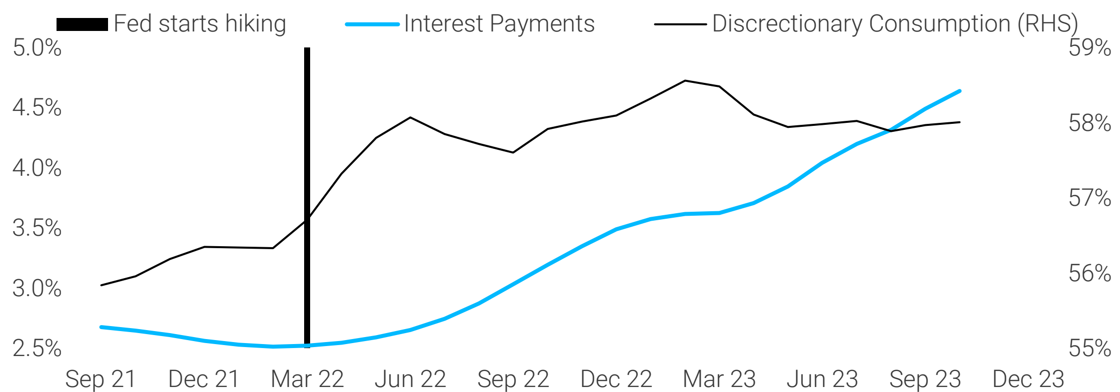
Chart 2: Primary deficit fails to narrow despite an improved economy.
Primary deficit = deficit w/o interest payments



Source: BEA, Treasury, GlobalData. TS Lombard

Underpinning the mild or no recession outlook is an expectation of relatively stable household consumption and business investment spending. Household discretionary spending relative to income has flattened since Fed rate hikes put a charge into interest payments on consumer debt (Chart 3).

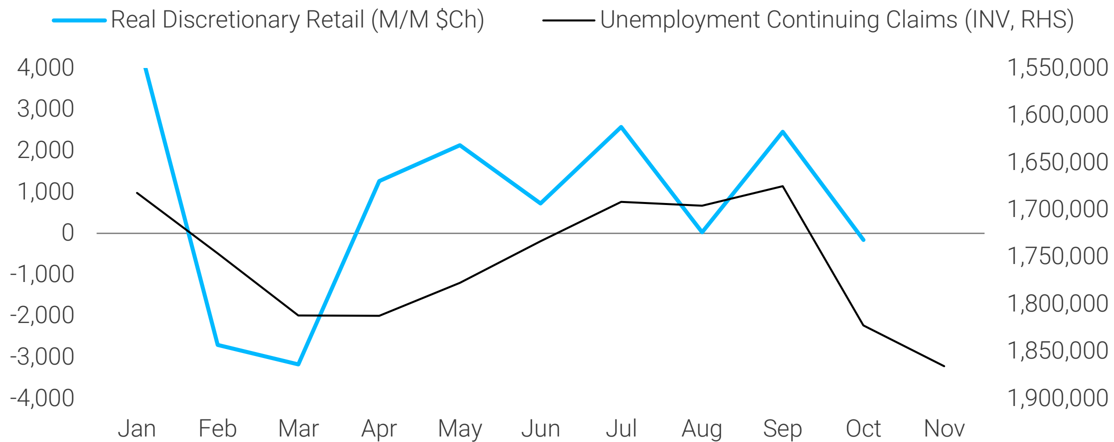
Chart 3: Rising interest payments cap ratio of spending to wages.
Series are 3M moving averages, % of wage & salary disbursements



Source: BEA, Federal Reserve, GlobalData. TS Lombard

Consumer spending ties to unemployment, and as claims have risen, discretionary retail spending will begin to tail off (Chart 4) Total until auto sales (imports + domestic) have slipped for three straight months. Still, a sharp decline in spending is unlikely to take hold.

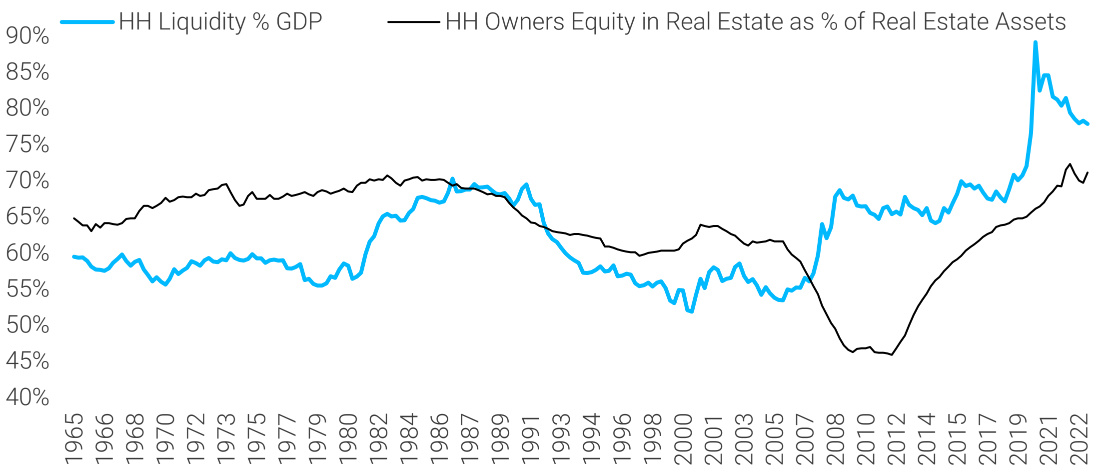
Chart 4: Rising continuing claims should pull real retail spending lower



Source: BLS, Census, DOL, GlobalData. TS Lombard

Household balance sheets remain awash in the liquidity transferred to them in 2020-21 and are underleveraged by virtue of over a decade of reducing debt/income ratios. There is also the return of household equity in real estate to mid-1980s percentages (Chart 5). For the moment, high real returns on short-term assets are holding cash in place and high borrowing rates are keeping equity locked up in real estate. Any quick drop of policy rates before an economic wobble turns into something more problematic unleashes these funds into risk markets and to purchase tangibles of one sort or another.

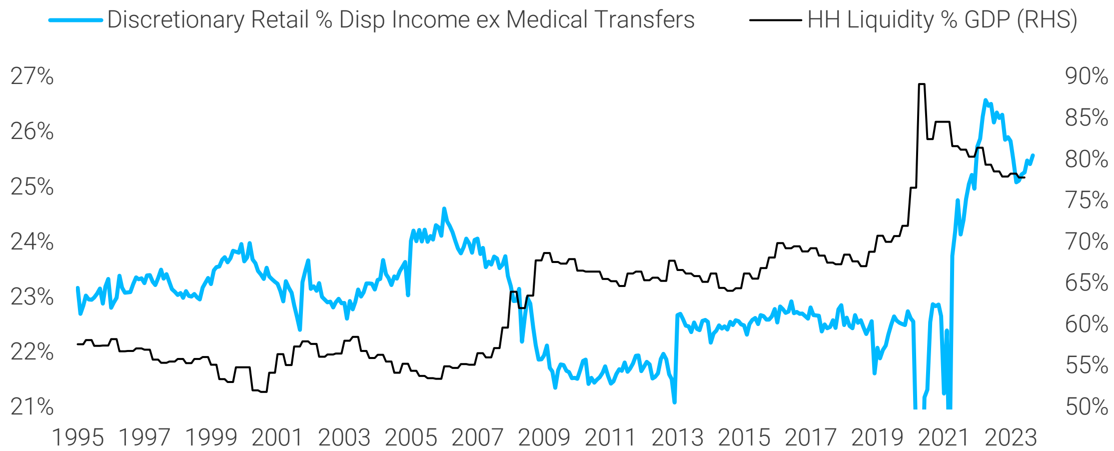
Chart 5: Household balances -- awash in liquidity and restored equity in homes



Source: Federal Reserve, GlobalData. TS Lombard

During past periods, higher liquidity meant lower discretionary retail as a percent of income (Chart 6), but not this time. Households were given the money, and it has buoyed spending and will again once real rates at the short end contract just enough.

Chart 6: This time, the surge in liquidity was not created by more frugal households



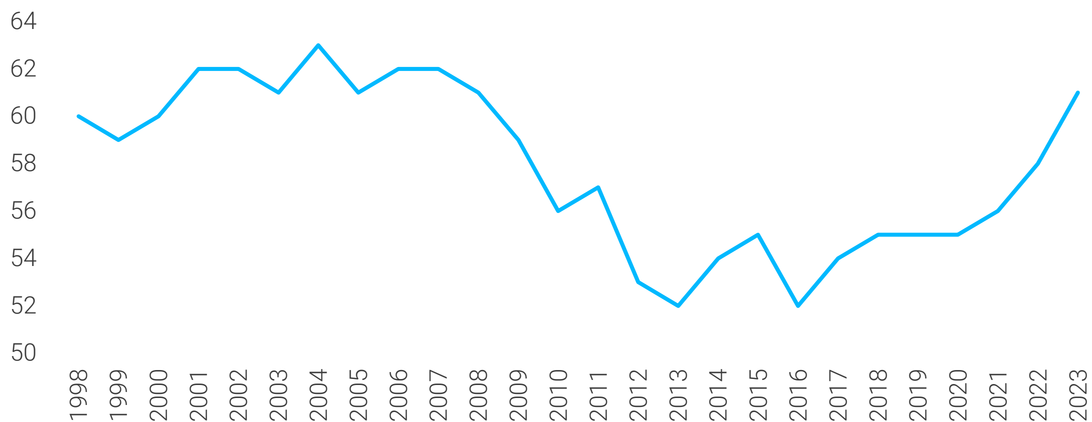
Source: BEA, Census, Federal Reserve, GlobalData. TS Lombard

Consumer spending contracts with rising unemployment, but the equity market is also a strong signal for spending, and consequently the lynchpin for household spending in a rising unemployment environment. We have today highest percentage of equity ownership since before the GFC, driven higher by the great transfers of 2020-21 (not all of it remained in short assets) (Chart 7). Enhancing this tie between equities and spending is the jump in retired persons the past several years, as evidenced by the sharp drop of labor participation among those 55 and over. This group, effectively unemployed, is that much more sensitive to equities impacting their spending habits.

If, as expected, the yield curve turns back positive with short rates falling more rapidly, and without a substantial recession taking hold, the coming year favours equities. Higher unemployment will negatively impact consumption, it will not to the same extent of years past – especially once the Fed drops rates and unleashes stored up liquidity that, in turn raises equity prices. The Fed's response to the wobbles determines the equity market and the market is the lynchpin for how serious this recession can become, or not**. Do not expect the Fed to sacrifice household faith in the equity market on the altar of 2% inflation.**

Chart 7: Equities matter again to households.

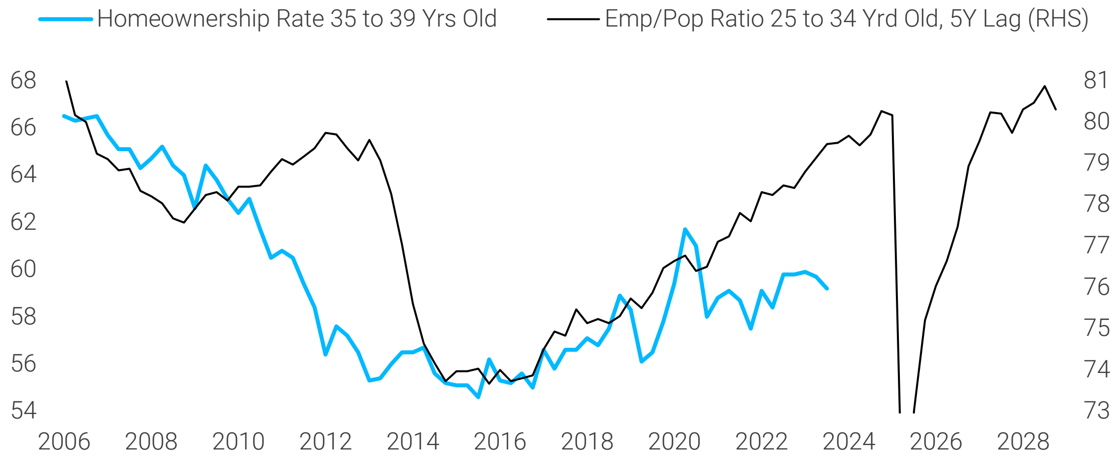
% of adults holding equities directly, in mutual funds, or through defined contribution pensions



Source: Gallup, GlobalData. TS Lombard

On the investment side, household purchases of new homes abated as mortgage rates rose, but less so than anticipated, and in the year ahead purchases should flip back up as 10Y yields fall. It would take a broad-based rise in unemployment to do serious damage to housing demand. Although millennials remain underinvested in housing, the long lag between the rising employment/population ratio (Chart 8) implies an upturn in home buying. It began slowly in the late-teens, and was since disrupted, spurred, and disrupted again – but the fundamental trend to greater homeownership remains intact and should reassert itself as 2024 wears on.

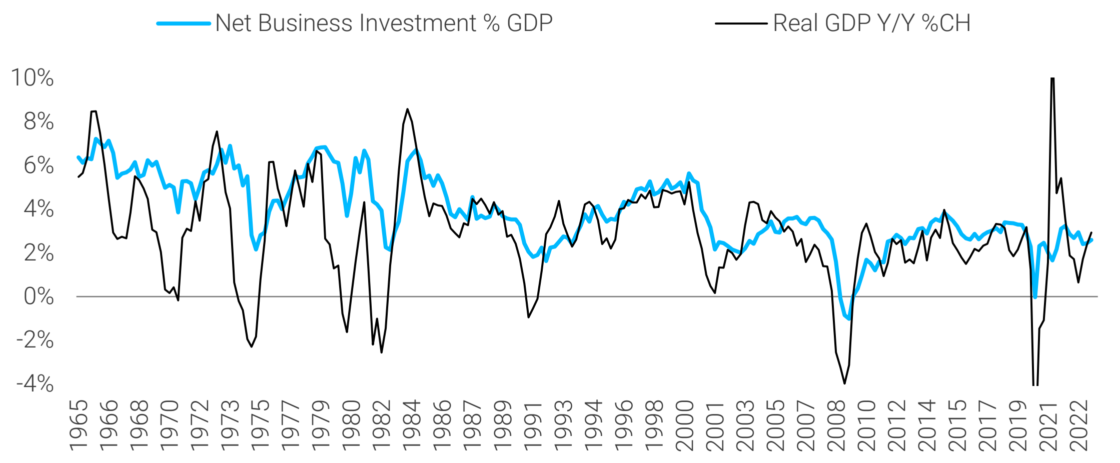
Chart 8: Recovery in homeownership by 35-to-39 yr. olds



Source: BLS, Census, GlobalData. TS Lombard

Business fixed investment in 2024 is potentially more interesting and has a critically more important trajectory for the coming years than spending on residential real estate. Housing drove the 2002-07 recovery (one of the weakest on record) to offset sagging business CAPEX, post the 90s boom. The 2010-19 expansion was earmarked by underspending for capital by business and households -- the upturn saved by QE inflating financial assets (equities most importantly). Business investment net of replacement as a percent of GDP has been cycling lower for decades, along with real GDP (Chart 9), as firms pushed production out of the US and used the earned labor arbitrage to reward investors through buybacks and/or dividends, rather than restore domestic capital investment.

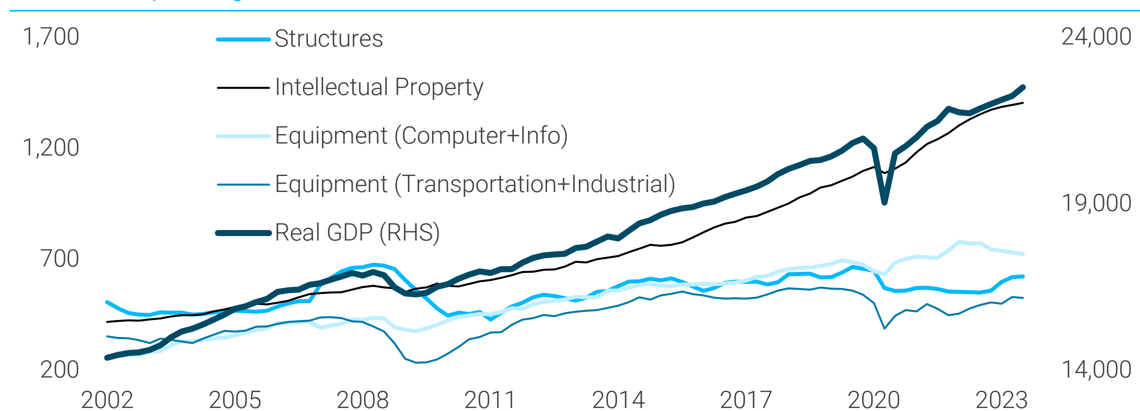
Chart 9: Long decline in net investment pulls down real GDP growth



Source: BEA, GlobalData. TS Lombard

The structure of business spending has shifted markedly in the past 20 years, from structures and equipment to intellectual property and computer related hardware (Chart 10). Near-term, this lessens the extreme cyclicality of business fixed investment evident in past cycles – and we are likely to see this dampened cycle in 2024. Longer term, and the long term could very well begin in 2024, the application of accumulated "intellectual products" into production process located within the US could create the long-awaited upturn in capital spending, pulling up productivity in response. Capital spending weakens with profits, with a lag, but because expected weakness is not likely to be overwhelmingly negative, and businesses are flush with cash in the aggregate, like households, and toss in the tax incentives to build in the US (including the accelerated depreciation in the Trump/Republican tax cuts), no great contraction in capital spending seems likely. If anything, a drop in yields could spur an increase in spending.

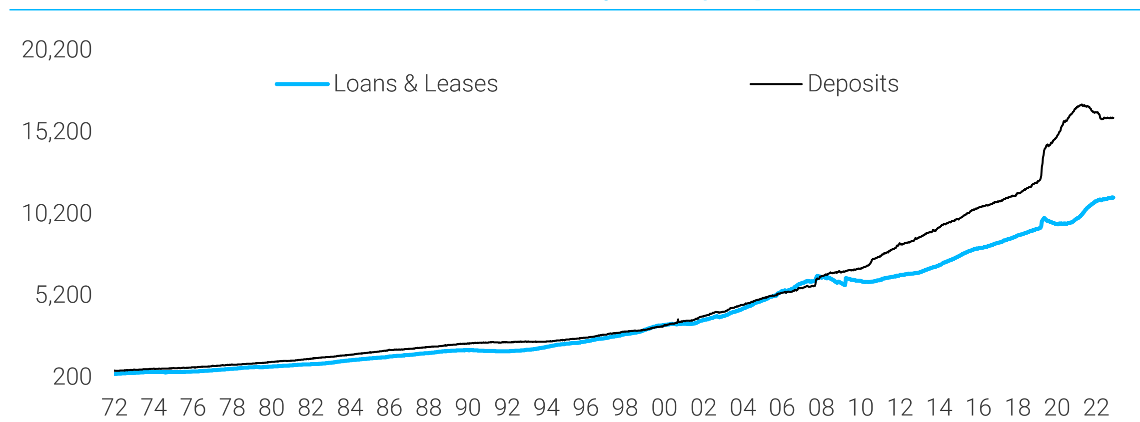
Chart 10: Only real spending in intellectual products has kept pace with real GDP.
Real dollar spending $billions



Source: BEA, GlobalData. TS Lombard

The Fed, for its part, will be biased to ease and whether it does or not (more likely does), QT will continue. There is still $900bn of ON RRP sitting on the balance sheet and recall that there was zero in March 2021, before the Fed leaned on MMMFs to support their balance sheet expansion because the banks were simply tired of getting deposits (QE+ Federal deficits) they did not create through lending (Chart 10). In Chart 10 you can also see the liquidity overhang discussed above. Banks, post the scarcity of reserve system, see reserves as an asset class and, as we have seen in the past few weeks, loans are dropping and reserves are rising, yet the balance sheet is shrinking because ON RRP is shrinking. All of which is to say that QT can serve the purpose of reducing the Fed's footprint in the Treasury market without disruption – to a point.

Chart 11: QE distorted bank balance sheets by adding deposits w/o loans



Source: Federal Reserve, GlobalData. TS Lombard

There is some concern that there is a limit to the bottom for ON RRP, and that shifting QT to diminishing reserves is less than ideal for the functioning of the repo market. These are problems the Fed typically addresses once they become a problem, rarely before. Until then, QT continues even when they start to cut rates – though perhaps not forever.

What can go wrong? Inflation. The disinflation trend to date is derived mostly from the unwinding of COVID distortions on supply chains, as evident in deflating goods prices and for shipping services as well. Service inflation is lower but remains stubbornly high. Services ex rent is running at 4% SAAR for the past three months, rebounding from 0.5% in May – when the economy also bottomed (to date). Pre-COVID, this measure of inflation was generally around 3% but was offset by a flat trend in goods inflation that pulled overall core inflation into the 1.5%-2.0% range.

All of which is to say, that if the economy manages less than a drive-by slow down, the Fed will be proven wrong in its belief that the funds rate is properly set (neutral real rate is higher). If there is a slowdown, the Fed will cut quickly to get the funds rate below 4% -- they can almost justify that today based on core inflation. Either wat, a higher inflation profile develops – though perhaps not until 2025. Inflation is always financed, and the Fed is holding back a massive amount of liquidity by virtue of very high real yields being paid at the short end, including interest on reserves. If short yields drop through some magic level against a positive economic backdrop and the curve dis-inverts, inflation will be head back towards 5%.

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