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FINANCIAL MARKETS

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A challenging year ahead for the U.S. economy?

By Jocelyn Paquet

- The soft landing thesis has undoubtedly gained in popularity in recent months, as evidenced by rising stock market valuations and narrowing credit spreads. The Federal Reserve's adoption of a much more accommodating tone following the release of encouraging inflation data has also contributed to the prevailing enthusiasm, especially as this comes at a time when GDP data remains solid.
- However, our analysis suggests that economic growth in the U.S. is less vigorous than it might seem. As for the future, the few leading economic indicators that have proven their predictive value in previous cycles almost all point in the same direction: that of an economic slowdown in 2024.
- And while we recognize that the probability of the Fed achieving a soft landing is non-zero, we have our doubts about the arguments underpinning this scenario. That's why our economic forecasts remain significantly less optimistic than the consensus. After a strong end to 2023, we expect growth in the U.S. to decelerate significantly in the first half of 2024. We then see the economy tipping into recession around mid-year.

With the year drawing to a close, the time has come for us to take stock of the economic situation and, more importantly for our readers, to offer our predictions for the coming months. The year 2023 will undoubtedly be regarded as a good one for the U.S. economy, which, according to our forecasts, should grow by 2.5% over the year as a whole, despite one of the most aggressive monetary tightenings in recent memory. This should be a comfort to those about to leave for a well-deserved end-of-year vacation. Without wishing to cut short the celebrations, we admit that our attention is already firmly focused on the year ahead. And those who follow our regular publications know that, on this front, our forecasts are decidedly more pessimistic than the consensus. To make things clearer, we have decided to compile in this document the reasons why we think the U.S. economy will go through a bit of a rough patch in 2024.

We begin our review by citing a source often overlooked by economists: the Federal Reserve's Beige Book. While we agree that this publication is not the most exciting to read, it nevertheless offers a good overview of the economic situation prevailing in the various regions of the United States. The national summary on the first page of each edition is also a good tool for tracking the economy over time, as the history of the survey goes back to 1970. And by historical standards, the comments contained in the most recent edition of this publication struck us as rather negative. The first lines of the report read:

> "On balance, economic activity slowed since the previous report, with four districts reporting modest growth, two indicating conditions were flat to slightly down, and six noting slight declines in activity."[1]

To the uninitiated, these comments may seem trivial. Is it not normal for some districts to report modest growth, while others report a slight contraction? The answer to this question is that growth as poorly diffused geographically as that reported in November by the Beige Book is in fact extremely rare outside periods of recession. To find a characterization of the economy similar to the one quoted above, we have to go back to the editions published during the darkest months of the pandemic or, before that, during the great recession of 2007-2009. In the latter case, it wasn't until March 2008 - four months after the start of what would turn out to be one of the worst recessions of the century - that the Beige Book painted as bleak a picture as it did in November 2023:

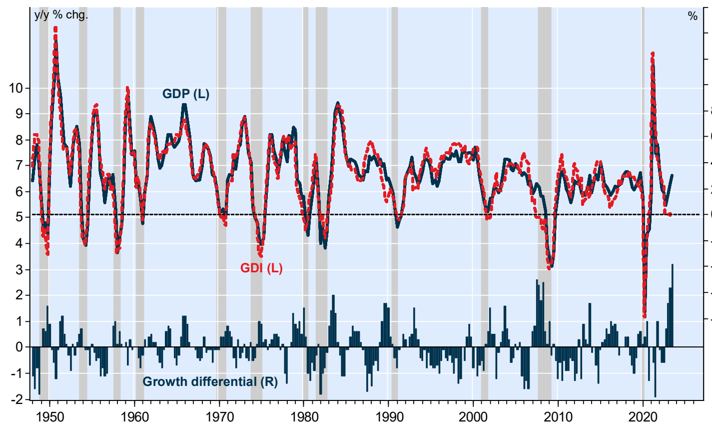
> "Reports from the twelve Federal Districts suggest that economic growth has slowed since the beginning of the year. Two-thirds of the Districts cited softening or weakening in the pace of business activity, while the others referred to subdued, slow, or modest growth."[2]

Of course, the similarities between today's language and that of 2008 don't mean that the U.S. economy is already in recession, let alone that it's about to go through the same kind of ordeal as it did then; other indicators relating to the labor market and consumer spending remain too robust for that to be the case. But could it be that growth isn't as robust as the GDP data suggest?

To answer this question, we need to look at other reliable measures of activity, and we have to admit that several of them seem consistent with an economy that is growing more slowly than the 5.2% annualized pace announced in the third-quarter GDP report. Starting with gross domestic income, or GDI. Our more erudite readers may recall that there are two main ways of assessing the size of an economy: by adding up the expenditure of all economic agents (GDP) or by aggregating all their income (GDI). In theory, these two methods should converge over the long term, but the fact that they are based on different data sources means that they often diverge slightly from one quarter to the next. Such divergence was in fact observed in Q3, when GDI grew at a much slower annualized rate than GDP (1.5% vs. 5.2%). This discrepancy would not merit our attention were it not for the fact that it followed three other quarters of superior GDP performance. Indeed, far from converging, these two measures of economic activity seem to have drifted further and further apart over the past year, to such an extent that GDP is now showing 3.0% year-on-year growth, while GDI is showing a slight contraction. Never in their 75-year history have these series sent out such contradictory messages.

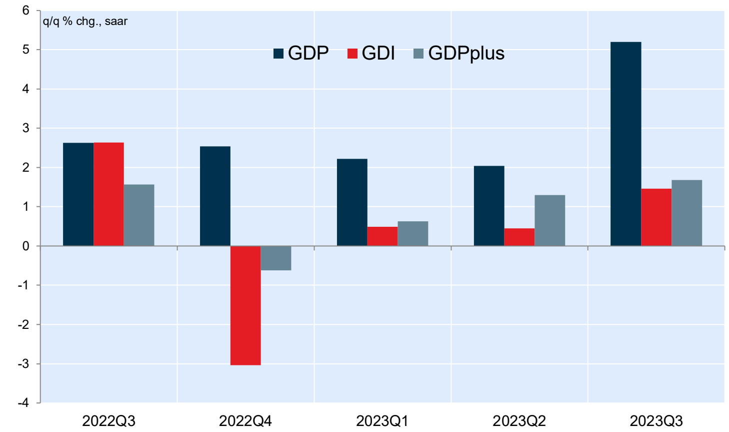
[1] https://www.federalreserve.gov/monetarypolicy/beigebook202311.htm
[2] https://www.federalreserve.gov/fomc/beigebook/2008/20080305/default.htm

U.S.: Two measures, two different stories
Gross domestic product vs. gross domestic income



NBF Economics and Strategy (data via Bloomberg)

U.S.: Economic growth likely weaker than GDP implies, still decent
Gross domestic product, vs. gross domestic income vs. GDPplus



NBF Economics and Strategy (data via Bloomberg)

So which measure should we trust? Both, according to a recent study by the Federal Reserve Bank of St. Louis:

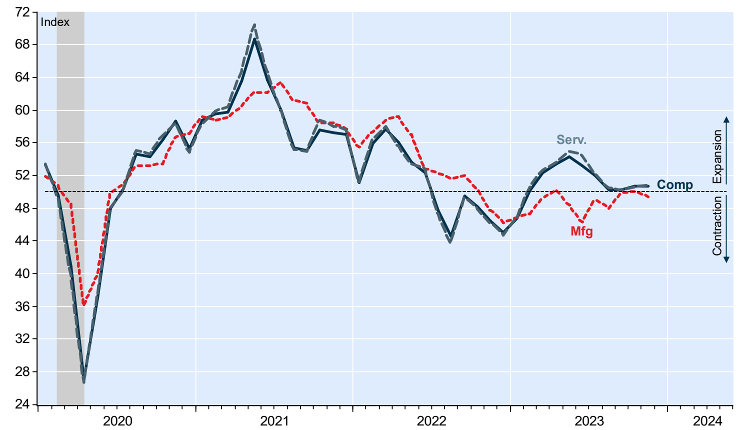
> "For now, GDP remains the prominent measure of output cited by both the media and policymakers. In the end, however, it may be prudent to use both series (or perhaps a measurement combining both) to measure output."[3]

This conclusion is based on the idea that both GDP and GDI are subject to statistical error, but that studying these measures together can help minimize these errors and paint a more accurate picture of economic activity.

Not stopping at simple recommendations, the Fed has developed a measure whose precise purpose is to combine the results of GDP and GDI. This measure, known as GDPplus, relies on a complex statistical filter[4] to smooth out variations in the two series and thus obtain a less volatile, joint indicator. And what does this indicator say today? Firstly, it confirms that the U.S. economy is not in recession, which is no surprise. But it also indicates that growth has been much less vigorous recently than GDP would suggest. Indeed, GDPplus grew at an annualized rate of just 1.2% on average over the first three quarters of the year.

This rate of growth seems much more in line with other proven indicators of economic activity, such as the composite PMI index published by S&P Global…

U.S.: PMI index consistent with only modest growth…
S&P Global Composite PMI



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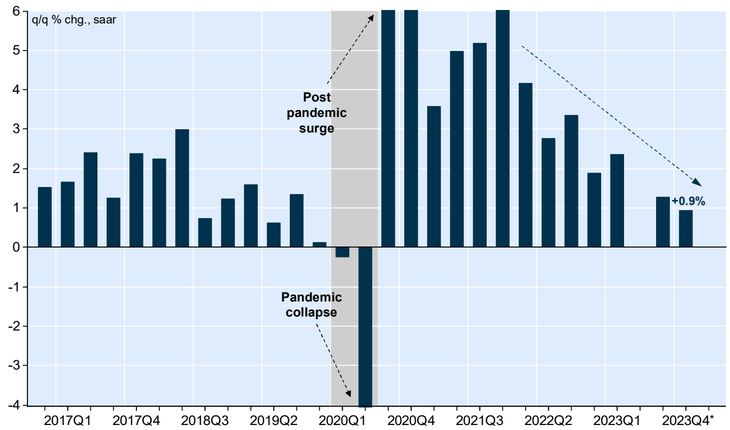
… or total hours worked as published in the Bureau of Labor Statistics' establishment survey.

[3] https://www.stlouisfed.org/on-the-economy/2016/march/better-measurement-output-gdp-gdi
[4] Kalman filter

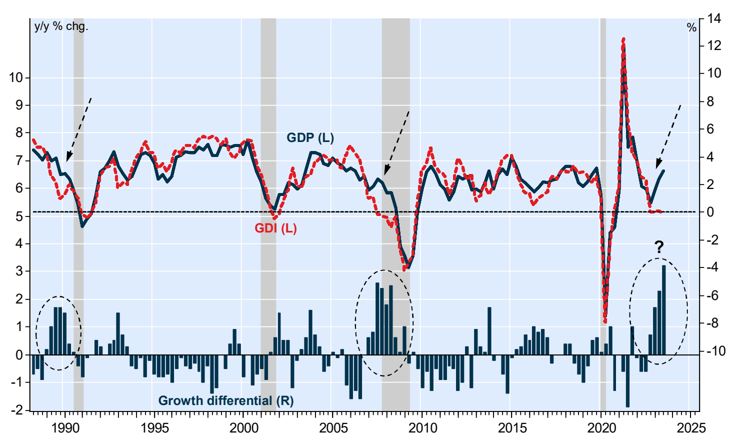
… as are total hours worked
Aggregate hours worked



*With one months of data still to come
NBF Economics and Strategy (data via Bloomberg)

While it's useful to have a measure like GDPplus to get a better idea of the current state of the economy, what's of particular interest to us as economic forecasters is how the economy will evolve in the months ahead. And there's every reason to believe that, at this stage of the cycle, we should be looking to the GDI for a better idea of what lies ahead. Because when it comes to signalling a late-cycle economic slowdown, GDI seems to trump GDP hands down. At least, that's the conclusion reached by Jeremy Nailwaik, a Fed economist whose study demonstrates the superiority of GDI in signalling the onset of a recession[5]. A quick look at the data seems to corroborate his conclusions, as GDI slowed much faster than GDP in the run-up to the 1990-1991 and 2007-2009 recessions.

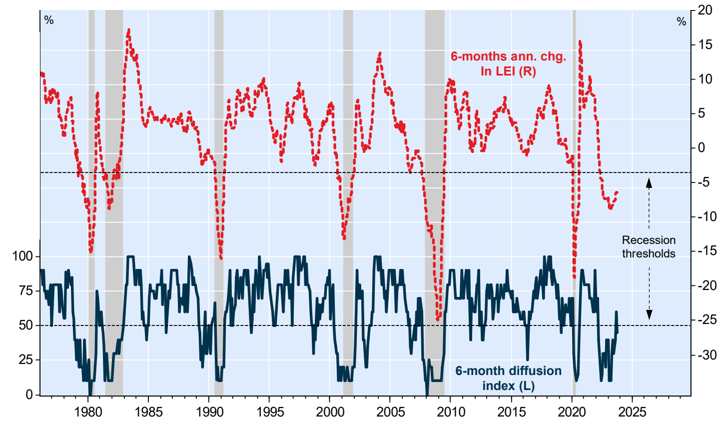
U.S.: GDI is a better leading indicator of economic turning points
Gross domestic product vs. gross domestic income



NBF Economics and Strategy (data via Bloomberg)

But our well-below-consensus growth forecast for 2024 is not based solely on blind faith in the predictive power of GDI; other indicators suggest that the US economy is heading for a period of contraction. These include the Conference Board's Index of Leading Economic Indicators (LEI). Historical analysis reveals that an annualized decline of 3.5% in this index over six months, combined with a diffusion index of less than 50%, generally heralds an impending recession. Unfortunately, both these conditions were present in October. And given that, using these two thresholds together, the LEI has not produced a single false recession signal in the last 65 years, we find it hard to believe that this time it will be any different, and that the economy will experience a soft landing.

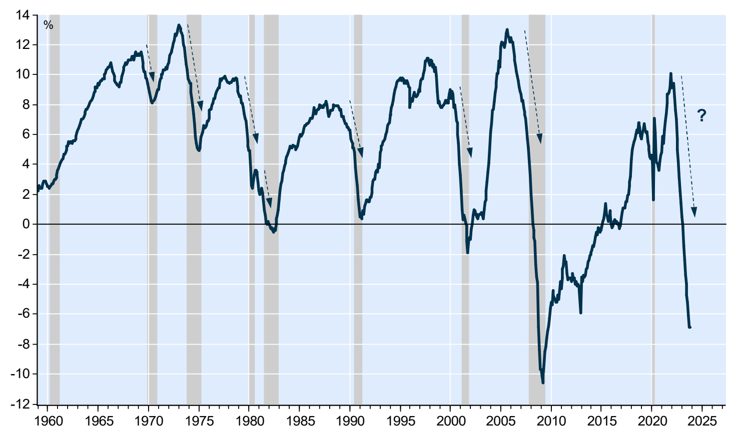
U.S.: Leading indicators signal downturn ahead
Leading Economic Indicator and diffusion index. Last observation: October 2022



NBF Economics and Strategy (data via Bloomberg)

It's also interesting to note how quickly the LEI has recently weakened in relation to the Index of Coincident Economic Indicators (CEI) also published by the Conference Board. Conceptually, this suggests that future growth will be much less vigorous than current growth, and historically this has been the case, with recessions almost invariably following periods in which the LEI level deteriorated relative to the CEI.

U.S.: Future growth seen as much less vigorous than current growth
Leading Economic Indicator – Coincident Economic Indicator (Conference Board)

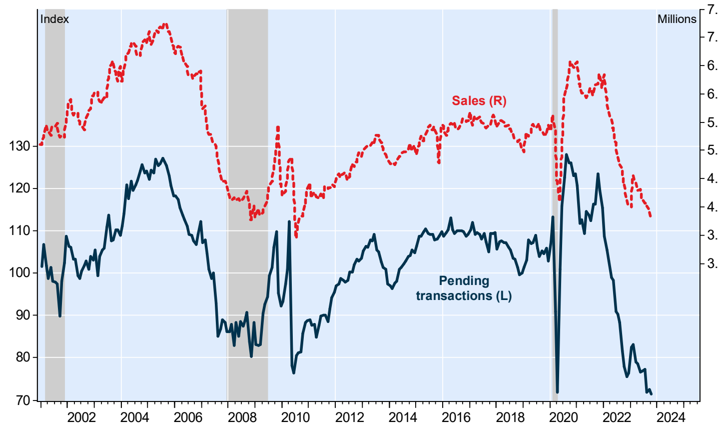


NBF Economics and Strategy (data via Bloomberg)

Of course, it is the Fed's violent monetary tightening in recent months that is likely to be the main factor behind the slowdown in growth reported by the LEI. Its effects are already being felt in several sectors of the economy. The real estate market, for example, seems completely paralyzed by rising borrowing costs, with resales slipping to their lowest level in 13 years in October and pending transactions falling to record lows.

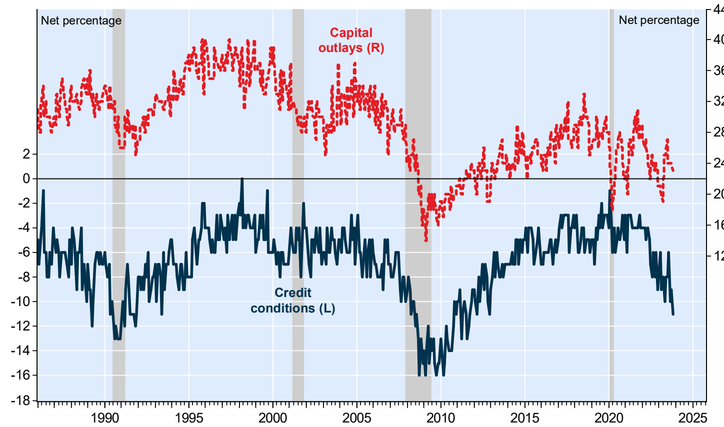
[5] Nalewaik, Jeremy J., "Estimating Probabilities of Recession in Real Time Using GDP and GDI", https://www.federalreserve.gov/pubs/feds/2007/200707/index.html

U.S.: Resale market paralyzed by higher borrowing costs
Existing-home sales vs. pending home sales



NBF Economics and Strategy (data via Bloomberg)

… and the situation could deteriorate further
Net percentage of firms expecting credit conditions to improve vs. net percentage planning to make capital outlays, NFIB Small Business Optimism Survey

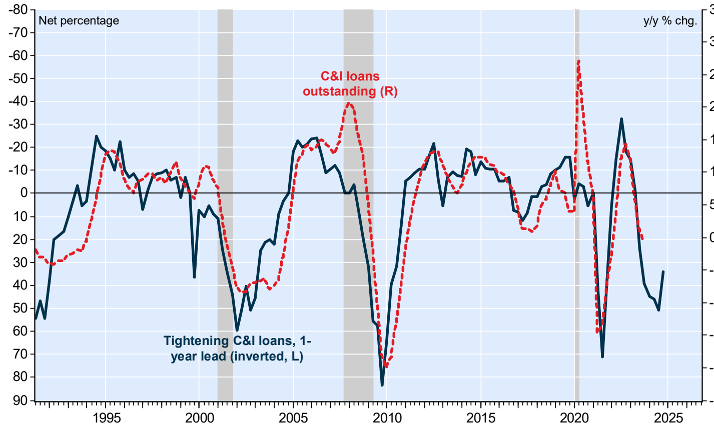


NBF Economics and Strategy (data via Bloomberg)

Business investment is also feeling the effects of rising interest rates, as evidenced by a third decline in machinery and equipment spending in four quarters in Q3. This is hardly surprising, given that lending conditions have tightened considerably, restricting access to credit in the commercial and industrial sectors.

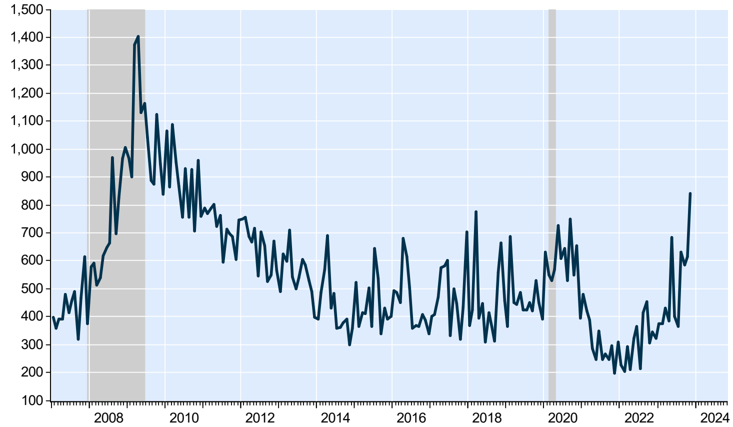
And beyond investment intentions, the very survival of some companies could be at stake in an environment where access to credit is more difficult and expensive. On this point, we note that the number of companies filing for protection under Chapter 11 of the U.S. Bankruptcy Code has risen rapidly in recent months.

U.S.: Tighter credit conditions weighing on bank lending to businesses
Commercial and industrial loans outstanding (all commercial banks) vs. net percentage of domestic banks tightening standards for commercial and industrial loans according to the SLOOS



NBF Economics and Strategy (data via Fred St. Louis)

U.S.: Businesses are starting to feel the impacts of higher rates
Chapter 11 bankruptcies filings

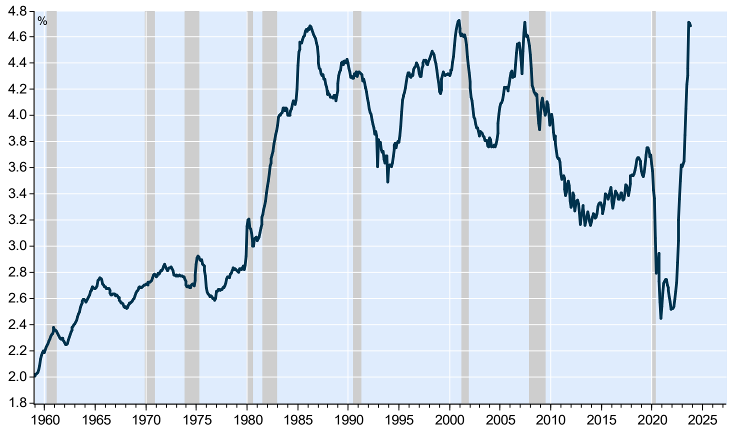


NBF Economics and Strategy (data via the American Bankruptcy Institute)

Judging by the results of NFIB's Small Business Optimism Survey, things don't look set to improve either. In the latest edition of the poll, a net 11% of respondents said they expected credit conditions to tighten further in the future. As this series is historically closely correlated with that following investment intentions, this development does not point to a major rebound in capital spending.

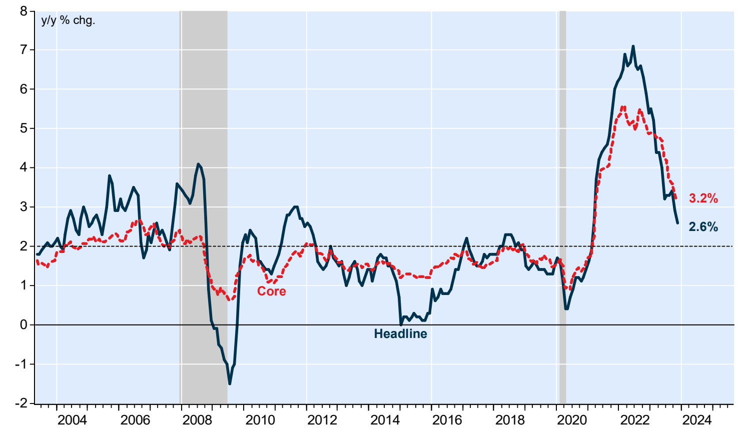
Businesses are not the only victims of tighter credit conditions. Even consumers, until now partially protected from the effects of rising rates by the popularity of fixed-rate mortgage products in the U.S., are beginning to show signs of weakness, caught up by the soaring costs of servicing non-mortgage debt.

U.S.: Rising interest rates taking a bite out of income
Non-mortgage interest payments as a share of wage/salary income



NBF Economics and Strategy (data via Bloomberg)

U.S.: Lower inflation has raised hopes to see rate cuts next year…
Personal consumption expenditures deflator (PCE)

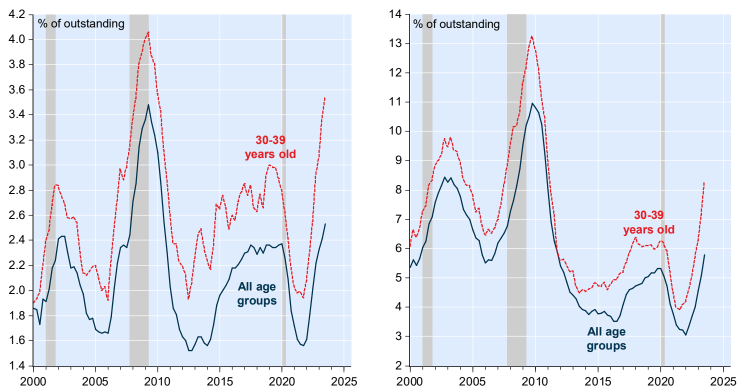


NBF Economics and Strategy (data via Bloomberg)

Many people are struggling to pay off their car loans and credit cards.

U.S.: Consumers finding it increasingly difficult to service their debt

Percentage of auto loans transitioning into serious delinquency (90+ days) | Percentage of credit card loans transitioning into serious delinquency (90+ days)



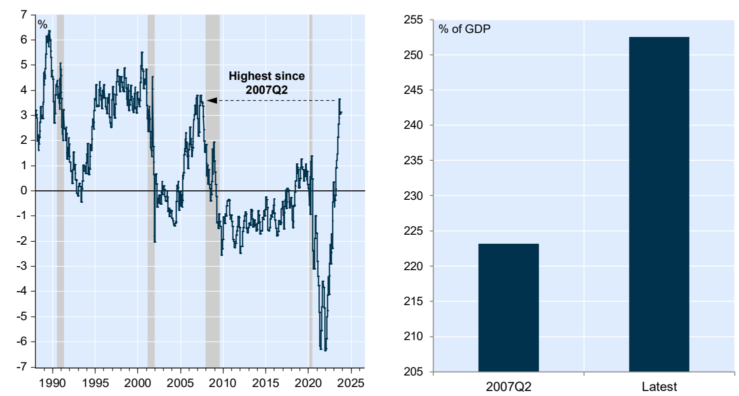
NBF Economics and Strategy (data via Bloomberg)

And while some may take solace from the fact that the Fed now seems much more open to the possibility of rate cuts in 2024 - a scenario that would obviously ease the pressure on economic agents - we're much more concerned about the evolution of *real* policy rates between now and when these cuts materialize. The sharp fall in inflation seen recently means that they are already at their highest level since 2007. And they are likely to rise further in the coming months if economists' forecasts of a further easing in price pressures prove correct.

These high real rates are likely to cause a few headaches for economic agents who had taken advantage of low borrowing costs in the past to increase their debt levels. Governments and corporations seem particularly at risk in this context.

… but in the meantime, it is translating into higher real policy rates

Fed funds rate deflated using the 3-month annualized rate of core PCE deflator | Credit to the non-financial sector

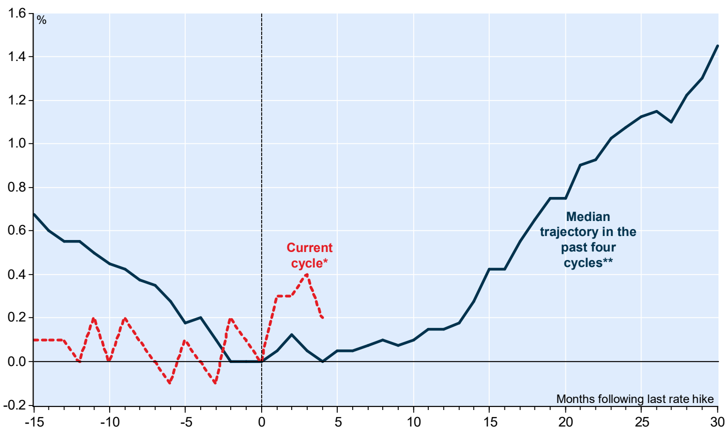


NBF Economics and Strategy (data via Bloomberg and BIS)

After a fairly solid end to 2023, we therefore expect growth in the US to slow markedly in the first half of 2024. This deceleration should enable the Fed to make rate cuts, but we believe they will come too late to prevent a few quarters of negative growth next year (see full forecast in appendix).

These forecasts obviously run counter to the consensus view that the Fed will succeed in engineering a soft landing of the economy. Without wishing to discredit this scenario - there is indeed a non-negligible probability that the central bank will achieve such a feat - we have certain reservations about the arguments generally put forward to defend it. One of these is the resilience of the labour market in the face of aggressive monetary tightening by the Fed. But such resilience has been seen before. In fact, a review of the last four cycles of monetary tightening (three of which ended in recession) shows that the unemployment rate generally begins to rise significantly only a few months *after* the last rate hike, not *before*. Assuming that the rate hike announced by the Fed in July is the last of the current cycle, the behavior of the unemployment rate thus seems to us to be rather in line with historical precedents. It is therefore impossible at this stage to draw any conclusions as to the relative resilience of the labour market in the current cycle.

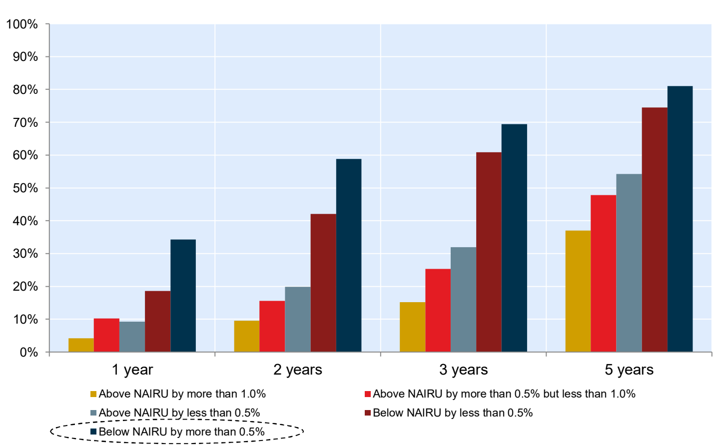
U.S.: Too early to judge the resilience of the labour market
Change in unemployment rate following the last rate hike of a cycle



*Assuming the last rate hike took place on 26 July 2023.
**Cycles which ended in 1989M05, 1995M02 (soft landing), 2000M5 and 2006M06, excludes the tightening cycle that ended with the pandemic.
NBF Economics and Strategy (data via Refinitiv)

As for those who believe that a low unemployment rate could somehow prevent the economy from falling into recession, we would like to remind them that this theory runs counter to historical data. These show that, as the unemployment rate falls below its long-term equilibrium level (NAIRU), the probability of recession increases. Let's be clear here: it's not the strength of the labour market that leads to recession, but all too often the Fed's reaction to that strength. Indeed, the lower the unemployment rate, the more the central bank tends to raise its policy rates, a process whose ultimate aim is to slow growth. This explains why, historically, recessions have been much more frequent in the months following periods of low unemployment. By way of illustration, the U.S. unemployment rate is currently below the NAIRU by more than 0.5%, a situation that historically implies a 70% risk of recession over three years. Three years sure is a long time, but remember that the unemployment rate has been in this range for almost two years already.

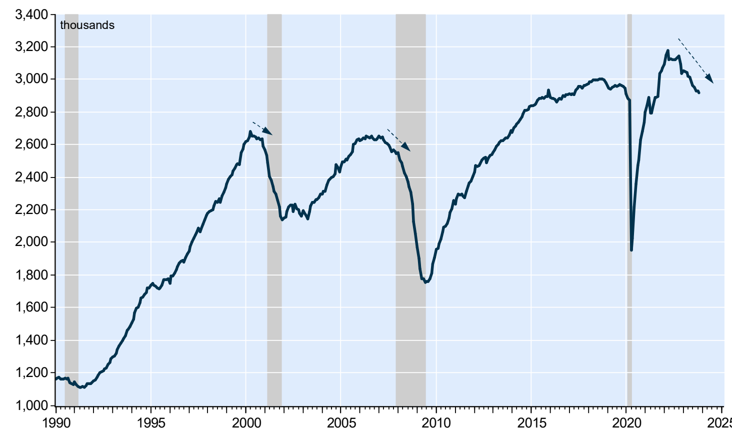
U.S.: Low unemployment rate = higher probabilities of recession
Historical weighted recession probabilities based on the level of the unemployment rate vs. NAIRU



NBF Economics and Strategy (data via Refinitiv)

Since a low unemployment rate is absolutely no guarantee of a resilient job market in the medium term, we have to rely on a number of tried-and-tested leading indicators to give us an idea of how demand for workers will evolve in the near future. And several of them suggest that the unemployment rate will behave in exactly the same way as it did following previous monetary tightening cycles, i.e. that it will rise more or less rapidly over the next 12 months. Of these indicators, employment in temporary help services seems to us to be particularly revealing. Historically, employers have tended to stop using consultants before proceeding with more costly lay-offs, which explains why employment in temporary help services generally begins to decline a few months before a recession. Such a decline is currently underway.

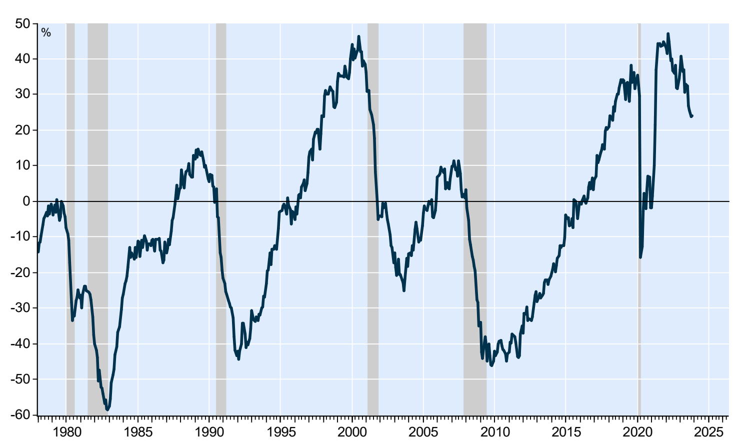
U.S.: Some advanced indicators of the labour market are flashing red (1)
Employment in the temporary help services category



NBF Economics and Strategy (data via Bloomberg)

The same is true of the Conference Board's Consumer Confidence Index, which has been collecting consumer opinion on the job market every month since the late 1970s. This opinion has tended to improve systematically during expansion phases, and to start falling either a few months before a recession, or when the economic slowdown begins. Well, never has this sentiment declined as much as it has in recent months, without the economy subsequently slipping into recession.

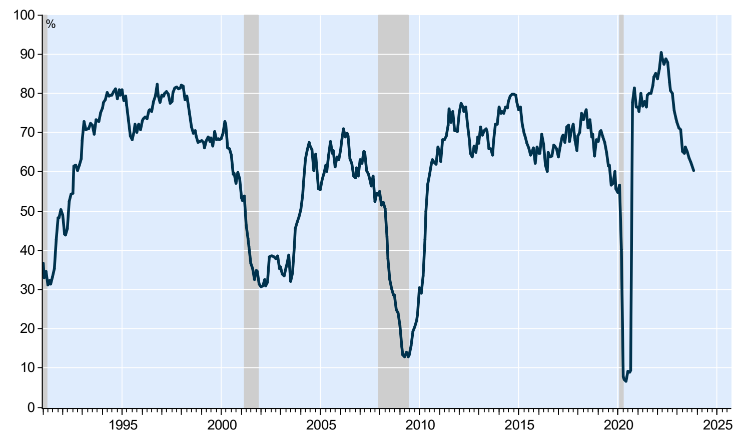
U.S.: Some advanced indicators of the labour market are flashing red (2)
Labour differential*, Conference Board's Consumer Confidence Survey



*Share of respondents stating that employment is plentiful at present – share stating that it is hard to find
NBF Economics and Strategy (data via Bloomberg)

The final indicator we'll mention is the diffusion of hiring. Since the early 1990s, expansionary phases have been characterized by widespread employment gains, while economic slowdowns have often been heralded by less diffuse job creation. This is because some sectors of the economy are affected earlier than others by the deterioration in activity, and therefore stop hiring sooner. As a general rule, however, recessions have tended to occur shortly after the six-month diffusion index published by the Bureau of Labor Statistics falls below 60%. This indicator was barely above this level in November, with only 60.4% of the sectors covered reporting an increase in headcount over the past six months.

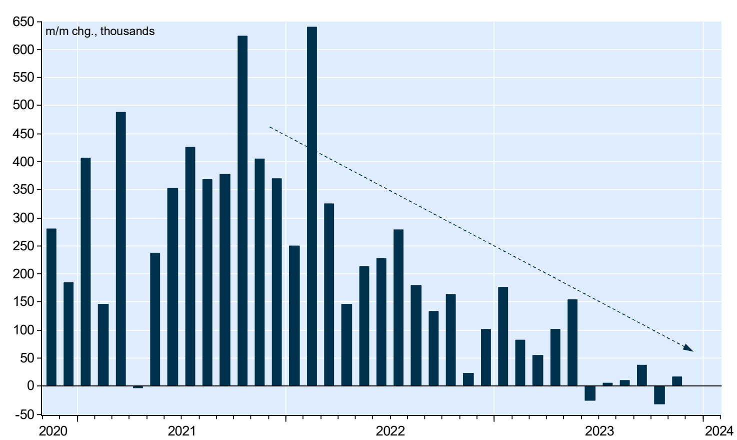
U.S.: Job creation becoming less diffuse (1)
Employment diffusion index (6 months), establishment survey



NBF Economics and Strategy (data via Bloomberg)

A closer look at the data reveals that recent job creation in the U.S. has been driven mainly by three sectors: leisure/hospitality, health/social assistance and government. The latter two sectors are known to be among the most acyclical, i.e., they are less affected by economic downturns. Outside these sectors, job creation has stalled for the past six months.

U.S.: Job creation becoming less diffuse (2)
Employment excluding leisure/hospitality, health/social assistance and government, establishment survey



NBF Economics and Strategy (data via Refinitiv)

Conclusion

The soft landing thesis has undoubtedly gained in popularity in recent months, as evidenced by rising stock market valuations and narrowing credit spreads. The Federal Reserve's adoption of a much more accommodating tone following the release of encouraging inflation data has also contributed to the prevailing enthusiasm, especially as this comes at a time when GDP data remains solid.

However, our analysis suggests that economic growth in the U.S. is less vigorous than it might seem. As for the future, the few leading economic indicators that have proven their predictive value in previous cycles almost all point in the same direction: that of an economic slowdown in 2024.

And while we recognize that the probability of the Fed achieving a soft landing is non-zero, we have our doubts about the arguments underpinning this scenario. That's why our economic forecasts remain significantly less optimistic than the consensus. After a strong end to 2023, we expect growth in the U.S. to decelerate significantly in the first half of 2024. We then see the economy tipping into recession around mid-year.

United States
Economic Forecast

(Annual % change)*	2021	2022	2023	2024	2025	Q4/Q4 2023	Q4/Q4 2024	Q4/Q4 2025
Gross domestic product (2012 $)	5.8	1.9	2.5	0.9	0.2	2.8	(0.7)	1.5
Consumption	8.4	2.5	2.3	0.9	(0.2)	2.7	(0.7)	1.1
Residential construction	10.7	(9.0)	(10.8)	1.2	1.0	(0.4)	0.5	2.1
Business investment	5.9	5.2	4.4	0.6	(0.5)	4.2	(1.2)	0.9
Government expenditures	(0.3)	(0.9)	3.9	3.0	2.2	4.2	2.5	1.6
Exports	6.3	7.0	2.7	0.5	(0.4)	1.8	(1.4)	1.1
Imports	14.5	8.6	(1.4)	1.5	0.1	0.8	0.1	0.9
Change in inventories (bil. $)	12.5	128.1	45.2	7.5	10.0	55.0	(20.0)	25.0
Domestic demand	6.6	1.7	2.2	1.2	0.2	3.0	(0.2)	1.2
Real disposable income	3.2	(6.0)	4.2	0.9	0.4	4.0	0.1	1.3
Payroll employment	2.9	4.3	2.3	(0.2)	(0.6)	1.8	-1.8	1.0
Unemployment rate	5.4	3.7	3.6	4.5	5.3	3.8	5.1	5.3
Inflation	4.7	8.0	4.1	2.8	2.3	3.2	2.5	2.1
Before-tax profits	22.6	9.8	(0.2)	(3.4)	4.7	-1.7	-5.0	9.9
Current account (bil. $)	(939.8)	(971.6)	(844.6)	(817.5)	(846.3)	...	...	...

** or as noted*

Financial Forecast**

	Current 12/19/23	Q1 2024	Q2 2024	Q3 2024	Q4 2024	2023	2024	2025
Fed Fund Target Rate	5.50	5.50	5.25	4.75	4.00	5.50	4.00	3.25
3 month Treasury bills	5.23	5.25	4.90	4.40	3.60	5.39	3.60	3.15
Treasury yield curve								
2-Year	4.41	4.55	4.30	3.85	3.25	4.43	3.25	3.25
5-Year	3.94	4.10	3.95	3.70	3.20	3.92	3.20	3.35
10-Year	3.93	4.20	4.10	3.85	3.55	3.93	3.55	3.70
30-Year	4.03	4.25	4.15	3.90	3.70	4.04	3.70	3.95
Exchange rates								
U.S.$/Euro	1.10	1.02	1.03	1.06	1.08	1.06	1.08	1.11
YEN/U.S.$	144	140	138	137	135	145	135	129

*** end of period*

Quarterly pattern

	Q1 2023 actual	Q2 2023 actual	Q3 2023 forecast	Q4 2023 forecast	Q1 2024 forecast	Q2 2024 forecast	Q3 2024 forecast	Q4 2024 forecast
Real GDP growth (q/q % chg. saar)	2.2	2.1	5.2	1.9	0.8	(0.6)	(1.4)	(1.7)
CPI (y/y % chg.)	5.8	4.1	3.6	3.2	3.0	3.1	2.8	2.5
CPI ex. food and energy (y/y % chg.)	5.6	5.2	4.4	4.0	3.5	3.0	3.0	2.6
Unemployment rate (%)	3.5	3.6	3.7	3.8	3.9	4.2	4.7	5.1

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