

The Slowdown Scenario



We live at a time when extreme voices get the most attention and so it is tempting, following a string of weak economic numbers, to yell the word “recession”. However, a balanced assessment of demand and supply suggests that we are, thus far, merely transitioning to slower growth. A slower growth path *is* a more vulnerable one, particularly because excessive monetary ease is more likely to weaken than strengthen the economy in the short run. Nevertheless, barring some outside shock, the baseline scenario should be a slowdown scenario, even as volatile markets remind investors of the importance of diversifying and paying attention to valuations.

The mood on the economy has changed quite quickly. The economic headline from just 12 days ago was that real GDP growth had, yet again, surprised to the upside, coming in at a robust 2.8% for second quarter, well above the 2.1% consensus expectation. Since then, however, we have seen higher-than-expected weekly unemployment claims and weak readings on construction, durable goods orders, home sales and manufacturing activity. This was topped off, on Friday, by a softer-than-expected employment report, both in terms of payroll job gains and the unemployment rate.

Softer economic data, combined with further signs of diminished inflation, had already led the Fed to signal an intention to cut rates in September. However, despite Chairman Powell's many hints that rate cuts would be slow and deliberate, futures markets have almost fully priced in a 50 basis point cut in the federal funds rate in September and 125 basis points in cuts by the end of this year. This change in the outlook for the economy and interest rates has helped cut the yield on a 10-year Treasury from 4.48% at the start of July to just 3.79% today. Meanwhile, since peaking in the middle of last month, the S&P500 has fallen by almost 6% while the more tech-focused Nasdaq is down 10.0%.

For investors, all of this raises some important questions: First, what is the most likely near-term scenario – recession or just slower growth? Second, how is the Federal Reserve likely to respond and what does this mean for short-term and long-term interest rates? And finally, given both the economic outlook and valuations across markets, how should investors consider adjusting their portfolios?

The Slowdown Scenario: Demand and the Consumer

Any analysis of the short-term outlook for the U.S. economy starts with the consumer. Recent data appear benign, with real consumer spending tracking 1.6% annualized growth since the start of the year. It is true that the personal saving rate, at 3.4%, remains well below pre-pandemic levels and that sentiment remains gloomy. However, July should mark a 17th consecutive month of positive year-over-year real wage growth while, even with the recent selloff, the S&P500 is up over 12% year-to-date, adding to household wealth. More affluent households are clearly seeing a disproportionate share of these wealth and income gains. However, the economy counts by dollars, not by heads, and, so far, it looks like consumer spending could continue on a 1.0%-2.0% growth path for the rest of 2024 and into 2025.

Capital spending also appears remarkably resilient, with real business fixed investment climbing 3.6% in the year ended in the second quarter. Strong corporate balance sheets and a rush of enthusiasm around AI technology are bolstering spending, despite obvious excess capacity in office space. In addition, with over 75% of market cap now reporting for the second quarter, S&P500 earnings per share are tracking a better than 10% year-over-year gain which should support capital spending going forward. All that being said, business caution could lead to a slowdown in non-residential construction and new equipment spending into 2025.

Elsewhere, homebuilding is subdued but at a level from which it is more likely to rise than fall, particularly given a recent decline in mortgage rates. Inventory accumulation was a little above trend in the second quarter and may be a modest drag on growth going forward. However, state and local government spending continues to rise while the U.S. international trade position is ugly but not worsening.

In short, barring a shock, demand in the U.S. economy appears consistent with real GDP growth falling from 3.1% year-over-year in the second quarter to a pace of close to 1% for the rest of 2024 before recovering to 2.0% growth in 2025.

The Slowdown Scenario: Supply and the Jobs Market

Looking at the economy from the supply side, output growth depends upon the growth in hours worked and the growth in productivity. With regard to labor growth, last Friday's job's report was weaker than expected in the latest sign of a softening economy. However, it is important not to overstate the weakness.

First, it should be noted that employment is still growing. The payroll survey showed the addition of 114,000 non-farm payroll jobs while the household survey showed an increase of 67,000 workers.

Second, while the Bureau of Labor Statistics claimed that Hurricane Beryl had no discernable impact on the data, statistical analysis suggests there *was* some minor negative effect. In particular, last month an estimated 436,000 people claimed to have a job but were unable to work during the survey week due to bad weather – about 10 times the normal very low July level. We estimate that this may have subtracted about 13,000 jobs from non-farm payrolls while bad weather may also have slightly reduced the length of the average workweek.

Third, other employment data still point to a relatively strong jobs market:

- The number of job openings stood at 8.2 million at the end of June – well down from a cyclical peak of 12.2 million in March 2022, but still significantly above its pre-pandemic peak of 7.6 million.
- The Conference Board consumer confidence survey still shows twice as many respondents indicating that jobs are plentiful compared to those who say they are hard to get.
- Weekly initial unemployment claims, although they have risen to 249,000 in the latest week, remain well below typical recession levels.

The growth in employment tends to lag the growth in real GDP and, with real GDP rising by 3.1% in the year that ended in the second quarter, payroll employment should rise, on average, throughout the rest of 2024 and into 2025, albeit at a slower pace. Relatively constrained growth in the labor force should make this consistent with an unemployment rate staying close to its current levels.

In addition, it should be noted that productivity growth remains very solid, with last week's data showing a 2.7% year-over-year increase in output per hour in the non-farm business sector. This will likely slow as output growth moderates. However, combined with continued gains in employment, it suggests that the economy has plenty of potential for continued non-inflationary growth.

The J-Curve of Monetary Ease

Solid productivity growth should provide the Federal Reserve with greater confidence that inflation is retreating. Apart from weakness in job gains, Friday's jobs report also showed a relatively subdued 0.2% rise in average hourly earnings to 3.6% year-over-year – its smallest gain since May 2021. Lower energy prices, due in part to signs of slower global growth, should also help reduce inflation and it is now possible that year-over-year growth in the consumption deflator could fall to the Fed's 2.0% objective as early as this September.

With more confidence on inflation and more worries with regard to growth, the Fed may feel inclined to act more aggressively in cutting rates at upcoming meetings. Indeed, unless we get markedly stronger economic data or some very obvious pushback from Fed officials in the days ahead, markets may well lock in an anticipation of a 50-basis point cut in September. Moreover, if the Fed does this, in the face of weaker economic data, they could feel compelled to frontload monetary easing with further 50-basis point rate cuts in November and December before pausing to see if growth strengthens again in early 2025.

One of the factors that makes such an aggressive path more likely is the unfortunate "J-curve" effect of monetary easing. While Fed officials have not, to my knowledge, articulated this problem, the reality in the modern economy is that interest rate cuts likely slow the economy first before stimulating it later – a sort of "J-curve" effect of monetary easing. In particular, when the Fed cuts rates, it hurts the interest income of consumers more than it cuts their interest expense, it undermines economic confidence among consumers and businesses and it gives everyone an incentive to wait before borrowing to see if rates fall further.

Later on, of course, these latter effects fade, and the business and consumer relief from lower interest payments, combined with the potentially beneficial effects of a lower dollar, can help stimulate the economy. But if, in the short run, monetary easing actually slows economic growth, the risk of outright recession could rise, making it harder for the Fed to stick to its intention to ease slowly.

Investment Implications

Still, even with the perverse short-term impacts of monetary ease, for now, a slowdown scenario seems more likely than outright recession. For investors, this has a number of important implications.

First, this may be a time to extend duration. It is true that, should a deeper market correction emerge, cash would outperform stocks for a period. However, we cannot know when such a correction would start or end. Meanwhile, more aggressive Fed easing would quickly erode current high short-term yields while long-term, high-quality bonds should benefit from a weaker outlook for both growth and inflation.

Second, investors should take a look at the assets in their portfolios with the highest valuations. If the market overall sees a significant pullback, mega-cap growth stocks may be the most vulnerable to correction.

Third, more aggressive Fed easing could precipitate a decline in the dollar, amplifying the return on non-U.S. stocks, suggesting the need to consider greater international diversification, and,

Fourth, investors may want to look at building more diversified portfolios in general, adding alternative investments to balanced allocations in public markets.

There is an old saying in politics that you should never waste a good crisis. The recent weakness in economic data will hopefully not turn into a significant crisis. However, it could lead to a market correction and more aggressive Fed easing, as we transition to a slower-growing, low inflation economy. This would be a good time for investors to check that portfolios that have benefitted from booming growth can be resilient in the face of something slower and cooler.

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