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PICTET WEALTH MANAGEMENT

2024 US macro outlook

The last mile or the final descent?

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FLASH NOTE

SUMMARY

- The pandemic has made mainstream business cycle analysis much more complicated and significantly increased macro volatility. In 2024, we expect the driving force of US economic momentum to shift from the unwinding of pandemic-related distortions and the accompanying policy response to restrictive monetary policy.
- We expect real US GDP growth to slow from a robust estimated 2.4% in 2023 to 0.8% in 2024, which is well below its potential. We believe the economy will tip into a mild recession in the first half of the year.
- We expect inflation to continue decelerating, with core Personal Consumption Expenditures (PCE) inflation down from 3.5% in Q4 2023 to 2.6% in Q4 2024. We believe 'supercore' (core services ex housing) inflation will only fall gradually, leading to sticky, above-target inflation.
- In our view, the labour market should be a key focus in 2024. While 2023 has been a year of so-called 'immaculate disinflation', we believe the last mile of reducing inflation further to its 2% target will require a softening labour market. Indeed, we see the unemployment rate rising to 4.5% by the middle of next year.
- Peak fiscal expansion is probably behind us and the impact of fiscal policy on economic growth will turn slightly negative in 2024. We expect a tight race for all three levels of government in the 2024 election. There is little reason to expect meaningful legislation to be passed before the election given that Congress is divided. Significant fiscal consolidation also seems unlikely after the election.
- The Fed hiked rates to their current level of 5.25-5.50% in July, and we believe this is the peak for this cycle. Falling (but still high) inflation will likely encourage the Fed to keep the policy rate on hold until June 2024, when we expect a first rate cut of 25bp. In all, slowing growth and a weakening labour market could push the Fed to cut rates by a total of 125 bps in 2024, bringing the fed funds rate down to 4-4.25% by the end of the year.

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- The main risk to our forecast is a harder landing with sharper job losses and a bigger slowdown in growth. There are also many downside risks linked to high interest rates persisting. A violent labour market adjustment due to unprofitable firms, a repeat of the banking crisis of March 2023 or external shocks that are inherently unforecastable could all push the economy into a deeper recession.
- On the flip side, there is also a narrow path to a soft landing if inflation reverts towards target without a further rise in the unemployment rate. Consumers and businesses could remain resilient for longer. Supply-side improvements could raise productivity and labour supply even further, reducing inflation without demand destruction. The Fed would wait longer to cut rates in this scenario and do so more slowly.

TIGHT MONETARY POLICY TO HIT GROWTH AS PANDEMIC TAILWINDS FADE

The pandemic has made mainstream business cycle analysis much more complicated and significantly increased macro volatility. The US economy grew strongly in 2023, easily avoiding recession despite the Fed implementing one of its most aggressive monetary tightening cycles. Consumers and businesses were still benefitting from the unprecedented fiscal stimulus put in place during the pandemic and low fixed interest rates long after covid ended.

Looking ahead, we expect the driving force of economic momentum to **shift from the unwinding of pandemic-related distortions to supply and demand and the accompanying policy response, to restrictive monetary policy**.

We expect real US GDP growth to slow from a robust estimated annual rate of 2.4% in 2023 to 0.8% in 2024, which is well below its potential level (chart 1). Growth is set to slow sharply in Q4 2023 after a blockbuster Q3, and we expect the economy to tip into a mild recession in the first half of next year, with the unemployment rate rising to 4.5% by the middle of 2024.

We expect **consumption growth to slow down** (but remain positive) as higher interest burdens and diminishing financial cushions make consumers more cautious. A cooling labour market will weigh on disposable income, reducing purchasing power, especially for interest-rate-sensitive items like durable goods.

Broad consumer financial stress remains manageable, but **cracks have started to emerge for the most cash-constrained consumers,** who will be hit first in a deteriorating labour market. Delinquency rates in auto and credit card debt have picked up and borrowing is subject to sharply higher interest rates, and these trends look set to persist. **Wealth accumulation and the depletion of excess savings have been uneven**, leaving little behind for low-income consumers in particular.

We expect **business investment to contract** in the coming quarters due to anemic capex plans, higher borrowing costs, election-related uncertainty, and reduced tax incentives. Despite strong headline business investment this year, **growth was confined to a few sectors**. Equipment investment was largely confined to transportation, where supply was increasing after a long period of decline. Investment in electric vehicles and semiconductors alone accounted for most of the increase in structures spending, driven by tax incentives in the Inflation Reduction Act and CHIPS Act. **This fiscal boost to capex is unlikely to remain as high as it did in 2023, and**

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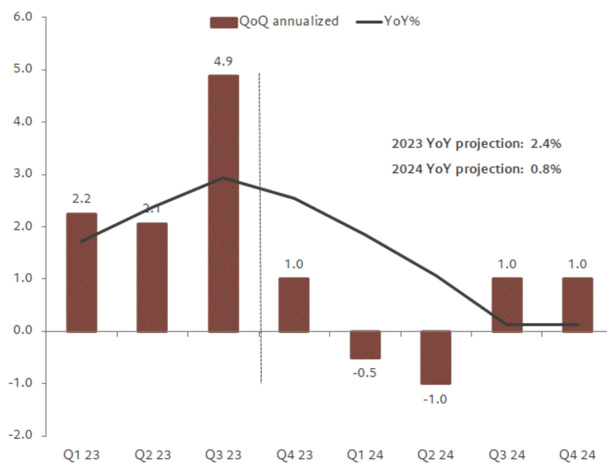
headwinds from high interest rates are likely to intensify as a growing share of firms face higher financing costs over the next two years.

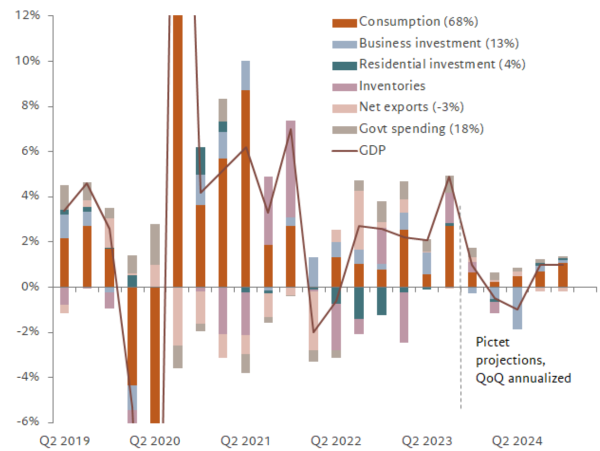
Residential investment is likely to fall in the near term as **higher mortgage rates drag on home sales**. But given structural undersupply and the lock-in effect restricting housing supply, construction is unlikely to fall sharply, putting a floor under overall housing investment.

Chart 1: Past and projected US real GDP growth



Source: Pictet Wealth Management, Bureau of Econmic Analysis, 16 November 2023

Chart 2: US real GDP growth by component



Source: Pictet Wealth Management, BEA, 16 November 2023

WHAT LANDING? THE LABOUR MARKET IS KEY

The markets fixate on two quarters of GDP contraction as a determinant of recession, but that is purely a technical definition. The recession arbiter in the US, The National Bureau of Economic Research, defines recession as a significant decline in economic activity that is spread across the economy and lasts more than a few months. In fact, 2001 was labelled a recession despite there *not* being two consecutive quarters of contraction. **In our view, where the labour market lands should be the key focus for 2024**.

While 2023 has been a year of immaculate disinflation, we believe reducing inflation further to the Fed's target of 2% **will require a softening labour market. The unemployment rate has already risen from a cycle-low of 3.5% to 3.9%, and we expect it to increase further to 4.5% by the middle of next year**.

Labour market softening will continue to be led by a decline in job openings and a slowdown in hiring. But eventually we expect a modest level of layoffs and more people entering the labour force to push unemployment up. The rise in unemployment we expect is **much smaller than the 2 percentage point increase that we see in a typical recession**, Given the considerable difficulty they faced hiring in the pandemic, businesses could be more reluctant to lay off large numbers of workers than in previous cycles.

In the past, when the number of people entering unemployment has exceeded the number of people leaving unemployment (due to being hired or exiting the labour

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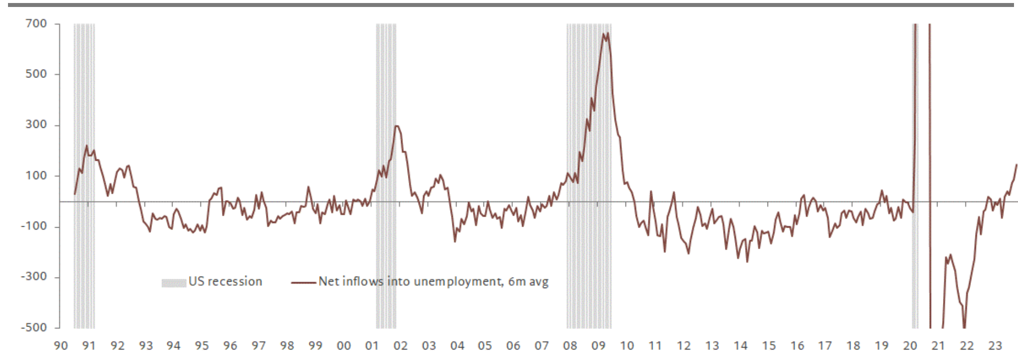
force), significant rises in the unemployment rate tend to follow (chart 3). Recently, the number of people entering unemployment has exceeded the number of people leaving it on a six-month average basis.

Importantly, **small businesses, which employ almost half of the US workforce, are facing sharply higher financing costs**. Small firms rely much more heavily on bank loans than large companies and lack sufficient access to the capital markets. Their loans are much more likely to be at floating rates and of shorter maturity, putting them under more pressure to reduce labour costs.

One significant risk to our forecast is that there could be a harder landing that results in more job losses and a sharper fall in growth. There are also many downside risks linked to high interest rates persisting. A violent labour market adjustment due to the failure of unprofitable firms, a repeat of the banking crisis of March 2023 or external shocks that are inherently unforecastable could all push the economy into a deeper recession. As 2023 has taught us, **"there are decades where nothing happens; and there are weeks where decades happen".**

On the flip side, there could also be a soft landing if inflation reverts towards target without a further rise in the unemployment rate. For one, consumers and businesses could remain resilient for longer. For another, supply-side improvements could raise productivity and labour supply even further, reducing inflation without demand destruction.

Chart 3: Net increase in the unemployment rate (thousands)



Source: Pictet Wealth Management, Bureau of Labor Statistics, 16 November 2023

INFLATION – WHERE NOW?

We expect inflation to continue falling next year, with core PCE down from 3.5% in Q4 2023 to 2.6% in Q4 2024 (chart 4). This process should continue to be led by core goods deflation and a slowdown in rental inflation (chart 5). We expect supercore (core services ex housing) inflation to decline gradually and remain above pre-pandemic levels, leading to **sticky, above-target inflation**.

The easing of supply-chain pressures, which has driven much of the fall in inflation we have seen so far in 2023, is likely to continue into 2024. Meanwhile, **weaker demand and a softer labour market** due to tight monetary policy will also drive inflation down further.

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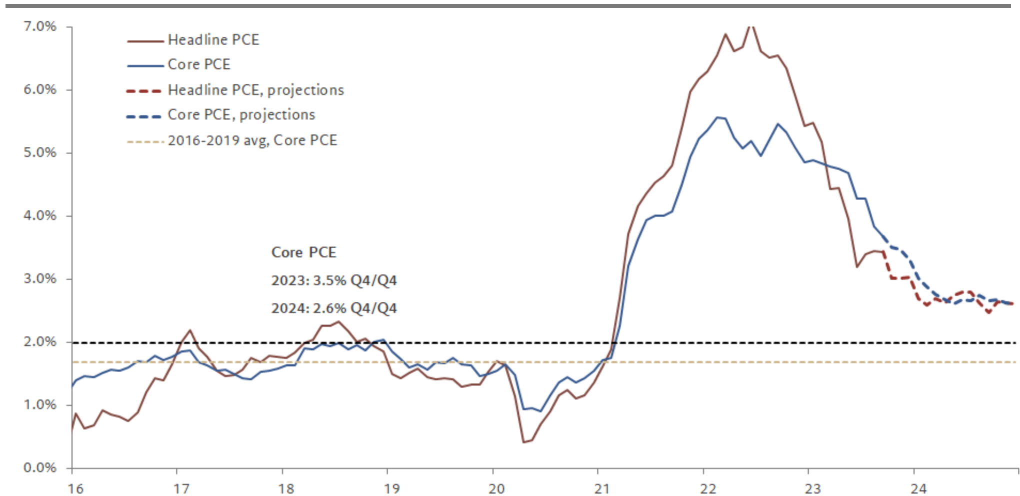
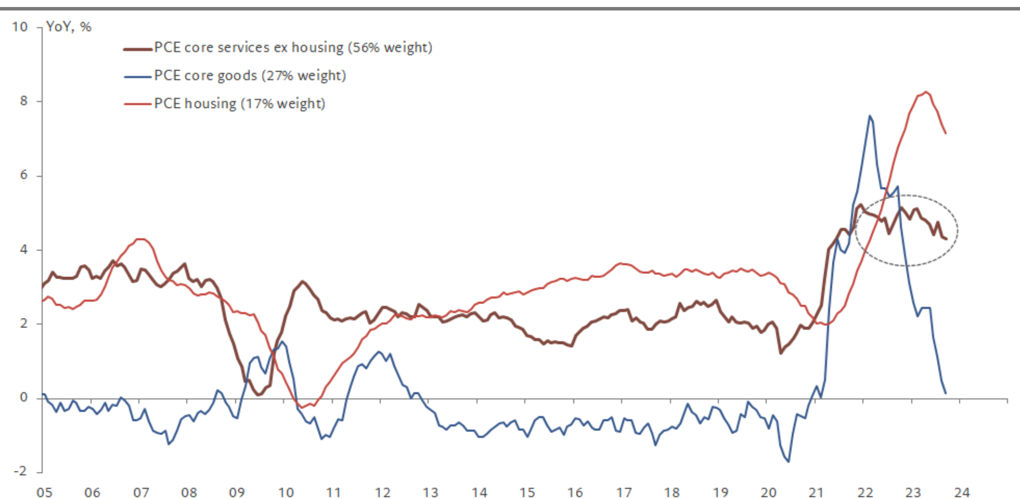
However, we do not expect core inflation to return to the 2% target in 2024, let alone its pre-pandemic average of 1.7%. Although inflation expectations remain well anchored, the cost environment will be slow to normalize. The prices of labour-intensive services have a loose relationship with wage growth. **Increasing labour market slack and below-potential growth should help bring wage growth down further**. But we only expect wage growth to slow gradually as some of the labour-intensive industries, such as health care and leisure & hospitality, are still suffering from labour supply shortages, which means wage pressures are likely to remain high. What's more, some inflation measures, including health care PCE, lag actual wage growth, so past increases will continue to feed through into consumer prices.

Chart 4: Past and projected headline and core PCE inflation



Source: Pictet Wealth Management, BEA, 16 November 2023

Chart 5: Breakdown of core PCE inflation



Source: Pictet Wealth Management, BEA, 16 November 2023

Risks to our inflation forecast are balanced. If the labour market weakens more than expected, inflation could fall back towards target more quickly. But if growth picks up again, inflation could prove even stickier. The conflicts in the Middle East and Ukraine could also exert upwards pressure on headline inflation.

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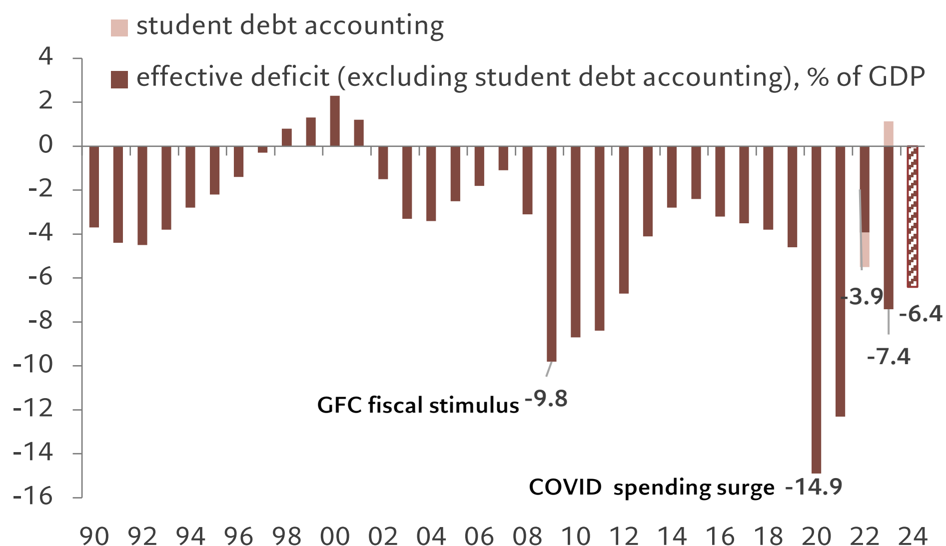
FISCAL POLICY – PEAK EXPANSION IS BEHIND US

Fiscal policy has been an important driver of the US's above-potential growth in 2023, but we believe peak fiscal expansion is behind us and the fiscal impulse to economic growth will turn slightly negative in 2024.

Unless there is a deep recession, we expect no new stimulatory fiscal policy legislation before the 2024 elections given the political gridlock in Washington. There could be some extra investment in response to infrastructure-related bills such as the Inflation Reduction Act, CHIPS Act and Infrastructure Investment and Jobs Act, but it is hard to foresee a sharp acceleration in public spending after its exuberant growth this year. Although Congress has passed a resolution to keep the government funded until mid-January, fiscal contraction is still a risk if it fails to pass full-year budgets by April 2024, which would trigger automatic spending cuts.

The fiscal deficit doubled in 2023 from USD1 trn to USD2 trn (up from 3.9% of GDP to 7.4%), after adjusting for student loan cancellations (which increased the deficit in 2022 and reduced it in 2023 without any policy being implemented, chart 6). **The major drivers of the growing deficit** – deferred tax revenues, lower capital gains taxes and increased outlays linked to past covid stimulus and infrastructure-related bills – **are unlikely to be repeated in 2024.**

Chart 6: Past and projected fiscal deficit as a percentage of GDP



Source: Pictet Wealth Management, US Treasury, Congressional Budget Office, 16 November 2023

We expect the deficit to narrow to USD1.8 trn (6.4% of GDP) in 2024. Revenues should pick up due to deferred tax payments coming in and no repeat of lower capital gains taxes, and by more than spending is expected to increase. **All of the projected increase in spending is driven by rising net interest payments**. The bill passed to suspend the debt ceiling earlier this year set spending caps for discretionary outlays, and there will be less spending from past stimulus measures. Overall, **the primary deficit** (the total deficit excluding net interest payments) should narrow slightly in 2024.

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A deficit of 6.4% of GDP in 2024 would still be large in historical terms, as the deficit has averaged around 3% outside recessions. **There is no strong political desire from either party for significant fiscal consolidation**, and as net interest payments rise, concerns about fiscal sustainability are likely to persist next year.

FED ON HOLD IN EARLY 2024, WITH RATE CUTS LIKELY TO START IN JUNE

The Fed hiked rates to their current level of 5.25-5.50% in July, and we believe this is the peak for this cycle. We believe that falling (but still high) inflation will **encourage the Fed to keep the policy rate on hold until June 2024**, when we expect a rate cut of 25bp. In our view, this would mark the start of a rate-cutting cycle, with falling inflation, slowing growth and a weakening labour market pushing the Fed to cut rates by 125bp to 4.00-4.25% by the end of 2024.

Recent data showing that inflation continues to fall, and the labour market is cooling have sharply reduced the probability of another rate hike. The Fed's policy stance will probably become more restrictive as slowing inflation and inflation expectations boost real rates. But the Fed wants to see a convincing and sustainable drop in inflation before it starts to normalise policy. As such, it will resist the pressure to cut for as long as possible.

We expect the **policy rate to remain well above the FOMC's estimates of the neutral level by the end of 2024** (the Fed's median estimate of the neutral rate is 2.5% but has probably increased recently). Given our projection that inflation will stay below 3% but above 2% and that there will be a mild rise in unemployment, we do not expect the Fed either **to rush to return inflation all the way back to target quickly** by tightening further, or to **cut rates aggressively**, in contrast to the two most recent cutting cycles in which rates fell quickly to the zero lower bound.

Both the pace at which inflation falls and the strength of economic activity will determine the timing and magnitude of rate cuts. If inflation remains sticky at a high level and growth remains solid, the Fed will be later and slower to cut rates. But if clear signs of a harder landing emerge, the Fed would be earlier and faster to cut.

Quantitative tightening (QT – the reduction of the Fed's balance sheet) could continue well into 2024, even as the Fed starts cutting rates. **But the process will eventually end** as bank reserves approach the lowest comfortable level due to liquidity constraints. Our estimate is that QT will end in Q4 next year, although there is considerable uncertainty about this. In our view, barring a deep recession, the Fed would prefer to keep QT humming in the background, calibrating its balance sheet policy to concerns about banks' liquidity constraints) and the functioning of the Treasury market. However, if the economy were to fall into a severe recession, the first rate cuts and the end of QT would probably occur at the same time.

We expect QT to continue with a USD60 bn monthly cap on Treasury run-off and USD35 bn monthly cap on mortgage-backed securities run-off until the end of Q3 2024. By Q4, the Fed could either end QT entirely or slow down its pace first (by halving the monthly caps, for example). Given that there is uncertainty surrounding estimates of the level of banks' reserve scarcity, stress in the funding markets or Treasury-market dysfunction could lead to QT ending earlier than expected. In

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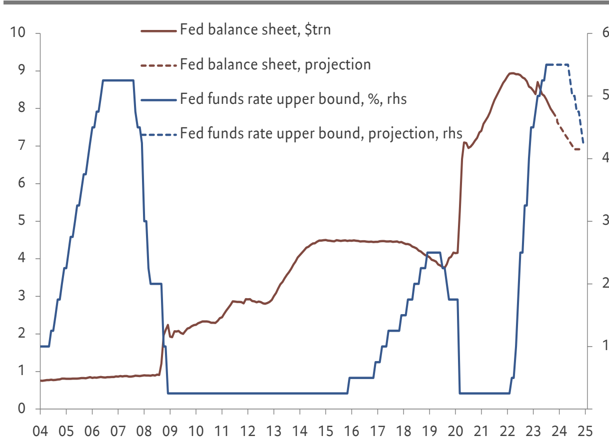
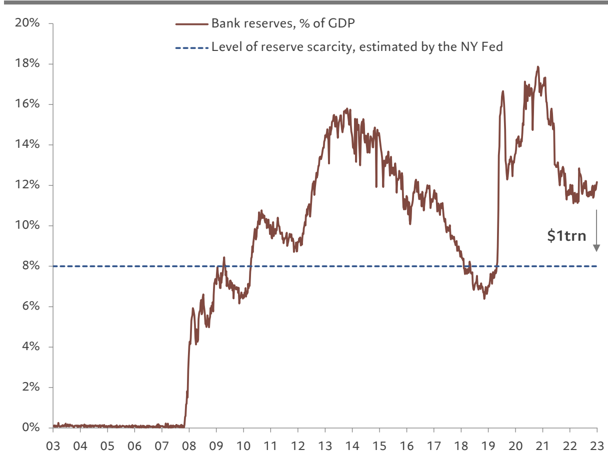
either scenario, the Fed could continue reinvesting its MBS holdings into Treasuries as it prefers a Treasury-only portfolio in the long run.

Chart 7: Past and projected policy rate and Fed balance sheet



Source: Pictet Wealth Management, FRB, 16 November 2023

Chart 8: Bank reserves at the Fed as percentage of GDP



Source: Pictet Wealth Management, FRB, NY Fed, 16 November 2023

A TIGHT ELECTIONS RACE

We expect the elections for all three levels of the government (the Presidency, the House of Representatives and the Senate) to be a tight race. Election day on 5 November is still a long way off, but polls suggest it is increasingly likely that the presidential race will be between President Biden and former President Trump. **There will be a lot of noise and uncertainty in the run-up to the election given the concerns around Joe Biden's age and Donald Trump's legal headaches.**

The two candidates differ drastically on a range of policy issues including tax, regulation, green energy, immigration, trade and the re-appointment of Fed Chair Jerome Powell, whose term expires in May 2026. There would also be a much higher level of policy unpredictability if Donald Trump becomes president again.

In the meantime, there is little reason to expect fiscally significant legislation to be passed before the election given that Congress is divided. Significant fiscal consolidation also seems unlikely after the election. Both candidates are keen to extend some or all of the 2017 Trump tax cuts, which are set to expire in 2025, with compensations likely coming from higher taxes under Joe Biden and lower welfare spending under Donald Trump. With the debt ceiling only suspended until January 2025, concerns about debt sustainability and polarisation in Congress are likely to persist.

The make-up of Congress will be crucial in determining whether legislation can actually be passed. The House is likely to go in the direction of whichever party wins the presidency, while the Republicans have an edge in the race for the Senate. However, neither party is expected to breach the 60-vote threshold in the Senate to prevent a filibuster – the rules allowing the Senate to delay or block a vote on a piece of legislation -, making it hard to pass any meaningful legislation.

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