The US economy is resilient

February 6, 2024 | Economic Update

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The US economy has proven more resilient and inflation has fallen more dramatically than most forecasters anticipated when the Federal Reserve initiated its aggressive credit tightening cycle in March 2022. Consumer price increases have declined sharply without the economy falling into recession and the odds of the downturn many economists forecast have diminished. Real GDP has surprised to the upside, continuing to grow at an above-trend rate, despite serious headwinds including high real interest rates, the lingering effects of COVID-era supply chain disruptions, wars in Ukraine and the middle east and last winter's regional banking crisis.

Consumption

Robust growth in *consumption* which accounts for over 70% of real GDP, continues to underpin the economy's recovery. Consumer outlays rose 0.7% in December, with both goods and services showing gains. Purchases of goods rose 0.9% in December, the largest single monthly increase since January 2023. Goods spending is up 5.0% in the past year when adjusted for inflation. Spending for services rose 0.6% in December and is up 6.3% in the past year, 2.3% when adjusted for inflation. The recent surge in consumer confidence, stemming from lower inflation, rising stock prices, widespread anticipation of lower interest rates ahead, and generally favorable employment conditions, has brought the Conference Board's January index to its highest level since December 2021, is predictive, in our view, of further strength in household outlays, albeit at a more moderate pace, in the months ahead.

Inflation and Productivity

On the *inflation* front PCE prices, the Fed's preferred inflation gauge, were up only 0.2% in December, bringing the twelve-month comparison to 2.6%, versus 5.4% in the twelve months ending December 2022. The main PCE price indices came in close to the FOMC's 2% target on a quarter-to-quarter sequential basis. "Core" PCE prices, which exclude volatile food and energy categories, also rose 0.2% in December and are up 2.9% when compared with a year ago, down from 4.9% in the year ending December 2022. Recently, the Fed has focused on a subset of the PCE inflation known as the "Super Core," which incorporates services only, excluding food, energy and housing. This measure rose 0.3% in December and is up 3.3% versus a year ago, improving from the 4.8% increase in the year ending December 2022. Aiding the Fed's inflation effort, US worker productivity has been rising, growing faster than expected in the fourth quarter, keeping unit labor costs contained. Nonfarm productivity, which measures hourly output per worker, increased at a 3.2% annualized rate last quarter as both output and hours worked rose, but output rose at a faster pace, leading to more output per hour. Since the peak in the business cycle pre-COVID, productivity is up at a 1.6% annual rate, close to the 1.5% average of the past twenty years. While these inflation measures have been encouraging and appear headed in the right direction, they remain above the Fed's 2.0% target, too early for the Fed to declare victory.

Jobs

The January *employment* report from the Department of Labor was the most surprising datapoint we have seen since year-end. The BLS reported employers added 353,000 jobs last month, the strongest monthly increase in a year, twice what economists expected. December's job gains were also revised higher to 333,000 from 216,000 further dispelling the view widely held among economists it was becoming harder to find a job. The unemployment rate, which was expected to rise to 3.8%, remained steady at 3.7%. And wage gains were strong, rising 4.5% from a year earlier, also exceeding expectations. These latest jobs numbers highlight a labor market that has been instrumental in supporting consumer spending and keeping the economy on its recovery path. Nevertheless, there are also some signs the labor market is softening, though gradually, which could further help to cool wage inflation. For example, first-time applications for state unemployment benefits, known as initial jobless claims, a widely followed high-frequency leading indicator, rose to a two-month high of 224,000 last week and other Labor Department data showed the number of people on unemployment rolls, so-called continuing claims, was at its highest level in two months at 1.89 million, the highest level since November. Compensation costs rose in the fourth quarter at the slowest pace since 2021. And the December Job openings (JOLTS) report showed jobs are not quite as easy to find, but many businesses are still hiring. Job openings rose at the end of 2023, topping 9 million for the first time in three months, suggesting the US labor market remains quite healthy, not softening as much as the Fed had hoped. Most importantly, the number of job openings for each unemployed worker was unchanged at 1.4. That ratio is down from a peak of 2.0 in 2022 and almost back to a pre-pandemic norm of around 1.2.

Recall the Fed left interest rates unchanged when they met last week, noting most officials expect to cut rates this year, though they will probably lack sufficient confidence about the sustainability of lower inflation to cut rates when they next meet in mid-March. The Fed is now widely expected to reduce rates beginning in June, but a cut at the May meeting is also a clear possibility.

So, despite some signs of softness in the labor market, the strong January payrolls report will likely keep the FOMC on course to hold rates where they are when they next meet in mid-March, as they await further evidence the trend toward lower inflation persists.

Below are a few of the notable economic reports we have reviewed since year-end and comments on each.

Real GDP increased at a 3.3% annual rate in the fourth quarter, easily exceeding expectations of a 2.0% increase. The largest contribution to real GDP growth was personal consumption, while every other component of GDP was higher, as well. "Core" GDP, which excludes volatile government purchases, inventories and international trade, includes personal consumption, business fixed investment, and home building rose at an annual rate of 2.6% in Q4. Real GDP expanded 3.1% for all of 2023, well-above 2.0% trend, on par with the pace of 3.2% of 2019, the year prior to COVID. While the economy entered 2024 with considerable momentum, and the odds of a recession this year have faded, the headwinds to future growth mentioned above remain.

ISM Manufacturing Index increased to 49.1 in January exceeding the consensus. (Recall that readings of this diffusion index above 50 signal expansion; readings below 50 signal contraction.) Measures of activity in January moved higher. The new orders index rose to 52.5 from 47.0 in December. The production index rose to 50.4 from 49.9. The employment index declined to 47.1 from 47.5 in December, while the supplier deliveries index increased to 49.1 from 47.0 in December. Activity in the US manufacturing sector contracted for the fifteenth consecutive month in January, but details of the report contain some signs of improvement. The best news comes from the new orders index, which moved into expansion for the first time in seventeen months. Output remained stable as the production index ticked up to 50.4. Despite some signs of improvement, demand remains soft and order backlogs have been contracting.

ISM Non-Manufacturing Index increased to a surprisingly strong reading of 53.4 in January from 50.5 in December, above all estimates. (Recall that readings of this diffusion index above 50 signal expansion; readings below 50 signal contraction.) New orders, supplier deliveries, prices paid backlog of orders and inventory sentiment indices all rose. The growing momentum in the services sector noted above is evident in this survey.

Orders for Durable Goods were unchanged in December following a 5.5% surge in November. The details of the report showed rising orders across most major categories were offset by a steep drop for defense capital goods. Stripping out the volatile transportation sector, orders for durable goods rose a healthy 0.6% in December. Looking ahead, several factors including restrictive monetary policy, the tightening of lending standards following stress in the banking sector last year, and reduced fiscal stimulus are likely to dampen business investment. In addition, the shift in consumer's preferences from goods to services in scarce supply during the pandemic will weigh on the sector.

New Single Family Home sales increased 8.0% in December to a 0.664 million annual rate, wrapping up a healthy year. The months' supply of new homes declined to 8.2 in December from 8.8 in November. The drop was entirely due to a faster pace of sales. The median price of new homes sold was $421,200 in December, down 13.8% from a year ago. The main issue with the housing market remains affordability. So, 30-year fixed rate mortgage declines of roughly 1% due to expectations of Fed rate cuts this year should support demand going forward.

The headwinds to growth noted above, coupled with the lagged effect of the decline in the M2 measure of money supply in 2023 and restrictive US monetary policy, are likely to dampen economic growth for the next couple of quarters but not push the economy into recession. Indeed, the above-trend readings of our firm's proprietary Economic Model, designed to signal a change in the direction of the US economy six to nine months ahead of an inflection point, have been pointing to expansion for seven months.

In short, we see strong ISM services, which account for roughly 80% of GDP, and improving ISM manufacturing, coupled with a still-strong labor market and upbeat consumer sentiment pointing to continued economic expansion ahead, albeit at a somewhat slower pace for a couple of quarters.

Equity Investment Policy

With more than half of the S&P500 index earnings for this season now in, both revenues and earnings have in aggregate exceeded expectations. Guidance is cautious but in line with historic norms. The most important takeaway from these reports is that on a year-over-year basis, earnings are growing again, a favorable development for equities and an important reason behind the improvement in corporate sentiment we have seen. The **Corporate Sentiment Indicator** index maintained by Bank of America shows sentiment has improved to a near record high. Interestingly, the year-over-year change in corporate sentiment has been highly correlated with quarterly earnings per share with a one quarter lead, pointing to a further earnings recovery ahead.

Despite the prospect for continued earnings improvement which, in our view, is likely to underpin equities near current market valuations, from a P/E perspective the S&P500 appears to be fully valued at 20.5x this year's expected earnings. However, the market's valuation is much more attractive at about 17x 2024 earnings when its component mega cap tech stocks are stripped out. Accordingly, clients' equity portfolios under our supervision remain fully invested within their established guidelines, and we have emphasized additions to value shares versus growth, given their statistical cheapness, expecting a broadening in stock market leadership as credit conditions ease in the months ahead. Clearly, a brief, sentiment-driven correction of 5%-10% following last year's outsized gains should not be ruled out.

Client's equity portfolios are well diversified, balanced between large cap *growth* and *value* shares, tilted toward *growth* which is our long-term bias. Our investment platform allows for modest allocations to domestic small cap equities and companies domiciled abroad in both developed and emerging markets.

As long-term investors we prefer to look beyond the inevitable near-term uncertainties and short-term investor preferences, to the coming economic cycle, spurred by easing credit conditions, sound underlying business and consumer fundamentals, and new productivity enhancing technologies, to the investment opportunities it will present. We intentionally pay scant attention to market timing, momentum-based trading strategies or technically driven trading approaches. Instead, we focus our energies on the same fundamental equity research that has been basic to our firm's wealth building strategy over the past thirty years.

Fixed Income Investment Policy

The Federal Reserve's restrictive credit policy has for the first time in a generation made bonds investable. Accordingly, we have used the recent period of elevated interest rates to extend durations in clients' bond portfolios toward a target of 2.5 years from durations short of one year. Maturing obligations, as well as some bonds nearing maturity have been replaced among clients' laddered corporate bond holdings with other highly marketable investment grade bonds maturing over the intermediate term where yields-to-maturity of 5.5%-6.0% became available. New bond purchases have generally been limited to five years or less to maturity.

material could have a material impact on the information presented herein by way of example. Past performance does not predict or guarantee future results. Investing involves risk; principal loss is possible.

Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. Definitions: **Personal Consumption Expenditures Index (PCE)**: A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

Conference Board's Confidence Index: The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. **ISM Manufacturing Index**: The ISM manufacturing index or purchasing managers' index is considered a key indicator of the state of the U.S. economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. **ISM Non-Manufacturing Index**: The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. **S&P 500 Index**: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. **S&P 500 Growth Index**: The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. **S&P 500 Value Index**: The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.