Andersen Monthly U.S. Economic Report

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NO LANDING IN SIGHT YET

The U.S. economy does not need lower rates. It has solid growth momentum. Real GDP growth in the 2nd Quarter is tracking in excess of its supply potential. Measured in price-adjusted real terms, real interest rates are not that restrictive.

With expected 1-year ahead inflation expectations running at 3.3%, an effective Fed funds policy rate of 5.33% does not look that high. This expected inflation number comes from a recent survey carried out by the Federal Reserve Bank of New York. In addition, there is economic support coming from new sources.

For example, supply chains are moving back to the United States. The CHIPS and Science Act of 2023 is having a big impact on investment spending (construction) in U.S. manufacturing. Construction of mega high-tech manufacturing plants in the U.S. is booming.

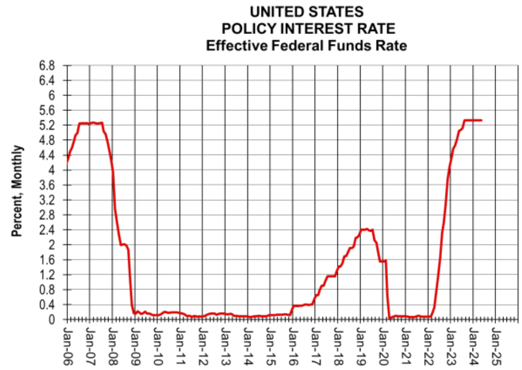
In addition, defense spending has ramped up sharply. Finally, household wealth is being boosted for parts of the population by house price and stock market gains.

Typically, the "wealth effect" works the other way when rates go up, and stay high. This time is different. House prices are up by 34 % (Case-Shiller) since the end of 2020 and the DOW is up by almost 30% since then. Not everyone benefits, but enough do, to make a difference.

Time will tell whether stocks are being boosted by "irrational exuberance" or by a valid earnings outlook. For now, the wealth effect, combined with little fear of job loss, are major supports to consumer spending.

Looking ahead, we think that an extended U.S. business cycle recovery is coming. The inverted yield curve appears to have given a false signal. The combination of circumstances in 2022 and 2023 that produced a yield curve inversion may have been the result of the economic shock from a 100-year disruption by a global pandemic.

We think the business cycle for the rest of the decade will be different from the decade of the teens Inflation will be higher than over the 2010 to 2019 period, but it will not be disruptive. Interest rates will remain high but will not exceed the average experienced over the 1990's. Money will again have normal time value. There will be no return to negative interest rates. A new global commodity cycle is also expected.



UNITED STATES

- Economy still at cruising altitude
- Diminished rate impact, despite a 23-yr high
- Bottom line: No landing anytime soon

- A new multi-year business cycle underway
- Will be different from decade of the teens
- A new cycle with higher inflation/higher rates

- Are interest rates restrictive enough?
- It's real (inflation adjusted) rates that matter
- Manufacturing construction surge
- Out-sourcing reversing + defense spending
- Household wealth gains (house prices, stocks)

- 2.7% "nowcast" Q2/24 annualized growth rate
- Job market still tight (jobless claims very low)
- Expected 1-yr ahead inflation has increased
- Up to 3.3%, from 3.0% a month earlier

- Expectations drive wage demands, wage costs
- Strong economy - costs passed on in prices
- Employee compensation a key cost factor
- Copper, gold/silver surge an inflation warning

- Zero 2024 Fed rate cuts a possibility
- Jun to Aug PCE reports a deciding factor
- Nov 5th Presidential election may delay cuts

- M/M core PCE slowed to 0.2% in April
- This is 2.4% at a compound annual rate
- 3-month m/m average now 3.4% (annualized)
- Fed wants mid-2% range for PCE stabilization
- This requires a series of months at this rate

- At least 3 or more months of 0.2% m/m needed
- Remember $1.002^{12}=2.4\%$ (annual rate)
- May not happen before Sep 18th Fed meeting
- September rate cut hopes may not materialize
- Earliest rate cut looks like November 7th
- Remember: cuts won't solve housing supply

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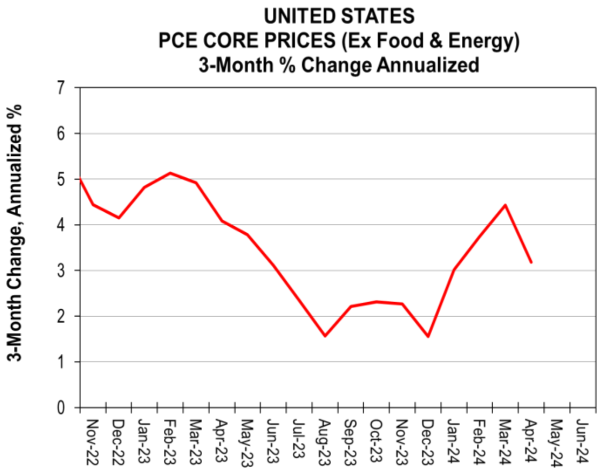
COVER PAGE CHART STORY



Fed decisions depend on PCE news.

The May 31st PCE report is out.

The core PCE is what to look at.

It shows a 0.2% m/m increase in April.

This follows m/m increases of 0.32% in March and 0.27% in February.

The financial markets have responded positively to the 0.2% March to April increase. They view it as being “friendly”. However, the Fed looks beyond the 1-month change.

The markets have over-reacted to Friday’s PCE news. Fed rate cuts are not coming soon.

The Fed is more interested in what has happened over a 3-month period.

The m/m increases over the 3 months from February to April average 0.26% (0.2, 0.32 and 0.27). Putting this at annual rates we get 3.17%. This is shown in the chart above.

It is down from the annualized January to March 3-month average change of 4.4%.

This is good but it is still well above the running 3-month change from August to December 2023. It means that the Fed will not be cutting at its June 12th meeting.

The next PCE report after that will be released on June 28th. It will be for the month of May. If it shows another 0.2% m/m increase (a good guess) the average 3-month increase will be an annual rate of 2.9%.

This would still be higher than core PCE inflation in the 2nd Half of last year. This would not be good enough for the Fed. It would hold again at its July 31st meeting. It wants to see a string of more than just 2 months with the 3-month annualized changes running at 2.5% or less.

By the September 18th Fed meeting, there could be a run of 3 consecutive months with the 3-month change averaging 2.4%. Would this be low enough for the Fed to cut? It would still be higher than the trend in the summer and fall of last year. In addition, the September date would be uncomfortably close to the November 5th Presidential election.

The bottom line is that even if we see a string of 0.2% m/m increases, the earliest Fed rate cut could be on either its November 7th or December 18th meetings. Given the politics, our guess would be the December meeting. Even that could be derailed if wage costs pick up.

BUSINESS CYCLE MOMENTUM

New Contributors to the U.S. Economy
Also a Higher Neutral Interest Rate

Peter R. Andersen, Ph.D.

GROWTH MOMENTUM FEEDS ON ITSELF: Rule #1 in forecasting the future is to get today right. Momentum counts. It can go either way – up or down. Momentum can also feed on itself, producing a multiplier-like response. For example, positive outcomes can be recycled into the system, as positive inputs with amplification effects. In economics, job growth creates income and spending power. In turn, this creates more employment growth. If employment goes the other way, the opposite can be true as well. Fortunately the U.S. job market is fueling a positive reaction. Payroll gains have been well in excess of 200,000/mo. since the fall of 2022, despite higher rates.

The Fed's effective policy rate was raised from 2.33% at that time to 5.33% now – an increase of 300 basis points. The job market has not paid attention. Average payroll growth in 2023 was 251,000 per month. So far in 2024 it has averaged 254,000 per month. Employment is more important than interest rates. We have consistently heard that many employers plan to increase their payrolls over the coming year, despite higher Fed interest rates. This is a pandemic effect. It has changed the willingness to work, and increased difficulty in hiring staff. The reasons are complicated and multi-faceted, but the end result is clear. Payroll job growth in the United States has momentum. Current interest rate levels are not as restrictive as we had thought they would be.

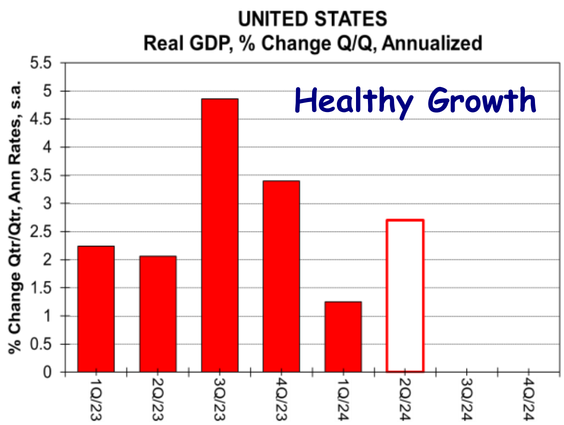
THE NEUTRAL INTEREST RATE: It is sometimes called the "natural" interest rate. In academic papers it is referred to as "r-star" (i.e. ***R****). It is the real interest rate that keeps the economy at full employment, and at the same time, keeps inflation stable. Notice that "stable" does not necessarily mean 2.0%. Simply put, it is the interest rate where monetary policy is in balance – it does not stimulate and it does not restrict. In the 2010-2019 decade ***R**** appeared to be declining but recent developments point the other way. The latest estimates for ***R**** for the U.S. have been revised upwards and are now it in the range of 2.25% to 3.25% (Source: Bank of Canada Staff Paper, April 2024). It is a wide range but at the upper end, it supports the notion that the Fed is in no hurry to cut.

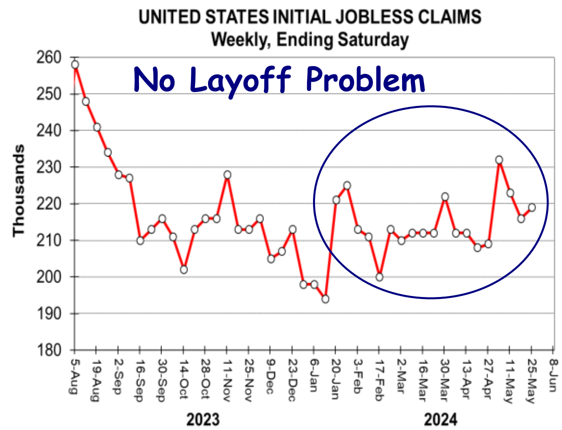
There is sustained full employment in the U.S. and relatively stable inflation at around 3%. It seems therefore that the current 5.3% Fed policy rate is close to an equilibrium rate. The debate on how to calculate ***R**** will continue to be controversial, but the situation today (with short-term inflation expectations around 3%) suggests that Fed rate cuts may not materialize in 2024. With ***R**** (the real neutral rate) at 2% and expected inflation at 3.3% (source: Federal Reserve Bank of New York), the current level of rates could be the new normal, at least for a few years.

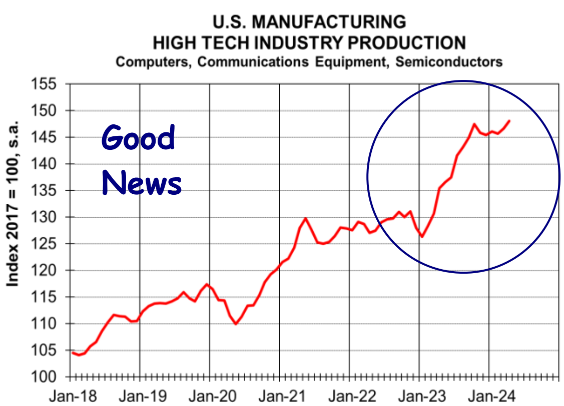
THE OFFICE MARKET PROBLEM: If rates stay where they are, and perhaps increase at the long end because of government deficits and a spike in government bond issues, office market refinancing risks will resurface. The issue was put on the back burner earlier this year as markets bought into the scenario that the Fed would cut by perhaps 6 times in 2024, with the first rate cut coming in March 2024. By year-end this scenario put the Fed policy rate down by 150 points to under 4.0%. CRE refinancing would have been easier. Now the rate outlook is raising the warning flag again for office market refinancing. The hybrid 3-day in-office work-week seems here to stay. With property valuations staying down and interest rates staying high, we can expect financial system worries in 2024 and 2025.

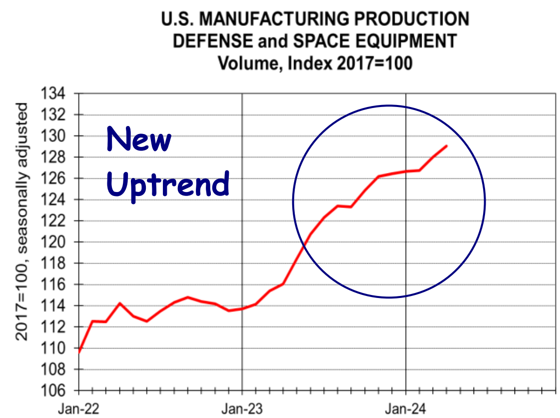
NEW BUSINESS CYCLE CONTRIBUTORS: Our optimism for the U.S. outlook is based on the resilience of employment, plus a number of other contributors – supply chain reshoring, manufacturing construction, health care construction, a wealth effect, defense spending and a stimulative fiscal policy. We are staying positive.

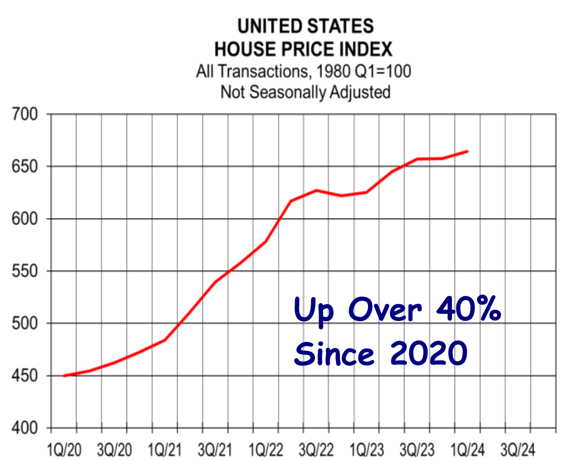
The U.S. economy is still doing well. It is on track to show a solid growth rate in the 2nd Quarter. Real GDP is estimated to increase at a 2.7% annual rate, following a 1.3% annualized increase in the 1st Quarter. Averaging these two Quarters, gives a 2.0% rate. This is in line what we saw in the 1st Half of 2023. In addition, it is above the economy's supply potential. Personal consumption expenditure, measured in real price-adjusted terms, shows a healthy trend. A wealth effect (housing and the stock market) is giving a consumer boost. The charts below show major contributions coming from high-tech industry production (computers, communications equipment and semiconductors) and also defense production. Output in high tech manufacturing, in volume terms, is up by 9% y/y in the latest month. This is good news for U.S. productivity, which shows signs of revival. Defense and space production is up by 11% y/y. It had been flat in 2022 and the uptrend began about this time a year ago. Government spending overall is also giving economic support. In the 1st Quarter of 2024, it was up by 6% in nominal terms from the same Quarter a year earlier.

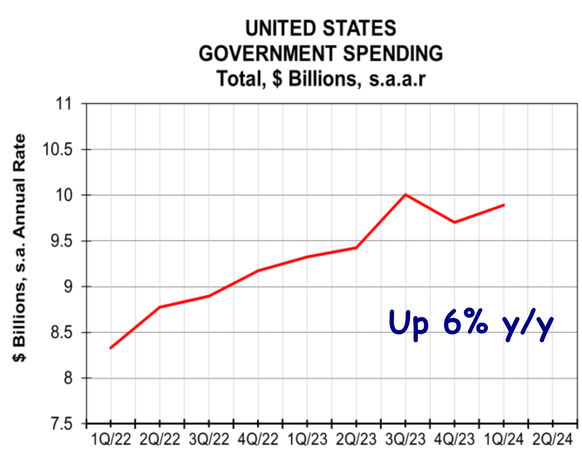






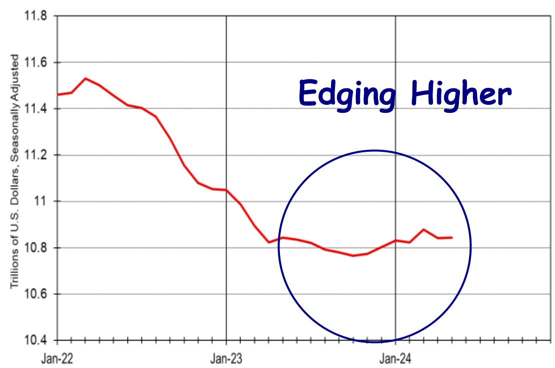






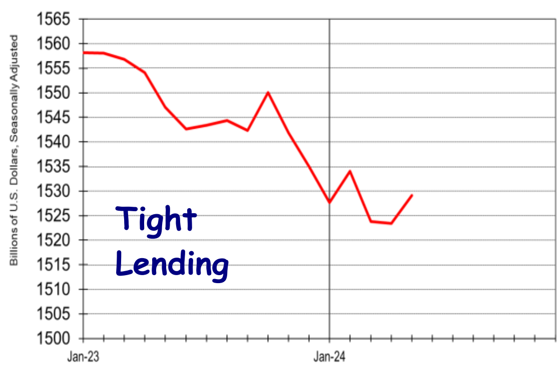
The banking system has stabilized since last year's bank failures. The downtrend in deposits has ended for the large banks, and deposits have been edging higher since last fall. The small banks, which are very exposed to commercial real estate risks, show a remarkable rebound in deposits. The banks are being cautious lenders though. The large banks show a pronounced downturn in business lending (commercial and industrial loans) that has carried through into 2024. Business lending at small banks has been basically flat since the spring of last year, but is well down from the beginning of 2023. Consumers are making heavy use of credit cards. Credit card balances are up sharply and are above pre-pandemic levels. Fortunately the delinquency rate on credit cards is not yet a problem. It is still well below previous peaks. It is higher than before the pandemic but still below what was seen prior to 2012.

DEPOSITS
UNITED STATES
LARGE COMMERCIAL BANKS

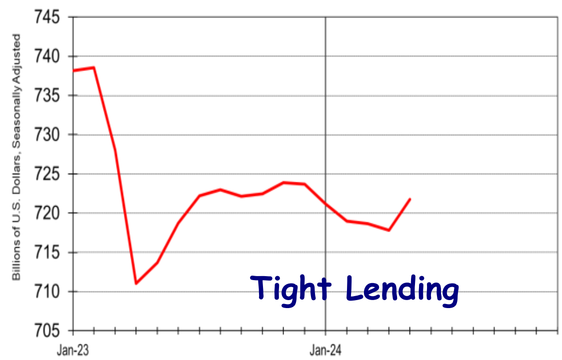


UNITED STATES
SMALL DOMESTIC BANKS
DEPOSITS

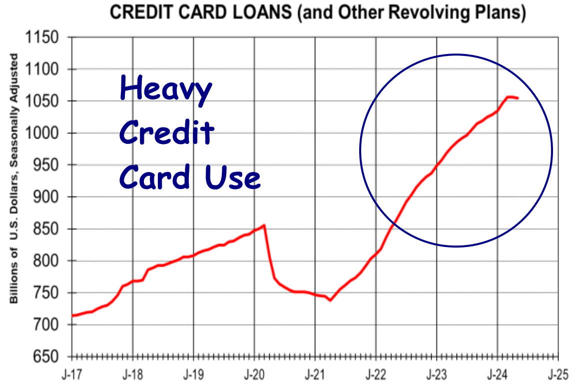
UNITED STATES
LARGE DOMESTIC BANKS
BUSINESS LOANS (Commercial & Industrial)



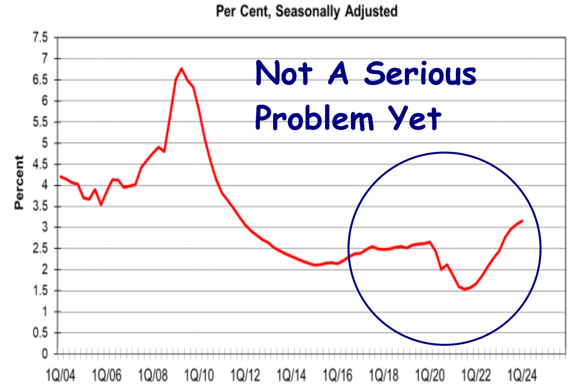
UNITED STATES
SMALL DOMESTIC BANKS
BUSINESS LOANS (Commercial & Industrial)



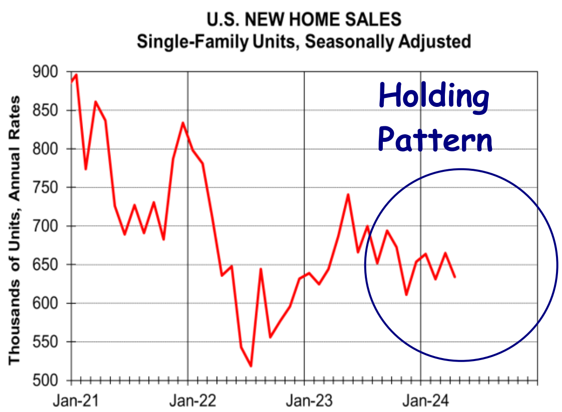
UNITED STATES
ALL DOMESTIC BANKS
CREDIT CARD LOANS (and Other Revolving Plans)

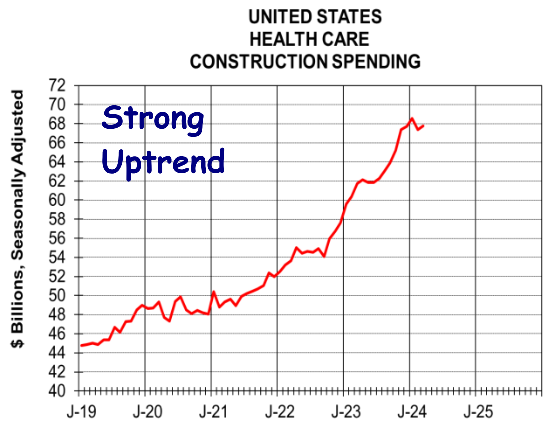


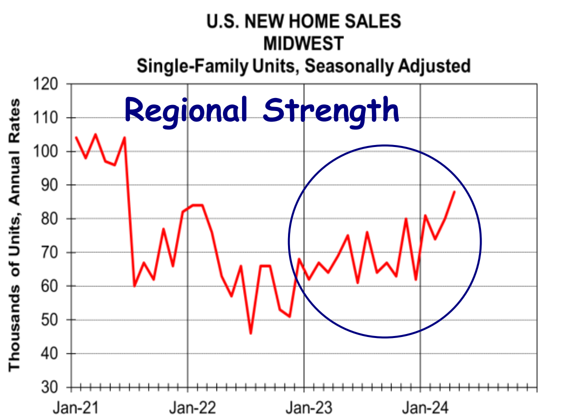
UNITED STATES
DELINQUENCY RATE - CREDIT CARD LOANS
Per Cent, Seasonally Adjusted

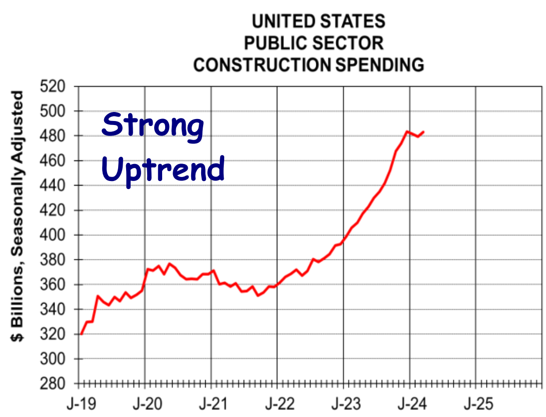


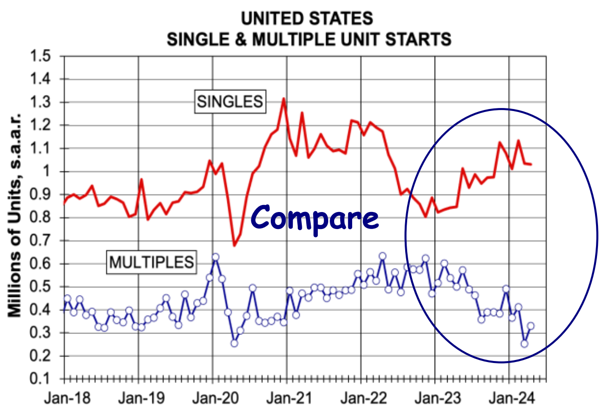
New home sales have been moving sideways since last fall. This is a shortfall from the boom in 2020 and 2021, but it is respectable. It is at the high end of the range seen over the years 2017 to 2019. New home sales are currently in a holding pattern. The next move, when it comes, will be up, not down. The underlying support for new housing is always employment. We will continue to have a fully-employed U.S. economy. As long as employment holds up, there will be housing demand. New home prices are reflecting strong demand. Median prices are up by 3.9% over the past year. More affordable homes now account for a greater share of new home sales. Builders are putting emphasis on sales volumes rather than margins. They are offering sizeable discounts and incentives. The chronic lack of supply in the resale housing market is pushing buyers into new housing. Over the first 4 months of this year, new home sales are up by 22%, from the same period a year ago, in both the Northeast and the Midwest. They are up by 14% in the West and down by 11% in the South. The charts below also show the remarkable surge in non-residential construction sectors.

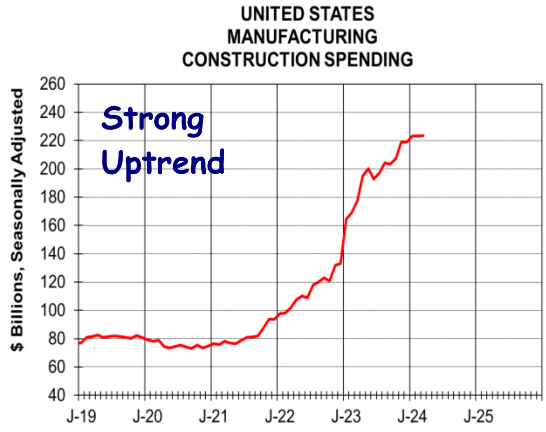












There are still inflation risks. The return to sustainable low inflation around 2.0% is an ambitious (and perhaps unrealistic) target. The era of low cost global supply chains is over. It is being replaced by lower risk and higher cost closer to home sourcing. In addition, wage inflation risk will remain as long as the U.S. economy stays at full employment. Food prices are running almost 30% higher than before the pandemic. This is what attracts the attention of people, not the latest month to month change. Workers have a legitimate reason to want to catch up. Hopes for lower wage inflation may be unrealistic. Wages and salaries for private industry workers in the U.S. are running 4.3% higher than a year ago. This is too high for a 2% inflation target. The price of gold, shown below, is an inflation warning. There is good news though. Important energy prices for industrial users (diesel fuel and natural gas) are down. In addition recent gains in office furniture prices are a positive indicator for commercial real estate.