

## Triumph of the Optimists

By Nicholas Riley, CFA, Investment Manager and Strategy Analyst

The key question for the US economy over the last two years has been whether inflation would fall closer to the 2% target without a recession. Widely referred to as a “soft landing”, historical precedent suggests it would have been very difficult to achieve.

Those on the pessimistic side of the argument expected inflation to become unanchored with a spiralling of higher wages and higher prices, and that a pronounced rise in unemployment would have been required to achieve the outcome. The more optimistic case centred around supply chains healing post pandemic which would have led to a normalisation of demand, helped by tighter monetary policy (higher interest rates).

From the perspective of financial markets, the debate is over and the optimists have won.

The inflation measure that the Federal Reserve targets is the Core Personal Consumption Expenditure index (Core PCE). Over the six months to the end of November, this measure of inflation rose at an annualised pace of just 1.9%. It is therefore unsurprising that the Federal Reserve has made a dovish pivot, indicating that they expect to cut interest rates later this year.

A very favourable trifecta of solid economic growth, falling inflation and a dovish central bank has been a powerful combination for financial markets across both bonds and equities.

However, a broader look at a range of inflation measures provides a more nuanced picture. At a basic headline level, year-over-year consumer prices (including food and energy) rose 3.4% to the end of December. Furthermore, a different “super-core” measure of inflation (core services CPI excluding housing), which the Federal Reserve themselves highlighted last year as an important measure of underlying inflation, has stopped falling and stabilised around 4%.

A mild recession was the consensus forecast this time last year, but growth estimates have been revised substantially higher. Estimates for growth in 2023 were revised from 0.3% to 2.4% and growth estimates for this year have been revised from 0.6% last summer to 1.3% now. To continue with the popular “landing” analogy, this raises the question of whether the US economy has landed at all.

The US economy may not have landed, but growth did slow substantially from the breakneck pace of 2021. Real final sales to domestic purchases (a good measure of underlying strength) was barely positive in late 2022. This is corroborated by a range of indicators across manufacturing, anecdotal news flow of company layoffs and a pickup in delinquencies for low income borrowers in the credit card and auto loan segments.

Reasons for the economic resilience have been widely covered. A savings cushion from the pandemic, a high percentage of fixed rate loans in the household and corporate sector and more support than expected from government spending have helped. Travel and leisure activities have also helped offset the slow down in housing and manufacturing.



Another supportive factor that has gone under the radar has been a productivity boom in the US energy sector. One of the lessons of 2022 when Russia invaded Ukraine was just how important energy prices are for growth and inflation. Impressive technological progress in drilling and extraction has boosted US energy such that production has surpassed the pre-pandemic high of 13.3m barrels per day. These efficiency gains have allowed production to rise even as the oil rig count has fallen and employment gains in the sector have been only 2% over the past year. Corporates are also making money, which was not always the case in the 2012-2015 cycle.

Consumer confidence numbers have now turned up decisively and there are signs that the US economy is not only resilient but reaccelerating. There is a risk that we see a second wave of inflationary pressure, which is what happened in the 1970s. Back then, this was due to an oil price shock, which remains a risk given the situation in the Middle East. Supply chains are also an inflationary risk due to disruption in shipping routes.

Bond markets appear to have gone too far in pricing cuts to interest rates over the coming 18 months. If these cuts are priced out (bond yields move higher) in an orderly way then equities and the economy will be able to adjust, but a disorderly sell off in bonds would prove to be a challenge.

The real path to a sustainable cycle from here is productivity. This would allow growth to pick up without reigniting inflationary pressure. With the US energy sector having a productivity boom, gains from technology spending made during the pandemic coming through and the impact of Artificial Intelligence yet to come, the signs are promising.

Geopolitical risks in a fractured world will continue to loom large and domestic political risks in the US will rise later this year. But overall, backing the optimists continues to be a good bet.

*Disclaimer: The views expressed are the opinions of the writer and whilst believed reliable may differ from the views of Butterfield Bank (Cayman) Limited. The Bank accepts no liability for errors or actions taken on the basis of this information.*