It's 2024 or Bust:

The Economy, the Fed, and Fiscal

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Key Takeaways

- The U.S. economy turned the corner in 2023: unemployment under 4%, strong growth, *and* big disinflation. But it remains a bumpy ride.

- The US recovery is stronger than its peer countries', especially Germany and the UK, likely due to differences in fiscal, rate- and energy-sensitivity.

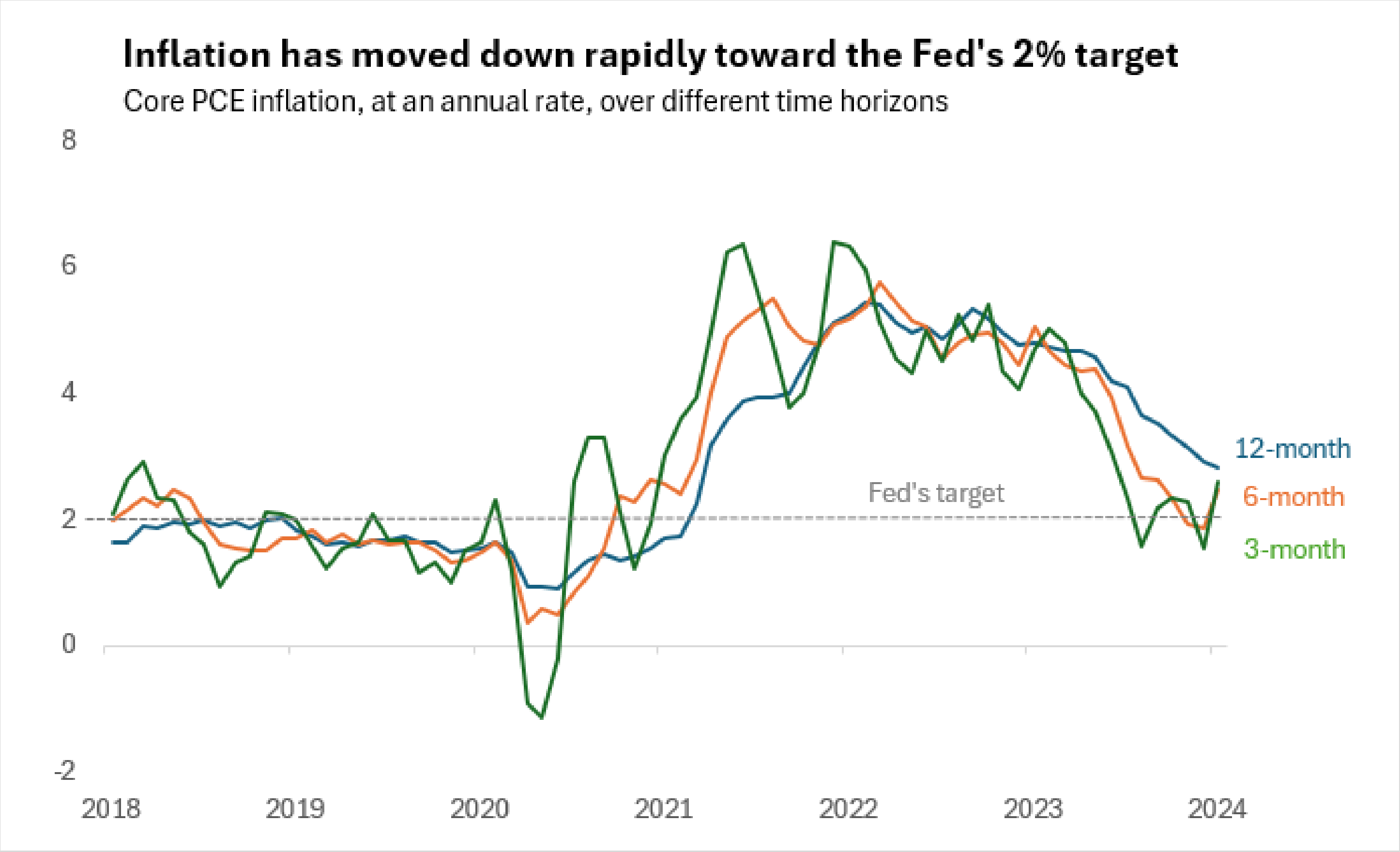
- The Fed will be very cautious with cuts this year, wanting more good inflation data, and an eye on the labor market. July is most likely first cut.

- The biggest risks: the Fed rattles markets even more, leading to something 'to break' or waits too long to diagnose a weakening of labor market.

US ECONOMY:
IN THE HOME STRETCH

Inflation is coming down more progress to come

The US economy is unwinding many Covid-related sources of inflation

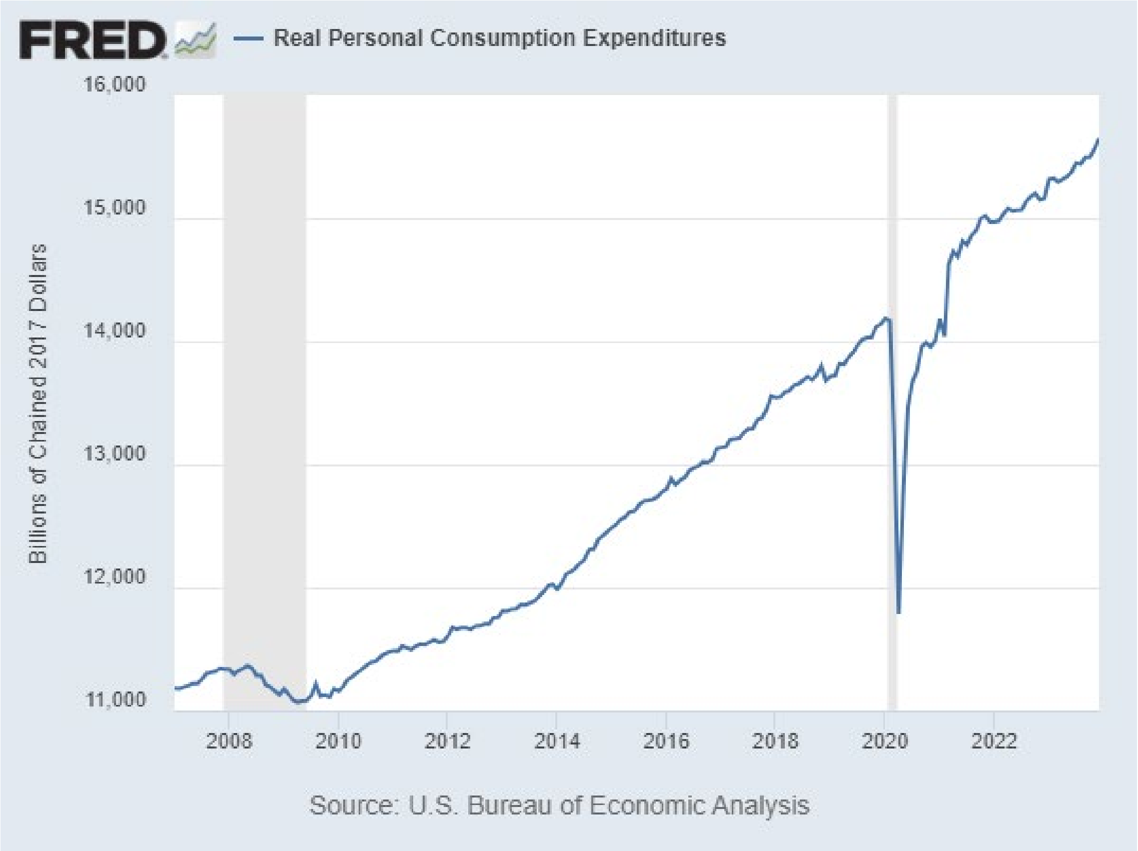


Source: Bureau of Economic Analysis. Chart by Claudia Sahm.

- The fight against inflation turned the corner in 2023 and 2024 is likely victory.
- Even so, January 2024 reminded us that every month won’t be a good month.

Resilience even with higher inflation and interest rates

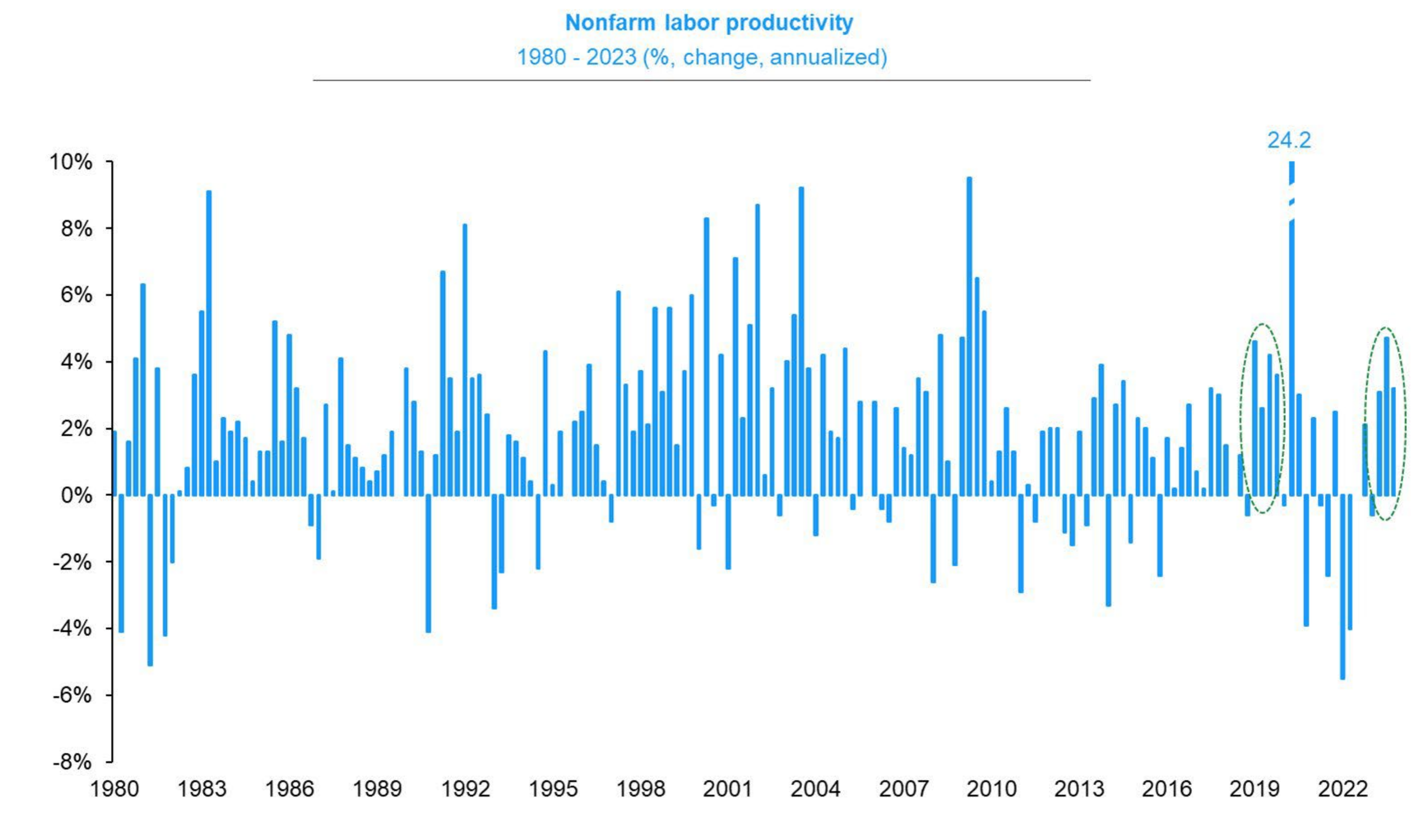
US family finances are in a better place than before the pandemic, despite higher inflation and interest rates.



- American consumer is spending, creating a virtuous cycle with labor market.
- Record-high increases in wealth relative to before the pandemic.

Soft landing is good; higher productivity is even better

Even a small pick up in long-term productivity growth would be a huge boost to economic prosperity.

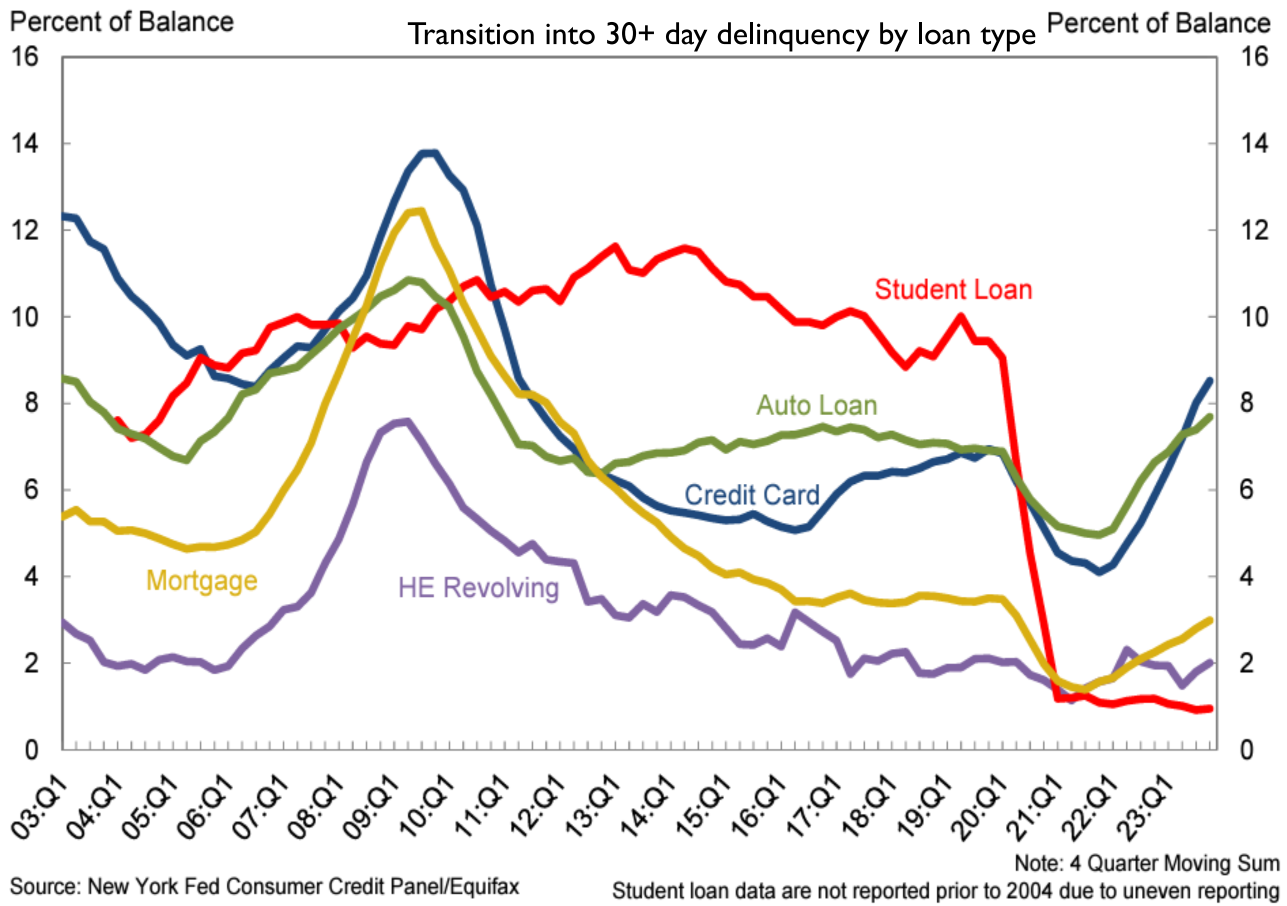


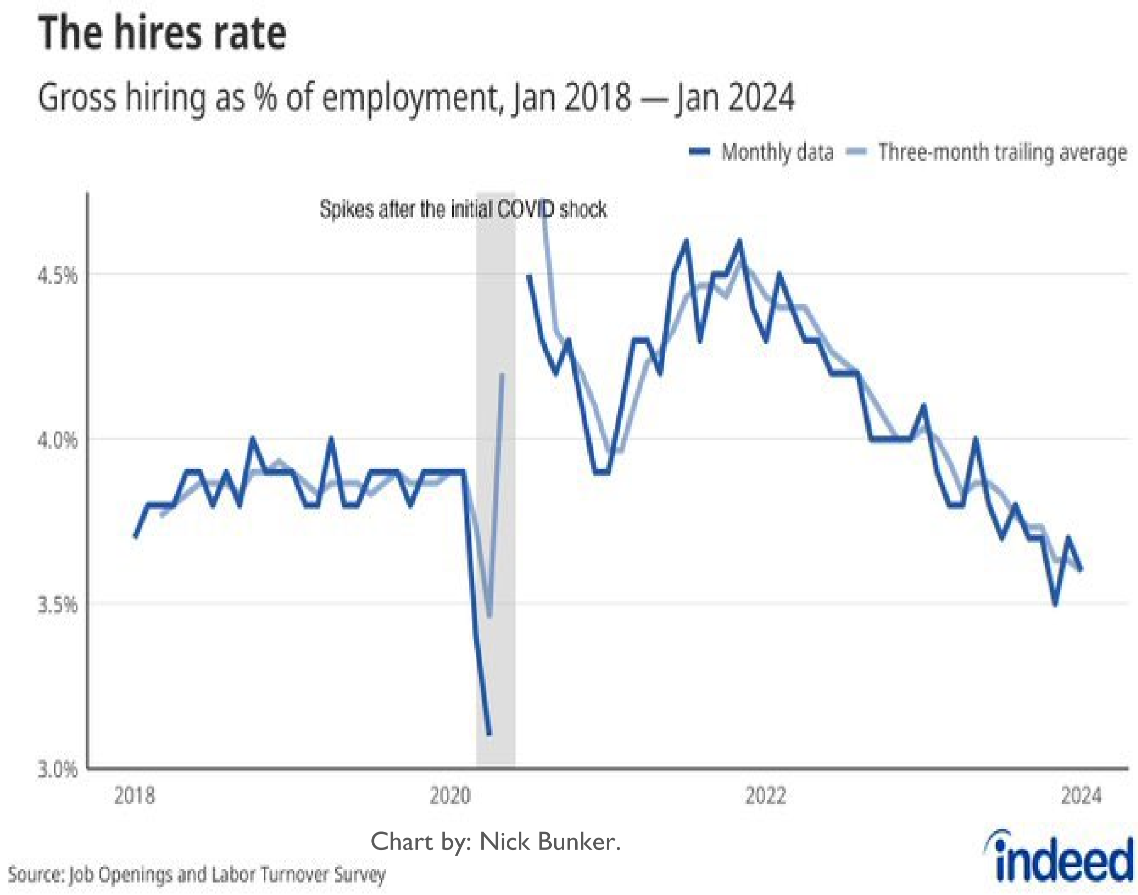
Source: BLS; EY-Parthenon [Greg Daco](#).

- Full employment economy, bringing millions of the sidelines, is a boost.
- Technologies like Work-From-Home and AI have potential for staying power.

Signs of stress among consumers and workers

Credit default rates are rising and hiring rates have moved down.



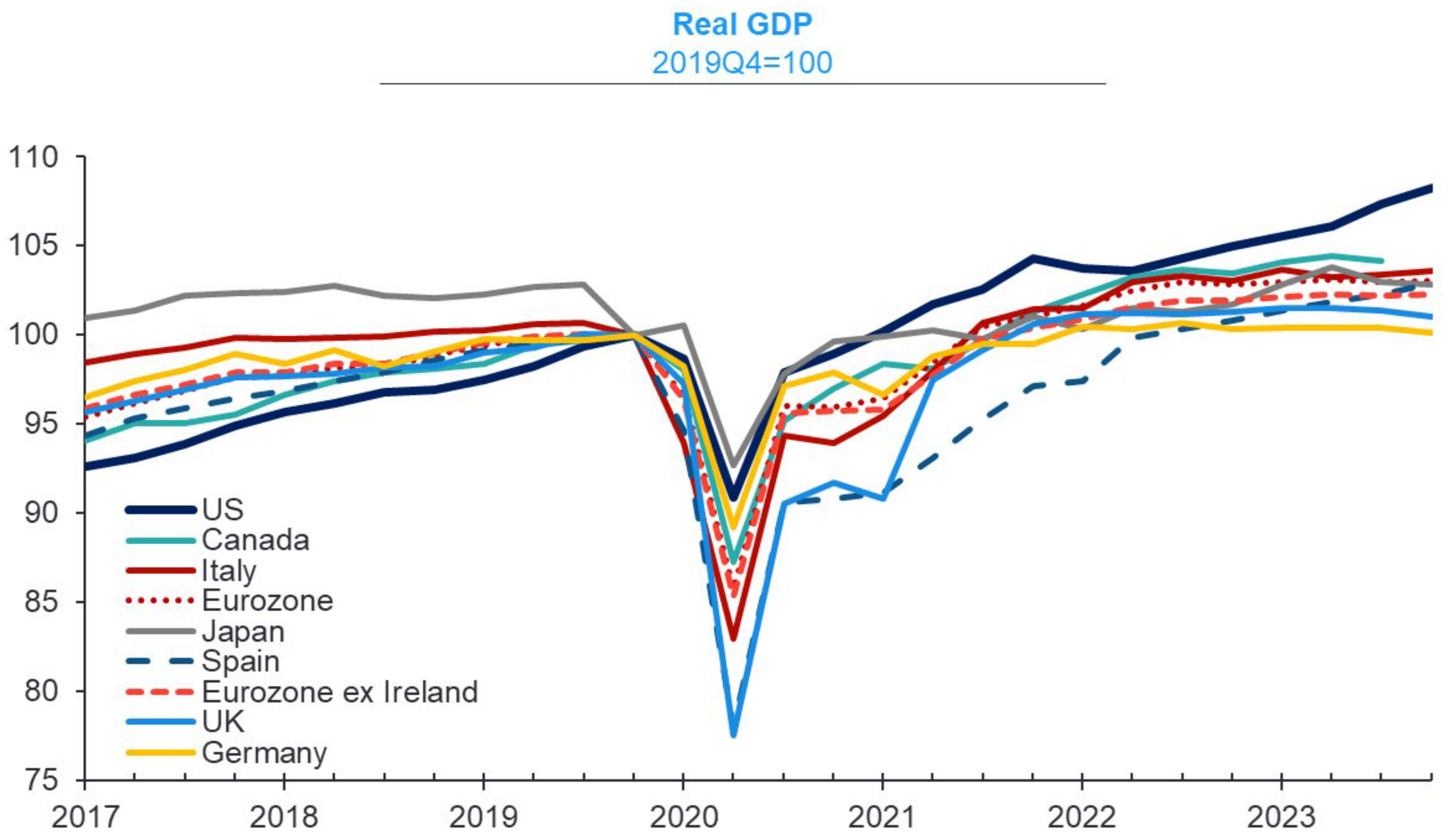


- Default rates on credit cards and auto loans above pre-pandemic levels.
- Rate of hiring is below pre-pandemic, though firing rate remains low.

GLOBAL ECONOMY:
STILL STRUGGLING

The US is the clear leader the recovery

GDP, inflation-adjusted, in US back on pre-Covid trend, while Germany, the UK, and Japan struggle.



Source: Haver Analytics; EY-Parthenon [Greg Daco](#).

- Some possible reasons: US fiscal stimulus larger, so consumers more resilient, higher productivity growth, less interest-rate and energy-price sensitive

Structural weaknesses before Covid playing a role

Covid and Putin amplified pre-existing problems in economies and policies.

Europe's Growth Engine Is Broken

Germany's economy shrank last year and new challenges point to more pain ahead Wall Street Journal.

Germany is stuck in a rut, and there is no quick way out.

The European powerhouse's economy, the largest on the continent and the world's fourth biggest, shrank last year, extending a six-year slump that is raising fears of deindustrialization and sapping support for governments across the region.

France tightens budget as economic growth slows Financial Times

Government pledges another €10bn in cuts due to lower than expected economic expansion

Brussels has recently struck a deal on reimposing revised fiscal rules that were suspended because of the pandemic and the war in Ukraine. Analysts expect France to be the least likely of the four biggest eurozone economies to meet the bloc's new annual targets for cutting public debt and limiting public spending.

UK Is 'On Track' for 4% Hit to Economy From Brexit, OBR Says

- OBR says UK 'on track' for 4% hit to potential productivity
- Brexit supporters have faulted BOE and OBR for pessimism

The Office for Budget Responsibility on Wednesday said its long-running prediction is "broadly on track" to show a 15% fall in trade and a 4% reduction in the UK economy's potential productivity compared to if the UK had stayed in the EU. Bloomberg.

- The world broadly shared in the shocks of the pandemic and Russia's invasion of Ukraine, but challenges in unwinding the disruptions vary considerably.

THE FED:
ITS "CONFIDENCE" GAME

More good inflation data to build confidence

- "We want to see more good data. It's not that the data aren't good enough. It's that there's really six months of data. We just want to see more good data along those lines. It doesn't need to be better than what we've seen, or even as good. It just needs to be good." Chair Powell

- Widely expressed sentiment that strong growth and labor market give the Fed a some 'luxury of time' to get confident of disinflation.

- As labor market tightness has eased and progress on inflation has continued, the risks to achieving our employment and inflation goals are moving into better balance.

- "The worst outcome, [Atlanta Fed President Bostic] said, would be for policymakers to lower rates and have to raise them again later if inflation moves higher."

The 1970s will continue to haunt the Fed

- No one wants to be Arthur Burns, who cut 'prematurely' in the 1970s.
- Complication of election year in US. Burns cut to help Nixon's reelection.

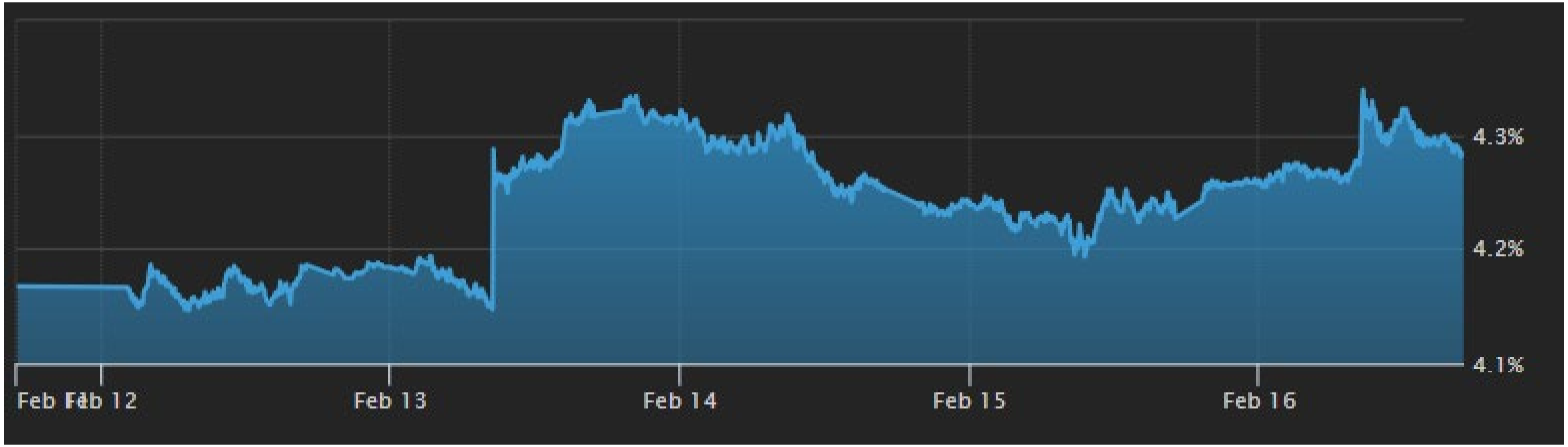
RISKS:

THE FED, THE FED, THE FED

Markets struggle to decipher the Fed's next move

Swings in market interest rates, stock market, and financial conditions create stress.

U.S. 10-Year Treasury Yields



Source. Wall Street Journal. (Feb 16, 2024).

- Fed's extreme data-driven approach makes markets sensitive to data releases.
- Fed 12th to 16th: CPI (high), retail sales (low), and PPI (high) swung yields.
- In contrast, San Francisco Fed President Mary Daly described that same week as leaving her views about inflation "unchanged."
- Volatility can stress markets, which have already been stressed.