STRATEGY FOCUS

United States: An atypical landing

- Besides being the world's leading economy, **the United States has also been one of the world's leading performers** in terms of GDP and GDP per head since the 2008 crisis.

- This outperformance, coupled with massive fiscal and monetary stimulus, helped the US economy bounce back fast after Covid. **The unprecedented nature of the crisis and speed of the subsequent rebound created disruptions and distortions which are taking time to work their way through, one notable effect being the leap in inflation.**

- Today, **economic policies are moving back toward normal and this should lead to a desirable slowdown in activity.** But some post-crisis disruptions and distortions persist, making it trickier to engineer a soft landing for the economy without prompting a recession.

- Besides these cyclical trends, recent years have made existing structural imbalances in the US economy worse, including inequality and external deficits. The effect may make the economy more vulnerable to a deeper recession. For all that, **companies' balance sheets and household finances look robust enough to limit the risks of a major crisis and we remain structurally bullish on the US economy and its financial markets.**

In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document
Unless otherwise specified, all statistics and figures in this report were taken from Bloomberg and Macrobond on 24/11/2022

SOCIETE GENERALE
Private Banking

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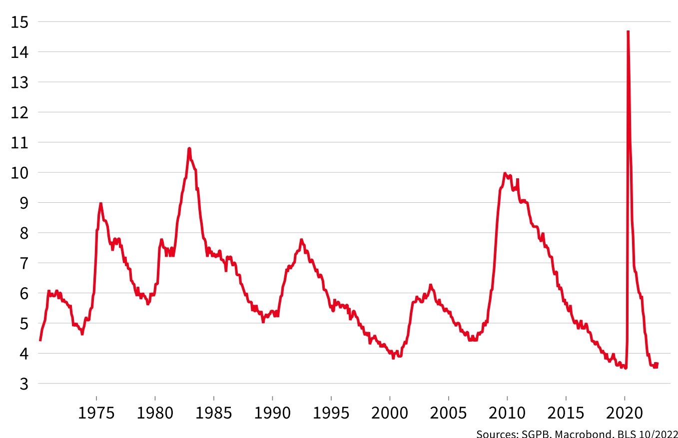
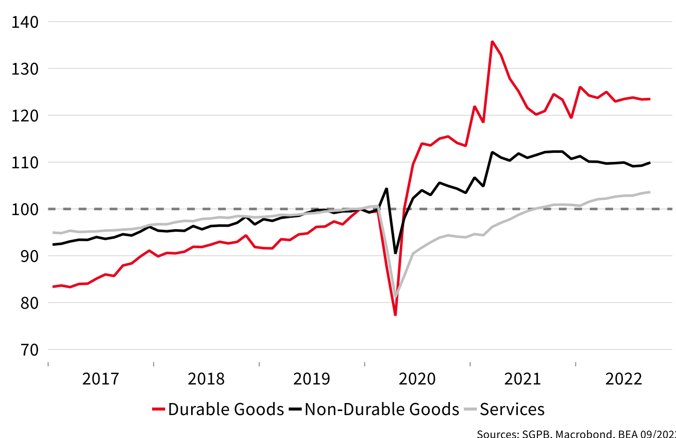
MANAGED SLOWDOWN IN GROWTH

Sharp post-Covid rebound The US economy bounced back sharply from the Covid crisis, helped by a highly expansionist mix of monetary and fiscal policy. After slumping during the pandemic, GDP surged back to its pre-Covid level within a year (compared to nearly 3 years following the Lehman crisis). This recovery came with an especially rapid rebound in the jobs market. Employment was back at its pre-Covid level within 2 years (compared to nearly 6 years post-Lehman) and unemployment is now running at an all-time low.

Post-Covid disruptions and distortions persist Hugely generous budgetary support for companies and households boosted their revenues during the critical phase of the Covid pandemic. The resulting surge in income, which Covid restrictions made hard to spend, had two effects: to significantly boost household savings (by around 12% of GDP) and to focus household consumption on buying goods, particularly durable goods. This excess demand for goods, one of the drivers of current inflation, continues to have a visible impact. The other big post-Covid disruption is the destabilisation of the American jobs market. Unlike in Europe, US companies shed workers wholesale during the pandemic and then rushed to rehire them once it was over. This particularity has two consequences, whose effects are still in evidence: some households, particularly people nearing retirement anyway, did not return to the labour market, and those who did came looking for wage rises.

A desirable slowdown in activity The US economy is starting to slow down from its post-Covid surge. Consensus forecasts put growth at just 0.4% in 2023 after 2% in 2022. The tail-off is being driven by a number of factors, including high inflation eroding spending power for families and, most notably, tighter monetary policies which are weighing on households and companies alike and hence, ultimately, the labour market. Consumption should drop substantially as a result. That said, there is still a large reservoir of savings out there and the labour market is only tightening slowly, which should allow a soft landing for consumer demand. Investment-side, the severe clampdown on financing conditions should continue to depress real estate investment and restrict corporate investment.



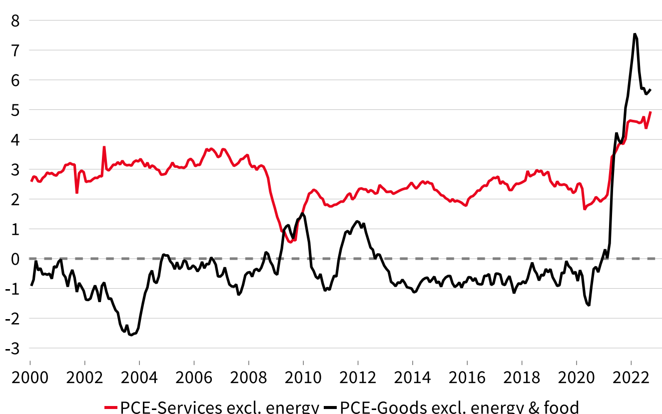


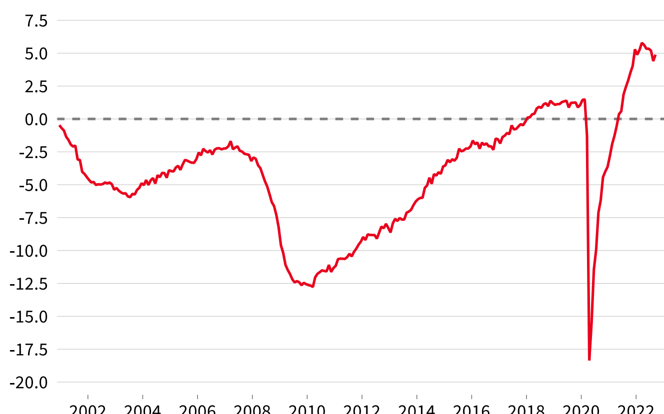
GRADUAL LANDING FOR INFLATION

Biggest inflationary surge in 40 years. The speed of the recovery brought with it a sharp leap in inflation, which touched 9% in June. At first, inflation reflected the pressure on goods prices as Covid aftershocks disrupted supply chains just as American household demand surged, an effect exacerbated by a global increase in commodity prices. In a second phase, however, price pressures spread out to the service sector. Partly, this can be explained by consumption of services returning to normal as the economy re-opened post-Covid, but it also reflected major pressures on salaries. The dynamics of the post-Covid labour market coupled with a lower participation rate than pre-pandemic tended to push up wages. Nominal salaries in the United states rose 6% on average in 2022, with the biggest rises focused on the lowest-paid and least -qualified jobs.

Latest figures show inflation has peaked… Inflationary pressure should ease over coming months. First, energy prices are projected to plateau or fall back slightly in 2023, which will automatically reduce annual inflation (as the base effect drops out). The fall in fuel prices has been one of the key factors in slowing inflation since September. Secondly, inflation should be helped by less pressure on the price of consumer goods as supply chains return to normal and demand eases. We are already seeing goods deflation in certain items such as cars.

…but getting back to the Fed's target will be a long haul. Unlike energy and goods prices, service price inflation will take some time to fall. The way service markets are structured makes them less flexible. Rent rises have been particularly steep, at nearly 7% compared to a 2% average pre-Covid, and will take time to come back down. Meanwhile, persistent imbalances in the jobs market will put upward pressure on wages and hence the cost of services. Note that the gap between labour demand and supply is at its highest since the 2000s. Unless there is a deep recession, the labour market will gradually move back to equilibrium and with it wage inflation. In these circumstances, we do not see inflation returning to the Fed target before 2024.





POLICY MIX STAYS RESTRICTIVE IN 2023

THE FED STILL WATCHFUL

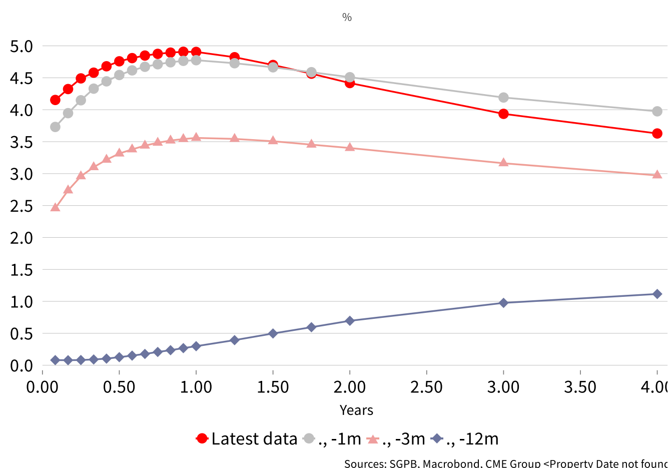
Hawkish u-turn early this year. At first, the Fed read inflation as a transitory phenomenon. But the acceleration of service prices and fears of a wage-price spiral ultimately drove it into a major policy shift. Now, since the start of the year, the Fed has hiked its Funds rate by 400 basis points and markets expect a further 100 bp tightening in coming months. At the same time, the Fed has been reducing its balance sheet (by USD 60 bn of Treasuries and USD 35 bn of MBS a month).

An atypical rate cycle. An odd feature of the current phase of monetary policy tightening is that despite its rapid pace, the slowing effect on the economy has been less evident that in previous cycles. Households have less debt and, crucially, little exposure to variable rates, which means they are better able to tolerate higher interest rates. Real estate investment is also lower as a share of GDP than in previous crises and there has been no phase of over-investment by corporates.

Radical change in tone. For many years the Fed was actively seeking to support the economy in a low inflation environment. Now that stance has been reversed. The current tone is deeply hawkish, stressing the determination to get underlying inflation back to 2% as soon as possible irrespective of the consequences for the economy and employment. In its policy and communications, the Fed is seeking to keep real rates positive across all maturities, including the very short term. This is now largely achieved. Treasury yields, deflated for inflationary expectations, are now positive. Looking ahead, we expect the Fed to keep hiking rates in coming months to a peak of 5% (upper bound) in Q1 2023. Thereafter, given our expectations that underlying inflation will be down to 3% by year-end, the Fed could start to ease policy by cutting rates at end-2023/start-2024. The subsequent decline in rates will be very gradual, with the Fed looking to keep policy rates above inflation.

US: OIS USD curve

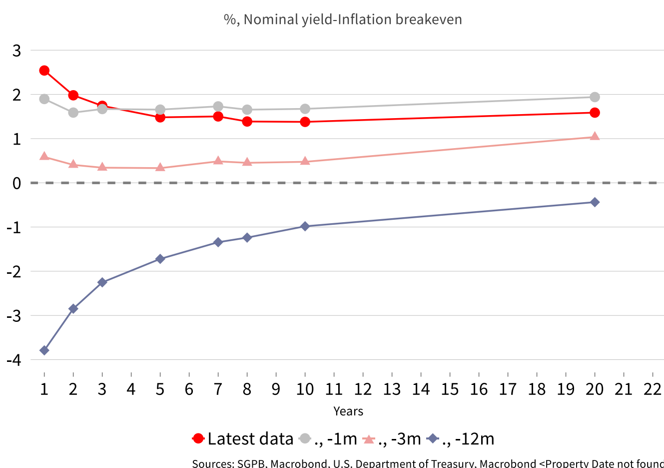
%



The curve represents the markets' expectations on the evolution of Fed Funds over a 4-year horizon. Thus, as of 11/23/2022 (latest data), the markets expect the Fed Funds rate to be 5% as of 11/23/2023 (1 year horizon).

US: Real sovereign yield curve

%, Nominal yield-Inflation breakeven



The curve represents the yields of US sovereign bonds at different maturities adjusted by the respective inflation hedge (estimated via US TIPS). Thus, as of 11/23/2022, the real yield of the bond with a 10-year maturity is 1.44%.

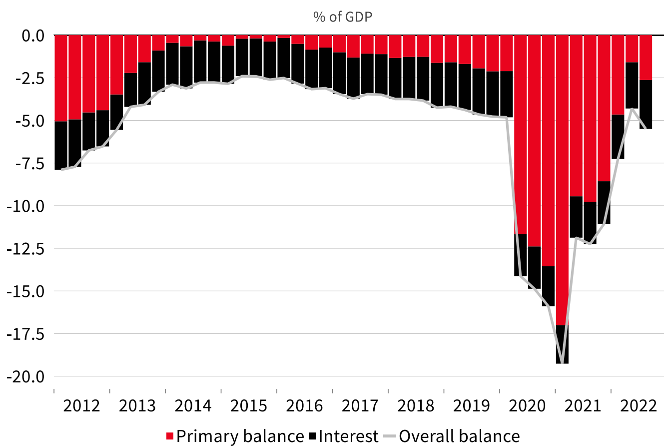
POLICY MIX STAYS RESTRICTIVE IN 2023

RESTRICTIVE FISCAL POLICY

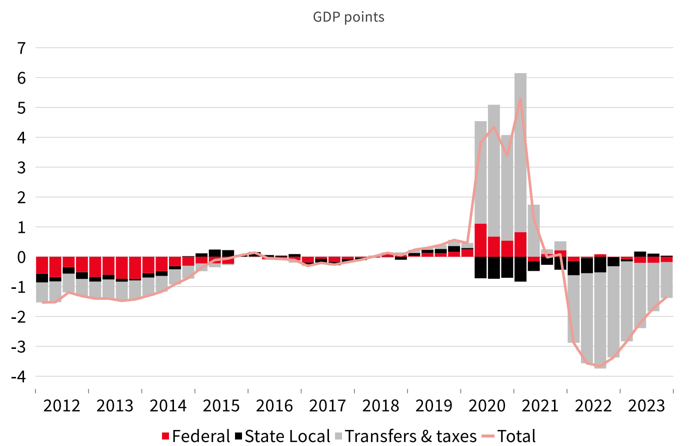
The United States government massively supported the economy during the Covid-19 crisis, with measures totalling 27% of GDP between 2020 and 2021. The main vehicles for these measures were social transfers, including mailing out cheques to families, extensions to unemployment benefits and non-repayable/guaranteed loans. The effect of such unprecedented largesse was to drive net growth in household incomes through the crisis while keeping company balance sheets healthy. It laid the ground for a fast and furious recovery post-Covid and contributed to the surge in inflation.

Back to normal from 2022. Fiscal policy has been quickly revised in 2022, as evidenced by the rapid adjustment to the government's budget deficit, which has fallen from 18% of GDP to 5% in less than a year. The speed of retrenchment mainly reflects the temporary nature of most Covid measures, including the cheque mailouts and unemployment benefit extensions, neither of which has been renewed. Another factor has been the strength of the recovery, with sharp nominal growth helping fill government coffers and narrow the deficit. Also, the United States economy has been much less hard hit by rise in energy prices than Europe, particularly in natural gas, of which the United States is a net exporter. The US government also released its strategic oil reserves to mitigate the rise in crude prices rather than resorting to subsidies or transfers. Overall, therefore, US public finances have been less badly damaged by the energy crisis than Europe's.

Fiscal policy to remain restrictive for the next few years. The Biden administration has successfully pushed through a number of budgetary packages, including the Infrastructure Investment and Jobs Act (IIJA) and Inflation Reduction Act (IRA), which legislate for increased investment and higher corporate taxation. The IIJA provides USD 550 bn over 10 years for new spending on infrastructure, funded by borrowing. The IRA earmarks USD 433 bn of spending for the energy transition, wholly funded by higher taxes on companies and higher-earning households. However, the Republicans took the lower chamber of Congress at the mid-term elections making it unlikely we will see any further big measures in the next two years.



Sources: SGPB, Macrobond, U.S. Department of Treasury, BEA 2022 Q3



Sources: SGPB, Macrobond, Hutchins Center on Fiscal & Monetary Policy 2024 Q3

SOUND FINANCES
HEALTHY HOUSEHOLD FINANCES…

Household finances as they go into this period of sharp economic slowdown and tighter financing conditions are, on the whole, pretty healthy. The sound state of family finances, with the potential to support consumer spending, is explained by several factors:

- **Household debt has fallen substantially since the 2008 financial crisis.** Having at one stage reached 130% of disposable income, household debt was down to 90% by the time Covid hit and subsequently edged up to 100% by Q3 2022. This deleveraging is mainly due to the reduction in real estate borrowing by households.

- **Most household mortgage debt is now fixed rate.** Nearly 90% of household real estate debt (70% of all household debt) is contracted at fixed rates, a sharp contrast with the situation pre-2008. Many households took advantage of the rock-bottom rates available in 2020-2021 to arrange or rearrange cheap mortgage deals with a long average maturity (20-30 years). As a result, unlike in previous crises, the sharp jump in Fed and mortgage rates now has less of an impact on household debt repayments. Its main effect is to freeze new projects but it has little effect on families which already have a loan in place.

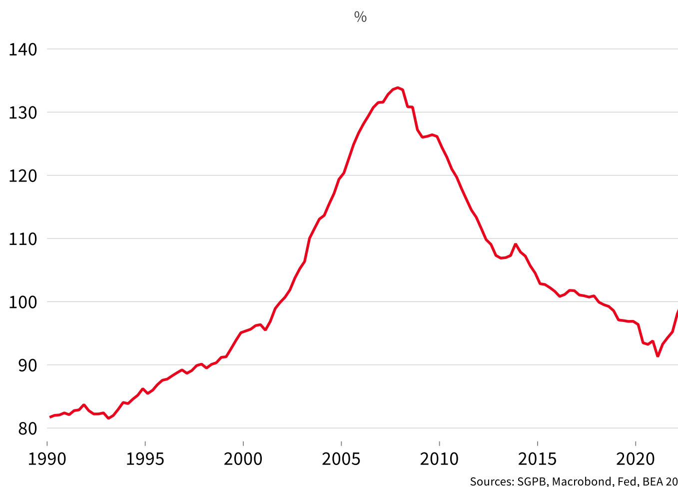
- **The home equity credit (loan backed by the value of property) is nearly irrelevant**. Households are unlikely to struggle to make their repayments even if property prices slump.

- **Still plentiful surplus savings**. Surplus savings, built up thanks to inflows of Covid transfers when consumption was restricted, totalled USD 2,300 bn at end-2021 and is currently reckoned to be USD 1,700 bn (7% of GDP).

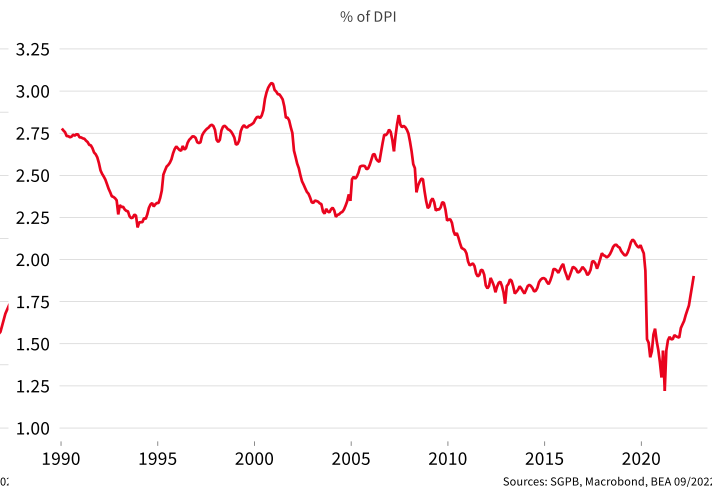
- **Nominal salaries still growing strongly** and faster than interest rates.

Overall, solid household finances should allow the US economy to avoid any overly harsh slowdown and will certainly give households a buffer against any new shock.

US: Households debt to DPI



US: Households interest payments



SOUND FINANCES
… AND ROBUST CORPORATE BALANCE SHEETS

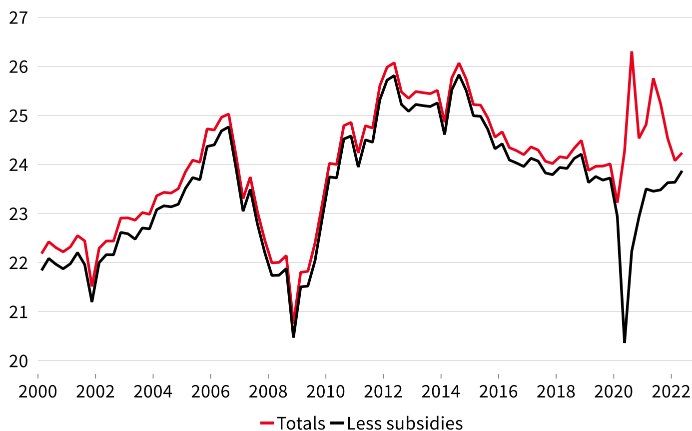
Like households, companies go into this phase of the cycle with more solid balance sheets than in the past, which should also limit the impact of tighter policy on corporate solvency.

- **Profits grew strongly in 2022**, helped by sharp nominal growth and robust growth in domestic demand. Margins remained generally stable.

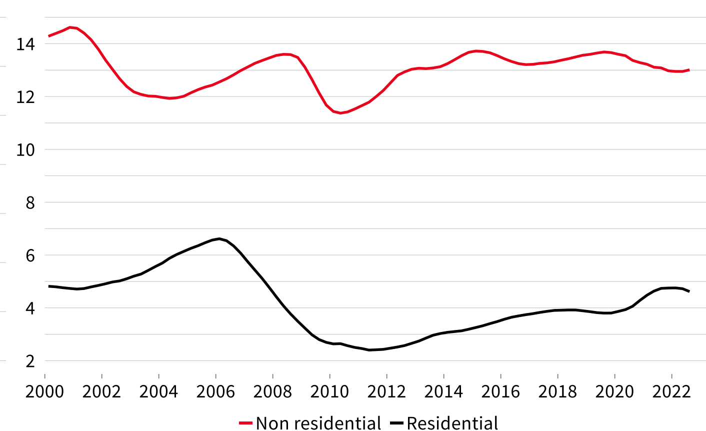
- **Cash rich.** At an aggregate level, companies still have substantial cash piles compared to their debt. Liquid assets at non-financial companies are 15% above their historical average. Many companies have taken advantage of the period of low interest rates and state-guaranteed loans to issue cheap debt, bolster their treasuries or buy back shares. In other words, as debt has not been used to fund investment, its repayment is less dependent on the economic cycle.

- **Past support packages and the policy of re-onshoring** will all help certain sectors, notably semi-conductors, renewable energy generation and some industrial sectors.

- **Real estate less important than in the past.** Residential investment has fallen significantly since the 2008 crisis, to 3.5% of GDP compared to 7% pre-Lehman. As a result, the sharp contraction in real estate investment prompted by the Fed's rate hike is taking less of a toll on the wider economy.



Sources: SGPB, Macrobond, BEA 2022 Q



Sources: SGPB, Macrobond, BEA 2022 Q3

FINANCIAL MARKETS REMAIN ATTRACTIVE

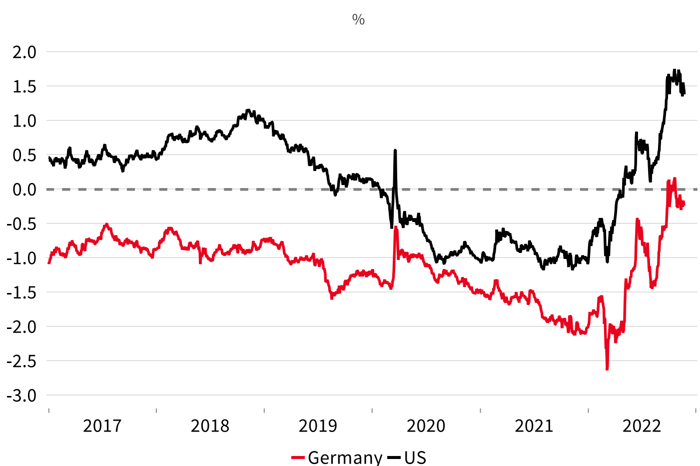
US assets are integral to any diversified international portfolio. US securities make up at least 60% of the main international equity, sovereign bond and corporate bond indices. Any neutral position on key international indices therefore implies major exposure to the United States market.

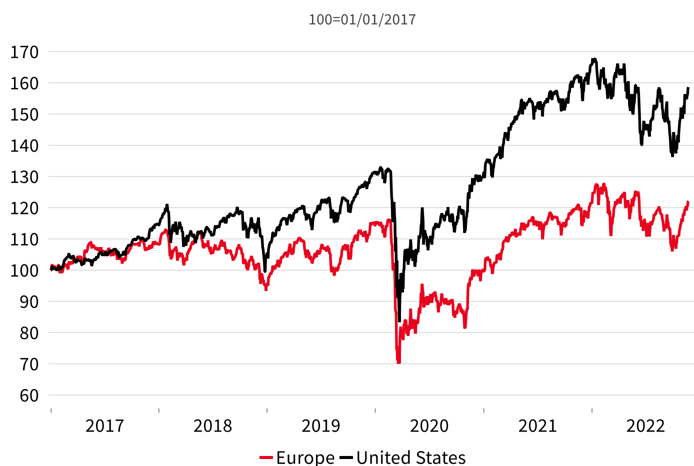
A relatively attractive cyclical outlook. The outlook for the United States may be somewhat gloomier over the coming year, but is still better than that for other financial markets. US growth is set to slow significantly. But Europe's economy is expected to enter recession with inflation running high. Emerging economies should experience modest growth as China continues to grapple with its problematic recovery. Political and energy risks in the United States will remain less acute than for other economies as the country is safely distanced from the Russian/Ukraine war and energy independent. On geopolitical tensions with China, the US economy and financial markets look less vulnerable to any tightening of trade sanctions.

Sectors with value. In equity markets, while the S&P500 is currently underperforming European indices to an extent rarely seen historically, this underperformance is mainly attributable to its heavy bias toward growth stocks - IT makes up 25% of the index - which are highly sensitive to real rates. However, looking at value stocks, the US index has actually outperformed its European peers over several years. Trend growth in the US economy remains more dynamic than Europe's and some sectors are less regulated.

Higher rates. Real interest rates have now turned positive in the United States and are higher than those in Europe. The real rate gap is one of the reasons behind the dollar's strength versus other leading developed currencies. This makes the US bond market more attractive in yield terms.

Dollar still strong. The dollar has made big gains in its main crosses this year: 5% against the CHF, 10% against the EUR, 12% against the CNY, 15% against the GBP and 22% against the JPY. Several factors have buoyed the greenback: the interest rate gap, the energy/political crisis boosting the dollar’s appeal as a safe haven, the rise in energy prices increasing demand for dollars. While much of the adjustment has now happened and the bulk of the interest rate rises is now also behind us, the other factors remain in play and should keep the dollar strong.





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