Economic Research Department 23 May 2024

Economic QuickView

The US Economy: Entering late-cycle with caution signs

Multiple red flags after years of outperformance. During the post-pandemic recovery since 2020, the US economy has proved resilient and outperformed many other advanced economies. Apart from growth, the US economy enjoys buoyant stock markets and full employment conditions. While high inflation has led the Federal Reserve (Fed) to take an aggressive monetary tightening stance, financial market participants generally expect the US economy to achieve a soft landing, an optimal outcome where inflation slows without triggering a recession, thereby allowing an orderly reduction of interest rates to their long-term neutral levels. While a soft landing remains a likely baseline scenario, there are multiple red flags that should not be ignored. Specifically, the US economy has demonstrated several distinct late-cycle signs, such as a period of above-potential growth, uneven and moderating growth momentum, weakening household financial conditions, a softening labour market, high stock valuations, high inflation and slower growth in corporate profits. Besides, fiscal buffers for countercyclical measures when a recession hits are also restrained after the rapid increase of public debt in recent years. Taken together, the risks for the US economy are continuously building up. In this report, we outline and analyse the challenges facing the US economy from the following perspectives:

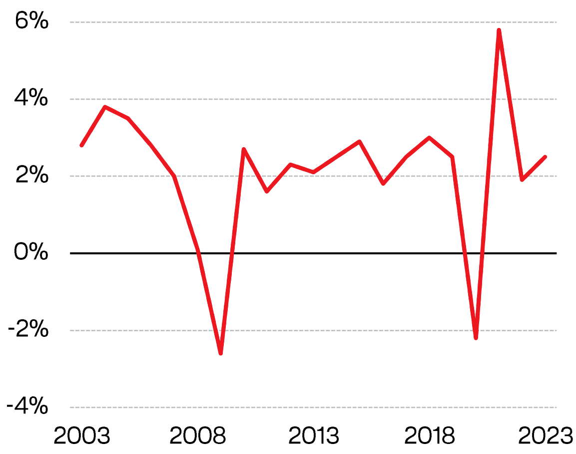
- An uneven recovery;
- Softening labour market conditions;
- Persistently high inflation; and
- Sharp increase in fiscal burden.

An uneven recovery raises concerns over US growth sustainability

The US post-pandemic outperformance has been spurred by various fiscal stimuli. The US economy has been expanding at a robust pace during the post-pandemic recovery. Based on the IMF's WEO database, the US economy grew at an average rate of 2.0% from 2019 to 2023, far higher than other G7 economies (0.2% to 1.2%). One of the major driving forces for the US's economic outperformance has been its elevated fiscal spending, with total government spending increasing to 31%, 30%, 25% and 23% of GDP during the fiscal years of 2019 to 2023, up from around 20-21% of GDP before the pandemic. Several notable spending programmes include direct cash payments to individuals, extended unemployment benefits, a suspension of student loan repayments and various incentives for green and infrastructure investment. In the fiscal year 2023, the US budget deficit stayed elevated at 6.3% of GDP, a level normally seen only during a recession. Such high levels of public spending are hardly sustainable and justifiable for a prolonged period, particularly as an increasingly higher share of Americans has shown worries about high public debts and high inflation.

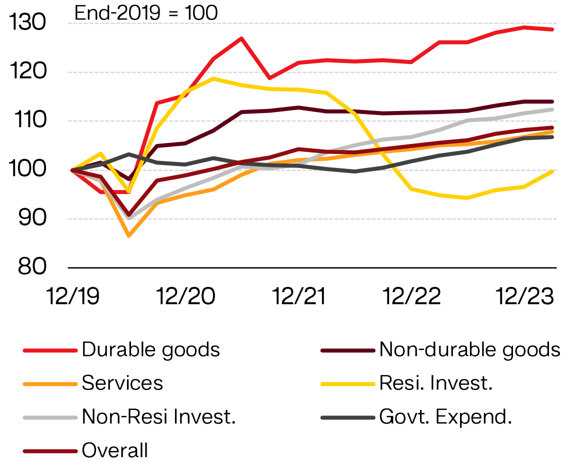
The recovery is fairly uneven across sectors. Among the major expenditure components, a visible diverging trend can be seen in the post-pandemic recovery. Goods consumption has been taking the lead. This reflected the boost from fiscal transfers, changing consumer behaviour, and solid employment conditions. Additionally, services consumption picked up after the broader economy reopened in mid-2021. On the contrary, residential investment underwent significant ups and downs due to the rapid change in the monetary environment as the fed funds rate spiked from 0%-0.25% to 5.25%-5.50% in around 16 months. Non-residential investment was less affected by monetary tightening amid a strong boost from artificial intelligence (AI)-related investment and the CHIPS and Science Act. As of Q1 2024, private consumption has stayed substantially above its trend level. However, it was largely driven by earlier fiscal stimuli, a tight labour market and strong financial market performance. Its increasingly stretched performance could suggest a high possibility of stalling or even retreating ahead. Meanwhile, residential investment has slowly picked up after an earlier correction, while non-residential investment is hinged on the technology cycle and the restrictive monetary environment. Overall, given the importance of private consumption in the US economy, any vulnerabilities in household finance, financial markets and job markets can have outsized impacts on the US economy.

US GDP growth



Source: Bloomberg

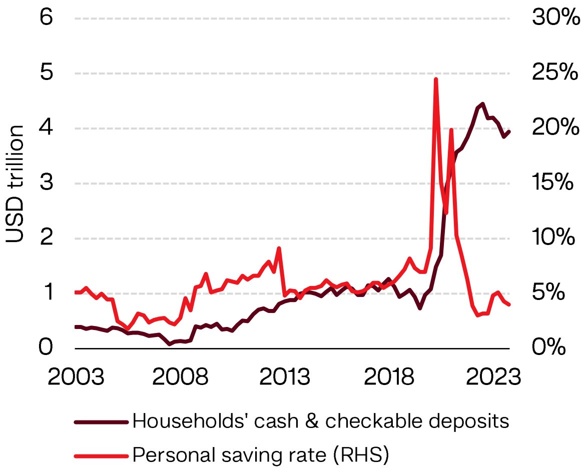
SAAR by expenditure components



Source: Bloomberg

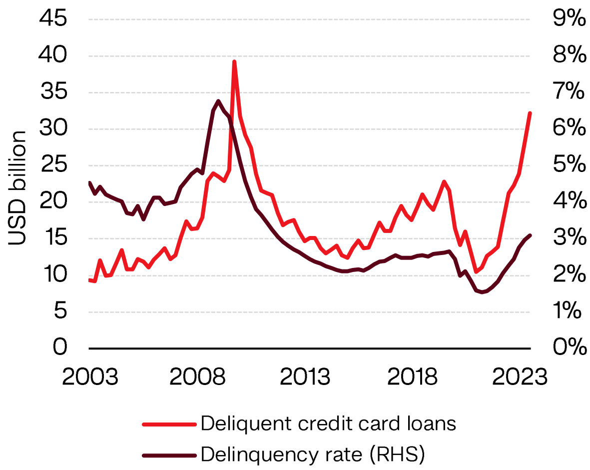
Resilient consumer spending looks set to moderate with lower saving rates and rising loan delinquencies. Excess savings were a major factor in enabling US households to maintain robust spending growth in the post-pandemic recovery. However, US consumers have not been saving as much as they previously did amid high inflation, high interest rates, and elevated spending. From January 2022 to March 2024, the US personal saving rate averaged 3.9%, far lower than that of about 6.0% before the pandemic. This implies that US households now have a smaller buffer to withstand future economic downturns, not to mention that the headline saving rate already masks the uneven financial situation across different household groups. In addition, the amount of households' cash and deposits peaked in Q1 2023, marking a turning point for their financial conditions. Specifically, low-income households could be facing greater financial difficulties as they tend to have fewer savings and more often use credit cards or personal loans to make ends meet. According to the US Fed, the average credit card interest rate surged from less than 15% in early 2022 to a record high of 21.6% as of February 2024, sharply raising the burden on credit card loans. The credit card delinquency rate also doubled, from around 1.5% in Q3 2021 to above 3% in late 2023. Together, these emerging trends suggest a rising possibility that consumer spending looks set to moderate in the future.

Saving rate and household liquidity



Source: Bloomberg

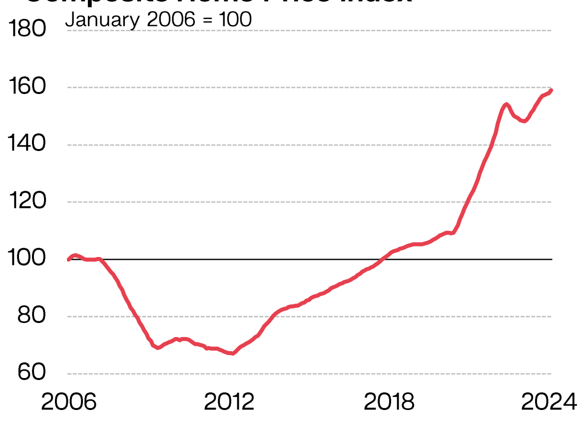
Delinquency of credit card loan



Source: Bloomberg

Residential properties have become increasingly unaffordable. The US residential property market has seen a solid increase in prices since the pandemic. Despite a rapid rate hike cycle, home prices in the US only had a brief consolidation from late 2022 to early 2023, and have resumed to grow again thereafter. As of February 2024, the S&P CoreLogic Case-Shiller 20-City Composite Home Price Index increased by 47% from the end of 2019. This makes the US one of the least affordable residential property markets among advanced economies. The sharp increase in home prices can be attributed to several supply and demand factors. First, the US has a limited inventory of housing supply after years of low levels of investment since the Global Financial Crisis (GFC) in 2008. Second, homeowners are reluctant to sell given the low fixed mortgage rates they have locked in, leading to insufficient listings with higher prices. Total housing inventory, which tracks the number of single-family and condo units available for sale, has been on a downtrend and slumped by around 70% since mid-2007. Third, there remains a strong demand for homeownership, given a low unemployment rate, a rise in work-from-home, and a strong rise in rental costs in previous years. While housing starts have already been rising, new supply is set to be ready after undergoing years of regulatory approval, planning, and construction. Worse still, the upcoming rate cuts by the Fed could invigorate another round of home price rallies before a potential increase in new and existing supply could help cool the market. All in all, a pricey housing market would eventually hurt consumer sentiment and even sow the seeds for an unsustainable housing bubble in the US.

S&P CoreLogic Case-Shiller 20-City Composite Home Price Index

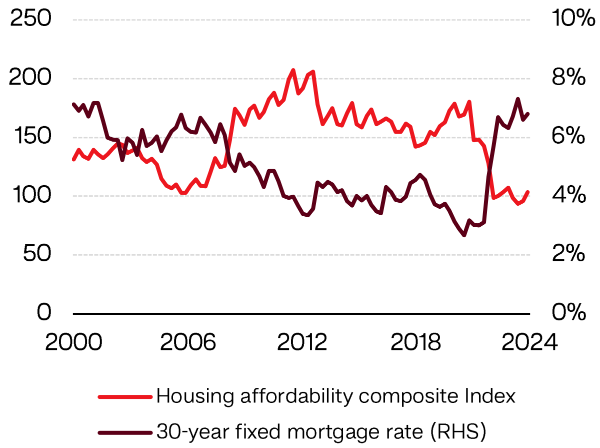


Source: Bloomberg

US existing homes sales and housing inventory

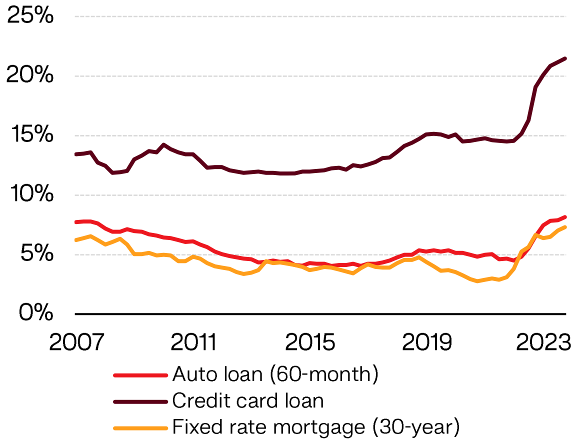
Source: Bloomberg

Housing affordability and 30-year fixed mortgage rate



Source: Bloomberg

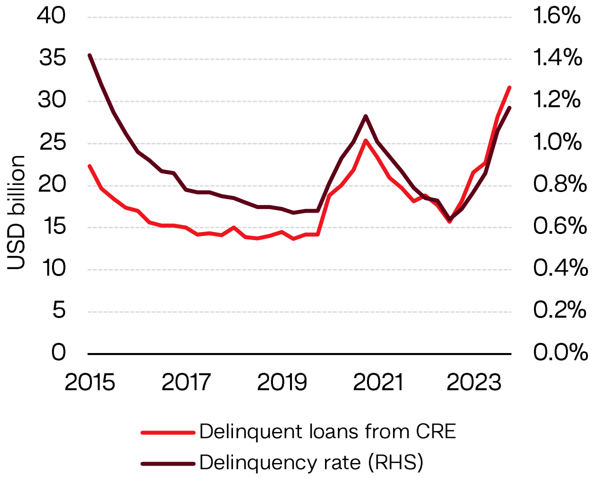
Interest rate charged on different type of loans



Source: Bloomberg

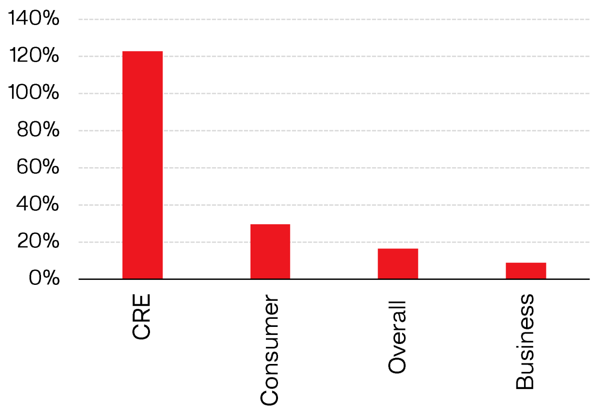
The commercial real estate (CRE) sector has been under stress with rising delinquencies and declining valuations. The demand dynamics for the CRE sector have witnessed a notable change as the COVID-19 pandemic led to the mass adoption of remote or hybrid working models. According to Colliers International, the average vacancy rate in US offices was 16.9% by the end of 2023, surpassing the prior peak of 16.3% seen at the height of the GFC in 2008. Moreover, the US CRE sector has taken a heavy toll due to a high interest rate environment. Tightened financial conditions amid higher interest rate expenses, declining property valuations and stricter refinancing criteria since 2022 have led to a notable increase in defaults on CRE loans. There were USD 32 billion of delinquent CRE loans in 2023, up by 123% compared to 2019, while overall delinquent loans merely increased by 16% during the same period. The performance of CRE assets was also subdued. Despite the strong rally in US stock markets, the S&P 500 office and retail REIT sub-indices are yet to return to their pre-COVID levels. As of the end of April 2024, they were down by approximately 15% and 50% from their levels at the end of 2019, respectively, whereas the S&P 500 surged by more than 50%. Data from the IMF estimated that US CRE prices recorded a drop of 7.5% in 2023, the largest decline since 2010. These underscored the financial pressures on the CRE sector. With persistently high inflation rates set to keep interest rates higher for longer, the outlook for the US CRE sector remains challenging.

Delinquency of CRE loans



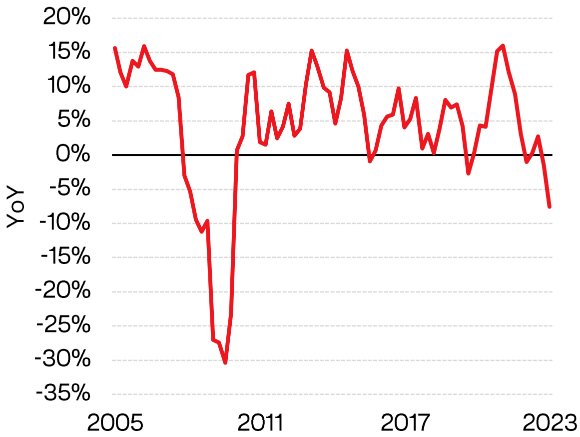
Source: CEIC

Change in deliquent loans from 2019-2023



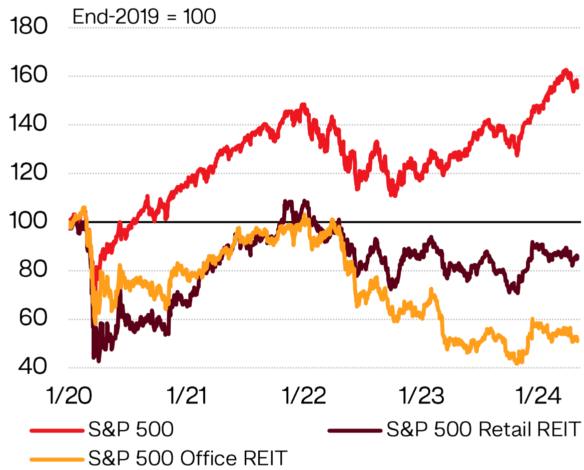
Source: Bloomberg

Change in CRE price



Source: International Monetary Fund

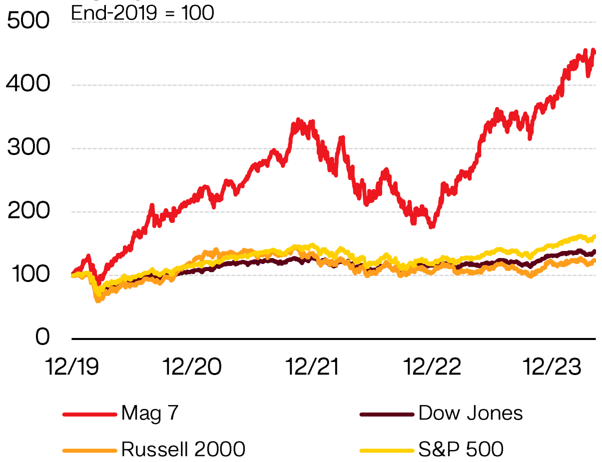
Commercial REITs performance



Source: Bloomberg

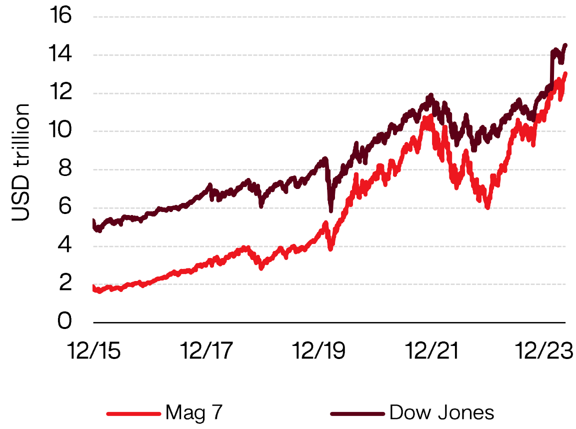
Stock markets have been heavily boosted by a few technological companies. While US stock indices excelled across the globe, a closer look showed that the majority of the gains were mainly fuelled by seven technology companies (namely, Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla, also known as the "Magnificent 7") due to investors' strong optimism over their dominant positions in AI and new technology development. Since 2020, the market capitalisation of the Magnificent 7 has been up by around 350%, compared to 62% and 38% increases for the Standard & Poor's 500 (S&P 500) and Dow Jones Industrial Average (DJIA), respectively. With the high trailing price-to-earnings ratio of 41x for the Magnificent 7, the market is currently pricing in significant earnings growth potential. The dominance of the Magnificent 7 not only indicates a narrower base of strong stock market performance, but that its volatility could also be driven by the same set of common factors or optimism.

US equity indices



Source: Bloomberg

Market capitalisation of Mag 7 and DJIA

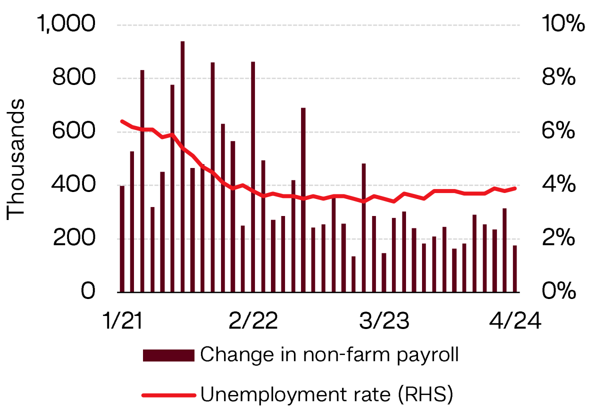


Source: Bloomberg

Tight labour market conditions show signs of softening

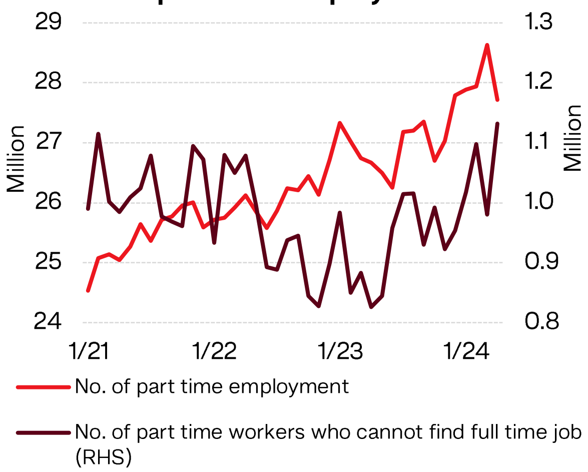
Slowly moderating headline labour market indicators after years of robust recovery. The tight labour market is one of the bright spots in the post-pandemic recovery, as the unemployment rate quickly returned and has continuously stayed near the full employment level of below 4% since late 2021. The monthly average of newly added non-farm payrolls reached 394,000 between January 2021 and April 2024. Tight labour market conditions have resulted in a notable increase in wage growth, with the annualised average hourly earnings increasing by 4.6% between January 2021 and April 2024, far exceeding the level that is consistent with the Fed's 2% policy target over time. Against this background and soaring inflation, the Fed has sharply raised rates since March 2022. The restrictive monetary environment has also gradually resulted in a moderation of the labour market, with the unemployment rate edging higher from a cyclical low of 3.4% in April 2023 to 3.9% in April 2024, the monthly average of newly added non-farm payrolls moderating to 246,000 in the first four months of 2024 and the hourly earnings growth decelerating to 3.9% year-on-year (YoY) in April 2024.

Change in non-farm payroll and unemployment rate



Source: Bloomberg

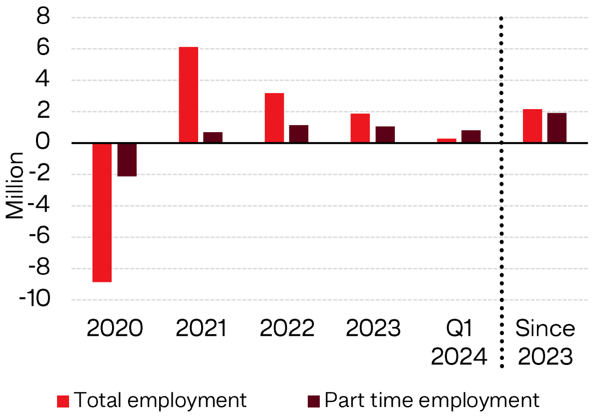
Number of part time employment



Source: Bloomberg

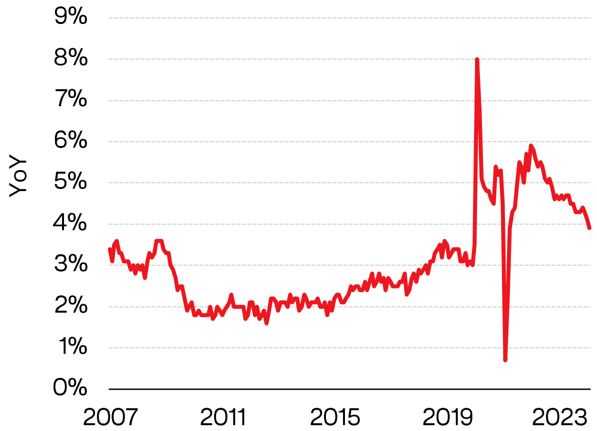
Deteriorating quality in new job creations. Despite relatively robust labour market conditions, the latest job creations were not coming from those of high quality, with most of the recent employment gains being attributed to part-time employment, which refers to those jobs that require less than 35 working hours per week. Since 2023, total employed persons have increased by 2.16 million, of which 1.92 million were employed part-time. At the same time, there has been a gradual rise in part-time workers who cannot find full-time jobs. This revealed that the labour market may not be as robust as the headline figures suggest.

Change in total and part time employment



Source: Bloomberg

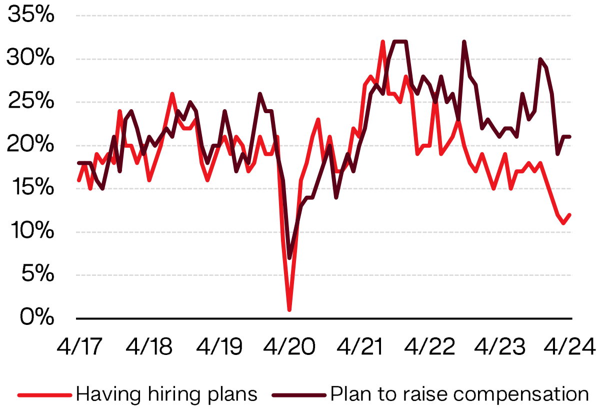
Change in average hourly earnings



Source: Bloomberg

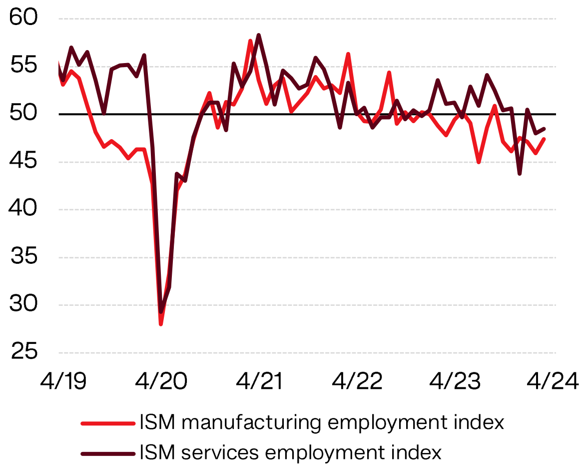
Business surveys pointed to lower hiring intentions in the private sector. Hiring plans among US small businesses have scaled back notably since 2023. According to the National Federation of Independent Business's surveys in April 2024, only 12% of small business owners planned to increase new jobs in the upcoming 3 months, indicating that small business owners are rather cautious about adding workers. Similarly, large corporations also showed fading demand for workers. Both the employment sub-indices in the manufacturing and services ISM reports have been mostly in contraction since the beginning of 2024, implying a contraction in labour demand. The Job Openings and Labour Turnover Survey (JOLTS) report showed that total nonfarm job openings continued their downtrend from a peak of 12.2 million in March 2022 to a still-above pre-pandemic level of 8.49 million in March 2024. Similarly, job postings on Indeed also pointed to a further decline in vacancies in early May. All the above indicators showed lower hiring intentions by the private sector, which could result in slower job growth and softening labour market conditions in the future.

% of small businesses having plans to hire or raise compensation



Source: Bloomberg

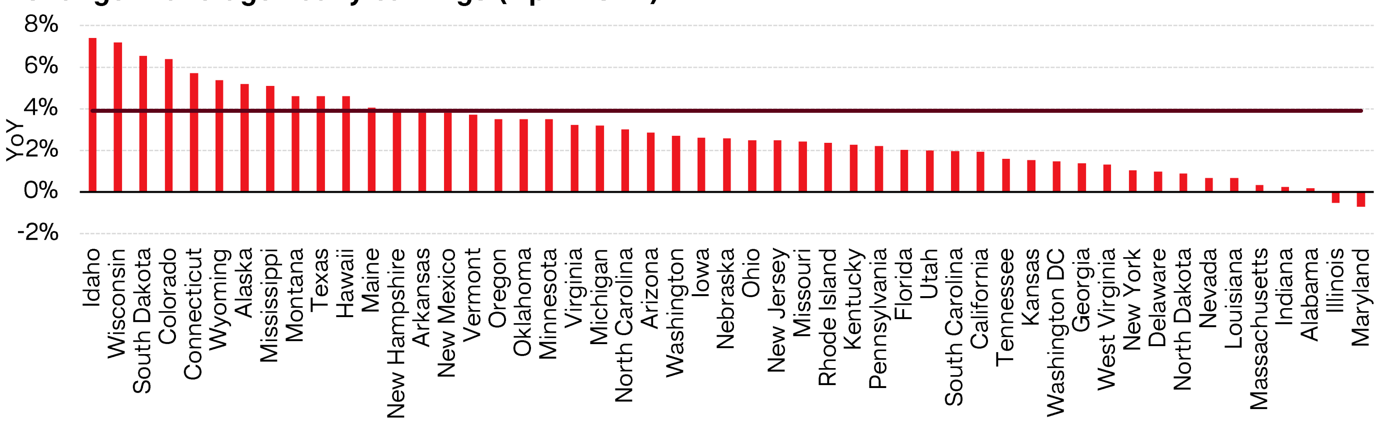
ISM PMI employment index



Source: CEIC

Labour market conditions varied notably across states. In terms of the unemployment situation, as many as 16 states had their unemployment rates at 4% or above in April 2024, while 15 states were reporting the same at below 3%. Likewise, 8 states reported at least 5% YoY growth in average hourly earnings, while another 19 states reported at or below 2% growth. All these metrics indicated that the US labour market is fairly diverse, with visible disparities across states. Differences in minimum wages, tax rates, industrial structure, and population growth are among the factors accounting for such diverse performance. For instance, tech layoffs had a significant impact on California, while Hawaii, Florida, and Nevada experienced a resurgence in tourism after the pandemic. Nevertheless, the regional unevenness could create imbalances in the overall economic landscape and pose challenges for policymakers to specifically address their economic situations.

Change in average hourly earnings (April 2024)



Source: Bloomberg

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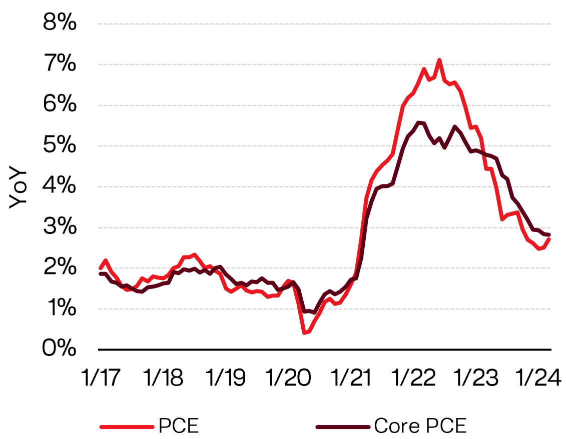
Profound implications from persistently high inflation

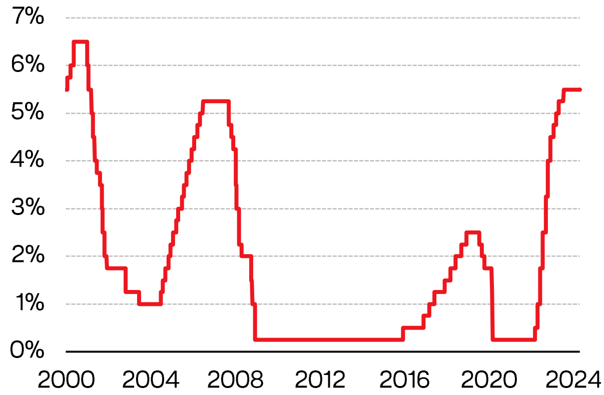
The cost-of-living crisis has caused significant financial hardship. Notwithstanding the strong recovery, the US has suffered from the worst inflation crisis in recent decades. Core personal consumption expenditures (PCE) inflation has been running above the Fed's 2% policy target for more than 3 years. A continued rise in the prices of various goods and services has significantly eroded purchasing power and real income, resulting in a reduction in the standard of living for many US households. It explained why consumer confidence in the US, as measured by both the University of Michigan Consumer Sentiment Index and the Confidence Board Consumer Confidence Index, has been below its pre-pandemic levels even amid a tight labour market and record-high stock markets.

US PCE inflation



Source: Bloomberg

US Fed funds rate (Upper-bound)



Source: Bloomberg

Disinflation progress has been slowing despite aggressive monetary tightening. In order to control multi-decade-high inflation, the Fed has adopted a restrictive monetary policy stance by raising interest rates and lowering its holdings of debt securities. Remarkable progress in the slowdown of inflation was seen from 2022 to 2023. That said, disinflation progress has been slowing or even stalling since 2024. Particularly, demand is now playing a greater role than supply in driving price gains, meaning that underlying price pressures would make inflation stickier and cause it to take a longer period of time to return to the Fed's 2% policy target. Besides, global commodity prices are surging again, which would pose more upside risks for future inflation trends and raise inflation expectations. In connection with this, even if the Fed is set to begin cutting rates in 2H 2024, interest rates are likely to come down gradually and stay notably higher than they were before the pandemic for a longer period.

The similarities between the Great Inflation of the 1970s and today's inflation sound the alarm. The Great Inflation was a period of persistently high inflation caused by a combination of expansionary fiscal policies and rising oil prices, which resulted in a second wave of resurging inflation that forced the Fed to hike interest rates again and dragged the economy into a severe recession. Today's economic backdrop shares many similarities with the situation in the 1970s, featuring high public spending, solid demand, geopolitical risks, supply-chain disruptions and rising commodity prices. At present, the US economy appears to be relatively immune from monetary tightening, but such resilience will be hit hard if the Fed is forced to maintain a prolonged period of high interest rates or raise rates again under a scenario of resurging inflation.

A sharp rise in the US fiscal burden

Sizeable public debts with high interest rates are doubling up the US fiscal burden. As mentioned previously, the US post-pandemic outperformance has been spurred by various fiscal stimuli, with the fiscal deficit to GDP ratio amounting to 6%-15% between fiscal years 2020 and 2023, leading to a sharp rise in federal debts held by the public from USD 16.8 trillion in 2019 to USD 26.2 trillion in 2023. Amid rising federal debt burdens and interest rate levels, the Congressional Budget Office (CBO) released its updated projections for the federal budgets in February 2024, which saw interest costs skyrocketing progressively by 147% from USD 0.7 trillion in 2023 to USD 1.6 trillion in 2034. In fiscal year 2024, interest costs are estimated to surpass defence as one of the major government expenses. Besides, federal debt held by the public is projected to increase by 84% from USD 26 trillion in 2023 to USD 48 trillion by 2034, raising the ratio of public debt to GDP from 97% to 116%. The rise in interest costs and debt levels reflects the lasting impact of its loose fiscal policy and rising policy rates in the ongoing monetary tightening cycle. The CBO also projects corporate profits to grow more slowly relative to GDP from 2024-2027 due to high interest costs.

Rising public debts could be a potential source of instability. In the future, the continuous rise of US debt could pose serious threats to economic growth and financial market stability due to more volatile bond yields, heightened risks for sovereign credit rating downgrades and crowding-out effects on other essential public spending. Besides, the fiscal room to implement further expansionary policies will be greatly reduced, leaving the US government with limited tools to support the economy in future recessions. Furthermore, no matter who wins the upcoming Presidential election, tighter control on fiscal spending or tax hike plans to boost public revenues will be needed in order to bring back a better balance of public finance. However, either solution is likely to weaken economic growth ahead.

Fiscal budget projections

Congressional Budget Office Projections (USD billions)	2023 actual	2024	2025	2026	2027	2034
Net-interest costs	659	870	951	1,005	1,049	1,628
Debt held by the public	26,240	27,897	29,749	31,515	33,233	48,300
Domestic corporate profits annual average as a percentage of GDP	9.9% (Estimate)	9.7%	9.6%	9.4%	9.2%	9.0%
Debt held by the public as a percentage of GDP by period-end **(1974-2023 average: 48.3%)**	97.3%	99.0%	101.7%	103.3%	104.7%	116.0%

Source: Congressional Budget Office

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Economic Research Department

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