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Research US

Could investment boom pave the way for a soft landing?

- **The US economy's early 2023 has been characterized by a 'goldilocks' combination of inflation surprising to the downside, and even more so by growth holding up much better than anticipated**
- **In this paper, we discuss the case for how the US economy could achieve a soft landing, with key focus on the recent stimulus-driven boom in both public and private investments, and on the implications for longer-term productivity.**

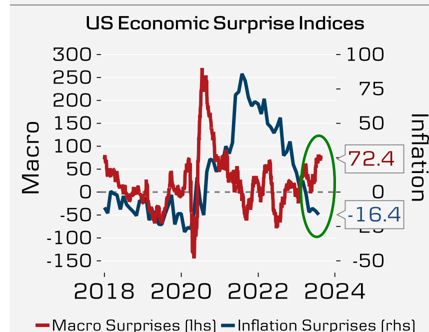
US inflation has cooled promisingly, with core readings below 0.2% in June and July, but as this partly reflects deflation in core goods prices, the Fed remains worried about inflation bouncing back, once the goods price normalization fades towards next year.

Tight labour markets remain the main headache for the policymakers, as nominal wage growth remains uncomfortably high around 4-5% annualized pace. **We focus on the recent surge in investments as a potential driver of higher productivity, which could help cool the rise in unit labour costs, even if nominal wage growth remains elevated.**

The conventional rule of thumb suggests, that if productivity growth remains around its pre-pandemic average (1.1%), wage growth of just above 3% would be consistent with 2% inflation. In order for inflation to come sustainably lower, either 1) the labour markets have to cool further and bring wage inflation lower or 2) productivity growth needs to pick up, which could allow companies to hike wages over 3% annually without the explicit need to pass rising labour costs onto consumer prices.

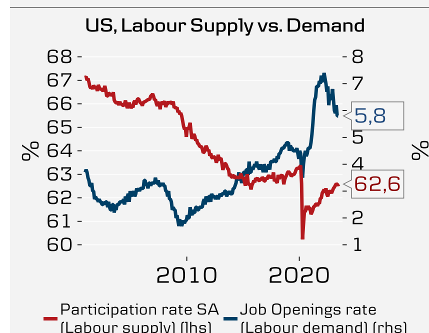
We have for long argued that the scenario 1 is the more likely one. **For now, labour demand (measured as job vacancies) and supply (labour force participation) have gradually converged towards normality, but still remain some way from pre-covid equilibrium**. Thus we remain sceptical that wage inflation could cool sufficiently without further decline in activity. However, the latest leading data indicators do not point towards a sharp weakening, and financial conditions impulse on growth does not suggest a clear downturn is in the cards either.

2023 has been so far characterized by easing recession fears



Source: Macrobond Financial

Labour demand and supply converging, but still some way from equilibrium



Source: Macrobond Financial, U. S. Bureau of Labor Statistics

Investment boom emerges

Hence we take a look at the scenario 2. For most of the pandemic period, growth momentum was largely driven by strong consumption, as investments were first weighed down by pandemic-related uncertainty and then by rising interest rates. This is still the case for example for residential investments, as mortgage rates remain high for now.

But the current upbeat consumption relies on an unstable foundation of too elevated nominal wage growth and likely some excess savings still remaining from the pandemic. This has been a key assumption for our more pessimistic growth forecasts. **Yet in contrast to 2022, the Q2 upside surprise was driven by an uptick in investments**, namely public state & local investments and private non-residential investments.

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The former reflects fiscal subsidies from the 2021 Infrastructure Investments and Jobs Act, directed at renovating public infrastructure, which the CBO estimated would increase public deficit by a total of 256 billion USD over the coming decade. The latter is driven by investment into high-tech production facilities, related to the ongoing shortage of semiconductors and geopolitical tensions (see for example *analysis by U. S. Treasury*). This was further boosted by the last years' Chips and Science act, which includes USD52.7bn of investment support for semiconductor manufacturing, as well as the Inflation Reduction Act, which includes USD216bn of tax credits to fuel corporate investment.

From a macro perspective, the rapid uptick in investments supports the idea of a soft landing even if consumption growth falters towards 2024. In contrast to the support measures targeted at protecting consumption (which, in retrospect, contributed to fuelling inflation), investment support can help ease inflation by increasing the economy's productive capacity and by lifting productivity. A key feature of Yellen's 'Modern Supply-Side Economics policy framework' (see for example *her recent speech*) has been to support the supply on fields the hardest hit by recent shortages, such as semiconductors and energy.

The fiscal support is also set to continue over the coming years. CBO estimates that majority of Chips production support will be paid out over 2024-2027, and that spending on both energy and infrastructure (relative to GDP) will remain above pre-pandemic levels towards the end of the decade. Note, however, that the positive growth impact largely relies on the expected increase in productive capacity, rather than rising budget deficits. US primary deficits are expected to remain slightly above pre-pandemic levels, but still decline in 2023-2024. The main drivers of increased federal spending are higher interest rates on public debt and rising costs on social security and health care due to aging demographics, **which will continue to limit potential for future deficit spending on investments.**

In other words, US fiscal policy is not expected to be particularly restrictive over the coming years, but the upcoming rise in debt-to-GDP levels reflects the economy's structural challenges, rather than a clear shift towards more expansionary policies.

Productivity matters for the Fed

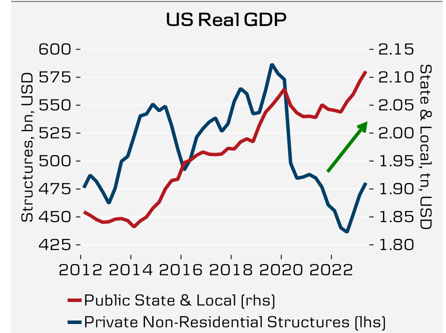
While forecasting productivity is difficult by nature, data released so far has been promising. Labour productivity surprised clearly to the upside in Q2, which meant that even though nominal wage growth has remained elevated, unit labour cost growth calmed down sharply. The increased investment activity helps explain the rise seen in manufacturing survey order-inventory balances even amid weak goods consumption.

Stronger productivity and growth potential would suggest longer-term neutral interest rate has risen in 2023, which would in turn imply that monetary policy stance is not as restrictive as it seems, hence **explaining the economy's apparent resilience against the sharp rise in nominal interest rates**. The most widely used models for the neutral rate, such as the NY Fed's Holston-Laubach-Williams model, only cover the beginning of the year for now.

The implications of faster productivity growth for the nominal policy rate would differ over short and long time horizons. In the near-term, if the recent decline in realized and expected inflation continues sustainably on the basis of slower unit labour cost growth, then the rise in neutral rate would not necessarily mean the Fed has to hike nominal interest rates further, as real interest rates will continue to rise in any case. Over the longer-term, real interest rates would decline, but stabilize at a higher steady state than otherwise.

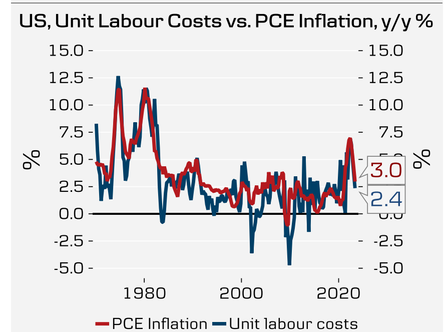
Persistent labour shortages are naturally a worry on an investment-driven growth cycle, especially when the starting point is a historically tight labour market, but it is worth noting

Recovery in public infrastructure and private high-tech production facility investments drove the upside surprise in Q2 GDP



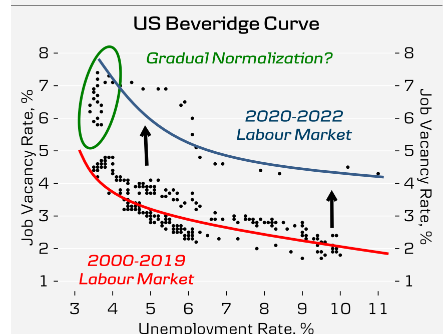
Source: Macrobond Financial, U. S. Bureau of Economic Analysis (BEA)

Pick-up in productivity growth has limited the rise in unit labour costs



Source: Macrobond Financial, U. S. Bureau of Labor Statistics, U. S. Bureau of Economic Analysis (BEA)

Declining job vacancies relative to unemployment suggest the labour markets are gradually normalizing



Source: Macrobond Financial, U. S. Bureau of Labor Statistics

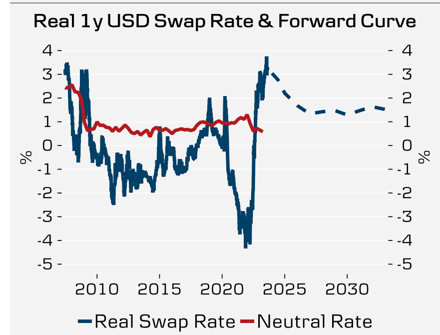
that employment in manufacturing recovered much faster than in services. Much of the employment growth this year in fact reflects easing labour shortages on services sector, while manufacturing has seen much more modest gains for a while now. The Beveridge curve, which plots job vacancies against unemployment rate, experienced a level shift higher during the pandemic, reflecting supply-demand mismatches in the labour markets. But this year, easing shortages show up as gradual normalization of the curve. And again, even if labour markets remain tight by historical standards, nominal wage growth above pre-covid levels could still be consistent with 2% inflation if productivity growth holds up.

We remain cautious about the growth outlook

If further signs of persistent uptick in investment growth and productivity emerge, it would mark an upside risk to our growth forecasts. Adjusting the 1y USD forward swap curve for expected inflation shows, that markets' expectations of real short rates over the next decade have recently risen above pre-pandemic neutral rate estimates, which could imply that markets are also turning more bullish on US long-term growth outlook. However, if productivity gains disappoint, the Fed could be forced to tighten monetary policy further, as limiting nominal wage growth becomes the sole option for sustainably cooling inflation. This would pose a downside risks for growth in 1-2y horizon, even if macro data remains resilient in the near-term. For now, we think the current level of real rates is restrictive enough, and that the Fed's next move will be a cut in Q1 2024.

In our current forecasts we still see a US recession as our base case, as the effects of past tightening feed into the economy. We are currently in the process of revising the forecast, and the more upbeat investment outlook likely means we have been too negative so far, but we continue to see the balance of risks tilted to the downside. Delinquency rates on consumer loans and household savings rates have begun to edge higher, reflecting a more cautious sentiment. Furthermore, the Fed's Q2 SLOOS results suggests banks have maintained their credit standards very tight in historical context. The sharpest tightening in real monetary policy stance was seen in Q3 2022, and with the usual transmission lag of 1-2 years, it might be that the ongoing soft landing optimism is just calm before the storm.

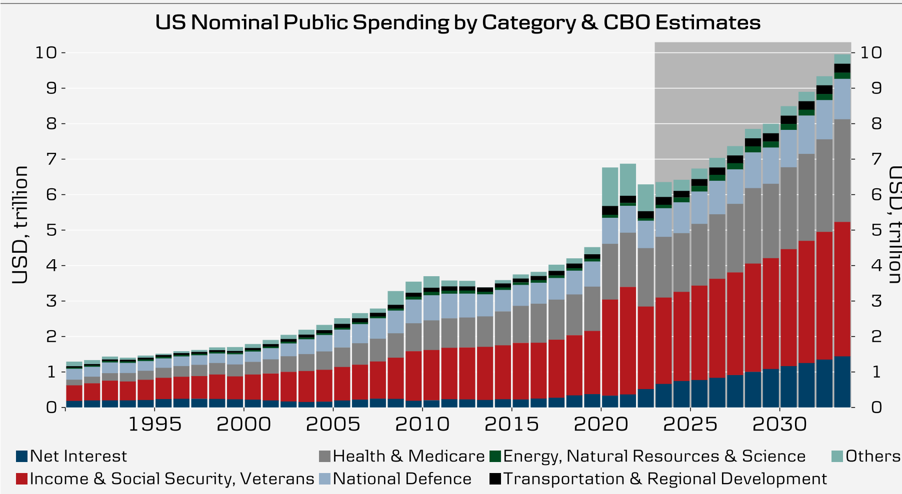
Markets expect real short rates to stabilize above pre-pandemic neutral rate estimates.



Sources: Macrobond Financial, Refinitiv. Deflated using inflation swaps. Neutral rate estimate: NY Fed's Holston-Laubach-Williams model

Note: Past performance is not a reliable indicator of current or future results.

The increase in US public spending over the next decade is primarily driven by higher interest costs and rising spending on social security and health care. Or in other words, structural challenges rather than more expansionary fiscal policy



Sources: Macrobond Financial, CBO, U. S. Treasury

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