TD Economics

The Only Constant Is Change

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Overview

The 6th century Greek philosopher, Heraclitus, had it right with the idea that nothing is constant but change. He was referring to the universe and life, more generally, but it's an apt depiction of the economy.

After a long period of upside surprises to the economic data, markets are adjusting to a shift in paradigm. Fear moments will dot the landscape until confidence solidifies that the economic path remains a soft landing, and not a hard one.

However, recent developments are not a departure from our forecast. Clear signs of a slowing U.S. economy are a necessary condition for the Fed to cut interest rates, even as markets stay highly attuned to downside data surprises, particularly within labor market indicators.

Forecast Evolving Largely As Expected = Growth Convergence

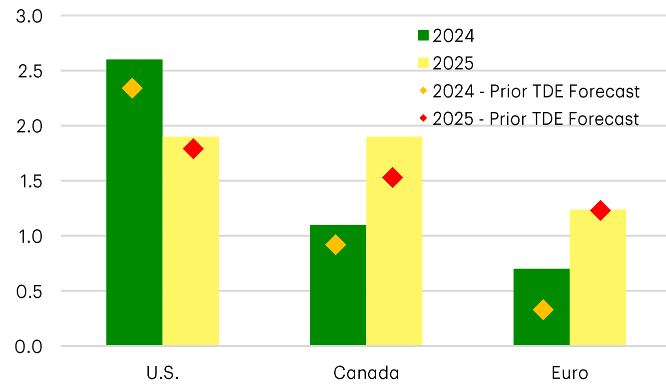
Jumping into the forecast evolution and whether the U.S. is nearing a recession path – this is quite a U-turn in narrative! Our prior discussions have been on U.S. exceptionalism. However, last quarter, I showed that the degree of economic outperformance to peers would need to be sustained for two entire years to truly meet that bar of exceptionality.

That's because global momentum tends to synchronize through the interconnectivity on trade flows and financial conditions. So although market chatter is rising on recession risks, I think we're just entering the turning point in the cycle that compresses some of the U.S. growth outperformance, but certainly doesn't portray a weak economy.

Our real GDP forecast is tracking 2% for the third quarter, similar to the Atlanta Fed and NY Fed nowcast models. This is not weak growth but is a long awaited return to trend. And relative to last quarter, we modestly upgraded our forecasts, not just for the U.S. but for peer economies.

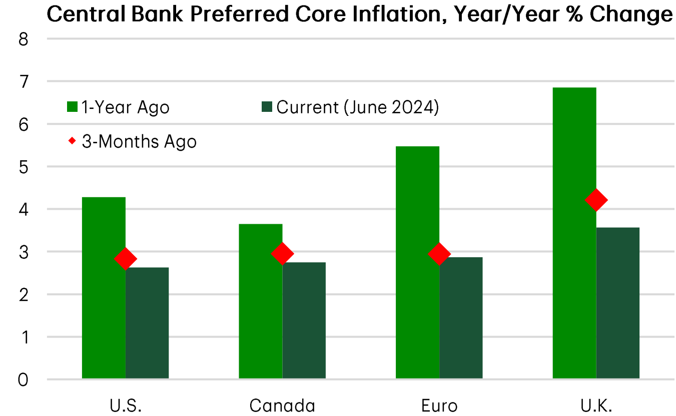
With economic growth finally synchronizing, the U.S. now really stands out as the outlier in not commencing an interest rate cut cycle. Aside from having the highest policy rate, inflation trends have also synched up to peers. In other words, the minimum necessary conditions are in place for the U.S. to follow peers in cutting. The compression in global economic growth offers reassurance to that narrative.

Real GDP Forecast, Year/Year % Change



Note: Prior TDE forecast = March 2024. Source: National Statistical Agencies, TD Economics.

Central Bank Preferred Core Inflation, Year/Year % Change

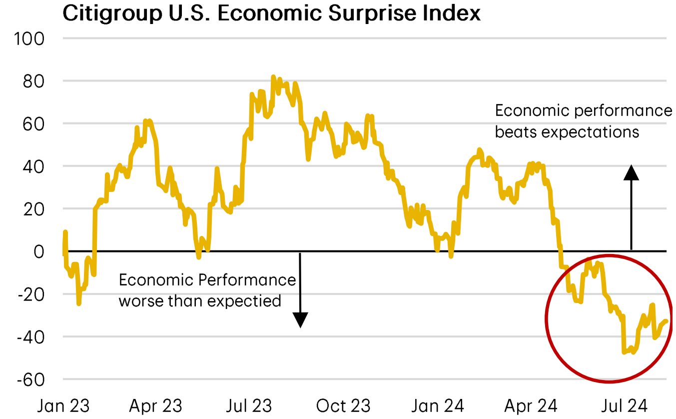


Note: U.S. - Core PCE, CA - Average of CPI-Trim and CPI-Median, Euro & U.K. - CPI ex. Energy, Food, Alcohol, and Tobacco. Source: National Statistics Agencies, TD Economics.

As U.S. Data Surprises Also Flip To The Other Side Of the Ledger

Nobody can blame markets for being jittery, however. Investors are recalibrating expectations to data performance, and pivot points in the economic cycle always feel a bit jarring. U.S. data was consistently to the upside of market expectations until only about three months ago, when the tables turned. No wonder this past quarter has been characterized by large swings in yields, currencies and volatility more broadly captured by the VIX.

Citigroup U.S. Economic Surprise Index



Source: Bloomberg, Citigroup, TD Economics. Last Observation: August 13th, 2024.

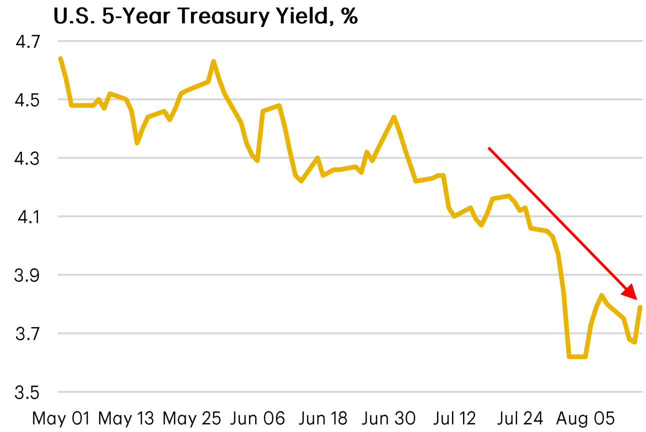
Markets React To Sting Of Disappointing Data

Until confidence builds that a slowdown is not the start of a recession, we could see more days or weeks captured by these graphs. The ongoing guessing game of the Fed's next move will swiftly manifest into yields and the greenback.

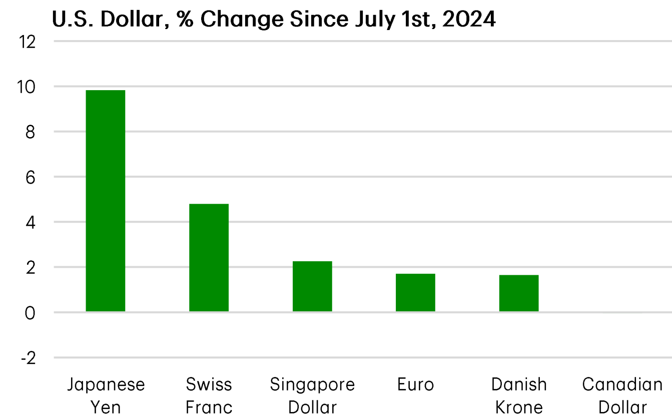
The U.S. dollar had an incredible first half of this year that pushed it up 5% on a trade-weighted basis. In a short period, its value came down 3%, largely on some unwinding of the Japanese carry trade, but not solely. Many other countries have been caught in the currency upswing as views coalesce around greater interest rate spread compression between countries on a more synchronized economic slowdown.

Canada's loonie is the exception. It has traded sideways to the U.S. dollar and depreciated against other peer currencies due to the offsetting impact of falling energy prices. We think there's a good chance offsetting influences will keep the currency within its current 72 to 76 U.S. cent range.

However, trading the U.S. dollar is rarely one-directional. It wouldn't be a surprise if the greenback regained some strength by year-end if market focus shifts back to geopolitical factors and flight-to-safety trades. We don't yet know what the U.S. election will mean for trade disputes, tax cuts, and prior geopolitical commitments made by America's leadership.



Source: Federal Reserve Board, TD Economics. Last Obsevration: August 15th, 2024.



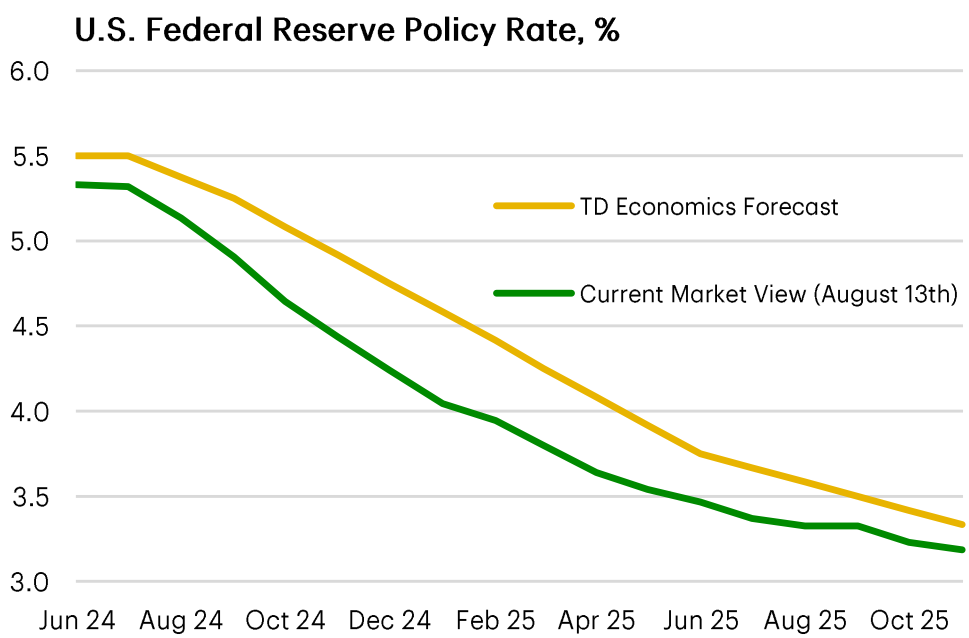
Note: Data as of August 7th, 2024. Source: Bloomberg, TD Economics.

Markets Are All-In On Rate Cuts

In the meantime, markets have priced U.S. rate cuts with some sense of urgency, with 100 basis points by year-end even though there's only three scheduled Fed meetings. Basically, markets are signaling that the Fed is already starting on its backfoot and needs to catch up to avoid a deeper slowdown.

We penciled in an even pace of 25 basis points at each meeting absent a sense of an impending recession. And, from a practical perspective, there's an optics and communication risk for the Fed to start with a 50 basis point rate cut that could trigger even more aggressive pricing across the curve that gets too far ahead of the Fed's assessment of economic risks.

The bottom line is that all major countries will be in ease mode if the Fed jumps on the rate cut band wagon in September....and then the discussion becomes about how low will rates go?



Source: Bloomberg, TD Economics.

Cutting Aggressively Is A Risky Strategy With Bouncy Inflation

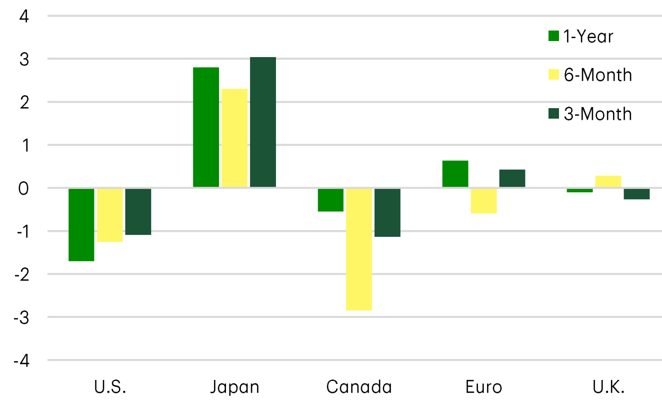
That answer sits in these metrics. During the last two quarters, the rapid decline of prices for physical "stuff" has led inflation lower (referred to as "core goods inflation"). The missing piece on inflation has been a decisive turn in service prices.

A slow descent is underway, but overall service prices remain universally elevated. In a perfect world, these prices would be expanding a full percentage point less than where it sits today.

Looking at the 3-month trend for clues on future direction, it's been favorable for the U.S., but not for other regions. The exact opposite story played out last quarter when U.S. inflation backed up while other countries benefited from a downdraft. This reinforces that the road ahead is going to be bumpy for service prices because consumer patterns have greater inertia.

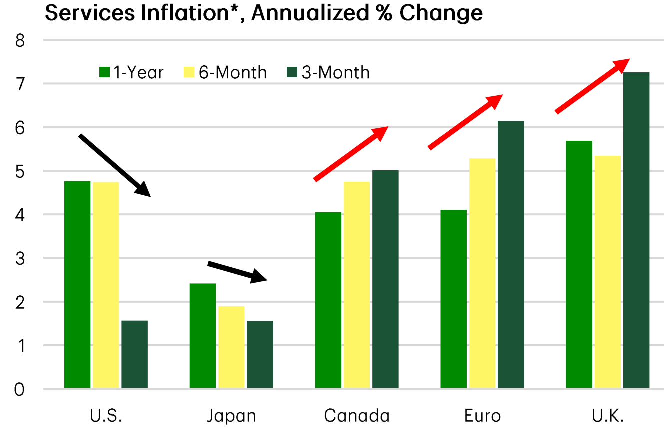
So why are central banks cutting at all? One reason is that the share of prices that are rising by 3% or more now represents only 30% of consumer purchases, which is consistent with historical patterns.

Core Goods Inflation, Annualized % Change



Source: National Statistical Agencies, TD Economics. Last Observation: June 2024

Services Inflation*, Annualized % Change



*U.S., Canada, Japan - excluding homeownership.
Source: National Statistical Agencies, TD Economics. Last Observation: June 2024

Trump's 2018 Tariffs Had Small Impact on Inflation, But Current Tariff Proposal Won't

So what happens to inflation if former president Trump is re-elected, and the administration follows through with broad global tariffs, as high as 60% on China and 10% on others?

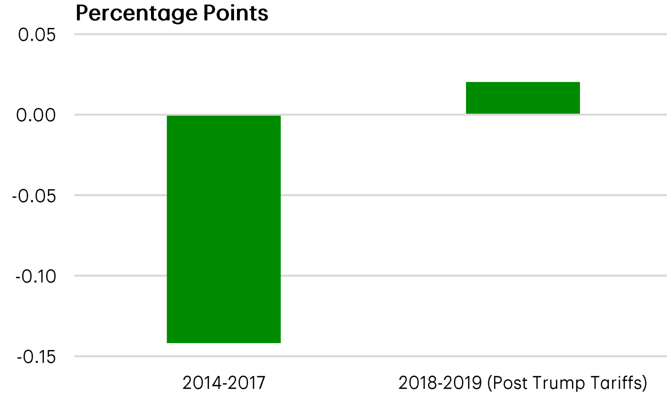
To understand this, we revisited Trump's past tariff cycle, which was modest by comparison and added about 10 basis points to inflation. It certainly wasn't disastrous, even as countries retaliated with tariffs on American products.

Remember the "great whisky tariff of 2018" by the E.U.? This was a 25% tariff in retaliation to U.S. tariffs on their steel and aluminum. It's a reminder of how isolated the tit-for-tat measures were in the 2018 and 2019 period, amounting to about $80bn in new taxes on products and impacting only 10% of U.S. imports, at their peak.

In contrast, the current proposal would bring the tally to more than $500bn in new taxes, with a high likelihood the countries retaliate. The E.U. is reportedly developing a two-stage strategy to first pre-empt possible tariffs with negotiations, and then, if necessary, to retaliate with targeted tariffs of 50% or more. Canada is thinking through a similar approach.

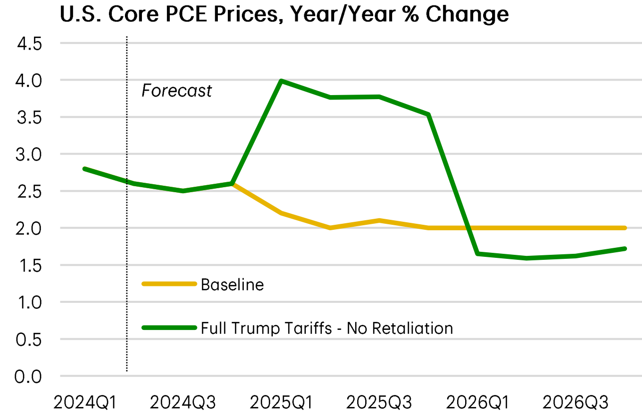
There's no doubt that a Trump administration would follow through with tariffs, but there's many possible combinations of events, such as what countries can negotiate, how long the tariffs stay in place, and whether carve outs would exist to prevent disruptions to American production.

Core Goods Annualized Contribution to Headline CPI, Percentage Points



Source: Bureau of Labor Statistics, TD Economics.

U.S. Core PCE Prices, Year/Year % Change



Source: BEA, Oxford Economics, TD Economics.

But in the meantime, here are some conclusions we can rely on:

1. The scale and magnitude would cause a meaningful lift to inflation.

2. Broad and deep tariffs would have the intended outcome of depressing demand for foreign products, but also dent U.S. real incomes.

3. The influence on inflation may not stop the Federal Reserve from easing policy, but would likely limit how low they can go.

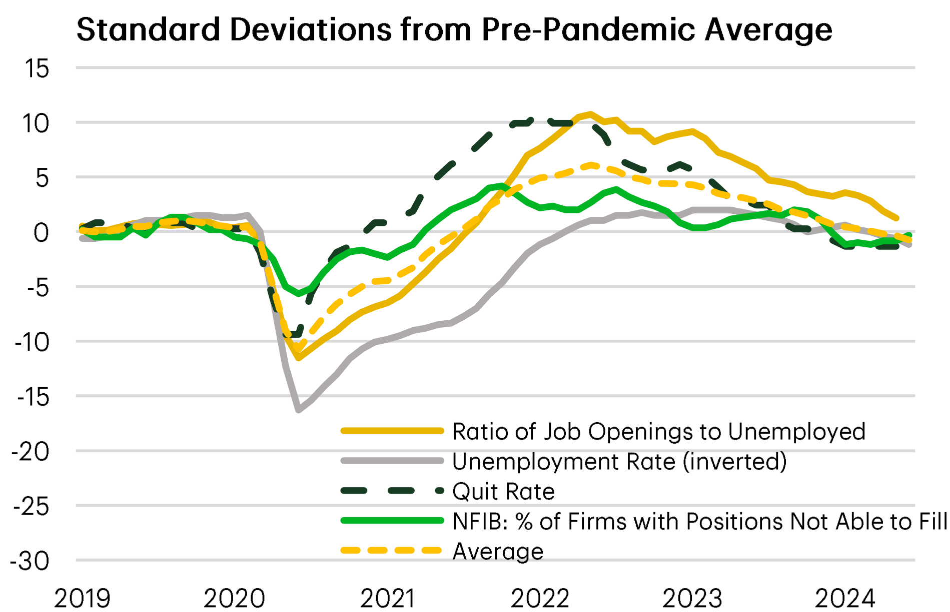
- For instance, when tariff wars were in full swing in 2019, the Fed still cut by 75 basis points because weaker domestic demand ruled the day.

- The policy rate is at a higher starting point this time, creating scope to the downside. But, getting to our estimate of the neutral rate (3%) could be tough in the absence of very weak domestic demand, which any administration would want to avoid.

Powell Says Labor Market Is Normalizing...Markets Fear The Worst

Turning now to the labor market dynamics that frayed financial market nerves in early August. The July employment data produced 114K jobs – not exactly portraying a falling sky. But that's yesterday's news and all that matters is what the job market looks like in 3-6 months.

On that front, this graph captures a broad set of labor market indicators, which leave no question that a cooler front has rolled onto American shores. Indicators have all normalized to pre-pandemic performances, creating a compelling argument to start adjusting interest rates rather than wait for all the stars to align on inflation. Doing so would risk the need for more aggressive action at a future date if too much slack builds in the economy.



Source: Bureau of Labor Statistics, NFIB, TD Economics.

Fiscal Supports Continue To Boost Business Investment

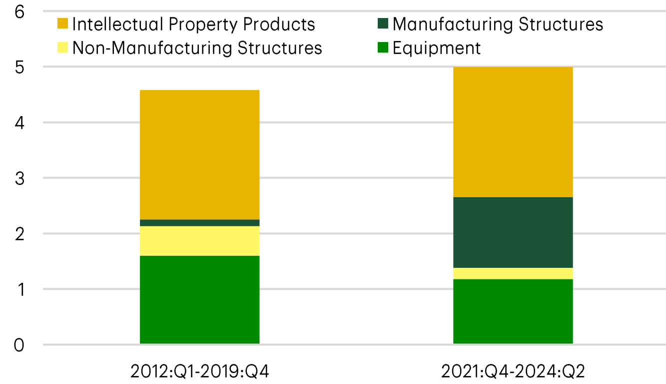
Now let's look beyond the job market, because there's a lot going right in this economy that helps to provide a counterbalance to market fears. I've been pointing out business investment resilience for about a year now. This is one area that continues to upstage predictions and even gained momentum in the first half of this year.

It's not the only area, so too is investment by all levels of government. State & local governments have spent most of the COVID relief funds, but there's still plenty to come from the Infrastructure Investment and Jobs Act (IIJA). These funds haven't even hit their full stride in economic impact. Recall, this is money allocated to rebuilding roads, bridges, railways, enhancing broadband access, and so forth.

The CBO estimates that those funds will amount to about $60 billion in 2025, rising to about $70 billion in each of the next two years. That compares to $40 billion this year. Irrespective of the next President, repealing these funds wouldn't be easy, it requires an act of Congress. And although Trump has indicated an intention to curtail initiatives, many Republican states are using and benefiting from these funds.

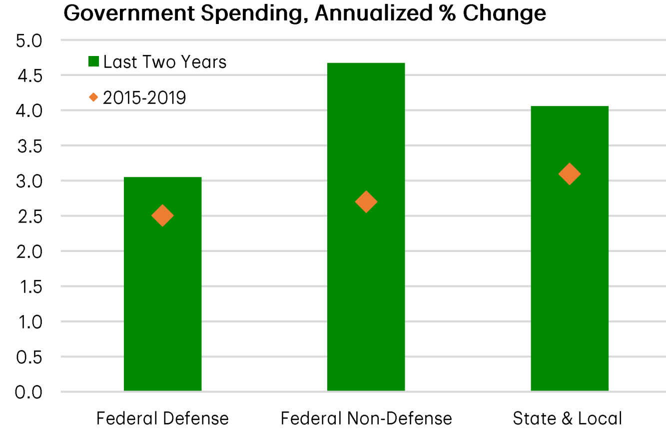
The bottom line is that the economy is still experiencing a one-two investment punch, through both private and public sector spending initiatives. However, we are weeks away from an election that will force forecasters to revisit views once the new administration and composition of Congress is known.

Contributions to Real Business Investment, Annualized Percentage Points



Source: Bureau of Economic Analysis, TD Economics.

Government Spending, Annualized % Change



Source: Bureau of Economic Analysis, TD Economics.

Markets will be attuned to how well Congress will address deficits and debt. To not do so risks yields embedding a higher term premium as political platforms are executed. In turn, this would undermine the cost of capital and investment.

Clients often ask: when will deficits and debt matter in the U.S.? I wish there was a precise answer other than to say: it'll matter when markets say it matters, revealed by punitive financial conditions. This is what it takes to jolt governments into making the hard, and often politically unpopular, decisions.

So to end, let's return to the words: nothing is constant but change. We're about to enter a period of many changes that go beyond just the decisions and the control of central banks and monetary policy.

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