Questions? We've Got Answers

Addressing Issues Impacting the Economic and Financial Outlook

May 15, 2024

This quarter's Q&A builds on the U.S. exceptionalism theme introduced at the start of the year. The American economy continues to leave peers in its dust. The downside of that outperformance is resurgent inflation, which has led us to push out the timing of that first interest rate cut to December, from July. The greenback has also been dominating peers, but we don't expect the risk of importing inflation through currency depreciation meets a sufficient condition to prevent other central banks from cutting interest rates ahead of the Federal Reserve. Globally, rising geopolitical risks aren't really leaving a mark in the hard data. At home, the U.S. election is likely to generate headlines in the coming months, with potential economic impacts also discussed below.

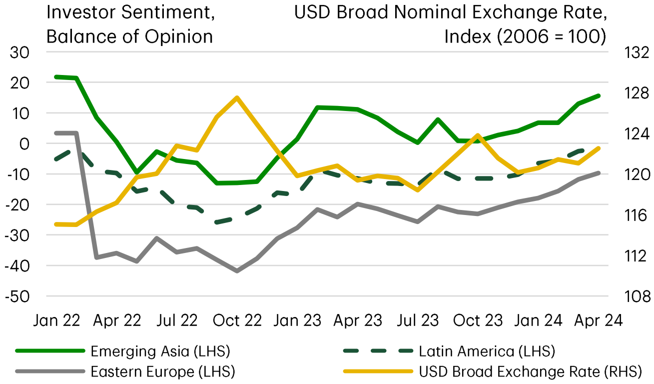
Questions & Answers

Q1. How is the global economy evolving amidst rising geopolitical risks?

The bottom line is that recent data do not show a major drag on economic growth materializing from geopolitical risks. In fact, the opposite is unfolding. Since our March forecast, data for major economies in Europe and China have been a bit better than expected. Real GDP in the first quarter for China printed above-consensus at 5.3% y/y (consensus: 5%). A catalyst has been a resurgence in exports, which seems at odds with the mixed signals coming from the manufacturing sector. This leaves us cautious in fully extending this trend as sustainable through 2024. Nonetheless, the consensus for China has edged up for 2024 real GDP to 4.8%, versus 4.6% earlier this year.

Similarly, the euro area flash estimate for GDP growth came in above expectations relative to the March Quarterly Economic Forecast (QEF). Truly, the big surprise was how broadly based growth was across EA member countries. This likely reflects some "pull-forward" of growth – as Ireland led the EA after having contracted in the previous quarter. This is another instance where some caution needs to be imposed on subsequent quarters. Despite this, the hand-off from Q1 nudges up the annual growth rate for 2024 to 0.5% (from 0.3%).

Chart 1: Despite USD Appreciation, Investor Sentiment Has Been Improving in Emerging Markets



Source: Federal Reserve Board, Sentix, TD Economics.

The global economy is not out of the woods on the transmission of geopolitical risks into the real economy. Two factors are likely to bear more weight as the year progresses. First, higher energy prices are a major consequence of the conflicts in Ukraine and the middle east. Europe is already challenged by energy security and is one factor behind our forecast of below-average growth for the region over the next two years.

Second, the strength of the U.S. dollar has been increasing as a geopolitical issue. Some emerging market (EM) central banks have taken steps to support their currencies despite tepid domestic growth. The strength of the U.S. economy means that central bank policy divergence will continue this year, keeping a floor under the USD, which means some pass through of negative impacts to EM growth and financial conditions. Despite this and other geopolitical factors, the economies are weathering through the challenges. Investor sentiment on EMs has been improving, with more focus on improving global economic dynamics as the tide that lifts all ships to avert the worst-case scenario of a global downturn (Chart 1).

Q2. How are commodity and currency markets responding?

Commodities, specifically oil, have reacted to the sporadic intensification of recent geopolitical events. This is causing short-term surges in prices (with swings averaging $5/bbl) before unwinding as tensions eased. While there hasn't been a sustained risk premium following recent events, this possibility cannot be dismissed at this juncture. For now, relative stability has seen fundamentals dictate price movement, allowing us to stick with our forecast from March.

As noted in the prior question, currency markets have followed suit with the U.S. dollar appreciating by around 3% over 2024 (Chart 2). However, most of this is due to widening policy rate expectations rather than an escalation in geopolitical tensions. Major currencies like the euro, pound, and loonie are down around 3% on the year, while the yen is down 10%.

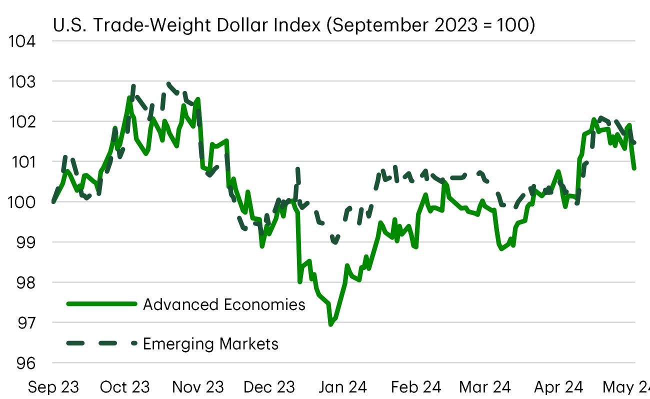
However, for the USD to see another big move higher, it would likely require a knee-jerk reaction to new developments or an escalation of events on the geopolitical front. Typically, this has greater risk-off passthrough to EM currencies, which so far have outperformed AE currencies this year.

Q3. Why is the U.S. economy still blowing away its peers?

In short, a combination of low consumer debt levels and generous fiscal policies enabled the U.S. economy to emerge stronger from the pandemic by creating less interest-rate sensitivity than prior cycles. In fact, while some countries provided more support in the form of loans or loan guarantees, the U.S. had the most generous direct fiscal supports among advanced economies. This was immediately followed up by several stimulative government policies (IIJA, IRA, CHIPS & Science) that continue to leave an outsized footprint on GDP growth.

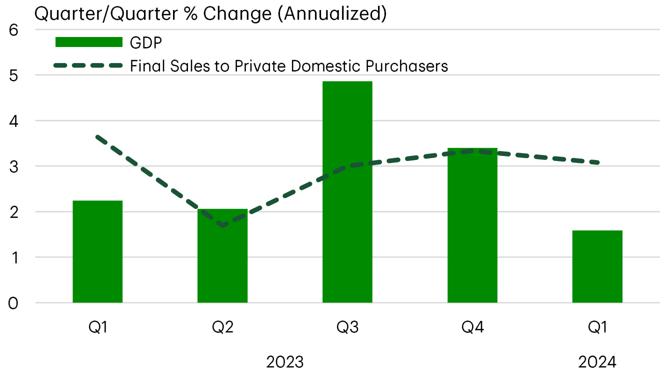
With first quarter economic growth slowing to 1.6% (q/q, annualized), it may be tempting to think that the nar-

Chart 2: The Greenback's Appreciation Over 2024



Source: Federal Reserve Board, TD Economics. Last Observation: May 3rd, 2024.

Chart 3: U.S. Domestic Drivers Remained Strong in First Quarter



Source: Bureau of Economic Analysis, TD Economics.

rative of U.S. exceptionalism has run its course. But we caution on betting against the U.S. economy just yet. For starters, that quarter was weighed down by a sizeable drag from net exports, which is a manifestation of strong domestic dynamics relative to peers. Focusing solely on consumer spending and investment reveals the domestic drivers to have expanded by 3.1%! This mirrors performances from H2-2023 and leaves no impression that spending on the home front is capitulating (Chart 3).

It may seem odd that consumer spending is still expanding at such a strong clip, particularly given that the tailwind from excess savings has faded from gale force to perhaps only a gentle breeze. But the consumer continues to benefit from a trifecta of other factors: strong labor market (and income), significant gains in net worth, and a relatively low exposure to higher interest rates. The latter is a by-product of America's "lessons-learned" from the global financial crisis combined with a unique 30-year fixed rate mortgage structure that allowed roughly 14 million households to lock in ultra low rates via refinancing activity in 2020 and 2021. Monthly consumer spending through March show that spending momentum was headstrong going into Q2. Naturally, this can't be sustained indefinitely. But it does mean that the "long and variable" lags of past interest rate hikes need more time to play through. And even when it does materialize in a more obvious way later this year, growth in consumer spending is still expected to expand at a multiple of most other advanced economies.

Outside of the consumer, fiscal tailwinds will also remain mildly supportive to growth this year. The CHIPS & Science Act and the Inflation Reduction Act combined to deliver a 1-2 punch to economic growth in 2023, adding roughly 0.6 percentage points (ppts) to GDP. This was almost entirely related to the construction of both semiconductor and electric vehicle battery facilities. With a significant share of the announced projects having already broken ground, the growth impulse to structures investment is unlikely to be repeated in 2024. However, in its place will be a new thrust stemming from the need to outfit these facilities with equipment and machinery. To date, only a small portion of equipment orders have been made. But as more projects near completion, equipment providers are likely to see a significant uptick in new orders over the next year.

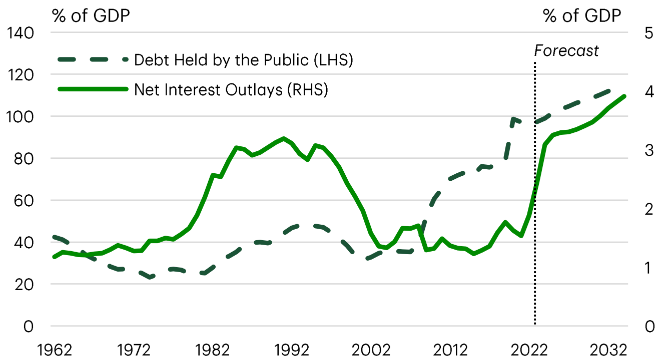
A similar story is playing out for state & local (S&L) spending. In 2023, this expanded by an impressive 4% and contributed 0.5 ppts to headline growth. Although the magnitude of last year's gain is unlikely to be repeated, there is still good reason to suspect that S&L government spending will again provide some countercyclical boost to 2024 growth. For starters, S&L governments are still sitting on roughly $40 billion – or 10% of the original relief package – of unspent COVID relief funds. These will need to be allocated and spent over the next few years. At the same time, outlays related to the Infrastructure Investment & Jobs Act are expected to more than double this year, potentially reaching $40 billion.

The punchline is that America's outperformance has been driven by several factors, none of which look set to completely dissipate in 2024 – keeping the economy at the top of the leaderboard for another year.

Q4. Will the outcome of the U.S. election make a big difference to the outlook?

The 2024 federal election is in less than six months and is likely to increasingly dominate financial headlines as election day approaches. Control of Congress and the White House could feasibly swing towards either political party in November, putting a wide range around possible fiscal and economic policies over the forecast horizon.

Chart 4: U.S. National Debt Continues to Grow Under Higher Rates



Source: Congressional Budget Office, TD Economics. Last Observation: 2034.

Before looking at the potential economic effects of either party's policy proposals, whoever controls Congress come January will likely need to deal with the unfinished business. It is probable that the federal government will still be funded by a continuing resolution at year-end, which would necessitate further budget negotiations in 2025. The spending limits legislated by the Fiscal Responsibility Act (FRA) will still apply, including the 1% cut to discretionary spending if a continuing resolution is still in place by May 1st, 2025 (unless Congress opts to reverse the provisions of the FRA). In addition, the expiration of the current debt ceiling suspension on January 1st, 2025, will likely result in the concurrence of budget negotiations with debt ceiling negotiations at year-end, which may carry over into 2025.

Beyond these near-term issues, the most notable legislative development next year will be the expiration of some of the provisions included in the 2017 Tax Cut & Jobs Act (TCJA) at the end of 2025. Both presumptive nominees for president have endorsed extending most of the expiring measures, but with key differences. President Biden's 2025 budget outlined extending all the TCJA's income tax cuts for households earning less than $400k per year. In addition, the budget outlined several tax increases. These include: a minimum 15% tax on companies with annual income over $1 billion; a minimum 25% tax rate on individuals with wealth over $100 million; an increase in the top income tax rate from 37% to 39.6%; and an increase in the corporate tax rate from 21% to 28% (note the TCJA originally lowered the tax rate from 35% to 21% in 2017).

In contrast, former President Trump is seeking to make the provisions of the TCJA permanent and lower the corporate tax rate further to 15%. Regardless of who resides in the White House next year, "decisions of the purse" will require an agreement within Congress, which also needs to consider the implications to rising national debt, particularly as higher interest rates increase the cost of kicking the can down the road (Chart 4).

Currently our baseline forecast embeds the assumption that the TCJA tax cuts remain in place across the board, as the U.S. has a long and reliable precedent of avoiding sunset clauses on tax cuts. Any deviation post-election requires a forecast review.

The same is true for economic policies that do not require Congress approval. For instance, Former President Trump has proposed imposing a blanket 10% tariff on all goods imported into the U.S. Our simulations show that the combination of higher domestic prices (as tariff costs are passed onto domestic consumers) and the high likelihood of retaliatory tariffs on the U.S. from trading partners would lead to a permanent 1.4 percentage point reduction in GDP. This is for illustrative purposes of policy in its "raw" form, as actual implementation relative to election rhetoric often reflects many adjustments along the way that would alter the analysis.

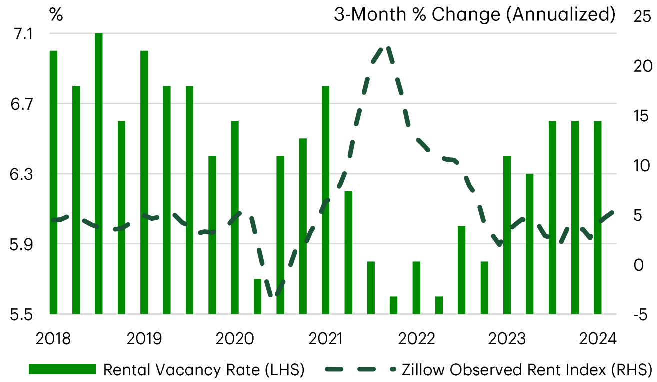
Longer-term considerations for the executive and legislative branches in 2026 include the appointment of the next Chair of the Federal Reserve and the first review of the United States-Mexico-Canada Agreement (USMCA). Although 2026 seems far off, the outcome of this November 5th will kick off a series of economic projection reviews in relation to the trajectory of fiscal policy, and by extension monetary policy.

Q5. How is higher population growth in the U.S. leaving its mark?

It was always a head-scratcher on how the labor market could sustain new jobs averaging 251K per month last year, without a corresponding escalation in wage pressures. Some light has recently been shed on this question with new information.

An alternative estimation of immigration by the Congressional Budget Office (CBO) has revealed far stronger population (and, hence, labor force) growth in re-

Chart 5: U.S. Rental Vacancy Rates Have Normalized to Pre-Pandemic Levels



Source: Census Bureau, Zillow, TD Economics.

cent years. According to the CBO, annual immigration flows have averaged 3 million over the past two years – considerably above the pre-pandemic average of 1.0 million per-year. The CBO maintains this elevated estimate through 2026. The uptick reflects a few factors, including a post-pandemic surge, but the bulk is a significant increase in the CBOs estimation of individuals categorized as other-foreign nationals. This includes people who entered the United States illegally and people who were permitted to enter using parole authority and who may be awaiting proceedings in immigration court. By the end of 2026, the combined effects could raise U.S. population by as much as 7 million individuals.

The effects have been most apparent in the labor market. Prior to the pandemic, the range of population and labor force participation projections done by the CBO, the Bureau of Labor Statistics and the Social Security Administration suggested that a sustainable monthly pace in employment growth was somewhere in the 60,000-140,000 range. Yet, payrolls averaged more than two times the mid-point of that range in 2023. As a result, most economists (ourselves included) had suggested that the labor market was far too tight, and that job growth would need to slow considerably – necessitating some increase in the unemployment rate – to bring the labor market back into better balance and cool inflation. But after taking onboard the CBO's revised immigration projections, there's now an alternative explanation.

Stronger population growth has likely raised near-term 'trend' growth in the labor force. Meaning, the ability for the labor market to absorb more workers without necessarily adding to inflationary pressures has temporarily increased, and by a large margin – likely somewhere in the 175k-200k range. So, while employment growth is likely slow through the second half of the year, it's unlikely to be as pronounced as previously thought.

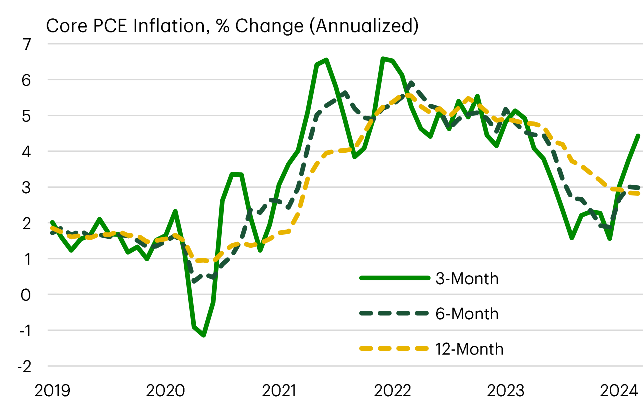
Beyond the labor market, higher immigration has also provided a tailwind to consumer spending. Using data on the average annual income that an immigrant earns and assuming a relatively high marginal propensity to consume, we estimate that the aggregate boost in spending in 2023 could have been as much as 0.2-0.3 percentage points. A similar lift will likely be felt in 2024.

From a housing standpoint, the impact has so far been muted. In recent years, household formations have grown roughly in line with its pre-pandemic trend, and there has not been a discernible uptick in home sales. This isn't entirely surprising, as immigrants tend to be renters long before they are buyers. Moreover, affordability challenges have also likely been a barrier for newcomers. It could, however, explain why there has been more persistent price pressures on rental rates (Chart 5). But even here, the impacts appear relatively muted, as the rental vacancy rate has gradually trended higher over the past year and has recently returned to its pre-pandemic level.

Q6. How concerned should we be about the uptick in U.S. inflation?

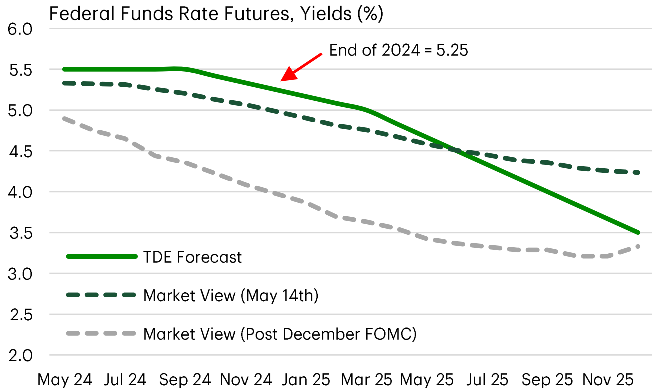
After slowing considerably through the second half of last year, progress on the inflation front has stalled

Chart 6: U.S. Inflation Progress Has Stalled in 2024



Source: Bureau of Economic Analysis, TD Economics. Last Observation: March 2024.

Chart 7: Market Moves to Price Fewer U.S. Rate Cuts



Source: Bloomberg, TD Economics.

through early-2024. As of March, the three-month annualized rate of change on core PCE inflation sits at 4.4% – the highest reading in twelve months – while the 6-month annualized, and 12-month rates of change have flattened to around 3% (Chart 6). A deeper dissection of the data shows that there are a few factors leading to the recent resurgence.

Falling goods prices have been a major source of disinflationary pressure over the past two years – accounting for roughly 80% of the decline in core PCE relative to its peak. However, with supply chains having largely healed from the pandemic, the downward force from lower goods prices is already petering out. At the same time, price pressures for core services have remained hot. There are two dynamics behind this. First, despite market-based measures pointing to a cooling in rental rates, very little has shown up in the shelter metrics of inflation. As of March, housing is still contributing a full percentage point to core PCE inflation, double its pre-pandemic contribution when inflation was running closer to 2%. Second, non-housing services, or the 'supercore' component, has heated up, with the three-month annualized rate of change accelerating to a near three-year high of 5.6%. Higher medical, financial service costs, and other personal services (including personal care, postal, childcare, and accounting services) have all been responsible for the uptick.

It's perhaps not surprising that we've seen considerable breadth within supercore inflation, given services spending advanced at an exceptional 4.0% q/q annualized pace in the fourth quarter. Outside of the pandemic, that has only happened three other times in the past twenty years! And this momentum looks set to carry over into at least the second quarter. All of this points to more near-term stickiness on supercore inflation. In combination with a slower adjustment on shelter prices, near-term progress on the inflation front looks limited. A further slowing in job gains through H2-2024 is needed to cool spending. This timing would also overlap to when the long lags from lower rental rates should finally feed through to push down shelter costs. It's a delicate balance, but likely a required pre-condition to returning price stability. And it's why we punted our first rate-cut call to December (Chart 7). Ultimately, core inflation isn't expected to return to 2% until late-2025, which allows for more normalization in the policy rate as Federal Reserve members gain greater confidence in its trajectory.

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