Questions? We've Got Answers

Addressing Issues Impacting the Economic and Financial Outlook

August 14, 2024

What a difference a quarter can make. Financial markets have done a 180 relative to our prior Q&A. From focusing on the risks of persistent U.S. inflation and punting out rate cuts largely into 2025, to now worrying that the Fed is behind the curve and has not cut fast enough! Globally, other G7 central banks are already on the move despite stubborn services inflation among some — a reminder that the rate cut process will involve some guess and test. We argue that the U.S. economy remains resilient and the Sahm-old labour market rules need context. We also discuss the potential risks to international trade from campaign promises in lead up to U.S. elections.

Questions & Answers

1. Is the global cooling in inflation going according to plan?
2. The global interest rate pivot has begun, will central banks take the stairs or the elevator?
3. What is the outlook for currencies and will King USD maintain its reign?
4. With market fears mounting, what is the U.S. economic outlook on the eve of the election?
5. Should we be worried about the cooling in the U.S. labor market?
6. When will lower interest rates provide relief for U.S. housing?
7. How might the 2024 U.S. election affect international trade?

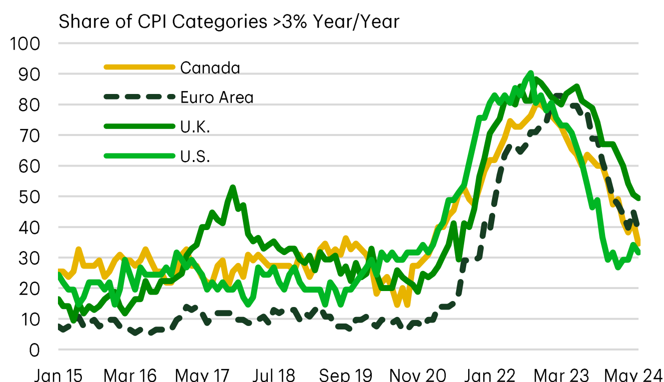
Q1. Is the global cooling in inflation going according to plan?

For the major central banks looking to tame inflation – the European Central Bank, Federal Reserve, Bank of Canada and Bank of England – price pressures have cooled largely in-line with expectations. More importantly, the declines are not solely driven by food and energy prices. The share of categories with prices running above 3% year-on-year (y/y) has stepped down significantly in the past year (Chart 1).

Leading the good news has been the rapid unwinding of price inflation for physical "stuff". Excluding food & energy, goods prices are contracting on an annual basis in the U.S. and Canada (-1.7% y/y and -0.5% y/y, respectively), are flat in the UK, and are registering modest gains (+0.6% y/y) in the euro area.

However, the road ahead might be bumpy as prices for services have shown persistence. On an annual basis, services prices are running at 5% in the U.S. and Canada, and even hotter in the U.K. at 6%. The euro area has the best performance, and yet that is holding at a still hefty 4%. What's more, only the U.S. has shown a notable improvement in

Chart 1: Inflation Breadth Narrows



Source: BLS, Stat Can, Eurostat, ONS, TD Economics. Last Observation: June 2024

the near-term trend, where the three-month annualized change has ticked down to 3%. In all other jurisdictions, near-term momentum leans to the upside.

With all central banks having either cut, or about to cut in the case of the Fed, the key question is whether this recent lift in services inflation will be a temporary blip, or limit the amount of relief central banks can deliver. This means that central bankers will remain highly data-dependent in their approach rather than relying on forecast models. Any renewed pressure on prices will be considered within the context of any loosening in labour market conditions that typically precede an easing in service prices.

Q2. The global interest rate pivot has begun, will central banks take the stairs or the elevator?

This answer depends on who you ask. Market pricing for all major central banks indicate a preference to use the stairs, with gradual 25 basis point rate cuts through the next eighteen months (Chart 2). The exception is the Federal Reserve, where disappointing employment data in July led to rampant market speculation that the first cut will be a doozy at 50 basis points in September. Since the Fed is last to the exit door, markets fret that they have fallen behind the curve and will be in a greater rush to normalize interest rates.

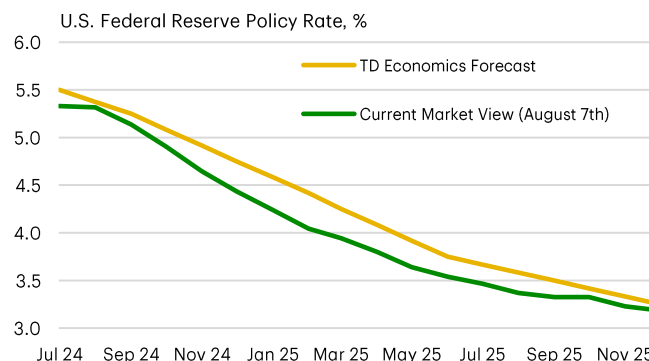
This threat caused U.S. Treasury yields to tumble 40 to 50 basis points in the final week of July and start of August. While we think cooler heads will prevail at the Fed, markets will need reassurance that the economic path is a slowdown and not recession. Only the incoming data will provide that proof point, meaning that every downside miss on consensus can inject more than usual volatility. One thing is for sure, the economy has lost its bouncy step as the long and variable lags of rate hikes finally make a mark. From our perspective, this economic slowdown is a necessary condition to underpin confidence at the Fed that inflation is under control and the process of lowering interest rates can commence. So far, the fundamentals do not predict an economy headed towards recession (see question 4). Provided that remains the case, we anticipate the Fed will take the stairs in lowering interest rates by 25-basis points per meeting starting in September. This would leave the policy rate at 4.75% by end-2024.

Q3. What is the outlook for currencies and will King USD maintain its reign?

The U.S. dollar trade weighted was on an incredible run over the first half of 2024 (up around 5% on a trade-weighted basis) (Chart 3). The relative strength in economic performance caused markets to anticipate a widening in spreads to peer countries, which proved correct until July.

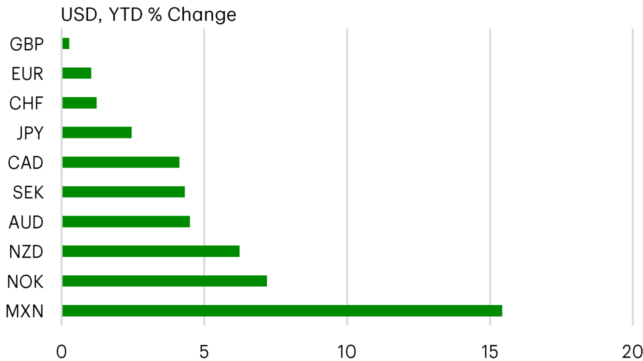
The recent Fed pivot (see above) has caused the U.S. dollar (USD) to depreciate by around 3% since the start of July. Much of this has been against the Japanese Yen, which has climbed approximately 10% over the past month, as that central bank carves a different path of finally raising interest rates. Other countries that have also been caught in the upswing are the euro, Swiss

Chart 2: Central Bank Policy Rate Expectation Are Coming Down for 2024



Source: Bloomberg, TD Economics.

Chart 3: The U.S. Dollar is Still Up Versus Major Currencies this Year



Source: WSJ, TD Economics. Data as of August 6th, 2024.

franc, and Singapore dollar. As for Canada, the loonie has largely sat on the sideline, trading sideways to the USD and depreciating against peers. This reflects the offsetting impact of falling energy prices. This lack of direction for the loonie is expected to persist going forward, with offsetting influences keeping the currency within its current 72 to 76 U.S. cent range.

We think the greenback could well be in for a reversal through year-end if market focus shifts back to geopolitical factors and flight-to-safety trades kick back in, to the benefit of U.S. dollars. One such event is what happens with the U.S. election. Does it open the door to a rehashing of trade disputes, the potential for tax cuts, and greater uncertainty for America's peers? Even if the Fed cuts rates aggressively, investors may seek the shelter of King Dollar once again.

Q4. With market fears mounting, what is the U.S. economic outlook on the eve of the election?

Markets are not completely in left field to worry about the downshift in U.S. momentum, but nothing in the data foretell a stalling out. So far, the data reinforce an expansion that has downshifted from fourth gear into second.

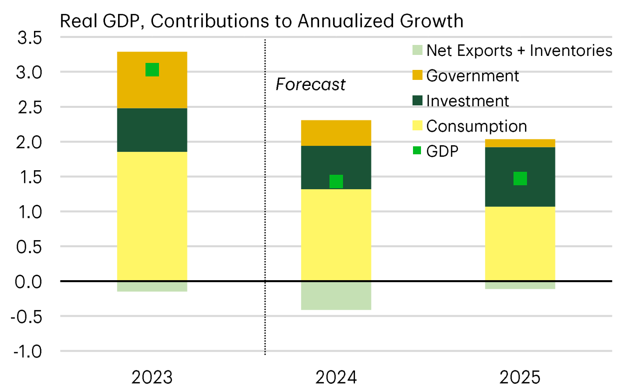
The 4% annualized expansion through the second half of last year has decelerated to a trend-like pace of 2% in H1-2024 (Chart 4). However, this shouldn't be interpreted as bad news. It provides validation that the 'long and variable lags' of restrictive monetary policy are finally starting to tighten their grip on the economy – a necessary condition to wring out the last bit of inflationary pressure and open the door for interest rate cuts.

Nearly half of the slowdown is attributed to cooler consumer spending, which shouldn't come as a surprise. With the tailwind from excess savings exhausted, consumers have increasingly relied on debt to fund spending. Earlier in the recovery, households were able to easily absorb these higher debt loads as an exceptionally tight labor market supported strong gains in real incomes. Now that the job market has turned a corner (see Question 5), real disposable income has slowed accordingly.

Even as spending has started to come to heel, it's still outpacing income growth. This cannot be sustained indefinitely. The share of income that households are dedicating to servicing non-mortgage debt is quickly closing in on levels last seen during the 2008 financial crisis. And delinquency rates across most consumer lending products have risen above pre-pandemic levels and are continuing to trend higher. All of this points to a return to thrift, which means consumption patterns should better align to income growth in the coming quarters.

But not all areas of the economy are bending under the weight of higher rates. Business investment has gained momentum through the first half of this year. Part of the strength has been due to a pick-up in equipment spending, which shot up by nearly 12% annualized in Q2 thanks to a 450% surge in aircraft purchases. While this is unlikely to be repeated, further investments directed to semiconductor manufacturing alongside sustained

Chart 4: The U.S. Economy Is Downshifting



Source: Bureau of Economic Analysis, TD Economics.

strength in software spending are likely to keep business investment growing at an above-trend pace.

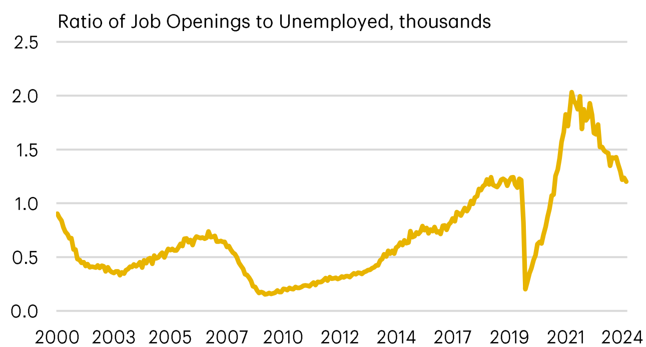
The U.S. economy is slowing, but not buckling, following last year's breakneck pace. This carries the markings of a true 'soft landing' that is allowing inflationary pressures to gradually drift lower. While current polling suggests the outcome of the election could go either way, one thing is looking more certain: the candidate who wins the White House is likely to inherit a resilient economy.

Q5. Should we be worried about the cooling in the U.S. labor market?

Non-farm employment has slowed markedly over the past year, confirmed by a disappointing 114K net jobs in July. However, caution is warranted in reading too much into a single month of data. The labor market is still averaging a healthy 170k jobs per-month over the last three months.

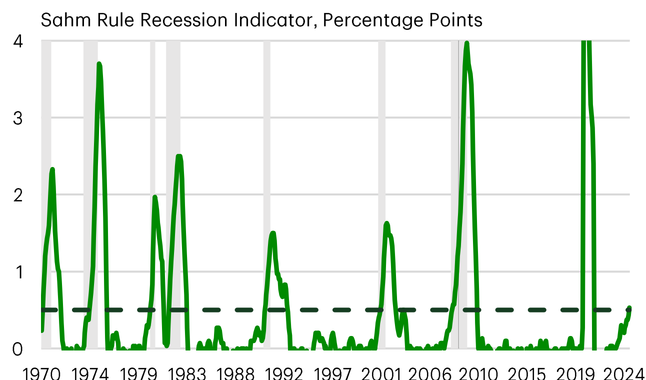
Still, it's impossible to ignore the degree of normalization that has taken place. For starters, employment gains have become increasingly concentrated in less cyclical sectors, like healthcare and government. Combined, these two sectors account for 29% of overall employment, but have been responsible for well over half of the jobs created in recent months. Another sign of weakness has been the pullback in temporary hires. Since peaking at nearly 3.2 million in March of 2022, demand for temporary workers has fallen by 15% or a whopping 467k jobs. This statistic has helped fuel market concerns that the Fed is already behind the curve because, in recent history, this magnitude has never happened without a subsequent recession.

Chart 5: Labor Market Imbalances Are Quickly Normalizing



Source: Bureau of Labor Statistics, TD Economics.

Chart 6: Sahm Rule Was Triggered In July



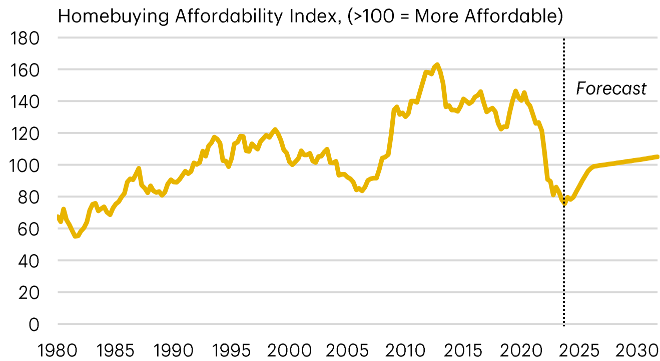
Source: Bureau of Labor Statistics, TD Economics.

However, not all labor market statistics are reinforcing that negative sentiment. The ratio of job openings to unemployed – a metric commonly used to assess the degree of imbalance in the labor market – has significantly receded from its 2022 highs. But it's only closing in on pre-pandemic levels (Chart 5). This period was not defined by a recession, which is why Chair Powell continues to refer to recent trends as a 'normalization' after an unusually long period marked by a breakneck pace.

The same can be said for the share of workers quitting their jobs and the share of small businesses intending to increase hiring over the next 3-6 months. At only 15%, it's near a cyclical low reached earlier this year.

One area grabbing increasing attention is the rise in the unemployment rate through the first seven months of 2024. At 4.3%, the near three-year high is also in stark contrast to its post-pandemic low of 3.4% (reached in April 2023). It's also trending above the pre-pandemic average of 3.7%. This has triggered market chatter on the Sahm rule (Chart 6). According to this rule, if the three-month average of the unemployment rate rises by half a percentage point or more relative to its previous 12-month low, a recession is likely to materialize over the coming months. However, Fed Chair Powell has referred to this as a statistical regularity and not an economic rule. Why? There's some reason to believe that this recession predicator will carry less statistical relevance or a longer lag than past cycles.

Chart 7: Housing Affordablity Should be Restored in the US by Mid-2027



Source: Census Bureau, BEA, NAR, forecast by TD Economics.

The uptick in the unemployment rate over the past year has been more influenced by a larger increase of entrants in the labor force compared to start of prior recessions. So while there's clearly a weakening in labor market fundamentals, the recent upswing is not (yet) a sure-fire sign that a downturn is imminent. That said, firm behaviors on hiring tend to have inertia and can be difficult to influence once a trend is established – suggesting the Fed can't wait any longer to cut rates.

Q6. When will lower interest rates provide relief for U.S. housing?

Our current forecast anticipates that 30-year fixed mortgage rates have already peaked at around 7% and will head lower in the second half of the year, dropping close to 6.0% by year end. Even with prices remaining elevated, this should provide some relief to the U.S. housing market starting in Q3 2024. Monthly mortgage payments on a median priced home are forecast to ease by 6-7% in response to the lower rates between now and the end of the year with our housing affordability index (HAI) rising marginally over the same period, meaning homes would become more affordable. Rates are anticipated to continue heading lower into next year and further improve the situation.

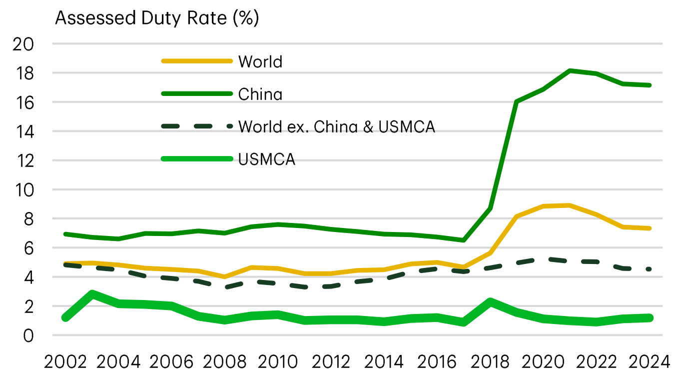
Even so, with limited supply propping up housing prices, a return to full affordability (i.e., the point at which the HAI = 100) remains in the distance. That is the point at which a family earning the median income is able to finance the purchase of a median priced home (assuming 20% down and monthly payments not exceeding a quarter of income). Given our base outlook for mortgage rates, home price and income growth, we expect that this point will be achieved by mid-2027 (Chart 7). Under this scenario, mortgage rates would need to trend near 5 to 5.5%, median home prices would grow at about 3% annually and income would advance by 4.5% annually, which is in line with its historical rate. Interestingly, it would take a more sizeable drop of approximately 300 basis points in mortgage rates, with both income and home prices at their current levels, to return full affordability to the market immediately – a highly unlikely outcome.

Q7. How might the 2024 U.S. election affect international trade?

Regardless of who wins in November, global trade will have to contend with an America that's leaning into industrial policy and self-reliance. The key differentiating factor will be whether the new administration will decide to "go at it alone" or continue to work with allies on strategic sourcing initiatives. The latter scenario represents an extension of the status quo, while the former would likely result in depressed global trade volumes.

First and foremost is the policy stance as it relates to China. Here, there is little relief in sight. The Biden administration imposed further tariffs on China (Chart 8) along with a raft of other non-tariff measures, like restricting access to advanced chips. Irrespective of the election outcome, these initiatives are unlikely to be reversed. The prospect of a Trump Administration also raises the likelihood of a 60% tariff applied to all imports from China, which would likely accelerate the trend we highlighted last winter of trade shifting away

Chart 8: Tariffs on China Persist, Despite Change in Administration



Source: U.S. Census Bureau, TD Economics.

from China and towards other economies.

For all other nations, Trump's proposed blanket 10% tariff has raised concerns. The E.U. is reportedly developing a two-stage strategy in response. First to pre-empt the possible tariffs with negotiations, and then to retaliate with targeted tariffs of 50% or more, if necessary. Canada is adopting a similar approach to the E.U. and holding pre-emptive discussions in hopes averting future tariffs. Canada and Mexico are highly reliant on trade with the U.S. and the USMCA agreement will be coming under review in 2026. As such, these countries likely won't want to rock the boat before the election and will likely continue seek solutions through diplomatic means or within the dispute terms of the USMCA agreement. However, as we saw in 2018, the existence of a trade agreement didn't preclude Canada from applying targeted countervailing duties on U.S. products – and the existence of the USMCA is no different. Ultimately, a broad and deep increase in tariffs would dent U.S. real incomes, depressing demand for foreign products. To the extent domestic substitutes exist, these will be consumed and where they don't, foreign goods will continue to flow – albeit likely at a slower pace.

For any media enquiries please contact Debra Moris at 416-982-8141

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