June 11, 2024

Tight Labor Market Conditions Overshadow Cooler Start to the Year

Economic INSIGHT

The U.S. economy slowed significantly across the first three months of 2024. While nominally still positive, GDP shed significant momentum from an earlier outsized increase of 4.1% in the second half of last year to just 1.3% in Q1. Amid the longest-running inversion of the yield curve on record, market participants are concerned of a more precipitous slowdown in the back half of the year and are pleading for a more accommodative monetary policy stance.

However, with disinflationary progress largely stalled since January and persistently tight labor market conditions, the slower pace of activity may prove less of a contagion factor for Q2. In fact, with consumer spending and business investment still strong, economic conditions remain broadly positive. This is perpetuating expectations for continued growth, the need for monetary policy stability, and disappointing investors' hopes for a near(er)-term rate cut by year-end.

A SLOWER PACE OF ACTIVITY

U.S. GDP reportedly rose 1.3% in the second-round report, revised down from an advanced estimate of 1.6%. Indicating an ongoing second derivative decline – or a reduced pace of still-positive growth – the domestic economy slowed from 4.9% in Q3 to 3.4% in the final three months of 2023 to now the weakest pace of expansion in nearly two years. Nevertheless, despite a relative decline from more robust activity in 2023, nominally, growth remains positive for the third consecutive year. Furthermore, in the aftermath of the COVID-19 recession, domestic activity has recovered more meaningfully relative to other developed counterparts abroad, with many overseas economies only recently emerging from a 2023 recession.

Country	Q2 2023:GDP	Q3 2023:GDP	Q4 2023:GDP	Q1 2023:GDP
U.S.	2.1%	4.9%	3.4%	1.3%
UK	0.0%	-0.1%	-0.3%	0.6%
Eurozone	0.1%	-0.1%	-0.1%	0.3%
Canada	0.7%	-0.3%	0.1%	1.7%

Source: Bloomberg

In the details, the latest U.S. GDP report indicated a noticeably slower pace of consumer spending. While maintaining positive momentum, consumer outlays were revised down a half of a percentage point to 2.0% in the second-round report, primarily a reflection

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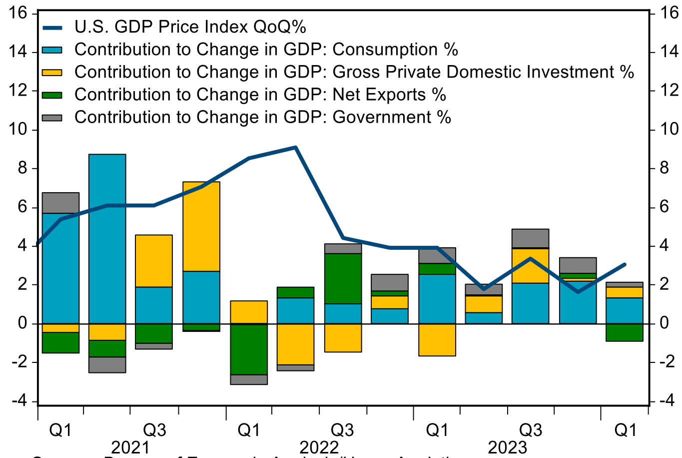
of a decline in goods expenditures (revised down from -0.4% to -1.9%) as opposed to services expenditures which were revised down a minimal one tenth of a percentage point to a still robust gain of 3.9%. Outlays on items such as vehicles (-0.38%) along with gasoline, fuel and other energy goods (-0.16%) in fact shaved off more than 0.40% from topline growth, the most since Q3 2021. Expenditures on services, meanwhile, including housing and utilities (+0.16%), financial services (+0.30%), and healthcare (+0.70%), added 1.76% to the headline number.



Source: Bureau of Economic Analysis/Haver Analytic

On the stronger side, business investment was revised higher in the second-round lookback at Q1 GDP, rising a more robust 3.3%, following an initial report of 2.9%. An ongoing flow of capital into technologies, including artificial intelligence (AI), was a particularly strong driver of investment growth at the start of the year. Residential investment was also a key support of more robust investment flows in Q1. A reflection of solid building activity with annual single-family construction up 2.5% January – March on an annual basis, residential investment rose 15.4% following a 2.8% rise in Q4 and contributing 0.57% to the topline read. Of course, with existing home sales falling 1.9% in April following a 3.7% decline in March, the most in one year, the overall level of housing market activity returned to a three-month low of 4.14 million at the start of Q2.

Additionally, the gap between exports and imports widened at the start of '24 to the highest level since Q3 2022 reflecting both relative strength in the U.S. dollar and strong domestic demand. While both exports and imports were revised higher in the second-round Q1 GDP report, up 1.2% and 7.7% respectively, net trade activity still resulted in a drag of nearly a full percentage point on headline growth.

UNCERTAINTY IN GROWTH, INFLATION

While the economy appears to be running at a slower-than-expected pace, consumers continue to spend and businesses continue to invest. This underscores the thesis of a still-solid economy and highlights the potential for a soft(ish) landing. While an earlier 525-basis point increase in the federal funds rate has clearly cooled or tamped down consumer spending relative to more robust post-COVID-19 levels, the lack of outright weakness compounds future uncertainty in terms of directional momentum in spending.

Furthermore, while business spending remains positive albeit modest, an ongoing slower pace of investment is likely to lead to at least a marginal increase in bankruptcies and closures in the coming 12-18 months as reduced profits or at least reduced profit expectations result in some credit quality issues. According to the Department of Commerce, corporate profits dropped for the first time in a year, falling 0.6% to $3.39 trillion from a record high in the fourth quarter.

GLOSSARY

AHE – Average Hourly Earnings

GDP – Gross Domestic Product

NFP – Nonfarm Payrolls

QoQ – Quarter over Quarter

YoY – Year over Year

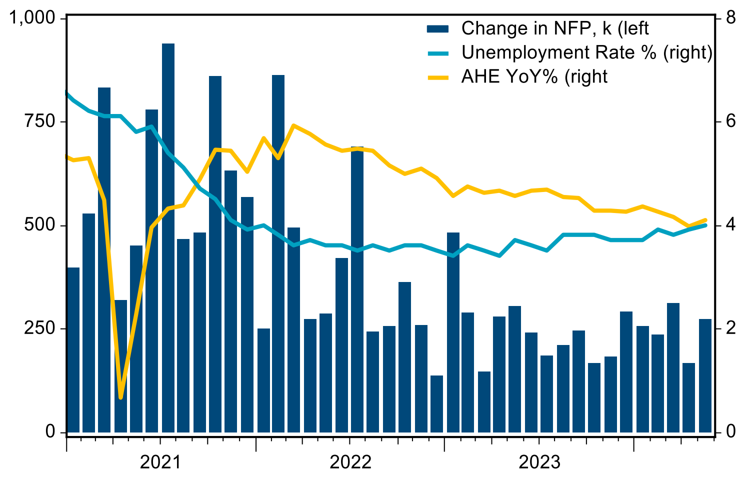
Inflation remains the largest hardship and threat for households and businesses. Balking at higher prices, consumers have nominally reduced dollars spent and continue to reallocate monies away from goods in favor of services. Meanwhile, higher parts, materials, borrowing, and labor costs continue to pose a challenge for corporate America, squeezing profit margins and adding further uncertainty to the outlook for the remainder of the year and 2025. Inflation had been on a clear disinflationary track for months leading into the current year. As of January, however, downward momentum has stalled and, in some cases, reversed course, forcing policy makers to reconsider whether the current level of rates will prompt the weakening trend in prices to – eventually – resume.

The latest read on inflation showed a 3.0% rise in Q1. While revised down from an earlier 3.1% increase in the first-round report, this remains the firmest quarterly price growth in six months.

WEAKNESS OVERSTATED

Federal Reserve (Fed) officials remain confident inflation will ease back towards the 2% target, allowing for rate reductions – eventually. The latest slowdown in headline GDP offers some compelling indications that demand is weakening, or at least cooling, implying the weight of higher rates is having the intended negative effect. Of course, excluding the volatility of inventories and trade (the highest concentration of weakness), growth in real final sales to domestic purchases rose 2.6%. While revised down from a first-round report of 2.8% and marking the slowest pace since Q2 2023, a near 3% acceleration sends a clearer signal of sustained underlying demand and activity. In fact, coupled with continued strength in the jobs market, the second quarter may prove surprisingly more robust in both activity and *inflationary* pressures, further delaying any adjustment in Fed policy.

The latest read on labor market conditions showed a 272,000 rise in payrolls, surpassing the 180,000 gain expected. Marking a two-month high in May, the three-month moving average rose from 237,000 to 249,000. The unemployment rate, however, ticked up, albeit minimally, from 3.9% to 4.0%, the highest since January 2022. Furthermore, wage pressures rose 0.4% in May and increased 4.1% on an annual basis, *up* from a 4.0% gain in April and marking the fastest pace since March.



Source: Bureau of Labor Statistics/Haver Analytic

While arguably rebalancing at a gradual pace in the aftermath of the fastest backup in rates in four decades, the expected slowdown in demand and overall impact on the U.S. labor market remains muted. Again, momentum is slowing in many key **categories** of economic activity, particularly as younger and lower-income consumers more heavily

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adjust spending; the readjustment, however, remains less than anticipated. The minimal rise in the level of layoffs coupled with still-solid demand for new hires limits any certainty of improvement in price pressures or for more dampened conditions for headline growth. This is undermining expectations for a near-term reduction in rates, let alone a *necessity* for less restrictive policy.

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