DUCENTA SQUARED
ASSET MANAGEMENT

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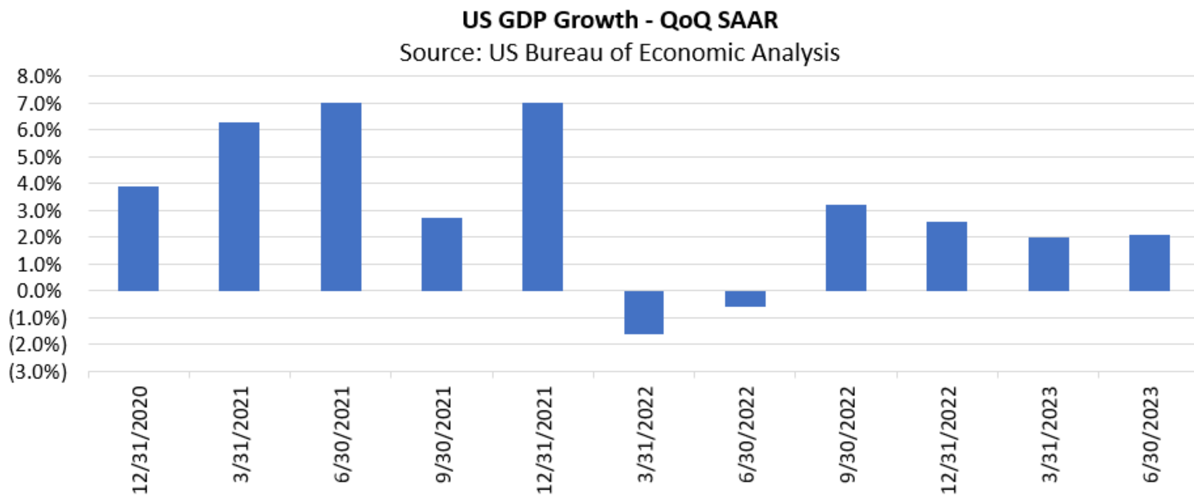
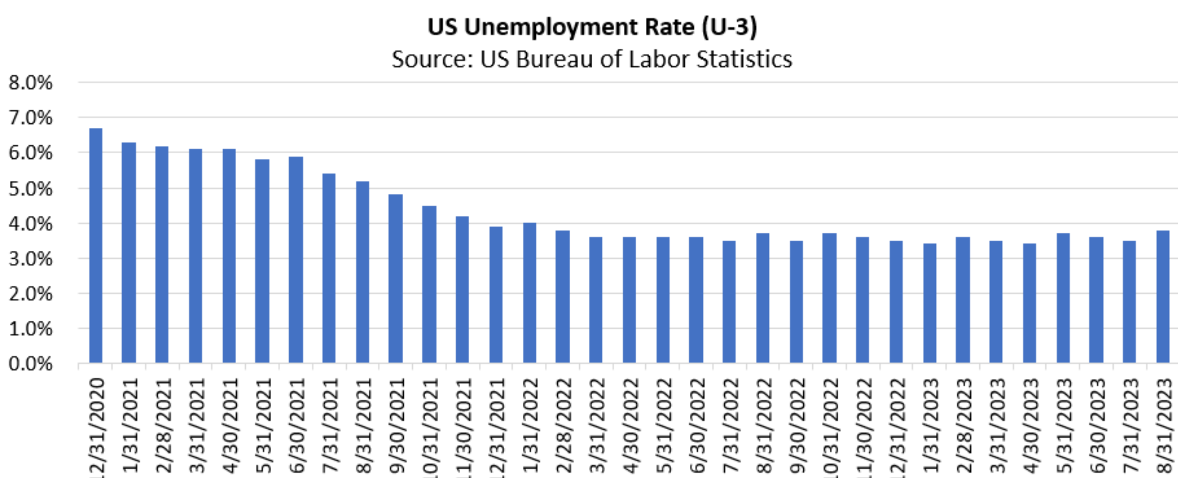
Soft landing, no landing?

Much to the consternation of economic forecasters who have spent months predicting an imminent recession here in the US, the economy has chugged along year-to-date, posting annualized GDP growth of 2.0% and 2.1% for the first and second quarters of this year, respectively (see chart). As of this writing, the Atlanta Federal Reserve forecasts that third quarter US GDP growth will accelerate to a 4.9% annualized rate. Far from growth receding into recession, it appears that at the very least growth has stabilized at a level in-line with what many economists would deem a healthy trend. This healthy economic growth has occurred against a backdrop of strong employment and a decline in broad inflation measures from the decades-long highs reached last year. Is this what a soft landing looks like?



The three pillars of economic growth comprise low unemployment, healthy consumer spending and business fixed investment. The unemployment rate bottomed out in April of this year at 3.4% but has only risen to a still historically low 3.8% as of the last August report (see chart). Other indicators of labor market strength, such as job openings to unemployed, although off cycle highs remain elevated relative to pre-pandemic norms. We continue to closely monitor weekly initial unemployment claims numbers as one of the best high frequency indicators of labor market health. So far, that data series has reflected a very strong employment situation.



The latest retail sales report for August shows that the consumer is still spending at a very healthy rate. The core retail sales number, the so called 'control group' which feeds directly into GDP calculations, is still normalizing from the very elevated spending levels recorded during the pandemic, but nevertheless registered 3.6% growth on a year-over-year basis. While retail sales largely reflect consumer purchases of goods, the personal consumption expenditures report provides a more balanced indication of consumer spending as it more completely incorporates spending on services. The latest personal consumption expenditures data from July indicates very solid year-over-year growth of 6.4%.

The third pillar, business fixed investment, had been contracting for four quarters beginning in the second quarter of 2022, as businesses broadly believed that the economy was headed toward a recession and were delaying capital investment. The continued resilience of the economy has, however, pushed businesses to resume capital investment. In the second quarter of this year business fixed investment increased at a +3.4% annualized rate. Increased capital spending appears to be continuing during the third quarter as the Atlanta Federal Reserve's GDP Nowcast is forecasting a positive contribution to GDP for business fixed investment.

Continued economic strength has provided a tailwind to risk markets as investors price in a "goldilocks" scenario where the Federal Reserve engineers a soft landing for the economy where inflation recedes toward the 2% target, growth remains positive, and labor markets remain healthy. Year-to-date, the S&P 500 is up 16% while the Bloomberg US Corporate Bond Index and the Bloomberg US High Yield Corporate Bond Index provided +239bps and +600bps, respectively, of excess return versus duration matched US Treasuries.

The chairman of the Federal Reserve, Jay Powell, has been firm in his commitment to return inflation to the 2% target rate. To this end, he has pushed back against the market's expectation of policy rate cuts coming sooner rather than later. The stronger-than-expected economy has seemingly convinced participants that delayed rate cuts will indeed be the base case. Currently, federal funds futures markets are pricing in a peak federal funds rate to occur January of 2024 followed by approximately three rate cuts by year end 2024. Interestingly, the current short-term Bloomberg consensus expects consistently positive quarterly GDP growth (i.e., no periods of negative GDP growth) and a peak unemployment rate of 4.4%. The consensus looks pretty goldilocks.

What do we expect? We still anticipate a mild recession in 2024. The timing is difficult to forecast, but we still expect it to start sometime in the first half of next year. So, we expect negative GDP. Is the consensus expectation of a peak unemployment rate of 4.4% consistent with that? Our expectation is probably not, but given the shallow recession forecast, we think the unemployment rate will remain historically low relative to past recessions, and possibly in line with the dot-com recession that had the unemployment rate peak at about 6%.

Past performance is no guarantee of future results.

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