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Why has the U.S. Economy been so Resilient?

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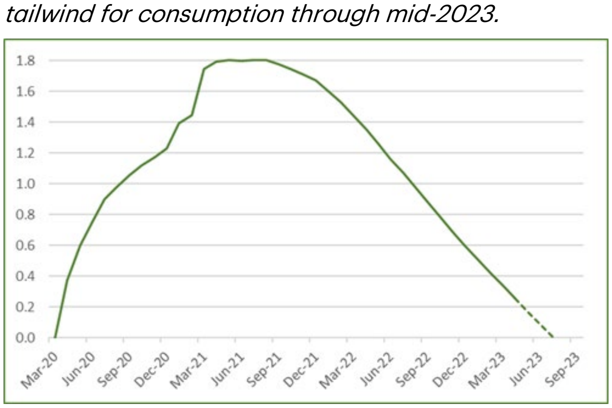
Why aren't we already in a recession? The U.S. Federal Reserve (Fed) has hiked by a whopping 500 bps, with more tightening still in the pipeline. And the consensus has been predicting a downturn for over a year now.

We believe there are three reasons why the economy has held up better than expected: the lingering impact of the aggressive 2020 and 2021 COVID stimulus packages, the renaissance of industrial policy since August 2022, and the relatively less restrictive stance of overall financial conditions.

COVID stimulus and excess savings

The first reason is that the American response to the COVID recession was fast and furious, with the CARES Act (March 2020), Tax Relief Act (Dec 2020) and American Rescue Plan Act (March 2021). As a result, personal income and savings immediately soared (Figure 1). While this stimulus provided a tremendous impulse for all sorts of consumption spending over the last three years, this legacy has now been entirely spent and will no longer be a positive driver for consumers.

FIGURE 1 – Cumulative excess real savings (USD tn): Peaked at $1.8 tn in mid-2021.
Drawing down this enormous stockpile provided a gusty tailwind for consumption through mid-2023.

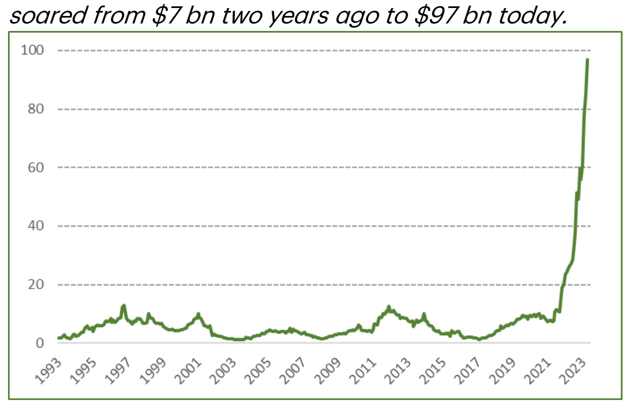


Source: Bloomberg Finance L.P., TD Epoch calculations

Industrial policy renaissance: Booming manufacturing construction

The second reason is that industrial policy has returned, after a 50+ year hiatus, with the August 2022 passage of both the $280 bn "Chips and Science Act" and the $400 bn "Inflation Reduction Act" (the latter is horrendously misnamed as its primary purpose is incentivizing domestic green tech investment). One direct beneficiary is manufacturing construction, up 105% yoy, with the electronics sector especially strong (Figure 2).

FIGURE 2 – Manufacturing construction: electronics (USD bn, saar).
Spending on facilities for manufacturing electronics has soared from $7 bn two years ago to $97 bn today.



Source: U.S. Census Bureau
SAAR: Seasonally-adjusted annual rate

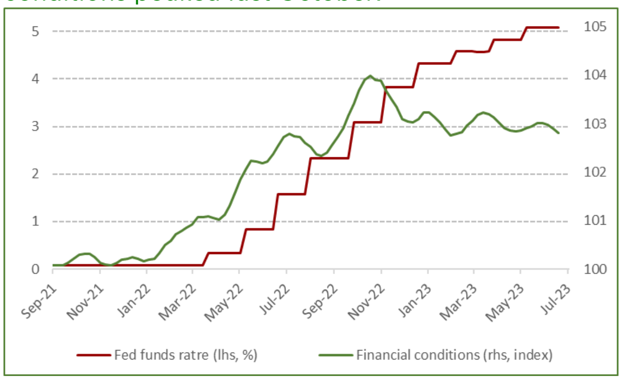
Industrial policy spending on green tech and semiconductors is likely to remain strong through 2032, with the balance of risks lying to the upside. However, broader measures of fiscal policy, which provided significant oomph for the economy in 2023, are tightening. To illustrate, consensus expects government spending growth to slow from 3% this year to 1% in 2024 and 2025.[1] This implies a slightly negative fiscal impulse over the next two years.

[1] This reflects the June 3 "Fiscal Responsibility Act", part of the debt limit deal, which sets a cap on federal discretionary spending for 2024 and 2025.

Financial conditions *vs* the Fed Funds Rate (FFR)

Third, while the FFR has skyrocketed, the same can't be said of broader financial conditions, which haven't budged an inch during the last twelve months (Figure 3). To illustrate, the 10Y yield is only a couple basis points higher than it was a year ago and the high yield spread is actually a touch lower (Figure 4). This helps explain why the U.S. household debt service ratio is only 9.6% of income.[2] However, the bad news is that this means the Fed has to keep on hiking until financial conditions tighten enough to wallop employment, services consumption, and wage growth.

FIGURE 3 – The FFR is still climbing higher, but financial conditions peaked last October.



Source: Bloomberg, Goldman Sachs Financial Conditions Index

FIGURE 4 In theory a higher FFR leads to tighter financial conditions for U.S. consumers and businesses. However, this isn't exactly what's been happening.

Even mortgage rates are flat over the last 9 months, which helps explain housing's recent strength.

Source: Bloomberg

Three scenarios for the next 12 months

With wage growth stuck at 6% and core inflation north of 4%, we expect the Fed to retain a tightening bias for at least the next two quarters. While so much tightening, over such a short period, would normally have ensured a recession, nothing about this cycle has been normal. That is why we have adopted a scenarios framework.

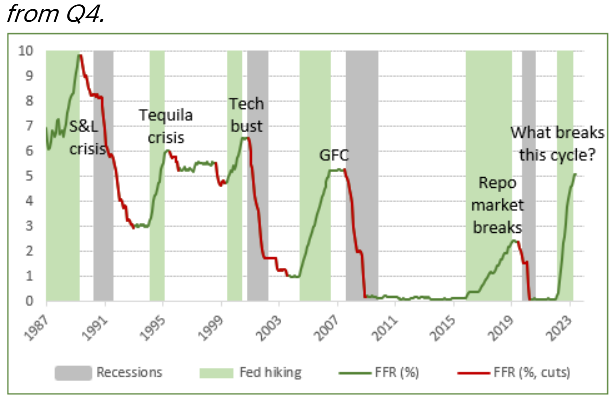
Our first scenario calls for a soft landing (40% probability), with sub-trend but positive GDP growth, inflation stuck well above target, a vigilant Fed, and EPS continuing to grow. We believe this implies a choppy SPX, with "fat and flat" (i.e., choppy but directionless) equity returns.

The second outcome involves a "short and shallow" recession (also 40% likely), with slightly negative GDP growth, inflation decelerating, moderate Fed cuts, and EPS declining by 5-10%. For equity markets we believe this could be similar to the 1990 recession in which the SPX declined sharply for two months but then quickly rebounded.

The third scenario is a hard landing (20% chance), in which something breaks. This is what happened on a massive scale in 2000-2002 and 2007-2009, although this time the imbalances are much less extreme (Figure 5).[3] Still, in a hard landing, GDP growth would be negative for an extended period of time, and EPS would slump by over 15%. In such an outcome the Fed would be focused on financial stability rather than inflation and would quickly slash rates by several percentage points. Equity markets could plummet by 15-30%.

FIGURE 5 – The Fed often hikes until something breaks: This, not declining inflation, is what typically drives Fed cuts.

We are skeptical of FFR futures which have priced in cuts from Q4.



Source: Bloomberg, TD Global Investment Solutions

Investment implications

The U.S. economy has been much more resilient this year than consensus expected. However, the first two reasons for this surprising strength, both related to fiscal policy,

[2] *This is significantly below the 1980-2019 average of 11.2% (in fact, the lowest during that period was 9.8%).*

[3] *The key vulnerabilities this cycle are in private markets, commercial real estate, and smaller banks.*

are fading. Further, the third reason, relatively unresponsive financial conditions, is forcing the Fed to tighten ever more aggressively.

Moreover, monetary policy works with lags that are famously long and variable. The Fed just started hiking 16 months ago and in previous cycles it has taken considerably longer (typically 21 to 42 months) for recessions to take hold. This suggests the current cycle might not be that different, it's just that tightening takes a long time to produce its desired effect.

We still believe a recession is more likely than not. However, it is impossible to have high conviction regarding the timing and depth of an eventual downturn. Rather, we prefer a scenario-based approach which favours a cautious stance, focused on quality companies with a demonstrated ability to return capital to shareholders and/or to produce a return on invested capital in excess of their cost of capital.