Weekly Market Flash

The 4-3-2 Economy
November 15, 2024

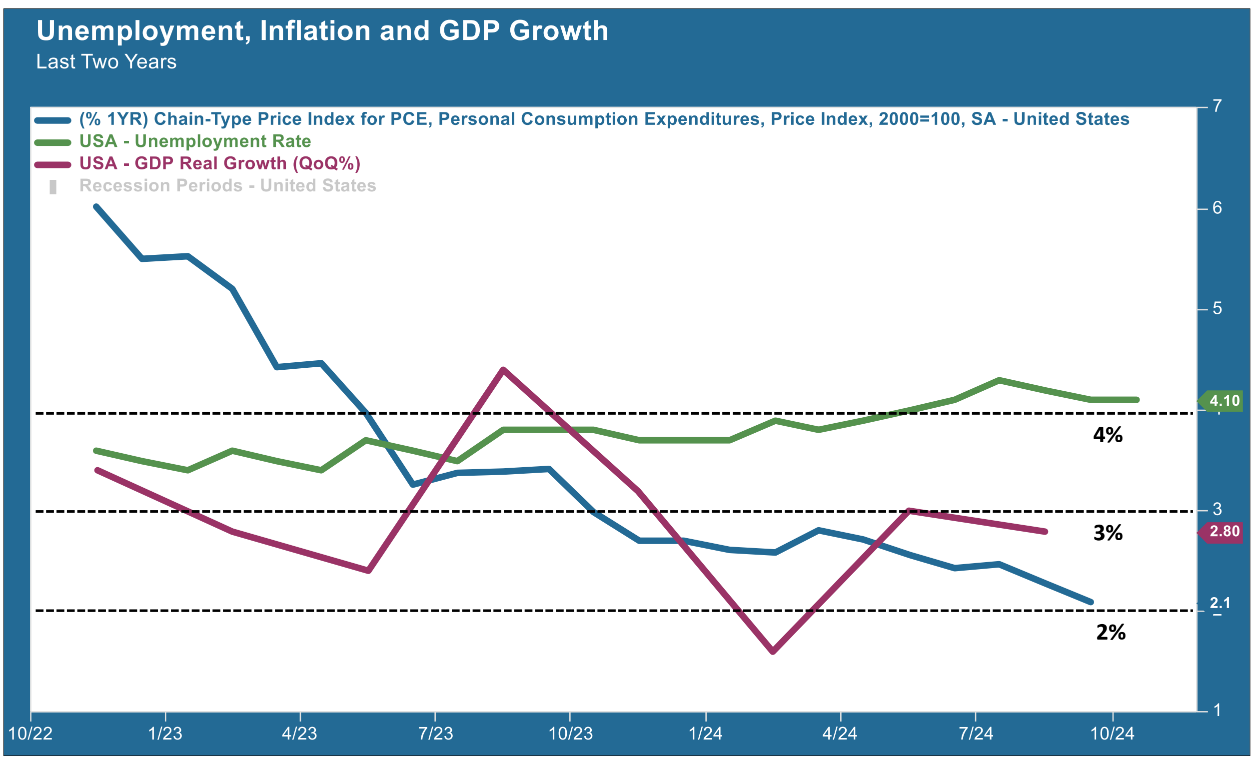
So what do we know now that we didn't know one week ago, regarding possible trajectories for the US economy? To be perfectly honest, not much. But if it is still too early to talk about the economy of the future, we can at least take stock of where we are starting from. We call it the 4-3-2 economy, which we think is a reasonable way to quantify what a soft landing looks like:

Four (4) percent unemployment (the current unemployment rate is 4.1 percent).

Three (3) percent real GDP growth (3.0 percent in Q2 and 2.8 percent in G3).

Two (2) percent inflation (still higher by most measures, but headline PCE is currently 2.1 percent).

Here's the 4-3-2 economy in one simple chart.



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, MVF Research, FactSet

This is the economy the current administration will be handing over to the next administration. But let's remember a couple important facts. First, if any institution in Washington can legitimately take credit for this economy, it is neither in the White House nor in the halls of Congress, but in the Eccles Building where the Federal Open Market Committee, since March 2022, has guided interest rates higher to break the back of inflation (getting that number back down to two percent) while not wreaking misfortune on the labor market (a four percent rate of unemployment is cooler than the blistering, historically low levels of 3.4 percent in early 2023 but well below the plus-five territory that typically accompanies a recession. Those two numbers – inflation and the unemployment rate – represent the Fed's dual mandate of maintaining stable prices and full employment. If the central bank can pull off that tricky feat (which most don't, hence the "soft landing" normally being the stuff of economists' dreams rather than reality), then a decent pace of economic growth should ensue. Three percent real GDP growth is healthy; in fact, it is probably pushing the boundaries of what the US economy is capable of achieving steadily over the long run. The Fed may have been late to the party when it made the first increase to the Fed funds target rate in March 2022, but it appears to have pulled off the soft landing.

The other important fact to remember is that the economic cycle ultimately depends on the decentralized decisions made by households and businesses around the world as to how much they intend to spend (households) and invest in productive capacity (businesses), and these economic agents only pay sporadic attention to what the legislative and executive branches of the government are doing (e.g., when tax rates change or business regulations come into or out of existence). Throughout the cycle when interest rates were going up, we heard a similar refrain on many of the quarterly corporate earnings calls we dialed into: "macro uncertainty is high, and we have less conviction around our sales targets in the coming twelve months." Yet consumers kept on spending.

Then, in 2023, businesses started investing again at levels not seen since the end of the 2008 global financial crisis. The catalyst for this new wave of spending, as we all know very well, was newfound enthusiasm about artificial intelligence as the apparent wonders of generative AI made themselves known. Now, there is still much debate about how useful all this capital investment will prove to be. Maybe it will be a productivity game-changer, maybe not (we are ever so cautiously on the side of thinking that it will). But it has certainly contributed to that 4-3-2 soft landing.

Nor should it come as a big surprise that the US stock market has continued to set record highs throughout the year, as the probability of the soft landing rose and with it the permission slip for the Fed to start cutting rates. The consensus forecast of analysts who cover S&P 500 companies is for mid-single digit growth in top line sales, with bottom-line earnings per share growing by around ten percent – with this trend likely to continue into the first quarter of next year.

That's where things stand today in the US economy. As we noted last week and will continue to observe in the weeks and months ahead, what works today might not work tomorrow. But it is a good starting point, and we would have to imagine that the rational course of action for any policymaker being handed a 4-3-2 economy would be to do as few things as possible to make it worse. That's not a guarantee by any means, but we think it's about as good a starting point as one could hope for.

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