Three calls for the US

Our big call for the US next year is that we see a sharp slowdown in US activity and the subsequent rebound is likely to be slower than hoped. Thankfully, our second call, that inflation will hit 2% by next summer and stay there offers the Federal Reserve scope to cut rates earlier and more aggressively than the market expects, which is our third call

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1 US experiences a sharp slowdown and slow recovery

After stellar third-quarter GDP growth of 5%, the US economy is set to experience slower, albeit still solid, growth in the fourth quarter with legacy household savings helping to maintain consumer spending. However, we are concerned that 2024 will be much weaker as stagnant real household incomes and tighter credit conditions weigh down and pandemic-era accrued excess savings are exhausted for many. Credit card delinquencies are on the rise while student loan repayments are only adding to the financial pressure on millions of households. Meanwhile, collapsing housing transactions, a general lack of affordability and plunging homebuilder sentiment suggest residential construction could weaken while softer durable goods orders point to a significant slowing in capital expenditure. With banks remaining wary, tight monetary and credit conditions mean the risk of recession is very real, especially with activity looking weak elsewhere in the world. The commercial real estate sector is also an area of vulnerability with the scope for significant loan losses potentially leading to a reignition of the problems seen in the small bank sector in early 2023. Financial sector stress would intensify and prolong a downturn in the real economy.

2 Inflation to hit 2% by the summer and stay there

Inflation has been showing encouraging signs of moderation and we think it will get to the 2% target in the second quarter of next year assuming gasoline prices stay at their current levels. Goods price inflation is close to zero, indicating supply chain issues have disappeared, but the Federal Reserve has been emphasising the super-core measures of service sector inflation that strip out food, energy and also housing costs. This is to get a better gauge of areas where the tight jobs market may keep inflation higher for longer. Fortunately, this too is responding well to tighter monetary policy with decent productivity growth and cooling wage growth helping to keep inflation pressures in check. Housing remains the main issue, but the Fed has clarity on its path given that it lags observed rents by 10-14 months. These rents are slowing sharply and mean that the housing components will help depress core inflation by around 1.5 percentage points over the next two to three quarters.

3 Fed to cut rates at every meeting from May onwards

The threat of recession, dampened inflation pressures and the prospect of a pronounced weakening of the labour market should open the door for the Federal Reserve to lower interest rates from May onwards towards more neutral levels. Even if inflation doesn't fall quite as quickly as we expect, the Fed's dual mandate of price stability and maximum employment should offer it the flexibility of responding swiftly to concerns about the path of the economy. We look for 150bp of rate cuts in 2024 with a further 100bp in early 2025, but the cuts could be more front loaded if financial stress returns amid likely increases in loan losses.

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