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No Stag? No Flation?

An update on latest developments in the US economy

PRIVATE BANKING

When asked about the risk of Stagflation for the US economy last week, Jerome Powell answered that he doesn't "see the Stag or the Flation actually". Yet, this question finds some ground in the latest economic data released in the US. Indeed, they have generally been disappointing regarding economic activity, and stronger-than-expected regarding inflationary pressures.

Is it enough to revive fears of a stagflationary scenario where growth would slow down below trend and eventually turn negative, while inflation would remain uncomfortably high?

We review below the recent US economic data and assess the risk of seeing the so far prevailing scenario of soft (or no) landing and slowing inflation being taken wrong-footed.

Stag?

Stagflation fears were first reignited by the release of **GDP** data that pictured a softer growth than expected during the first quarter (+1.6%), along with a stronger than expected increase in price levels (+3.1%). However, the disappointment in growth was mostly caused by weak inventory growth and a deterioration in the trade balance, while private domestic demand held firm and grew at an above-3% pace for the third consecutive quarter. Indeed, business investment continues to grow, even if at a moderate pace, as highlighted by the mild rise of **Durable Goods Orders** in March.

In the meantime, household consumption remains on a firm expansion trend that was also pictured by above-expectation **Retail Sales** and **Personal Spending** data in March. The continuing rise in **Personal Income** keeps powering the main driver of the US economy, consumer spending, supported by the resilience of the labor market. Indeed, the **Unemployment Rate** (3.9% in April) and new **Jobless Claims** are still close to historical lows and ensure that the key driver of households' spending behaviors remains positively oriented for the time being.

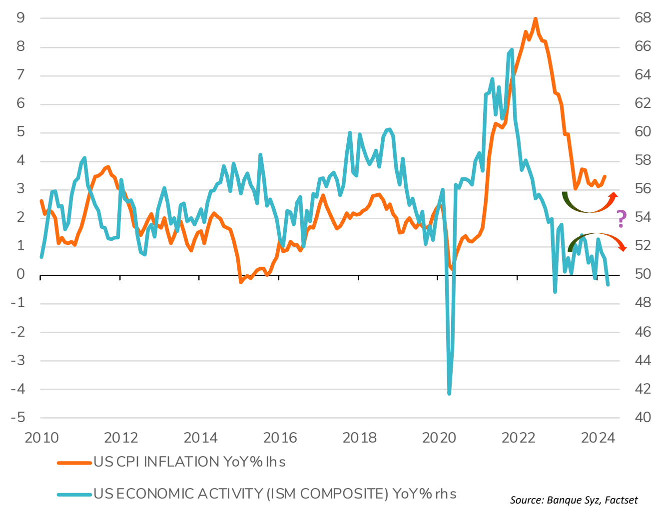
However, a few worrying signals have also appeared recently on the momentum of these dynamics. Strikingly, consumer confidence has dropped in April, with the sentiment on the labor market edging lower. The pace of monthly **Non-Farm Payrolls** creations has declined to a 6-month low in April (175k), while the **Unemployment Rate** ticked up to a 2-year high. The number of **New Job Openings** and of workers leaving voluntarily their job **(Quits Rate)** also declined to post-pandemic lows, pointing to a continuation in the normalization of what has been a very tight labor market over the past three years. In parallel, business activity surveys have also proved to be on the soft side recently: both the **ISM Manufacturing** and the **ISM Services** declined to "contraction" levels, while some regional indicators (**Chicago PMI, Empire Manufacturing)** have been below expectations in April and reversed the positive momentum of the previous months. The **NFIB confidence index of Small Businesses** declined to an 11-year-low.

This synchronized deterioration in households and business confidence indices is therefore a legitimate source of concern for the US economic outlook in the months ahead. While current activity data still point to solid economic activity, weakening sentiment could eventually translate into weaker consumption and investment spending, finally materializing the recession risk that haunted markets for most of 2023 before being dissipated by stubbornly strong activity data. Jerome Powell is certainly right in seeing no stagnation of the activity for the time being, but markets are entitled to be concerned and to attach a rising probability to the risk of a significant growth slowdown for the second half of the year.

Flation?

In parallel, data related to inflation have consistently been above expectations recently. **CPI and PCE inflation indicators** both came out above consensus for March, as it had been the case since the beginning of the year. Headline inflation is picking up, while the less volatile "core" inflation fails to slowdown as anticipated and remains at a level too high compared to the Fed's target ("core" CPI at 3.8% YoY, "core" PCE at 2.8%, vs Fed's target at 2.0%). **The "Prices Paid" component** of business confidence surveys is rising again, as are **households' inflation expectations.** Gauges of wage evolution such as the **Employment Cost Index** or **Unit Labor Cost** have been strong over Q1, reflecting no tangible sign of an easing in upward pressures on wages yet, even if **Hourly Wage Growth** continued to moderate gradually in April.

Inflation and its main underlying driver, wage growth, remain too high in the US for the time being. The disinflationary trend at play since mid-2022 has stalled since the end of last year and some indicators even suggest a recent pickup that would go against the Fed's scenario of a gradual easing in inflationary pressures throughout 2024. The rise in oil and gasoline prices since the beginning of the year may have played a role, but some underlying inflation dynamics also appears to be stickier-than-hoped so far. After the succession of shocks in the past four years, the inflation outlook remains highly uncertain. The jury is still out on whether a "return to normal" is just taking longer to materialize than expected, or if this succession of shocks combined with structural shifts in global supply chains have fundamentally altered inflation dynamics in the US.



Source: Banque Syz, Factset

Our take

- Data released in the past few weeks have clearly challenged the scenario of "resilient growth and slowing inflation" that financial markets had embraced since the end of 2023.
- For the time being, the loss of growth momentum appears to be contained and can still be squared with long-held expectations of economic slowdown after an unprecedented cycle of monetary policy tightening. But such slowdown also raises the risks of a more pronounced deterioration in the months ahead.
- A growth slowdown should in any case dampen inflationary pressures that have been mostly driven by strong final demand lately. In that sense, the likely trend for inflation continues to be toward a lower pace. However, the risk of potential supply shocks keeping inflation too high cannot be ruled out neither.
- While it is certainly too soon to speak of Stagflation for the US economy, as stated by Jerome Powell, recent developments have brought back this potential risk in the mind of investors. Let's hope that the Fed's Chairman will still be able to say that he doesn't see neither stagnation nor inflation in the second half of the year.

For further information

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