

# US economy - On track for a smooth soft landing



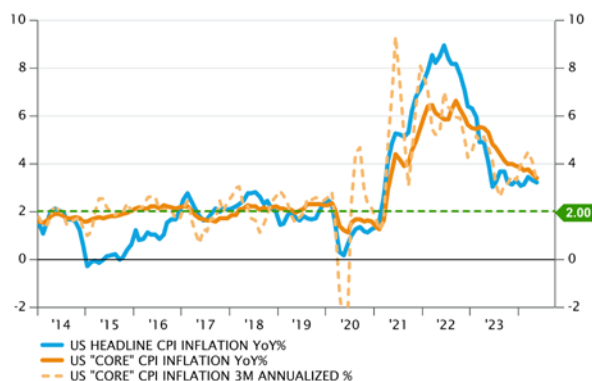
The past couple of weeks have brought useful insights about the US economy. And although pockets of weakness, risks and uncertainties remain, while the Presidential election looms, the general situation today appears to be quite good for the world's largest economy. Business activity remains clearly positive, inflation has resumed a slowing trend after a short-lived unexpected pickup, and the Fed has clear room for easing its monetary policy if needed but has no need to rush neither. The scenario of a smooth, soft landing, where inflation would gently converge toward the Fed target, growth would gently converge toward its long-term potential, and the Fed would eventually gently loosen its monetary policy toward a neutral stance, no longer appears to be a pipe dream.

## Inflation has resumed a slowing trend

Inflation had been unexpectedly reaccelerating in the first months of 2024, running at a 4.5% annualized rate during the first quarter. This had stoked concerns that inflationary pressures were stickier than expected, as a still tight labour market, resilient demand for services and sector-specific price dynamics (shelter, motor vehicle insurances) were preventing upward pressures on inflation rates to abate. Even inflation expectations had started to pick up again, highlighting the risk of households starting to anticipate a state of sustainably higher inflation.

Fortunately, those fears have been alleviated by data released over the past month. Yesterday's CPI report pointed to a clear moderation of the inflation dynamic that makes the Q1 reacceleration likely to be a "bump" on the disinflationary road rather than a truly worrying development. While prices of shelter (housing rents) show no sign of slowing down yet, prices of other services have not increased last month, for the first time in more than two years. In the meantime, prices of durable goods continue to decline as they have for more than a year.

**Chart 1: Inflation resumes a downward trend after the Q1 rebound**

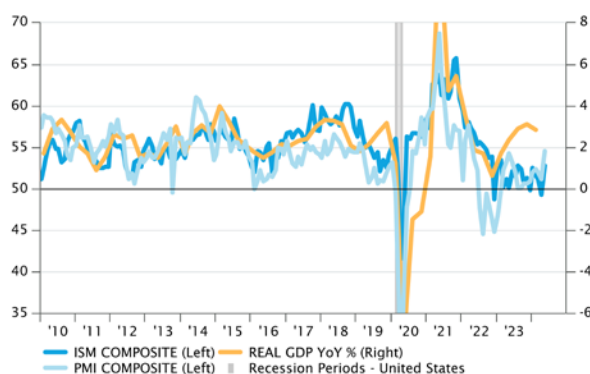


Consequently, the CPI inflation rate fell to 3.3% in May. More importantly, the "core" inflation rate, a better gauge of underlying price dynamics, slowed to its lowest level in three years, at 3.4%. The trend toward lower inflation and softer price pressures therefore remains in place, even if it proves to be a gradual process and even if some sectors still experience persistent price increases. Reassuringly, this appears to be felt by consumers as well, as inflation expectations have recently receded after a Q1 rebound.

## Economic growth remains firm, and the labor market normalises

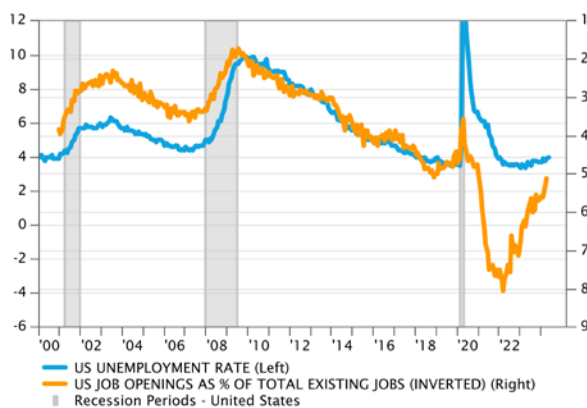
Growth remains firm in the US and recent data have shown no sign of slowdown. The soft GDP growth experienced in Q1 (+1.3%) was mostly due to inventory adjustments and external trade, while domestic demand grew at a healthy +2.5%. And real-time estimates of GDP growth for the second quarter currently point to a solid +3.1% expansion rate. Growth continues to be led by the service sector, as reflected by the strong rebound in the ISM Services in May. A gauge of small business activity (NFIB index) that had drifted to a 10-year low in March has been rebounding over the past two months. PMI indices for the manufacturing and service sectors have improved in May and the PMI Composite is up to its highest level in two years. Quoting the Fed, "economic activity continues to expand at a solid pace".

**Chart 2: Activity indicators have picked up in May and GDP growth remains firm**



Some recent indicators have pointed to an easing in tensions on the labour market. They suggest that the imbalance between demand and supply for workers that had characterized the US economy since 2021 is now close to being bridged. The perception of households on the job market has also become gradually less upbeat, even if it remains clearly positive. Underlying dynamics within the labour market have also shifted toward more temporary jobs at the expense of full-time contracts.

**Chart 3: The post-Covid imbalance of the labour market is close to being solved**

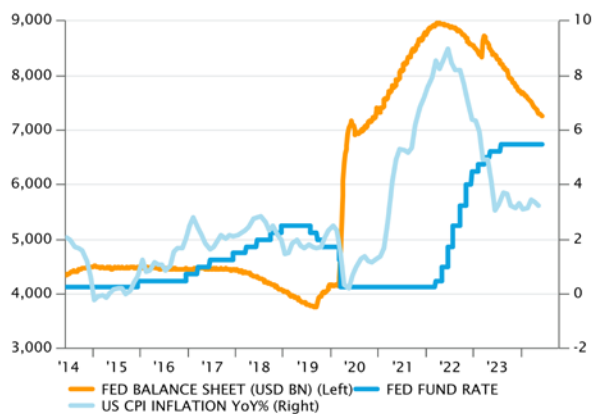


However, those developments shouldn't be seen as worrying for the economic outlook, as they are merely an adjustment from a situation of unprecedented tightness of the job market. Labor shortages in many sectors have been a remarkable feature of the past three years, caused by a combination of lower immigration, demographic dynamics, a change in the relationship with work caused by lockdowns and Work-from-home, and surging demand for service sector jobs. This situation has led to an acceleration in wage growth that has fueled domestic consumption, but also raised inflationary pressures, becoming the key source of concern for the Fed. The current easing of the US labor market is therefore a welcome development as it will contribute to normalize underlying inflationary dynamics. As it stands, it doesn't threaten the growth outlook as employment remains high: job creations continue to be positive and the unemployment rate, at 4%, is still close to its historical lows.

## The Fed will cut rates, but it is in no rush

Those developments on inflation and economic activity are probably as close to the perfect set up for the Fed as they could ever be. After having been caught by surprise by the surge in inflation in 2021/22, the Fed has reacted forcefully with an aggressive monetary policy tightening. Short-term rates have been raised from 0.25% to 5.5% in 18 months, the most aggressive rate hike cycle since the 1970's. Some \$1.7tn liquidity has been removed in two years via Quantitative Tightening (close to 20% of the Fed's balance sheet at its peak). And unlike in any other monetary policy tightening cycle, it hasn't triggered a recession!

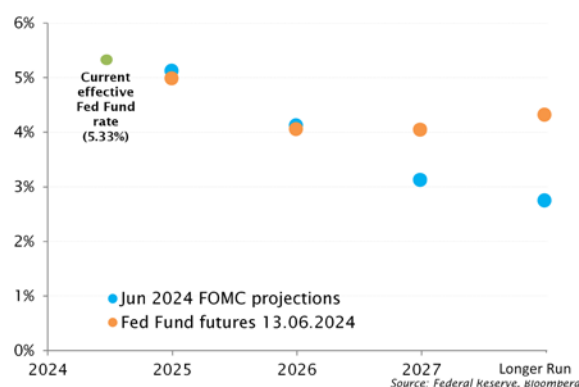
**Chart 4: The monetary policy tightening in 2022/23 was a historic one**



Last Wednesday, Fed members updated their economic and rate forecasts. And what they expect can be deemed as a "perfect" soft landing, in which economic growth and the unemployment rate will stabilize close to their long-term trend while inflation, that is still above the 2% target, will gradually slow down toward the desired level. The Fed indeed confirmed its forecast of a 2.1% GDP growth in the US this year, followed by 2% growth in 2025 and 2026. It maintained its forecast of an unemployment rate at 4.0% this year and marginally revised up its projection for the following years, at 4.2% and 4.1%. In parallel, inflation forecasts were slightly revised up and point to a more gradual easing in upward price pressures before reaching the 2% target in 2026.

The implications of this economic outlook are clear: no need to rush! While the current monetary policy stance likely is too restrictive if growth and inflation behave as expected in the coming months, there is no evidence yet that it is already spelling troubles for the US economy as a whole (even if some sectors such as real estate are obviously already feeling the pinch of higher rate levels). The Fed can therefore afford to wait for "gaining greater confidence that inflation is moving sustainably toward 2 percent" before reducing its interest rate. This has led almost all FOMC members to reduce the number of rate cuts they expect to implement by the end of the year. While, in March, the majority expected three 25bp cuts in 2024, the median projection is now for only one 25bp cut this year. One of the two "missing" cuts has been postponed to 2025, when median projections are now for four 25bp cuts. And the other one has simply "disappeared", likely a consequence of the resilient growth and slower disinflationary trend mentioned above.

**Chart 5: Fed's median rate projections and Future markets' rate pricing**



However, the trend remains clearly toward a recalibration of the level of interest rates in the years ahead under the current economic scenario. While revised up yesterday to 2.75% (from 2.5%), the neutral Fed Fund rate is still estimated to be much lower than current rate levels, highlighting the fact that current monetary policy is restrictive for the long run in the US. Financial markets currently hold a different view and do not expect short term rates to decline below 4% in the years ahead. This would imply that the neutral policy rate might have been raised a lot by the various shocks experienced by the US economy in the past four years. It may also reflect an additional premium for the uncertainties around economic policies after the US Presidential election, especially on the fiscal side.

In any case, the latest rate projection adjustments made by the Fed do not alter the big picture: as the US economy continues to grow firmly and inflation gradually slows down, short-term interest rates will have to be lowered. The timing and the magnitude of the rate adjustment will be dictated by the evolution of the economy, as always.

## For further information

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