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CIO Office Viewpoint

US economic outperformance is poised to narrow

Investment Solutions

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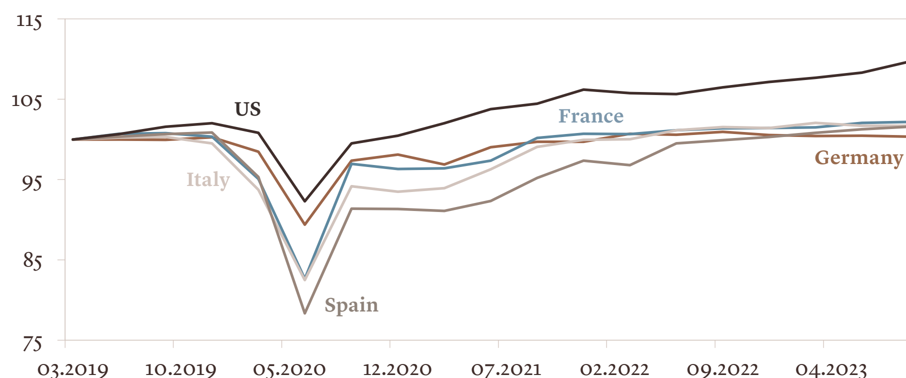
The US economy's exceptional performance, compared with other developed markets, can be traced back more than a decade. Strong third quarter US expansion has widened that divergence. However, we think a slowing US economy means that this gap is set to narrow, but not entirely close.

The US economy has defied predictions of a recession in 2023 with remarkable growth, recording third-quarter expansion of 4.9% compared with the same period a year earlier. At the same time, the eurozone's economies grew just 0.1% year-on-year (see chart 1) and Japan's may even have shrunk.

Some of this US economic outperformance can be attributed to a more robust recovery after the Great Financial Crisis, followed by government generosity through Covid, higher capital expenditure and levels of consumer spending supported by historically low unemployment and rising real wages. In addition, most US homeowners are shielded from higher borrowing costs through long-term, fixed-rate mortgages. This combination of rising wages and fixed mortgages implies that home repayments have been falling in real terms in the US, unlike elsewhere, where wages have either not risen as much, or adjustable-rate mortgages are more common - or both. A booming technology sector has also contributed to US economic expansion. Furthermore, since early 2022 the US has been less impacted than European economies by the shock of energy costs that followed Russia's invasion of Ukraine.

1. The US's growth gap will likely narrow from here

Real GDP levels since before the Covid pandemic (100 = Q1 2019)



Sources: Bloomberg, Lombard Odier

Key takeaways

- Exceptional US performance compared with other economies will narrow, but not disappear over the coming quarters as consumption declines, labour markets move into better balance, and high interest rates slow activity
- While these trends may leave the Fed space to make a first interest rate cut in the second half of 2024, monetary policy will likely stay restrictive with rates around 5% a year from now
- US Treasury yields have risen closer to pre-2008 averages in part because investors are re-assessing the 'neutral' policy rate; we estimate this is now nearer to 3.5%
- We retain our overweight allocation to US Treasuries and continue to favour exposure to the US dollar.

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Data as of 6 November 2023 unless otherwise stated.

Work it out

Yet US third quarter performance was still exceptional. Services spending over the quarter was double the average of the decade pre-Covid (see chart 2). Did 'fun-flation' play a part? The popularity of concert tours by singers such as Beyoncé, Madonna or Taylor Swift did have a local impact on consumer spending, which in total rose 4.0% in the quarter. More significant, by far, was a massive increase in federal defence spending compared with the recent past. The latest quarter also saw a 1.3% contribution from companies building up their inventories.

Where will it go from here? We expect US growth to slow in the final quarter of the year. After such aggressive monetary tightening, a period of below-trend growth is probable. Business investment is declining, the restocking of inventories will not be repeated, while high rates continue to filter into interest rate sensitive sectors. Resumption of student loan repayments will also weigh on some consumers' purchasing power.

Finally, the US labour market continues to rebalance. Perhaps job market conditions are not – yet – outright weakening, but with wages now barely growing in line with inflation, very low savings, rising credit card delinquencies and volatile energy costs, US households' third-quarter pace of consumption seems unsustainable. We therefore expect some deceleration in the months ahead. Taking all this into account, we see the US economy growing by 2.3% for the full year, slowing to 0.7% in 2024.

Recent strong growth and resilient labour markets point to the disinflation trend slowing, but continuing to gravitate towards the Federal Reserve's target. September's US personal consumption expenditure (PCE) deflator, the Fed's favoured measure, and consumer price inflation (CPI) data both rose slightly compared with a year earlier. The three-month annualised change for seasonally adjusted core PCE inflation stood at 2.4%, despite September's slight gain. Without additional energy and food price shocks, inflation should decelerate further in coming quarters.

Hung up

Core PCE readings may even fall below the Fed's own projections for the last quarter of 2023. This likely provides a justification for the central bank to leave rates unchanged through the rest of the year. After a second consecutive Fed pause on 2 November, the market consensus is also that the Fed's hiking cycle is now complete, supported by Chair Jerome Powell's comment that financial market conditions are now tight.

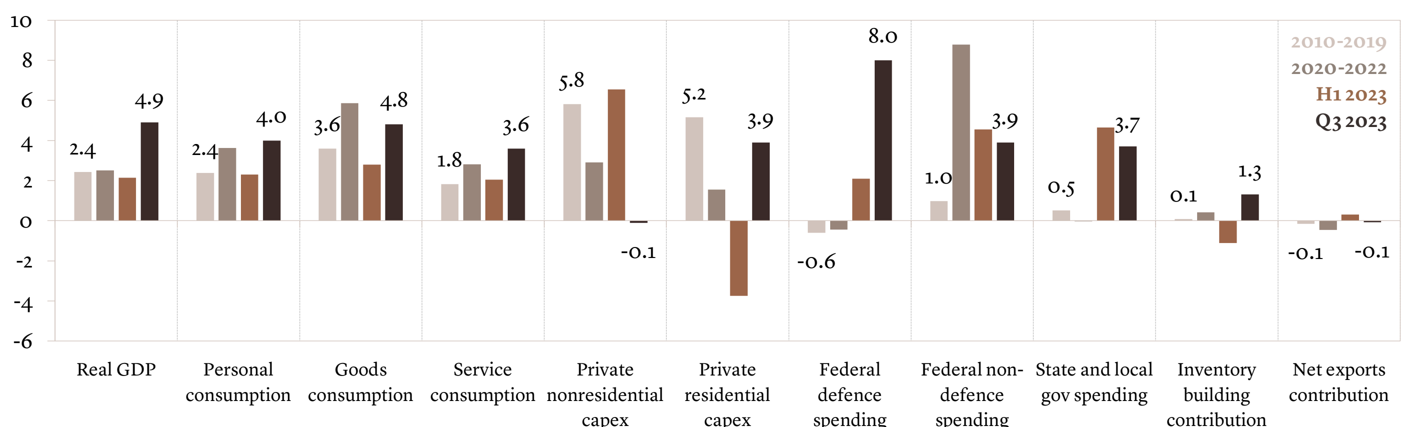
That is in line with central bank policy in other developed economies, including the eurozone, UK and Switzerland, where growth has already begun to stall. This said, the risks of a resurgence in US inflationary pressures, given exceptional growth, or a potential oil price shock, remain – and Mr Powell has not ruled out further increases in the policy rate.

Ten-year Treasury yields continued to rise in recent months. What is behind this increase? The Fed's balance sheet reductions have removed a key buyer of 10-year debt, even as the supply of Treasuries is increasing. The US budget deficit is forecast to hit USD 1.7 trillion for 2023, from USD 1 trillion in 2019. Foreign demand for US Treasuries is waning with Chinese holdings of US Treasuries declining 12.5% in July 2023 compared with the previous year. Japan's gradual loosening of yield curve control should also make its own sovereign debt more appealing, trimming demand for US equivalents. Long-term yields are also correcting from very low levels and from the long-lasting yield curve inversion.

Until the 2 November, the speed of the rise in 10-year Treasury yields to a high of 5% was surprising, but should be seen in an historical context. In the decade before 2008, 10-year yields averaged between 5-6%. The benchmark note now yields 4.58%.

2. Remarkable US third-quarter growth is unlikely to be repeated

Real GDP growth (or contribution to real GDP growth) by economic segment, % or % point quarter-on-quarter



Sources: US Bureau of Economic Analysis (BEA), Bloomberg, Lombard Odier

Does the resilience of the US economy mean that interest rates will be structurally higher in future? Part of the recent rise in yields is due to investors re-evaluating the 'neutral' rate of interest, or a level that neither drives nor restricts growth. In the past, the Fed has estimated this around 2.0-2.5%. We now think this neutral policy rate is nearer 3.5%.

Will yields rise further? If the US economy remains strong and inflation subdued, perhaps. Yet we see growth slowing, and disinflation continuing to fall towards the central bank's 2% average target. That would give the Fed space to make a first rate cut in the third quarter of 2024, with another nearer the end of next year. A year from now, that may leave the Fed's benchmark around 5%.

Is it over now?

Does lower growth mean that US corporate earnings outperformance will also narrow? Over recent decades, US corporations have delivered above-trend earnings thanks to tax and interest rate cuts, as well as the economies of scale that follow near-monopolies in some technology sectors. This translated into an outperformance of earnings growth in the US versus other markets, leading over time to investors assigning a higher valuation multiple to US corporate earnings. In other words, US equities' broad outperformance was mostly justified by stronger fundamentals. It seems likely that US innovation in the short-term will continue to support earnings in particular sectors, including artificial intelligence. But the divergence with other stock markets is unlikely to be as wide, arguing in favour of continuing a regional diversification across portfolio investments.

In this environment, our investment strategy remains cautious, as we seek to balance the lagged effects of high interest rates against recent economic resilience. We retain a neutral allocation to equities, and an overweight allocation to fixed income, focusing on US Treasuries – which now offer competitive expected returns – and investment grade credit. We continue to favour exposure to the US dollar. While the currency could see some consolidation as US outperformance moderates, sluggish growth elsewhere and still-high Treasury yields should keep the dollar well supported, particularly against sterling and the euro.

Samy Chaar
Chief Economist

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SWITZERLAND

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Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
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FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
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lausanne@lombardodier.com

VERBIER
Banque Lombard Odier & Cie SA · Bureau de Verbier[1]
Route de Verbier 53 ·1936 Verbier · Suisse
verbier@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZUG
Bank Lombard Odier & Co Ltd[1]
Baarerstrasse 52 · 6300 Zug · Schweiz
zug@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
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MILAN
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dubai@lombardodier.com
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Israel Representative Office · Bank Lombard Odier & Co Ltd
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JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
1st floor · Block B · The Village Office Park
309 Glenwood Road · Faerie Glen · Pretoria 0081
South Africa · pretoria@lombardodier.com
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Lombard Odier & Cie (Bahamas) Limited
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Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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