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As growth moderates, CIO also expects outperformance from quality stocks, those of companies with strong balance sheets, high profitability, and exposure to resilient earnings streams. (UBS)

US outlook is still positive, despite speed bumps

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Last week was not a good one for those arguing the US is headed for a "Goldilocks" period of falling inflation, strong growth, and swift rate cuts.

Inflation data on the high side of expectations and soft retail sales raised the possibility of the consumer running out of steam. The recent February payrolls report also indicated the labor market may not be as strong as was presumed just a month ago.

Such setbacks in the data may cause some investors to lose confidence in the prospect of a soft landing for the US economy, let alone a Goldilocks scenario. But we view these more like speed bumps along the journey, for several key reasons:

The disinflation trend remains evident. The details of the February consumer price index (CPI) indicated that much of the hot January print was due to one-offs, damping reacceleration concerns. Moreover, disinflation is a global phenomenon, with core inflation measures (weighted by GDP) nearly back to 2%. This common trend reflects the fact that much of the inflation surge and subsequent decline over the past three years was due to pandemic-related supply distortions that have largely abated. The recent stickiness of US core inflation, relative to that in the Eurozone, is likely a by-product of US growth exceptionalism, suggesting that it's more of a strong demand story than a supply one, at this point.

The labor market is cooling, and growth is returning to a sustainable pace. The moderation of US growth back toward trend from an unsustainable pace—it annualized to 4% in the second half of 2023, while the Atlanta Fed GDP tracker for the first quarter of 2024 is down to 2.3%—is positive news for the disinflation outlook. Historically, there isn't a strong and consistent lead-lag relationship between wage inflation and price inflation. Yet, the fact that the cooling labor market is now much closer to being in balance suggests inflation is far more likely to continue falling, rather than

get stuck at current levels. Multiple labor market indicators—average hourly earnings, the Atlanta Fed wage tracker, the employment cost index, quit rates, National Federation of Independent Business (NFIB) hiring and compensation plans, job openings to unemployed ratio—are back to either mid-2020 or mid-2021 levels and trending lower.

The key point for the market outlook is that the Federal Reserve wants to cut rates, even with inflation coming down more gradually than expected a few months ago. During his Congressional testimony two weeks ago, Chair Jerome Powell said that the Fed needs "just a bit more evidence" that inflation is headed to 2% before cutting rates and that "we're not far from it." They won't even need that if the cooling labor market suddenly turns cold. In other words, the Fed appears not to want to mess up the soft landing and will be tolerant of a more gradual disinflation trend. That's the Fed put, in another name.

So, while recent data have painted an ambiguous picture about growth and inflation trends, we think it's best not to overanalyze each data point and instead be clear-headed about the general direction of travel. The US macro environment is fairly healthy, and it should stay that way. Our base case is for a soft landing with three Fed rate cuts this year, a backdrop that is favorable for quality bonds. As growth moderates, we also expect outperformance from quality stocks, those of companies with strong balance sheets, high profitability, and exposure to resilient earnings streams.

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