US economic data will need to walk a fine line in the coming months to sustain the recent rally. (UBS)

US economy needs to tread a fine line

13 February 2024, 4:14 pm CET, written by UBS Editorial Team

US jobs data are likely to be the highlight of the day, with investors looking for further signs that the US economy is headed for a soft landing. The optimal outcome for markets would be slowing of growth sufficient to allow the Federal Reserve to cut rates decisively in 2024, while not being so abrupt as to kindle fears of recession.

At present, markets are priced for this optimal outcome, with the S&P 500 gaining 19.4% so far this year to stand just 4.4% below the all-time high struck at the start of 2022. The VIX index of implied US equity market volatility, a popular measure of fear in markets, is close to historical lows—pointing to a degree of over-confidence, in our view.

As a result, US data will need to come in neither too strong, nor too weak over coming months.

Investors will be hoping that employment growth slows, without declining too swiftly. The consensus forecast for today's November data is for just this balance. The expectation is for employment to expand by around 180,000 over the month, up only modestly from 150,000 in October. That would be a reassuring result after an unexpectedly strong gain of 297,000 in September, which fueled market worries that an overheated labor market would make it hard for the Fed to justify an end to rate rises. Job creation has been gradually moving lower for much of 2023. At some point, however, investors will want to see a stabilization. Readings much below 100,000 with a declining trend could spark fears that a recession is on the way, as fading job security encourages consumers to save more. Investors will also be looking for continued signs that the growth in average hourly earnings is moderating, rather than turning negative.

Risks remain that inflation data, which has recently been reassuring, could disappoint investors. While we believe inflation is on track to continue declining gradually, it remains possible that there are months when progress appears to cease. Any such data releases could cause a deterioration in market sentiment, especially since markets have been pricing

an aggressive pace of easing from the Fed in 2024, with around 125 basis points of cuts. We believe around 75 basis point of cuts is more probable based on current data. Investors will also be monitoring the release today of the University of Michigan consumer inflation expectations survey. Last month, this showed consumers bracing for an average inflation rate of 3.2% over the coming five years, the highest level since 2011.

The deceleration of GDP growth will need to be gradual to support the recent market rally. The latest GDPNow reading from the Atlanta Fed, a running estimate of growth based on that latest data, points to annualized expansion of 1.2% for the fourth quarter. While this rate of growth would be reassuringly mild—especially following the well-above trend 5.2% growth rate in the third quarter—a further significant decline could start to fuel fears that a recession is looming.

So, US economic data will need to walk a fine line in the coming months to sustain the recent rally. While we expect stocks to sustain recent gains and advance modestly higher in 2024, equity markets are already pricing in plenty of good news. As a result, we expect a return to more normal levels of volatility. Our forecast is for the S&P 500 to end 2024 at around 4,700, a limited gain relative to the current 4,585. Against this backdrop, we believe investors should consider focusing on high-quality equities. Companies with strong returns on invested capital, resilient operating margins, and relatively low debt on their balance sheets have tended to outperform in periods of tepid economic growth.

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Read the original report : **US economy needs to tread a fine line, 8 December 2023.**

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