STATE STREET GLOBAL ADVISORS

September 13, 2024
Commentary

Weekly Economic Perspectives

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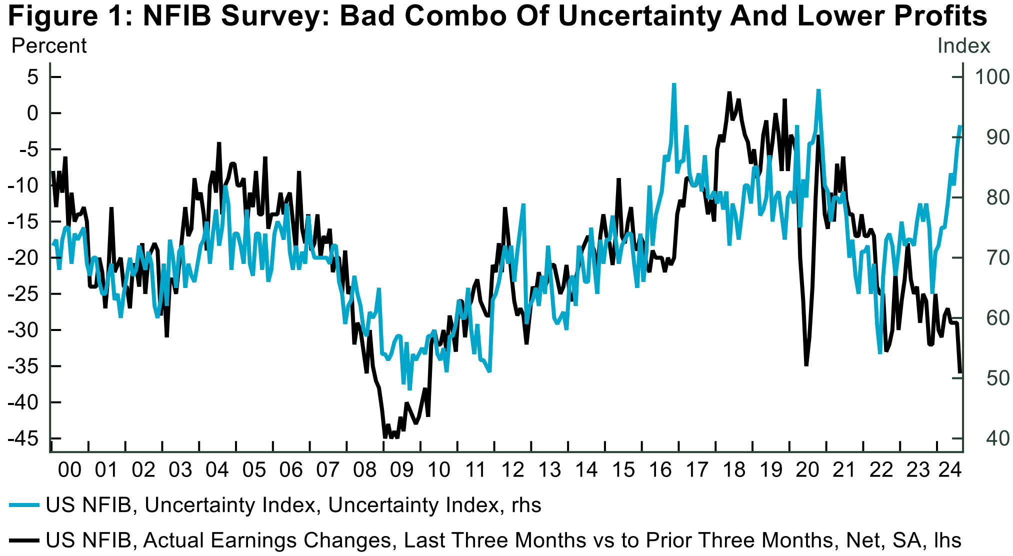
The Economy

Policy divergence theme proves short-lived as Fed gets ready to cut.

US

Small business sentiment fared worse than anticipated in August, more than retracing its July improvement. The NFIB (National Federation of Independent Business) index dropped 2.5 points to a three-month low of 91.2, but the real story wasn't in the headline. It was the outsized decline in some of the components that could signal another round of deterioration ahead. The NFIB index has long been the "black sheep" so to speak among US macro indicators in that this metric has bucked the otherwise broad-based improvement seen elsewhere (for instance, in GDP and unemployment statistics). It had been languishing near multi-year lows since mid-2022 as inflation spiked and labor shortages besieged employers, and it has only shown visible improvement in the last couple of months. The August update puts the sustainability of that incipient revival into question. Perhaps the most worrisome detail was the steep collapse in the current profitability metric. Not only was the sequential deterioration large, but it left this component at the lowest level since the Great Financial Crisis (GFC), edging out even the Covid extreme lows. One month never makes a trend, but the trend had already been downward, so this warrants close scrutiny. The combination of shrinking profits and elevated uncertainty does not bode well for either capex or hiring. This is especially true given that sales expectations, which bounced up last month, pulled back rather sharply. And it is already showing in the employment metrics. Current employment declined to the lowest level since August 2022 and hiring intentions cooled. This ties well with the recent softness in employment shown by the payrolls report. All in all, a cautionary message from the small business community.

Figure 1: NFIB Survey: Bad Combo Of Uncertainty And Lower Profits



Sources: SSGA Economics, NFIB

The August inflation data largely met our and market expectations and, in the initial aftermath of the release, appeared to cement expectations for a typical 25-bp rate cut from the Fed on September 18. This had already been our expectation, and we still stick to it, although the odds of a larger move have risen again in light of what appears to be indirect signaling (via Wall Street Journal) from FOMC that the size decision is, indeed, a close call. Overall **consumer prices** rose 0.2% and core (excluding food and energy) prices increased 0.3% m/m. The headline inflation rate eased four tenths to 2.5% y/y, the lowest since February 2021. The core inflation rate was unchanged at 3.2% y/y.

In all fairness, we were a little surprised to see persistent softness in used car prices, which declined 1.0% m/m and are now down 10.4% y/y. The reason is that auction data via the Manheim index show auction prices down just about 4.0% y/y and typically, the two move fairly closely together. Admittedly, the CPI data follows Manheim with a lag, but that lag is usually just a couple of months so we could get a little payback to the upside in September. Elsewhere, both food and energy prices were tame and medical services declined for the second month in a row, which we did not expect. On the other hand, shelter inflation came in higher than anticipated, driven by a reacceleration in owners' equivalent rent (0.5% m/m) and a 1.8% bounce in lodging away from home. The OER uptick is frustrating in the context of moderating market rental inflation, but it was at least accompanied by a step down in rent of primary residence. Other categories were a mixed bag. Vehicle insurance costs increased 0.6% m/m—half July's pace—and allowed the inflation rate to ease to 16.5% y/y. This is still extremely high but down notably from 22.6% y/y in April. By contrast, following five consecutive declines, airfares jumped 3.9% m/m. Given airlines have cut back on seat availability in the fall, we could see further gains here, although they could be offset by lower oil prices which may allow airlines to protect margins without raising prices.

As we concluded following the July CPI data, we think that the Fed has what it needs to deliver a 25 basis point cut next week. But there wasn't enough here to call for a larger cut, and with the same message coming from the August payrolls report, **a 25 bp cut and a dot plot showing 75 bp worth of 2024 cuts, plus 125 bp more in 2025 is out baseline expectation for the September 18 Fed meeting**.

That said, a Wall Street Journal Thursday authored by Nick Timiraos (widely seen as the "Fed voice") weighed arguments for a 25 vs 50 bp cut fairly evenly. On cue, having priced out the 50 cut almost entirely earlier in the week, the market shifted to almost even odds on Friday. There is a fair amount of data released on Monday and through Wednesday morning, which we believe will still sway the Fed in favor of a 25 bp move, but at this point, the outcome is pretty open. In reality, it won't matter a whole lot, though going 50 would open the Fed to accusations that it may be unduly influencing the impending election. It would also be an implicit recognition that the FOMC had been wrong in its assessment of the economy at the June/July meetings.

On the other side of the policy spectrum, the fiscal picture remains frightening. The **budget deficit** ballooned to $380.1 billion in August, pushing the fiscal-year-to-date (October to August) deficit to $1.897 trillion and easily on track to exceed the $2.0 trillion mark for the fiscal year as a whole.

Canada

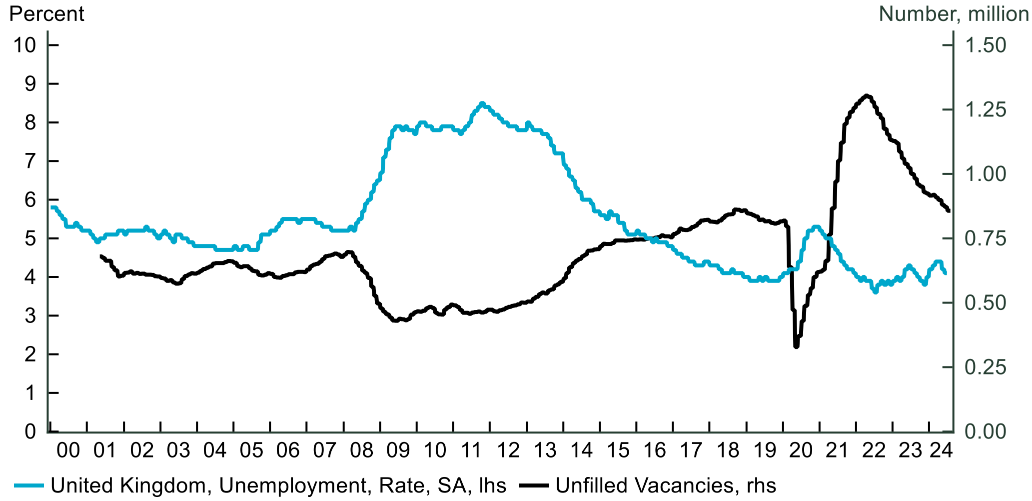
Following two consecutive declines, the value of building permits rose by 22.1% m/m, triple expectations, with both residential and non-residential sectors expanding.

Residential permits increased 16.7% m/m, led by higher multi-unit construction intentions (+29.3%). Meanwhile, non-residential sector permits were up 31.8% during the month, driven by the increase in commercial (+18.4%), industrial (+98.6%) and institutional (+14.8%) components.

UK

The **unemployment rate** edged down one-tenth to 4.1%, in line with market expectations, but other latest labor data revealed further easing in the job market. Labor demand eased further as headline vacancies in the three months to June declined from 872k to 857k in the three months to August. Wage pressures eased. Growth in regular pay (excluding bonuses) inched down three-tenths to 5.1% y/y. Meanwhile, the growth in average total pay (including bonuses) for the three months to June fell sharply from 4.6% y/y to 4.0%, though mainly due to base effects.

Figure 2: UK Labor Market Shows Further Signs of Easing



Sources: Macrobond, SSGA Economics, ONS
Updated as of 9/15/2024

Industrial activity continues to struggle. Production output fell by 0.8% m/m in July, bucking the expectations of a 0.3% increase and reversing all gains in previous month. The decline was led by lower manufacturing (-1.0% m/m), electricity and gas (-1.7%) and water supply and sewerage (-0.7%), which was partially offset by an increase in mining and quarrying.

Eurozone

In line with expectations, the **ECB** lowered the deposit facility rate by 25 basis points to 3.5%. In line with changes to interest rates structure announced earlier in the year, the main refinancing rate was lowered to 3.65% and the marginal lending facility rate to 3.9%. Broadly speaking, the economy is evolving in line with the Governing Council's expectations. Staff forecasts were little changed: growth projections were lowered by 0.1 ppt per year over the forecast horizon, but changes of this magnitude are to some extent just rounding error. Headline inflation forecasts were unchanged and the underlying view of a pick-up later this year on unfavorable base effects remains in place. The most important new development is that the ECB now have more visible evidence that wage pressures are starting to diminish. In our view, that warrants a cut at each of the two remaining meetings this year. The market is currently putting slightly higher odds on two rather than one cut and we suspect those expectations will cement further once the Fed officially begins its own easing cycle and signals a series of cuts through year-end.

Japan

The race to elect the new leader of the ruling **Liberal Democratic Party**, and thus the new Prime Minister is announced. The official campaign has begun on September 12 and the elections will take place on September 27. The 367 Diet members will join another 367 LDP party members for a total vote count of 734 (in the first round). With a record nine candidates running for office, it is improbable that one of them wins a majority. Hence, the result will be decided in a second round that takes place on the same day, but between the top two candidates of the first round. The number of party members voting will be reduced to 47, representing the prefectures (total votes of 414), so the candidate with the strongest support from the Diet is likely to win. As things stand, the top contenders are former Environment Minister Shinjiro Koizumi (age 43), former LDP Secretary-General Shigeru Ishiba (67) and former Economic Security Minister Sanae Takaichi (63). With campaigning kicking off this week, we expect more clarity on candidates' stances to fully develop over the next two weeks. We will be keenly watching those who are inclined to declare a victory on deflation, and how candidates may shape up fiscal policy.

The sentiment among Japan's small and medium enterprises was sound in August, as reflected in the **Economy Watchers Survey**, which rose for a fourth month by 1.5 points to 49.0. Affirming the ongoing revival in households, the sub-index rose 1.8 points to the same index level. The most important outcome for us is the comments that firms are gradually passing higher costs to consumers, which underpins our expectation that household demand will continue its solid recovery.

This sentiment was also echoed by a **hawkish Bank of Japan (BoJ) member**, Naomi Tamura who said that the Bank may have to raise its policy rate to 1.0%, in line with our long-held view. However, given that the Bank's forecast horizon spans till 2027, its path could remain gradual. The Bank of Japan (BoJ) meets next week and is universally expected to make no changes to policy whatsoever. The Bank will likely maintain hawkish guidance and may highlight an upbeat outlook on the economy, especially inflation and consumption. The Bank's forecast range extends till 2027, so they have ample room to hike to our terminal rate forecast of 1%, however we expect that to happen by December 2026.

The key will still be what the US Fed would do two days before the BoJ meets. If the Fed cuts by 50 bps, we may observe considerable volatility in the yen (USDJPY below 142 now), and Japanese equities. If the rally continues on larger than expected cuts in the US, inflation outlook in Japan will come under pressure. Finally, we expect the national CPI to have risen 2.9% y/y in August.

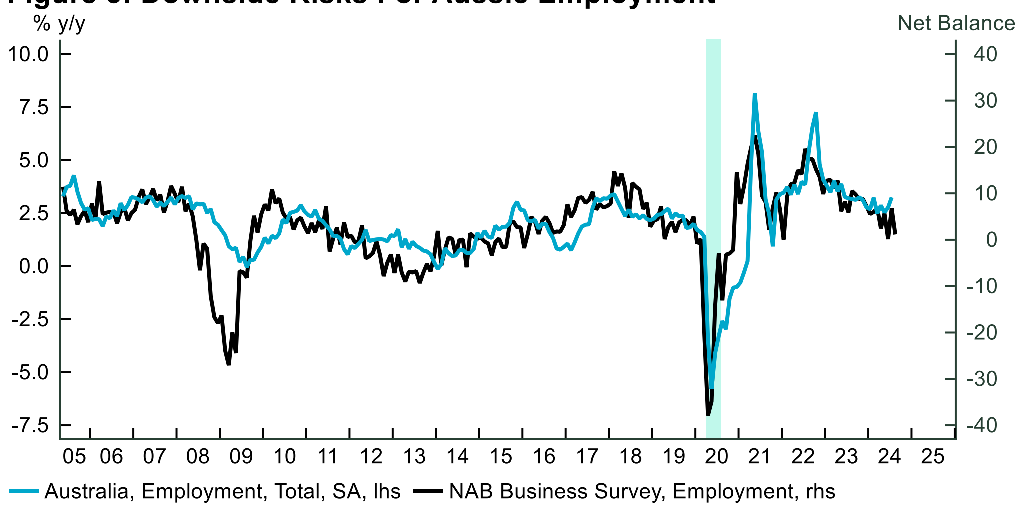
Australia

Two months ago, the Commonwealth government introduced the Stage 3 tax cuts, which were feared to lift inflation. However, we have not even noticed an improvement in **consumer sentiment** so far; instead, it declined 0.5% m/m to 84.6 points in September, in a broad-based decline. Perception of the economy over the next 12 months and 5 years fell 2.6% and 1.0% respectively. Worse, unemployment expectations deteriorated sharply by 3.7% and the index measuring 'time to buy a major household item' was low at 82.6, well below the long-run average of 124.2, indicating that the tax cuts have not had any big impact.

Business confidence also eased, with the NAB business conditions declining three points to +3 in August. Consistent with consumer sentiment, the component measuring employment fell sharply by 6 points to +1. Industry wise the sentiment eased dramatically for wholesale sector (-18 pts to -3), manufacturing (-9 to -9) and retail trade (-6 to -10, lowest since 2020). Most importantly, measures of prices continued to ease; the labor cost growth fell 70 bps to +1.7% q/q while final product prices growth eased to 0.6% q/q, the slowest since 2021.

This continued soft sentiment could weigh on the labor market data next week; we expect employment to have risen 20k or less and the unemployment rate to remain elevated or even rise a tenth. However, we fear if the cyclical decline in employment per historic standards has run its course, in which case the actual data may feature an upside surprise. We will know next week.

Figure 3: Downside Risks For Aussie Employment



Sources: SSGA Economics, ABS, NAB, Macrobond
Updated as of 9/15/2024

Week in Review (Sep 9 –Sep 13)

Country	Release (Date, format)	Consensus	Actual	Last	Comments
Monday, Sep 9					
US	Consumer Credit (Jul, $bn)	10.4	25.5	5.3 (↓)	Credit growth supporting consumption.
JN	GDP (Q2, q/q, final)	0.8%	0.7%	-0.6%	Good.
AU	Westpac Consumer Conf Index (Sep)	n/a	84.6	85	Poor. But will it translate into poor hard data?
AU	NAB Business Confidence (Aug)	n/a	-4	1	Poor reading.
Tuesday, Sep 10					
US	NFIB Small Business Optimism (Aug)	93.6	91.2	93.7	Weaker details.
UK	Average Weekly Earnings (Jul, 3m y/y)	4.1%	4.0%	4.6% (↑)	Good.
UK	ILO Unemployment Rate (Jul, 3mths)	4.1%	4.1%	4.2%	In line with expectations.
GE	CPI (Aug, y/y, final)	1.9%	1.9%	2.3%	Already known.
Wednesday, Sep 11					
US	CPI (Aug, y/y)	2.5%	2.5%	2.9%	Largely as expected.
UK	Industrial Production (Jul, m/m)	0.3%	-0.8%	0.8%	Downside surprise.
JN	PPI (Aug, y/y)	2.8%	2.5%	3.0%	Sufficient price pressures in the pipeline.
Thursday, Sep 12					
US	PPI Final Demand (Aug, y/y)	1.7%	1.7%	2.1% (↓)	Due to base effects.
US	Initial Jobless Claims (07-Sep, thous)	226	230	228 (↑)	No impending doom here.
US	Continuing Claims (31-Aug, thous)	1,850	1,850	1,845 (↑)	No impending doom here.
US	Monthly Budget Statement (Aug, $bn)	-292.5	-380.1	-243.7	Not good at all. In fact, it's terrible!
EC	ECB Main Refinancing Rate	3.65%	3.65	4.25%	Change to rate corridor, plus 25 bp cut.
CA	Building Permits (Jul, m/m)	6.6%	22.1%	-13.0% (↑)	Good.
Friday, Sep 13					
US	U. of Mich. Sentiment (Sep, prelim)	68.5 (p)	69.0	67.9	Mixed inflation expectations.
EC	Industrial Production (Jul, m/m)	-0.30%	-0.3%	0.0% (↑)	Weak.
FR	CPI (Aug, y/y, final)	1.9%	1.8%	1.9%	Supports further ECB cuts.

Source: for data, Bloomberg®; for commentary, SSGA Economics.

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* Pensions & Investments Research Center, as of December 31, 2023.

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