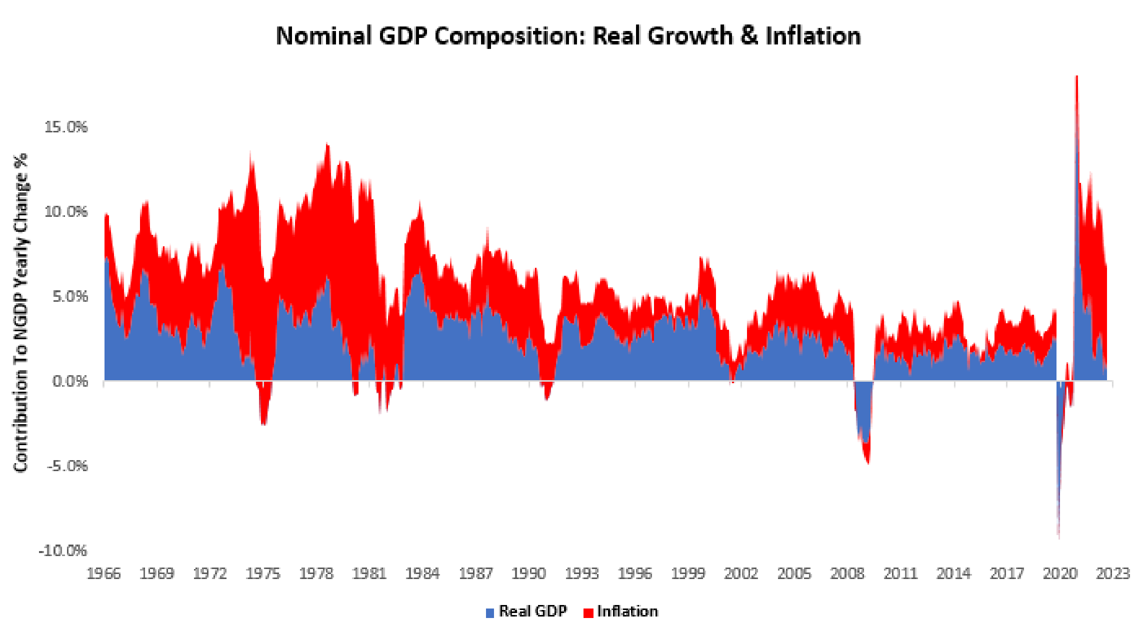
Month in Macro

This report is part of our ongoing effort to provide economic and market guidance to our subscribers during a period of historic levels of uncertainty. This note aims to share our research team's internal checkpoint process in evaluating the current state of the economy as it pertains to markets. The pages that follow will have familiar content for those who follow our work, but with the added benefit of our connecting the dots across all the economic and financial data our systems use to make portfolio decisions. Our primary takeaways are as follows:

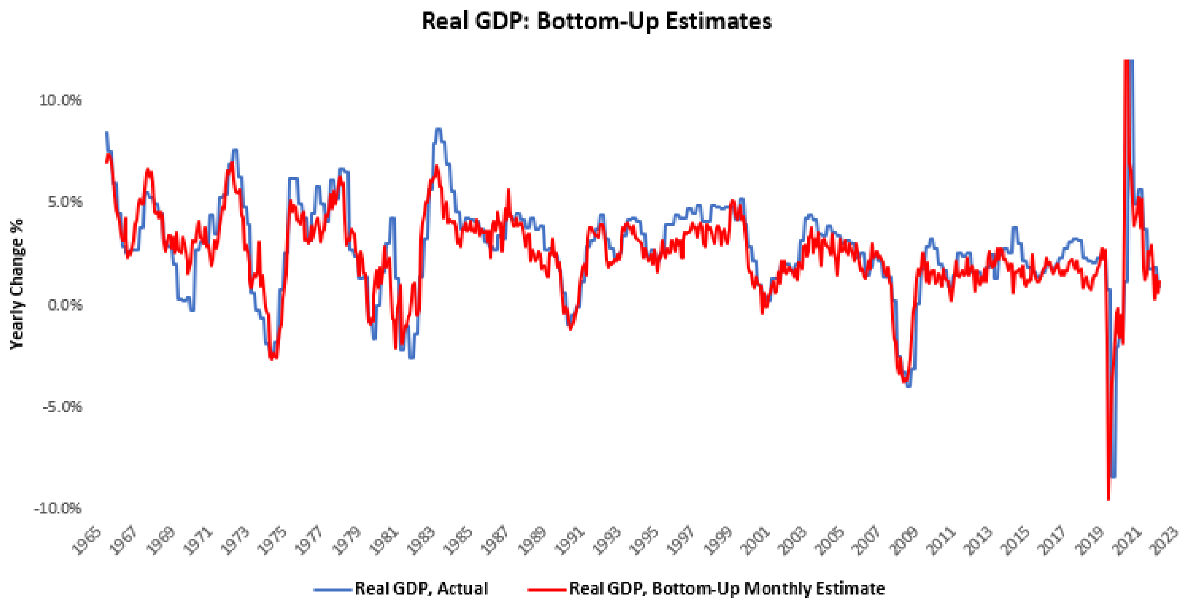
- ***Nominal activity accelerated as we entered 2023, with real growth accelerating strongly to offset modest cooling in inflationary pressures. At the same time, reported corporate earnings reflected pressures from the prior quarter.***
- ***Alongside an acceleration in nominal income activity, we also saw an improvement in balance sheet conditions from private sector expansion and an amelioration in policy tightening.***
- ***The combination of these forces allowed spurred risk appetite, with aggregate equity allocations rising modestly. However, the economic impulses that drove these dynamics will likely prove transitory, with the potential for a reversal as we move further into 2023.***

As we have mentioned here previously, we are at a complex junction in the macroeconomic cycle. Initial conditions have been met to expect contractionary GDP over the next six months. The most recent data has run counter to these expectations. However, after a thorough assessment, we think it makes sense for us to maintain our expectations for contractionary GDP. In the pages that follow, we detail our tracking and inference of conditions, along with the drivers of our expectations.

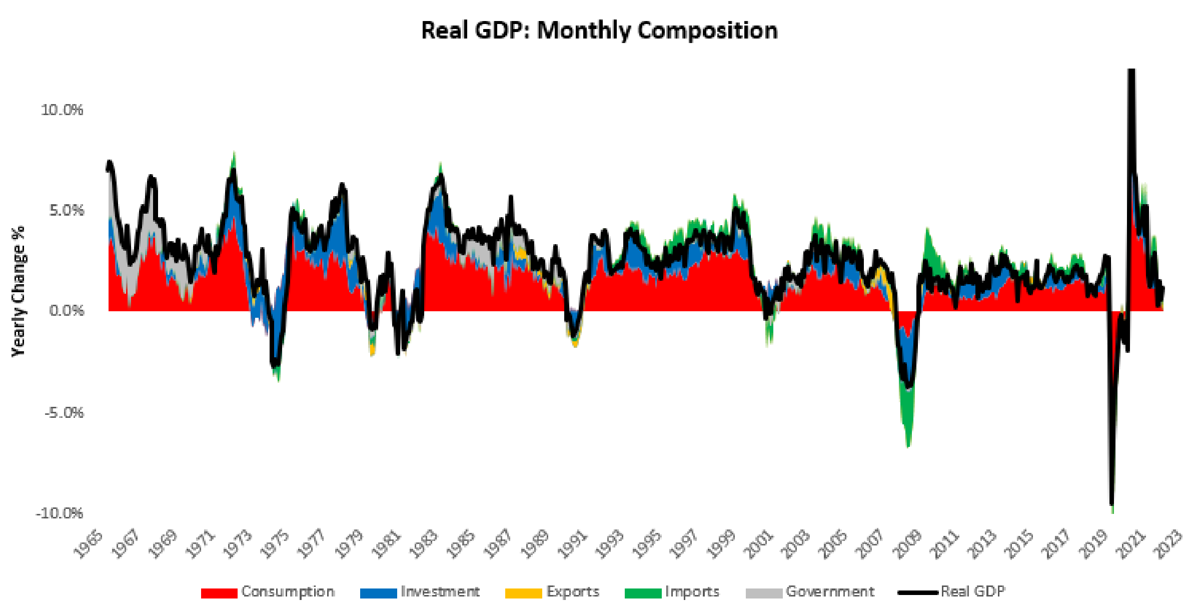
We start by showing our high-level tracking of nominal GDP, broken into its real GDP and inflation components:



The latest data places our nominal GDP estimates at 7.1% versus one year ago, with real GDP at 1.1% and economy-wide inflation at 5.9%. These estimates show nominal GDP rising as real GDP grew while inflation dwindled modestly from prior readings. There was a significant and widespread acceleration in real GDP data, which pulled out estimates higher by almost 1%. Nonetheless, the trend remains one of weakening real GDP. We show our bottom-up estimates of GDP versus official data below:

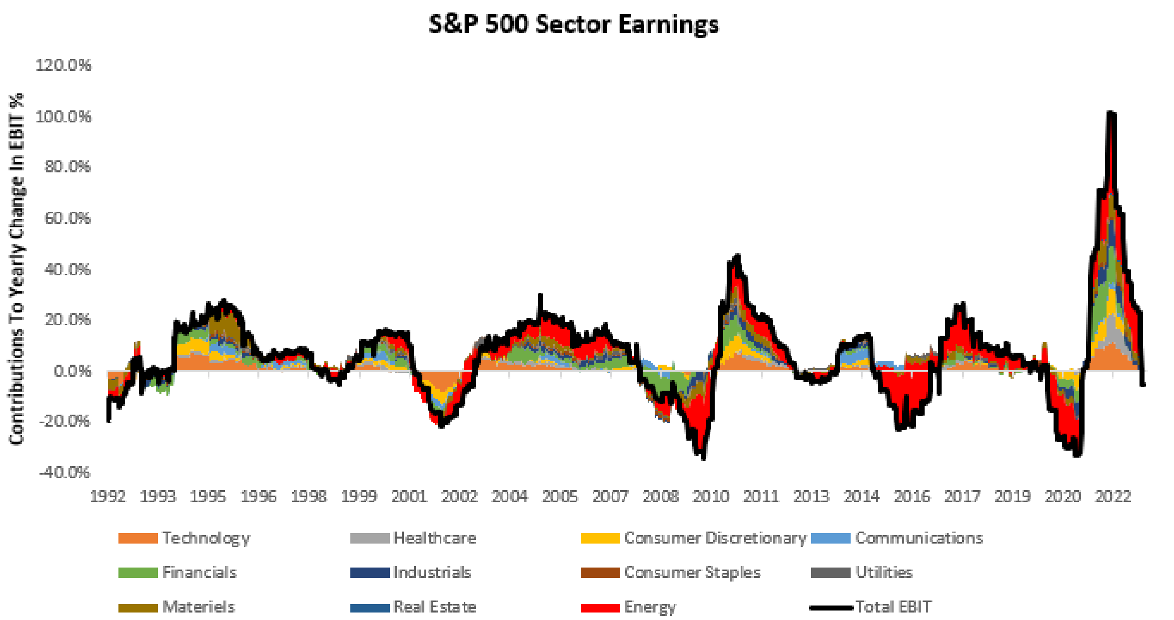


We obtain our bottom-up estimates of GDP by nowcasting each of the components of GDP, giving us a granular understanding of the drivers at play. Below, we show the composition of our current estimates of GDP by the major categories of GDP:

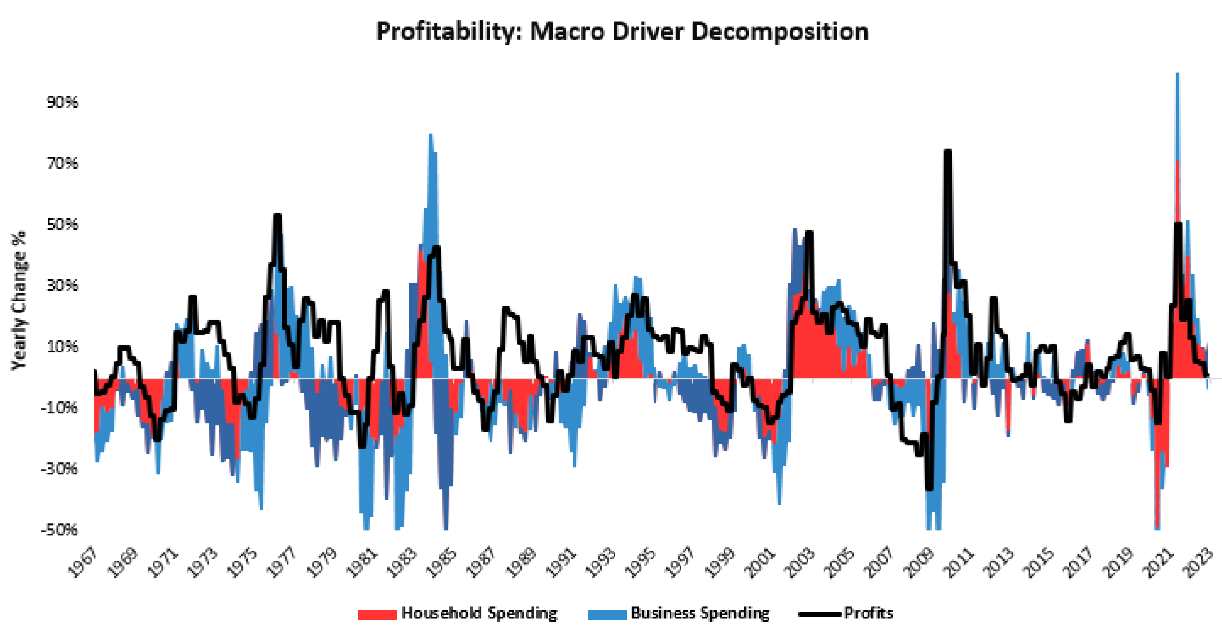


While the recent improvement in real GDP data has been broad-based, the lion's share of improvement has come from increased consumer spending, while investment activity remains weak.

Alongside this GDP data, we have also received a full set of public-equity profit data, which point to a continued slowing in profits conditions through the end of last year:

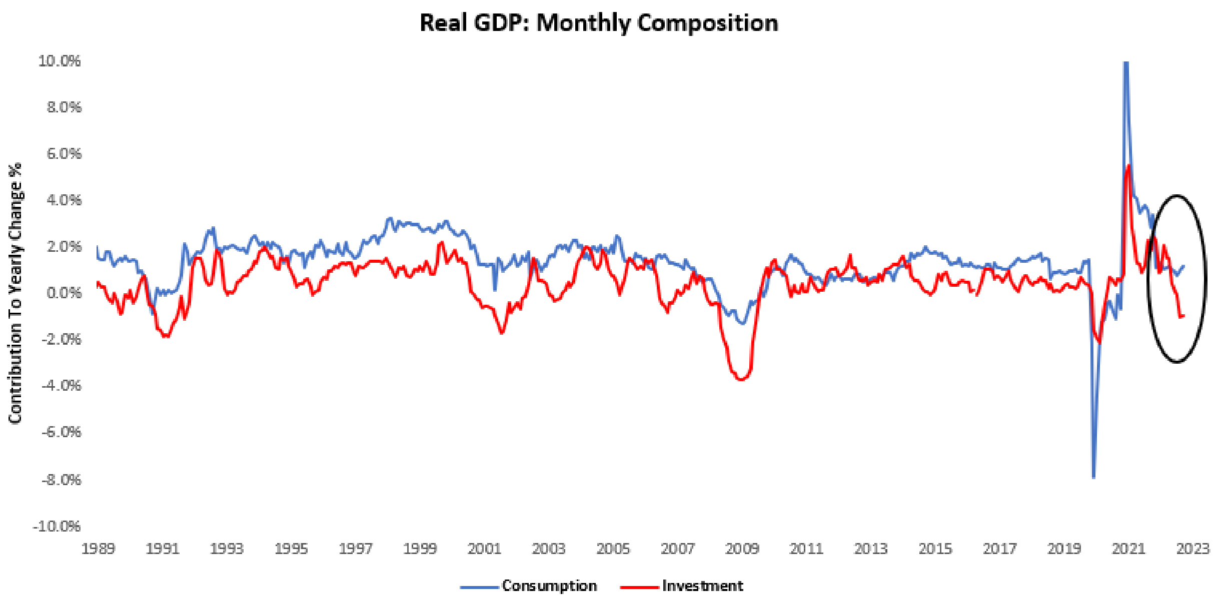


Our macroeconomic decomposition of the factors driving these moves suggests that similar dynamics to those in GDP are at play for profitability, i.e., that consumption is the current support for profitability, and business reinvestment remains a drag. We show their combined contributions to profitability below:

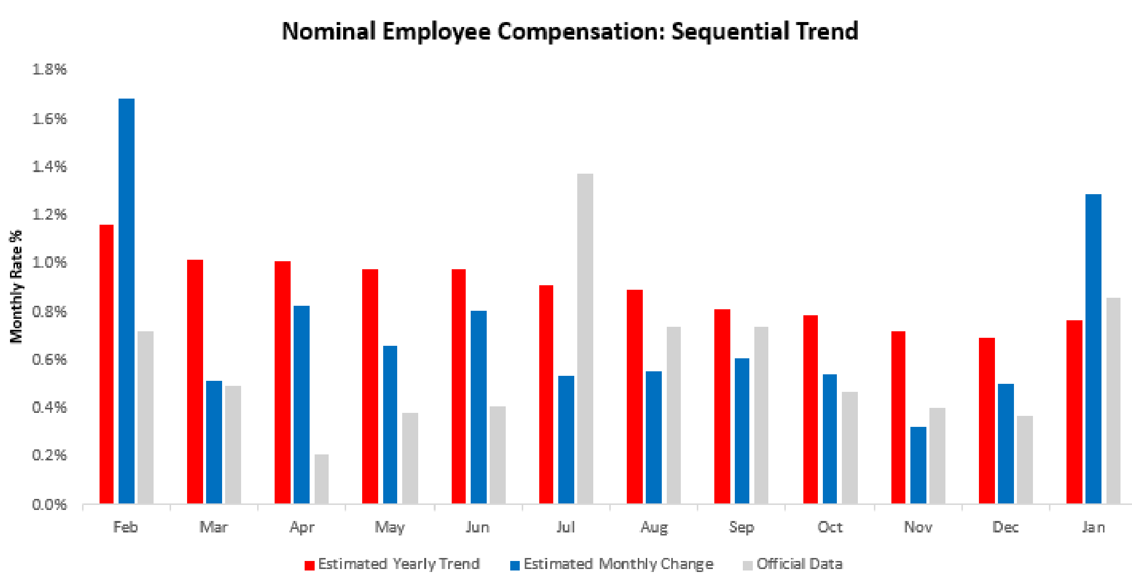


Therefore, we see two segments of the economy at odds regarding their implications for economic activity, i.e., a weakening business sector weighing on profits and GDP and a steady personal sector supporting spending in these areas.

Personal consumption and income far outweigh the business sector's activity; however, the business sector is far more cyclically sensitive. As a result, the business sector can often have outsized impacts on the marginal changes in GDP growth. Below, we show the relative contributions of consumption and investment to real GDP to illustrate their impact on total activity. Further, we highlight the most recent divergence:

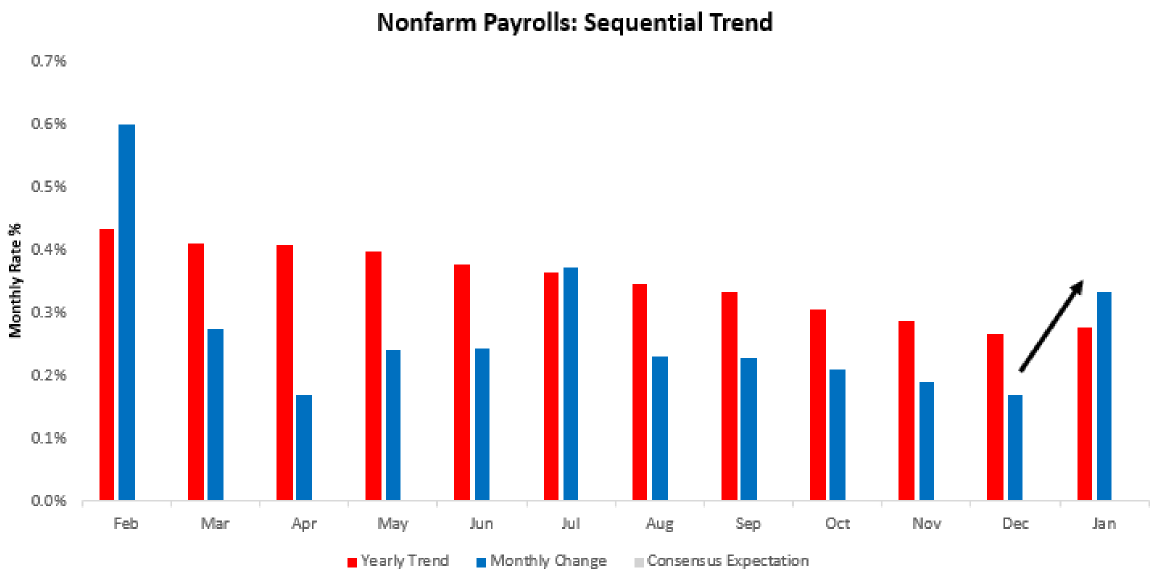


At this junction, we think it is crucial to understand that the driving factor behind the remaining growth of the economy is nominal consumer spending. This consumption spending is primarily financed by income, which in turn is a function of nominal wages, hours worked, and labor force growth. This income, when spent relative to existing output, determines inflation. Therefore, any increase in the drivers of nominal income potentiates nominal spending, which drives inflation. In January, our monthly estimates of nominal employee compensation rose by more than 1%, with official data later in the month corroborating a 0.9% increase in January alone:

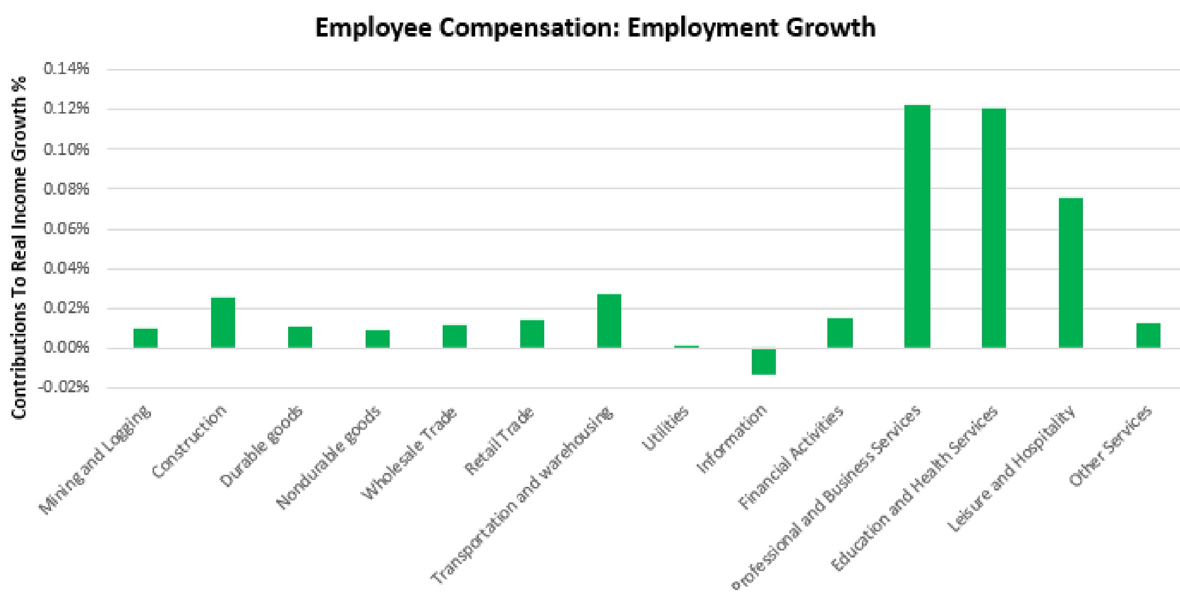


For informational purposes only.

When we look at the drivers of these sequential changes, we see the primary impetus for this jump in nominal income was increased employment. This employment growth largely came from a significant increase in employment. We show the sequential change in nonfarm payrolls below:

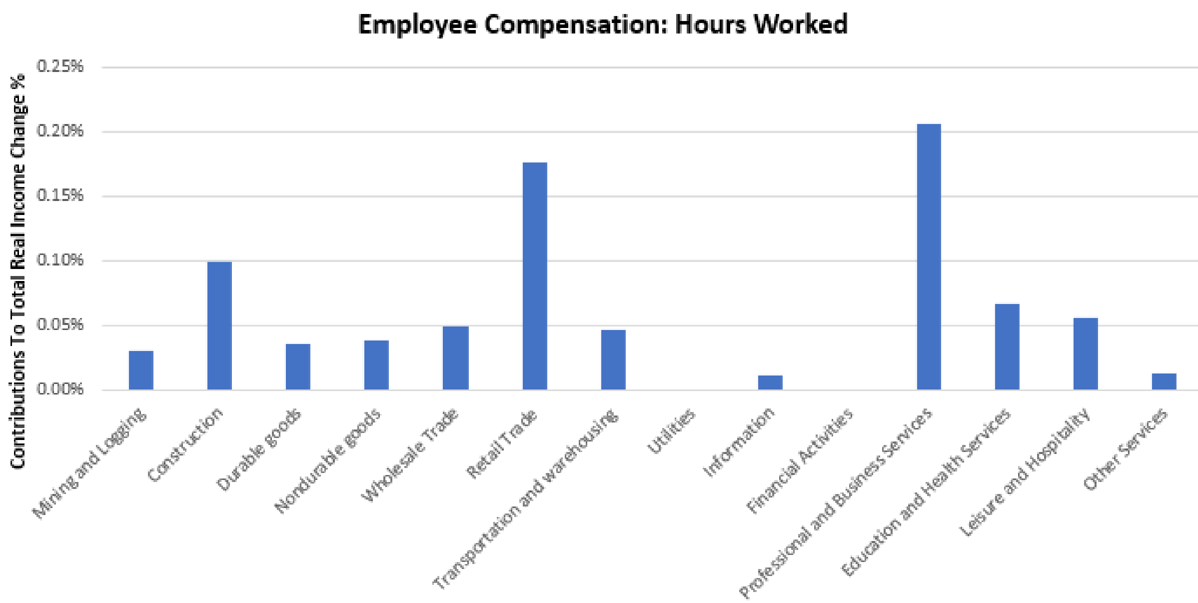


This increase in income was predominantly driven by an improvement in real income, with employment and hours worked driving these gains. Below, we show the distribution of the increase in employment growth:

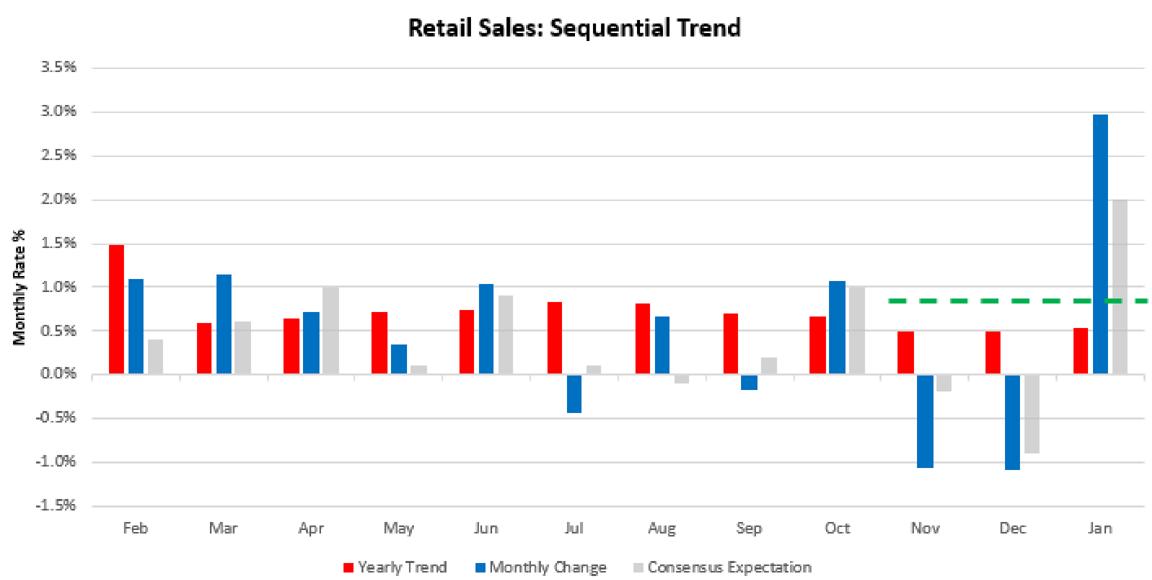


As we can see above, professional and business services were the primary drivers of employment contributions to real income growth, education, and leisure.

Next, we show how increased employment was accompanied by increased hours worked. We note once again the relatively significant contribution from professional and business services:

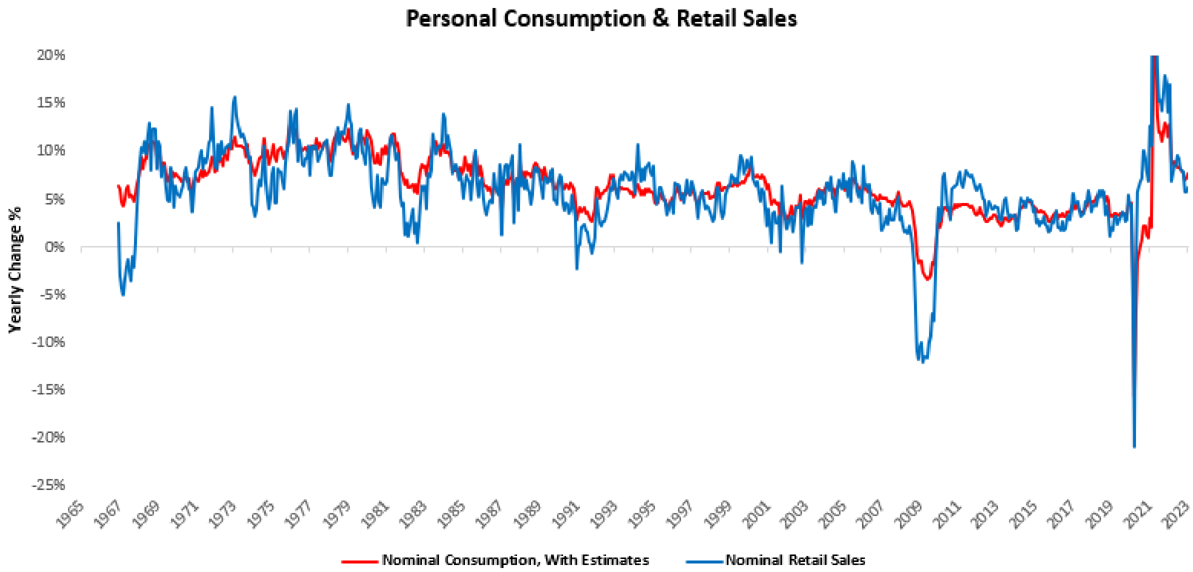


This combination of factors drove strong spending, as evidenced earlier in the data calendar in the form of strong nominal retail sales data:

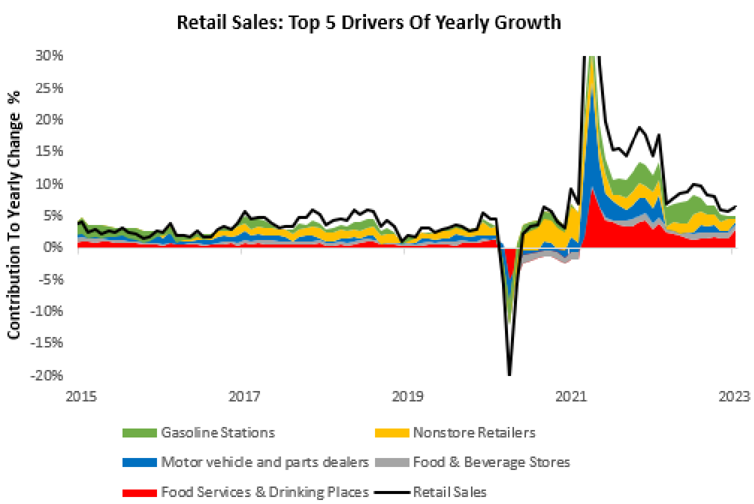


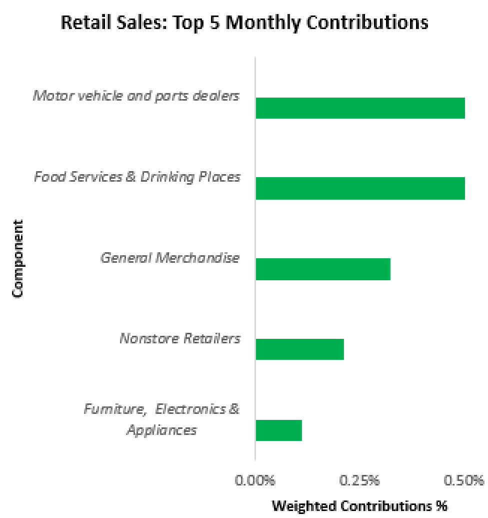
As we can see above, nominal retail sales had a solid rise, bucking the recent trend of weakening data. Retail sales are a core component of personal consumption, and this strength in retail sales (emanating from strength in income) drove an increase in personal consumption. Retail sales typically have more volatility than total personal consumption, a much broader spending estimate. However, this print saw significant pass-through.

Below, we show the relationship between nominal retail sales and personal consumption:



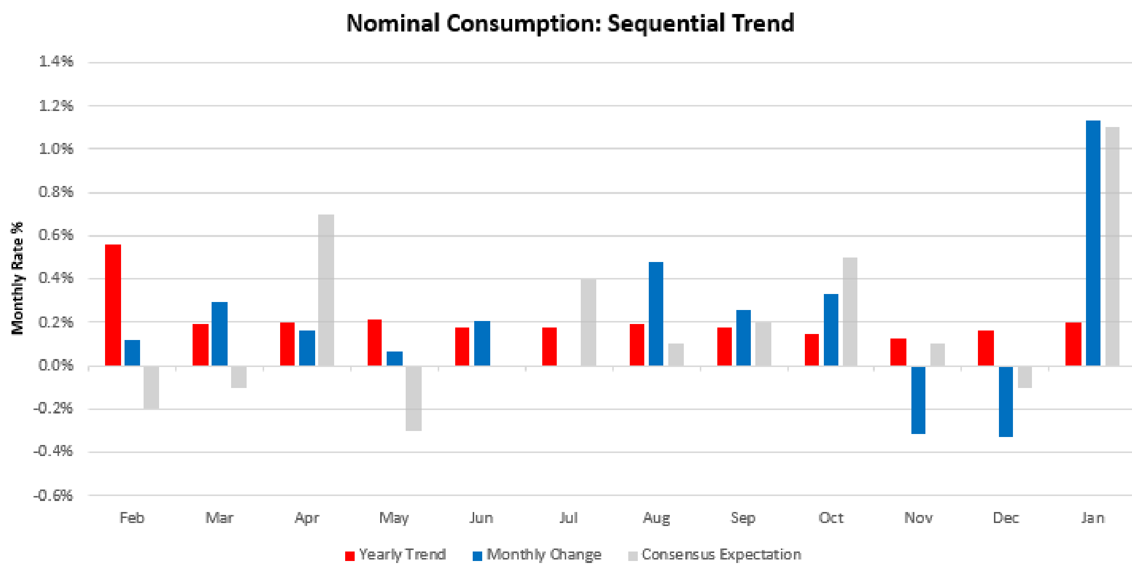
Looking under the surface of this retail sales data, we show the top 5 drivers of the most recent print of retail sales and the recent context of the top 5 drivers of retail sales over the last year:



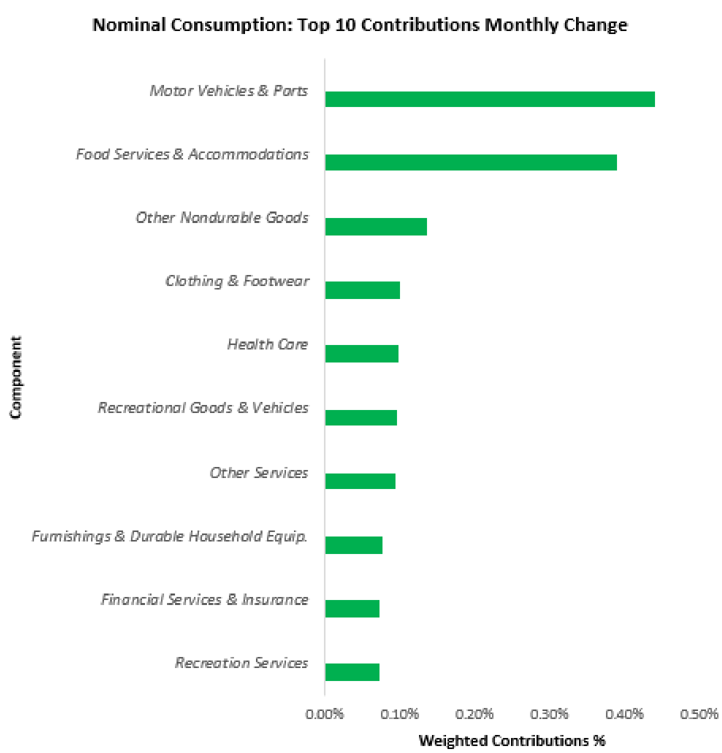


Over the last year, motor vehicle and parts dealers (0.55%), food & beverage Stores (0.72%), gasoline stations (0.49%), nonstore retailers (0.49%), & food services & drinking places (2.94%) have been the primary drivers of the 6.38% growth in retail sales. Consistent with these cyclical spending numbers, the most recent impulse in nominal income financed and expansion in nominal spending in these areas. Of particular note was the drastic rise in motor vehicle & parts spending.

This spending on motor vehicles made its way into the aggregate economic data, which we see in the form of heightened consumption spending:

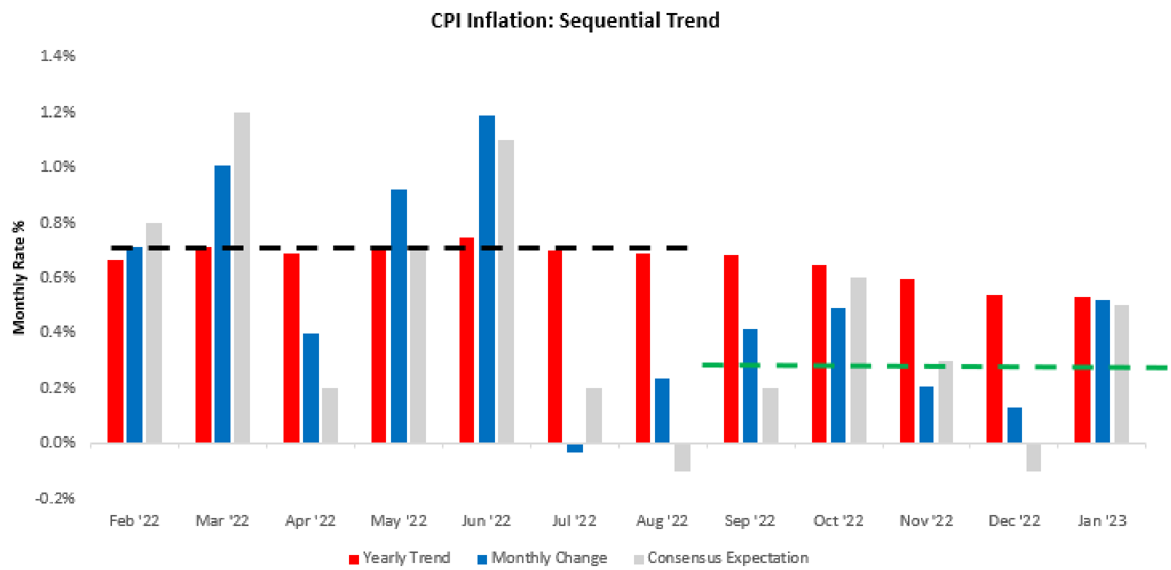


We show how this spending was distributed much like retail sales below, with motor vehicles, food, and goods accounting for the majority of this increase in nominal personal consumption.

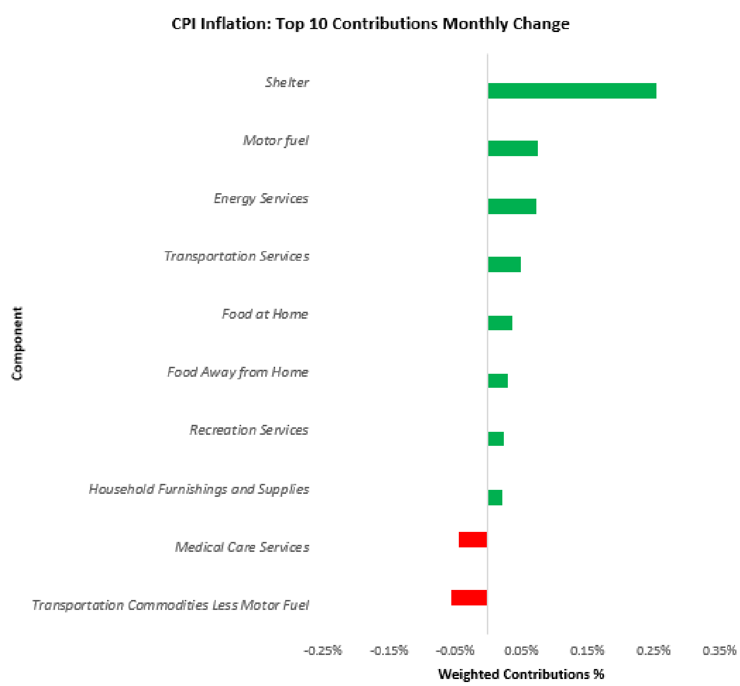


Now, as described at the outset, nominal spending relative to output determines inflation. This jump in nominal spending resulted in an increase in inflation.

Below, we show the sequential evolution of the most recent CPI data, reflecting the nominal spending rise. However, it is crucial to note that, unlike nominal spending, inflation did not show a large jump relative to its recent history.

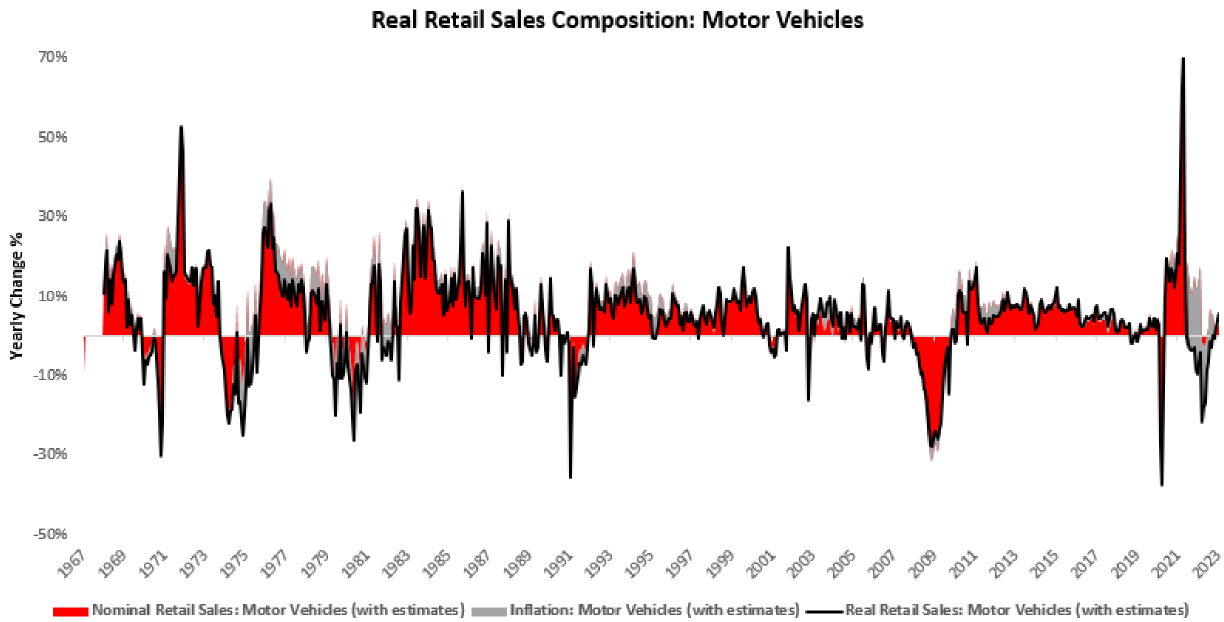


The primary driver of this divergence between the strength of nominal spending and inflation was that car prices decreased as units sold increased, i.e., real growth drove nominal spending. Below, we show the top 10 drivers of the most recent CPI inflation print:

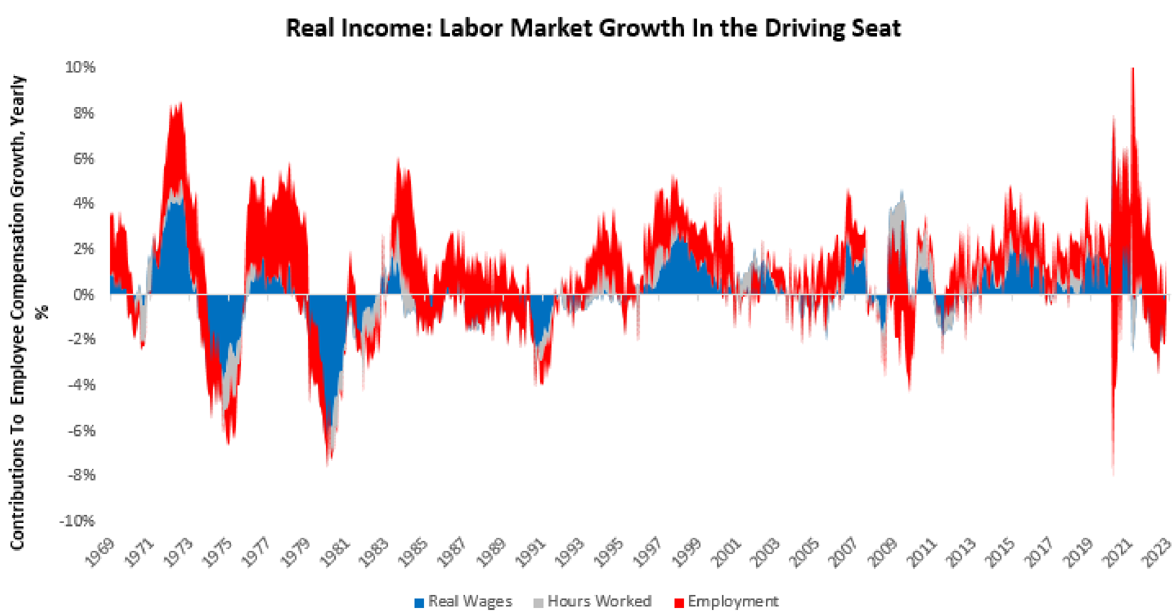


Without this deflation in car prices, inflation would have been 10% higher, with headline inflation consistent with an annualized inflation rate of 6.8%.

This combination of declining automobile prices and increasing output resulted in a significant increase in real consumption spending. Real retail sales for motor vehicles increased by 7% in January alone, which supported real personal consumption. Below, we show real retail sales for motor vehicles, along with the attribution of nominal spending and inflation:

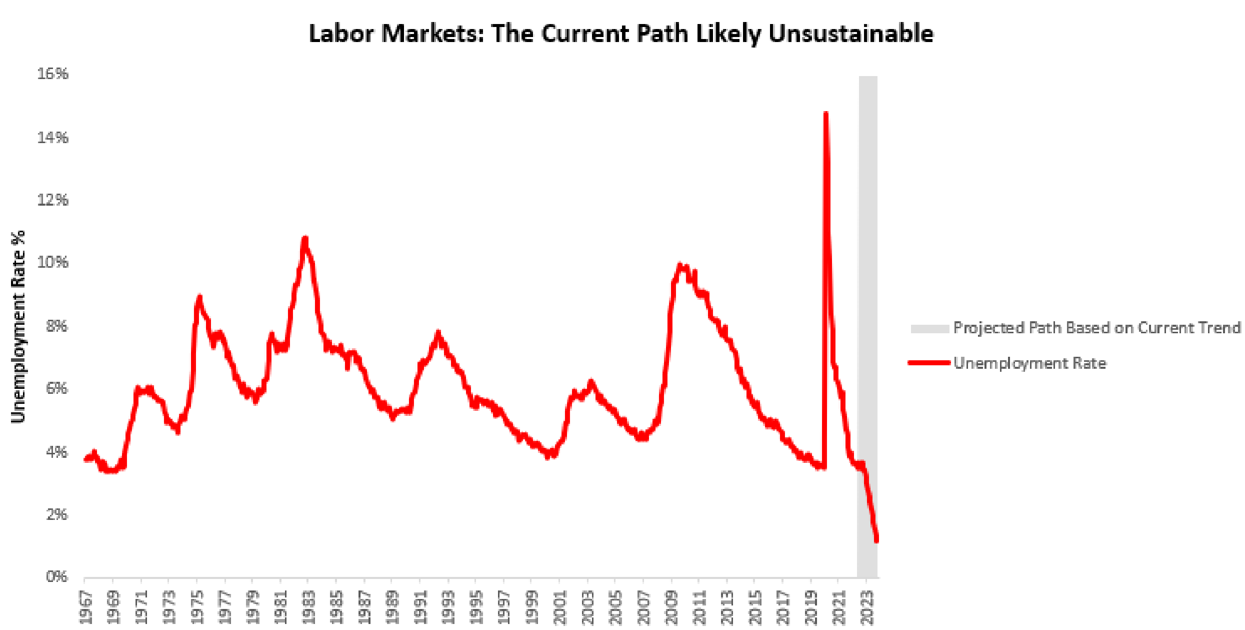


While we think it is possible for automobile output to continue to expand and deflationary forces to remain in play in that sector, we think it is unlikely that such large pulses can continue. This implies there is likely to be a slowing in nominal and real spending in the coming months. Furthermore, we think it is crucial to recognize at this junction the source of this real spending is gains coming from employment. We visualize the contribution of employment, wages, and hours worked to real employee compensation below:



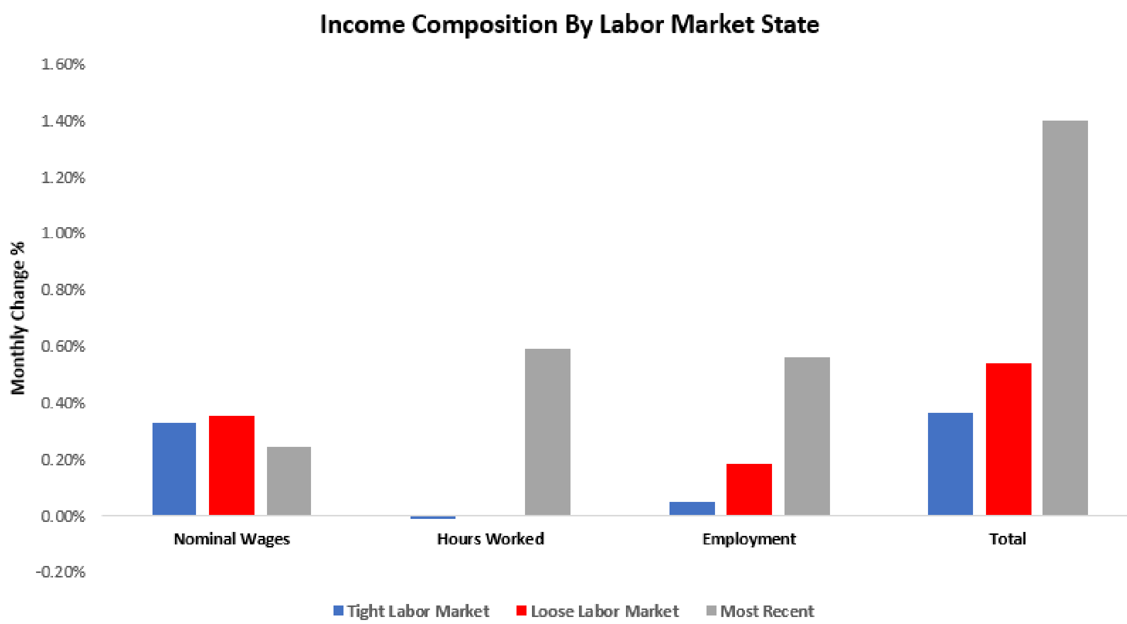
As we can see in the previous visual, employment accounts for more than 100% of real income growth, i.e., to sustain current income growth (which finances spending growth), we need to maintain at least the pace of employment growth. This pace is an increasingly difficult task for the economy in the current environment as unemployment rates remain at secular lows, i.e., labor markets are extremely tight. Below, we show unemployment rates, our estimation, and our assessment of past periods where labor markets have been significantly tight relative to their recent history, which is the shaded areas.

Additionally, we also project the most recent trend in employment data to get a sense of the destination based on the current trajectory:

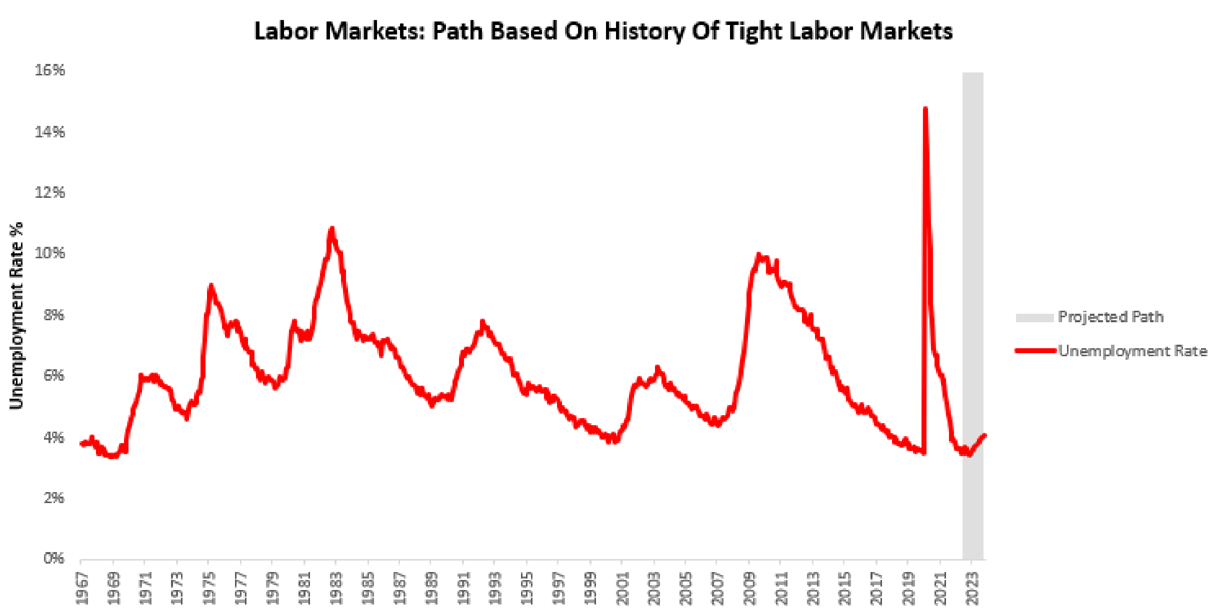


Based on the current trend in recent data, we would end 2023 with an unemployment rate of 1.2%.

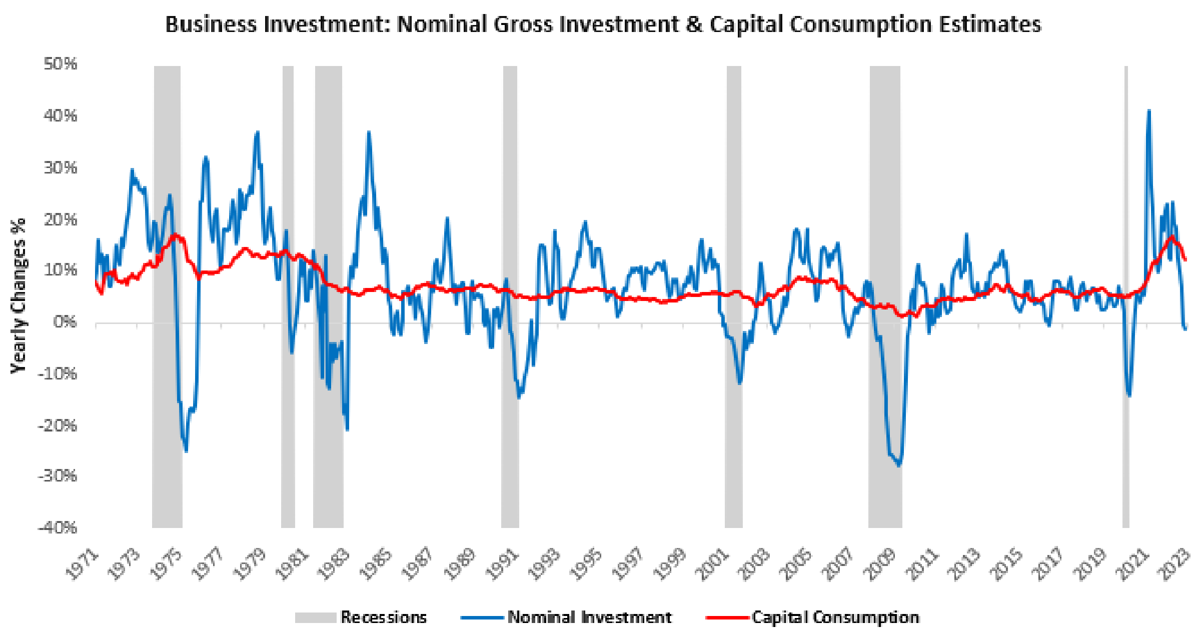
This trajectory would be wholly unprecedented and far out of line with any assessment of the natural unemployment rate for the economy. Furthermore, most recent data is inconsistent with previous periods of tight labor markets. Below, we show the 3-month forward change in nominal wages, hours worked, and employment during periods when the labor market was tight or loose. To contextualize, we also show the most recent data prints in grey:



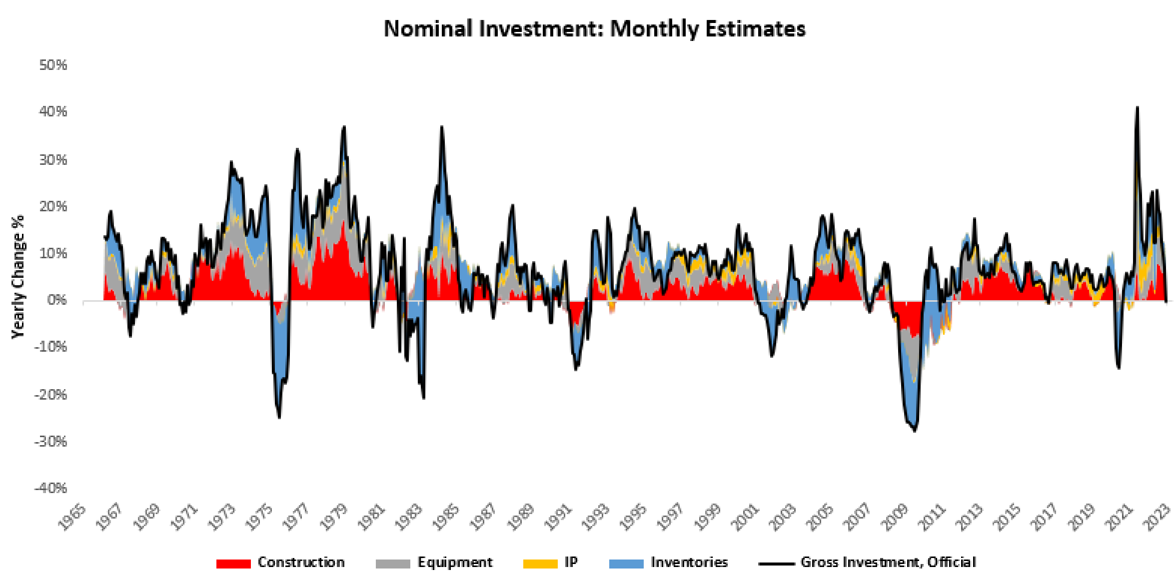
As we can see above, the most recent change in employment and hours worked is anomalous relative to previous periods of tight labor markets. Furthermore, the combination of factors this month is anomalous relative to any period in history (tight or loose). Therefore, we think it is more likely to see a slowing in labor market conditions rather than a continuation of current labor market conditions. Below, we the expected path based on this assessment:



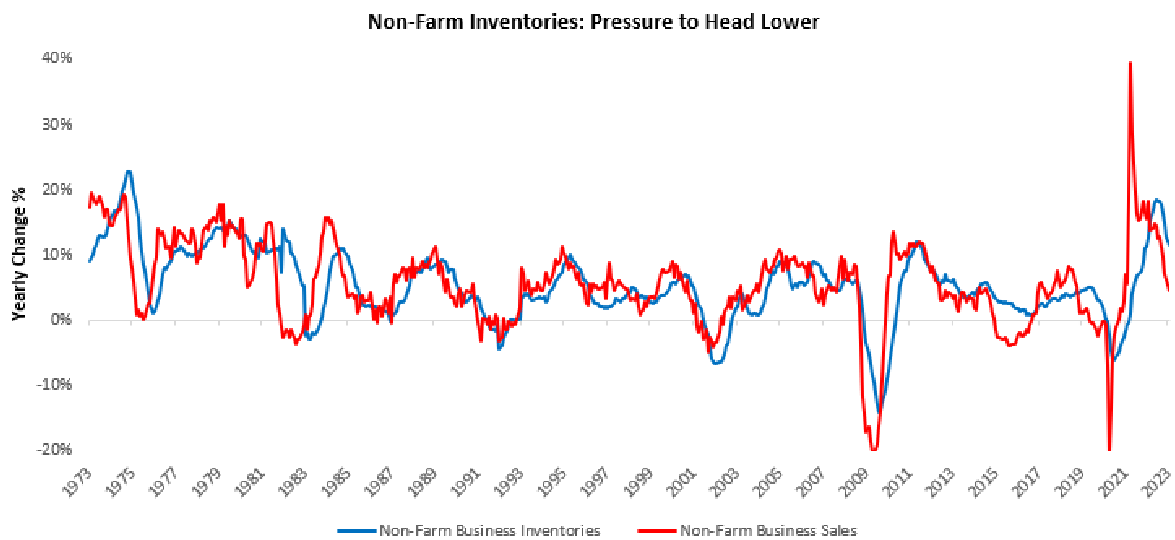
Remember that this increase in unemployment rates would occur without any contraction in total employment but rather a modest slowing. Based on our tracking of economic conditions, we think the conditions are brewing not just for a slowing in employment but an eventual contraction after a period of slowing. We expect these pressures to manifest as business profits continue to erode as we progress through the economic cycle. This profit erosion has begun, with a significant weakening of business investment relative to capital consumption. Below, we show our monthly estimates of these dynamics:



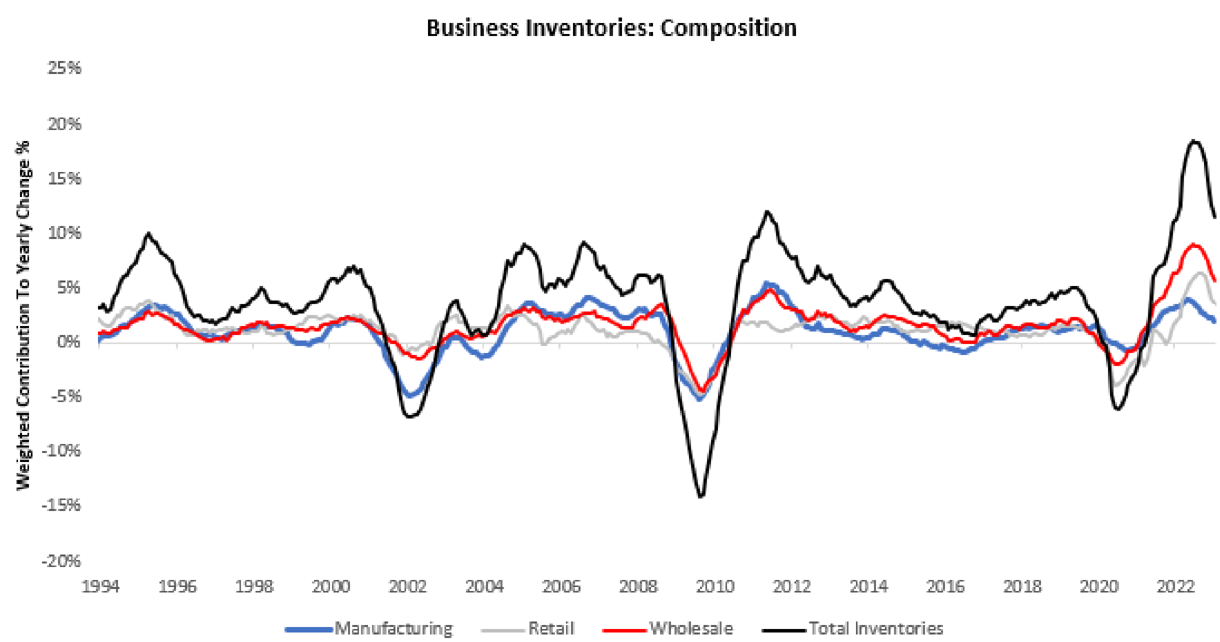
Capital consumption refers to the depreciation of fixed assets ad the expenses associated with their upkeep, while investment refers to the gross investment in new assets. The greater investment relative to capital consumption, the greater the potential for future output. As we can see above, investment is significantly below capital consumption growth, implying weaker investment for future production. Below, we show the composition of these declines in investment:



The primary driver of declines in investment has been a steady reduction in inventories, which is simply a function of a declining nominal sales environment. Below, we show how nominal business sales continue to decelerate, pushing inventories lower:

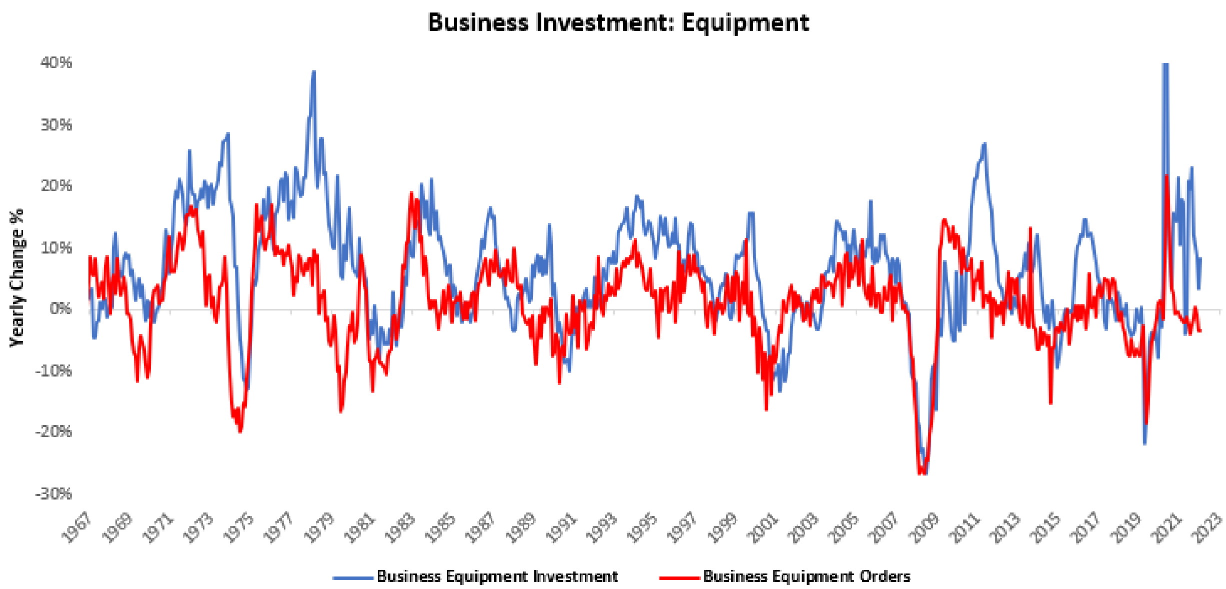


Total business sales are below the rate of change of inventories, suggesting downward pressures on future inventory growth. The gap between sales & inventories is significant relative to history, suggesting strong downward pressure on inventories. Below, we zoom in on the composition of these inventories:

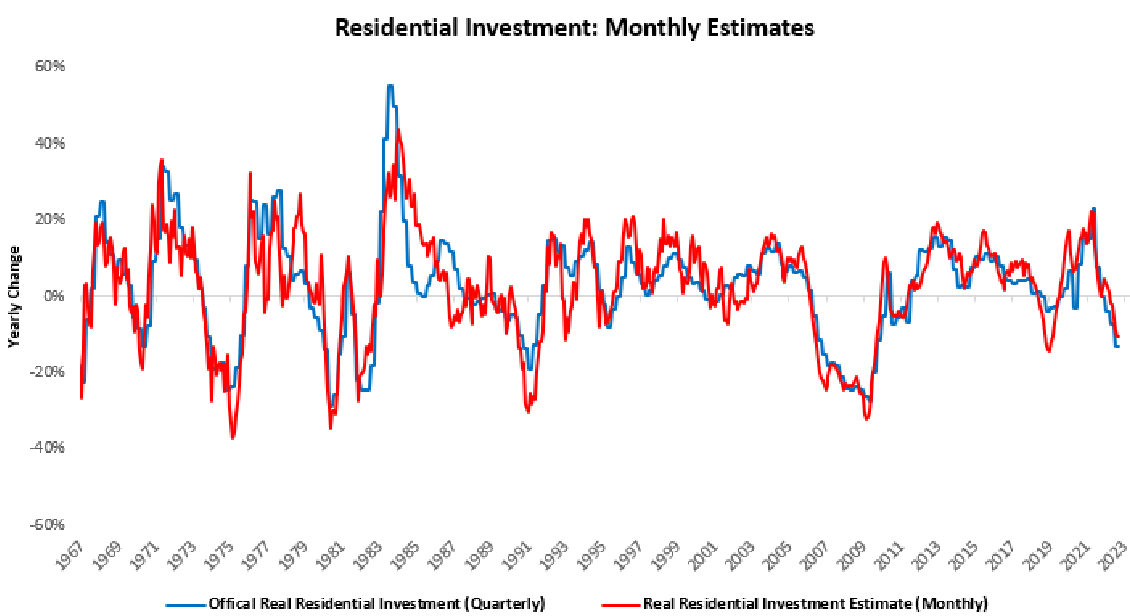


As we can see above, the declines in inventories are broad-based, and we expect these to continue as we progress further through the economic cycle and nominal activity dwindles. This decline will remain a headwind for business investment, GDP, and profits.

Alongside this potentially weak inventory investment, we will likely see weakness in business equipment investment, mainly from a weakening of orders for the same. We show our monthly tracking of these dynamics below:

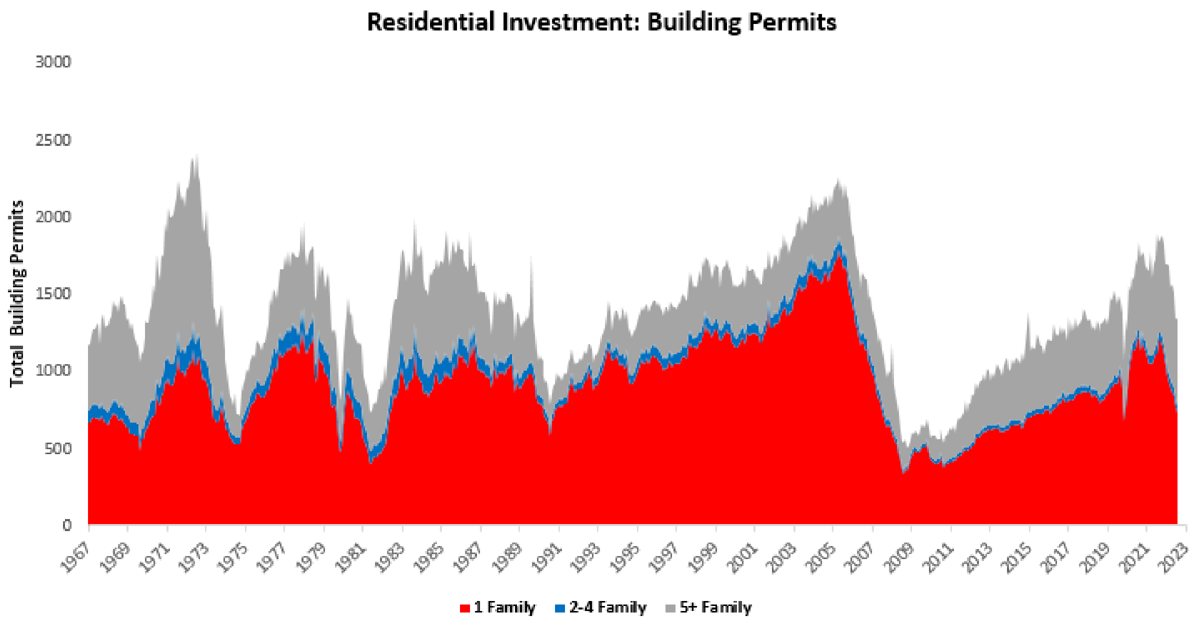


Finally, and potentially most importantly, real construction activity is likely to continue on its path of weakening. Below, we show how the most recent data is already in contraction, with solid downward momentum:

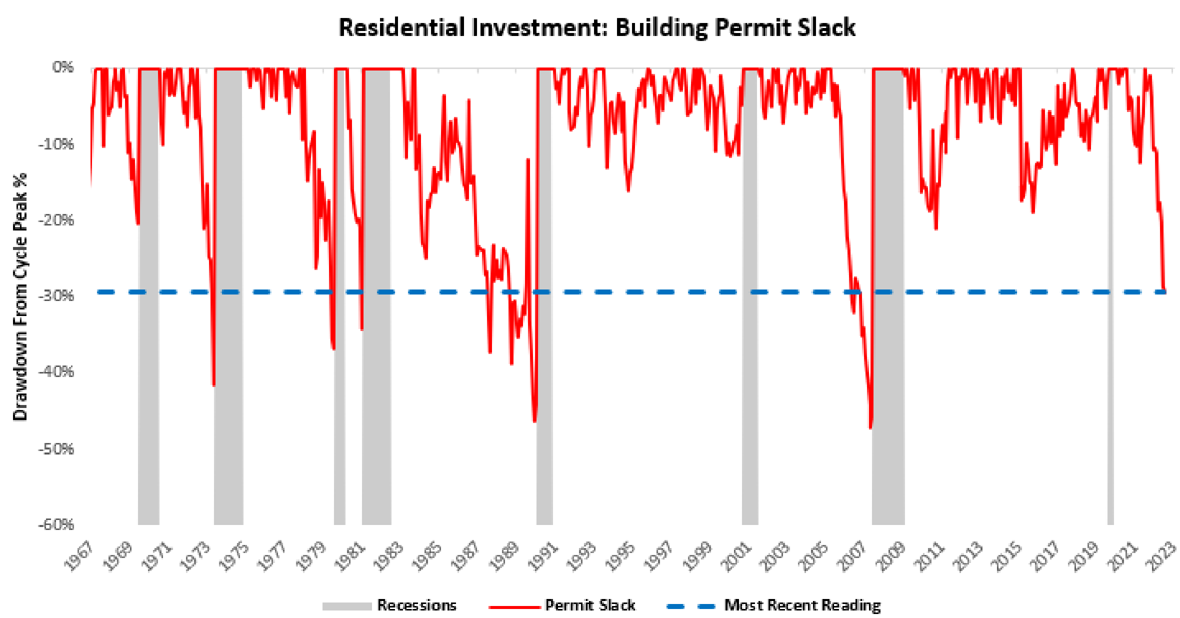


As we can see, real residential investment remains in the contractionary territory; furthermore, the latest data suggest a further decline in activity in this sector as we enter 2023. These conditions are likely to persist as we move through 2023.

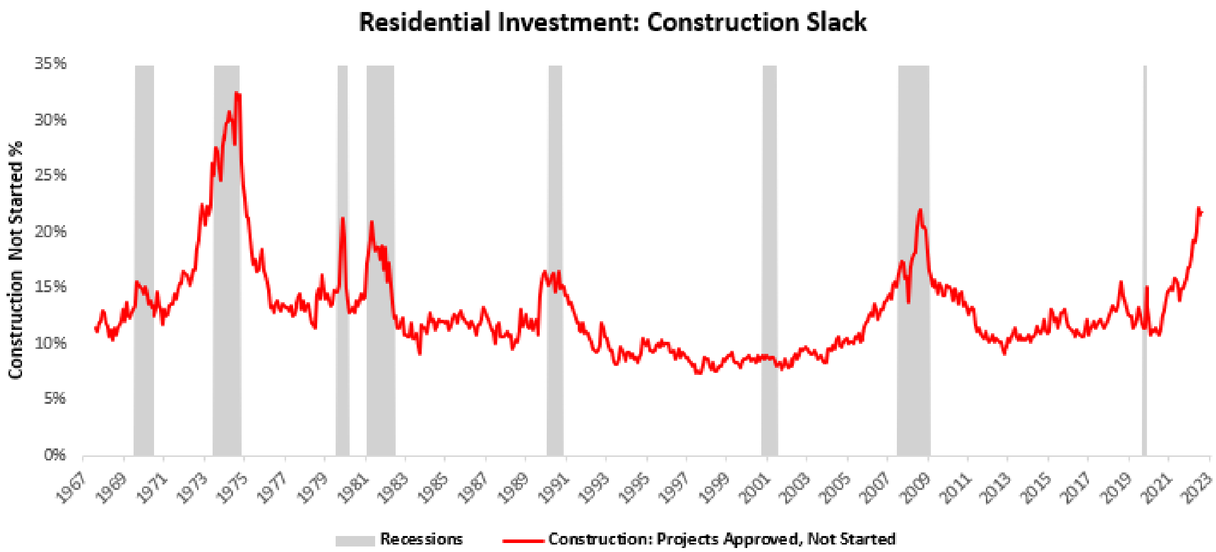
Within the residential market, the initial weakening stages take hold as the Fed increases interest rates, which flows through to mortgage rates and reduces demand for new construction projects. We see this in the softening of residential permits. Below, we show the slowdown in residential permits by the type of permit:



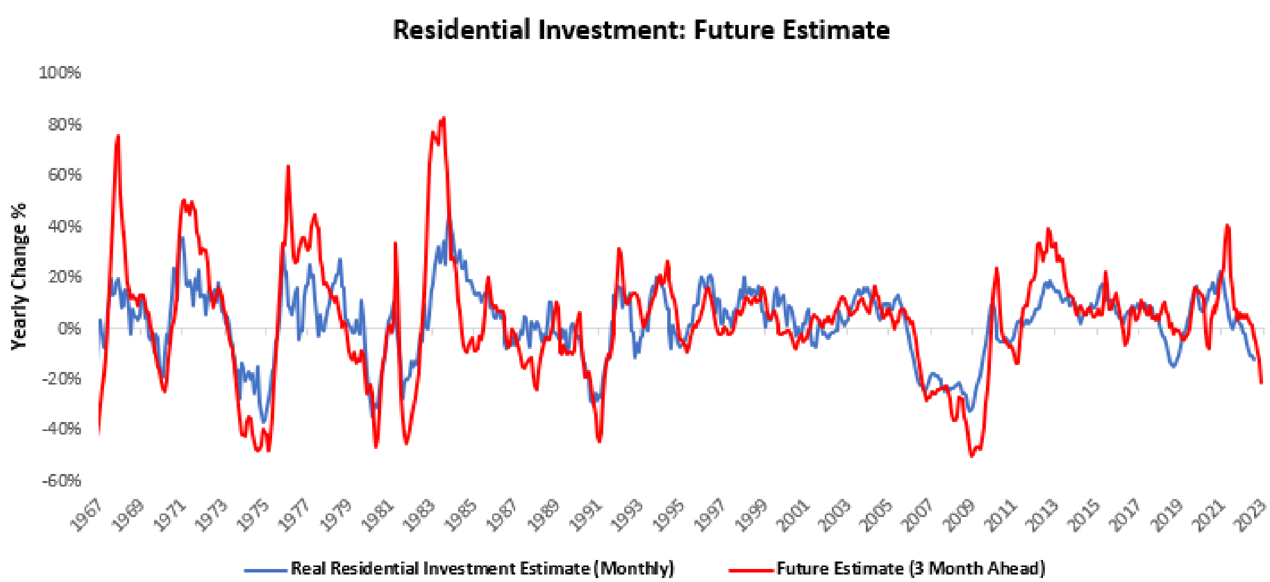
As we can see above, building permits across various project sizes have declined, suggesting that future construction will soften. The primary driver of this softness is the weakening of single-family building permits, consistent with their relatively large share of total residential projects. This drawdown in construction permits is consistent with recessionary pressures seen in past cycles. Below, we visualize this below:



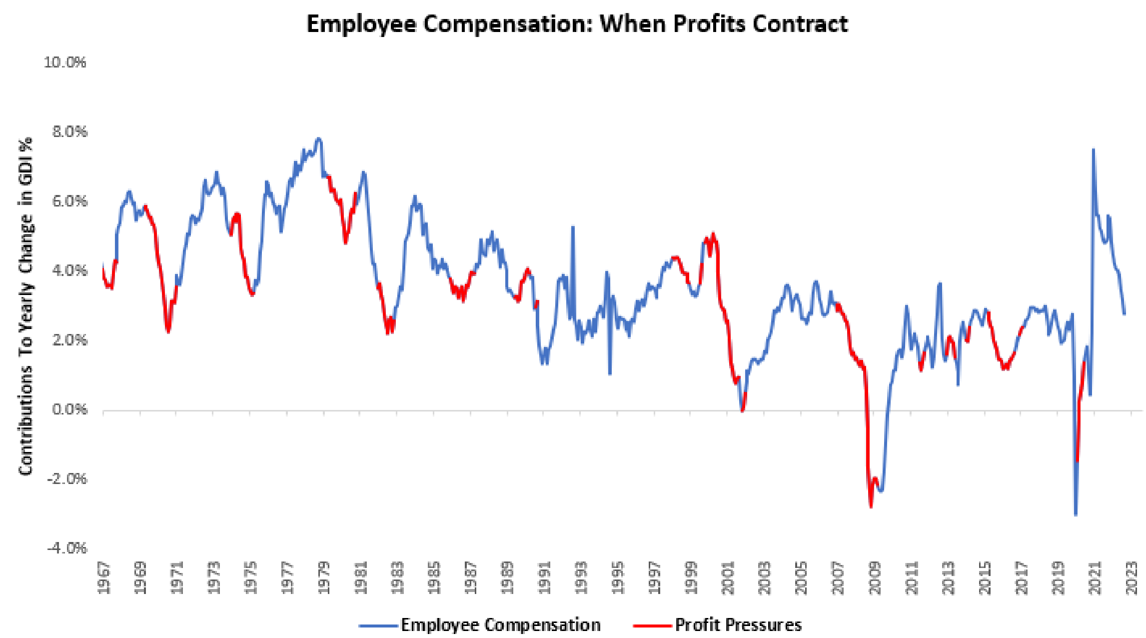
Above, we showcase our measure of the slack in building permit relative to its economic cycle peak. As we can see, the current weakening of permits is consistent with pressures that lead to a contraction in economic activity. We see further indications of this weakening of the construction sector in the form of unstarted projects. While permit activity can often occur as expectations for activity and financing remain positive, the spending impact occurs when these projects are initiated. As economic conditions and demand fall short of expectations, unstarted projects rise, i.e., construction slack rises. We show our tracking of this construction slack below:



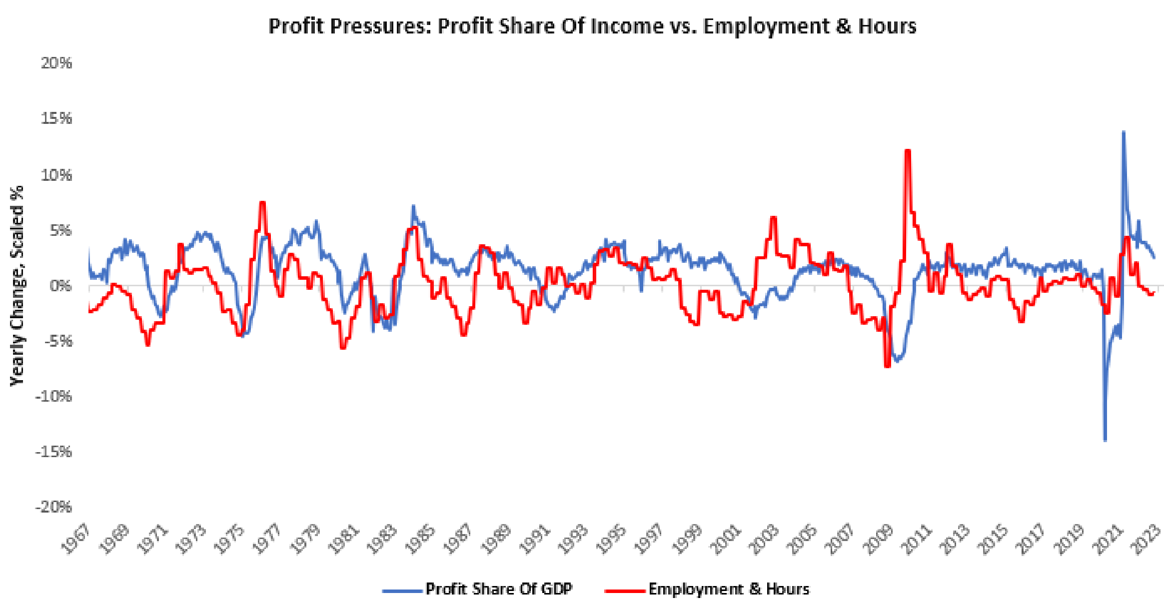
As we can see, the rise in unstarted construction projects is a cyclical pressure on the economy that impacts investment spending and creates a drag on GDP. These factors suggest that ongoing weakness in residential investment will likely continue, significantly weighing on broader investment conditions along with GDP and profitability. Below, we show our future estimates for real investment:



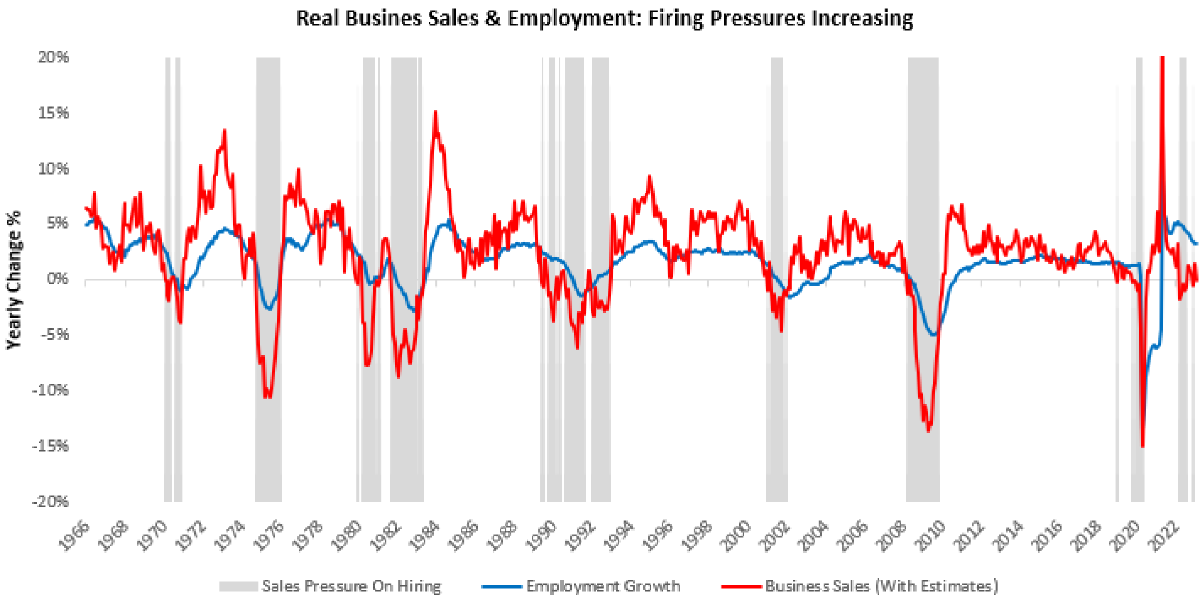
Therefore, our overall expectation remains for business activity and investment to continue to weigh on GDP data, with our latest data already showing weakness. We think the composition of this weakness is a telling sign of things to come. In an environment where nominal GDP is declining but with business activity falling faster, there is mechanical pressure on profitability. As business profits enter a contractionary state, companies can no longer rely on topline expansion to see profits grow, and they resort to cost-cutting in various forms. The first sacrifice tends to be reinvestment; the second is hours worked, and finally, employment. Through this channel, contractionary profits tend to result in a drag on nominal income. We show this below:



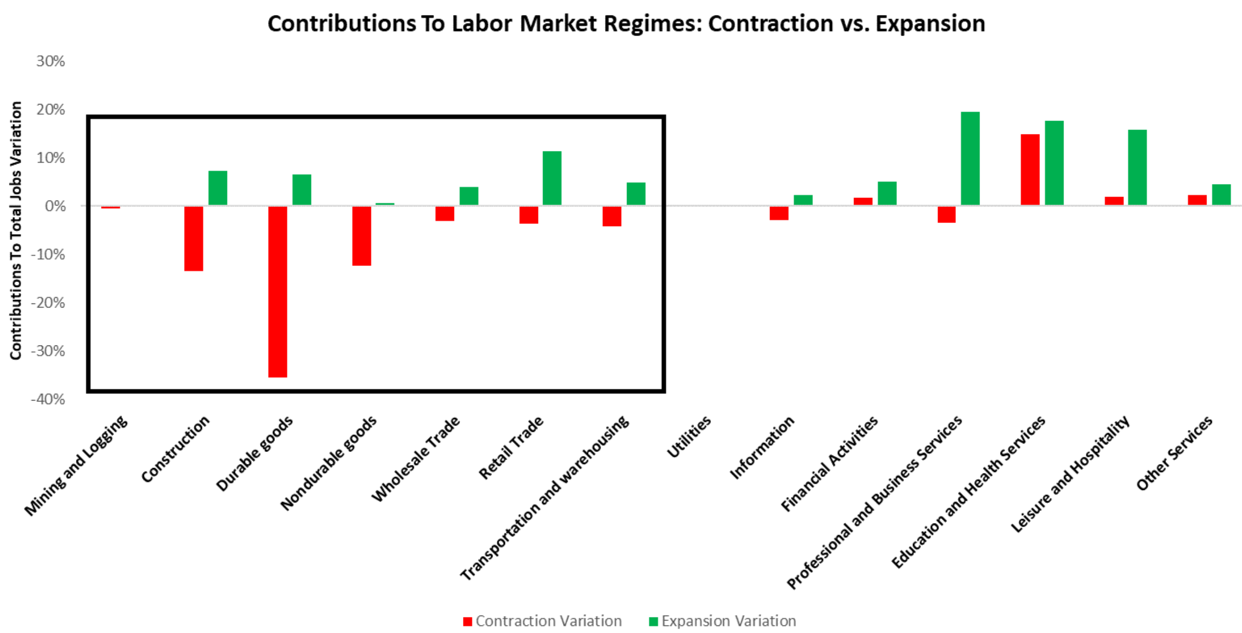
For further context, we show the relationship between the change in the profits share of GDP and changes in the sum of hours worked and employment:



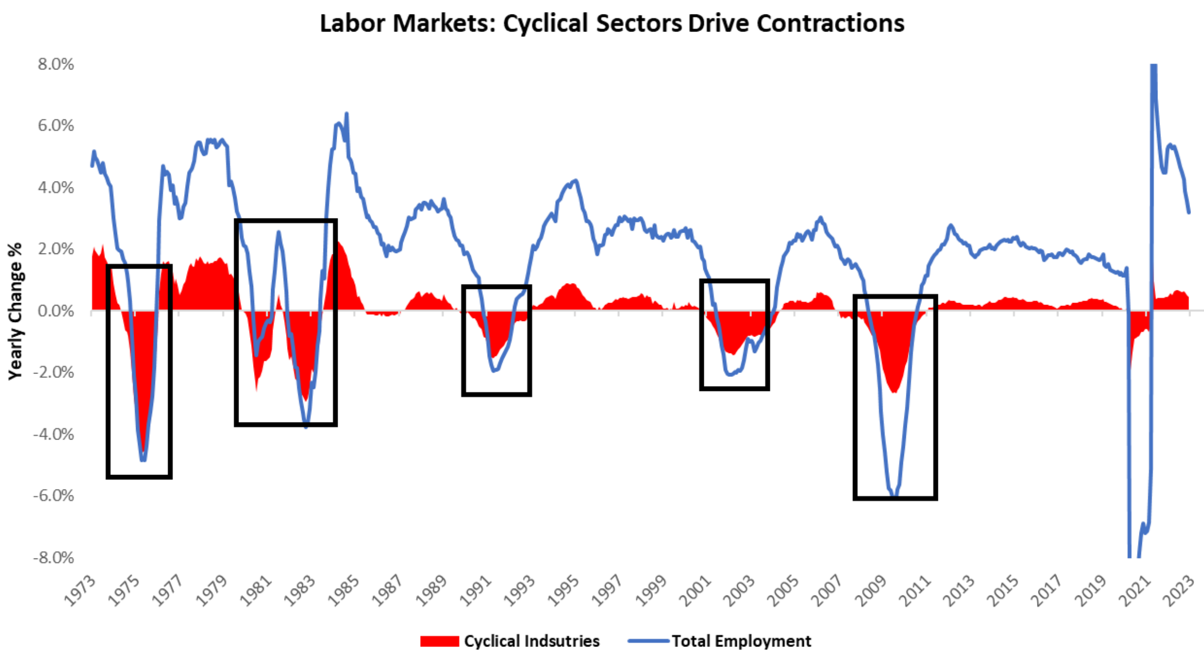
Furthermore, this profit pressure exists at a bottom-line level (albeit still modest) and on a topline basis. Sales growth is below employment growth, suggesting downward pressures on future hiring. The divergence between sales & hiring is significant relative to history, suggesting strong downward pressure on future employment.



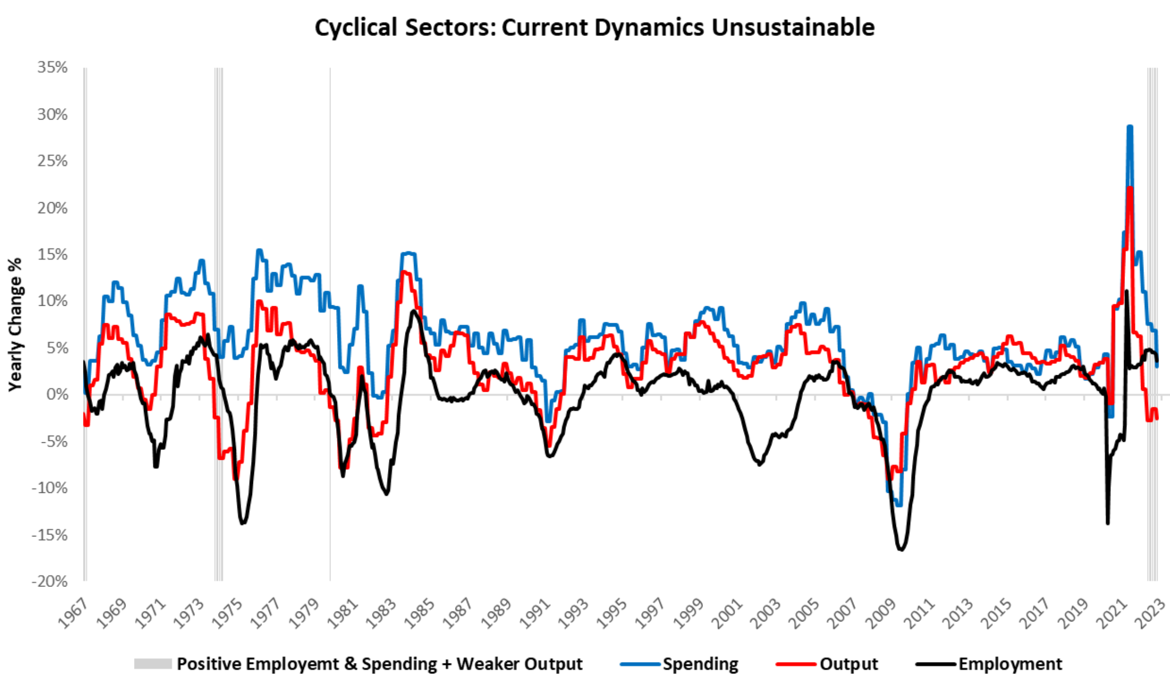
Since 1966, every contraction in real sales has led to a contraction in employment. If business sales remain in a contractionary territory as they are today, employment is likely to follow; the question is what will drive this contraction. Our analysis leads us to think that the economy's cyclically soft and leverage-sensitive areas will first show signs of weakness. Below, we help contextualize this expectation by looking at the contributions of various sectors to expanding and contracting labor markets:



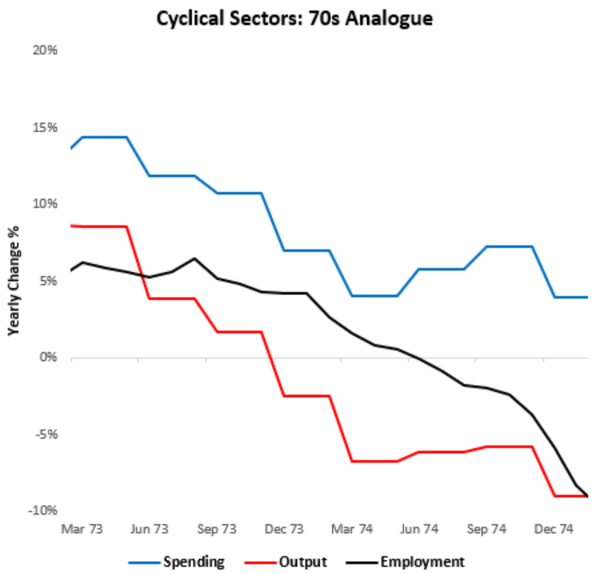
The illustration above shows the contributions of various sectors to total labor market variation when labor markets are expanding (green) or contracting (red). As highlighted above, a small segment of cyclical industries drives almost all downside variation in labor markets. We show this over time below:

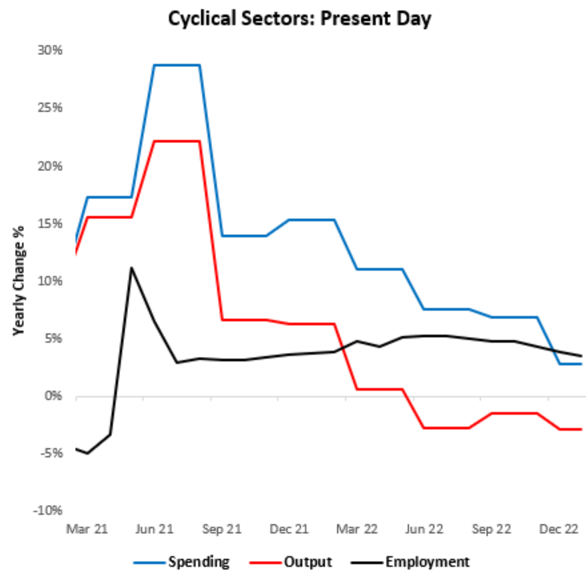


As we can see above, barring the most recent COVID-19 contraction, cyclically sensitive areas of the economy drove the lion's share of employment downturns. This context is particularly important in today's setting, as when we examine the output in these areas, they are in contraction, while nominal income and employment remain positive. We judge these dynamics to be unsustainable:

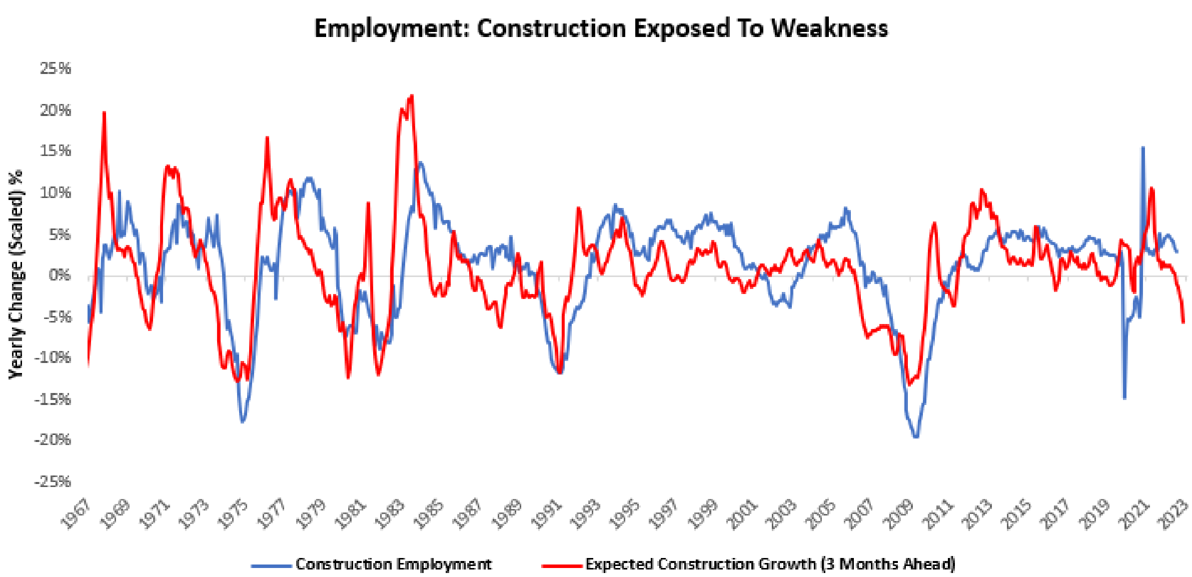


The visualization above shows the evolution of nominal spending, output, and employment in cyclically sensitive sectors. Additionally, we highlight periods that resemble today, i.e., where spending and employment are positive, but output is negative. These episodes have been a rarity, with the most recent analogs only in the 1970s inflation. All these episodes resolved themselves through lower employment and decelerating spending, which we judge today as consistent with this history. Below, we zoom in on the most relevant analog and compare it to today's dynamics:





As we can see above, while employment remained positive for a while, output fell; eventually, the weakness in output flowed through to employment in cyclical sectors. In today's context, we see construction employment as the most exposed to this risk. We show this below:



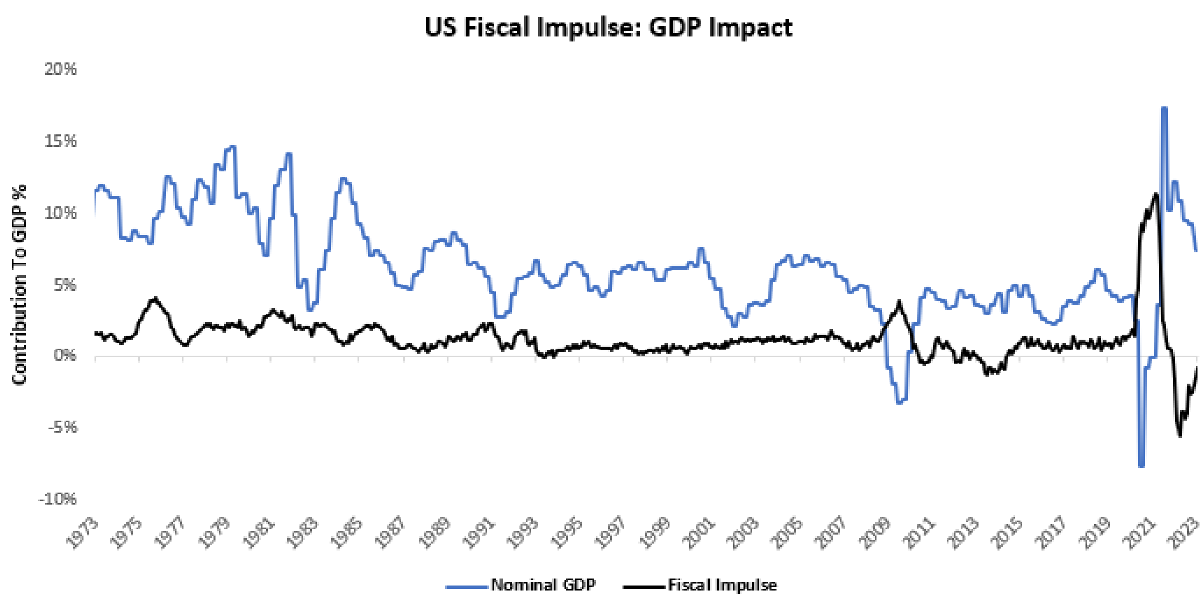
Therefore, in the coming employment data, we will monitor these dynamics carefully to understand if conditions are evolving in line with our expectations.

For the time being, employment remains the stronghold of economic activity. Alongside strong employment, we also saw a material increase in liquidity as we came into 2023.

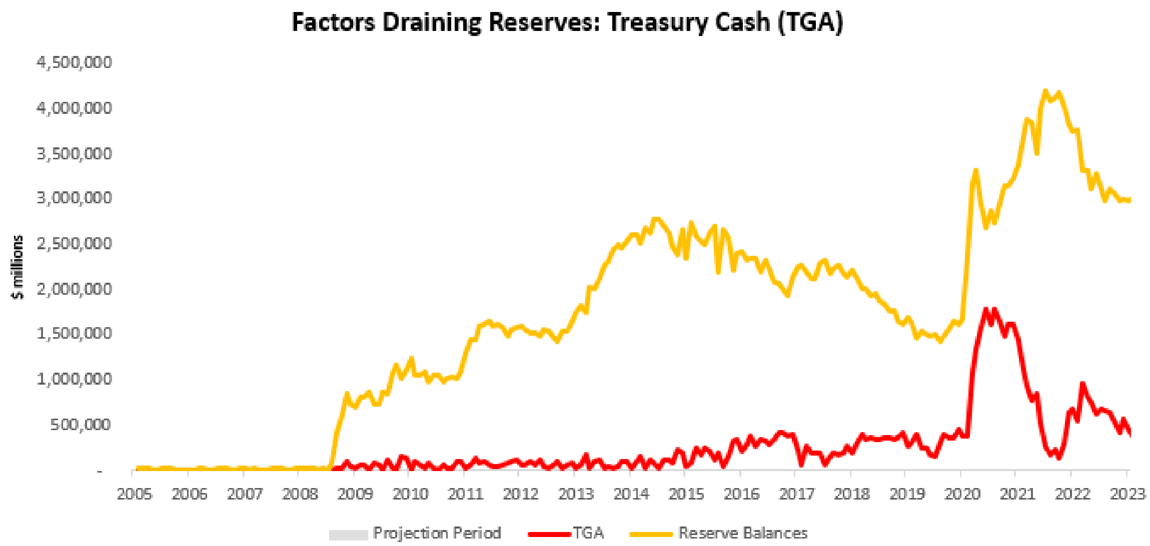
Before we dive into our tracking, we think it necessary to outline our thoughts on liquidity. Liquidity is the flow of cash and cash-like assets in the economy that potentiate future economic activity. This flow can be created by either the private or public sectors by creating financial assets and their corresponding liabilities. Liquidity is a store hold of economic value, with minimal risk of nominal dollar loss. All financial assets exist somewhere on the liquidity spectrum; however, they differ in where they rank in the liquidity hierarchy. This ranking is primarily driven by the risk of the borrower issuing the financial liability. Therefore, the government sits atop the liquidity totem pole, followed by financial institutions, corporates, and households. Given that all liquidity is essentially a liability, two dimensions impact liquidity— issuance (quantity) and interest rates (quality). Higher issuance & lower interest rates increase liquidity, and lower issuance and higher interest rates impair liquidity.

Finally, what is essential to recognize is that liquidity is stimulative to real economic activity. When corporations, governments, or households issue a security, that security creates an asset for buyers and lenders, a liability for the issuers and borrowers. It also instigates spending by the issuer as they put the capital to use. Thus, as liquid asset issuance increases, so does the economy's spending while potentiating further market investment capacity. We highlight this mechanism as we believe this has been a strong driver of market and economic activity.

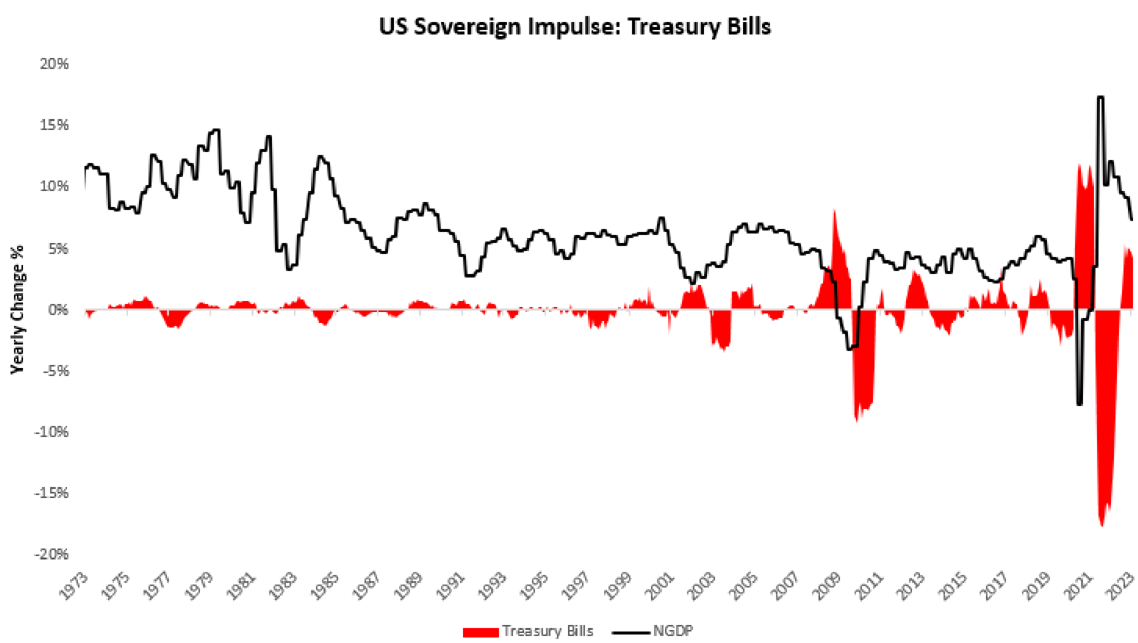
Currently, we are seeing cross currents in the liquidity ecosystem. Policymakers have been moving to contract liquidity, while the private sector has responded to heightened nominal income by increasing issuance. If we zoom into the context of the most recent months, policymakers continue to withdraw liquidity through contracting fiscal spending, but at a slower rate:



As we can see above, the fiscal impulse has begun to slowly creep toward positive territory, though it remains a drag on activity. We look at the composition of this impulse; it came from the treasury reducing its existing cash balance. Nonetheless, the Treasury did issue debt, but the issuance was not the primary driver of spending. Below, we show the reduction in treasury cash, which was a support to reserve balances held by the Federal Reserve:

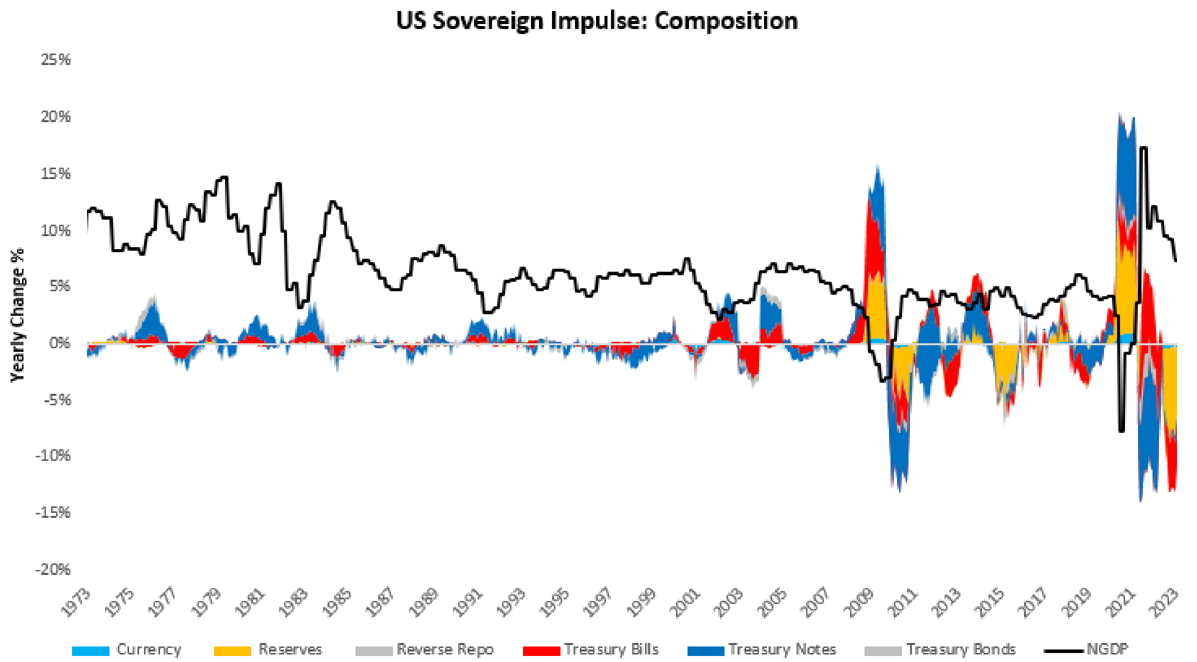


A surge in Treasury bill issuance also accompanied this reduction in the cash balance, boosting the fiscal impulse. We show this rise in bill issuance below:

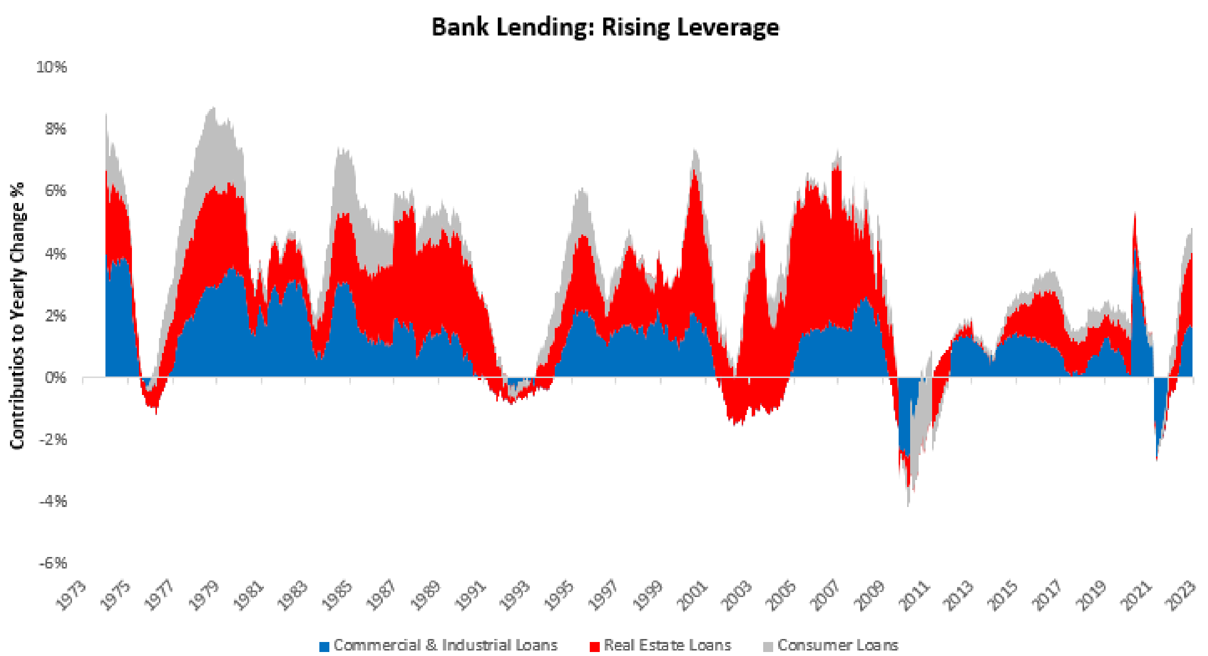


The combination of these factors created a stimulative impact on economic spending and increased financial liquidity asset markets.

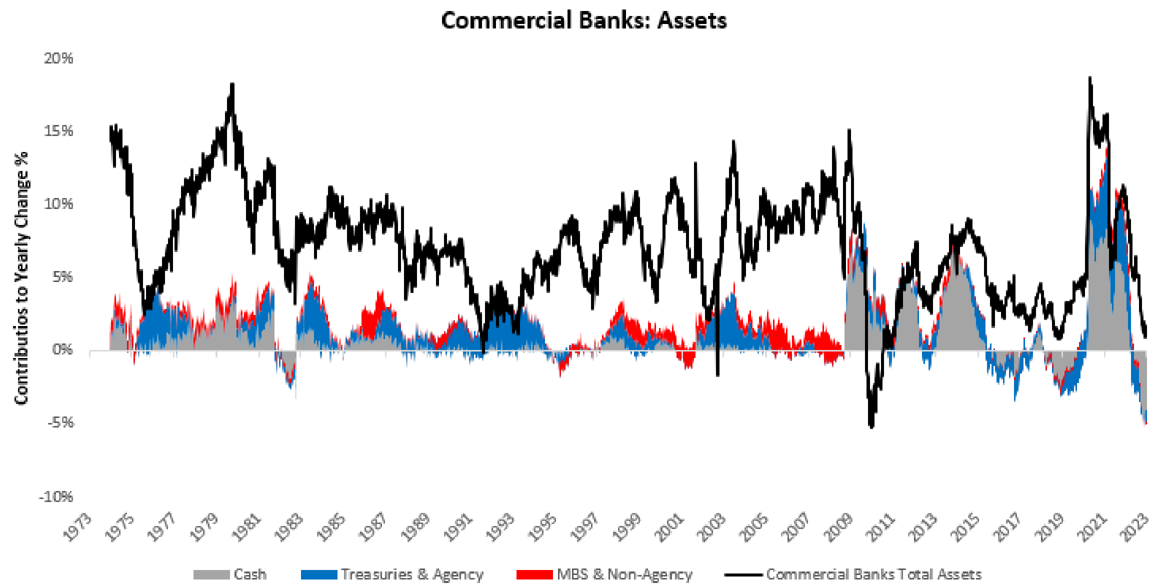
Below, we show the composition of the sovereign impulse, which nets out the cross current between the Fed and Treasury balance sheets to illustrate the government impulse to the economy and markets:



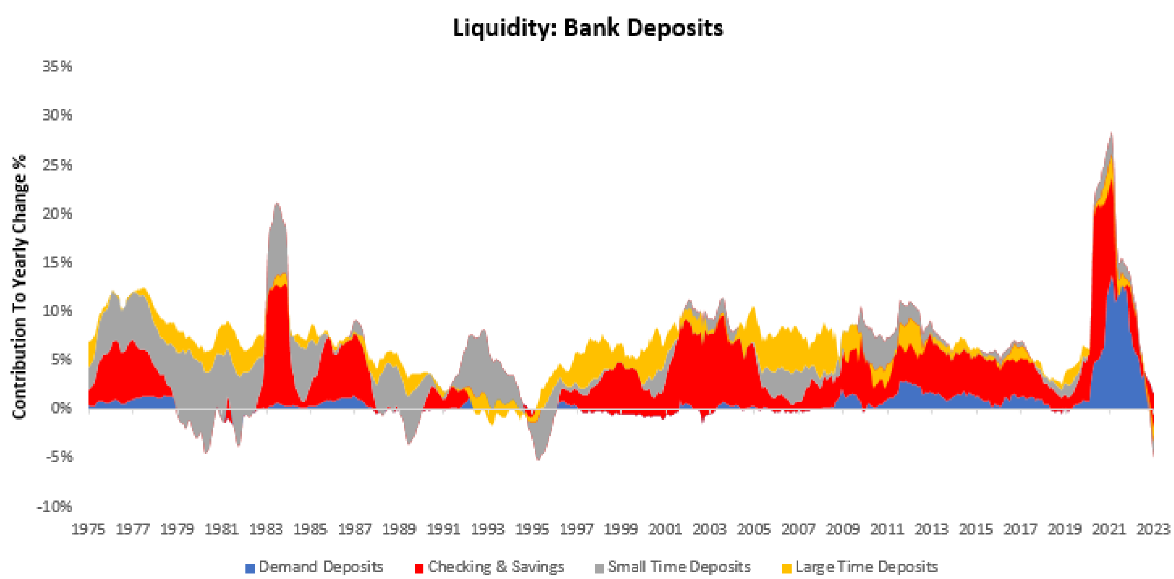
Overall, conditions have indeed improved but are far from positive. Now, while this impulse from the government became less negative, the impulse from the private sector improved in the second half of 2022. Particularly, we saw bank lending increase as nominal activity allowed nominal interest payments to be met. Below, we show how bank lending expanded last year:



Now, while this increase in lending activity has occurred, these impacts were offset by declines in reserve balances/cash (through quantitative tightening) and Treasury, Agency, and MBS reductions. Combining these factors leads to a contraction in the aggregate bank balance sheet. We show this below:

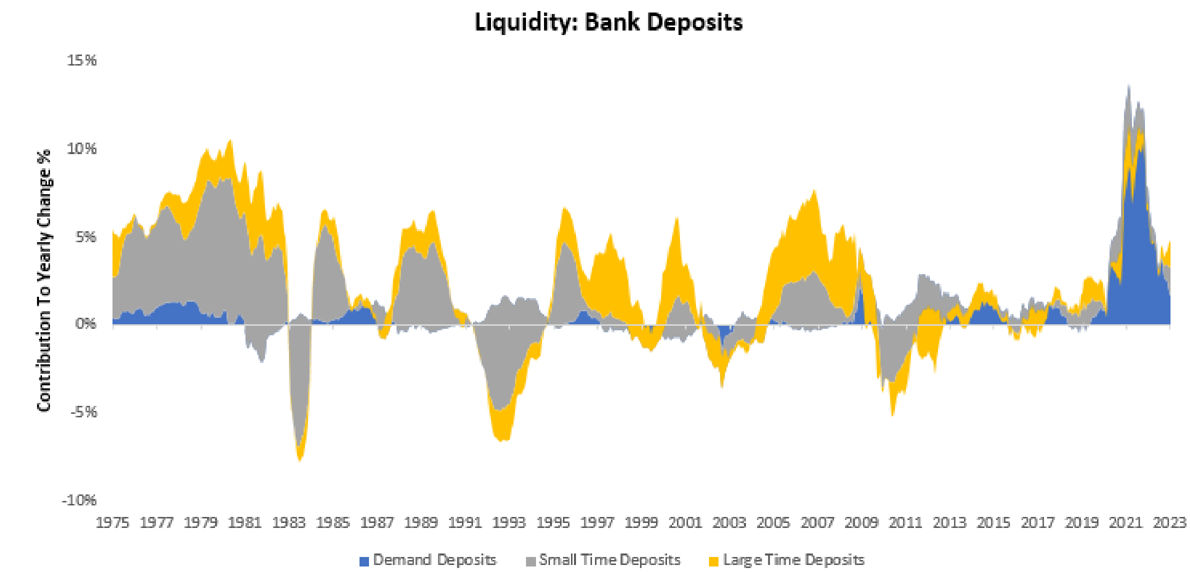


This decline in the banking sector has meant that deposits have declined for the non-bank private sector; we visualize this below.

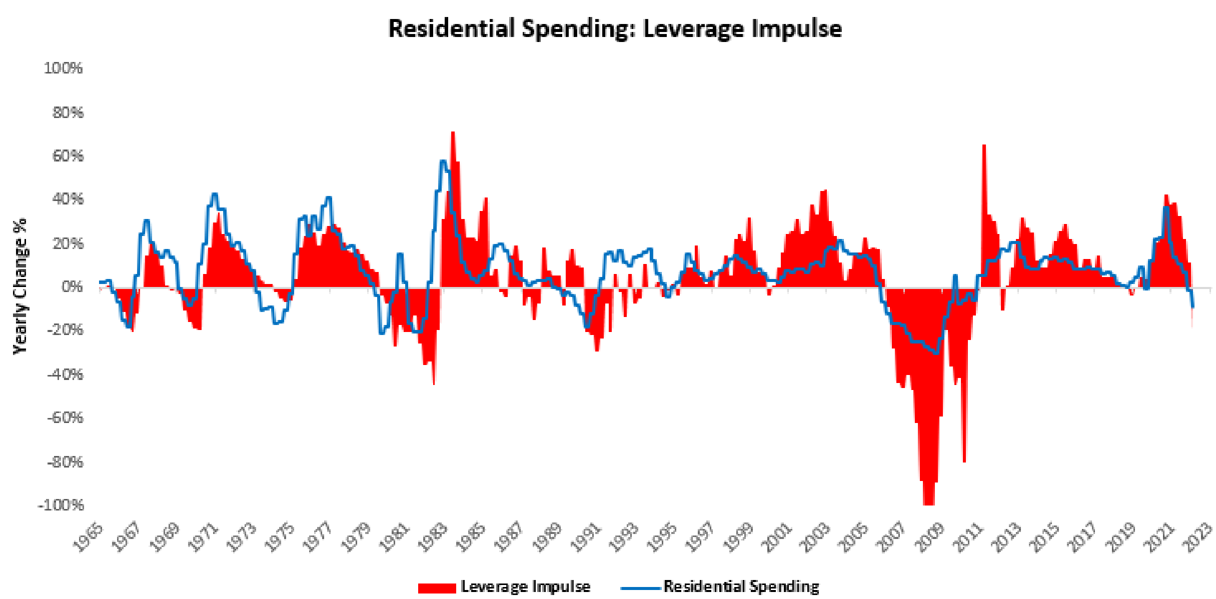


As we can see above, aggregate deposits have declined. However, this decline has come from decreased checking and savings deposits.

For clarity, we exclude checking and savings to show how other areas of private sector deposits have indeed increased:

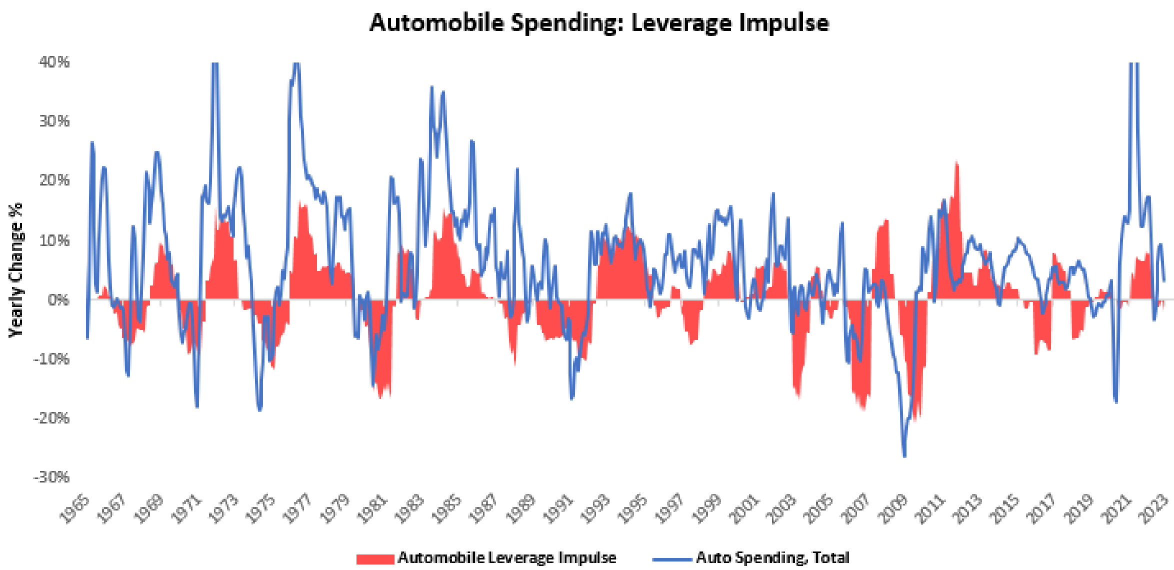


Therefore, while checking and savings accounts have been drained by tighter fiscal policy and quantitative tightening, all other deposits have benefitted as private sector credit expands. This confluence of events will likely be in the rearview mirror as we now see our tracking of the leverage impulse into the economy weakening. Below, we show how our estimates of this leverage impulse into the residential market are fading:

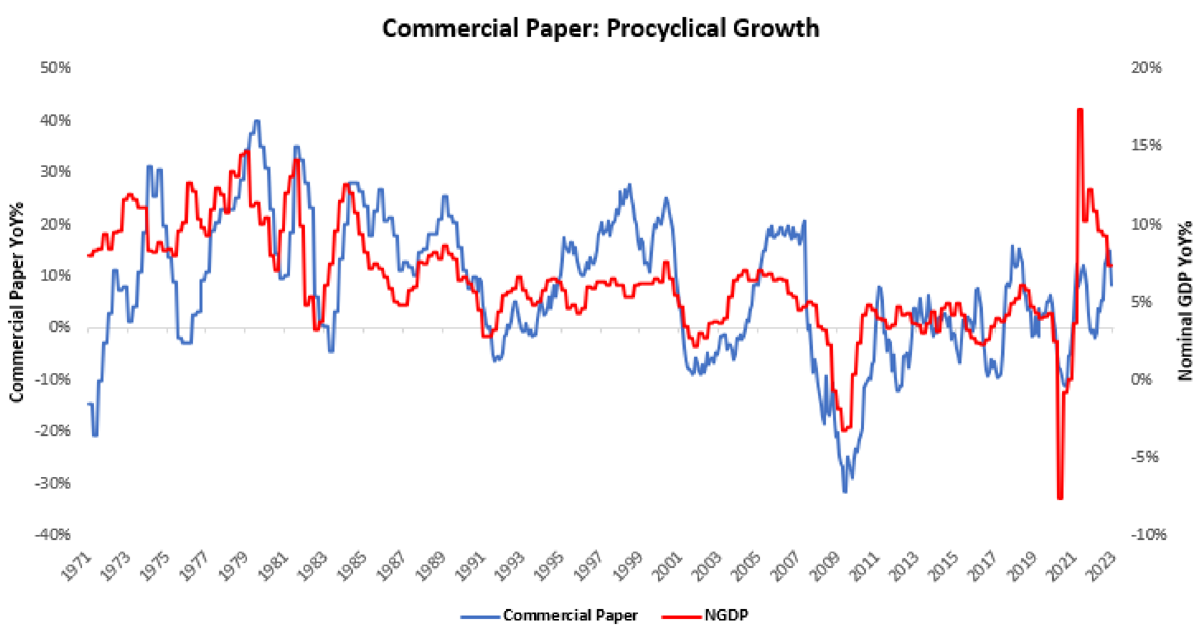


Our estimates of the leverage impulse into residential spending have now begun to contract, consistent with our latest tracking of nominal residential investment.

We have also begun to see the initial stages of slowing in the automobile sector, which is also a prominent consumer of borrowing:

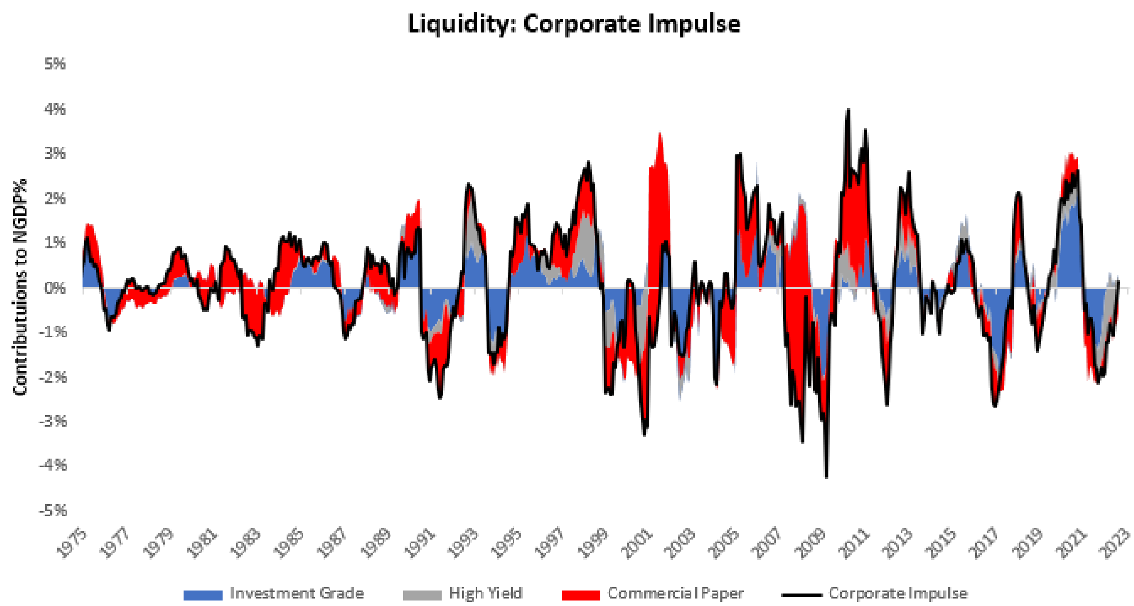


Therefore, we expect that while liquidity creation helped spur activity over the last few months, it will likely be a drag in the coming quarters as financial conditions remain tight relative to nominal income. We see some evidence of this in the slowing of commercial paper issuance:

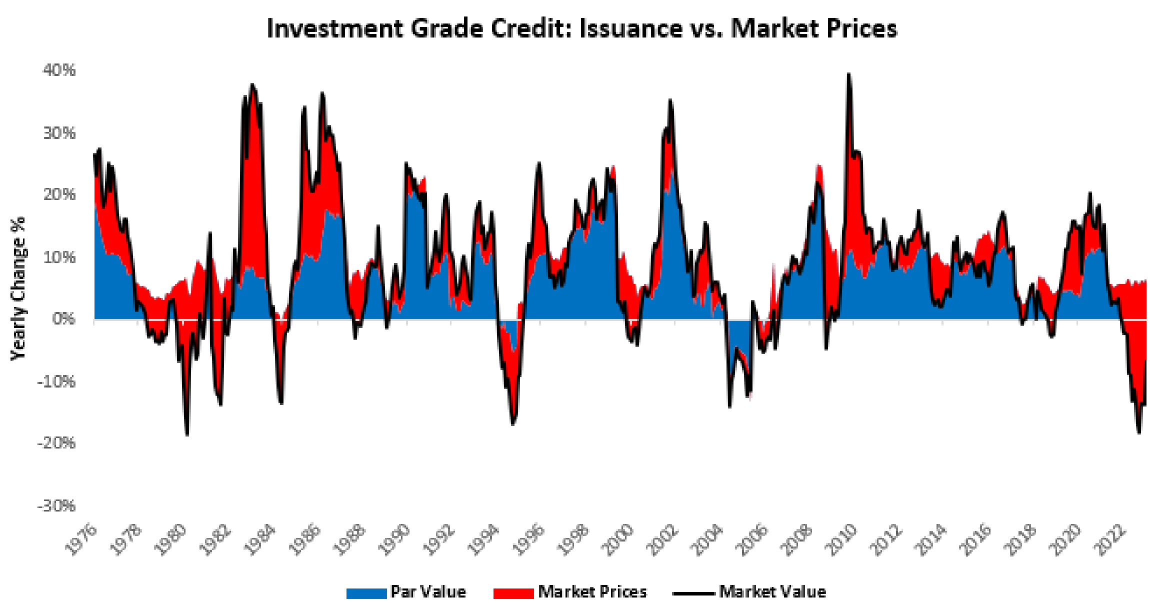


Commercial paper is typically issued in a pro-cyclical fashion. Recently, commercial paper rebounded as both the real economy accelerated and the policy liquidity drain slowed.

This acceleration in private liquidity occurred alongside a broad rebound in corporate issuance, which we show next.

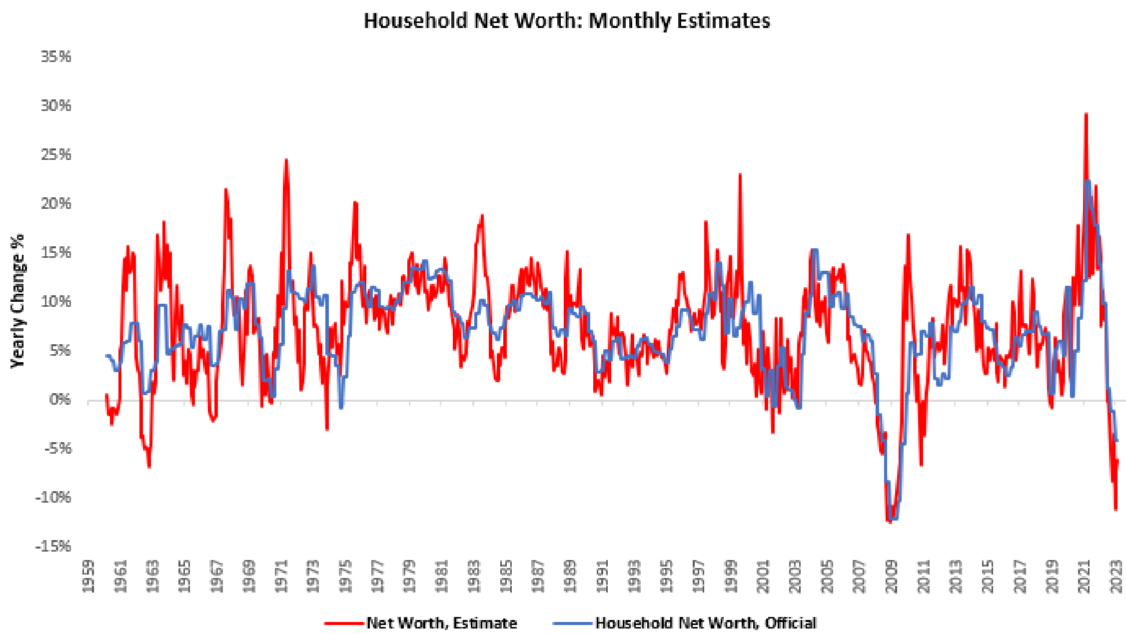


What we think is important to recognize about this economic cycle is that so far, we have not seen a significant pullback in private-sector lending and borrowing. In fact, most of the impact of tightening liquidity we have seen has been from mark-to-market losses and through the net worth channel. We show the non-financial investment grade market as a case in point:

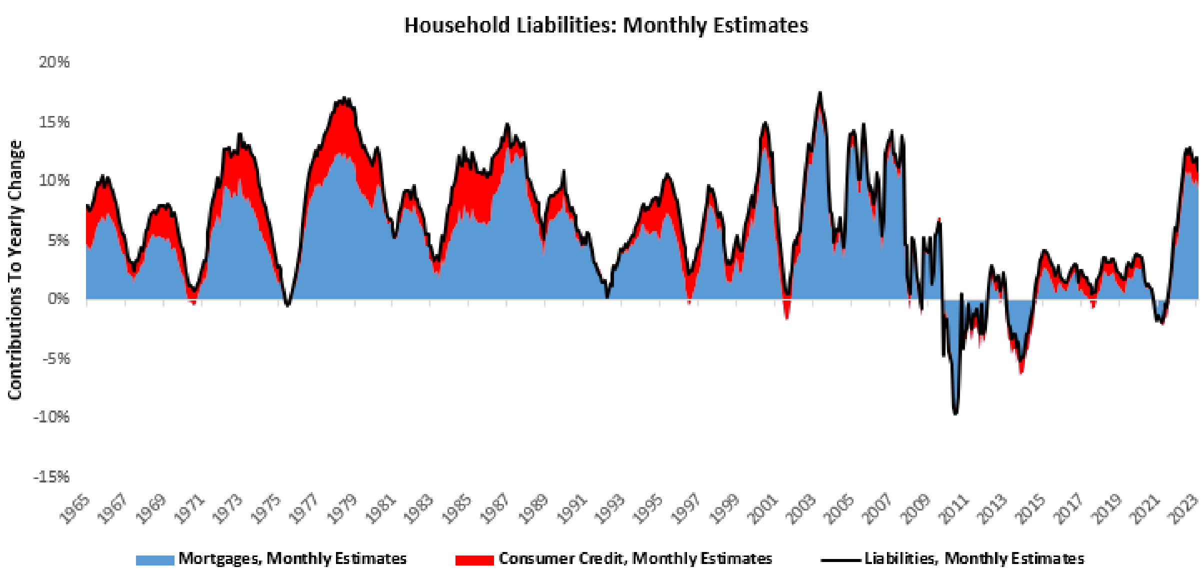


As we can see above, all of the reduction in investment grade market values have come from price. Now, it is extremely uncommon to have an outright contraction in issuance, i.e., it is extremely rare to have an event where debt cannot be refinanced. However, we think it imperative to note that corporate issuance has not slowed in any meaningful way yet.

We see a similar dynamic within household balance sheets. Our tracking suggests that while household net worths have declined as asset values have declined, household leverage has, in fact, increased. We show household net worth below:

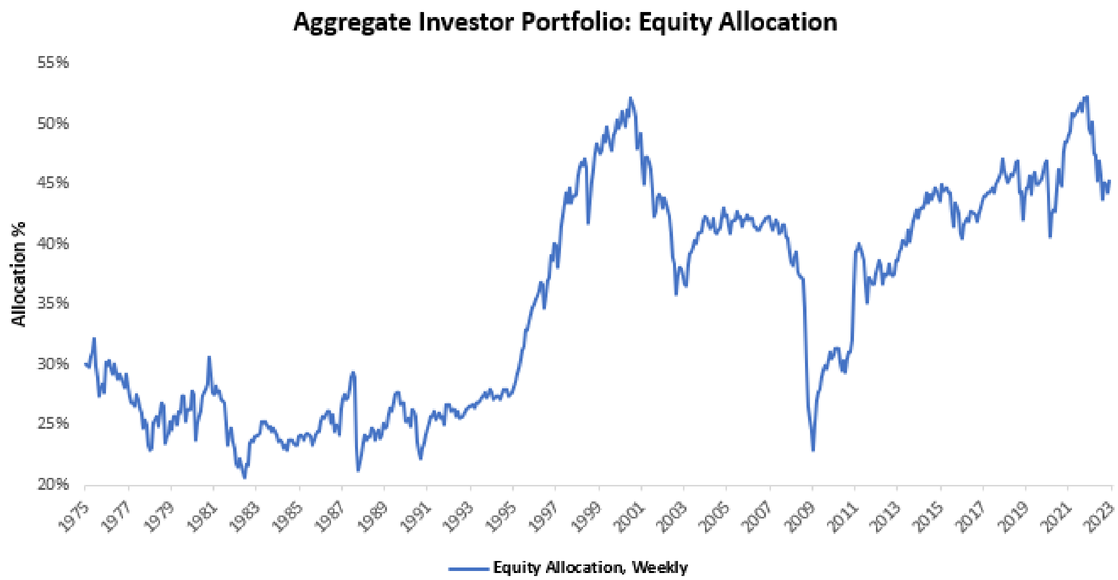


As we can see, household net worths have indeed decreased; however, they have decreased while borrowing has increased, which we show below:

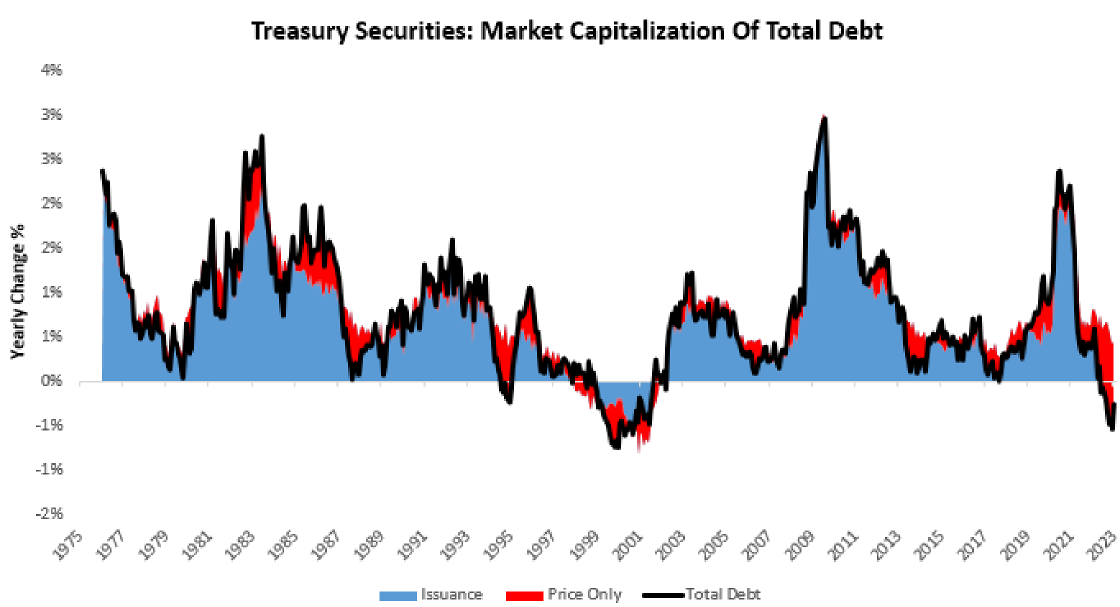


Therefore, there is likely to be more pressure on spending activity to come in the future as the private sector adjusts to slowly rising interest rates amidst declining nominal activity. For now, the combination of increased nominal growth with a real growth bias, stabilizing policy tightening, and modest disinflation has allowed risk-taking to resurface.

Below, we show our tracking of the aggregate investor allocation to equities. Amidst the dynamics of better liquidity and rising real and nominal growth, the aggregate equity allocation has risen very modestly:

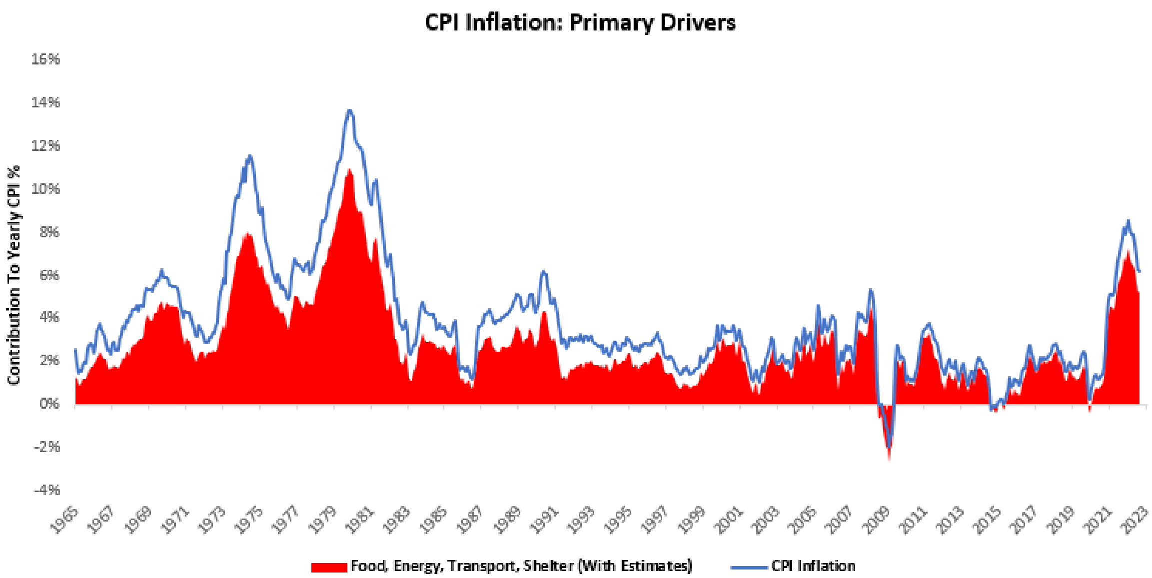


The change in equity allocation is partly due to a rise in equity asset prices but also supported by a sustained drawdown in treasury securities market values. We show how total Treasury liabilities continue to drawdown despite positive issuance:

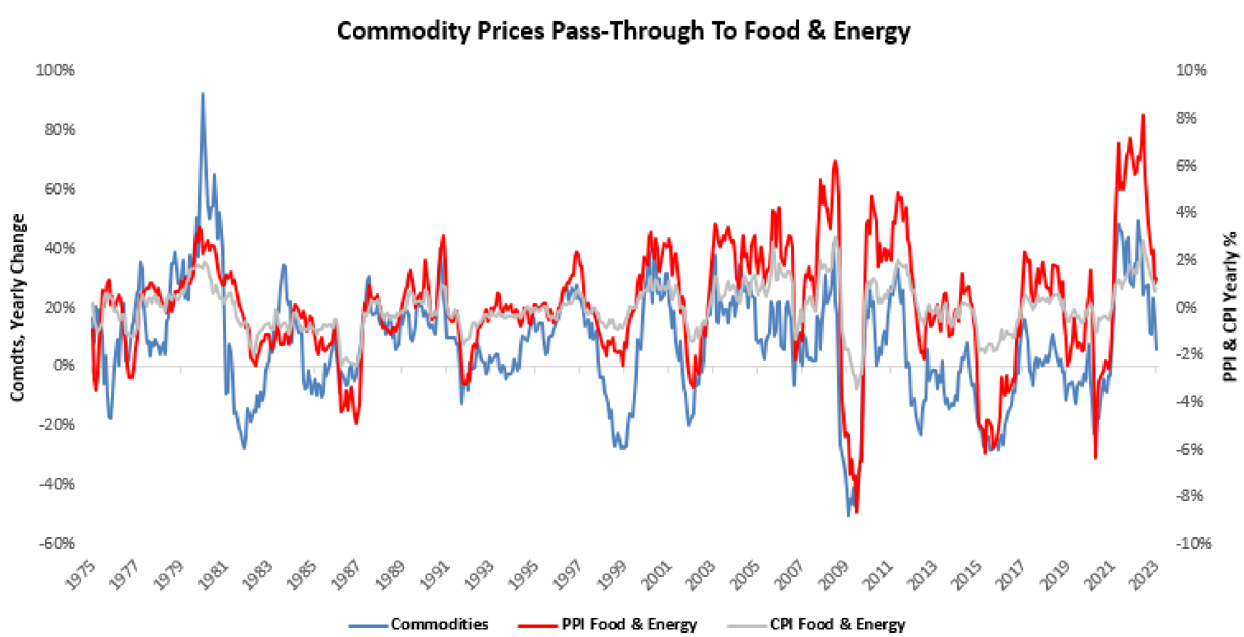


Overall, economy-wide balance sheet dynamics have largely moved to price in higher discount rates. However, we are yet to see the impact of weakening net worth and income relative to a rising cost of capital on private sector issuance. We think it is likely that this will be the next shoe to drop in the economic cycle.

As we approach the conclusion of this note, we think it is important to touch on the inflation outlook. In our view, four big forces will determine inflation outcomes: food, energy, transport, and housing. This expectation is consistent with history and the last inflationary shock. Below, we show how these items account for virtually the variation in inflation over time:

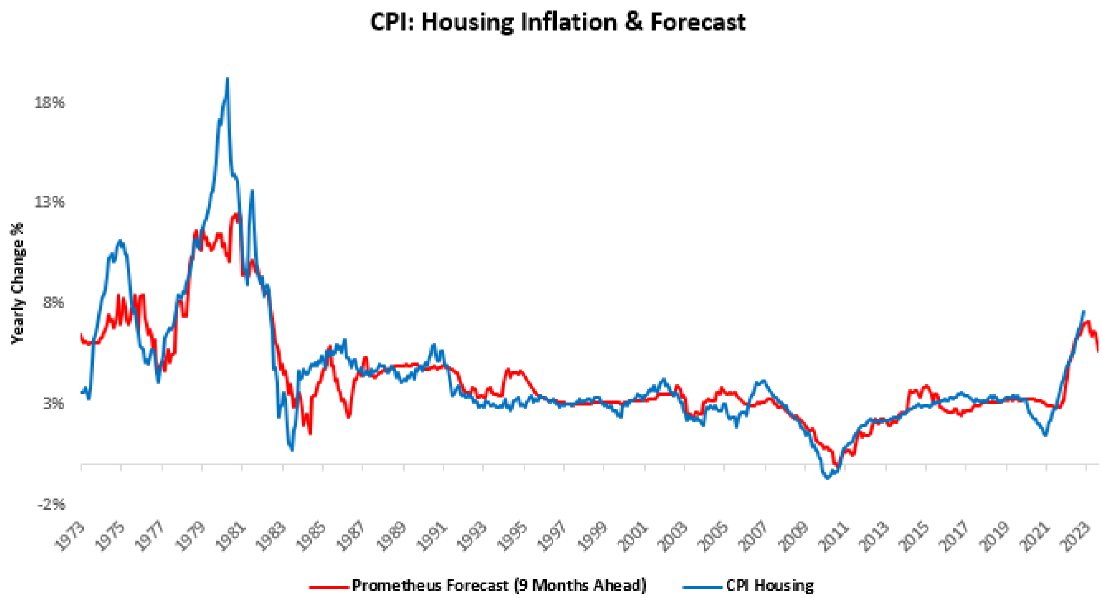


As we can see above, food, energy, transport, and shelter account for almost all of the variation in CPI over time. Food and energy inflation are largely a function of input costs, i.e., the costs of raw commodities. These costs are passed on to consumers relatively quickly, and therefore their impact on CPI and broader inflation data is almost contemporaneous:

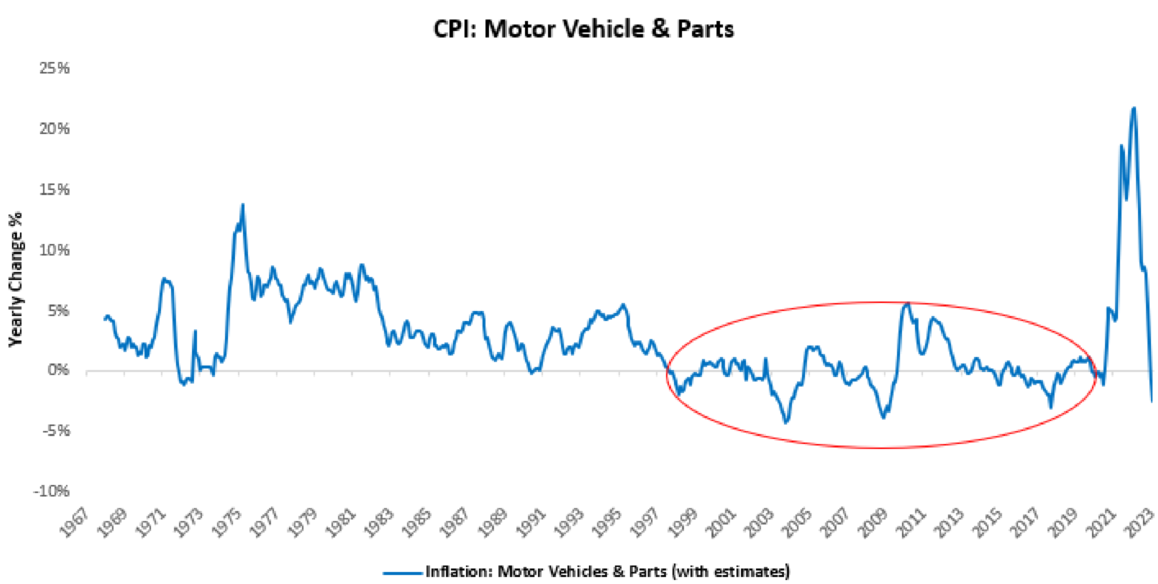


The pass-through from commodity prices implies that further disinflationary pressure is likely to come for food and energy, particularly as base effects accumulate.

Turning to the housing sector, which is the largest component of CPI, we are likely to see further softening as well. As we have explained here and in our other publications, there is a computational lag in changes in home prices and rent to CPI data. Housing remains a weak area of the economy, with deflationary pressure emerging. Below, we show our estimate of the impact of declining real estate activity on home prices over the next nine months:

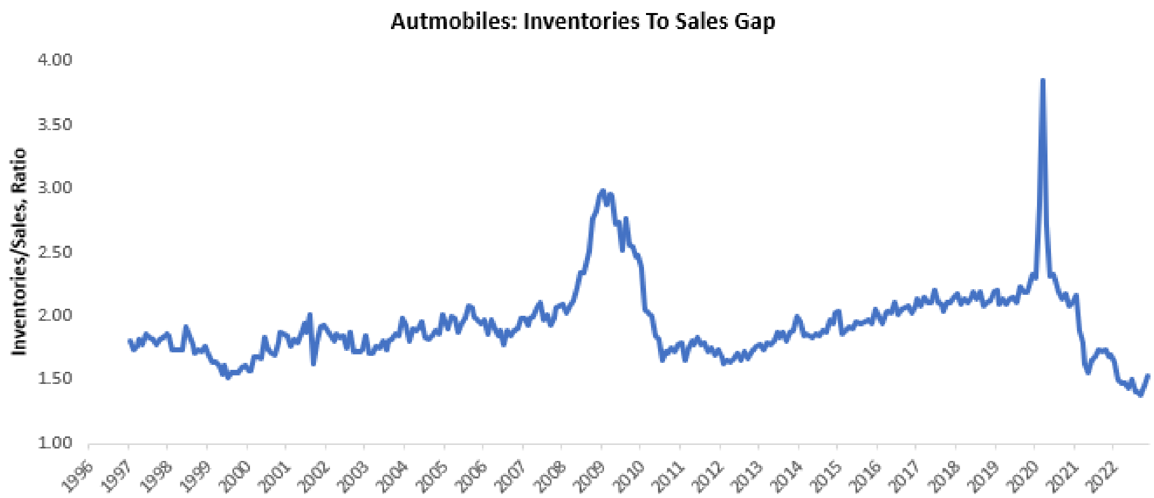


Finally, we turn to transportation. Within transportation, we are particularly focused on retail prices of transportation commodities, i.e., motor vehicles and parts. We think is crucial to recognize that automobile deflation has been a fairly common occurrence in the modern era. In fact, it has been a strong contributor to real sales expansion.

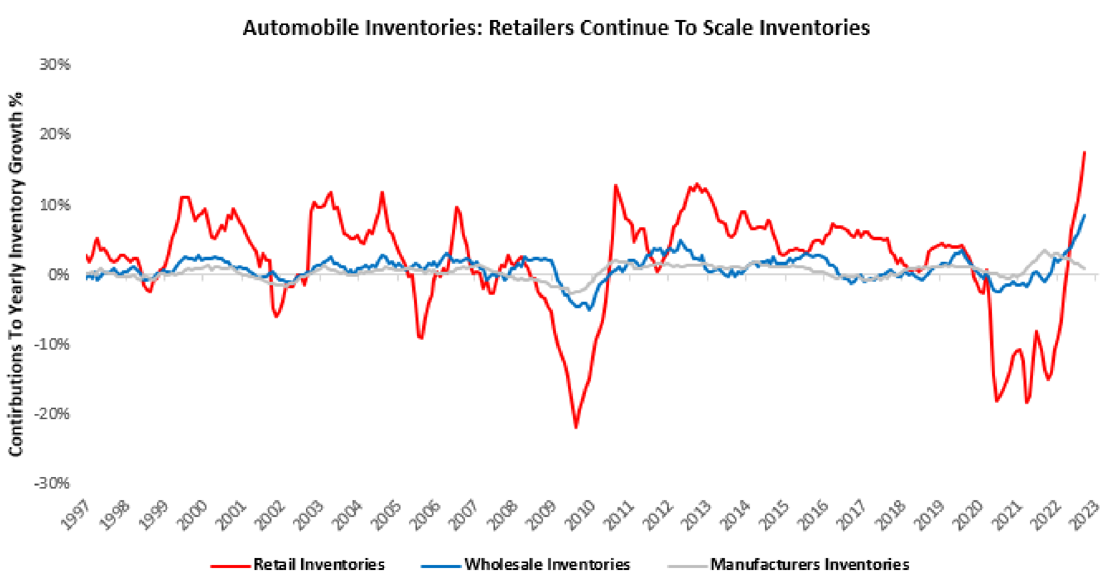


With the COVID-19 shock, followed by the Russia-Ukraine shock, we saw a dramatic fall in automobile supply and, in turn, an even more dramatic rise in prices.

This drastic decline in demand resulted in an extremely large drawdown in automobile inventories relative to their sales. This gap between sales and inventories is one that automotive businesses are looking to close but struggling to do in today's environment:



In past cycles, an aggregate inventory-to-sales ratio of two has been adequate for the smooth functioning of the automobile market. Businesses are trying to achieve these levels but struggling to find adequate supply. In particular, retailers have been rapidly trying to add to their inventory:



In our assessment, this force remains supportive of inflationary pressures. However, this force will likely dissipate as automobile retailers and wholesalers get closer to their pre-pandemic inventory levels. While business dynamics may support automobile prices, we think it is important to recognize that consumer dynamics are showing weaker automobile demand. If sales fall, the need for inventories will weaken, bringing down business demand for automobiles. Overall, we assess that mixed forces remain in the auto sector, but the broad inflation picture favors disinflation in the near term.

Conclusions:

To reiterate the views laid out at the onset of this note:

- ***Nominal activity accelerated as we entered 2023, with real growth accelerating strongly to offset modest cooling in inflationary pressures. At the same time, reported corporate earnings reflected pressures from the prior quarter.***
- ***Alongside an acceleration in nominal income activity, we also saw an improvement in balance sheet conditions from private sector expansion and an amelioration in policy tightening.***
- ***The combination of these forces allowed spurred risk appetite, with aggregate equity allocations rising modestly. However, the economic impulses that drove these dynamics will likely prove transitory, with the potential for a reversal as we move further into 2023.***

While activity increased as we began 2023, the composition of activity paints a picture of future weakness. Employment remains the stronghold of the economy, but business sector dynamics, along with liquidity constraints, are likely to weigh on the ability of businesses to continue to employ workers at the current rate. The transition into a contraction is not something that can be perfectly estimated. Still, we have a solid understanding of the pressures in place and how conditions will likely transpire. This is not a time for excessive risk-taking and is unlikely to be the beginning of an acceleration in cyclical activity. Patience pays. Until next month.

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