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The 6% economy

Blog

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The first official estimate of 1Q US GDP growth will be released on 26 April. The Bloomberg consensus forecast is 2.5%, while the Atlanta Fed GDPNow tracking estimate is 2.9%. Even if the final number falls short of 3%, it will still be a remarkable demonstration of strength by the US economy, coming after 4.9% and 3.4% growth in 3Q23 and 4Q23 respectively, and the most aggressive Fed tightening cycle in over four decades. Yet, this achievement may be downplayed, viewed as a product of fiscal largesse or as backward-looking data that's not a good indication of where the economy goes from here. Too strong of a number may even be bad for the markets by compounding inflation re-acceleration anxiety.

For all the cheering, dismissing, or hand-wringing that may follow the number, it's important to ask a simple question: Is this what the economy is landing on, one that grows at a 6% nominal rate? While investors spent much of last year debating whether the economy would experience a soft or hard landing, there was little explicit discussion about what the economy would actually land on in the soft outcome. The implicit assumption was that real growth would slow to around the long-term trend rate—generally accepted to be about 2%—with inflation also falling back to the Fed's 2% target. In other words, to roughly 4% nominal GDP growth.

What's playing out is something quite different. In 1Q, CPI inflation annualized to 4.6%, so a crude forecast for 1Q nominal GDP growth is 7% —the sum of inflation and the consensus estimate for real GDP growth. Moreover, both the GDPNow tracking estimate and economist forecasts rose steadily over the past month, which was about 2% or lower in early March. Given that positive momentum, it's understandable why the "no landing" scenario has recently gained adherents. But the implicit assumption in that view is that a 6% nominal growth rate is unsustainable and that the economy will eventually land at a lower level.

Yet, the longer the economy grows at a 6%-plus nominal rate, the more likely that it has landed to a new macro regime defined by this higher growth rate, not 4%. The forecast for 7% in Q1 already comes after annual nominal GDP growth of 10.6% (2021), 9.1% (2022), and 6.3% (2023) over the last three years. Looking back over the past few decades shows that 6% is not extraordinary and closer to the rule than the exception. The nominal growth rate averaged 5.85% from 1992 through 2000, about 5.4% from 2002 to 2007, but only 4% in the 2010s (Fig. 1). Recency bias may be why many investors have anchored on 4%. But as time passes, it's becoming increasingly clear that the “lower-for-longer” 2010s regime, weighed down by the weak post-Global Financial Crisis recovery, is the anomaly, not the new normal.

Fig. 1: The 2020s economy looks more like the 1990s than the 2010s, so far

Annual US nominal GDP growth

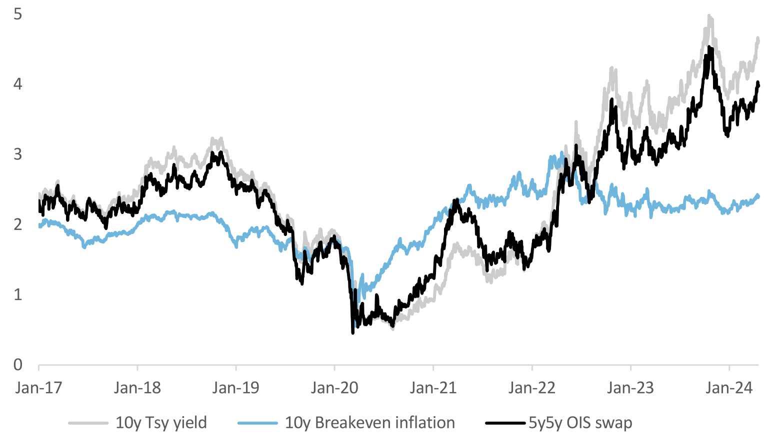
Source: Bloomberg, UBS, as of 19 April 2024

This doesn’t mean that nominal growth will average 6% in the 2020s, but there are good reasons why a rate between 5% and 6% is a realistic expectation. The risks for inflation are skewed to the upside because of potential supply constraints in the labor market, and due to geopolitical disruptions or climate events. How elevated inflation stays depends on the Fed. Its economic projections call for gradual disinflation and their willingness to cut rates while core inflation is still well above 2% suggests that inflation up to 3% is tolerable, conditional on long-term inflation expectations staying anchored. It will be harder for real GDP growth to remain close to 3%. But households collectively in strong financial shape, a Federal government biased towards spending, the need for more investment, elevated immigration, and faster productivity growth could combine to keep growth well over 2%.

The "6% economy" is essentially the one described in our Roaring ‘20s presentation, with the likelihood of this scenario occurring predicated on positive supply-side developments. The most recent productivity and immigration data are consistent with this outcome. More such positive supply stories will be necessary for this economy to persist for the rest of this decade.

Investors may not be distilling their economic outlook to a nominal GDP growth rate, but much of what’s happening in financial markets right now reflects an implicit debate about the sustainable level and composition of nominal growth. One clear impact is on interest rates and how much the Fed will cut in this cycle. All else equal, the higher nominal growth remains, the higher rates should be. The 75bps rise in the 10-year Treasury yield and the market going from pricing nearly seven Fed rate cuts to less than two this year coincides with the market-implied neutral fed funds rate also going up about 70bps (Fig. 2). There are other factors driving rates higher, but the rise is consistent with investors starting to embrace the idea that the US economy is in a higher nominal growth regime.

Fig. 2: 10-year Treasury yield rise has tracked the market-implied neutral Fed funds rate higher
In %



Source: Bloomberg, UBS, as of 19 April 2024

The rate rise has been a headwind for equities in April, and why rates are rising matters a great deal for the investment outlook. Stocks can usually digest fairly well higher rates due to better growth expectations, which was largely the case in Q1. But it was the third straight month of inflation exceeding expectations that lifted rates even higher in April. With both growth and inflation currently at elevated levels, the challenge for investors is determining how much of the 6% economy will be accounted for by growth and how much by inflation. The recent sticky inflation data may require tighter financial conditions to slow growth, thereby tilting the 6% nominal growth to a less favorable inflation-growth balance for risk assets. Yet at the same time strong nominal growth is good for earnings.

The bottom line: The US is in a new macro regime, one that can be called the 6% economy or, less elegantly, the 5–6% economy, reflecting its nominal growth rate. This regime may not persist, but investors are starting to accept it as a very plausible outcome. Yet it's also not without its investment challenges because the tension between good growth also being potentially inflationary is a situation that investors haven't had to navigate in many years. The resumption of disinflation this year (that we expect) should alleviate this tension and allow risk assets to resume their grind higher. But until that happens and investors are comfortable investing in this regime, expect more bouts of market volatility.

Appendix

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