

Macro & Markets: The perfect soft landing is fading away

Marketing communication

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The consensus expects a perfect soft landing but that is an extremely tight rope to walk when there are upside and downside risks to the economy. Recent data indicate that upside risks are growing and that is a bigger problem than it sounds.

What happened last week. Stocks rose and bonds fell after the majority of economic data surprised on the upside. Business sentiment figures were better than feared in the euro area and wage negotiations moderated albeit at a high level. This does not seem to conflict with our baseline scenario that the ECB will cut its policy rate in June. In the US, job data suggest that growth concerns are overdone. The FOMC minutes and FedSpeak suggest that stronger-than-expected economic data mean that there is no rush to cut interest rates. This is bad news for bonds and can eventually turn out to be bad news for stocks if central banks tighten financial conditions to slow down the economy. Our baseline scenario is still that the ECB will start cutting interest rates in June and that the Fed will wait until September (our latest [forecast](#)). Risks are tilted to no interest rate cuts by the Fed, which is what today's macro and markets will be about.

Fading a perfect soft landing. Starting this year, investors were all in on the idea that the US economy was moving into an environment of 2% inflation and slower but still solid economic growth, which would trigger the Federal Reserve (Fed) to cut interest rates imminently and significantly. The soft landing expectation led to a massive rally in stocks, bonds and credit over the fourth quarter last year: the bond market expected the Fed to cut interest rates by about 200bp over the coming 15 months; the stock market had increased by more than 15%; and the credit market had rallied by more than 100bp.

The big rally in the financial market highlights that a lot of good news is priced into the consensus expectation. The consensus expects a soft landing in the economy and central banks to start to ease monetary policy. That is an extremely tight rope to walk, especially when there are large upside and downside risks to the economy. There is a downside risk that economic growth will disappoint and an upside risk that

economic growth starts to accelerate. Both risks are bad news for the financial market, which has priced in a lot of good news. Recent economic data suggest that the odds of the upside risk scenario are growing, but that does not mean that there is no downside risk scenario. Higher borrowing costs increases the likelihood of sudden downturns. Paradoxically, the upside risk scenario is likely to result in a more restrictive monetary policy, which increases the probability of an economic downturn in the future.

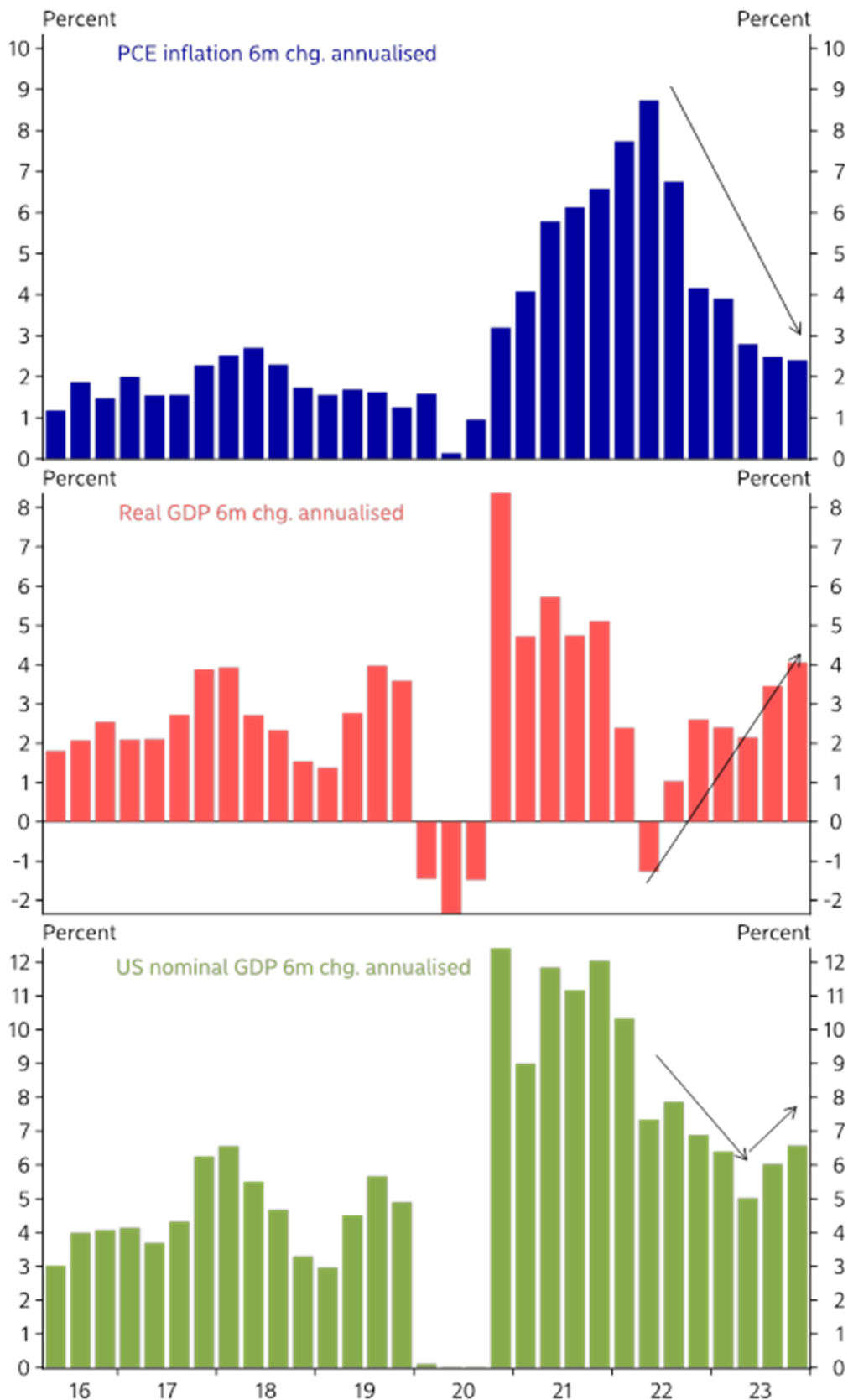
Upside risk to the soft landing. In my latest macro and markets article “Risks of reheating” I wrote about how the soft landing consensus and the Fed were underestimating the strength of the economy and the risk of future inflation.

Shaping the perfect soft landing, the consensus and the Fed thought that economic activity had slowed in the fourth quarter, and that the economy was on a downward trajectory, which would bring economic growth lower this year and ensure that inflation would move sustainably towards the Fed’s 2% target.

Instead the opposite is happening: On an annualised basis, the US economy grew by 3.3% in the fourth quarter, which was four times higher than the Fed’s 0.8% forecast. The consensus and the Fed have not been wrong in their inflation forecast: Inflation has indeed fallen down towards 2% during the second half of last year. The problem in their economic forecast is that they clearly underestimate the nominal side of the economy. Over the last quarters, nominal GDP growth has increased, raising real GDP growth to a rate around 4%, that is way above most estimates for the neutral rate of growth, which is the rate that the economy can sustain without generating excess inflation. In comparison the Fed’s own estimate of the neutral growth rate is 1.8%.

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Chart 1. Economic conditions are too strong



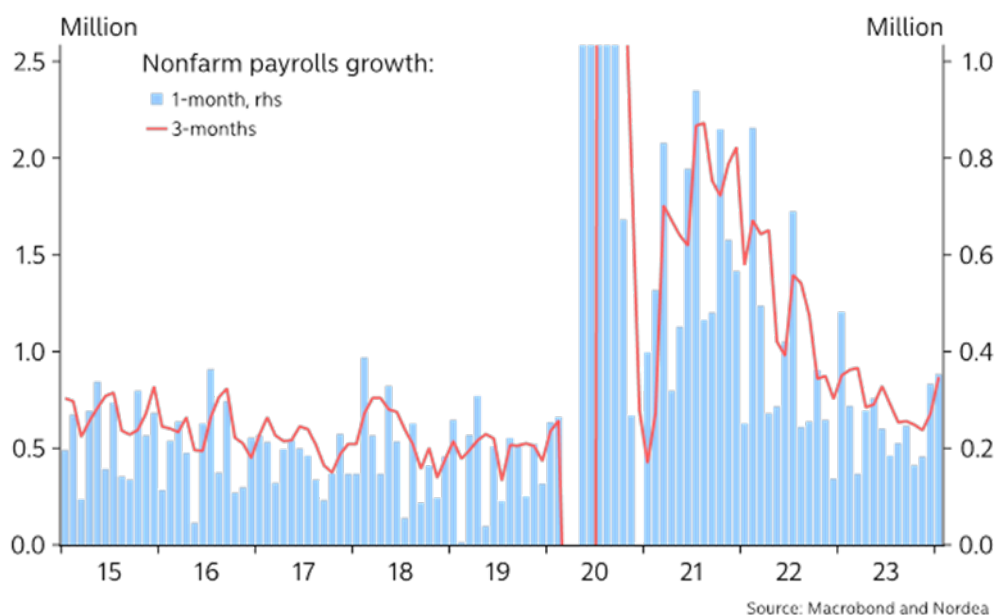
Source: Nordea and Macrobond

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The bottom-line here is that given the current set of economic conditions – falling inflation, rising real growth, and rising nominal growth – we cannot rule out that inflation will not start to accelerate and become a problem. If anything, recent economic data, indicates that the economy has strengthened and put upward pressure on prices. Nonfarm payrolls showed surprisingly strong job gains, and the CPI and PPI price reports showed the highest price pressure in many months.

The job report showed that jobs grew by 353,000 in December, which was much higher than the forecast of around 180,000. The report also showed an uptick in average hourly earnings after a steady decline over the summer. Part of that is due to falling hours worked. Yet, the downward trend in labour indicators seems to have stalled, with the latest data points actually rising. The unemployment rate was stable at a historically low level of 3.7% and there are no indications – looking at jobless claims – that unemployment is set to rise any time soon.

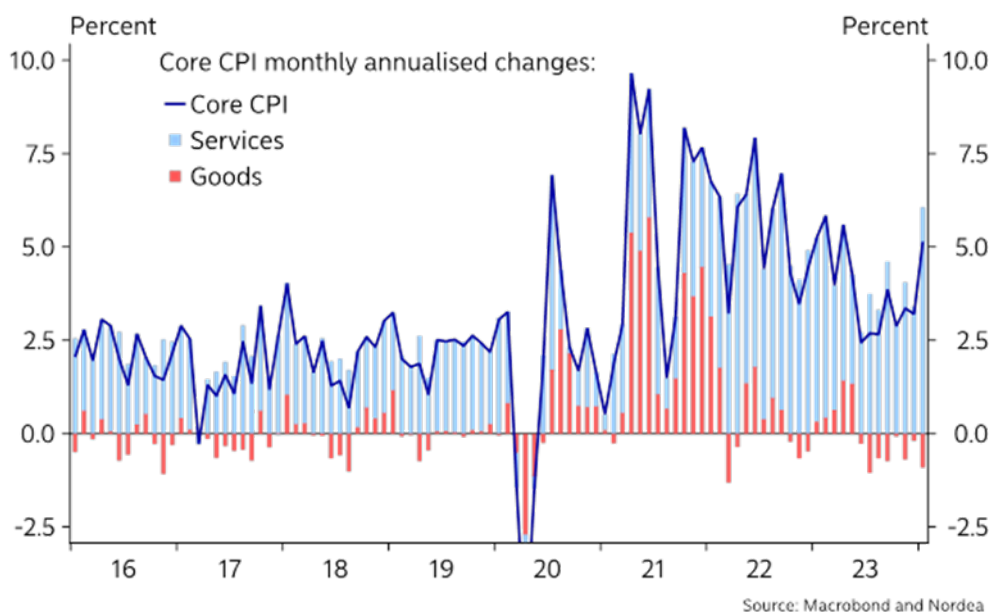
Chart 2. Job gains keep surprising



The CPI report was uncomfortably firm and showed that core CPI prices rose by 0.4% m/m in January, which is the highest growth rate in six months. Core CPI services excluding housing, a measure that is tightly connected to the labour market, rose by an alarming 0.8% m/m. Prices of goods, which have been a large factor in lowering inflation, continued to fall. There are likely some technical quirks in the January inflation report, but the overall firm price pressure is hard to ignore. Inflation continued to broaden in January as a larger share of categories experienced inflation and a smaller share of categories experienced disinflation or deflation. The median core CPI figure, which measures the breadth of inflation, rose by 0.5% m/m and is showing a clear trend of rising inflation.

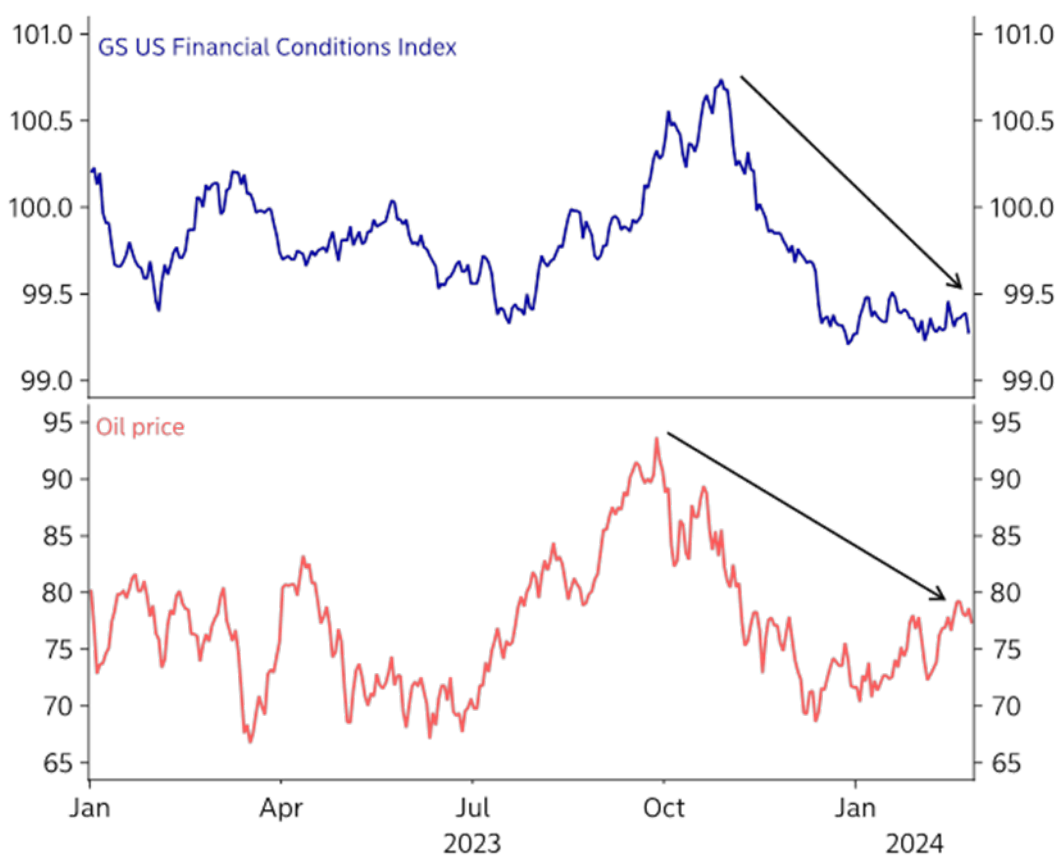
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Chart 3. Inflation is broadening and rising



The upside risk should not be that surprising. The big rally across financial markets that began back in October has eased financial conditions and will be a significant growth impulse to an economy that is already too strong. Record-high prices on stocks and real estate will strengthen household demand and much lower bond and credit yields will make borrowing much cheaper today compared to just four months ago. The National Association of Home Builders (NAHB) just posted its third consecutive monthly gain and reported that buyer traffic is improving as even small declines in interest rates produce a disproportionate positive response among likely home purchasers. Similar pent-up demand was observed among US companies, which took advantage of lower longer-term borrowing costs, by issuing a record amount of corporate bonds in January. Important to consumers, oil and gasoline prices have declined by 20% since September, which is a decline that is unrelated to the US economy, but yet frees up a meaningful amount of cash for spending on other goods and services.

Chart 4. Financial conditions are a positive impulse to the economy



Source: Macrobond and Nordea

The upside risk scenario has two implications for the Fed. First, it strongly indicates that monetary policy is not that restrictive on the economy. Second, that means that there is no rush to ease monetary policy and stimulate the economy. Right now, growth concerns seem overdone, and the economy seems to be stabilising on a strong trend. Recent economic data flag the risk that the economy and inflation is actually accelerating. If that happens on a sustainable basis, then the next move could be an interest rate hike instead of a cut.

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