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MACRO MORNING BRIEFING

September 6, 2024

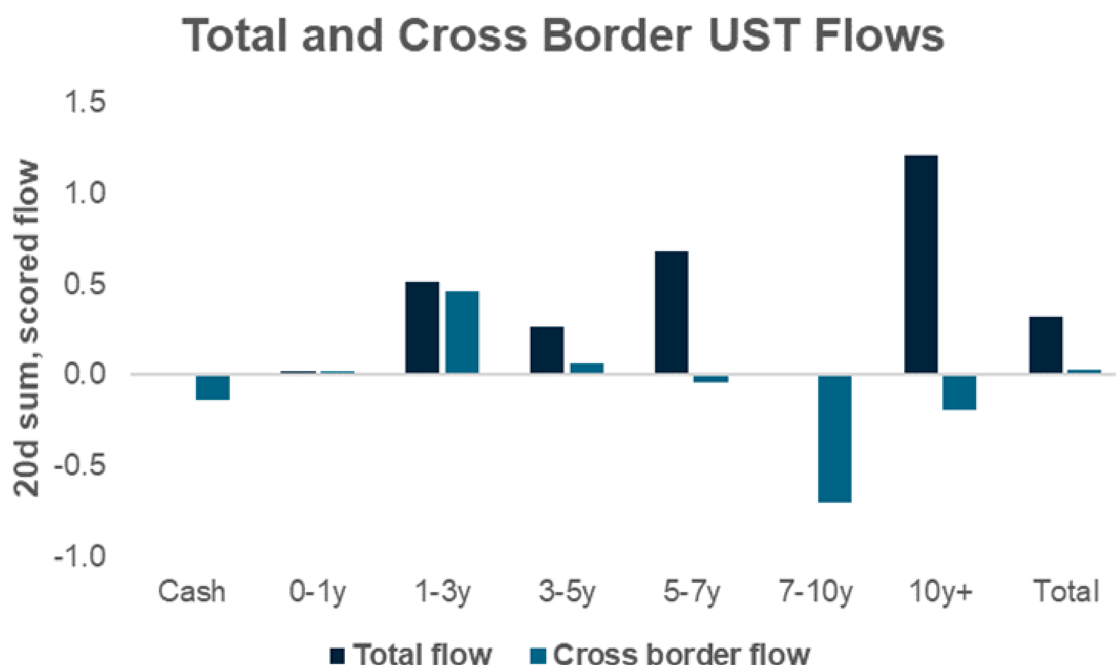
Clinging to US Exceptionalism

- **The US unemployment report is seen as decisive for the pace of FOMC easing** – with the market expecting almost 1.5% of cuts by the end of January 2025. This is a risk skew that could dominate the rest of the month.
- **The larger picture risk for markets comes from US exceptionalism**, where productivity from AI and investments into US “onshoring” leave the rest of the world lagging in terms of growth. US soft-landing hopes vs. a recession may drive more volatility.
- **The US election risks are likely to return in the week ahead** with the September 10 debate between Vice President Harris and former President Trump seen as key for the momentum of national industrial policy and US rate risks from fiscal policy vs. monetary policy and political interference.

The risk of August sets the playbook for September. Markets have a history of volatility in September as investors return from holidays and search for better returns with lower risk. The current turning point for markets now depends on the size and scope of FOMC easing. The bond market prices in a recession while the stock markets lean toward a soft landing. The US economic data will be the tiebreaker in this battle for trend and risk appetite. The other market, FX, has seen the USD fall notably in August and the course for further USD weakness depends not just on FOMC easing plans but on the success of policy abroad, too. This shows up in what our data reveal concerning investor thinking about the future – appetite for cash is unwinding again. First, we have seen a bounce back in buying US fixed income internationally, but unlike the June and July episodes this buying is in the front-end. Second, domestic bias in the US remains in owning duration. Third, the overall mood

of equities to short-term safe bills is shifting lower – our Mood index is now -0.04 after hitting a high of 0.25 early in the summer. Fourth, the shorting of US equities over the last three months has cost clients some 3%.

Exhibit #1: US Fixed Income Flows



Source: iFlow, BNY

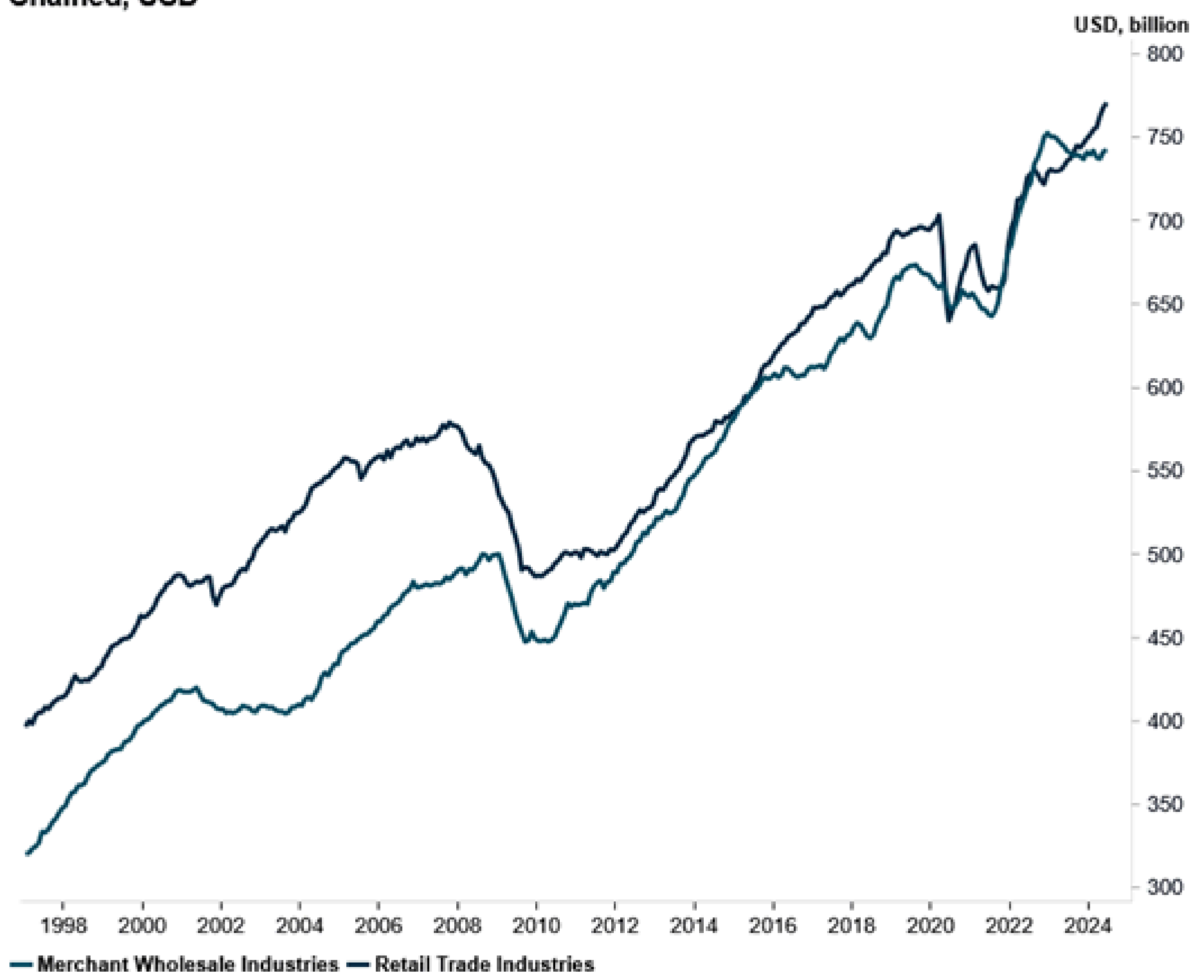
The debate over 25bp or 50bp of easing is expected to be resolved by the US unemployment report, but the speed of rate changes ahead vs. the rest of the world is not, so the USD weakness trend could falter. The rate markets price in a recession risk now with 2-year US trading near 3.75% implying over 2% in rate cuts in less six months. The recent 30-year history of recessions has no examples where quarterly growth above trend has led to a recession. The ratio of US private inventory to final sales has been on a downtrend post-Covid, and the history of recessions suggests inventories need to rise for several quarters before calling a recession – this was the case from 2021 to 2022. The common problem of all business cycles is the potential for a recession, as consumer demand fails to meet inventory estimates. The last time markets expected a recession was in December 2022 – and since then we have seen no trend of inventories lagging behind sales. But for the rest of the world there is a problem as the buildup of US inventories can be a reflection of imports or the restarting of US factories. The current situation implies a bit of both. We can see that US dependence on international trade continues but with differing roles between China and Mexico, along with the European Union and Canada.

Exhibit #2: Mexico Beats China on Trade But the EU Wins?

Source: Macrobond, BNY

There is more to the post-Covid shift in trade than tariffs and the USMCA. The markets have been underestimating the role of Europe in US trade and the political discord regarding how to approach US trade policy – along with the political risk of a change after the election – for the EU without clear French or German leadership.

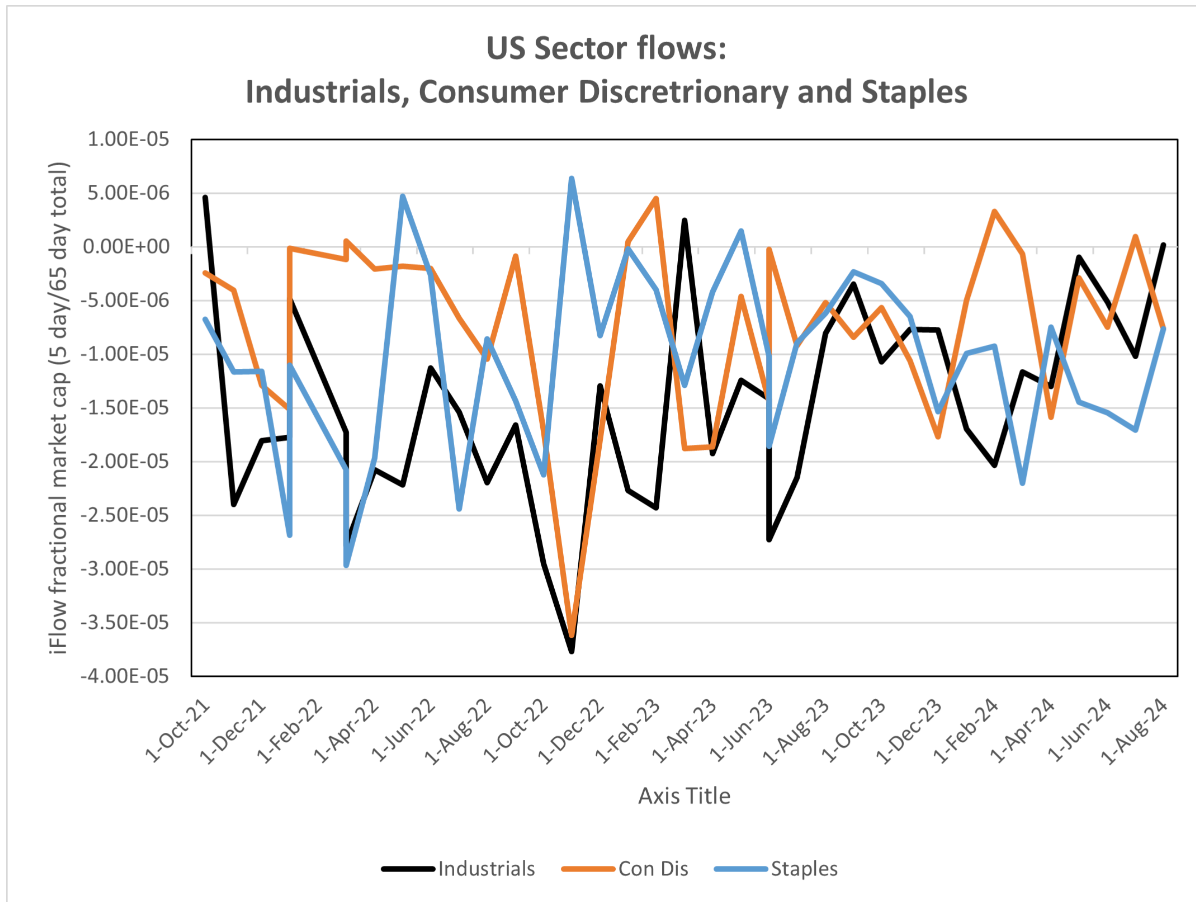
Exhibit #3: The Split between Wholesale and Retail Inventories Matters



Source: Macrobond, BNY

The question for 4Q growth revolves around inventories that are rising now and whether they will be met with ongoing consumer demand during the year-end holiday season. This is the key spread between retail and wholesale inventories, and it makes clear investors have to be watching the source of further accumulation. There are many reasons why companies build up inventories – fear of disruptions, fear of inflation, expectations of future demand, and taxes. Some reasons are out of their control, for example, when competitors win or sales drop because of consumer income fragility. The role of just-in-time inventory management ending with the US shift in trade toward China has been ongoing but important. So, too, has the focus of the Biden presidency on national industrial policy, which puts pressure on how future demand for goods will play out. The spread between wholesale and retail inventories has changed since the Chinese trade dominance from 2009-2016. Covid clearly generated incredible volatility, and the current conditions may be a signal we are returning to a more "normal" pre-GFC and pre-Covid world for US inventories and global trade.

Exhibit #4: US Sector Flows



Source: iFlow, BNY

As we can see from our client flows around US retail sectors and industrials – there is more noise now than trend. The recovery of all sectors from the lows of December 2022 highlights that episode of “rolling recession” risk and since then businesses have done well with some clear fears about consumers and US rates following. The rally up in consumer discretion sector shares last month has unwound already. From this subset of sectors, it is clear that US stock-pickers and index trackers aren’t convinced of a recession risk. Further, the ability for the FOMC to pull forward demand with rate cuts into 4Q may only add to convictions about soft landings regardless of US unemployment data for August.

Bottom Line: The risk of volatility ahead is based on more than the FOMC rate decision or the US election. The role of ECB and PBoC policy in driving domestic demand and growth will be important for how the USD trades and how markets see US exceptionalism risks. The role of investors globally putting money to work in the next few weeks will set the pace for how growth develops in 2025. When looking at

the factors of US CPI and the ratio of US inventory to sales and considering the risks of recessions – spikes in inventories precede dramatic drops in growth. Inventory squeezes are clearly part of the CPI story, particularly for goods. The bet for investors and companies in 2024 rests on consumers and that link back to wages, productivity and margins looks uncertain and not just for US monetary and fiscal policy but for the role of global trade and supply chains in the months ahead as well. For the USD, the onshoring of production and the home bias may extend the US exceptionalism trade that worked so well in 1H2024.

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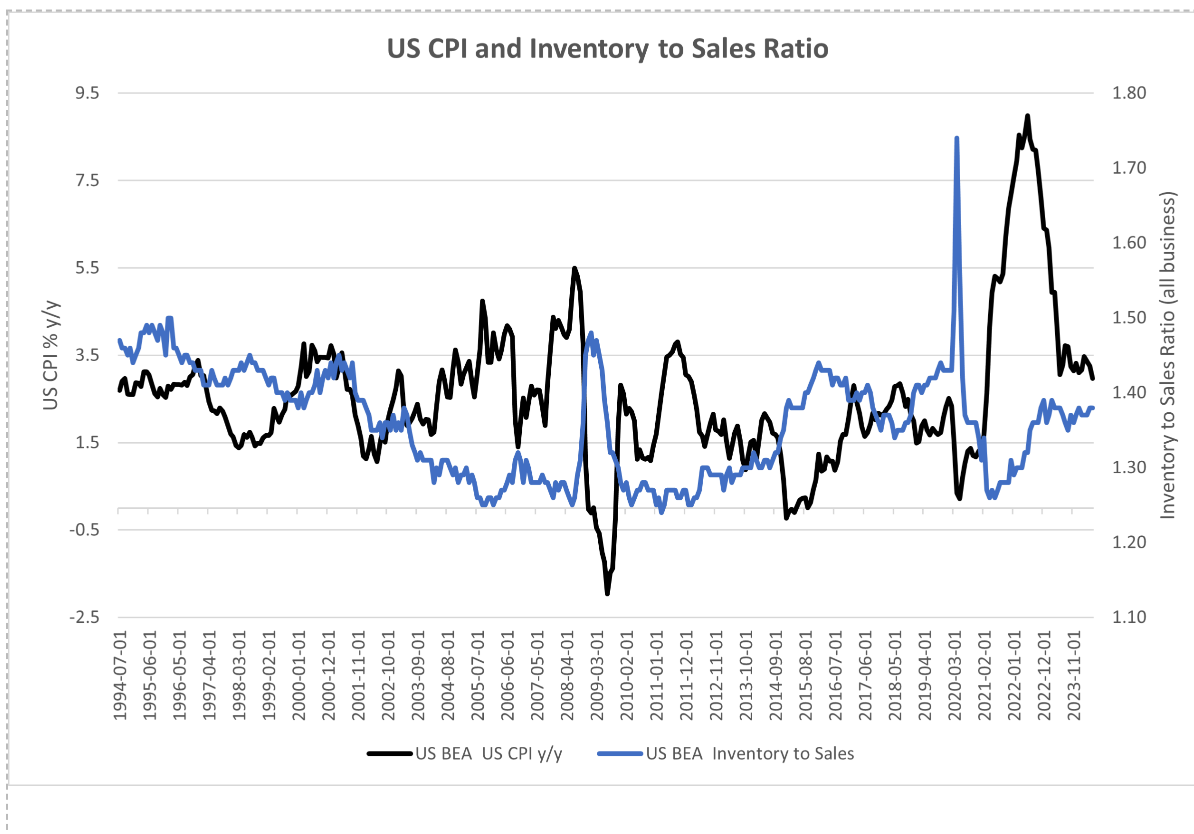
Exhibit #5: US CPI and Inventories/Sales Help Track Policy



Source: St. Louis FRED, BNY

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Please direct questions or comments to: iFlow@BNY.com

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