SEPT. 2023

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A complicated preeminence

The U.S. economy, despite its challenges, remains a bright spot for global investors

On our recent family vacation to Paris, our taxi driver very much wanted to chat. "Americans?" he asked. He continued making friendly small talk by asking what I did for a living, and when I told him, it triggered a long rant about why American companies are so much better than French companies when it comes to pioneering new industries like artificial intelligence (A.I.).

As "aha" moments go, this one wasn't earth-shattering. But taken with other vignettes—the incredible buying power of the dollar, our hotel forced to ration air conditioning due to the energy crisis—it was a reminder of how much better the long-term economic outlook is in the U.S. versus Europe and many other developed economies.

For all the handwringing about rising interest rates and recent stock-market volatility, the big story of 2023 remains the remarkable resilience of the U.S. economy. Europe is struggling with slowdowns and recessions (not to mention exchange rates unfavorable for consumers in Europe but very favorable for American tourists). The U.S., meanwhile, saw its GDP grow at a 2.1% clip in Q2 2023—better than expected and higher than the Q1 growth rate. Defying gloomy predictions, the economic momentum has carried over to Q3, with some real time trackers putting growth at above 5% for the quarter.

FIVE KEY TAKEAWAYS

1
Early this year, doomsayers were predicting recession, but the U.S. economy has been remarkably resilient, with 2Q GDP up 2.1%.

2
Resilience of U.S. stands in sharp contrast to Europe, where major economies are slowing or already in recession.

3
Possibility of a U.S. recession remains, as high borrowing costs and the possibility of additional Fed rate hikes take their toll on businesses and consumers.

4
Stocks, after rallying earlier this year, are likely stuck in a consolidation phase until corporate earnings stabilize and catch up with higher valuations. Bonds, meanwhile, are an attractive alternative.

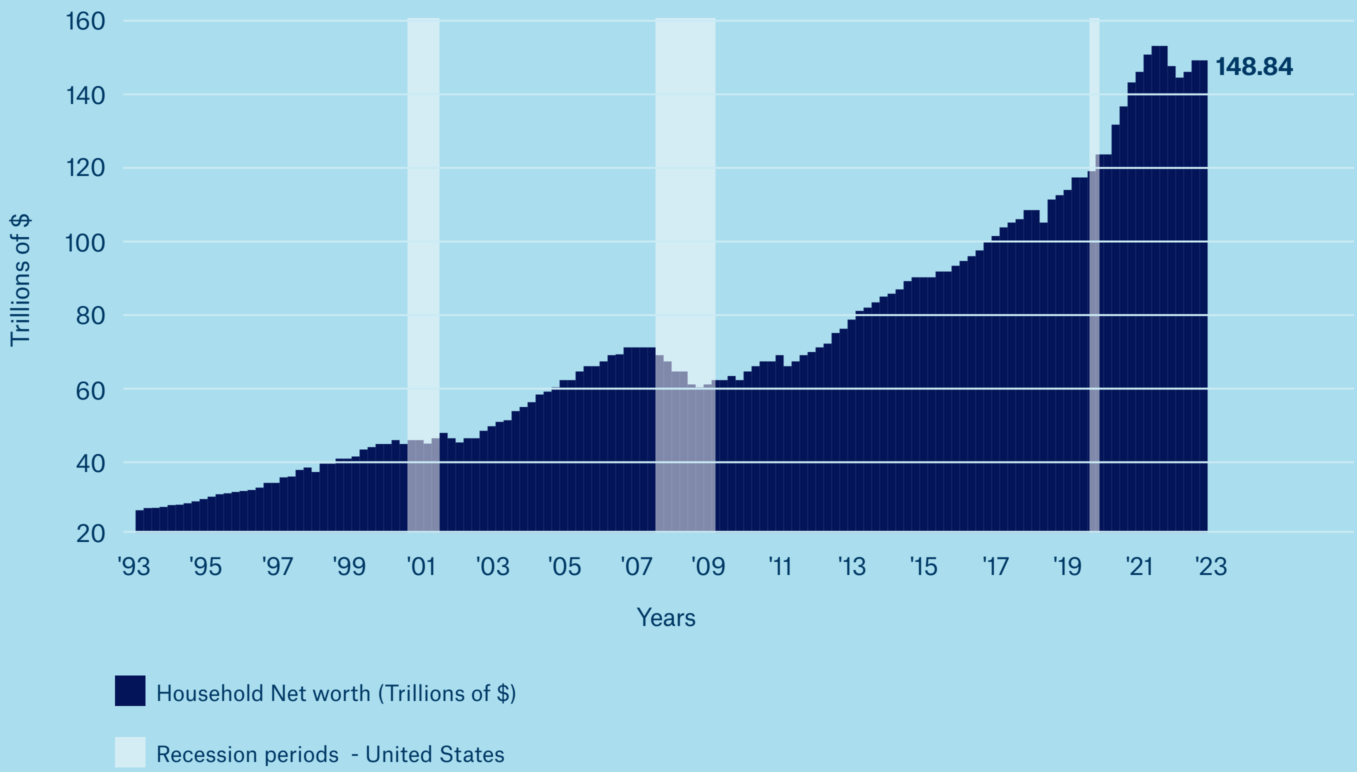
5
Regarding Fitch downgrade of U.S. credit, we are more sanguine. Yes there are legitimate concerns about government debt levels, but U.S. economy is much better positioned, long-term, than China or other economic rivals.

Earlier in the year, investors displayed a sturdy appetite for risk assets like equities. The S&P 500 rallied almost 20% through July, with the technology-heavy Nasdaq climbing 37%. However, the recent breakout in bond yields has caused stocks to pull back by 5%. The 10-year Treasury yield has risen more than 60 basis points to 4.34%, the highest level since 2007, and the 30-year yield sits at 4.45%, its highest level since 2011. Federal Reserve (Fed) watchers are worried the strong GDP numbers will trigger new rate hikes (even though inflation has already come down to 3.2% from its peak of 9.1% in 2022). Increased Treasury supply and higher bond yields outside the U.S. have also contributed to rising rates.

How has the American economy coped so well with higher borrowing costs? One source of strength has been an historically tight labor market: The unemployment rate, even though it has risen a bit, remains low at 3.8%, with the economy having created more than 1.9 million jobs this year. Consumers are also benefiting from wealth effects that come from household net worth hovering near an all-time high of $149 trillion *(Figure 1)*. Interest-rate-sensitive sectors like housing have held up, as has new business investment. Home prices have stabilized, moving higher in the last few months despite mortgage rates touching 7.5%. Factory investments have risen, especially for semiconductor manufacturing facilities, thanks to the incentives set forth in the CHIPS and Science Act enacted last year.

FIGURE 1

U.S. household net worth



Source: Factsheet financial data and analytics
Data through: 09/01/2023

In short, the U.S. economy is booming.

This is not to say that it's all clear sailing. The possibility of a slowdown or a mild recession cannot be ignored. The yield curve[1] remains inverted, historically a reliable predicter of recession. Corporate earnings and margins are also moderating, bank lending standards are quite restrictive and inflation, though lower, remains elevated compared to the Fed's target of 2%.

It seems likely that the Fed will keep monetary policy tight for some time. The longer the cost of borrowing remains high, the more pressure this will apply on companies and consumers, especially those with weaker balance sheets and significant debt to refinance. Essentially, the bite from Fed rate hikes is taking longer than usual to slow the economy because so many households and businesses locked in low borrowing costs by refinancing their loan obligations in 2020 and 2021. According to Redfin, 62% of homeowners have a current mortgage rate below 4% and for 23% of homeowners, the rate is below 3%.

Investors will have to manage through these cross currents of a strong economy pushing against a Fed attempting to achieve still-unmet inflation goals. The stock market is in the process of digesting first-half gains, which means equities are likely stuck in a consolidation range until corporate earnings stabilize and catch up with higher valuations. Bonds, on the other hand, are attractively valued compared to stocks and can potentially provide ballast against equity volatility over a 12- to 18-month time horizon, in our view.

U.S. debt downgrade reignites fiscal concerns

Fitch Ratings' recent downgrade of its sovereign credit rating on the U.S. to AA+ from AAA has brought up familiar concerns about the country's financial health. The rating agency cited an erosion in confidence over fiscal governance in the aftermath of the debt ceiling showdown in Washington. Another concern involves deteriorating debt dynamics, with Fitch expecting the general government debt-to-GDP ratio (which includes federal plus state and local debt) to rise from 112.9% this year to 118% in 2025. The rationale behind Fitch's downgrade echoes previous action by Standard and Poor's, which cut its own U.S. rating to AA+ from AAA in the aftermath of the 2011 debt-ceiling standoff.

We are more sanguine on this front, due to the structural strengths of the U.S. financial system and its comparative advantages as a preeminent economy. Consider the core U.S. strengths:

- America continues to extend its dominance in the global economy. It accounts for 58% of the nominal GDP of the G7 (group of seven largest developed economies), up from 40% in 1990. [2]The U.S. accounts for one-fourth of global GDP with only 4.2% of the world's population.
- The dollar's status as the world's dominant currency should remain unchallenged for several decades to come. The dollar still accounts for roughly 60% of global currency reserves and 85% of forex trading.[3]

[1]The difference between short term yields such as the 2-yr treasury bond yield and longer term yields such as the 10-yr treasury. As of Sept. 6, 2023, this inversion is at -0.74%.

[2]Economist. America's economic outperformance is a marvel to behold. April 13, 2023

[3]Bank of International Settlement, "Revisiting the international role of the dollar." December 2022

It is the most frequently used currency in global trade, accounting for 96% of trade invoicing in the Americas, 74% in the Asia-Pacific region, and 79% in the rest of the world over the period of 1999-2019.[4] This dominance is due to the unique combination of the size of the U.S. economy, global integration of its markets, a transparent and open system, a credible legal system, geopolitical heft, and the depth and liquidity of its financial markets.

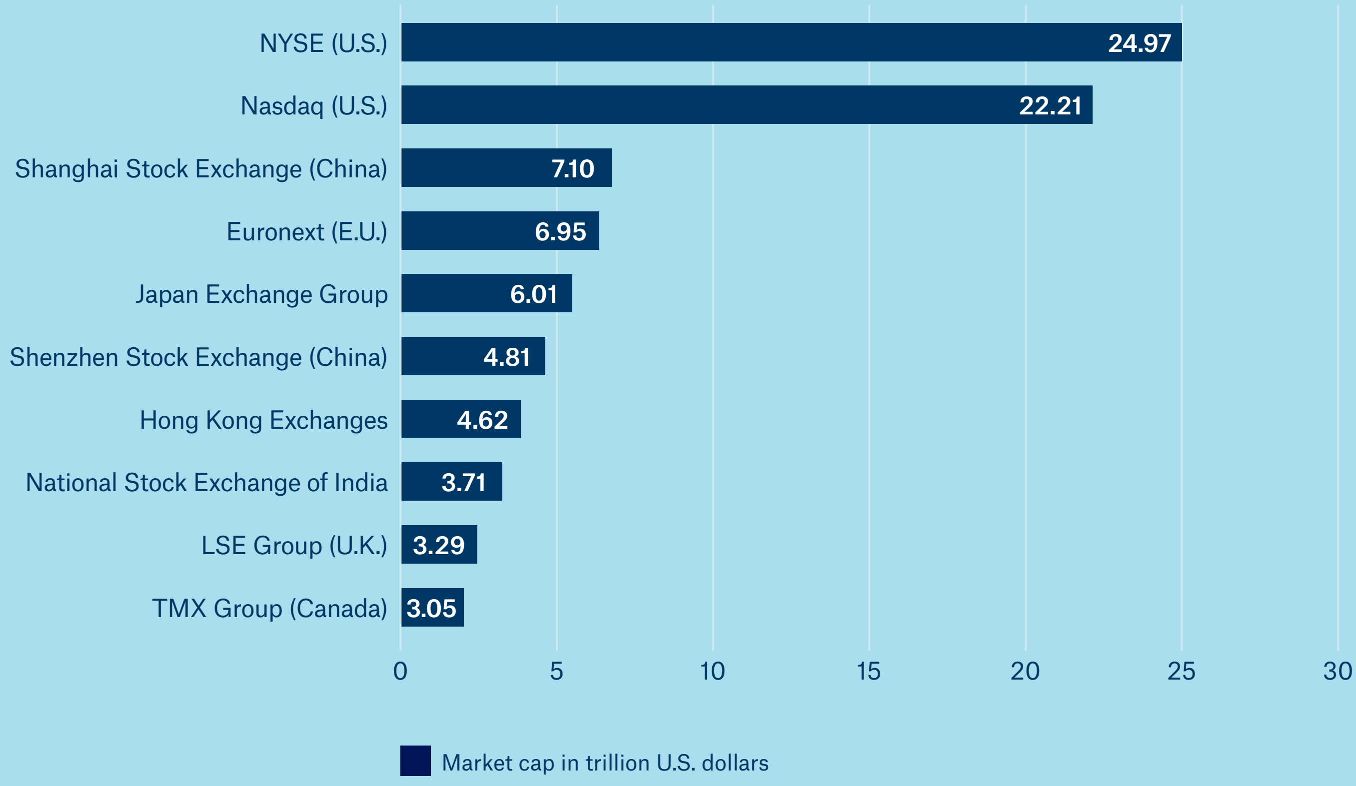
- The U.S. capital markets are the deepest by far, and American exchanges are home to the world's largest and most valuable companies. The market capitalization of listed companies on the New York Stock Exchange and the NASDAQ is $47 trillion. In China, for companies listed on the Shanghai and Shenzhen stock exchange, it is roughly $12 trillion. For the Japan Exchange Group, it is $6 trillion.[5] As of January 2023, the value of stocks listed on U.S. exchanges made up 42% of the global total *(Figure 2)*.

[4]Federal Reserve. "The International Role of the U.S. Dollar" Post-COVID Edition". June 2023

[5]Statista, August 2023

FIGURE 2

Largest stock exchanges worldwide by market capitalization of listed companies (in trillion U.S. dollars)



Source: Statista, data as of July, 2023

- The U.S. dominates the ranks of the most valuable brands in the world with its companies making up seven of the top 10 and half of the top 100 ranked brands.[6]

- The U.S. has a demographic advantage. The United Nations forecasts that China's population will decline from ~1.43 billion in 2022 to 1.3 billion by 2050—and to below 800 million by 2100. In comparison, the U.N. projects the U.S. population to grow from 333 million in 2021 to 394 million by 2100.[7] Also, China's working-age population peaked in 2014 and is projected to shrink to less than one-third of that peak by 2100.[8] Labor forces in other developed nations are shrinking too. Germany's, for example, is projected to decline 11% between 2022 and 2060. Compare that to the U.S., where the labor force is projected to grow 16% over the same period, adding 25 million workers.[9]

- The U.S. continues to dominate the higher education field, with eight of the top 15 schools featured in the Quacquarelli Symonds (QS) World University Rankings for 2024. These universities attract smart young talent from across the globe, who then enter the labor force and contribute to new business formation. According to the National Foundation for American Policy, immigrants have founded or co-founded nearly two-thirds of the top Artificial Intelligence companies in the U.S., and 70% of graduate students in A.I.-related fields are international students.[10]

- The U.S. remains an innovation powerhouse, ranking second behind Switzerland in the Global Innovation Ranking done by the World Intellectual Property Organization (WIPO). This considers human capital, institutions, technology and creative output, and market and business sophistication measures, among others.

This combination of structural strengths may be hard for other nations to replicate, but it doesn't mean that America can keep ignoring the deterioration in its fiscal outlook. There are domestic challenges of increasing political polarization and the rising cost of servicing government debt. The latter is crowding out more productive spending and will eventually trickle through to consumers and corporations in the form of higher interest rates. That would mean higher borrowing costs for everything from credit cards to mortgages. It could also mean greater market volatility, particularly given the diminished capacity for fiscal and monetary support during future downturns. There are also credible challenges to its technological and geopolitical leadership primarily from China.

These are important caveats. But make no mistake, the American economy is well-positioned for the future. The outline for the next great bull market is now taking shape (something I'll have more to say about in coming months). Just like my taxi driver in Paris, I fully expect the story of that next great bull market to be an American one through and through.

[6] Brand Finance

[7] Pew Research Center. Dec 2022.

[8] World Economic Forum. July 2022

[9] National Bureau of Economic Research. April 2022.

[10] https://nfap.com/research/new-nfap-policy-brief-ai-and-immigrants/. June 2023

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