NATIXIS INVESTMENT MANAGERS | SOLUTIONS

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PORTFOLIO ANALYSIS & CONSULTING

Charts and Smarts®

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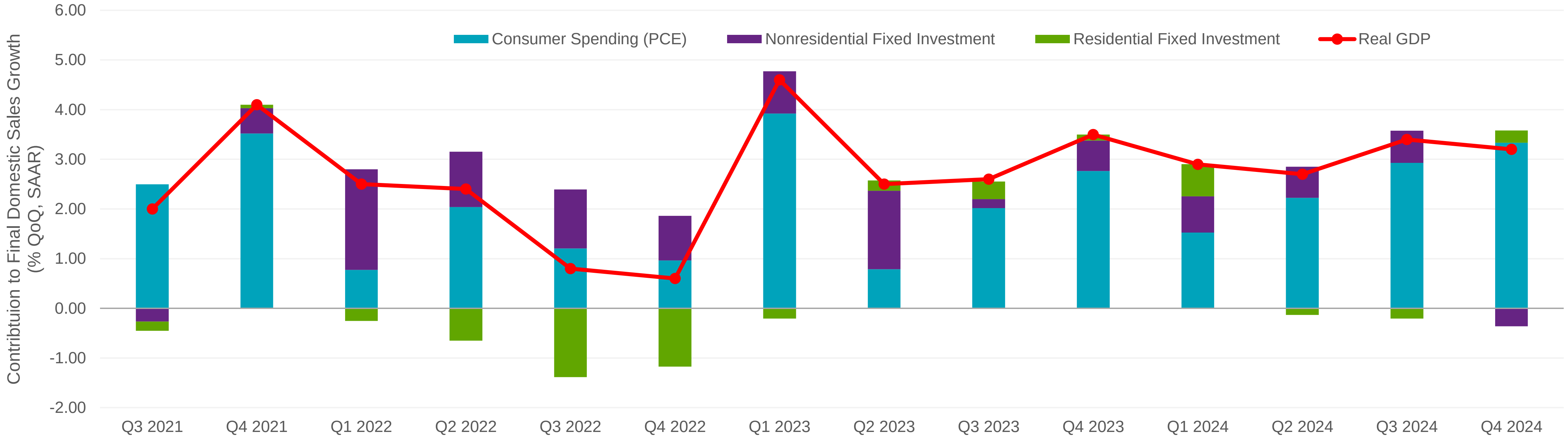
The Shape I’m In

Contributions to Real Final Private Domestic Sales (Q3 2021–Q4 2024)

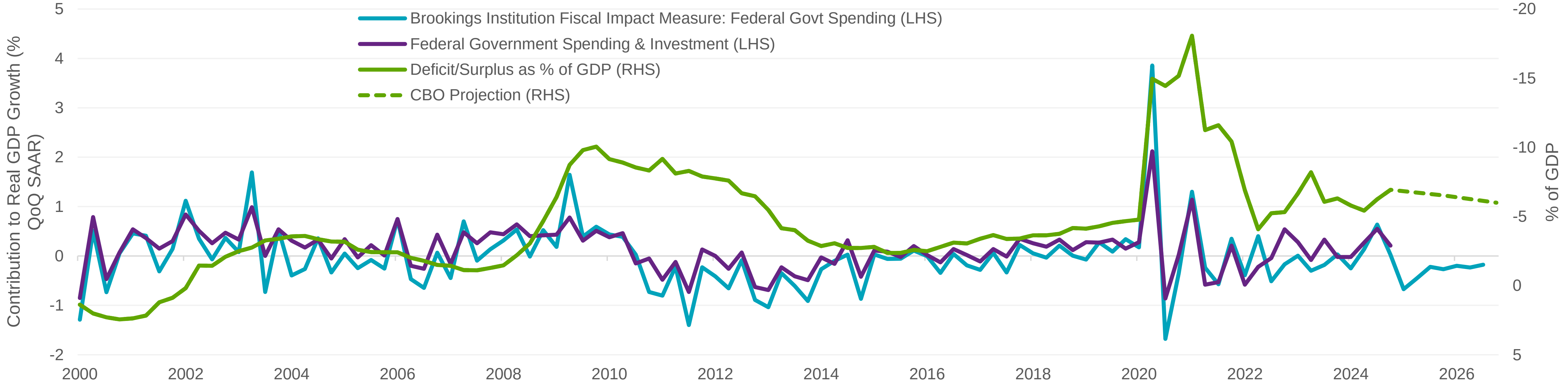


With Scott Bessent now official installed as Treasury Secretary, it’s worth dissecting the so-called “3-3-3” plan he advocated for in the lead up to his confirmation hearings. The plan sounds like a worthy and ambitious goal as it seeks to spur 3 percent real GDP growth, on average, through deregulation, reducing the federal deficit from 6% of GDP down to 3% by 2028, and increasing domestic oil production by 3 million barrels a day. A nice and tidy plan. But does that proposal really stand up to scrutiny? Let’s start with the plan’s first pillar: 3% growth. Between 2009 and 2019, the US economy averaged an annualized quarterly growth rate of 2.45%. Averaging 3% growth is certainly an admiral goal, but it’s hardly ambitious given the underlying momentum in the economy. Over the past eight quarters, the US economy has averaged a pace of over 2.8% annualized quarterly growth, while real final private domestic sales – the best measure of underlying momentum which strips out government spending and investment, inventory investment and net exports – has averaged nearly 3.2% over that time. Close enough for government work. That said, the composition of growth has grown more unbalanced in recent quarters as the housing market has reentered stasis and nonresidential investment has cooled. As we’ve highlighted in recent months, with nominal income growth continuing to cool and housing remaining hamstrung by limited supply and high rates, there’s scope for sequential cooling in the economy from these robust levels. All told, not only is Secretary Bessent’s target not quite as ambitious as it sounds, but it may also be more challenging than it appears, given the looming outlook and a limited near-term growth impulse from the administration’s deregulatory push.

Source: Portfolio Analysis & Consulting, Bloomberg. PCE represents Personal Consumption Expenditures Price Index. QoQ represents quarter-over-quarter. SAAR represents seasonally-adjusted annualized rate.

Jawbone

Budget Deficit vs Fiscal Impulse (12/31/99–9/30/26E)

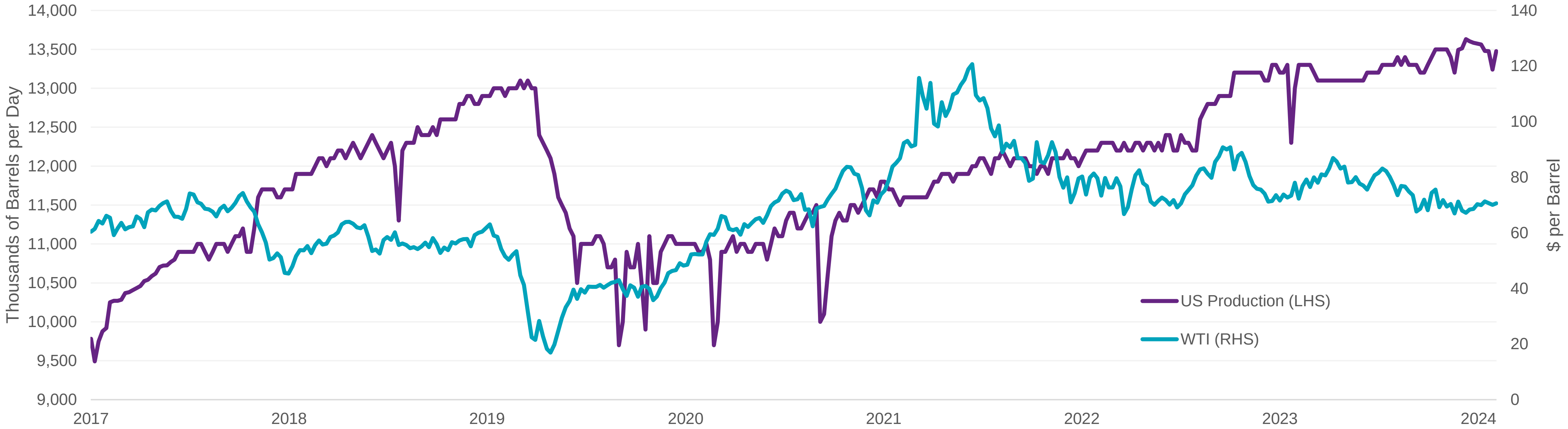


The second pillar of Secretary Bessent's plan, a reduction of the federal budget deficit to 3% of GDP, is closely intertwined with the first objective. And just as with the first goal, details are sparse, and success is likely to prove similarly challenging for multiple reasons. The deficit is always contentious, given the political nature of the topic, but it's problematic in an economic sense as well. When it comes to the fiscal impulse, or the contribution to growth from federal government spending and investment, it's not the level of spending that translates to growth, but rather the change in the size of the deficit. A high deficit certainly helps put a higher floor under activity, but it's the sequential change in the deficit that translates into a growth impulse. The chart above demonstrates this dynamic, particularly where high deficits don't translate to strong growth contributions. Of course, this is partially a function of the traditional countercyclical nature of deficit spending whereby fiscal deficits tend to climb in recessions as activity falls, and spending increases to provide support to the economy. But it's the change in the deficit as a percent of GDP that translates to a growth impulse. Given current legislation, the nonpartisan Congressional Budget Office (CBO) currently estimates the budget deficit to fall modestly from nearly 7% of GDP, as of the end of 2024, to 6% by the end of 2026 with real GDP estimated to grow 1.9% and 1.8% in 2025 and 2026, respectively. That compression translates to a modest fiscal drag as seen in the Brookings Institution projections. One way to shrink the deficit is by growing out of it, but given the potential for cooling growth in coming quarters, that seems unlikely. That leaves policy changes to either increase revenues or reduce spending. Without diving down the contentious political rabbit hole, either of those options lead to a negative growth impulse which makes achieving 3% the growth target that much more challenging. Bottom line: the first two "3s" are admirable but are in direct tension and similarly challenging.

Source: Portfolio Analysis & Consulting, Bloomberg. GDP represents gross domestic product. QoQ represents quarter-over-quarter. SAAR represents seasonally-adjusted annualized rate.

It Makes No Difference

US Crude Oil Production vs Price (12/20/17–1/31/25)

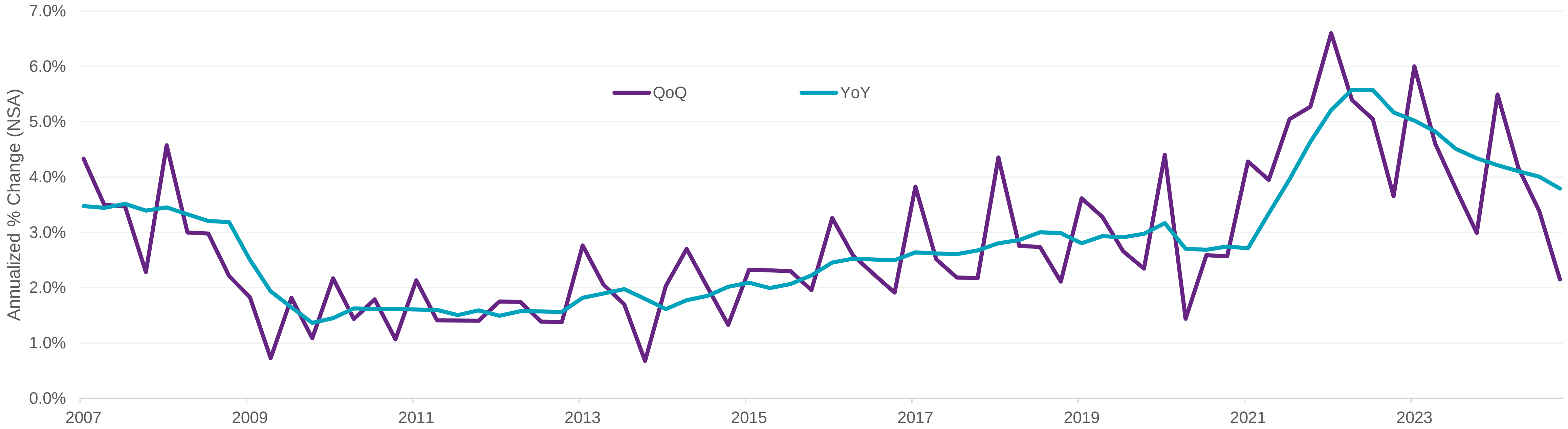


Onto the final "3" on an equally sensitive and misunderstood topic: oil production. Gone are the days of OPEC controlling the flow of crude oil on the global stage. The US has taken the crown as the world's swing producer of oil, and while the final pillar of Secretary Bessent's 3-3-3 plan is straightforward – increase oil output by 3 million barrels per day – US oil production already sits close to all-time highs at over 13 million barrels a day. While the narrative that overly restrictive regulations and permitting have restricted supply is popular and compelling, it's a narrative that holds little water. Access to federal lands is not the limiting factor. The vast majority of domestic production occurs on private land, while thousands of leases already held on federal land are going unused. The true limiter is oil companies themselves. Throughout the 2010s, oil companies effectively subsidized the consumer via massive gains in well yields, thanks to horizontal drilling. Oil companies prioritized volumes over price leading to a painful bust cycle in 2014 and 2015. The result: share prices for the energy complex plummeted on the order of nearly 50% as EPS and return on equity tanked. Management teams were forced to find their religion, and slowly but surely, they have. It's no longer about volumes or prices. It's all about profits and return on equity as management teams prioritize maximizing shareholder value. Higher oil prices won't spur a massive increase in output, nor will slick campaign slogans. Only higher equity prices will. You can lead the oil industry to public lands, but you can't make them drill.

Source: Portfolio Analysis & Consulting, Bloomberg. WTI represents West Texas Intermediate crude oil price.

The Night They Drove Old Dixie Down

ECI: Wages and Salaries for Private Industry Workers ex Incentive Pay (3/31/07–12/31/24)

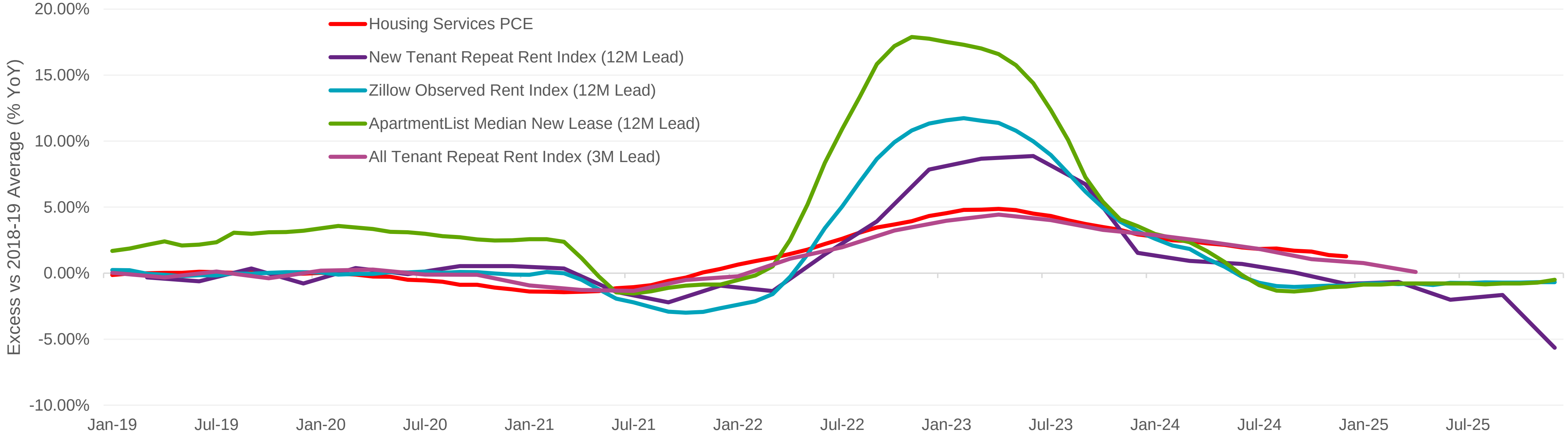


The consistent theme we've continued to harp on as we push on into 2025 is that the market and the Fed remain overly hawkish. Too sanguine on labor markets and growth, and too pessimistic on inflation. Fears of an imminent collapse in employment have quickly receded since last autumn's panic, while the scars of last year's hot first quarter inflation prints remain emblazoned in the memories of investors and FOMC members alike. The latest payrolls print has only helped further bolster the hawks in the view that labor markets are stabilizing, and perhaps even reaccelerating, thereby posing renewed risks to the inflation side of the mandate. While we agree that labor markets have certainly shown encouraging signs of stabilization, suggesting the cooling we've witnessed has been a function of normalization as opposed to something more pernicious, we are hard pressed to see clear signs of reacceleration. And more importantly, there's simply no evidence the labor market is set to provide a renewed inflationary impulse anytime soon. Risks remain skewed to the downside as cyclical employment stagnates, and the fog of policy uncertainty dents animal spirits and hangs over corporate decision making. As a result, while labor markets remain resilient, wage pressures continue to fade as evidenced by the Fed's preferred wage indicator, the Employment Cost Index (ECI). Specifically, the Fed prefers to look at wages and salaries for private industry workers excluding incentive pay occupations, which continues to show a steady trend back to pre-pandemic levels, with the latest print showing the slowest pace of wage growth since the second quarter of 2022. The labor market continues to provide a disinflationary impulse to the economy as nominal wage growth slowly slows.

Source: Portfolio Analysis & Consulting, Bloomberg. ECI Represents Employment Cost Index. FOMC represents Federal Open Market Committee. QoQ represents quarter-over-quarter growth. YoY represents year-over-year growth. NSA represents non-seasonally adjusted.

The Weight

Housing Services PCE vs Market Rents (1/31/19–12/31/24)



Despite the continued run of encouraging inflation data, the consensus remains overly hawkish on the scope of progress back to the Fed's 2% target in 2025. As we've discussed at length, there are two key sources of that concern: trade policy and resilient growth. With respect to trade policy, there's been no shortage of tape bombs, but little in the way of clear details of the scope, magnitude and purpose of tariffs. Despite the lack of clarity, price hikes amidst a backdrop of declining nominal income growth and increasing price elasticity after the inflationary experience of the past few years suggest that the greater risk from tariffs is likely to be through lower growth, not sustained inflation. But when it comes to the current data flow, there's little evidence of sticky inflation as a result of strong real growth. And despite the pervasive fear of prints remaining stubbornly elevated above the Fed's target, shelter costs would like a word. Shelter inflation has at long last downshifted back to the pre-pandemic pace, a welcome sign for a category that represents nearly 18% of the core PCE basket and is responsible for 25 basis points of the current overshoot of the 2% target. The Cleveland Fed's All Tenant Repeat Index, which swaps market rents into the BLS's methodology for shelter costs, has proven to be a reliable leading indicator for official inflation prints with about a three-month lead. Not only does shelter looked set to erase its contribution to the core PCE overshoot, but it very well may begin to offset other residual upside contributors as well. All told, cooling nominal incomes, easing shelter costs, and easy comps as we push through the first quarter paint a much more optimistic inflation outlook than the broad consensus currently holds.

Source: Portfolio Analysis & Consulting, Bloomberg. PCE represents personal consumption expenditures price index.

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