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# AOR Update: U.S. Economy, Equities Set to Lead Again

2 November 2024

## Key Takeaways

- ▶ A resilient U.S. economy has stood out against other developed nations in recent years with stronger economic growth and healthier corporate profits that have fuelled outsize stock market gains.
- ▶ We believe that three of the four key components of exceptional relative U.S. economic growth — the consumer, productivity gains and a solid fiscal impulse — should remain intact while the fourth (growing labour supply) is likely to come under pressure but should not derail the expansion in 2025.
- ▶ Backed by a green and improving signal for the ClearBridge Recession Risk Dashboard, we are bullish on the U.S. economy in the year ahead and expect GDP growth to deliver an upside surprise relative to current forecasts. Coupled with broadening earnings participation, we expect U.S. equities to maintain their positive momentum.

## Trump Win, Fed Pivot Support Resilience

The “most anticipated recession ever” failed to materialise this past year, with the U.S. economy achieving a soft landing. The pace of expansion is likely to stay buoyant in 2025 as the economy rides the tailwinds of both a fiscal impulse, courtesy of Donald Trump’s election win and a Republican sweep of Congress, and a monetary impulse from the Federal Reserve’s pivot to a rate-cutting cycle.

Over the past several years, the resilience of the U.S. economy has stood out against other developed economies. A key question for investors is whether this trend can continue, as stronger economic gains have translated into a healthy corporate profits environment that has fuelled outsize stock market gains. Our starting point for such analysis continues to be the ClearBridge Recession Risk Dashboard, which is our north star when thinking about the health of the U.S. economy. Fortunately, the dashboard’s overall signal is currently in green/expansionary territory and it has been consistently improving over the course of 2024. There are no changes to the dashboard this month (Exhibit 1).

We believe there have been four key components of exceptional relative U.S. economic growth over the past few years: the strength of the U.S. consumer, productivity gains, growing labour supply and a solid fiscal impulse. Looking ahead, three of these are likely to remain intact in 2025, while the fourth, growing labour supply, should be less of a benefit, but not so much less that it could derail the U.S. economy.

The U.S. consumer has been a source of strength, initially powered by accumulated savings and generous government transfer payments during the pandemic. As these funds waned, a strong labour market fuelled further upside as wage gains and broad job creation helped boost labour income, the largest single source of spending power for most Americans and closely tied to aggregate consumption trends. These trends appear largely intact as the calendar approaches 2025, with average hourly earnings holding up at a healthy growth rate of 4.0% year over year in October versus 4.3% coming into the year, for example.

Exhibit 1: ClearBridge Recession Risk Dashboard

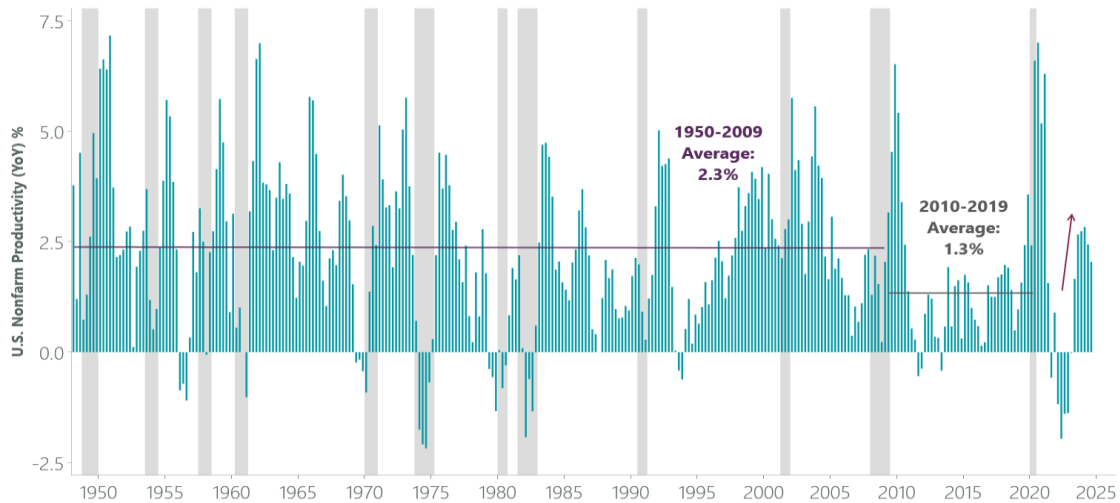
	November 30, 2024	June 30, 2024	March 31, 2024
<b>Consumer</b>	Housing Permits	●	●
	Job Sentiment	✗	✗
	Jobless Claims	↑	●
	Retail Sales	●	●
	Wage Growth	↑	↑
<b>Business Activity</b>	Commodities	↑	●
	ISM New Orders	✗	●
	Profit Margins	↑	↑
	Truck Shipments	●	●
<b>Financial</b>	Credit Spreads	↑	↑
	Money Supply	●	●
	Yield Curve	✗	✗
<b>Overall Signal</b>	↑	↑	●

↑ Expansion      ● Caution      ✗ Recession

Source: ClearBridge Investments.

Sticky wage gains have been a source of concern, and some worry that corporate profit margins will be crimped as businesses have to pay their workers more. We take a different view, however, believing that wages relative to a worker’s output (unit labour costs) are actually the key for profit margins. This is an important distinction because productivity gains (a worker’s output) have been robust over the past several quarters, returning to levels consistent with the 1950-2009 average as opposed to the post-Global Financial Crisis experience. Looking ahead, we believe productivity will remain healthy given lower levels of job churn; if workers are changing jobs less frequently, these employees are more experienced, typically more tenured and more productive.

Exhibit 2: Productivity is Back



Data as of 7 November 2024, latest available as of 30 November 2024. Sources: U.S. Bureau of Labor Statistics (BLS), NBER, Macrobond. Gray shading represents recessionary periods.

Lower labour churn also means that the pace of hiring should be slower, all else equal. This means that the labour market may look less healthy than it has and raises a risk to continued U.S. exceptionalism if the strong domestic labour market cools. In fact, our primary worry on this front is less about workers staying in their roles longer and more about declining immigration, which has been a source of economic strength in recent years. Already the pace of immigration has slowed since President Biden's executive actions to secure the boarder were issued in June. Incoming President-elect Trump is expected to take actions to further slow the pace of immigration into the U.S., which should further cool the pace of job creation and weigh on economic growth at the margin in 2025.

On the positive side, the future Trump administration appears likely to deploy stimulus in the form of individual tax cuts, which should increase the fiscal impulse (relative to baseline) and help fuel economic growth. Fiscal stimulus has been a strong component of U.S. economic growth in recent years on the back of the Inflation Reduction Act and the CHIPS Act. While the fiscal impulse has begun to wane with little incremental government spending coming on-line, Trump's election and the Republican sweep open the door to using the budget reconciliation process to enact tax cuts. This means the outlook for the fiscal impulse heading into 2025 should help support economic growth.

Putting all this together, we believe the U.S. economy will remain healthy in 2025 with the potential for upside to the consensus 2.0% GDP growth estimate. While a good economy doesn't necessarily translate to a good stock market, we believe the near-term path for the market is positive as December historically ranks as one of the best months from a seasonality perspective.

Coming on the back of U.S. stocks' best month of the year in November, it would not be a surprise to see some choppiness emerge in the new year as 2024's strong returns are digested. However, a robust economy and broadening earnings participation are important foundations that should underpin U.S. equities over the intermediate term. In particular, they should continue to be supportive for small caps, value and the equal-weighted S&P 500 Index, which have been gaining ground on a relative basis versus large caps, growth and the cap-weighted S&P 500 since mid-July, rewarding investors with diversified portfolios.

## About the Authors



### **Jeffrey Schulze, CFA**

Managing Director, Head of Economic and Market Strategy | *ClearBridge Investments, LLC*

- 19 years of investment industry experience
- Joined ClearBridge Investments in 2014
- BS in Finance from Rutgers University



### **Josh Jamner, CFA**

Director, Investment Strategy Analyst | *ClearBridge Investments, LLC*

- 15 years of investment industry experience
- Joined ClearBridge Investments in 2017
- BA in Government from Colby College

## ClearBridge Investments ClearBridgeInvestments.com.au

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