PICTET WEALTH MANAGEMENT

US and Euro area macro

Mind the gap - what to make of the two-speed economies?

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FLASH NOTE

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SUMMARY

- Despite one of the most aggressive monetary tightening cycles in history, the US and the euro area are currently two-speed economies. Divergence between manufacturing and services sector performance is not uncommon, especially in recent decades, and tends to occur more frequently in the later stage of the business cycle. In fact, past US recessions have almost always been led by contraction in the goods sector as services barely declined.
- A resilient labor market is underpinning a solid services sector in the US and Europe. The labor market has always been a lagging indicator, and we suspect its sensitivity to interest rates and economic growth is lower this cycle, especially in the early part of supply/demand rebalancing. If this is the case, it would strengthen the argument for policy rates to be higher for even longer to dampen demand and battle inflation.
- In the US, we expect weakness in the goods sector and a slowdown in services to lead to a mild recession, with the worst quarterly contraction occurring around the turn of the year. We now see a peak to trough real GDP decline of -1.0%, revised up from our previous forecast of -1.8% and significantly below a -2.2% contraction in a median recession. The US economy has shown extraordinary resilience, and the lags to monetary policy tightening seem to be rather long and sensitivity rather low. But cracks are showing.
- In the euro area, we expect weakness in the manufacturing sector to continue while services should gradually slow albeit still supporting the economy in the coming quarters. The resilient labour market and real wage gains should support households' consumption while tighter financial conditions should weigh on investment. In all, after a modest rebound in Q2, we expect growth to stagnate in H2 2023. Euro area GDP is expected to expand by 0.5% in 2023 as a whole. There will be some divergence between countries, with more services-driven economies doing better than economies more manufacturing-oriented such as Germany.

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MANUFACTURING WEAKNESS AND SERVICES RESILIENCE

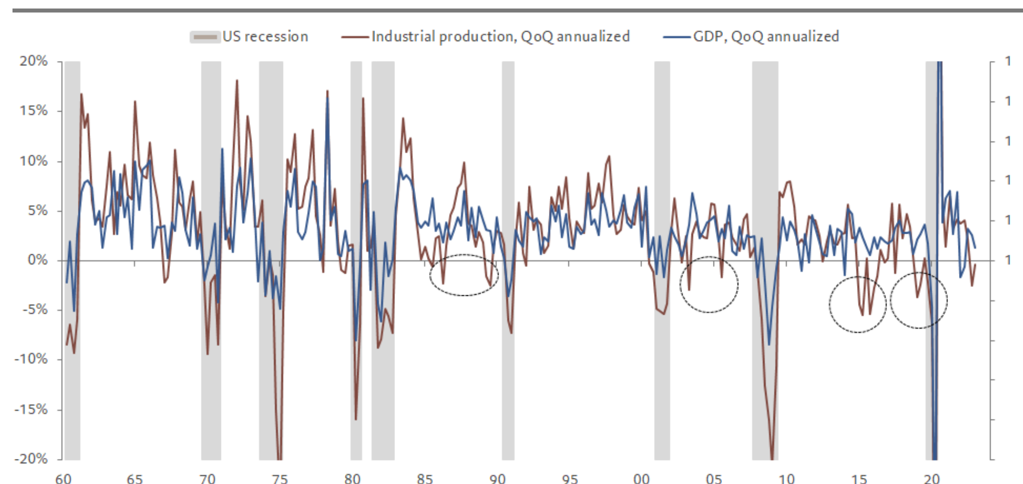
Despite one of the most aggressive monetary tightening cycles in history, the US and the euro area are currently two-speed economies. The services sector, the labor market, and consumption remain resilient, while the manufacturing sector has deteriorated with souring sentiment and contracting industrial production.

This is not uncommon, especially in recent decades, and tends to occur more frequently in the later stage of the business cycle - compared to manufacturing, the services sector is less cyclical, less interest rate sensitive, and generally lags.

In the US, manufacturing used to be the cycle - from the 1960s to the 1980s, an IP (industrial production) recession always led to an economy-wide GDP recession (Chart 1). As the services sector became an increasingly larger share of the economy, from less than half in the 1950s to over 70% now in both value added and employment, there have been several instances where a contraction in IP did not eventually lead to a recession. The most recent episodes were the energy slowdown in 2015/16 and the trade war-induced manufacturing slump in 2019.

Interestingly, in both instances the Federal Reserve turned dovish - the Fed paused for a year in its hiking cycle in 2016 and started cutting rates in the summer of 2019.

Chart 1: US - There have been several instances where a contraction in industrial production did not eventually lead to a recession. Interestingly, in both 2016 and 2019 the Fed turned dovish



Source: Pictet Wealth Management, BEA, as of 4 July 2023

The divergence between services and manufacturing is also apparent in ISM surveys, one of the best leading indicators for the business cycle. ISM manufacturing has been in contraction for eight months, while services stayed above 50 despite recent declines (Chart 2). However, the two series do co-move, and when both are below 50, there's a high likelihood the US is in a recession.

In fact, past US recessions have almost always been led by contraction in the goods sector as businesses cut capex and reduced inventories, households spent less on

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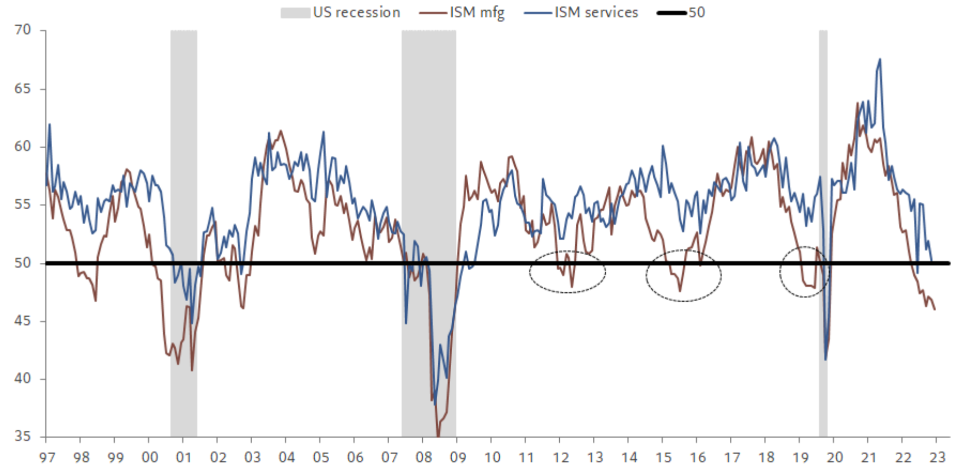
discretionary goods, and the real estate sector suffered. On the other hand, the services sector only contracted in the pandemic recession when people were forced to cut spending due to the lockdown. Normally, services spending is slow-moving and rarely declines, as a large part of services is the non-cyclical, nondiscretionary consumption of items such as shelter and health care.

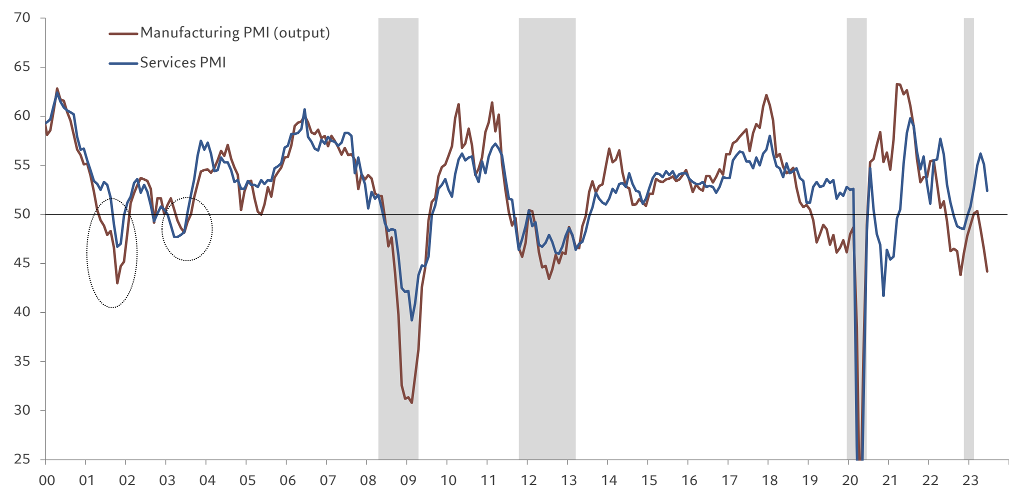
Chart 2: US – ISM manufacturing has been in contraction for eight months, while services stayed above 50 despite recent declines



Source: Pictet Wealth management, BEA, as of 4 July 2023

Compared to the US, the gap between manufacturing and services has been more pronounced in the euro area. Pent-up demand from the reopening of the economy, a resilient labour market and fiscal support have all been factors supporting services activity since the end of last year. Several reasons explain the weakness in the manufacturing sector. First, the inventory boost that helped production after the pandemic is losing steam. Second, external demand has been low. Third, monetary policy transmits more quickly and forcefully in the manufacturing sector.

Chart 3: Euro area manufacturing versus services PMI



Source: Pictet Wealth Management, S&P Global, as of 4 July 2023

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Prolonged outperformance of the services sectors only occurred before the pandemic in 2019 when the manufacturing sector was suffering from weak global demand. At that time, manufacturing PMI was in contraction territory (i.e., below the 50 threshold). In almost all the recessions (here defined as at least two consecutive quarters of negative GDP growth), both manufacturing and services PMI were below 50. The exception was this winter, when only manufacturing PMI was in contraction territory.

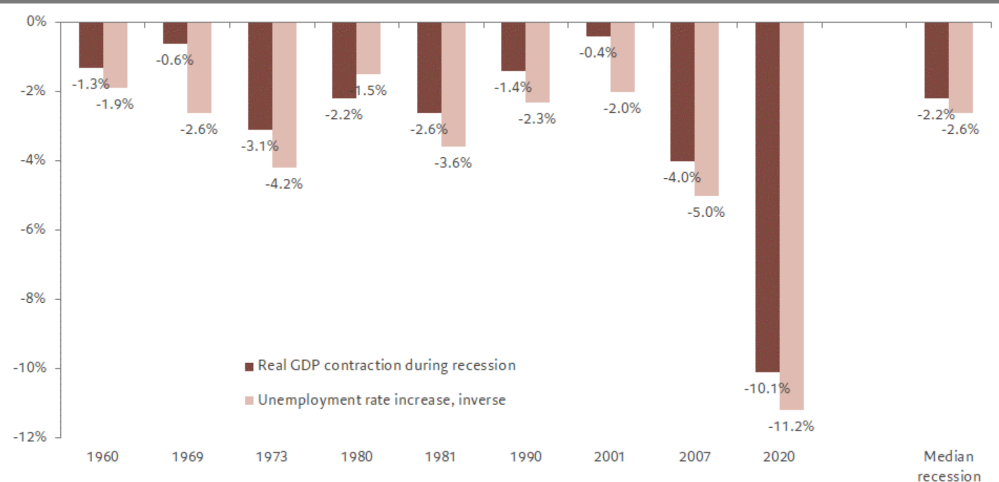
In two cases, PMIs were below 50 and there was no recession at euro area level in 2001 and 2003. At that time, the weakness in some countries such as Germany and Italy was compensated by strength in Spain and France.

The key question for the outlook is how the gap will close. There are already some early signs that manufacturing weakness is spreading to the services sector. Some services activities such as transport and logistics have signalled that they were suffering from the negative development in manufacturing. In previous cycles, "the services sector has catched down to manufacturing, but with the current strength in the labour market, it could take much longer than in the past for the services sector to feel the effects of monetary policy tightening[1]".

LABOR MARKET MORE LAGGED THIS CYCLE, INCREASING ECONOMIC RESILIENCE

A resilient labor market is underpinning a solid services sector. The labor market is traditionally a lagging indicator as employers cut investment and inventories first before letting go of workers.

Chart 4: In past US recessions, the labor market always contracted, but the sensitivity to economic growth varied



Source: Pictet Wealth Management, BEA, BLS, as of 4 July 2023

In past US recessions, the labor market always contracted, but the sensitivity to growth varied. The median increase in the unemployment rate was 2.6ppt with a median peak-to-trough real GDP contraction of 2.2% (Chart 4). Coming into 2023, the labor market is starting from a historically tight position. Even after recent

[1] Christine Lagarde (27 June 2023), "Macroeconomic stabilisation in a volatile inflation environment", Speech in Sintra.

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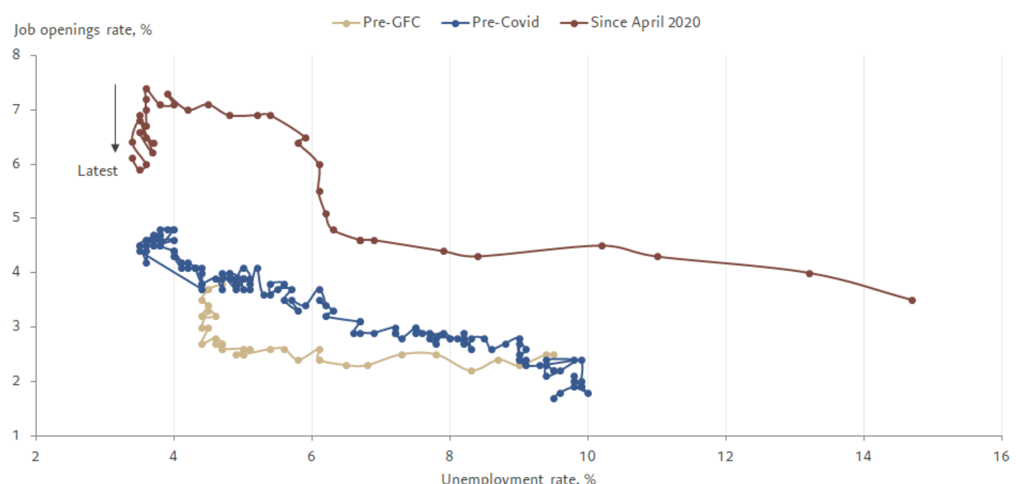
declines, there are still 1.8 available jobs for every unemployed person, significantly above its pre-pandemic peak of 1.2 and the highest since the 1950s.

We suspect the labor market sensitivity to growth and interest rates is lower this cycle, especially in the early part of rebalancing supply and demand. This is supported by early evidence from the Beveridge curve (Chart 5), which shows job openings have come down recently without a commensurate rise in the unemployment rate.

During the pandemic, the Beveridge curve shifted out (red line in Chart 5), suggesting a higher level of labor mismatch as layoffs rose significantly at any given rate of job openings. Divergent performance across industries also created a massive labor reallocation. It is incredibly hard to predict whether the labor market will stay in this new normal of lower matching efficiency or return to its pre-pandemic trend (shifting in of the curve). So far, the evidence favours the latter, which suggests unemployment may not rise as much as job openings decline. Firms had a difficult time hiring during the initial phase of pandemic reopening and they may be more reluctant to layoffs now, at least initially. If this is the case, it would strengthen the argument for policy rates to be higher for even longer to dampen demand and battle inflation.

Chart 5: US Beveridge curve - job openings have come down recently without a commensurate rise in the unemployment rate



Source: Pictet Wealth Management, BLS, as of 4 July 2023

A look at past recessions in the euro area shows that as the economy enters recession, unemployment tends to increase (Chart 6). But the sensitivity to growth has varied. For example, compared with the shock in output due to Covid lockdowns, the deterioration in the labour market has been less pronounced than in past recessions. It has also been less pronounced than in the US. Part of the explanation comes from different labour market policies. European countries adopted various short time work schemes inspired by the German model *Kurzarbeit* aimed at keeping people employed.

Like in the US, labour markets are already exceptionally tight in Europe meaning that a recession will have a smaller negative impact on employment. This winter for example, when the euro area experienced a technical recession, there was almost no impact in the labour market. However, it is worth noting that this winter

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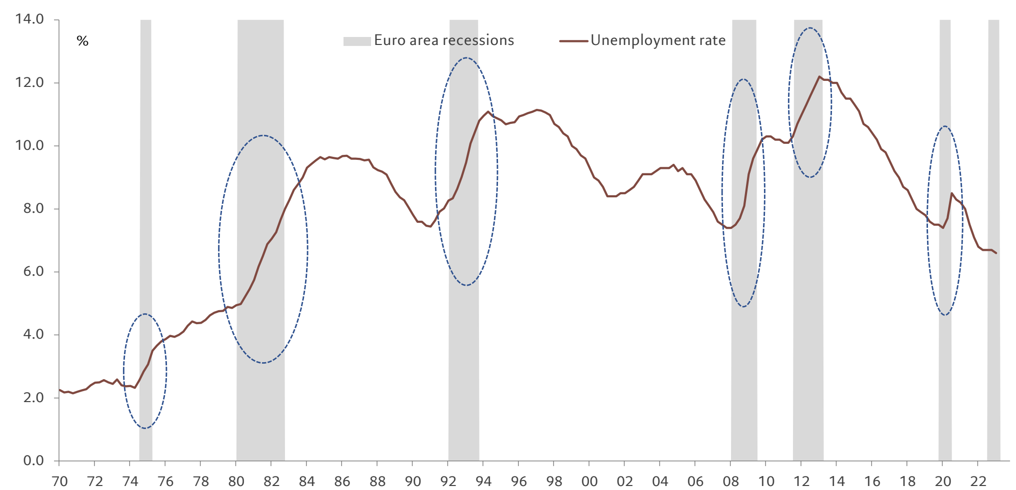
recession was driven by some idiosyncratic factors in some countries such as a drop in public spending in Germany linked to a reduction in COVID-19 testing and vaccination.

Chart 6: Euro area recessions and unemployment rate



Source: Pictet Wealth Management, Eurostat, as of 4 July 2023

MACRO OUTLOOK – MIND THE GAP

A key question for both regions is how the gap between services and manufacturing will resolve itself.

In the US, we expect weakness in the goods sector and a slowdown in services to lead to a mild recession, with the worst quarterly contraction occurring around the turn of the year. We now see a peak-to-trough real GDP contraction of -1.0%, revised up from our previous forecast of -1.8% and significantly below a -2.2% contraction in a median recession. The US economy has shown extraordinary resilience, and the lags to monetary policy tightening seem to be rather long and sensitivity rather low. But cracks are showing.

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