US Macroeconomics

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Government Spending Boom Forestalls Fed Cuts

Consumer goods spending and gross private domestic investment together account for over 40% of real GDP. These combined components fell in three of the four quarters spanning Q2 2022 to Q1 2023. On a year-over-year basis, they turned positive in Q3 2023 before showing 2.5% growth in Q4 2023.

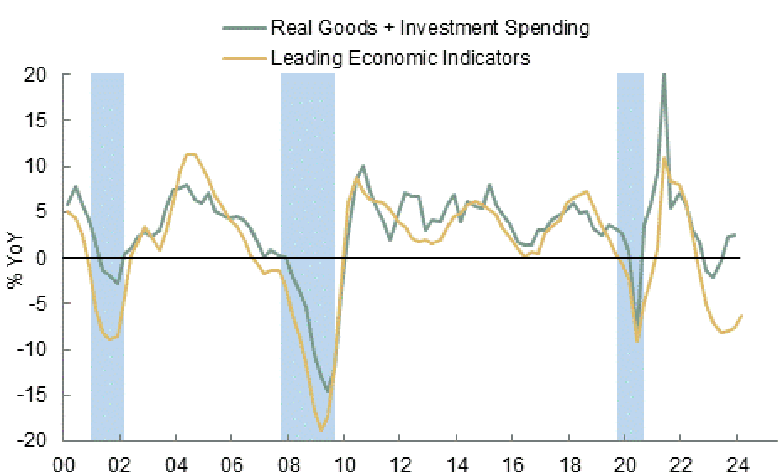
Now, **the trend in consumer goods and investment spending has moved closely with the year-over-year growth in the Index of Leading Economic Indicators** (LEI), as shown in the left-hand side chart below. A sizeable portion of the economy was in recession just as the LEI had predicted.

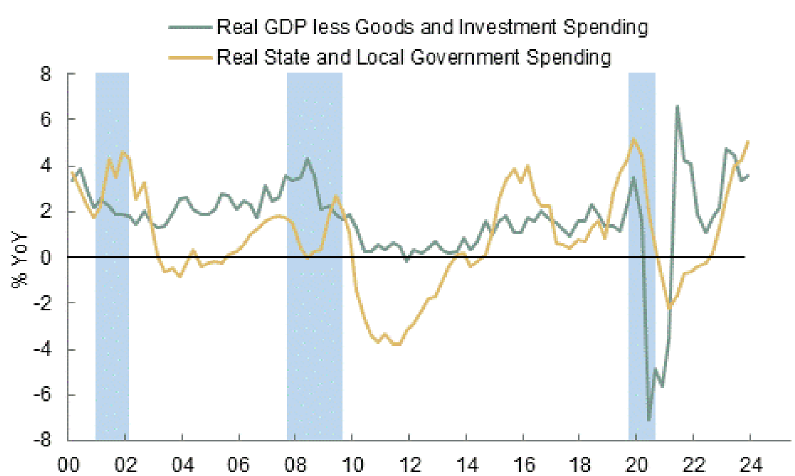
Admittedly, there remains a large gap between the two series. The still soft year-over-year readings in the LEI suggest that there could be further weakness ahead for consumer and investment spending. Moreover, to the extent that long-term interest rates rise further because of sticky inflation and a Fed remaining on hold, **the cyclical side of the economy remains vulnerable to the downside**. However, this is not the case for the rest of the economy.

Real GDP less consumer goods and private investment spending continues to boom because of historic increases in government spending at both the federal and state and local levels. **Real GDP less consumer durables and investment spending grew 4.4% at annualized rate in Q4 2023 and was up 3.6% from four quarters earlier**. During this time overall government spending grew an even faster 4.6%

To place the current backdrop in context, spending is rising at a similar pace experienced during the pandemic and the jobless recovery of the early 2000s. See right-hand side chart below. The gains are occurring both at the federal (3.9%) and state and local (5.1%) levels. To be sure, **government spending is immune from restrictive monetary policy**. And because of this, the Fed needs to keep interest rates higher than they otherwise should be in order to offset this stimulus and its inflationary pressures.

This situation is obviously unsustainable over the long-term. But in the short-term, it can persist a while longer. We will be closely watching the bond market to see if it lifts Treasury term premium and hence long-term interest rates. When this happened last fall, the Fed suddenly grew worried and pivoted to the possibility of 2024 rate cuts.





Source: BEA, Conference Board, Haver, SMBC Nikko

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