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Quarterly Economic Outlook

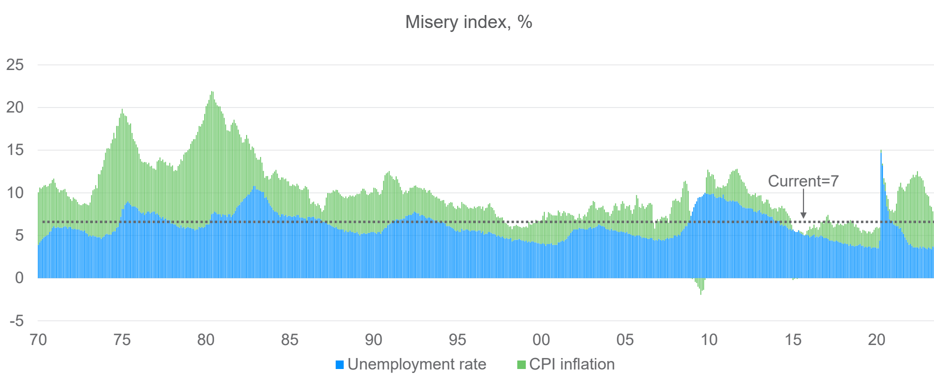
BY COLIN SEITZ

Macroeconomic outlook

The U.S. economy is performing well. Unemployment remains below 4%, where it has been for the past two years. The last time unemployment was this low for this long was in the late 1960s. Back then, an unemployment rate that low was not sustainable since it was below the economy's full-employment unemployment rate. This was one reason inflation took off in the 1970s. Today, given the nation's different demographics and better job-matching, the economy can sustain near-4% unemployment, our current estimate of full employment.

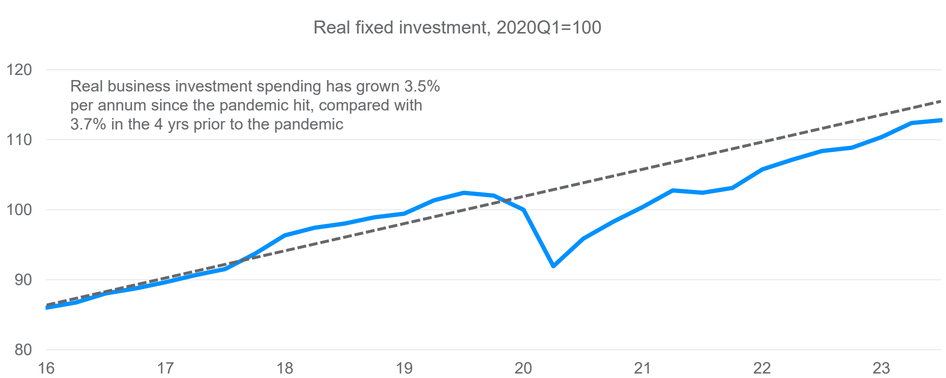
Indeed, despite low unemployment, inflation continues to moderate. Year-over-year consumer price inflation is near 3%, and core CPI would be back to the Federal Reserve's target if not for stubbornly strong growth in the cost of housing services. But the growth in housing costs is set to meaningfully throttle back given weak effective market rents, which the Bureau of Labor Statistics uses to construct the CPI for housing services. Rental vacancy rates are on the rise and will increase more in coming months given the ample supply of new apartment units in train.

Chart 1: About as Good as It Gets



Sources: BLS, Moody's Analytics

Chart 2: Business Investment Recovers From the Pandemic



Sources: BEA, Moody's Analytics

The so-called misery index—the sum of the unemployment and CPI inflation rates, which nicely summarizes the economy's broad performance—has rarely and only briefly been as good as it is now. The index is close to its optimal reading of 6.5% (the sum of the economy's estimated full-employment unemployment rate of 4% and the Fed's CPI inflation target of 2.5%) (see Chart 1).

Consumers are doing their part and spending just enough to support broader economic growth. With inflation moderating, real after-inflation incomes and thus consumers' purchasing power are improving. Still-substantial excess savings built up during the pandemic by middle- and especially high-income households also support spending. Near-record stock prices and housing values and still-low and stable debt service burdens are also helping.

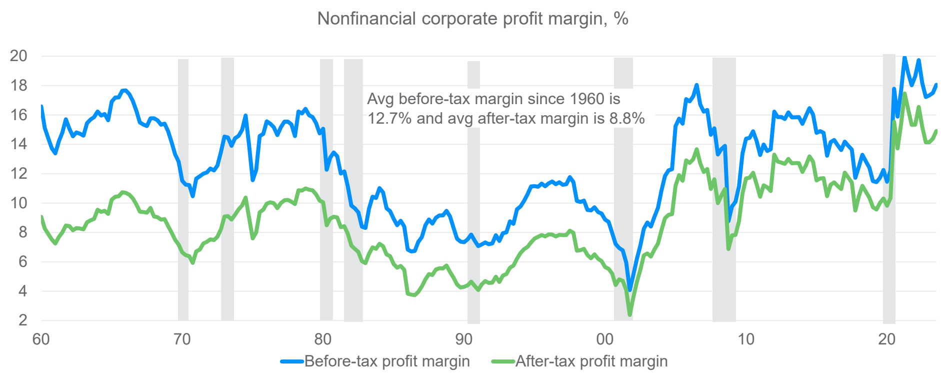
And businesses are hanging tough. They continue to add strongly to payrolls and maintain investment. While difficult to disentangle, historically the first indication that the economy is in trouble and recession is dead-ahead is when anxious businesses rein in their activities. Rising layoffs undermine consumer sentiment, and weakening investment presages a pullback in consumer spending. A self-reinforcing vicious cycle that characterizes a downturn takes hold.

None of this is happening today. Indeed, layoffs remain exceptionally low and investment spending is sturdy. The growth in real business fixed investment, which excludes inventory investment, is consistent with pre-pandemic trends (see Chart 2).

In the four years leading up to the pandemic, real business fixed investment grew at a 3.7% per annum pace. Despite getting hit hard during the pandemic shutdowns, it has grown just about as strongly in the nearly four years since. Investment in structures, including commercial real estate, has lagged, but equipment investment has kept pace with overall spending. Additionally, intellectual property investment, which includes software and research and development, has enjoyed outsize gains.

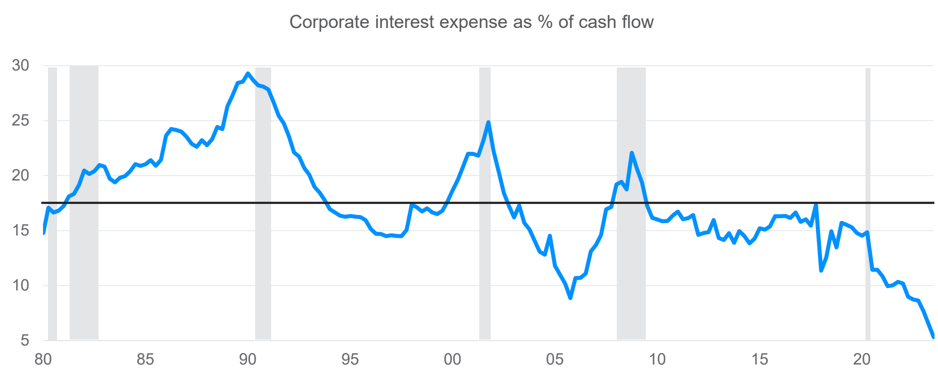
While there are crosswinds, the tailwinds behind business investment should continue to blow hardest. Most significant, businesses are highly profitable, suggesting juicy returns to more investment. Profit margins, measured as the ratio of before-tax profits for nonfinancial corporations to the gross product of those businesses, have been higher but not often (see Chart 3).

Chart 3: Pumped-Up Profit Margins



Sources: BEA, Moody's Analytics

Chart 4: Businesses Have Locked In Previously Low Rates



Sources: BEA, Moody's Analytics

Profits got especially pumped up during the pandemic, when businesses' costs rose sharply with the supply-chain and labor market disruptions, but shortages empowered businesses to increase their prices even more. Businesses are also benefiting from steadily falling tax rates, culminating with the big tax rate reduction in the Tax Cut and Jobs Act passed under President Trump. Profit margins on an after-tax basis are about as wide as they have ever been and almost twice their average since the 1960s.

Businesses thus have an outsize economic incentive to continue strong investment. Over time, the increase in their productive capacity and the intensifying competitive pressures that result should push profit margins back down to something more typical, but that will take a while. This is in keeping with the adage that prices rise like a rocket and fall like a feather. Even this assumes that the apparent concentration of activity in fewer businesses across markets in recent years does not overly stymie competition.

The Fed's aggressive interest rate hikes and higher long-term rates have also done little to dent corporate profitability, at least so far. Interest expense as a share of corporate cash flow fell to a record low near 5% (see Chart 4).

While the return on new investment is high, the cost of capital remains low by most historical standards, and this is despite the runup in interest rates. This goes in part to the near-record stock prices and lofty equity valuations. The price-earnings multiple on the Standard & Poor's 500 is 20 times, more or less—higher if based on trailing earnings and lower if based on forward earnings. This compares with a long-run average PE multiple closer to 15 times and implies a below-average cost of equity capital. Of course, this varies considerably across companies, and especially so now with the valuations of the so-called magnificent seven technology stocks so much higher than for the rest of the market. The cost of debt capital also remains reasonably attractive as corporate borrowing costs have not risen nearly as much as risk-free Treasury yields.

The crisis that roiled the banking system in March sparked a tightening in underwriting standards for bank loans to businesses—commercial and industrial loans—but the fallout on credit availability has been surprisingly modest. In the immediate wake of the crisis, half of senior loan officers at commercial banks said they were raising their standards to make a loan to companies of all sizes. In the past, when so many banks tightened and C&I loans outstanding declined, the economy was already in recession (see Chart 5).

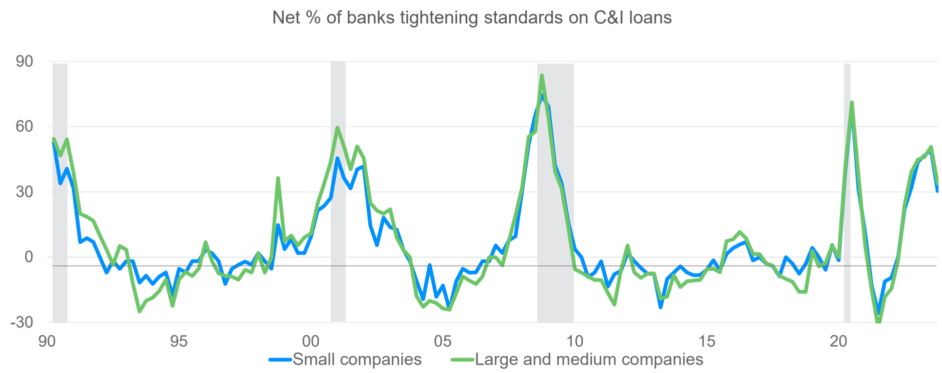
Not so this time. Businesses have not had the same trouble getting credit despite tighter underwriting. According to small businesses surveyed by the National Federation of Independent Business, a net 8% say credit is hard to get. It was close to twice that during the financial crisis. And in response to the Moody's Analytics weekly survey of business confidence, only 5% said getting credit was their biggest problem. More than twice that percentage said so at the height of the pandemic and during the financial crisis. C&I loans outstanding have gone sideways but have not declined.

Business investment is also enjoying a meaningful boost from recent federal legislation that provides more funds for public infrastructure, tax breaks for semiconductor fab construction and research and development, and a host of incentives for green energy development. Most of the latest investment has been in new construction. Manufacturing construction put-in-place has surged from a consistent $75 billion per annum to well over $200 billion (see Chart 6). As construction projects are completed, the new fab plants will need to be fitted out with equipment. Public construction has also jumped from close to $350 billion per annum to $450 billion, lifting investment for construction equipment and for supplying manufacturing and mining industries.

The extraordinary increase in new-business formations since the pandemic hit should also provide a longer-term boost to business investment. Just prior to the pandemic, applications to the Internal Revenue Service to start a new business with a high propensity to hire workers was near 1.25 million per annum. Since the pandemic, it is closer to 1.75 million (see Chart 7).

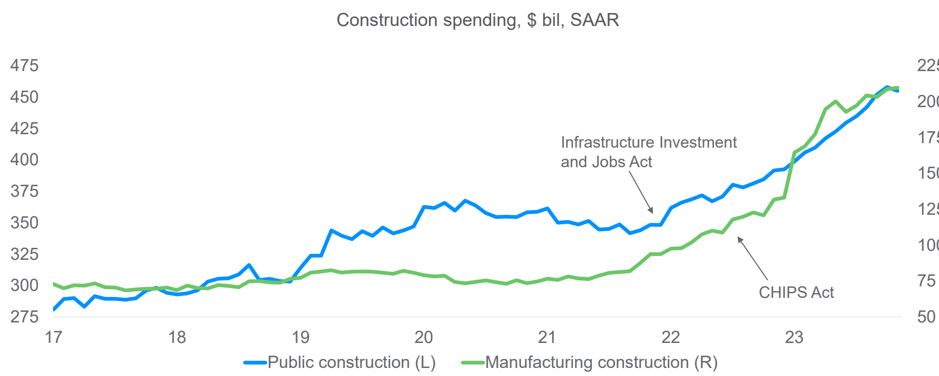
Concern that the economy will suffer a downturn is steadily fading, as the economy continues to perform well and prospects are improving as inflation recedes without an increase in unemployment. Waning economic fallout from the pandemic and the Russia/Ukraine war is a key reason, but so too is the resilience of American consumers and businesses. Consumers continue to do their part, spending just enough to keep the economy moving forward, but not so much that it fans inflation and interest rates.

Chart 5: Banks Tighten Down on Business Lending



Sources: BEA, Moody's Analytics

Chart 6: Fiscal Policy Provides a Tailwind



Sources: Census Bureau, Moody's Analytics

Chart 7: Businesses Form at an Extraordinary Pace

Sources: Census Bureau, Moody's Analytics

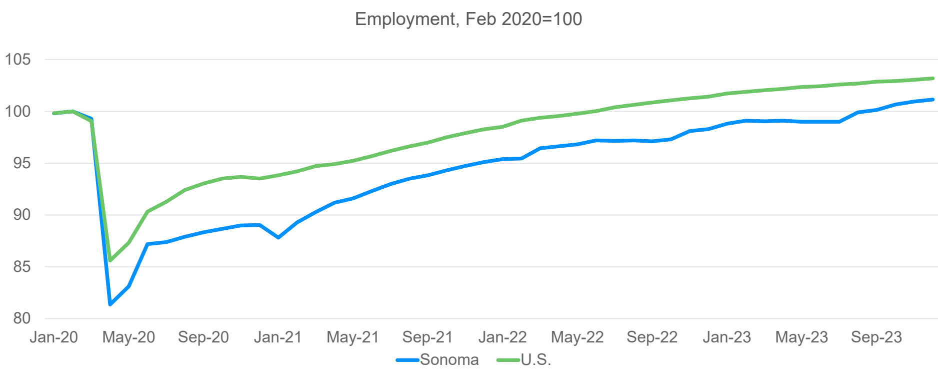
Businesses are also hanging tough. Despite higher interest rates and tightening credit, they remain stalwart in their refusal to lay off workers and rein in investment. And with good reason; the returns to expansion are high given their extraordinary profitability—much higher than their cost of capital. With new businesses forming at an extraordinary pace and a highly supportive fiscal policy, odds are increasing that the economy will find a soft landing.

Sonoma County outlook

Sonoma County's economy found some renewed momentum through the second half of 2023 (see Chart 8). While the national economy continues to slow, job growth in the county accelerated in the last three- and six-month periods, significantly outpacing both California and the nation during those times. Leisure/hospitality has found another gear following a mid-year swoon and annual job growth is running ahead of the national average even as payrolls are cresting new highs. Construction is powering ahead, driven by renewed nonresidential construction (see Chart 9). On the other hand, the jobless rate has crept higher over the past year, while the labor force has flatlined below its pre-pandemic level. House prices rose in fits and starts in 2023, but are still below their mid-2022 highs, matching the California trajectory. Permit issuance is inching slowly higher but remains below its pre-pandemic pace.

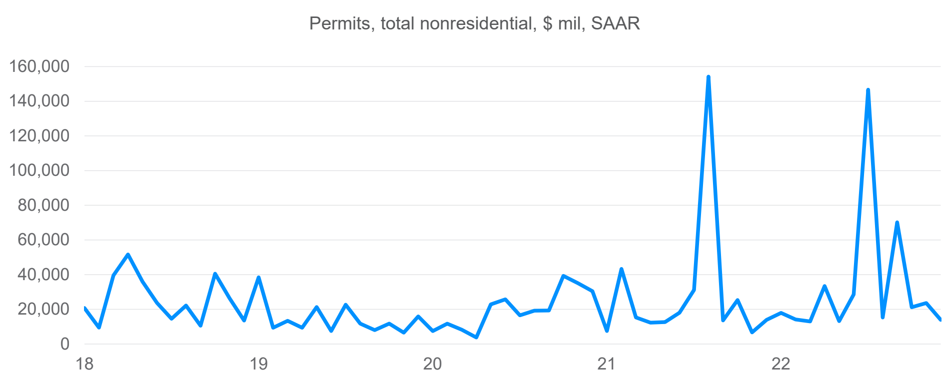
Sonoma County and the U.S. economy will continue to slow, but crucially avoid any outright job losses. After payrolls advanced 2.8% in 2023, job growth will slow to around half that pace in 2024 as the economy downshifts (see Chart 10). Total payrolls are already past their pre-pandemic level; combined with a slowing national economy, these will apply restraint to Sonoma's key industry clusters. Sonoma's major industry, tourism, is cyclical. With income growth decelerating, cyclical industries will face challenges as consumer spending slows from last year's pace.

Chart 8: Sonoma County Makes Up Some Ground



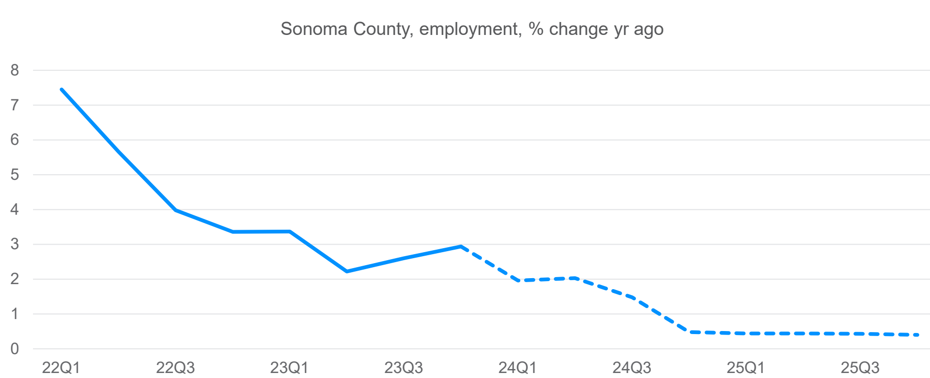
Sources: BLS, Moody's Analytics

Chart 9: Nonresidential Permitting Finds Another Gear



Sources: Census Bureau, Moody's Analytics

Chart 10: Job Growth Will Slow to a Crawl



Sources: BLS, Moody's Analytics

Tourism will settle into a slower pace of growth as payrolls have recouped their losses from the pandemic and staffing levels are normalizing. Payrolls are already 8% above their pre-pandemic levels, compared with just 1% for the region; combined with a slowing labor market, this will ensure job growth downshifts during the next year. Arrivals at Charles M. Schultz-Sonoma County Airport increased again in 2023, albeit at a reduced pace than in 2022, signaling that pent-up demand for travel is waning. Still, the metro area's plentiful tourism draws will keep visitor spending ticking and enable modest growth. Sonoma boasts world-class wineries and weather that make it a popular year-round destination. A cooling U.S. economy ensures that spending on recreation pulls back relative to 2022 and 2023, and leisure/hospitality will settle into a slower pace of growth.

However, weak demographic trends will undermine steady growth in tourism and the beverage industry. Sonoma County's affordability challenges have led to an exodus of residents for six consecutive years as people move to lower-cost areas away from the coast. The housing market is among the least affordable in the U.S., so rapid improvement in migration trends is unlikely. Declining numbers in the working-age population will put a speed limit on labor force and job growth, leading to below-average growth in population-dependent industries, including healthcare. While migration trends are still not favorable, they have improved in recent years and compare favorably to nearby Napa, where out-migration has accelerated since the pandemic.

California's larger grape harvest in 2023 should balance the market after consecutive years of smaller-than-expected crop yields. According to the California Grape Crush Report, grape prices per ton increased about 7% in 2022 after surging 25% in 2021. These increases are likely to give way given earlier reports of a strong harvest this year. More-available supply will keep a speed limit on price increases, though the quality of the harvest will ensure that prices do not decrease. The county's other largest agriculture product will similarly see a retreat in pricing power. After peaking in mid-2022, milk prices declined sharply and are only now beginning to rebound. Milk prices now sit only slightly higher than their pre-pandemic level, which is still significantly lower than their highs from nearly a decade ago. U.S. and global demand for nondairy alternatives continues to rise and chip away at market share of the dairy market, which will limit price increases for Sonoma County dairy farmers. Coupled with improved drought conditions that should see milk production in California increase in the next two years, this suggests that milk prices will modestly tick downward this year and next.

Sonoma County's near-term outlook is on stable footing, though the economy will expand at a slower pace than last year. Tourism will settle into a reduced pace of growth as the national economy slows, but still drive modest advances. Unfortunately, weak population growth will outmuscle the advantages of a high quality of life and an educated workforce, relegating the county to a slightly below-average performer relative to California.

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CONTACT US
For further information contact us at a location below:

U.S./CANADA
+1.866.275.3266

EMEA
+44.20.7772.5454 London
+420.234.747.505 Prague

ASIA/PACIFIC
+852.3551.3077

OTHER LOCATIONS
+1.610.235.5299

Email us: helpeconomy@moodys.com
Or visit us: www.economy.com