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WEEKLY ECONOMIC COMMENTARY

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Global Economic Research
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312-557-8820
ct92@ntrs.com

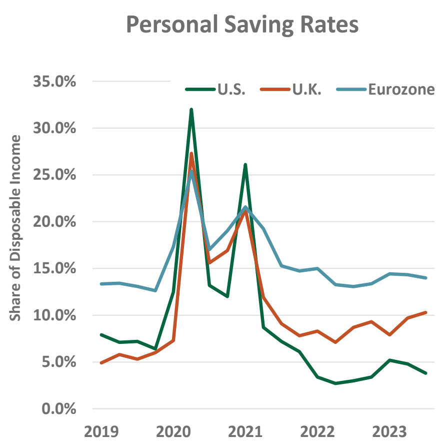
Ryan James Boyle
Chief U.S. Economist
312-444-3843
rjb13@ntrs.com

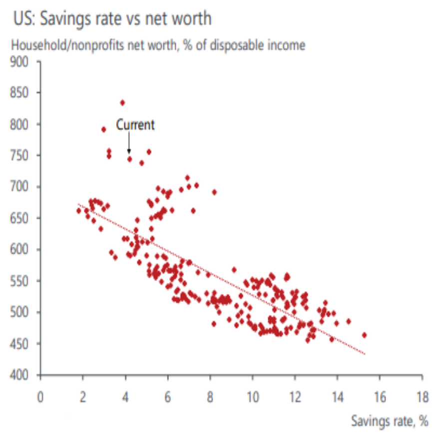
Vaibhav Tandon
Chief International Economist
630-276-2498
vt141@ntrs.com

When I started earning money as a paper boy, my parents made me open a savings account at the local bank. Every week, I would take my pay (eight dollars!) and my passbook to a teller, who would update my principal and interest using a huge accounting machine. On rare occasions, I was allowed to withdraw fifty cents to purchase a milk shake at the local Woolworth's.

By my count, there are at least five anachronisms in that story. But the focus on savings remains as relevant today as it was back then. Putting money aside is important for individuals, and the aggregate amount of saving is important for an economy. Recent discussions of saving rates and their relationship to spending illustrate how much has changed over the decades, and how much remains the same.

Saving rates rose immensely across economies during the pandemic period. Government support programs, many designed to stimulate demand, elevated household incomes. A considerable portion of the transfer payments were set aside for later use, given the uncertain outlook and restricted access to services like leisure and hospitality.





Sources: Haver Analytics, Oxford Economics

As economies reopened, households began to dip into their reserves. Saving rates are down significantly over the past three years; in the United States, they stand at about half of their pre-pandemic level. A high level of saving can provide fuel for future spending; low levels of saving might lead to belt tightening. This is one of the reasons forecasters have been expecting much more modest growth in consumption.

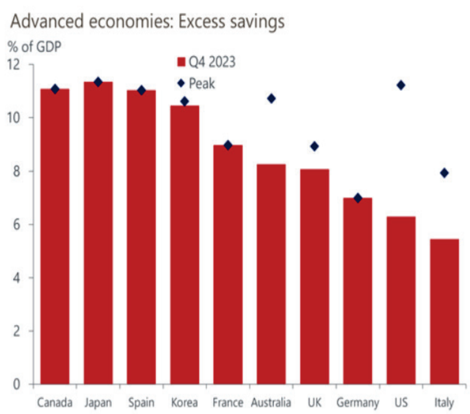
The saving rate, though, is an incomplete gauge of household wherewithal. Real incomes are the most direct driver of consumption; strong wage growth and falling inflation should continue to support spending this year.

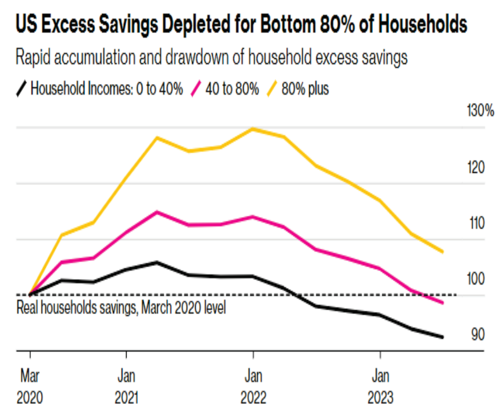
Further, the saving rate is based on the difference between income and spending for a given period; it does not include accumulated savings done in the past. And measures of income do not include asset price appreciation. As shown in the chart above, high levels of wealth are closely correlated with low saving rates. In this way, rising net worth creates "wealth effects," allowing investors to spend more out of their incomes without compromising their solvency.

Savings have been depleted, but consumption has powered on.

The unexpectedly powerful run of equity markets during the last few months of 2023 (the U.S. S&P 500 rose by 11.7% during the fourth quarter alone) provided an enrichment that may have been overlooked by forecasters. Retailers had a much-better-than-expected holiday season, which boosted growth in gross domestic product (GDP).

The data suggest that most countries still have a huge volume of savings in excess of pre-pandemic levels. According to Oxford Economics, western countries have between 6% and 11% of their GDP remaining in reserve. This is an immense sum: in the U.S., the total is more than $1.5 trillion dollars.





Sources: Oxford Economics, Haver Analytics, Federal Reserve, Bloomberg

These amounts, however, are concentrated among upper income households which have a lower propensity to spend. Those with more modest means, who spend more out of their incomes, have largely exhausted their extra resources; these families have begun borrowing again. Consumer debt, which dropped sharply during the pandemic, has returned to 2019 levels. The cost of interest on that debt will take a bite out of budgets in the months ahead.

It has been frustrating, but gratifying, to see consumption exceed expectations so consistently over the past few quarters. Nonetheless, projections (including ours) are once again calling for more modest results in the new year. While commentary often focuses on downside risks, potential upside cannot be dismissed. And that may delay interest rate cuts from central banks.

I made my first trip to a bank branch in many years recently. There were almost no tellers on duty. I was there to access my safe deposit box, which contained the savings bonds my children received when they were young; the time had come to disburse them to their rightful owners. The branch manager offered to determine current values for the certificates by taking a picture with his phone. Oh, how the times (and saving) have changed…

Sinking In

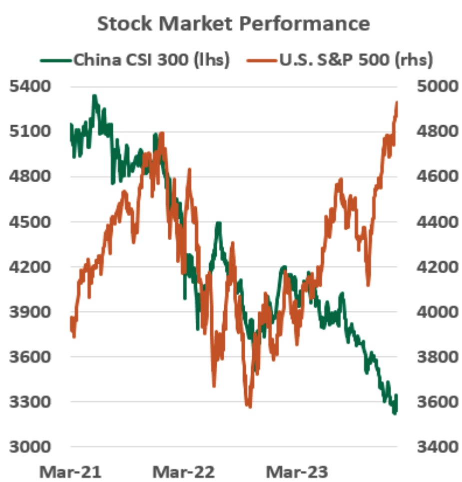
Gross domestic product (GDP) is often considered the most important indicator of the health of an economy. But there are other measures that provide different perspectives, which can be more timely and impartial. The level of equity markets is one such indicator that provides a window into what's going on.

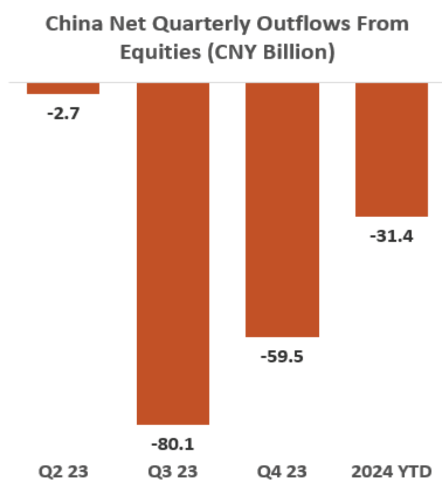
This is an especially important reflection for China. The official statistics reflect real economic growth of 5% in 2023, among the best in Asia. But those statistics have a history of being favorably constructed. By contrast, Chinese equities were the worst performers in the Asia-Pacific region in 2023. This year is not off to a great start either, with the CSI 300 Index down about 5% in January. Since the peak reached in February 2021, the index has slumped 44%.

Proximity to China is proving to be expensive for Hong Kong equities as well. Mainland companies account for over two-thirds of the Hang Seng Index's market capitalization; the index closed 14% lower in 2023, its fourth consecutive yearly loss. Chinese and Hong Kong stocks combined have lost $6 trillion in value in the last three years.

China's stock market is struggling at a time when other global indexes have provided double-digit returns. The U.S. S&P 500 has soared to fresh records while Japan's Nikkei 225 has been trading at a multi-decade high.

The pessimism reflected in the markets is becoming increasingly hard for Chinese policymakers to ignore. Authorities are under pressure to arrest a decline in investor confidence, and they have stepped up measures to stem the rout. Regulators have tightened capital outflows by limiting access to funds that invest in offshore securities. They have been issuing unofficial instructions or "window guidance" to some of the biggest investors, discouraging them from being net sellers of equities. Last week, officials announced curbs on short-selling and cuts to bank reserve requirements to inject more liquidity into the financial system.





Sources: Haver Analytics, Yahoo Finance, Bloomberg

China's equity market downturn is deepening.

Media reports suggest that Chinese officials are seeking to do more to stem the selloff. According to Bloomberg, policymakers are mulling a CNY 2 trillion ($280 billion) stabilization fund to buy onshore shares through the Hong Kong exchange link.

The above interventions, however, have done little to reverse negative investor sentiment. China's property market remains troubled. Home prices fell the most in almost nine years last December. Local governments are deeply indebted. Deflationary pressures are building. Foreign investments have tumbled. Geopolitical tensions with the U.S. have little prospect of easing, especially in a U.S. election year. Recovery in corporate earnings looks unlikely with these issues unresolved.

The selloff is discouraging consumer spending and business investment, adding to the list of troubles.

The bear market for stocks may not be as painful as the downturn in property markets, which poses risks to financial stability. Equities account for only a fraction of household wealth relative to real estate. However, the slump in equities is deepening despair among small investors, who make the bulk of stock purchases.

Presenting a rosier picture won't be enough to cause a turnaround in investor sentiment. That will require authorities to address the host of challenges plaguing the Chinese economy. Better headline numbers alone won't help China avoid negative headlines.

Giving The Business

Small businesses are a vital part of the American economy. The U.S. Small Business Administration estimates that they represent over 46% of employment and account for the majority of new job creation. Small business openings are an expression of optimism in an entrepreneur's ability and support from their community.

Particularly in the current cycle, small businesses have caught our attention as a bellwether of credit stress. While still performing well today, we will watch small businesses' performance as an indicator of potential trouble.

The sample to monitor has grown. During the pandemic, new business formation surged, and the trend has endured. Many people saw the interruption to their work routines as a cue to strike out on their own. Though the worst of the COVID era is in the past, new business applications and openings have remained elevated.

U.S. consumer review site Yelp observed that 2023 was a record year for new businesses appearing on the platform. Restaurants and travel destinations are well represented in this collection; demand for new experiences, dining out and takeout meals has endured. Home services like painting and decorating, which are easy to establish, were the largest category of new businesses. As the cost of new dwellings rose to levels unattainable for many households, consumers are instead spending on upgrading their existing homes.

Small business performance is an important economic indicator.

Small businesses are an important barometer because they are the borrowers most exposed to rising credit costs. They typically rely on revolving credit from banks, priced at variable rates. Debts in many sectors have been structured to avoid the impact of higher rates. Larger businesses issued high volumes of bonds before rates began to rise. Small businesses, however, cannot access capital markets and have felt the pain of higher financing costs.

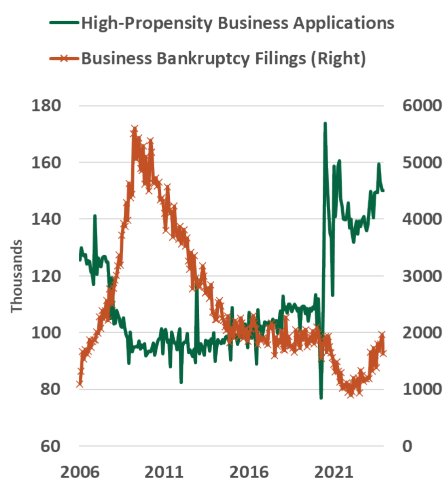
The stress on small business owners is accumulating. They have had to reckon with the same inflationary forces as other firms, but they are less likely to have the pricing power of larger incumbents to sustain their margins. The monthly survey by the National Federation of Independent Business shows a rising share of owners see a lack of labor and tighter credit as their biggest risk; prior to the pandemic, credit never merited mention as a top concern.

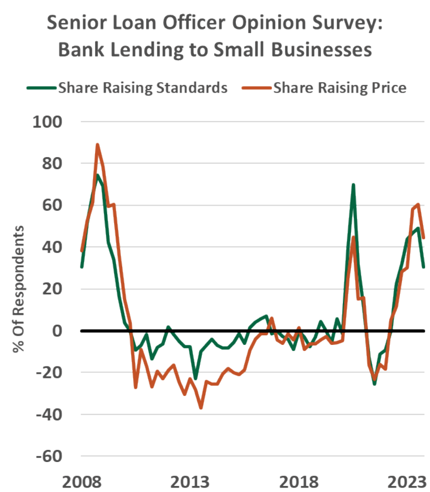
Worries are justified, as banks continue to tighten their commercial lending standards. Even when credit is granted, the cost is higher, and limits are lower. Many lenders, particularly smaller community banks, have their fortunes tied to the small business environment. Recent earnings from publicly-traded banks have shown loan charge-offs and provisions for future losses in commercial loans were still rising through the end of 2023.

Some businesses will fail, an unfortunate but routine outcome. Much like anomalously low consumer credit defaults, the pandemic led business bankruptcy filings down to modern record lows in 2021. Most businesses qualified for programs like the Paycheck Protection Program (PPP), federal loans that were forgiven for businesses that maintained employment through the pandemic. These loans-turned-grants were lifelines during the COVID era, but that buffer has been depleted.

Bankruptcy data will help to gauge the business cycle. In 2023, monthly bankruptcy filings returned to 2019 levels; these are far below the peaks seen in the years following the 2008 financial crisis. Not overly alarming, but something to watch.

Inflation and interest rates have hampered the profitability of small firms.





Sources: Census Bureau, Administrative Office of the U.S. Courts, Federal Reserve, Haver Analytics

We will also monitor business deaths, a grim term for the phenomenon of a business closing permanently. Where a bankruptcy may allow a business to reorganize and reopen, a death is a permanent closure identified after a business shows no employment activity for three consecutive quarters. Establishment deaths were elevated in 2022, but lower than births; on net, the number of small businesses is still growing.

The outlook calls for continued growth, which requires new firms to take new borrowings in order to create new jobs and new wealth. In the year ahead, the fates of small businesses may determine whether our economic landing is soft or hard.

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@NT_CTannenbaum