

Shaping Trends

Assessing Economic Cycles: A Structured Macroeconomic Framework (i)

Linking Economic Fundamentals to Growth Forecasting for Informed Investment Decisions

Overview

This white paper is the first installment of a three-part series that systematically explores our macroeconomic framework. Understanding the current stage of an economic cycle is essential for informed asset allocation, portfolio construction, and risk assessment. To address this need, we introduce a structured macroeconomic framework designed for developed economies, with a particular focus on the U.S. context. By examining the transmission mechanisms from fundamental economic variables—which, ideally, should be exogenous—to broader economic indicators, we provide a systematic method to anticipate macroeconomic trajectories.

Linking Economic Fundamentals to GDP Growth: A Medium-Term Perspective

The final goal of our macroeconomic framework is to try to understand in which stage of the cycle the economy is as well as which are the risks that can trigger a change to a new stage. In this regard, our macroeconomic analysis begins by identifying the GDP components that are most critical for assessing the medium-term economic trajectory. While the component's GDP weight is a relevant factor, its correlation with GDP growth emerges as an even more decisive criterion.

For instance, in the U.S. economy, business investment (which includes both equipment and intellectual property investment) holds considerable importance despite representing less than 10% of GDP. The reason is that, given its direct link to employment, the evolution of business investment is essential for private consumption trend, which is by far, the component with the highest weight on GDP. Conversely, the Eurozone stands out as a region where exports play a more pivotal role—particularly when compared to the U.S. This disparity largely stems from the Eurozone's far greater exposure to the external sector compared to the U.S.

The second step in our analysis involves identifying the specific variables that influence the evolution of each GDP component, not just in the current or next quarter but over the medium term. We refer to these variables as 'fundamentals.'

Since these fundamentals serve as the foundation of our model, they should ideally be exogenous variables, unaffected by the economic cycle. In practice, however, it is challenging to find economic variables that influence the cycle without being influenced by it in return. Acknowledging this difficulty, we strive to select variables that are as exogenous to the cycle as possible.

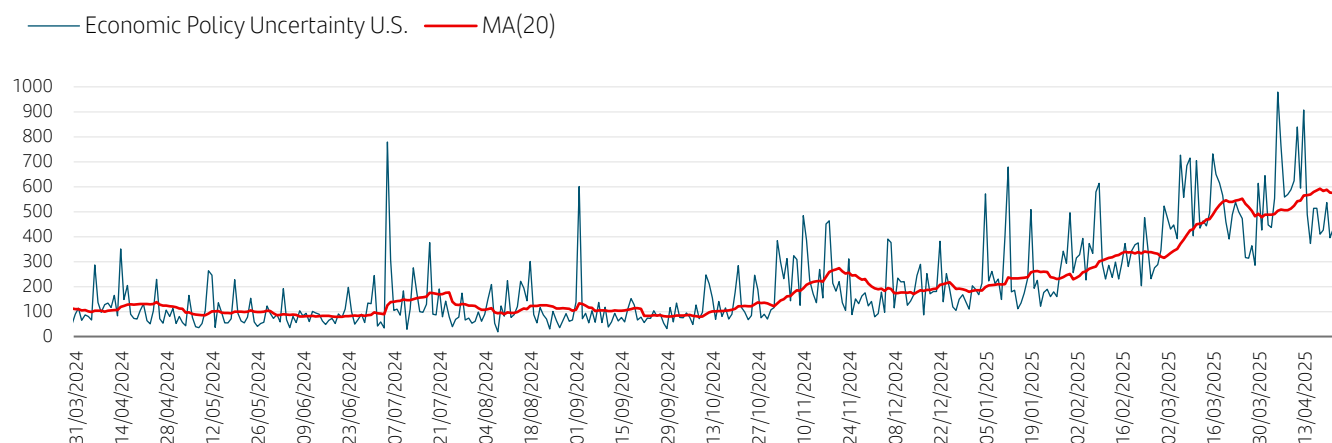
For instance, in the case of US business investment, we identify as key fundamentals two primary factors: first, credit conditions applied by banks to non-financial companies (in this regard, we closely monitor the Senior Loan Officer Opinion Survey of the Federal Reserve report or SLOOS); and second, variables related to the financial position of non-financial corporations (that reflects the health of their balance sheets) as corporate profits and gross operating surplus.

Similarly, when examining another key U.S. GDP component, residential investment, key fundamentals include mortgage credit conditions, credit demand and metrics related to mortgage financing accessibility and housing affordability.

Continuing with the previous example related to the U.S. economy, the current trajectory of non-financial corporate profits suggests a reasonable rise in business investment growth. As to residential investment, the current stance of credit conditions and demand conditions for mortgages according to SLOOS report would suggest that residential investment is not going to accelerate over the next quarters.

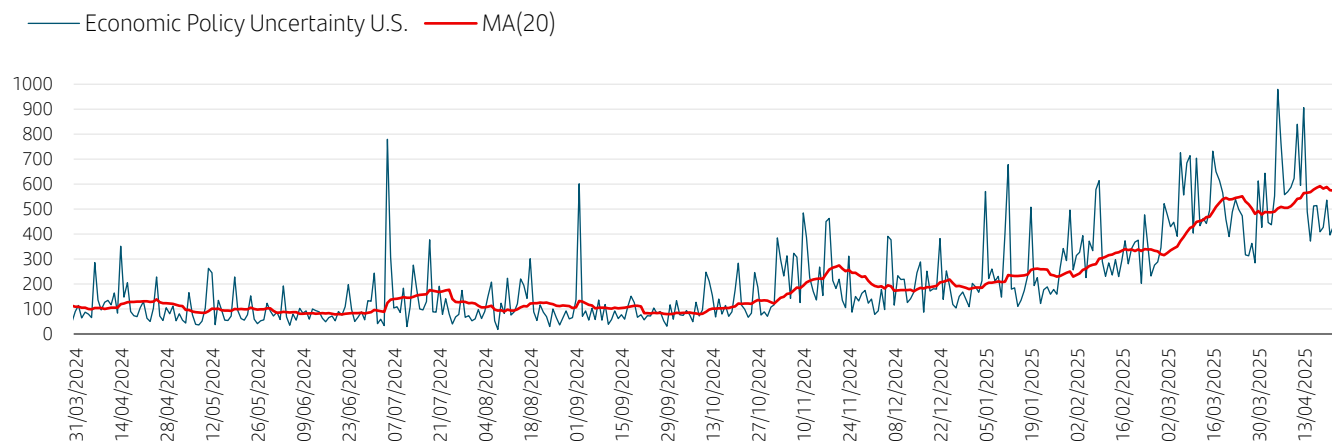
Business investment and profits before taxes of non-financial corporates: yoy growth

Source: Santander Asset Management & Bloomberg



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Next, as the fifth step, we evaluate whether these GDP component forecasts align with signals from other indicators, such as current hard data, confidence indicators and our proprietary nowcasters (Economic Pulse, Real Time Macro,...). In cases of discrepancy, we generally consider signals derived from fundamentals to be more reliable—particularly over the medium term (which is our main focus) rather than the immediate future.

Specifically, when analyzing U.S. business investment, we closely monitor the evolution of business confidence indicators such as ISM, Philadelphia Fed, and PMI. For U.S. residential investment, the most reliable signal appears to be the NAHB indicator. Lastly, in the context of U.S. private consumption, the key references to watch are the Michigan and Conference Board Expectation indexes.

The sixth and final step is to aggregate the estimations of the various GDP components, not merely through a bottom-up process. Instead, to assess the potential current stage of the cycle, we prioritize the signals emerging from the most significant components identified in the previous steps.

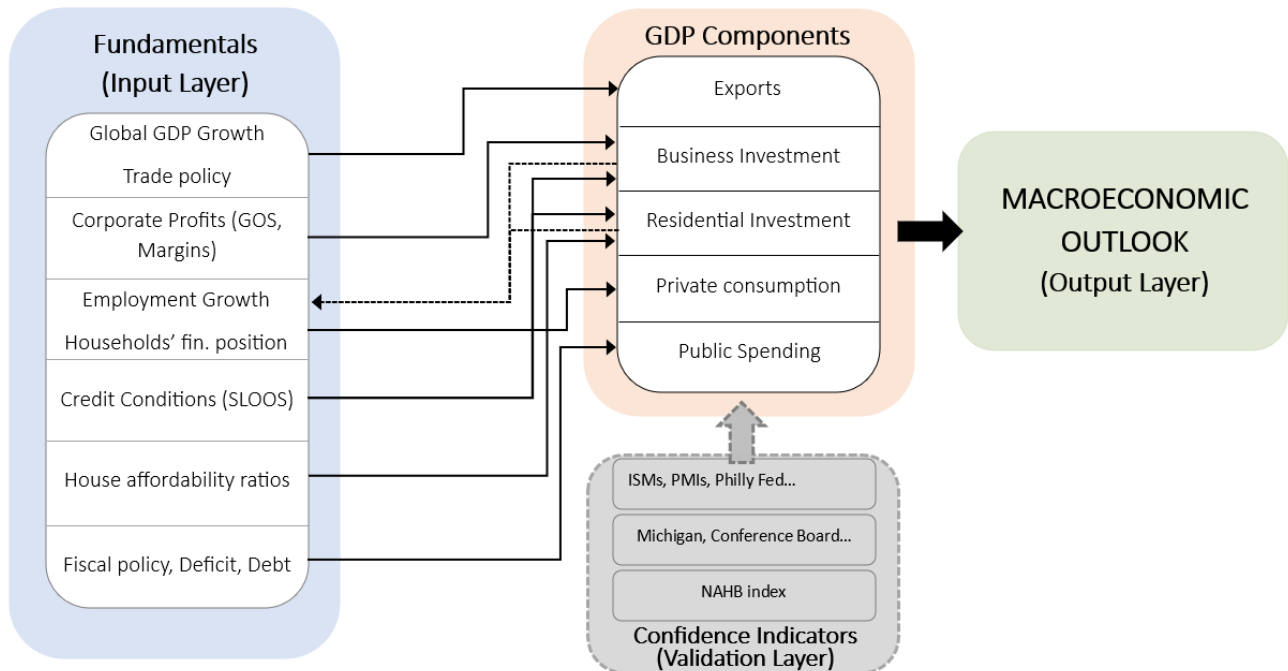
Framing the Path Forward

As the first installment of our three-part series, this white paper has laid the groundwork for a comprehensive macroeconomic framework to understanding the stages of the economic cycle, emphasizing the crucial role of identifying GDP components and their underlying fundamentals. The upcoming installments will delve deeper into specific components and their interactions within the economic cycle, providing enhanced clarity on how shifts in fundamentals impact broader macroeconomic trends.

By continually refining our understanding of the economic cycle's phases, we aim to equip investment professionals with the analytical tools needed to navigate an evolving economic landscape. As we progress through the series, each paper will build on the foundational concepts outlined here, ultimately presenting a cohesive and pragmatic framework for strategic decision-making.

Título gráfico

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