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AN ECONOMY ON THE MOVE - KEY TRENDS THROUGH THE LENS OF U.S. GDP

Executive Summary

- Gross Domestic Product (GDP) is the best aggregate representation of the ongoing strength of the U.S. economy and therefore provides an effective way to assess the health of the business cycle and its potential impact on market fundamentals.
- Nominal GDP expanded by 6.3% annualized between the end of 2019 and Q3 2024. However, real GDP growth, a measure that keeps the price of the goods and services produced by the economy constant, grew more in line with the long-term trend over the same period of time (2.3% annualized). This means that almost two-thirds of the nominal economic expansion in the U.S. since 2019 stems from higher prices for goods and services. Assuming gradual further progress towards the Fed's 2% target, we expect nominal GDP growth to gradually decelerate to the long-term trend of around 4.5% annualized.
- The major components of the U.S. economy have not materially changed since 2019. But a deeper look into the details of the national GDP accounts reveals some interesting developments over the past several years. These developments provide macroeconomic confirmation that some of the trends we have observed since the pandemic have affected the inner workings of the U.S. economy, and therefore offer at least a partial explanation as to why traditional economic paradigms might have been challenged lately.
- In turn, this likely impacts the fundamentals driving market performance, presenting both opportunities and challenges for investors. Our view is that investors are best served by a long-term, diversified asset allocation approach, complemented by prudent tactical allocation designed to capture significant shifts in fundamental dynamics and add value during periods of uncertainty.

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The U.S. economy has outperformed the rest of the world on many fronts over the past few years. Strong and resilient household consumption, an acceleration in private investments focused on the development of artificial intelligence (AI) technologies, and persistently high government spending provide some of the clearest evidence of U.S. outperformance relative to many developed and emerging market economies. Gross Domestic Product (GDP) is the best aggregate representation of the ongoing strength of the U.S. economy and therefore provides an effective way to assess the health of the business cycle and its potential impact on market fundamentals (from corporate earnings growth to interest rates).[1] It measures the final monetary value of all goods and services that a country produces over a given period of time, usually a calendar year or a quarter. In this FocusPoint, we dig deeper into this widely used economic indicator and discuss some of the insights that it offers into how the U.S. economy is evolving.

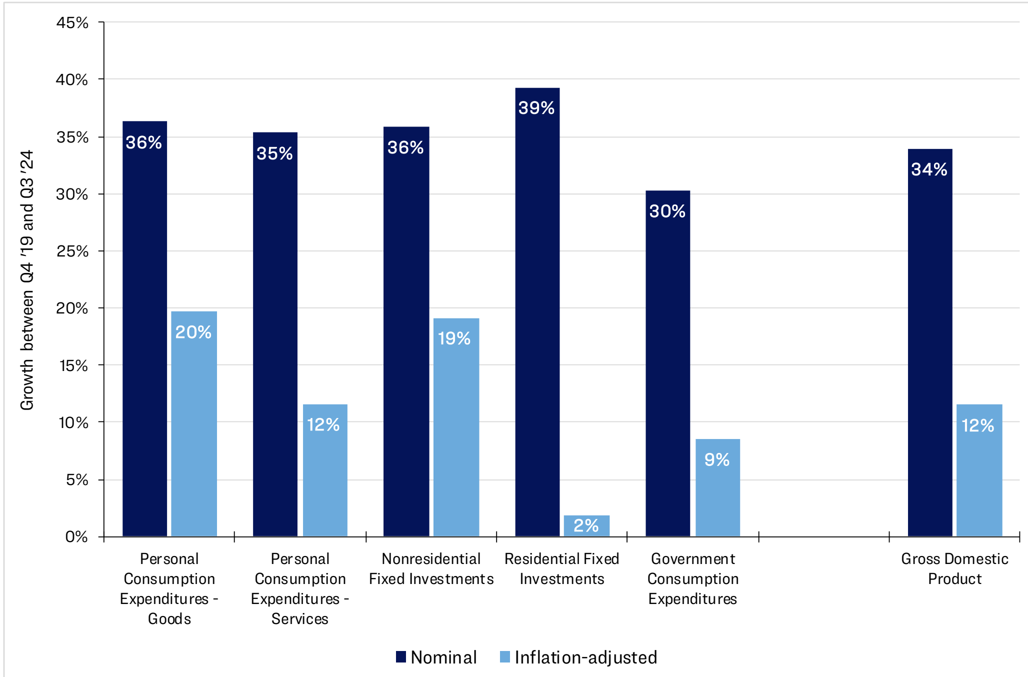
A key distinction to make when looking at GDP is between nominal and real, or inflation-adjusted, data (Figure 1). Nominal GDP expanded by 34% between the end of 2019 and Q3 2024, or 6.3% annualized. This compares to 5.6% annualized throughout the 1990s, 4% annualized throughout the 2000s and 4.1% throughout the 2010s.

[1] It is important to remember that the U.S. economy is not the equity market, and vice versa. For example, while services make up almost 70% of total household consumption, they only account for ~40% of S&P 500 earnings.

However, real GDP growth, a measure that keeps the price of the goods and services produced by the economy constant, grew more in line with the long-term trend over the same period of time (2.3% annualized). This means that almost two-thirds of the nominal economic expansion in the U.S. since 2019 stems from higher prices for goods and services.

FIGURE 1

Difference between nominal and real GDP growth between Q4 2019 and Q3 2024.



Source: Bureau of Economic Analysis, TIAA Wealth Chief Investment Office.

This discrepancy is likely unsustainable, in our view, as it signals that "real" consumption has not fully adjusted to the higher level of prices, which initially were mostly driven by COVID-related supply shocks. Encouragingly, inflation, or the rate of change in prices, has been gradually slowing since the peak in 2022, and has so far occurred without any noticeable slowdown in "real" economic activity. On average, market consensus projects real GDP to keep growing at or slightly above 2% over the next two years. But with inflation (defined as the rate of change of the personal consumption expenditures price index [PCE]) down to 2.5% year-over-year (YoY) at the end of 2024 from 6.6% in 2022, and assuming gradual further progress towards the Fed's 2% target, we expect nominal GDP growth to gradually decelerate to the long-term trend of around 4.5% annualized.

GDP is composed of four major categories:

- **Personal consumption**, which in turn can be broken down into goods consumption and services consumption. Both have risen significantly since 2019, by 36% and 35% on a nominal basis, respectively. After adjusting for inflation, "real" goods consumption has expanded by 20%, while household consumption of services, which have experienced stickier price pressure, has grown by 12%.

- **Private fixed investments**, which can also be thought of as a proxy for private capital expenditures or capital formation and are divided into residential and non-residential investments. Residential comprises the starkest discrepancy between prices and volumes. After adjusting for inflation, residential fixed investments have only expanded by 2% since 2019, even as their nominal growth is the largest among all major GDP components (39%).

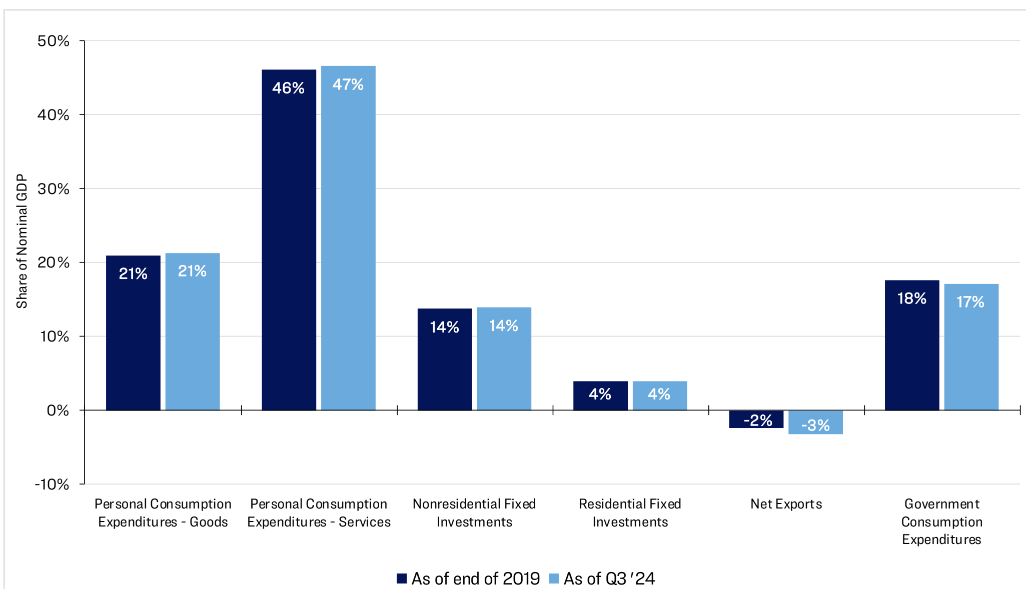
- **Net exports,** or the difference between the value of goods and services exported to other economies and the value of goods and services imported into the U.S. economy. The U.S. economy features a structural trade deficit (most recently -3% of GDP), as its perennially strong domestic consumption requires imports to complement domestic production of goods and services. This means that net exports are most often a drag on GDP growth.

- **Government consumption expenditures**, which over the past two years have expanded by 3.8% annualized, three times the average annualized pace between 1990 and 2019. This is not surprising, given that the federal government has run an average primary budget deficit[2] of ~-4% of GDP over the past two years, which compares to ~-2.2% between 2000 and 2019.

Figure 2 shows that the composition of the U.S. GDP has been fairly stable since 2019. At the margin, remarkably strong domestic consumption has led to a widening of the trade deficit, evident in the bigger drag that net exports exert on nominal GDP. But altogether, the major components of the U.S. economy have not materially changed—a symptom of a mature economy with a proven and balanced "business model."

FIGURE 2

Composition of U.S. Nominal Gross Domestic Product.



Source: Bureau of Economic Analysis, TIAA Wealth Chief Investment Office.
The sum of the parts doesn't add up to 100% due to the GDP residual.

[2] Federal budget revenue minus federal budget expenditures, net of interest payments on outstanding Treasury debt.

That said, a deeper look into the details of the national GDP accounts reveals some interesting developments over the past several years. These developments provide macroeconomic confirmation that some of the trends we have observed since the pandemic have affected the inner workings of the U.S. economy, and therefore offer at least a partial explanation as to why traditional economic paradigms might have been challenged lately (as we discuss in our most recent CIO Perspectives).

1. **Services consumption.** Healthy spending on services is crucial to ensuring trend or above-trend economic growth, as it accounts for 70% of all household consumption and more than 45% of all GDP in the U.S. Since the end of 2021, nominal services consumption has grown at an annualized rate of 8%—almost double the annualized rate between 2010 and 2019 (4.1%). As mentioned above, most of this nominal expansion is attributable to elevated price inflation. "Real" growth in services spending has expanded 3% annualized over the same period, a pace that is still significantly higher than in the 2010s decade (1.9% annualized). Service PCE inflation peaked at almost 6% YoY in 2022 but is still running at almost 4% YoY. Persistent price pressure in the service industry is increasingly creating a two-speed economy, evident in the bifurcation between low- and high-income consumers, and in spending trends. Interestingly, healthcare spending rose 5.7% annualized in 2024 as of September, double the annualized pace between 2010 and 2019. But other categories like recreational services (1.6% annualized) and food and accommodation services (-0.4% annualized) noticeably slowed in 2024.

   We draw two conclusions from these insights: 1) an aging population is keeping healthcare spending robust even against the backdrop of challenging affordability, therefore making the biggest category of services consumption less sensitive to the business cycle; 2) less-solid growth in other spending categories could be a sign that declining affordability could be starting to bite into the buying power of a growing cohort of consumers, therefore raising the stakes on how inflation evolves throughout 2025. This represents a key risk for markets in 2025, and hinges on several factors, from trade and immigration policy to geopolitics.

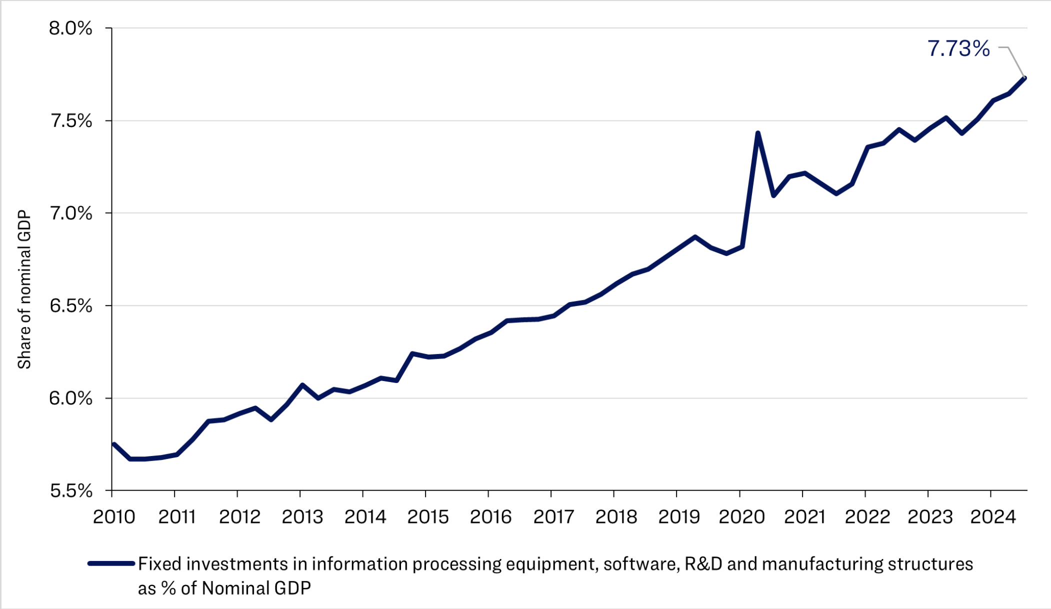
2. **Fixed investments.** This category has proven more sensitive to recurring economic and monetary uncertainty and to rising interest rates than household consumption over the past couple of years. As a result, we can observe much more dispersion within this category, with some areas having grown significantly since 2020 and others having stagnated. A deeper dive reveals how some of the most important trends that have driven corporate earnings growth, market performance and investor sentiment are already shaping the macroeconomy. We focus on two:

   a. Assessing the broad impact of AI is not straightforward. The technology has already reached a stage where it is likely affecting several segments of the economy, from capital expenditures to productivity and even spending habits. An indication of the powerful momentum behind this trend is contained within the fixed investment GDP category. The sum of investments in information processing equipment, software, research and development (R&D), and manufacturing structures (for example, data centers) as a share of nominal GDP has grown steadily since 2010, and has accelerated since 2019, up to 7.8% from 6.8% (Figure 3) even as nonresidential investments as a share of GDP have remained stable.

This highlights the tremendous growth in AI just over the past few years but also suggests this growth (for now) may have "cannibalized" other private investments, rather than complemented them.

FIGURE 3

The impact of AI-related investments on GDP.

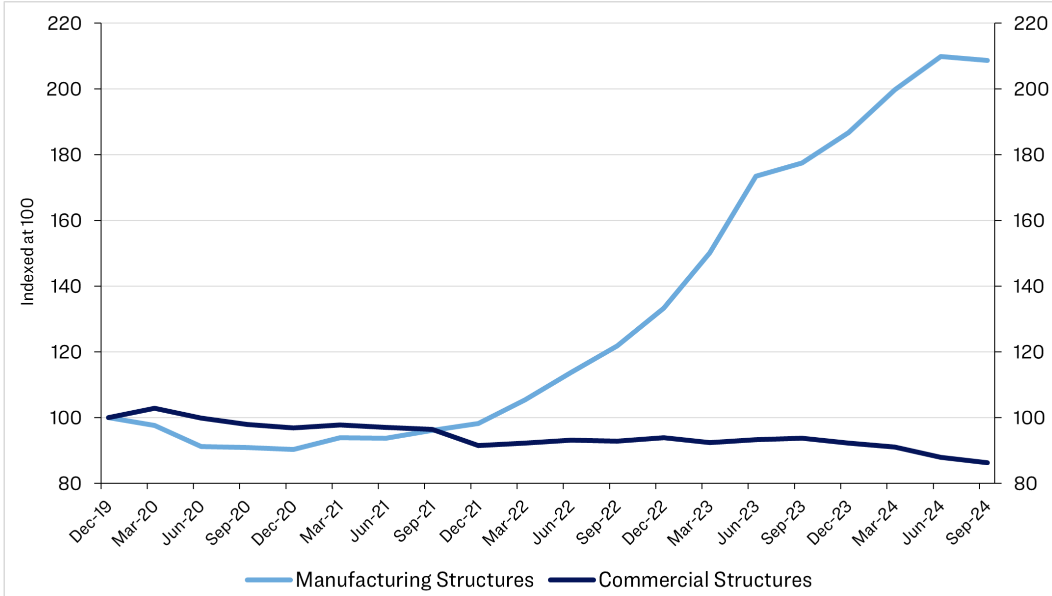


Source: Bureau of Economic Analysis, TIAA Wealth Chief Investment Office.

b. The stark contrast between the growth in manufacturing structures and commercial structures (Figure 4) provides clear evidence of how AI has supplemented rather than complemented other private investments over the past few years. After adjusting for inflation, private investments in manufacturing structures have grown by almost 110% since 2019, boosted by the construction boom in data centers and supported by funds provided via President Biden's CHIPS and Science Act aimed at insourcing the production of critical semiconductors. On the other hand, private investments in commercial structures have fallen by 14% in real terms since 2019, bogged down by changes in shopping and working habits following the pandemic, the retreat by traditional and alternative lenders providing capital to this segment, and rising delinquency rates on outstanding loans. As a result, the combination of manufacturing and power structures now accounts for 42% of total nonresidential private investments, up from 33% in 2019, while commercial structures account for 29%, down from 31% in 2019.

FIGURE 4

Private investments in manufacturing and commercial structures.



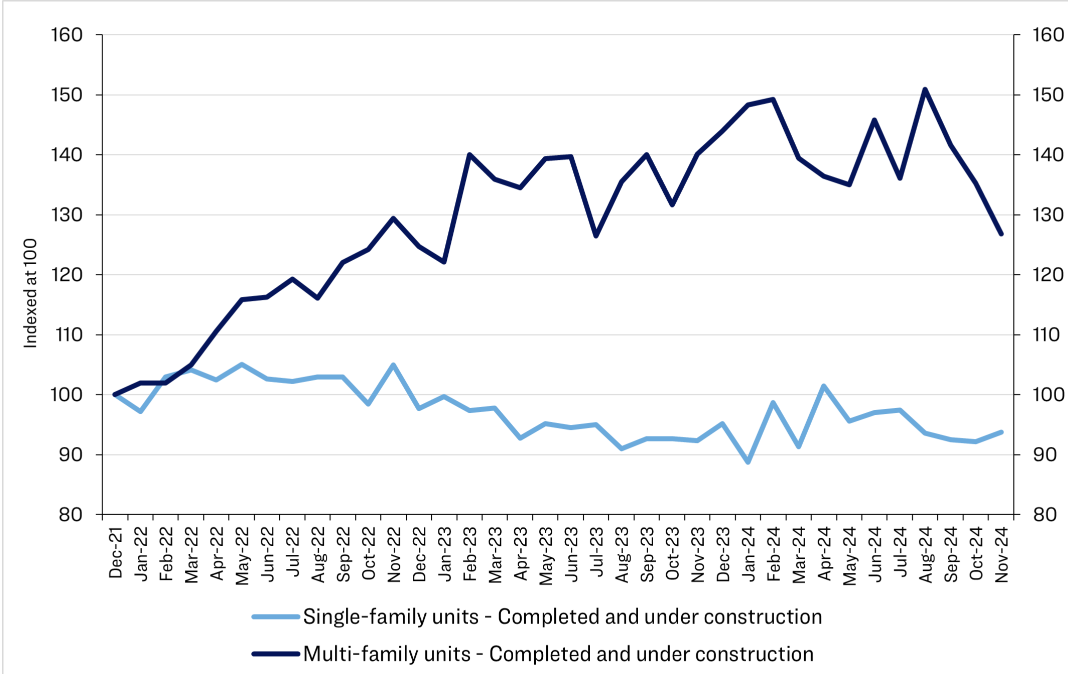
Source: Bureau of Economic Analysis, TIAA Wealth Chief Investment Office.

3. **Residential investments.** Between 2019 and 2021, both single-family and multi-family residential investments grew significantly, even in real terms (+27% and 23%, respectively). However, since 2022 single-family investments have declined by almost 19%, while multi-family investments have expanded by an additional 3%. While the sum of single-family homes completed and under construction has contracted by 11% since 2021, it has increased by 27% for multi-family units (Figure 5). This has pushed the supply of apartments above demand levels, which has begun to wane, especially in previously booming areas like the sunbelt. The inventory of multi-family units has climbed to an equivalent of 5.1 months of supply, above the 4.5 pre-COVID average, while it remains low in the single-family space (3.7 months of supply, relative to the 4.5 pre-COVID average). In turn, this has pushed vacancy and delinquency rates higher for multi-family housing, while they remain close to historical lows for single-family homes.

    a. There is plenty of evidence that the housing market is currently imbalanced, from buyer demand persistently outstripping supply of existing and new homes to the stickiness of shelter inflation even against the backdrop of dismal affordability. The recent growth gap between single- and multi-family residential investments is further proof that equilibrium in the housing market might not be within reach in the near term. The shortage of homes in the U.S. is estimated to be in the neighborhood of 3 to 3.5 million units, almost all of them single-family. And yet, since 2010 the share of residential investments represented by single-family homes has dropped from 89% to 77%.

FIGURE 5

Divergence between multi-family and single-family housing.



Source: U.S. Census Bureau, TIAA Wealth Chief Investment Office.

Conclusions

Household consumption remains the main contributor to economic growth in the U.S., which is why ongoing resilience of the current business cycle likely continues to be contingent upon the health of the labor market. However, there is plenty of evidence that the underlying composition of GDP has been evolving, and the secular nature of most of these trends suggests that the business cycle could progressively become less and less dependent on traditional economic paradigms. This in turn likely impacts the fundamentals driving market performance, presenting both opportunities and challenges for investors. Our view is that investors are best served by a long-term, diversified asset allocation approach, complemented by prudent tactical allocation designed to capture significant shifts in fundamental dynamics and add value during periods of uncertainty.

CIO FOCUS*POINT*

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