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Quarterly Review and Outlook

Fourth Quarter 2024

The Global Capacity Glut

Factories across the world are growing increasingly idle. Global industrial capacity utilization (CAPU) has fallen significantly, and a rising unemployment rate has followed suit, signaling that the available factors of production globally are progressively more redundant. The reason this is relevant is that since 1990, this thirty-four year correlation is consistent with the U.S. experience where data has been available for seven decades. As such, CAPU appears to be the dominant supply-side variable in determining inflation in the United States, China, Japan, U.K. and the EU.

CAPU - At Recessionary Levels

In the United States, CAPU has plummeted to levels lower than at the start of all of the cyclical recessions since 1967 (Chart 1). This vividly reflects a significant underutilization of resources, a circumstance which has historically led to moderating economic growth. Based on nearly complete fourth quarter 2024 data, the U.S. CAPU is estimated to have been 76.9%, a significant 3.2 percentage points lower than the post-1967 average and 6 percentage points below the historical level of 82.9%, which is the average entry level for the cyclical recessions. This surplus capacity reflects an irregular cyclical decline in industrial production from the fall of 2022.

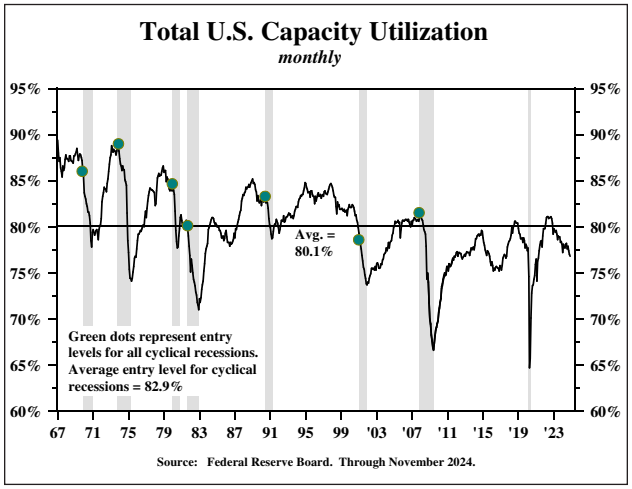

Chart 1

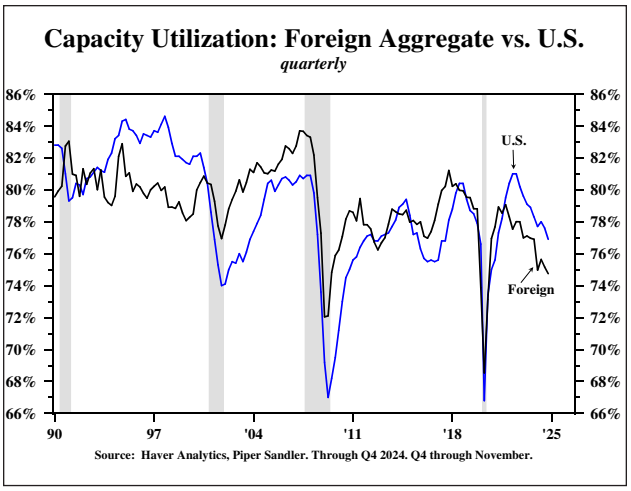

Chart 2

The estimated level of CAPU outside the U.S. in the fourth quarter was 74.8%, 4.3% lower than its post-1990 average of 79.1%. Since 1990, foreign CAPU has generally led U.S. CAPU (Chart 2). The lead time of foreign CAPU over the U.S. has been strikingly evident for the past ten years. During this period, foreign economies consistently underperformed that of the U.S. In late 2024 all four major foreign region's CAPU was significantly less than their post-1990 averages. As shown in Table 1, the latest CAPU in the U.K., the EU, Japan, and China were below their post-1990 averages by 9.5%, 4.7%, 15.9%, and 2.2%, respectively. This capacity glut explains why

 (please see disclosures on last page)

U.S. Capacity Utilization vs. Major Foreign Economic Regions

		Post 1990 Average	Latest	Latest % Change from Average	Latest Straight Change from Average
		1.	2.	3.	4.
1.	U.S.	78.8%	77.1%	-2.2%	-1.7%
2.	U.K.	79.6%	72.0%	-9.5%	-7.6%
3.	China	76.7%	75.0%	-2.2%	-1.7%
4.	Japan	82.8%	69.6%	-15.9%	-13.2%
5.	Euro Area	80.7%	76.9%	-4.7%	-3.8%
6.	Foreign Aggregate Less U.S.	79.1%	74.8%	-5.4%	-4.3%

Source: Haver Analytics, Piper Sandler.

Table 1

China, the world's leading manufacturing economy, is experiencing outright goods deflation. With the yuan depreciating in the foreign exchange markets, China's goods deflation is being transmitted globally.

The four CAPUs for these economic regions illustrate the well-established concept of global interconnectedness (Chart 3). This concept underscores the fact that the economic performance of one region can significantly impact the others, even though the individual areas have different financial conditions, fiscal policies, demographics, aggregate debt levels, political regimes, methods of statistical collection, and a host of idiosyncratic considerations. This interconnectedness became more pronounced after the Great Financial Crisis, also reflecting the much closer global coordination of monetary and fiscal policies, even in 2024 when Japan was the only country not to reduce their key monetary policy interest rate. CAPU in all five regions declined sharply during the worldwide pandemic, thus serving to authenticate the econometric estimates. (please see 'Note on the Methodology of the Econometric Calculations' on page 3)

Rising Unemployment: A Pivotal Factor in Economic Growth

The U.S. unemployment rate (UR) has risen from a low of 3.4% in April of 2023 to 4.1% in December of 2024, an increase of 20.5%. This rise in unemployment was mainly a result of a highly noteworthy loss of six hundred twenty four thousand jobs in the private sector of the household survey, which reached its cyclical peak in 2023. The global aggregate UR for all five countries has also moved higher (Chart 4). By the end of 2024, the global aggregate UR had risen sufficiently to return to the level at the end of 2022, pointing to slower economic activity and weaker investment and, in turn, weaker consumer spending.

Three rules linking the unemployment rate to recession are worthy of discussion. These rules provide a framework for evaluating the lag between a rising UR and the magnitude of an increase in the UR before the start of an economic contraction. First, Edward McKelvey, a retired Goldman Sachs economist, found that when the current value of the

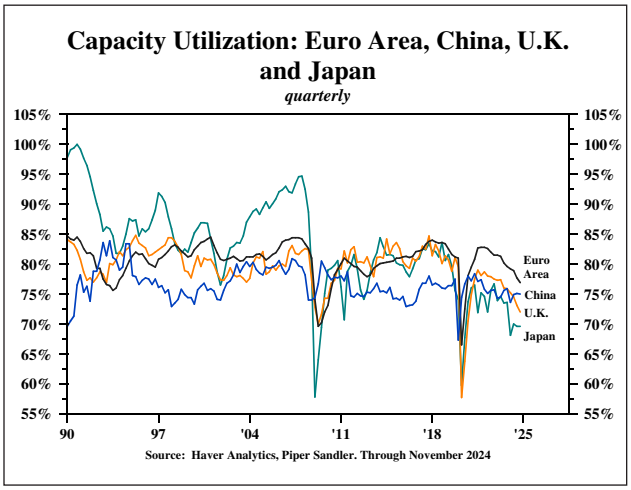

Chart 3

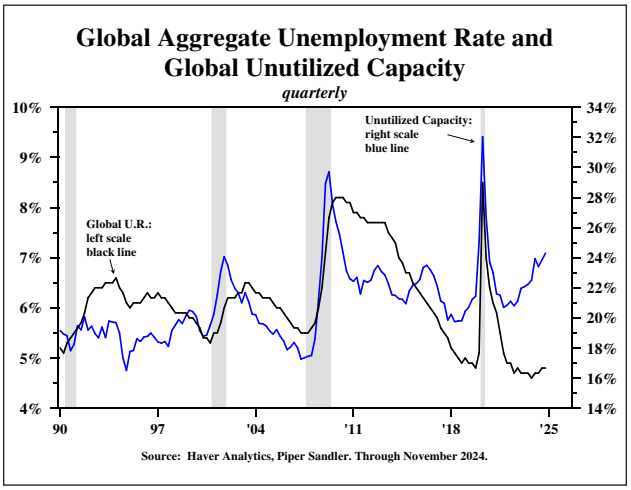

Chart 4

3-month moving average of the UR is subtracted from its 12-month low, and the difference is 0.2 percentage points or more, then a recession is likely to occur. Next, a former Fed economist, Claudia Sahm, found that the recession hurdle is for a difference of 0.5 percentage points, similar to McKelvey's rule. Third, writing in the December 20, 2024, edition of 'Mish Talk', macroeconomic writer Mike Shedlock calculated a recession is triggered by a 0.015 percentage point difference between the current 3-month moving average from its five-month low. Shedlock's procedure also eliminated recession calls when prolonged high unemployment was part of a continuing recession, not a new business cycle. Shedlock's rule was based on data dating back to 1948, a more extended sample period than either McKelvey or Sahm.

The McKelvey and Shedlock indicators currently exceed their recession entry levels. The Sahm indicator would be triggered by 0.1 percentage point increase in the 3-month average. Although widely rejected, the risk of an oncoming economic contraction remains elevated, an event that would further increase the overhang of excess capacity.

Inflation and Bond Yields

Historically, on an annual basis, there has been a high correlation between the thirty-year Treasury bond yield and the inflation rate. That relationship did not hold in the past two years when the long bond yields rose even though the inflation rate moved downward. Despite this recent divergence, inflation and the long bond yield moved in the same direction for 71% of the years since 1954, when Treasury bond yields started trading freely. Historically, such divergences have been brief.

The previously discussed fundamental determinants of inflation indicate the prospects for slower price increases are even more significant than in any year since the late 1990s. In addition to the growing factory capacity glut and rising UR, the percent decline in modernized world dollar liquidity (WDL) reached another record low in the fourth quarter. The accelerating decline in WDL will intensify the liquidity/money squeeze domestically and globally. We estimate the trend adjusted real M2 declined further in the fourth quarter. Since the Fed's first reduction in the policy rate in September, critical consumer and small business borrowing rates have remained unchanged or increased. Such considerations argue that lower inflation will lead to a surprising drop in thirty-year Treasury bond yields in 2025.

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Note on the Methodology of the Econometric Calculations

Rigorous data collection and econometric modeling have been instrumental in filling in voids needed to derive measures of CAPU for the past thirty-four years. The methodology used is the same as that used by the Board of Governers of the Federal Reserve System. For the U.K., a more extended time series was constructed by econometrically linking industrial production into a discontinued CAPU series, deriving a U.K. series from 1990 to the present. Conversely, China currently publishes CAPU, but the series has only been available for the latest decade. Based on the extended historical industrial output data, an econometrically derived CAPU was estimated from 1990 to the start of currently published data. Econometric backcasting was also used to fill historical gaps in the EU data. Japan's CAPU was reindexed to 100% at the secular all-time high in late 1990 when their two-decade boom started to unravel. As such, Japanese CAPU has an upper bound of 100 and is thus consistent with the other four economic regions.

DISCLOSURES

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