Economic Update

FIRST QUARTER 2024

APRIL 3, 2024

1Q2024 - LONGEST INVERSION EVER?

Although forecasts at year-end were calling for aggressive policy rate cutting to start as early as March, here we sit with virtually no change in policy stance and no cuts, interest rates selling off, and a yield curve that remains inverted. In fact, the curve has been inverted for the past 21 months, going back to July of 2022. This matches the longest inversion on record, and it is worth noting that the inversion could go on for considerably longer. The previous longest period of inversion started in August of 1978 and ended in May 1980, at which time the curve steepened considerably for four months. By September of 1980, however, the curve was inverted once again and remained so for an additional 13 months. All totaled, between August 1978 and June 1982, 2s vs 10s was inverted for 39 out of 47 months.

Importantly, there is nothing indicating the curve needs to "normalize" anytime soon. Personal consumption remains resilient, labor markets are relatively healthy, business activity is on the upswing, and inflation may be gaining steam. The Federal Reserve (Fed) has signaled it is more than comfortable being patient and short rates have already stayed "higher for longer" than anyone expected. With the risk of recession fading, despite tighter monetary policy, risk assets have been on fire: the S&P 500 was up 10% in 1Q while credit spreads moved tighter. The U.S. Government continues to run massive budget deficits without any real penalty. By some measures, term premiums further out the curve are non-existent or even negative. In sum, financial conditions are easier today than before the Fed started tightening policy.

4Q GDP growth measured 3.4% q/q annualized, bringing full-year 2023 growth to 3.1% y/y. Personal consumption accelerated again to 3.3% q/q annualized from 3.1% q/q annualized in 3Q. Gross private investment fell considerably to only 0.7% q/q annualized on weaker residential fixed investment. Notably, within residential fixed investment, permanent site investment (single family and multifamily structures) was dragged down by -4.5% q/q annualized investment in multifamily structures. Looking ahead, 1Q GDP growth is expected to be 1.5%-2.5% q/q annualized, with continued consensus regarding economic strength and the avoidance of recession. Full-year growth for 2024 is now projected to be 2.0%-2.5%. Recession probabilities continue to move lower and, as we have pointed out over the past two quarters, forecasts calling for a mild recession have been virtually eliminated.

FED STILL EXPECTS POLICY EASING, EVENTUALLY

In its final meeting of 2023, the Fed stayed on hold and provided a dovish message indicating interest rate cuts would be forthcoming in 2024. The market had been begging for a dovish "pivot" and with the message finally received, futures priced in a whopping seven policy rate cuts by January 2025, despite the updated December Summary of Economic Projections (SEP) dot plot suggesting a median of only three cuts in 2024. The Fed stayed on hold in January and signaled that while its next move would likely be a cut, the timing of it would be data dependent.

Quarterly Key Points

- 1Q GDP growth is expected to be 1.5%-2.5% q/q annualized, with continued consensus regarding economic strength and the avoidance of recession. Full-year growth for 2024 is now projected to be 2.0%-2.5%.
- The Fed stayed on hold again in March and reiterated its message of patience. The updated SEP showed median year-end 2024 Fed Funds at 4.625%, suggesting the Fed still anticipates cutting three times this year. For now, market expectations have converged with Fed messaging.
- Progress towards meeting the Fed's 2% inflation target has slowed considerably, and there are signs that inflation is headed higher once again. At the very least, it is fair to say inflation has proven stickier than hoped, and the Fed has been justified in taking an extended pause before easing.
- There is nothing indicating the curve needs to "normalize" anytime soon. Personal consumption remains resilient, labor markets are relatively healthy, and business activity is on the upswing.
- Mortgage rates have increased, commensurate with a broader selloff in Treasury rates and reduced expectation of Fed cuts in 2024. Existing home sales activity has improved but is still at low levels, historically speaking. New home sales are back to very near the pre-pandemic trend.

Our View

- The broader economy and markets have tolerated policy tightening much better than expected. As of now, there is a relatively high degree of congruence between the Fed's messaging and market expectations for rate cuts this year. A steeper curve seems to be at hand, but normalization is not a foregone conclusion anytime soon.
- Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Nevertheless, we remain cautious and cognizant that the biggest risks are unexpected. We continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

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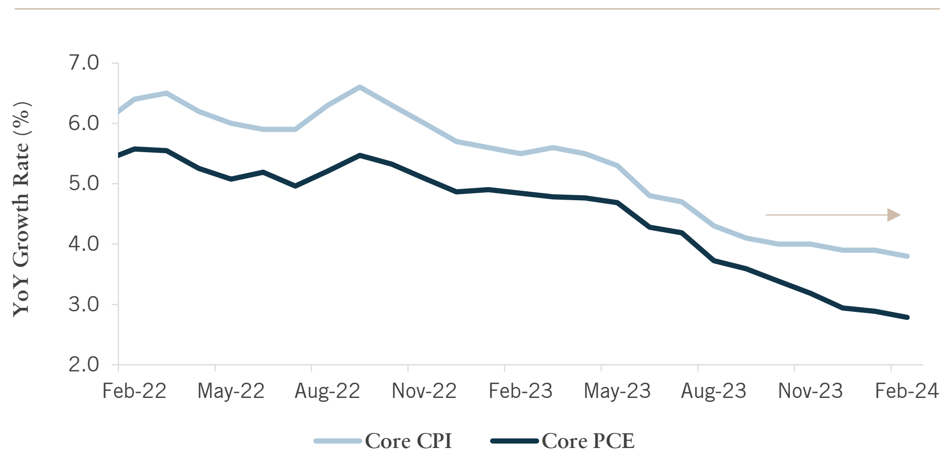
1Q'24 ECONOMIC UPDATE

By the time the March meeting rolled around, the market was digesting two months' worth of stubborn inflation numbers and a paring back of interest rate bets, pushing cuts out to mid-summer and reducing expectations to only three or four cuts. The Fed stayed on hold again and reiterated its message of patience. Furthermore, the updated SEP showed median year-end 2024 Fed Funds at 4.625%, unchanged from December, suggesting the Fed still anticipates cutting three times this year. Further, it does not believe a recession is on the horizon. For now, market expectations have converged with Fed messaging.

INFLATION STALLS OUT ABOVE 2%

FIGURE 1: CORE CPI VS. CORE PCE[1]



[1]Source: Bloomberg.

Progress towards meeting the Fed's 2% inflation target has slowed considerably (Figure 1), and there are signs that inflation is headed higher once again. Last quarter, we noted some concern about the easing of financial conditions related to rallying interest rates and the run-up in equity prices, and the possibility of this leading to more inflation. Many are also pointing to continued Government deficit spending as a contributor to stubborn inflation. Whatever the underlying cause, it is fair to say inflation has proven stickier than hoped, and the Fed has been justified in taking an extended pause before easing.

Headline CPI measured 3.4% y/y, 3.1% y/y, and 3.2% y/y in December, January, and February respectively, while core CPI increased by 3.9% y/y in both December and January, and 3.8% y/y in February. On a month-over-month basis, headline CPI jumped to 0.3% in January and 0.4% in February. Core CPI followed suit, increasing by 0.4% m/m in both January and February. PCE inflation numbers show a similar pattern. Headline PCE bottomed out at 2.4% y/y in January but then accelerated to 2.5% y/y February. Measured month-over-month, headline PCE jumped back up to 0.4% and 0.3% in January and February after three months of essentially 0.0% change. Core PCE came in at 2.9% y/y and 0.5% m/m in January and 2.8% y/y and 0.3% m/m in February.

Inflation expectations have increased as well. 2-year breakeven inflation rates widened by 70 bps (0.70%) to 2.72% and 5-year breakevens drifted up by 29 bps to 2.44%. Meanwhile, 10-year breakeven rates increased by 15 bps to 2.32% and the 5-year, 5-year forward breakeven increased by a smaller amount, to 2.25%. In our view, the stability of longer-term inflation expectations is comforting, but the rapid increase in shorter-term inflation expectations brings rate cuts this year into question somewhat. The 2-year Treasury sold off by 37 bps while the 10-year Treasury sold off by 32 bps, leaving the curve inverted by 42 bps. Virtually all the adjustment happened in February when it became apparent that progress on inflation was stalling out.

ECONOMY REMAINS RESILIENT

Broadly speaking, the economy continues to hold its own. On the consumer side, the labor market remained strong to start the year, with 229k and 275k jobs added in January and February, respectively. While job gains have consistently been stronger than expectations, revisions have been downward in every month but two since the beginning of 2023. Although many of the revisions remain above initial expectations, the signal is that job creation has been slightly weaker than initially advertised. The unemployment rate ticked up to 3.9% in February. Total employment is lower by ~900k workers over the past three months while the labor force is lower by ~700k. Initial jobless claims remain

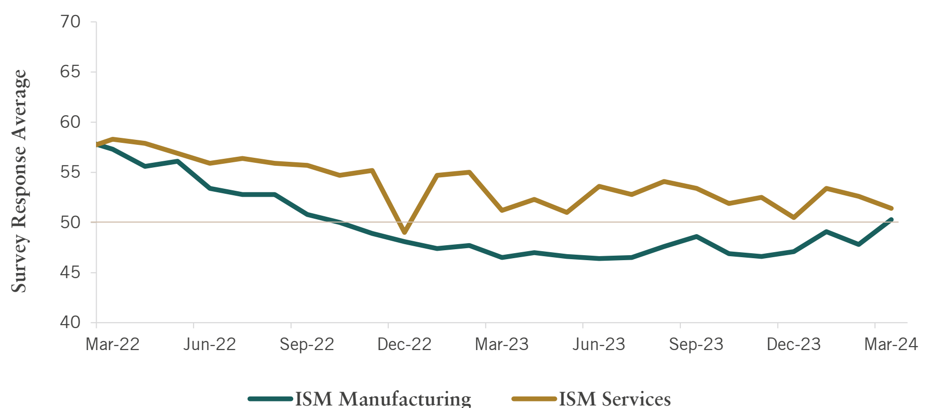
low, registering only 210k in late March. The often-cited ratio of job openings to unemployed workers is now 1.37 marking the lowest measurement since fall of 2021.

Personal income growth jumped to 4.9% y/y in both December and January before falling slightly to 4.6% in February. While still robust, this is a full percentage point lower than the 5.5%-5.8% y/y measurements in the first half of last year. Monthly measurements have generally been 0.2%-0.4% m/m for the past year. Nominal hourly earnings growth followed a similar pattern, falling to 0.1% m/m in February after an outsized 0.5% m/m in January. With a few exceptions, nominal hourly earnings growth has been between 0.3% m/m to 0.4% m/m every month since April 2022. With inflation trending lower, nominal wage gains are translating into real wage gains. Year-over-year real hourly earnings have been positive in every month since May 2023, most recently measuring 1.3% y/y and 1.1% y/y in January and February, respectively.

The University of Michigan Consumer Sentiment Index has been hovering at just below 80 so far in 2024. These are the highest consumer sentiment readings since the middle of 2021. While this is still considerably lower than pre-pandemic, and there is a fair amount of monthly variation, the upward trend that is emerging is undeniable. Nominal personal consumption expenditures increased by 0.8% m/m in February after slipping back to 0.2% m/m in January. PCE core followed a similar pattern, gaining 0.4% m/m in February following a -0.2% m/m reading in January.

Personal savings measured as a percentage of disposable income has trended lower since early summer 2023, measuring only 3.6% in February. This suggests that consumers in the aggregate are not able to save as much as a percentage of their disposable income, most likely due to inflation. An alternative narrative that incorporates the wealth effect posits that with household net worth at an all-time high, saving is not a priority. Consumer revolving credit has consistently grown at an elevated rate over the past year. The most recent measurement in January came in at 7.7% m/m annualized and 8.5% y/y. As a percentage of nominal GDP, consumer revolving credit outstanding has yet to return to pre-pandemic trend; however, we acknowledge that the trajectory of the absolute dollar amount outstanding is somewhat concerning.

FIGURE 2: ISM MANUFACTURING AND SERVICES[2]



[2]Source: Bloomberg.

Mortgage rates, as measured by the Freddie Mac Weekly Survey rate, have increased, commensurate with the broader selloff in Treasury rates and reduced expectation of Fed cuts in 2024. Existing home sales jumped to 4.4 million annualized in February, marking the highest measurement in almost a year; however, this is still a very low level of activity, historically speaking, comparable to 2010-2011 when the market was emerging from the GFC. New home sales increased to 662k units annualized in February. This is very near the pre-pandemic trend that was in the 600k to 650k range. Existing home supply remains very low at ~3 months. Many argue that the low level of existing home supply is evidence of a strong lock-in effect, whereby existing homeowners with low mortgage rates are unwilling to move because they have "locked-in" extremely low financing. The supply of new homes, on the other hand, remains elevated at ~8 months of supply, well above pre-pandemic levels.

Business activity has also started to bounce back, with the ISM Manufacturing PMI improving to 50.3 in March, marking the first expansionary reading since October 2022 (Figure 2). We note a consistent upward trend that started in late 2023 and accelerated during the first quarter with readings of 49.1 and 47.8 in January and February, respectively. Business new orders have also moved into expansionary

territory, measuring 52.5 in January, 49.2 in February, and 51.4 in March. The ISM Services PMI has consistently been around 50-55 for the past year, recently registering 53.4, 52.6, and 51.4 in January, February, and March, respectively.

LOOKING AHEAD

It has been two years since the Fed started tightening monetary policy. Overall, the broader economy and the markets have tolerated this policy tightening regime much better than expected. Since pausing hikes in mid-2023, the Fed has stuck to its guns, despite an almost constant drone advocating for aggressive interest rate cuts. As of now, the market has capitulated, leading to a relatively high degree of congruence between the Fed's message and market expectations for rate cuts this year. Benign forecasts reflecting continued economic resilience and the avoidance of a recession are now consensus and risk assets are sending an "all clear" signal.

Nevertheless, we remain cautious and cognizant that the biggest risks are unexpected. Policy rates often go up the staircase and down the elevator, and we could be only one surprise away from a dramatically different investment landscape. The yield curve has been inverted for 21 months, matching the longest continuous period of inversion on record. A steeper curve seems to be at hand, but normalization is not a foregone conclusion anytime soon. Accelerating inflation continues to be a risk and, while not our current expectation, it would not be without precedent for the Fed's next move to be a hike.

This extended period of restrictive monetary policy means liquidity could quickly become a concern and volatility in risk assets could return reflecting fatter tails and the risk of unintended consequences. Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add value where yields and spreads look relatively attractive. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

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