Economic Update

SECOND QUARTER 2024
JULY 3, 2024

Quarterly Key Points

- 1Q GDP growth was revised down to only 1.4% q/q annualized after an initial estimate of 1.6%. Personal consumption retreated to 1.5% q/q annualized from 3.3% in 4Q. 2Q GDP growth is expected to be 1.7%-2.0% q/q annualized while full-year growth for 2024 is projected to be 1.5%-2.5%.
- The Fed remained on hold throughout the quarter, leaving rates unchanged at both its May and June meetings. The updated SEP showed median year-end 2024 Fed Funds at 5.125%, suggesting the Fed anticipates one cut this year. Market expectations are leaning towards two cuts by the end of the year, with the first coming in September or November.
- After bouncing somewhat higher in the first quarter, inflation is once again heading in the right direction with major inflation measures falling over the past several months, regardless of the basis (y/y, m/m, rolling 3-month). Additionally, the rate of change also appears to have increased across a number of measures.
- Interest rates whipsawed throughout the quarter as the market repriced monetary policy and inflation expectations. The 2-year Treasury ended the quarter at 4.76%, 14 bps higher than at the end of March, while the 10-year Treasury finished at 4.40%, 20 bps higher. The net result is the curve remains inverted by 36 bps.
- As we head into mid-year, broad economic measures are becoming more harmonized. The labor market has a slightly weaker tone relative to the start of the year, with 165k and 272k jobs added in April and May, respectively. The ISM Manufacturing PMI fell back to 48.5 in June after briefly measuring above 50 in March. The ISM Services PMI fell to 48.8 in June, marking the second contractionary reading in the past three months, and the lowest in the past four years.

Our View

- Market expectations are in-line with the Fed's projections and volatility remains relatively low. Nevertheless, we remain cautious. The trajectory of economic slowing could accelerate, and we are reminded that policy rates often go up the staircase and down the elevator. Alternatively, inflation could re-ignite leading to an extended period of restrictive monetary policy.
- Going forward, we will continue to opportunistically add spread where valuations make sense. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

2Q2024 - BLIND SQUIRRELS & BROKEN CLOCKS

For the past several years, we have been living with an almost constant economic forecast: a recession is 3-6 months away. The prediction is logical. After all, the yield curve has been deeply inverted, consumers have experienced dwindling "excess savings" and ballooning credit card debt, and labor markets have been dissected to find underlying weakness. This would ultimately lead to the Federal Reserve (Fed) aggressively easing monetary policy and a significantly steeper yield curve. However, as these forecasts failed to materialize, counterfactuals provided ample support - like the golfer who would easily break 80 if not for all the double bogeys and three putts, we heard a lot of "if you take out X, Y, and Z, inflation is actually falling fast."

Our intent here is not to throw economic prognosticators under the bus. The past handful of years have been unusual to say the least, with many previously existing economic relationships coming into question. Behind each forecast, there were inconsistencies in the data and sufficient evidence to take an opposing view. However, as we head into mid-year, broad economic measures are becoming more harmonized. Inflation numbers are all trending lower, labor markets finally have a hint of slack, and consumer spending and business activity have slowed. Even market expectations are aligned more closely with the Fed. As the sayings go "even a blind squirrel finds a nut once in a while" and "even a broken clock is right twice a day." Whatever the phrase, it seems the blind squirrel and the broken clock may finally have their day in the sun, to a certain degree.

1Q GDP growth was revised down to only 1.4% q/q annualized after an initial estimate of 1.6%. Personal consumption retreated to 1.5% q/q annualized from 3.3% in 4Q, while gross private investment picked up to 4.4% q/q annualized on strong residential investment of 16.0%. Notably, within residential fixed investment, single family permanent site investment remained strong at 16.8% q/q annualized, while multifamily investment fell for the second quarter in a row to -7.8%. Looking ahead, 2Q GDP growth is expected to be 1.7%-2.0% q/q annualized while full-year growth for 2024 is projected to be 1.5%-2.5%. Recession probabilities remain low with the median recession probability forecast on Bloomberg down to only 30%.

FED EASING EXPECTED BY END OF YEAR

The Fed remained on hold throughout the quarter, leaving rates unchanged at both its May and June meetings (no meeting in April). In May, the Fed reiterated a patient stance in the face of stubborn inflation through the early part of the year. As a result, market expectations regarding rate cuts were pushed out to later in the year, with the distinct possibility of no cuts in 2024 momentarily entering the debate. However, the Fed did slow the rate of quantitative tightening by reducing the runoff cap for Treasury securities to $25 billion per month and suggested that additional hikes were unlikely.

In June, the official statement noted that "there has been modest further progress towards the Committee's 2 percent inflation target." The updated Summary of Economic Projections (SEP)

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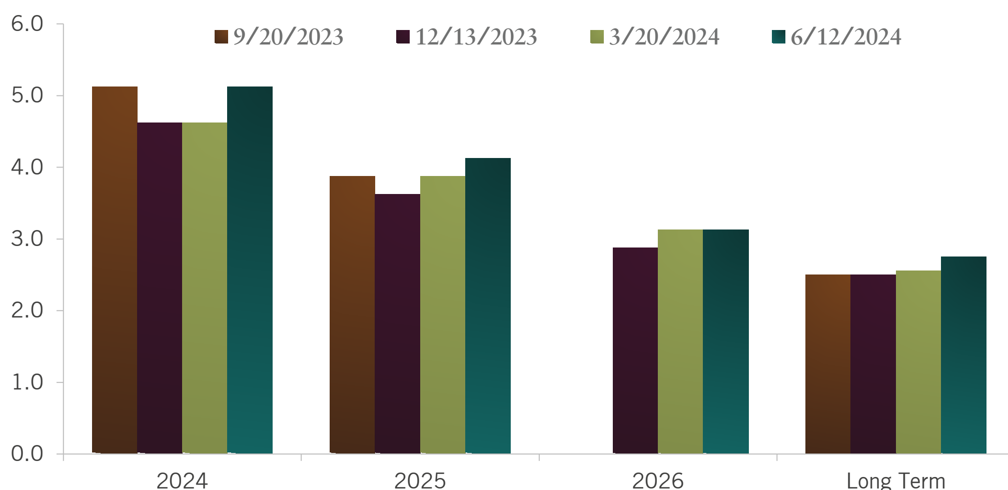
showed median year-end 2024 Fed Funds at 5.125%, suggesting the Fed anticipates one cut this year (Figure 1). This is two cuts less than the March SEP. The median projection for full-year 2024 GDP growth remained at 2.1% while the median projection for the 2024 year-end unemployment rate was also unchanged at 4.0%. The median core PCE inflation projection for 2024 increased to 2.6% from 2.4%, consistent with fewer projected cuts. Market expectations are leaning towards two cuts by the end of the year, with the first coming in September or November.

FIGURE 1: FOMC MEDIAN FED FUNDS RATE PROJECTIONS (%)[1]



[1]Source: Federal Reserve.

INFLATION BACK ON TRACK

After bouncing somewhat higher in the first quarter, inflation is once again heading in the right direction with major inflation measures falling over the past several months, regardless of the basis (y/y, m/m, rolling 3-month). Additionally, the rate of change also appears to have increased across a number of measures. Headline CPI measured 3.5% y/y, 3.4% y/y, and 3.3% y/y in March, April, and May respectively, while core CPI increased by 3.8% y/y, 3.6% y/y, and 3.4% y/y during the same time periods. On a month-over-month basis, headline CPI fell to 0.0% in May while core CPI increased by only 0.2%. Rolling averages imply an annualized run rate of approximately 2.5% to 3.5%, still higher than the Fed's target but trending lower. Furthermore, the rate of change in month-over-month numbers is accelerating such that our rolling 3-month analysis is lagging, and the true run rate is perhaps even lower.

PCE inflation numbers show a similar pattern. Headline PCE fell back to 2.6% y/y in May after bouncing up to 2.7% y/y for several months. Measured month-over-month, headline PCE fell to 0.0% in May after three consecutive 0.3% monthly readings. Core PCE slipped back to 2.6% y/y and 0.1% m/m in May. 2-year breakeven inflation rates fell back down to 2.11% while all other measures of longer-term inflation ended the quarter largely unchanged. 5-year, 10-year, and 5-year, 5-year forward breakeven rates all ended within basis points of each other in the 2.25%-2.30% range. In our view, the decrease in 2-year inflation expectations and the stability of longer-term inflation expectations are consistent with the Fed easing at some point in the not-too-distant future.

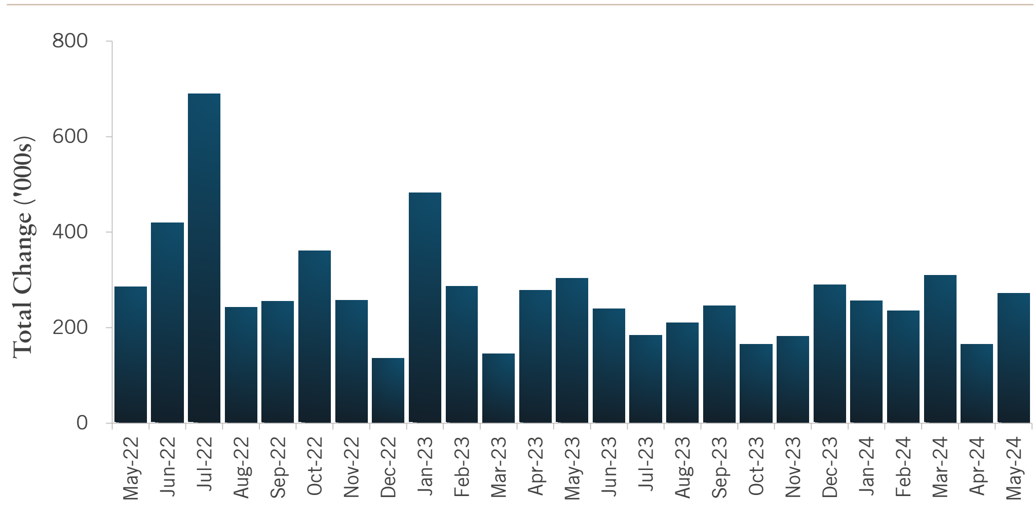
Interest rates whipsawed throughout the quarter as the market repriced monetary policy and inflation expectations. The curve sold off in April, continuing a trend that started in the first quarter. 2-year Treasuries briefly broke through 5% while 10-year Treasuries touched 4.70%. With inflation showing no signs of slowing, talk of a 5% 10-year entered the discussion. However, by May broader economic trends reversed along with Fed sentiment, leading to a rally that retraced rates almost back to where they started the quarter. The 2-year Treasury ended the quarter at 4.76%, 14 basis points (bps, 0.14%) higher than at the end of March, while the 10-year Treasury finished at 4.40%, 20 bps higher. The net result is the curve remains inverted by 36 bps. The adjustment was almost entirely in real rates with 10-year real rates higher by 23 bps.

KEY ECONOMIC INDICATORS SHOW SIGNS OF SLOWING

The labor market has a slightly weaker tone relative to the start of the year, with 165k and 272k jobs added in April and May, respectively (Figure 2). While job gains continue to beat expectations, it is noteworthy that revisions have been downward more times than not over the

recent past. The unemployment rate has slowly increased to 4.0% in May. The labor force is higher by 300k over the past three months while total employment is only higher by 115k. Unemployment claims, while still well within historical norms, appear to be slowly increasing. Job openings have fallen rapidly to 8.0 million jobs available, while the quits rate has been steady at 2.2% for the past handful of months. The often-cited ratio of job openings to unemployed workers is down to 1.21, marking the lowest measurement since summer of 2021.

FIGURE 2: NON-FARM PAYROLLS[2]



[2]Source: Bloomberg.

Business and consumer activity also slowed during the quarter. The ISM Manufacturing PMI fell back to 48.5 in June after briefly measuring above 50 in March. ISM business new orders followed a similar pattern, falling back to just 45.4 in May and 49.3 in June after increasing into expansionary territory earlier this year. The ISM Services PMI fell to 48.8 in June, marking the second contractionary reading in the past three months, and the lowest in the past four years. After robust growth in first quarter, retail sales dipped lower throughout the spring. Adjusted retail sales measured -0.2% m/m in April and only 0.1% m/m in May. Nominal personal consumption expenditures increased by 0.2% m/m in May after slipping to only 0.1% m/m in April. PCE core followed a similar pattern, gaining 0.3% m/m in May following a -0.1% m/m loss in April.

On a positive note, personal income growth has slowly increased back to 4.6% y/y in May after hovering at 4.3% y/y earlier this year. While still healthy, this is slightly slower growth than the 5.5%-5.8% y/y measurements in the first half of last year. Measured year-over-year, nominal income growth has measured 4.0%-4.1% y/y since March. Year-over-year real hourly earnings have been positive in every month since May 2023, more recently measuring 0.5% and 0.8% in April and May, respectively. The personal savings rate measured as a percentage of disposable income has been holding steady at just under 4% since last fall.

Mortgage rates, as measured by the Freddie Mac weekly survey rate, ended 2Q almost exactly where they started at 6.9%. Despite the busy spring/summer housing season, existing home sales volume slipped back to only a 4.1-million-unit annualized pace in May. As we have highlighted repeatedly, this is comparable to the 2010-2011 timeframe when the housing market was emerging from the GFC. New home sales also slipped to 619k units annualized in May. This is very near the pre-pandemic trend of 600k to 650k. Existing home supply remains very low at ~4 months while the supply of new homes, on the other hand, remains elevated at ~9 months.

LOOKING AHEAD

Virtually all measures of inflation are trending lower once again after a discouraging first quarter and the broader economy appears to be cooling in a controlled fashion. The Fed has indicated that monetary policy easing is forthcoming, so long as lower inflation trends continue. Market expectations are in-line with the Fed's projections and volatility remains relatively low. Nevertheless, we remain cautious. The trajectory of economic slowing could accelerate, and we are reminded that policy rates often go up the staircase and down the elevator. Alternatively, inflation could re-ignite leading to an extended period of restrictive monetary policy. The upcoming election is an added source of uncertainty.

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2Q'24 ECONOMIC UPDATE

Although policy easing is on the horizon, an extended period of restrictive monetary policy means liquidity will continue to be 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 spread where valuations make sense. 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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