Economic Update

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THIS MONTH

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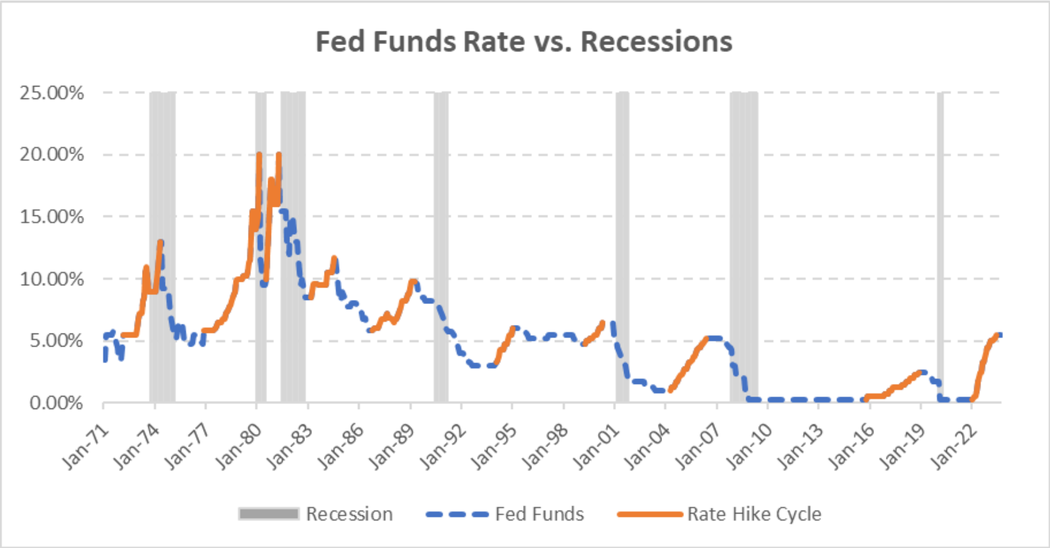
Commentary

The markets ended 2023 in a celebratory mood. Thanks to a strong fourth quarter rally, equity markets (based on the S&P 500) ended the year near an all-time high and up 24%. In addition, bond market prices soared with yields experiencing their largest two-month decline since 2008 (the 10-year yield declined by 100 basis points). The initial impetus for the gains in the financial markets was better-than-expected progress on the inflation front. Inflation levels are lower by two-thirds since they peaked near 9% in the middle of 2022.

The Federal Reserve kept the party going by not pushing against market expectations of declining rates (as many expected that they would) at the conclusion of their mid-December meeting. The Fed now expects to cut rates by 75 basis points in 2024 and by almost 200 basis points by the end of 2025. In studying the 10 rate hiking cycles over the past 50 years, the only consistent pattern has been that once the hiking cycle is over, a rate cut comes relatively soon. The average time from the last hike to the first rate cut has been only five months. Since the last cut was in July, we are already at the five month point in this cycle. It is also interesting to note that 20% of the rate hiking cycles (in 1984 and 1994) did not end in a recession even though the popular press denotes a much smaller percentage (see the graph below).



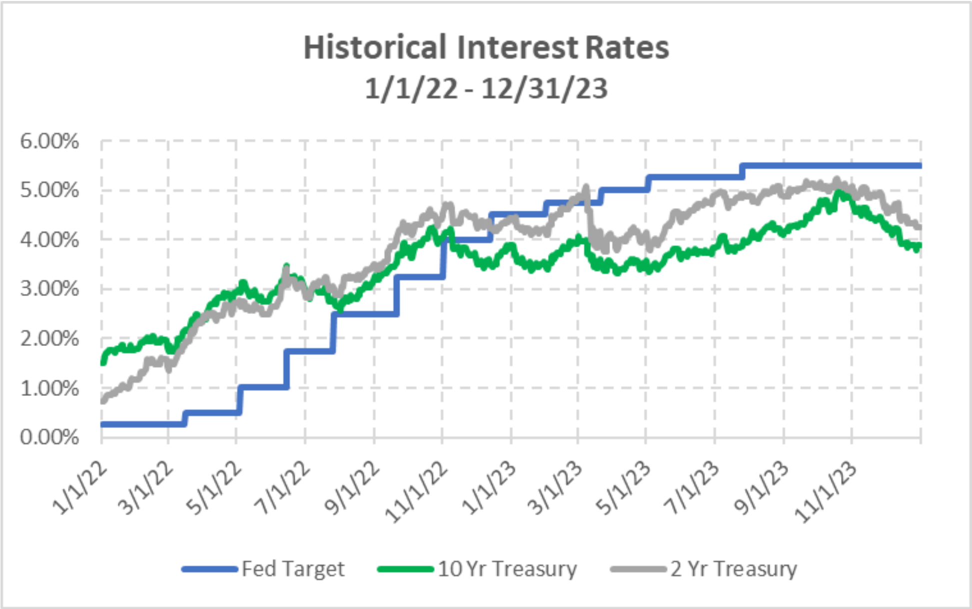
Of course, to avoid a recession, you need a relatively strong consumer sector. Today's consumer has thus far been able to weather the headwinds from the resumption of the student loan payments, the United Auto-Workers strike and stretched finances due to inflationary effects. Consumers have been buoyed by a tight labor market, a large increase in household wealth (largely due to real estate gains) over the last few years and remaining excess savings from the

COVID-19 fiscal transfers. We don't see an imminent sign that consumer spending will collapse, however, cracks are starting to form. The breadth in the labor market gains has been worsening, "excess" savings amounts continue to dwindle and the less wealthy consumers appear increasingly stretched.

We still think that a recession is more likely than not in the latter half of 2024 and place the odds near 60%. Unless there is an exogenous event, the recession should be mild given that consumer balance sheets should be able to absorb some stress. If inflation continues to recede, the Fed can be more aggressive to avoid a downturn.

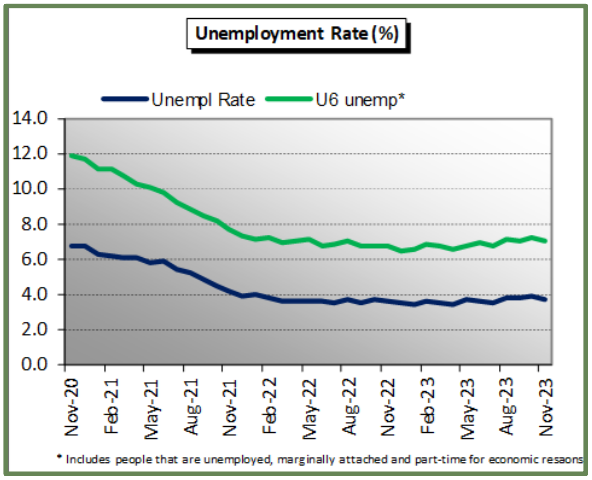
Fixed Income Outlook

Treasury yields fell significantly in the last two months of 2023, with the longer end of the curve declining by 100 basis points. The market now expects 150 basis points of cuts in 2024 compared to the Fed's projection of half that amount. The market is pricing in a 75% chance of a rate cut in March. This timing seems a little aggressive to us unless there is a quick deterioration in the labor market. We look for the Fed to execute its first rate cut in May and for a cumulative 100 basis points of cuts this year.



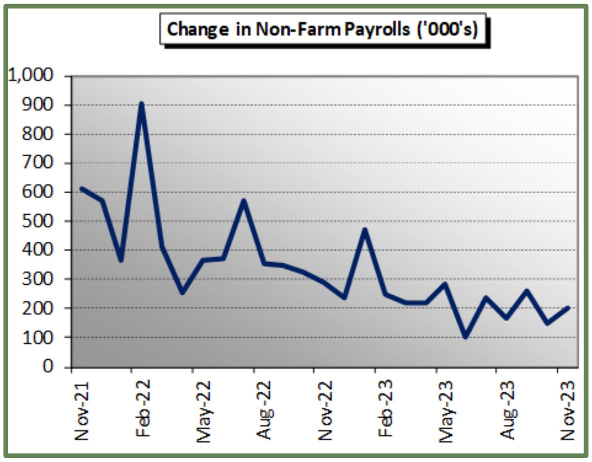
Labor Readings

(Data source: Bloomberg)



Unemployment Rate Drops

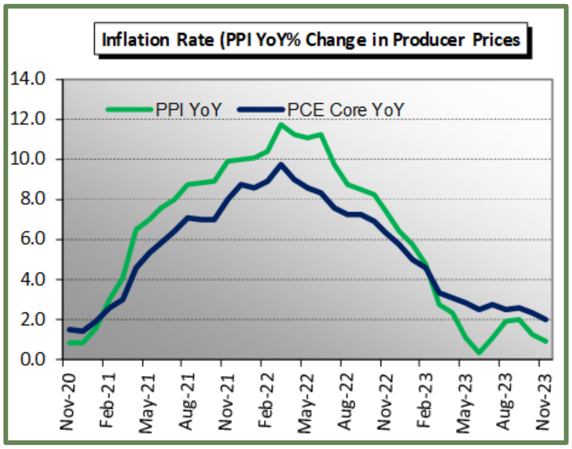
The unemployment rate in November dropped for the first time in four months. The unemployment rate decreased to 3.7% from 3.9% the previous month. The market was expecting the rate to remain unchanged. The underlying details of the report were strong, with both the size of the labor force and the number of employed experiencing significant gains.



Payroll Growth Beats Estimates

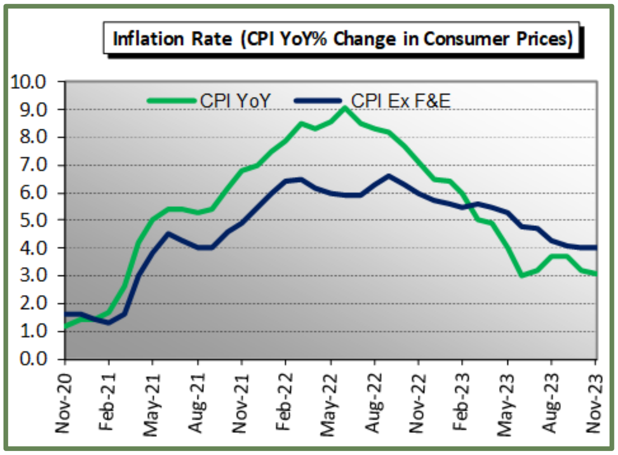
Payroll growth in November was 199,000 compared to an estimated 185,000 gain. In addition, the previous two months' job gains were revised upwards by 85,000. The gains were driven by the government and healthcare sectors, as well as a one-time increase due to workers returning from strikes. Job gains in the cyclical sectors have been slowing down.

Inflation Readings
(Data source: Bloomberg)



Producer Prices Continue to Decline

Headline and core producer prices were lower than expected in November. There wasn't a month-over-month change in producer prices. The year-over-year change in core producer prices reached the lowest level since January 2021.

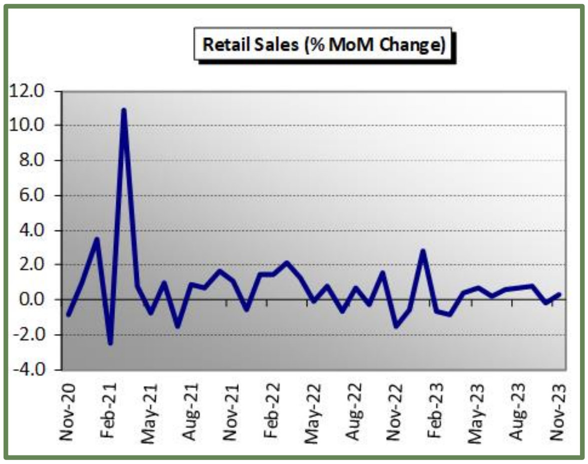


Consumer Inflation Slightly Higher than Expected

The month-over-month inflation rate increased by 0.1% compared to an expectation of no change. The year-over-year inflation rate for both the headline and core were in line with expectations. Inflation levels are down significantly from the peak in the middle of 2022. Core goods prices fell for the sixth consecutive month while services prices remain sticky.

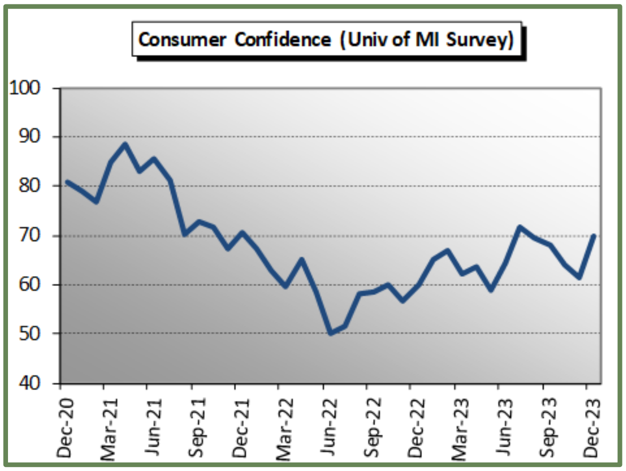
Consumer Readings

(Data source: Bloomberg)



Retail Sales Increase

Retail sales in November increased by 0.3% compared to the market expectation of a decline of 0.1% (on a month-over-month basis). Eight of the 13 categories experienced increases, which was led by restaurants and bars. Control group sales, which are used to calculate gross domestic product (GDP), advanced by 0.4%. This was double the market expectation, which indicates that the fourth quarter GDP should be solid.



Consumer Confidence Climbs

Consumer confidence in December was in line with expectations but experienced a significant jump from the prior month. Inflation expectations fell for both the long-term and short-term gauges. All five of the confidence components rose during December.