Economic Update

FOURTH QUARTER 2024
JANUARY 6, 2025

Quarterly Key Points

- 3Q GDP growth was revised up to 3.1% q/q annualized after an initial estimate of 2.8%. 4Q GDP growth is expected to remain strong at 2.0-3.3% q/q annualized. Full year growth for 2024 is now projected to be ~2.7%.
- The Fed delivered another "hawkish cut" of 25 bps. The FOMC official statement was virtually unchanged; however, the updated Summary of Economic Projections and Powell's press conference comments leaned more hawkish. The market expects only a few controlled rate cuts through 2025.
- Progress on inflation has stalled out, with most measures of inflation bottoming out and some even trending higher through the fall and the end of the year. First noted at the end of the third quarter, core inflation numbers appeared to have increased modestly month-over-month and year-over-year. The trend continued in the fourth quarter.
- After a weaker tone through the summer, the labor market regained some strength into year-end and consumer spending remained solid. Annual adjustments to GDI suggest that income growth and saving have been slightly stronger than previously thought, perhaps explaining the surprising resilience of consumer spending despite restrictive monetary policy over the past several years.
- Business activity is rebounding consistent with other broad measures of economic activity. Manufacturing and business new orders are trending upward, while services activity continues to be a bright spot. Despite mortgage rates still hovering near decade highs, prices remain elevated.

Our View

- Along with the new year comes the potential for considerable change. The election ushered in a Republican controlled government and the incoming President's proposed policy changes have the potential to be wide reaching. Inflation does not seem ready to give up, and further monetary policy easing has been brought into question. Labor markets, consumer spending, and business activity have outperformed expectations. Forecasts reflecting the avoidance of a recession remain the consensus.
- 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.

4Q2024 – A BEAR STEEPENING TAKES SHAPE

Beginning with a review, the third quarter ended with interest rates rallying to the lowest point of the year and the curve steepening on the winds of the newly arrived Fed easing cycle that began with a bang in September. However, the necessity of Fed easing is subject to market debate as many measures of financial conditions and liquidity in 2024 have been more favorable than prior to when the Fed started hiking rates in 2022. Risk assets have performed well as evidenced by the S&P 500 ending the year nearly 25% higher and investment grade credit spreads at or near all-time tights.

For the past year, the market largely expected a bull steeping of the Treasury curve once the Fed started easing. However, as markets revised policy easing expectations, an unanticipated bear steepening took shape through the end of the year. 2-year Treasury rates were primarily unchanged moving only 1 bps lower year-over-year, whereas 10-year Treasury rates rose by 69 bps. The net result is that the 2-year Treasury versus 10-year Treasury curve steepened by 70 bps during the year with the full change coming from 10-year Treasury rates, a surprising outcome.

3Q GDP growth was revised up to 3.1% q/q annualized after an initial estimate of 2.8%. Personal consumption accelerated to 3.7% q/q annualized from 2.8% in the second quarter. Gross private investment fell sharply to only 0.8% q/q annualized due to a drop in residential fixed investment. 4Q GDP growth is expected to remain strong at 2.0-3.3% q/q annualized. Full year growth for 2024 is now projected to be ~2.7%. Recession probabilities remain low with the median recession probability forecast on Bloomberg at only 25%.

THE U.S. ELECTION AND GOVERNMENT SPENDING

Despite the focus on monetary policy, the presidential election stole the show in the fourth quarter. President Trump overwhelmingly won the general election in early November, promising tax cuts, tariffs, immigration reform, ending global conflicts, lower inflation, relaxed regulations, and an overall growth-oriented agenda. With Republicans sweeping both the House and the Senate, the Trump 2.0 agenda is expected to move quickly. However, it may still be a challenge to pass broad sweeping reforms.

Last March, Congress approved a continuing resolution that funded the government through the September 30 fiscal year-end. In September, Congress resorted to another continuing resolution to avoid a government shutdown. It was a relatively straightforward process as neither party wanted to upset the apple cart right before the presidential election. The new stop-gap measure was limited in scope and only extended funding until December 20th. Fast forward to late December, the usual spending standoff returned resulting in a late night, 11th hour vote to avoid a government shutdown. The new resolution extends funding until March 14th. Additionally, the new year will usher in a new round of debt ceiling debate as the current suspension expired on January 1, 2025. Technically speaking, the U.S. Government has not run out of cash just yet, as Treasury Secretary Yellen can use extraordinary measures to triage cash outlays for a period. One thing is certain, the government funding and spending debate will continue into 2025.

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THE FED PROCEEDS WITH CAUTION

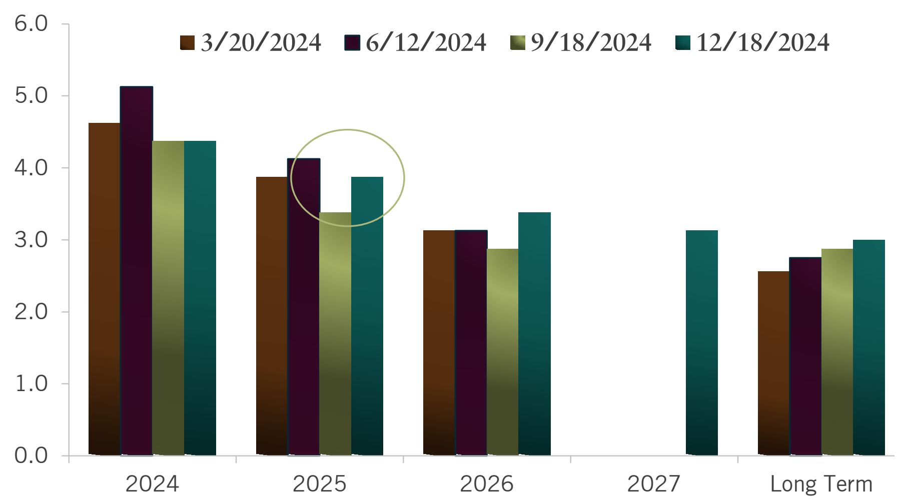
The ink had hardly dried on the September FOMC statement and the initial 50 bps cut when a plethora of relatively strong economic data emerged. A strong September employment report was accompanied by resilient measures of consumer spending and stubborn core inflation measures north of the Fed's 2% target. Coupled with the growth oriented and potentially inflationary Trump agenda, many started questioning the potential for continued easing.

Despite the data turning stronger, the Fed eased by another 25 bps in November, in line with market expectations. The idea of a potential pause gained momentum going into December. However, at the December meeting, the Fed delivered another "hawkish cut" of 25 bps. The FOMC official statement was virtually unchanged; however, the updated Summary of Economic Projections and Powell's press conference comments leaned more hawkish. Furthermore, there was a dissenting vote by Cleveland Fed President Beth Hammack.

During the post meeting press conference, Fed Chair Powell's remarks included "being closer to the neutral rate" and caution toward further cuts so long as labor markets remain firm. In response to questions, Powell reaffirmed the Fed's commitment to the 2% inflation target. The median dot plot now indicates only two cuts in 2025, a decrease from four cuts in September (Figure 1). Additionally, the median Fed forecasts for 2025 included GDP growth moving up to 2.1% from 2.0%, unemployment moving down to 4.3% from 4.4%, and core inflation moving up to 2.5% from 2.1%, leaving little room for policy easing.

The market expects only a few controlled rate cuts through 2025. The Fed does not believe a recession is on the horizon as the "no-landing" scenario seems to be the base case. Despite sticky inflation and the hawkish Fed tone, risk assets charged ahead on continued economic resilience and the expectation of benefits that will be bestowed by the incoming administration.

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



Source: Federal Reserve.

INFLATION PROGRESS SLOWS

Progress on inflation has stalled out, with most measures of inflation bottoming out and some even trending higher through the fall and the end of the year. First noted at the end of the third quarter, core inflation numbers appeared to have increased modestly month-over-month and year-over-year. The trend continued in the fourth quarter.

Headline CPI crept up to 2.6% y/y in October and 2.7% y/y in November after falling to a low of 2.4% y/y in September. Core CPI increased by 3.3% y/y in September, October, and November. On a month-over-month basis, headline CPI inched up to 0.3% in November after four straight months of 0.2% increases. Meanwhile, core CPI has increased by 0.3% in every month since August. On a rolling 3-month average basis, headline CPI averaged 0.2% m/m in the three months ending in November. This rolling average implies an annualized run rate of approximately 2.5% to 3.5%, higher than the Fed's target range and higher than the measured run rate through early fall.

PCE and PPI inflation numbers show a similar pattern. Headline PCE accelerated to 2.4% y/y in November after falling to only 2.1% in September, while core PCE edged up to 2.8% y/y in both October and November. Measured month-over-month, both headline PCE and core PCE fell to 0.1% m/m in November after several months ranging between 0.2% and 0.3%. Headline PPI increased from 0.2% m/m in September to 0.3% in October and 0.4% in November. Core PPI measured 0.3% m/m in both September and October before falling slightly to 0.2% in November. On a year-over-year basis, core PPI was 3.4% in November and headline PPI was 3.0%.

2-year breakeven inflation rates rose to approximately 2.55% after reaching a low point of 1.47% in mid-September. Long-term inflation expectations, represented by the 5-year breakeven, 10-year breakeven, and 5-year, 5-year forward breakeven rates, are between 2.30% and 2.40%.

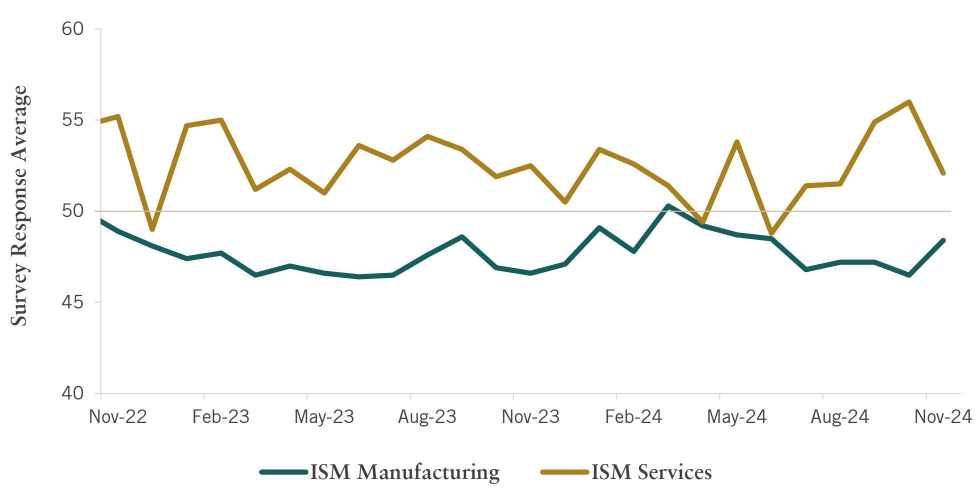
ECONOMY REMAINS ON SOLID FOOTING

After a weaker tone through the summer, the labor market regained some strength into year-end. Following an exceptionally strong nonfarm payroll report in September with 255k jobs added, employers added only 36k jobs in October due to labor strikes and the effects of hurricane Helene. November job growth rebounded, adding 227k jobs; however, some of the gains are a recovery of jobs that were lost temporarily in October. The three-month average, which smooths the temporary dislocation, measured 172k in November, marking the highest average since last spring. The unemployment rate bounced around slightly in the second half of the year, peaking at 4.3% in July before retracing back to 4.1% in September and October. Despite a strong nonfarm payroll number, November unemployment edged up to 4.2% reflecting 413k fewer individuals in the labor force versus the -723k change in total employment (net change of 310k more unemployed) over two months.

Consumer spending remained solid through the fourth quarter. Personal income growth measured 0.3% m/m and 5.3% y/y in November, while October personal income was revised up to 0.7% m/m and 5.5% y/y. Recall that upward revisions earlier this year, as a result of annual adjustments to gross domestic income (GDI), suggest that real personal income growth has been slightly stronger than previously thought. Adjusted retail sales jumped to 0.9% m/m, 0.5% m/m, and 0.7%m/m in September, October, and November respectively following a revised -0.1% m/m reading in August. Core personal consumption expenditures followed a similar pattern, gaining 0.5% m/m, 0.1% m/m, and 0.3% m/m in September, October, and November respectively. The personal savings rate measured as a percentage of disposable income has been hovering in the 4.4% - 4.5% range for the past handful of months. As with personal income growth, annual revisions to GDI earlier this year led to upward revisions of personal savings rates. These upward revisions suggest that consumers have been saving more than previously thought, perhaps explaining the surprising resilience of consumer spending despite restrictive monetary policy over the past several years.

Business activity is rebounding consistent with other broad measures of economic activity. Manufacturing and business new orders are trending upward, while services activity continues to be a bright spot (Figure 2). The ISM Manufacturing PMI remained below 50 throughout most of the year. ISM business new orders had largely followed a similar pattern, but more recently it marked the first expansionary readings since March with measures of 50.4 in November and 52.5 in December. The ISM Services PMI remained strong, measuring 56.0 and 52.1 in October and November, respectively. Industrial production also remained largely unchanged, measuring between 102 and 103 since early 2022. However, capacity utilization has been on a steady downward trend. Since reaching a post-pandemic peak of 81% in 2022, the index has ground down to 76.8% in November.

FIGURE 2: ISM MANUFACTURING AND SERVICES



Source: Bloomberg.

30-year fixed mortgage rates, as measured by Freddie Mac, increased to 6.90% by the end of December after falling to 6.10% in late September, ending approximately 20 bps higher than rates at the end of 2023. Existing home sales increased slightly to a 4.2-million-unit annualized pace in November. New home sales volumes have bounced around between 600-700 thousand units annualized for the past several years. Existing home supply remains very low at ~4 months. Many argue that the low level of existing home supply is evidence of a strong lock-in effect of extremely low financing. The supply of new homes, on the other hand, remains elevated at ~9 months, well above pre-pandemic levels. Despite mortgage rates hovering near decade highs, the S&P Case Shiller home price index continues to grind higher. The 20-city composite registered seasonally adjusted monthly gains resulting in home prices increasing 4.2% y/y in October.

LOOKING AHEAD

Along with the new year comes the potential for considerable change. The election ushered in a Republican controlled government and the incoming President's proposed policy changes have the potential to be wide reaching. Only time will allow for us to judge the potential impact. The post-election euphoria has passed, and the market now has a wait-and-see approach regarding potential policy changes. The potential for disruptive government policy changes at home and abroad, along with global political uncertainty remain possible sources of volatility.

Inflation does not seem ready to give up, and further monetary policy easing has been brought into question. Labor markets, consumer spending, and business activity have outperformed expectations. Forecasts reflecting the avoidance of a recession remain the consensus. The Fed's forward guidance and the market's expectations are currently in sync. The direction of monetary policy feels highly uncertain, as we were reminded by the curve's unexpected bear steepening reaction post policy easing. 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.