STONEBRIDGE
Capital Advisors

STONEBRIDGE ECONOMIC OUTLOOK

December 28, 2023

Daniel E. Laufenberg, Ph.D.
Chief Economist

The views expressed here reflect those of Daniel E. Laufenberg as of the date noted and not necessarily those of Stonebridge Capital Advisors. They may change as economic fundamentals and market conditions change. This commentary is provided as a general source of information only and is not intended to provide investment advice for individual investor circumstances. Past performance does not guarantee future results.

Overview

The U.S. economy has performed much better in the second half of this year than anticipated in the previous forecast published in September. More importantly, the solid momentum in the second half of 2023 is now expected to provide momentum for the economy in the first half of 2024. In particular, solid real growth, a relatively stable unemployment rate, and the downward trend in inflation in recent months has the consensus believing that the Federal Reserve's interest rate policy has successfully engineered a "soft landing." During the press conference following the Fed's December policy meeting, Chair Powell essentially reinforced this view by noting the federal funds rate is "likely at or near its peak for this tightening cycle." He also said that "the economy has surprised forecasters in many ways since the pandemic, and ongoing progress toward our [two] percent inflation objective is not assured," noting that the Fed is "prepared to tighten policy further if appropriate."[1] I would interpret his comments to mean that the Fed believes it has hiked rates enough but is not totally convinced!

Market participants are apparently convinced that the Fed is finished with rate hikes and are now looking for the Fed to cut rates in the near future. Indeed, some investors have referred to the Fed's decision to maintain its target range for the federal funds rate between 5-1/4 and 5-1/2 percent for two consecutive meetings as a "pivot" in policy. I suggest that it was more a pivot in expectations about future policy, rather than a pivot in policy. After all, the Fed did not cut its interest rate target at the December meeting. However, in fairness to the debate, the Fed most certainly elevated the likelihood of lower rates in the future when the members of the Fed's policy committee projected such cuts in their updated economic projections released following their December meeting. As a result, bond and stock markets rallied. In other words, the pivot was manifested by the decline in long-term interest rates in anticipation of a future pivot in the Fed's policy rate. Whether this market pivot in anticipation of a policy pivot is appropriate will depend on whether inflation continues to slow to a pace more in line with the Fed's objective of two percent.

Most forecasters expected inflation to slow in 2023. The greater unknown was whether it would slow to the Fed's target without an economic recession. Although inflation has slowed, it remains well above the Fed's inflation target. Still, I think a recession is necessary for the Fed to achieve its inflation target, but I no longer expect that recession in 2024. Indeed, I now-seem to be more in line-with the consensus view that the "goldilocks" scenario for the U.S. economy in the second half of this year will continue in 2024. That said, it is still far from a sure thing. Recall that recessions generally are the result of a shock to the economy. A potential shock at this point would be if inflation reaccelerates rather than slows as anticipated, most likely eliminating the likelihood of the Fed following through on their projected rate cuts. My sense is that without the economic contraction that I had in the previous forecast, the Fed will not rush to cut rates as quickly or as dramatically as the market now expects.

Note that when long-term interest rates were climbing earlier this year, the perception was that they were adding to the Fed's restrictive policy stance and reducing the need for further hikes in the federal funds rate. Now that long-term interest rates are retreating, the same argument could

[1] December 13, 2023, Chair Powell's Press Conference, Federal Open Market Committee of the Federal Reserve System, PRELINARY Transcript.

be applied but in the other direction. That is, long-term interest rates have already made the “pivot” in policy, making it less likely that the Fed will be in a hurry to cut the federal funds rate.

Details

As shown in Table 1, the economic forecast has changed substantially from the forecast in September.[2] Recent data on real growth, employment, and especially inflation favor these changes. First, real gross domestic product (GDP) in the third quarter grew at a surprisingly strong 5.2 percent at an annual rate and is on track to climb another 2.5 percent in the fourth quarter. As a result, real GDP for all of 2023 (on a fourth-quarter to fourth-quarter basis) is now expected to increase a stellar 3.0 percent, double the pace over the same period shown in the previous forecast and well above the 0.7 percent pace for 2022.

More importantly, real GDP growth for all of 2024 is now expected to be better than it was in September as well, due in large part to the resiliency of consumers. In particular, real disposable personal income (DPI) has climbed 4.3 percent over the twelve months ending in November, suggesting that consumers continued to acquire the wherewithal to support real spending. Although real personal income is likely to increase again in 2024, the pace is expected to fall far short of 2023. After all, one important factor contributing to real DPI over the last year was the 8.7 percent cost-of-living increase in Social Security benefits in January 2023. The cost-of-living increase scheduled for January 2024 will be only 3.2 percent, suggesting that the increase in real income next month will be about a third of the gain a year earlier. Moreover, the wages and salaries component of real personal income is expected to be flat on a seasonally adjusted basis in January. As a result, real DPI growth in January 2024 is expected to slow to about 2.0 percent from a year earlier, about half the pace anticipated over the twelve months of 2023. The implication is that in the absence of inflation reaccelerating next year, consumers should still have the means to increase real spending in 2024, but at a much slower pace from 2023.

Second, the labor market has remained surprisingly tight, despite the Federal Reserve hiking its policy interest rate 525 basis points over the last 20 months. For example, the latest data showed the unemployment rate at 3.7 percent in November - very little changed from the 3.6 percent rate in March 2022 when the Fed started hiking rates. I expected the unemployment rate to be higher by now. The fact that it is not suggests that employment gains have kept pace with labor force growth, both surprisingly robust. According to the household survey, the labor force has increased 3.96 million since March 2022, while persons employed have increased 3.64 million.

[2] When comparing the details of the forecast in Table 1 to previous forecasts, it is important to note that the layout has changed. Most notably, the first column of data is the annual data for 2023, the next four columns are the quarterly forecasts for 2024, and the final two columns are the annual forecasts for 2024 and 2025. This is the first attempt at a forecast for 2025.

Table 1
U.S. Economic Forecast

	Annual	2024 Quarterly				Annual	
	2023f	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**2024f**	**2025f**
Real Gross Domestic Product	**3.0**	1.9	2.7	1.5	0.7	**1.7**	1.5
Consumer Price Index, All	**3.2**	2.7	3.1	3.2	2.6	2.9	2.5
Consumer Price Index, Core	**4.0**	3.0	2.8	3.2	2.6	2.9	2.5
GDP Chain-Type Price Index	**2.8**	2.2	2.5	2.6	2.0	2.3	2.0
Civilian Unemployment Rate	**3.8**	3.9	3.8	3.9	4.0	**4.0**	4.5
Price of WTI crude oil ($/bbl)	**79.4**	75.2	80.5	83.0	83.0	83.0	80.0
Trade-Weighted Dollar	**121.0**	121.0	120.0	122.0	121.5	**121.5**	119.0
S&P 500 Operating Earnings	**211.2**	53.0	54.8	53.1	51.0	**211.9**	220.0
Percent vs. Year Ago	**7.2**	0.9	0.0	1.6	-0.0	**0.0**	3.8
91-Day Treasury Bill Rate	5.5	5.4	5.3	5.3	5.2	**5.2**	4.0
10-Year Treasury Note Yield	4.4	4.0	4.1	4.2	4.3	**4.3**	4.2
30-Year Mortgage Rate	7.4	6.8	6.5	6.5	6.7	**6.7**	6.3
Bank Prime Rate	8.5	8.4	8.3	8.3	8.2	**8.2**	7.0

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.

Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar, and all interest rates are averages for the last quarter of the year indicated. S&P 500 operating earnings per share are for the period indicated.

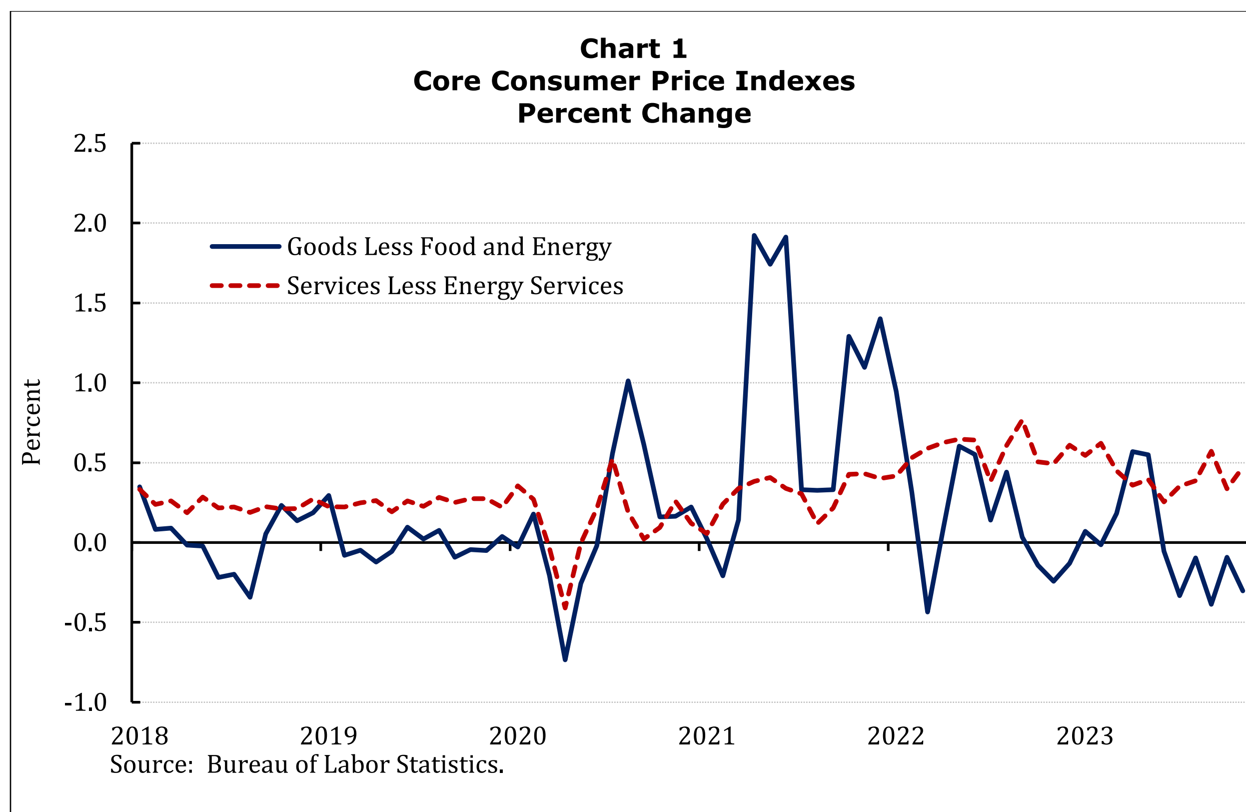
Quarterly changes in real GDP and all measures of inflation are percent changes from the previous quarter at annual rates. For the unemployment rate, the price of crude oil, the trade-weighted dollar, and all interest rates, quarterly estimates are averages for the quarter indicated. S&P earnings are per share for the period indicated. Trade-weighted dollar is the new broad index from the Federal Reserve Board.

f—forecast: bold type reflects a major change from the previous forecast.

Payroll jobs, as reported in the Establishment Survey, have increased a total of 5.66 million since March 2022, or an average of 293 thousand per month. Goods producers added 665 thousand jobs, while private service producers contributed 4,104 thousand jobs and governments added another 894 thousand jobs over this period. The disruptions that plagued producers during the pandemic have now mitigated considerably, especially in the more labor-intensive service sector. The two sectors accounting for a large share of the service sector job gains are: (1) health care and social assistance and (2) leisure and hospitality. For the most part, the job gains in these sectors since March 2022 reflect a rebound from the jobs lost during the pandemic. In the case of health care, the number of employees on payroll now exceeds the pre-pandemic level. However, in the case of accommodations and food services, the number of employees on payroll is still below its pre-pandemic level.

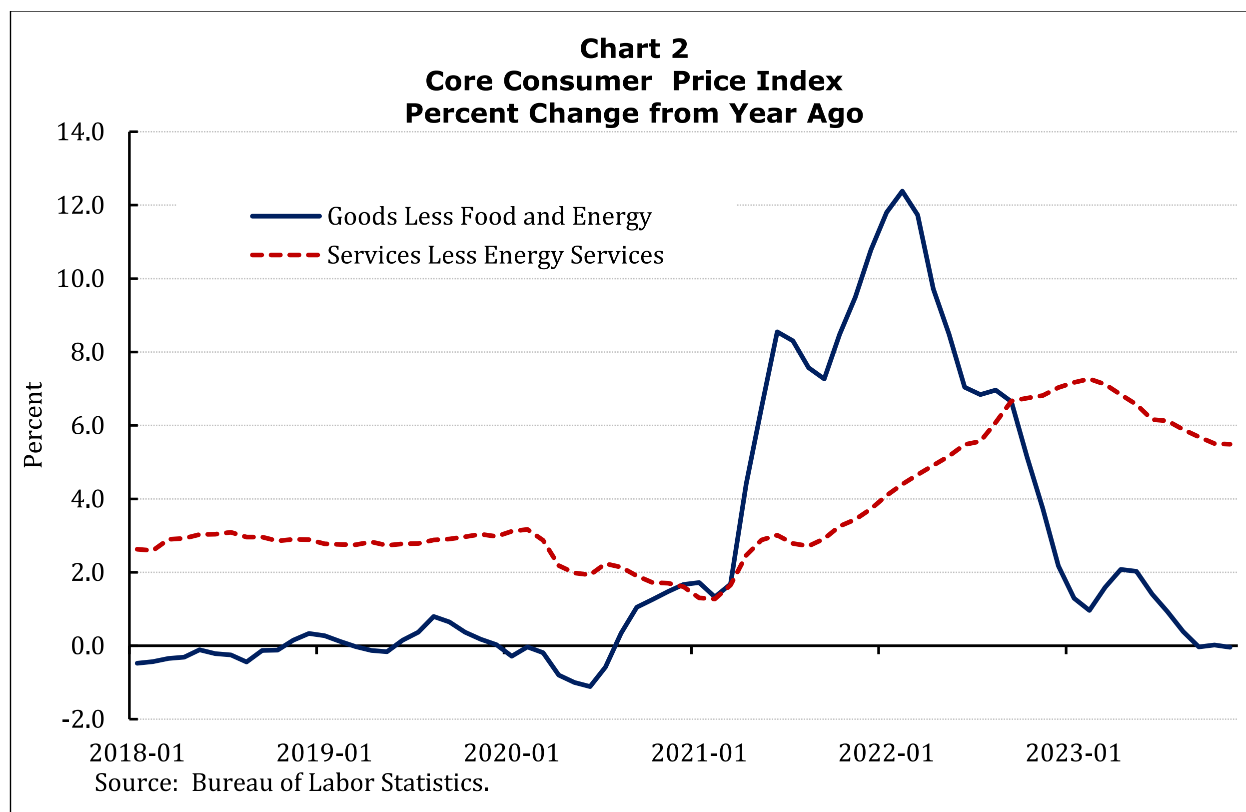
Although total employment has increased since the Fed started hiking its policy rate in March 2022, real hourly wages are flat; that is, the 7.1 percent increase in the average hourly wage for nonfarm workers has been offset by the 7.1 percent increase in the consumer price index (CPI). This was not the case only two months ago. As recently as September, real hourly wages were lower than they were in March 2022, due to consumer price inflation exceeding the gain in average hourly wages. Over the last two months ending in November, the CPI rose a mere 0.8 percent at an annual rate, while the average hourly wage for private-sector workers rose 3.4 percent at an annual rate. Indeed, the recent improvement in real hourly wages may help explain why consumer confidence, as reported by the Conference Board, surged to 110.0 in December from 101.7 a month earlier.

Finally, a major surprise has been how quickly the overall CPI has slowed in recent months, despite the absence of a meaningful slowdown in real economic activity. Of course, much of the slowdown in overall CPI in recent months has been due to a sharp drop in energy prices (down 25 percent at an annual rate from September to November); food prices over the same period increased at a 3.2 percent annual rate.



Of course, if the volatile food and energy prices are excluded, the CPI rose 3.1 percent at an annual rate over the two months, and 4.0 percent over the twelve months, ending in November. Nevertheless, the source of this inflation is entirely from core services (see Chart 1 and Chart 2). As shown by the solid blue line in Chart 1, the month-to-month percent changes in consumer prices of goods excluding food and energy fell in October and again in November and were down 2.3 percent at an annual rate for this two-month period. The same cannot be said about services less energy services. As shown by the broken bronze line in Chart 1, prices of core services increased at an annual rate of 5.0 percent for the two months of October and November, most likely too high for the Fed given that such services account for 58 percent of consumer spending and 74 percent of all spending excluding food and energy.

Chart 2 plots the percent change in the monthly CPI for goods excluding food and energy and services excluding energy services from a year ago. It is more encouraging than the month-to-month changes because both the goods and services components have slowed significantly so far this year. The temptation is to extrapolate such gains into 2024. In order for such an extrapolation to be correct, it is essential that the price advances in core services continue to drift lower. However, the 5.0 percent increase at an annual rate for the last two months suggest that lower core services inflation is not a sure thing.



Core goods inflation is already at its pre-pandemic level, both on a month-to-month and on a year-over-year basis (see Charts 1 and 2). Whether this low inflation can be sustained is unclear. The key will be whether the consumer goods sector can increase supply to satisfy stronger demand without adding to unit costs. Unit costs are derived by dividing hourly compensation costs by units produced per hour (productivity). According to the Productivity and Costs data from the Bureau of Labor Statistics, the percent change in labor productivity in the manufacturing sector was returned to its sluggish pace in the decade prior to the pandemic, while the percent change in labor productivity in nonfarm business sector has rebounded markedly, following very volatile swings due to the pandemic effect.

On balance, consumer inflation is likely to remain sticky, causing somewhat of a dilemma for monetary policy in the months ahead. In particular, if the economy remains robust, it is very unlikely that the Fed will feel the need to cut its policy rate aggressively, if at all. At the moment, market participants seem to disagree. Disinflation is expected to continue, encouraging fixed-income investors to extend duration in anticipation of cuts in the Fed's policy rate by the end of 2024. Equity investors are encouraged as well, not only by lower longer-term interest rates but also that the widely anticipated disinflation will occur without a meaningful economic correction. Stay tuned. It could get very interesting in the months ahead.