STONEBRIDGE
Capital Advisors

STONEBRIDGE ECONOMIC OUTLOOK

March 18, 2024

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 outlook for the U.S. economy in 2024 is very similar to what it was in the previous report. In particular, economic growth in 2024 is likely to be much slower than it was in 2023, unemployment should edge higher but not dramatically, job gains will slow to a pace more in line with labor force growth, and inflation on average may slow but certainly not as quickly as currently anticipated. Indeed, it will be the stubbornly elevated inflation expected this year that will be the key to the Federal Reserve's monetary policy (what is so often referred to by Fed officials as being "data dependent"). I remain convinced that the only way inflation slows enough to satisfy the Fed's 2.0 percent objective is if real economic growth slows far more than expected. As a result, I doubt that the Fed will be in a rush to cut its federal funds rate target as quickly or as often as priced into the market. Although I do have the Fed cutting its funds rate target by 25 basis points late this year, it is because I expect the economic data to provide sufficient evidence to justify the Fed's action by then. Nevertheless, it would not be a surprise if they decided to do nothing this year. Of course, if the U.S. economy does show signs of faltering and inflation slows more than I anticipate, then the Federal Reserve will certainly cut rates more aggressively. At the moment, such an economic retrenchment seems unlikely to happen in 2024 but could be an issue in 2025.

Long-term interest rates in this environment most likely will remain elevated as well. After all, if the Fed keeps short-term interest rates over 5 percent for longer than currently anticipated, long-term interest rates should reflect the upward adjustment in expected short-term interest rates. As a result, the forecast shows the yield on 10-year Treasury notes actually drifting slightly higher this year as the reluctance by the Fed to cut short-term interest rates becomes clearer.

With regard to corporate profits, as long as businesses have pricing power, profit margins most likely can be sustained and profits can continue to improve. Of course, pricing power exists only if consumers are willing and able to accept the higher prices. If consumers start to balk at higher prices, then the outcome is more problematic. In particular, if the cumulative effect of higher prices starts to weigh on consumers because 1) incomes fail to keep pace with inflation, 2) consumers exhaust their debt options, and 3) the strong wealth effect dissipates, then consumers will be forced to retrench spending. In turn, this consumer resistance to higher prices most likely would curtail businesses' ability to increase revenue by raising prices. When businesses cannot increase revenue, they generally attempt to reduce operating costs (improve efficiency) by cutting jobs. Without jobs, consumers most likely will be forced to cut their spending even further.

Although consumer spending in January appeared to struggle a bit, it was far from conclusive when real personal consumption expenditures (PCE) declined 0.1 percent owing to a sharp drop in real spending on goods. In particular, based on the consumer data currently available, it looks as if real PCE on goods will register a solid gain in February. This uptick in real spending on goods, combined with further gains in real consumer spending on services, should boost real PCE in February enough to suggest that it is on track in the first two months of the year to grow enough to support the forecast for real GDP growth in the first quarter of 2.1 percent at an annual rate.

Details

In 2023, the economy was far more resilient than most economists expected, myself included. As measured by real gross domestic product (GDP), the economy grew 3.1 percent over the four quarters of 2023, including a surprisingly robust 4.0 percent annual rate in the second half. Also, the unemployment rate ended 2023 below 4.0 percent for the second consecutive year, suggesting that the economy continues to operate at full employment. Finally, consumer price inflation, regardless of how it is measured, slowed sharply last year. Indeed, the improvement in consumer price inflation without the anticipated uptick in the unemployment rate led many to believe that the economy could achieve the "soft landing" so often advertised as the objective of monetary policy but seldom achieved. Some market participants hinted at the possibility of a soft landing shortly after the Fed ended its string of interest rate hikes in July, but it became a more widely accepted outcome in December when the Federal Reserve's policy committee expressed the possibility of interest rate cuts in 2024.

I suspect that the hope of a soft landing for the U.S. economy will not be altered, given that real GDP is expected to grow at about a 2.0 percent annual rate most of this year. What 2.0 percent growth means for inflation depends on whether real GDP growth exceeds the U.S. economy's potential growth rate and for how long. Potential growth is an estimate of economic growth at full employment and is essentially the sum of the percent change in total hours worked (i.e., labor force growth at full employment) and the percent change in real output produced per hour (productivity). For the last decade at least, my estimate of the potential growth rate for the U.S. economy has been about 1.5 percent (0.5 percent increase in total hours worked and about 1.0 percent increase in productivity). Last year, the U.S. economy grew 3.1 percent at full employment, suggesting that the underlying inflation rate should have remained elevated. One reason inflation slowed last year may have been due to the end of the COVID-19 pandemic and supply disruptions rather than potential growth. If this is the case, then the relationship between actual and potential growth may be more important going forward.

Several sectors contributed to real GDP growth last year, but it was consumer spending—with real personal consumption expenditures climbing 2.6 percent over the four quarters of last year—that led the way. In 2024, consumer spending is expected to continue leading the way but at a less robust pace due to an expected slowdown in real income growth. After all, consumers tend to spend it if they have it.

In this regard, 2024 got off to an interesting start. One aspect of interest was the confusion about personal income growth in January. For example, real personal income jumped 0.7 percent, while real disposable personal income was flat. Apparently, the 6.0 percent surge in current personal taxes in January offset the income gains from the increase in Social Security benefits, a large jump in dividend income, and a solid increase in worker wages and benefits. More importantly, based on the employment data for February, real disposable income, as well as real personal income, should register solid gains in February, suggesting that consumers will once again have the means to spend.

Table 1
U.S. Economic Forecast

	Annual	2024 Quarterly				Annual	
	2023f	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**2024f**	**2025f**
Real Gross Domestic Product	3.1	2.1	2.3	2.0	0.9	1.8	1.1
Consumer Price Index, All	3.2	**3.5**	3.3	3.2	2.6	**3.2**	2.3
Consumer Price Index, Core	4.0	**3.9**	3.7	3.5	2.9	**3.5**	2.5
GDP Chain-Type Price Index	2.6	2.2	2.5	2.4	2.2	2.3	2.0
Civilian Unemployment Rate	3.7	3.8	3.7	3.8	3.9	3.9	4.6
Price of WTI crude oil ($/bbl)	79.4	76.8	79.5	81.0	80.0	80.0	70.0
Trade-Weighted Dollar	121.0	121.0	120.0	122.0	121.5	121.5	119.0
S&P 500 Operating Earnings	**213.5**	**54.0**	**55.8**	**54.3**	**53.0**	**217.1**	**225.3**
Percent vs. Year Ago	**8.4**	0.2	**1.8**	**3.9**	**-1.6**	**1.7**	3.8
91-Day Treasury Bill Rate	5.5	5.5	5.5	5.4	5.2	5.2	4.0
10-Year Treasury Note Yield	4.4	4.2	4.3	4.3	4.4	4.4	4.2
30-Year Mortgage Rate	7.4	6.7	6.5	6.6	6.7	6.7	6.3
Bank Prime Rate	8.5	8.5	8.5	8.4	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.

In theory, whenever the economy grows faster than its potential, it typically means that either inflation will accelerate, or the measure of potential growth is too conservative. At the moment, it looks like my estimate of potential growth is too low. Over the four quarters of 2023, total hours worked (up 0.6 percent) were roughly in line with my estimate, but productivity (up a whopping 2.6 percent over the same period) far exceeded my estimate. The surge in productivity associated with the end of the pandemic most likely has played out, suggesting that the adoption of new technology, especially the more widespread application of artificial intelligence in the service sector, will be essential to productivity improvement in the future. My estimate of productivity

improvement going forward is up a bit from what it was before the pandemic but certainly not anywhere near 2.6 percent. Indeed, productivity gains likely will fall in line with something more sustainable, which may be higher than 1.0 percent but only marginally. I estimate sustainable productivity improvement at full employment to be about 1.2 percent a year at best.

Over the first two months of 2024, the labor market remained very tight, with job gains averaging over 250 thousand a month, the unemployment rate averaging 3.8 percent, and the labor force participation rate steady at 62.5 percent. By most standards, the U.S. economy is considered to be operating at full employment, suggesting that at some point job gains will slow to a pace more in line with the roughly 125 thousand a month increase in the labor force. Despite this slowdown in job creation, it will still be enough to keep the unemployment rate low as long as the economy continues to expand.

Moreover, the inflation rate, as measured by the consumer price index (CPI), slowed markedly to 3.1 percent over the twelve months ending in December 2023 from 6.4 percent over the twelve months ending in December 2022. Despite its improvement, inflation was still well above the Federal Reserve's target of 2.0 percent. As a result, the Fed stopped hiking its policy rate (the federal funds rate) last year but failed to follow through with the policy rate cuts so widely anticipated. Many observers argued that the downward trend in inflation would continue, and that the Fed was risking a recession by keeping interest rates elevated longer than necessary. The Fed's response was that it needed to be convinced by the data before it would lower its policy rate rather than rely solely on the speculation that inflation would continue its downward trend.

Of course, the Fed tends to monitor many different measures of consumer price inflation other than the CPI. In particular, the inflation measure preferred by the Fed at the moment is the personal consumption expenditures chain-type price index (PCE price index) for various reasons. An important consideration for market participants is that even though the percent change in the PCE price index and the CPI track in the same direction, the percent change in the PCE price index generally is at a level below the percent change in the CPI.

Because of the Fed emphasis on the PCE index, financial analysts often dismiss the CPI reported by the Bureau of Labor Statistics (BLS) as less important than the PCE price index reported by the Bureau of Economic Analysis (BEA). For the CPI, the weights assigned to each component are essentially fixed, whereas for the PCE index, the weights depend on the actual share of total consumer spending on each component. Also, the basket of goods and services used by the CPI are only out-of-pocket expenditures by consumers, whereas the basket of goods and services used by the PCE index represents total expenditures on consumer products, regardless of who paid for them. As a result, the actual or implicit weights assigned to specific prices in the two indices often differ markedly. Examples of two such items are health care and shelter. The weight used on health care services in the CPI for the fourth quarter of last year was 6.5 percent, but in the PCE it was 18.2 percent. On the other hand, the weight on shelter (including utilities) was roughly 36 percent in the CPI, but only 19.9 percent in the PCE index. A major difference is that the weights in the CPI represent the share of out-of-pocket expenditures on each component paid directly by consumers, while the weights in the PCE index represent the share of total consumer expenditures on each component regardless of who paid. Needless to say, total consumer expenditures as used

to calculate the PCE price index are larger than the expenditures paid for directly by consumers used to calculate the CPI.

Of course, if inflation as measured by the CPI is generally higher than inflation measured by the PCE index, then the obvious question is how low the CPI will need to be for the CPE index to hit the Fed's goal of 2.0 percent. Based on various studies, the average gap between the percent changes of the two indices tends to be about 0.5 percent on a year-to-year basis, suggesting that the PCE index will hit the Fed's 2.0 percent goal when the CPI is at 2.5 percent.

However, this gap varies considerably from time to time. In recent years, the gap has widened to about 0.7 percent, well above the long-term average of 0.5 percent. More importantly, the historical data suggests that the gap between the inflation measures tends to widen when overall inflation rises and narrows when overall inflation slows. The implication going forward is that when inflation does slow, PCE inflation may not slow as quickly as CPI inflation, causing the gap to narrow and, in turn, creating some added confusion about inflation and inflation targeting. Although I expected inflation to be higher than the consensus going into this year, the pace for the first two months has exceeded even my expectations. As a result, the inflation estimate for the first quarter has been revised upward slightly, providing some support for the above consensus estimates for CPI inflation over the remainder of the year. By the way, the upward surprise to inflation so far this year is consistent with an economy growing above its potential.

Given my forecast, the investment implications are far from obvious. Risk is still favored and likely to remain so for at least the first half of this year. That said, equity valuations already look a bit lofty given my outlook for corporate profits. After all, if the Fed does not lower rates, then corporate earnings will drive the stock market. As long as businesses have pricing power, profit margins can be maintained. However, pricing power also means that inflation does not slow, making it less likely that the Fed will feel the need to cut short-term interest rates. It is somewhat of a catch-22 for risk.

Market participants are assessing credit risk to be very low at the moment, with the spread between the yield on Baa-rated corporate bonds and the yield on 10-year Treasury notes reaching a level in February that was the lowest since the late 1990s. The bond market seems to reflect the increased likelihood of a soft landing for the economy, with lower inflation and lower interest rates over the remainder of this year. Based on my forecast, the consensus is too optimistic about a soft landing, suggesting that credit risk could become more intense again sometime later this year. If long-term Treasury yields drift higher as I expect, it is unlikely that such a move would be considered a positive for corporate bonds. In that regard, the yield on the 10-year Treasury note has already backed up nearly 50 basis points since the end of last year. If the Fed is not going to cut rates anytime soon, then buying the dips becomes less attractive. Needless to say, the situation is very fluid, which makes it more interesting but also more stressful for many—and I am too old to be stressed about anything, not even my golf game.