STONEBRIDGE
Capital Advisors

STONEBRIDGE ECONOMIC OUTLOOK

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Overview

The outlook for the U.S. economy in 2024 in this report is very similar to the one published in March. Economic growth is likely to be considerably slower than it was in 2023, unemployment is expected to edge higher, nonfarm payroll job gains will slow to a pace more in line with labor force growth, and inflation probably will decelerate but not as quickly or as much as preferred by the Federal Reserve's monetary policy committee. Indeed, the key drivers behind the course of monetary policy this year will be positive, albeit uneven, economic growth and the painfully slow deceleration of the rate of inflation—what is often referred to by Federal Reserve (Fed) officials as being data dependent. The economic data reported for the first five months of the year clearly support the outlook.

The only meaningful difference between this forecast and the previous edition is a matter of degree rather than direction. In particular, according to the preliminary estimate from the Bureau of Economic Analysis, real gross domestic product (GDP) grew 1.3 percent at an annual rate in the first quarter, which was slower than the advance estimate of 1.6 percent and the 2.1 percent pace anticipated in the March forecast, and well below the 3.1 percent pace for all of 2023. However, there is some evidence suggesting that real GDP growth will accelerate in the second quarter to about a 2.8 percent pace, which is somewhat stronger than the 2.3 percent growth rate anticipated in the previous forecast. As a result, the average growth rate for the first half of 2024 shown in this forecast is very similar to that shown in the March forecast; that is, 2.0 percent now versus 2.2 percent earlier. For all of 2024, the estimate in March was 1.8 percent. Now, it is 1.7 percent.

Moreover, the average yield on the 10-year Treasury note for the fourth quarter of 2024 (4.2 percent) is expected to be a bit lower than the average of the 10-year yield for the fourth quarter of 2023 (4.4 percent), rather than remain unchanged as shown in the March forecast. If the Fed keeps short-term interest rates more elevated than anticipated, long-term interest rates should reflect the upward adjustment in expected short-term interest rates. As a result, this forecast implies that the yield on 10-year Treasury notes will actually drift slightly higher this year, as the reluctance by the Fed to aggressively cut rates becomes clearer. Although it is not obvious in the quarterly data, a 4.1 percent yield on the 10-year Treasury note in December this year would actually be slightly above the 4.0 percent rate in December of last year.

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 as long as consumers are willing and able to accept the higher prices. If consumers start to resist 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, such a-retrenchment by consumers most likely will curtail business activity and total revenue. When businesses cannot increase revenue through higher prices or increased volume, they generally attempt to reduce operating costs by cutting jobs. As unemployment increases, consumer spending most likely will retrench even further. I suspect that this phase of the business cycle is in its early stage, but likely will intensify as the year unfolds.

Details

First-quarter real GDP grew at a 1.3 percent annual rate, well below the March forecast of 2.1 percent but consistent with the slower pace expected for all of 2024. All of the growth in real GDP in the first quarter could be attributed to the 2.0 percent gain in real personal consumption expenditures (PCE), given that the other categories essentially canceled each other out; that is, the negative effects on real GDP growth from a wider deficit in net exports and a slowdown in business inventory accumulation apparently offset the positive effects on real GDP from gains in business fixed investment and government expenditures.

In the second quarter, although net exports may prove to be a drag on growth again, the accumulation of business inventories should be strong enough to offset it. As a result, real GDP growth in the second quarter is expected to increase 2.8 percent at an annual rate (see Table 1), led by gains in PCE, business fixed investment, and government spending once again.

First, real PCE is estimated to increase at a 2.5 percent annual rate in the second quarter, following a 2.0 percent gain in the first quarter. Interestingly, real PCE appears to have gotten off to a slow start in the second quarter, as suggested by the slight decline in April. Unlike the first quarter, when the surge in real PCE on services more than offset the moderate drop in real PCE on goods, the boost in spending on services in April was not enough. Despite the disappointing April report, the strong momentum in real PCE over the three months of the first quarter put real PCE in April at a level that was already 1.3 percent at an annual rate above the average for the first quarter. The implication is that only small gains in May and June are needed for second-quarter real PCE growth to match the forecast.

In that regard, retail sales excluding food services in May rose 0.2 percent, following a 0.3 percent decline in April, providing some support for a gain in real consumer spending on goods in May. Of course, spending on services will account for the bulk of real PCE growth once again in May. In the month prior to the pandemic (January 2020), consumer spending on goods accounted for about 31 percent of all spending. This ratio spiked to 35 in March 2021, before retreating to 32 percent in April 2021. The assumption underlying the forecast for real PCE for the remainder of the year is that as total consumer spending slows, the percentage of total consumer spending on goods will remain roughly at its April level.

Second, business spending on equipment and intellectual property is expected to contribute substantially to real GDP growth in the second quarter. This should be no surprise given the ongoing enthusiasm about artificial intelligence (AI). After all, before AI can contribute to corporate profitability, businesses must first invest in the equipment and software required to utilize it. Such investments may help explain the uptick in intellectual property spending in the first quarter, as well as the expected boost in business fixed investment on equipment and further gains in business spending on intellectual property in the second quarter. These two categories of business investment are expected to contribute about 0.8 of a percentage point to real GDP growth in the second quarter, after contributing 0.4 of a percentage point to real growth in the first quarter. Whether businesses continue to invest aggressively in AI will depend on the profitability of the investments already made.

Table 1
U.S. Economic Forecast

	Annual	2024 Quarterly				Annual	
	2023	**Q1**	**Q2*f***	**Q3*f***	**Q4*f***	**2024*f***	**2025*f***
Real Gross Domestic Product	3.1	**1.3**	**2.8**	1.8	0.9	1.7	1.1
Consumer Price Index, All	3.2	**3.8**	3.0	2.9	2.5	3.0	2.2
Consumer Price Index, Core	4.0	**4.2**	3.5	3.3	3.0	3.5	2.4
GDP Chain-Type Price Index	2.6	**3.0**	2.4	2.3	2.2	**2.9**	2.0
Civilian Unemployment Rate	3.7	3.8	**3.9**	**4.0**	**4.1**	**4.1**	4.8
Price of WTI crude oil ($/bbl)	78.5	77.5	81.0	80.0	78.5	78.5	70.0
Trade-Weighted Dollar	121.9	121.0	**122.4**	122.0	121.5	121.5	119.0
S&P 500 Operating Earnings	213.5	54.9	**57.1**	**58.5**	**55.0**	**225.5**	225.3
Percent vs. Year Ago	8.4	4.5	**4.1**	**12.0**	**2.0**	**5.6**	0.0
91-Day Treasury Bill Rate*n*	5.5	5.5	5.5	5.4	5.2	5.2	**3.5**
10-Year Treasury Note Yield*n*	4.4	4.2	4.3	4.2	4.2	4.2	4.2
30-Year Mortgage Rate	7.3	6.8	**7.1**	**7.2**	**7.1**	**7.1**	6.3
Bank Prime Rate	8.5	8.5	8.5	8.4	8.2	8.2	**6.5**

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.

n*—The 3-month and 10-year Treasury yields are at "constant maturities," which are interpolated by the U.S. Treasury from the daily yield curve for Treasury securities. This curve, which relates the yield on a security to its time to maturity, is based on the closing market bid yields on actively traded Treasury securities in the over-the-counter market calculated from composites of quotations obtained by the Federal Reserve Bank of New York.*

f*—forecast: data points in bold type reflect a major change from the previous forecast.*

Third, spending by state and local governments increased 2.6 percent at an annual rate in the first quarter, while federal government spending declined 0.7 percent. As such, state and local government spending accounting for all of the 0.2 percentage point contribution to real GDP from the government sector. In the second quarter, while state and local government spending is likely to increase again in the second quarter, federal government spending should register a gain as well. After all, it is a presidential election year, which tends to boost federal spending on infrastructure during the final two quarters of the year. For state and local governments, bond issues, sales tax increases, and budget surpluses seem to be driving spending at this level. On balance, government spending is expected to contribute 0.4 of a percentage point to real GDP growth in the second quarter, which is double its contribution in the first quarter.

Another statistic that favors a rebound in real GDP growth in the second quarter is the industrial production for the month of May. According to the Federal Reserve Board, output in the manufacturing sector increased a solid 0.9 percent in May, following a 0.4 percent decline in April. Assuming no change in June, factory output is on track to increase 2.3 percent at an annual rate in the second quarter. Once produced, the output is then consumed or added to inventories. Although both destinations of factory output will contribute to real GDP in the second quarter, they may have implications for factory output in the third quarter. That is, if the bulk of the gain in factory output in the second quarter ends up in inventories, then it may have negative implications for further gains in factory output in the third quarter.

Looking ahead

Hence, as usual, the key to growth in the second half of the year will be the purchasing power of consumers. In that regard, there has been concern about real disposable personal income (DPI) growth recently. For example, in April, real DPI was up a mere 1.0 percent from a year earlier, while real PCE was up 2.6 percent over the same period. This gap between income and spending growth is unsustainable. The question is: Will real income growth improve, or will real spending growth slow to a pace more in line with income? Although it is likely to be both, I expect spending to slow more than income improves as the year unfolds.

Of course, real DPI relies primarily on employment and inflation—employment to acquire income and low inflation to maintain its value. Over the twelve months ending in April, personal income grew 4.5 percent. However, after adjusting for inflation (2.7 percent) and tax payments (0.8 percent), real DPI in April was up a mere 1.0 percent from a year earlier. That said, there is evidence suggesting that real DPI likely rebounded in May, reflecting the sizable gain in wages and salaries after adjusting for zero consumer price inflation. As a result, real DPI in May is expected to be 1.4 percent higher than a year ago, indicating a meaningful improvement in purchasing power.

As shown in Table 1, the overall CPI jumped 3.8 percent at an annual rate in the first quarter, which was even higher than my above consensus estimate. However, the first quarter is old news. In more recent months, the CPI has slowed considerably, including essentially no change in May and the prospect of another benign reading in June. More importantly, the CPI excluding food and energy (core CPI), which also slowed markedly in May, caused many to be tempted to declare "inflation dead." Such a declaration may be a bit premature given that core CPI, unlike headline inflation, is expected to rebound somewhat in June. Recall that while core inflation is not the goal, it does provide valuable information about the underlying direction of consumer prices. After all, food and energy prices tend to be extremely volatile and can temporarily distort inflation information. In the long run, only headline inflation matters.

In that regard, despite the recent slowdown in May and possibly another again in June, the CPI in the second quarter is still on track to advance at a 3.0 percent annual rate and the core CPI is expected to advance at a 3.5 percent annual rate. The conclusion is that the Fed will need either more good news on inflation, or signs of weakness in the labor market before lowering its federal funds rate target range. The outlook detailed above does not portend the Fed lowering rates anytime soon. Some market participants expect the Fed to cut rates before the presidential election for political reasons.[1] Of course, in the past, if the Fed saw a need to make a policy move in a presidential election year, they typically did it either several months prior to the election or waited afterwards.

The Fed has made one thing clear—it remains committed to getting inflation down to a more sustainable level, which the Fed defines as 2.0 percent. Although there has been clear improvement toward the Fed's objective in recent months, it is too soon for the Fed to declare that its goal has been achieved. My concern is that for inflation to fall to 2.0 percent on a sustained basis, the economy will need to retrench in a meaningful way. Whether this retrenchment is defined as a recession by the National Bureau of Economic Research (NBER) most likely will depend on what happens to employment. Apparently, two consecutive quarterly declines in real GDP are not enough. Recall that real GDP declined in each of the first two quarters of 2022 (a negative 2.0 percent and a negative 0.6 percent, respectively) and it was not identified by the NBER as a recession. The primary reason was because unemployment remained low. Given the ongoing shortage of workers, a slowdown in economic growth may not necessarily translate into a surge in unemployment. Instead, there may be fewer jobs openings to consider.

[1]Financial market participants looking for politics to drive the Federal Reserve's policy decisions may be disappointed. Federal Reserve Board Chairman Jerome Powell served as a political appointee in the Treasury Department under George H.W. Bush, was nominated to the Federal Reserve Board by Barack Obama, promoted to Chair of the Federal Reserve Board by Donald Trump, and retained in that position by President Biden. Jerome Powell's term on the Federal Reserve Board ends on January 31, 2028, but his term as Chair ends May 23, 2026.