STONEBRIDGE
Capital Advisors

STONEBRIDGE ECONOMIC OUTLOOK

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Overview

As expected, the Federal Reserve cut its federal funds rate target at its September policy meeting. However, cutting by 50 basis points to a target range of 4.75-5.0 percent was a surprise, given that the recent economic data actually has been more optimistic than earlier, which tended to favor a less aggressive policy directive. Clearly the Fed is concerned that without an aggressive move by them at this juncture, the risk of economic stagnation outweighs the risk of inflation reaccelerating. According to the Stonebridge Capital Advisors' forecast for the second half of the year, the risks may not be as skewed as the Fed seems to believe. In fact, the U.S. economic outlook even before the rate cut was looking better. Based on recent data, the forecast for the second half of 2024 now shows somewhat better real growth, a normalization of the unemployment rate at a still low level, and a tad lower but a more volatile rate of inflation than shown in the *Economic Outlook* published in June.

Of course, fixed-income markets had already priced in a meaningful rate cut by the Fed, as reflected in the downward shift in Treasury yields across all maturities. For example, on September 16, prior to the September Fed policy meeting, the yield on 3-month Treasury bills was at 4.9 percent--down 60 basis points from 5.5 percent at the end of June, while the yield on 10-year Treasury notes was at 3.6 percent--nearly 100 basis points lower than 4.6 percent at the end of June. The larger drop in long-term interest rates reflected the market's expectation that the September rate cut is the first of many. What I find interesting is that on September 19, a day after the Fed rate cut, the 3-month Treasury yield slipped another 20 basis points to 4.7 percent, but the 10-year Treasury yield edged up 10 basis points to 3.7 percent. Hence, the Treasury yield curve, which remains inverted, went from being inverted by 90 basis points at the end of June to being inverted by 130 basis points on September 13 to being inverted by 100 basis points on September 19.

But this is only the initial response to the Fed's rate cut. In the event of further rate cuts, which is now the consensus view, it is unclear what will happen to long-term Treasury yields. Assuming that the improvement in inflation is as uneven as the Stonebridge forecast expects and the federal budget deficit expands in 2025 considerably more than currently estimated by the Congressional Budget Office, then long-term Treasury yields may struggle to fall much further than they already have. Of course, with less inflation and the implied loss of pricing power, corporate profits most likely will face substantial headwinds in the second half of this year and into 2025. In this regard, the hope of many is that artificial intelligence will deliver productivity gains that will drive profits in the absence of such pricing power.

One other factor that could drive financial markets later this year and into 2025 is the ongoing expectation that the federal government will do what is necessary with fiscal spending to prevent an economic slump or make it far less painful, if one does occur. The last two recessions provide a precedence for such a view. After all, in the 2008 recession, the federal government rescued many financial institutions and a few automakers from bankruptcy. During the pandemic recession of 2020, the federal government expanded its rescue efforts to include nearly everyone and every business, regardless of size or need. Indeed, the federal government's total cost of the 2020 bailout far exceeded the $800 billion spent on the "great recession" of 2008—estimates range from $2 trillion to $3.3 trillion. Although structural changes and regulatory provisions were supposedly put in place to prevent the need for such a massive relief program ever again, a massive government

bailout is still viewed as a viable safety net, which in turn may provide consumers with a false hope of being rescued by the federal government again.

Table 1
U.S. Economic Forecast

	Annual	2024 Quarterly				Annual	
	2023	**Q1**	**Q2**	**Q3*f***	**Q4*f***	**2024*f***	**2025*f***
Real Gross Domestic Product	3.1	1.4	3.0	**2.4**	**1.3**	**2.0**	1.2
Consumer Price Index, All	3.2	3.8	2.8	**1.4**	2.5	2.6	2.2
Consumer Price Index, Core	4.0	4.2	3.2	2.1	3.0	3.1	2.4
GDP Chain-Type Price Index	2.6	3.1	2.5	2.0	2.2	2.4	2.0
Civilian Unemployment Rate	3.7	3.8	3.9	4.2	4.2	4.2	5.0
Price of WTI crude oil ($/bbl)	78.5	77.5	81.0	77.6	**75.1**	**75.1**	70.0
Trade-Weighted Dollar	121.9	121.0	122.4	122.5	121.5	121.5	119.0
S&P 500 Operating Earnings	213.5	54.6	**58.6**	**58.5**	**56.0**	**227.7**	220.3
Percent vs. Year Ago	8.4	3.9	**6.9**	**12.0**	**3.9**	**6.6**	**-3.2**
91-Day Treasury Bill Rate*n*	5.5	5.5	5.5	5.2	**4.8**	**4.8**	3.5
10-Year Treasury Note Yield*n*	4.4	4.2	4.3	4.0	3.8	3.8	4.0
30-Year Mortgage Rate	7.3	6.8	7.1	**6.6**	**6.3**	**6.3**	6.3
Bank Prime Rate	8.5	8.5	8.5	8.2	8.0	8.0	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.*

The slight increase in the pace of economic growth in the second half is due to a more optimistic view on consumer spending than suggested earlier. In that regard, the level of real personal consumption expenditures (PCE) in July was already up at a 3.0 percent annual rate from the second quarter and is on track to contribute at least 2.1 percentage points to third-quarter real gross domestic product (GDP) growth. The net contribution to third-quarter real GDP growth from the other components is expected to be near zero, as gains in business investment and government spending are offset by losses in net exports and residential investment. On balance, real GDP in the third quarter is now expected to be 2.4 percent at an annual rate, up from the 1.8 percent growth rate expected in June. Moreover, real GDP growth in the fourth quarter has been revised upward as well to a pace of 1.3 percent at an annual rate from 0.9 percent earlier. As expected, all of the stronger gain in real GDP in the fourth quarter most likely will come from real PCE.

Real PCE was up a stellar 2.9 percent at an annual rate in the second quarter, while real disposable personal income (DPI) increased only 1.0 percent. In fact, this has been the case for the twelve months ending in July, with real PCE up 2.7 percent but real DPI up only 1.1 percent. This suggests that consumers have been either using their savings or taking on more debt to help pay for the surge in consumer spending over the last year. This dissaving behavior is reinforced by the drop in the personal saving rate to 2.9 percent in July 2024 from 4.4 percent a year earlier.

Recall that this measure of personal savings is defined in the National Income and Product Accounts (NIPA) as disposable personal income less personal consumption expenditures. The more widely accepted measure of savings is essentially the change in net worth. The difference between the two is that net worth includes any capital gains or losses, while the NIPA definition does not. In the last couple of years, rising home prices and record high equity prices have provided consumers with a much higher level of savings than reported by NIPA, which may allow them to rely on savings to finance spending for longer than the NIPA measure of the personal saving rate alone might suggest. Economists refer to the impact of savings and debt on consumer spending as the wealth effect, which can substantially—but generally only temporarily—boost real PCE growth relative to income growth. Hence, it seems that the wealth effect and its boost to consumer spending will continue as long as asset prices continue to climb.

As expected, a sharp increase in real business investment—including both fixed investment and inventory accumulation—and an uptick in government spending on goods and services added to real GDP growth in the second quarter. Real fixed business investment grew 5.2 percent at an annual rate in the second quarter, adding about 0.6 of a percentage point to second-quarter real GDP. Real business inventories added another 0.8 of a percentage point to real GDP, bringing the total contribution to growth in the second quarter to 1.4 percentage points. During the remainder of the year, I expect business investment to continue to grow but at a much slower pace, while government spending on infrastructure projects likely will remain robust.

Finally, both residential investment and net exports detracted from real GDP growth in the second quarter and are expected to do so again in the second half of the year. Residential investment most likely will be a further drag in both the third and fourth quarters, but maybe not as much as anticipated before the Fed rate cut. Remember that mortgage rates had already adjusted markedly to the expectation of a Fed rate cut, so there may not be much room for them to fall sharply lower

without clear evidence of a soft landing for the economy. Net exports, which are exports minus imports, are expected to be a drag in the second half but the exact timing of the drag is unclear. I expect the bulk of the drag from net exports to be in the third quarter, due to another jump in imports reflecting continued consumer spending and the ongoing push by businesses to rebuild inventories in preparation for the holidays.

The conclusion is that real GDP is expected to grow 2.0-2.5 percent at an annual rate in the third quarter before slowing to 1.0-1.5 percent annual rate in the fourth quarter. The slower pace of real GDP growth in the fourth quarter seems more appropriate at full employment given the changing demographics of the U.S economy. In particular, since the Bureau of Labor Statistics started collecting data in 2007, the foreign-born labor force has increased 40 percent, while the native-born labor force has increased only 6 percent. Nearly all the divergence in foreign-born labor force growth occurred after the "great recession" of 2008. The key is that without foreign workers, the U.S. economy would not have performed as well as it has over the last 15 years. Nevertheless, despite the large gains in foreign-born workers in recent years, native-born workers still account for 80 percent of the labor force. More important for the outlook is whether foreign-born workers will continue to be such a huge factor to labor force growth going forward.

Under these circumstances, the unemployment rate is expected to stabilize over the remainder of this year at a level slightly above 4.0 percent—the unemployment rate in July edged up to 4.3 percent but then retreated a bit to 4.2 percent in August. This is very consistent with the Stonebridge forecast, suggesting that the labor market is normalizing at a level commonly associated with full employment. In addition, it means that the monthly increases in nonfarm payroll employment will be more in line with the monthly gains in the labor force. On average, this has been the case for the last five months ending in August, during which the monthly increase in nonfarm payroll employment averaged 134 thousand, while the monthly increase in the labor force averaged 130 thousand.

Furthermore, inflation is on track to improve more in the third quarter than shown in the June forecast, but then is expected to retrace most of this improvement in the fourth quarter. The better inflation in the third quarter is likely to be more of a "base effect" than the change in prices over the three months of the quarter. For example, the CPI on a quarterly average basis is expected to be up a mere 1.4 percent at an annual rate in the third quarter (as shown in the Table 1), but on an end-of-quarter basis (September versus June), it is on track to increase at an annualized rate of 2.2 percent. As a result, the average for the third quarter is likely to provide a base that will make it more likely for CPI inflation to reaccelerate in the fourth quarter. At the moment, CPI inflation is expected to be up 2.5 percent in the fourth quarter, which may still be acceptable to policymakers but not as benign as the 1.4 percent pace in the third quarter.

Over the 12 months ending in August, the overall CPI is up 2.6 percent, with the 4.8 percent increase in the CPI for services more than offsetting the 1.2 percent decline in the CPI for goods (the Bureau of Labor Statistics refers to goods as commodities). Indeed, goods prices have declined in 8 of the last 12 months, including the last four. One reason the CPI will be up only 1.4 percent in the third quarter is due to the sizeable declines in goods prices in May and June, 0.35 percent and 0.36 percent, respectively. As a result, the average CPI for goods was well below the average for the quarter, which means the average for the third quarter will need to increase

considerably just to get back to zero. Although July and August have shown less goods deflation (the price declines are smaller), the average CPI for goods in the third quarter is on track to be down 2.0 percent at an annual rate.

Moreover, the increase in the CPI for services decelerated somewhat over the three months of the second quarter as well, contributing to the base effect on inflation in the third quarter. As a result, the CPI for services is on track to be up 3.5 percent in the third quarter rather than the 4.8 percent gain over the last year.

Interestingly, the base effect for the overall CPI may be operating in the other direction in the fourth quarter. Instead of inflation decelerating over the three months of the quarter like it did in the second quarter, CPI inflation is on track to accelerate somewhat over the three months of the third quarter, resulting in the September CPI to be at a level above its average for the third quarter. Of course, for CPI inflation to register the expected 2.5 percent annual rate of increase in the fourth quarter, service inflation will need to be sustained at about 4.0 percent and goods inflation will need to be near zero rather than negative.

Investment Implications

If the Federal Reserve follows market expectations and cuts its federal funds rate target by a total of 75 basis points this year, followed by more cuts next year, I contend that asset allocation will depend more on the justification by the Fed for aggressively cutting interest rates than on the rate cut itself. First, given the Stonebridge Capital Advisors' economic forecast, the Fed may find it difficult to justify another rate cut this year after cutting 50 basis points at its September meeting. After all, the economy is still expected to expand roughly in line with its potential, the unemployment rate is expected to stabilize at a level that more closely resembles full employment, and inflation is expected to slow but very unevenly. In this case, investors should own high quality bonds and stable dividend stocks.

Second, in order for the Fed to aggressively cut interest rates, the implication is that the economy is heading for a recession in the absence of lower rates. I contend that there is still a substantial risk that inflation could reignite if the Fed gets too cute about cutting interest rates prematurely. In the event that inflation does reignite, long-term interest rates would spike higher, causing both bonds and equities to face substantial headwinds. In this case, cash would be preferred.

A third possibility is that the U.S. economy is already in a recession and that the Fed needs to cut short-term interest rates immediately. The argument is that recessions are generally not recognized as such in the initial data but show up in data revisions. In this regard, some contend the revised data will confirm that the U.S. economy is already in a recession, as inferred by the inverted yield curve, a declining index of leading indicators, weak levels of consumer confidence, goods price deflation, weak housing data, and defaults on consumer loans. In this case, risk would be out of favor, with a preference toward high quality bonds. The problem is that some of these factors have long and variable lags as indicators or that various sectors of the economy are experiencing a series of rolling downturns that never quite drag the overall economy into a recession.

At present, I favor the first economic scenario but cannot totally ignore the other two. For that reason, I would stay the course, which in all three cases tends to favor quality, regardless of whether they are equity or fixed-income investments.

Prices Matter

The U.S. is a market economy, which means that it relies heavily on markets to determine the allocation of resources to the production and consumption of goods and services. The mechanism used to clear markets (where demand equals supply) is price. For example, if the demand for a particular product increases, the initial response would be a higher price for that product. The higher price, in turn, is a signal to businesses that they could increase the supply of the product and sell it at a price that would cover the added costs of more output. Of course, if demand declines, the initial response would be a lower price, signaling to businesses to cut production.

Alternatively, the price could increase because of disruptions in production, creating a supply shortage. The initial response is a higher price, which not all consumers are able or willing to pay, causing demand to fall and the market for this product to clear. On the other hand, an innovation that allows businesses to produce more with the same inputs (improved productivity) means more output at the same price. Of course, the only way the market clears with a sharp increase in output without a corresponding increase in demand is a lower price.

The bottom line is that in the U.S. economy, prices clear markets. As a result, prices provide important information to consumers and producers that allow for the efficient distribution of resources and boost our standard of living. Nevertheless, there are times when market conditions in aggregate can become excessive, and prices can spiral out of control. However, in such episodes, prices are not the problem but only the signal of a problem. The solution is not government control of prices. The best way to get price inflation under control is to address the cause of higher prices.

Supply disruptions can be the most painful form of inflation because it generally means that there is less product available at any price. I am old enough to remember the 1973 oil embargo, which halted oil shipments from OPEC to the U.S. from October 1973 to March 1974. Since we were very dependent on OPEC, the price of crude oil increased sharply, causing a worldwide energy crisis that led to a combination of high inflation and economic stagnation (stagflation). The result was a U.S. recession from November 1973 to March 1975. Moreover, because of stagflation, the response of monetary policy to this recession was complicated. Skyrocketing energy prices were an important incentive to encourage oil companies to boost domestic production, which most likely would worry OPEC about losing its share of the U.S. market. It was not until crude oil prices were allowed to fully adjust to market conditions that supply recovered.

In the current economic environment, inflation has already improved because most of the supply disruptions in the goods sector caused by the pandemic have ended. However, as was the case following the 1973 oil embargo, some of the price effects from the disruptions during the pandemic most likely will take longer to dissipate, especially in the services sector. Indeed, not until the demand for services slow dramatically or the supply of services increase sharply will service inflation improve more in line with the Fed's target of overall inflation. Hence, the Fed may not

be as anxious to cut its federal funds rate target range as aggressively as financial market participants now expect.

An Explanation?

During a recent conversation with a client, I was asked why I had removed the recession from my forecast of 2024, which was a polite way of asking why I was so wrong last year. The purpose of this section is an attempt to provide an explanation. To begin with, I rely on historical relationships, theoretical analysis, and intuition when forecasting the U.S. economy. One such historical relationship, founded in theoretical analysis but still requiring some intuitive interpretation, is something I call the LQ Indicator. This proprietary index, which I developed decades ago, has done a very good job over the years of anticipating major turning points in the stock market cycle, and in turn, the business cycle. One aspect of the Indicator is that when it drops to a level well below 100 and remains within a narrow range at the lower level for an extended period, it usually means that equity prices, as measured by the S&P 500 index, will reach a record high just before the start of a bear market. More importantly for the economic forecast, it also suggests that the current expansion is about to end and a recession lies ahead.

In late 2019, the Indicator had fallen to a level of about 30, where it was stabilizing around that level and the S&P 500 index was hitting new highs. At the time, I interpreted this action by the Indicator to suggest that a recession was about to begin and the stock market would correct accordingly. As a result, the Stonebridge Capital Advisors (SCA) economic forecast warned that a bear market and a possible recession was ahead. Of course, when governments imposed stay-at-home orders in early 2020 in response to the COVID-19 pandemic, it plunged the economy into a recession and the S&P 500 index dropped, making me look like a genius—for about two months, which was how long the recession lasted according to the National Bureau of Economic Analysis. In March 2020, the Indicator began to climb, rising above 100 (which is the signal to buy equities) by August of that year. However, the Indicator did not get much above 100 or stay there very long before it plunged once again to a reading of 24 by July 2022. More interestingly, the Indicator has remained within a relatively narrow range ever since.

Now here is where I got confused and misread the Indicator. I thought that the rally in the S&P 500 Index following the end of the COVID-induced recession into early 2022 was the peak in the market that generally precedes a recession. Recall that real GDP declined in each of the first two quarters of 2022, which defines a recession for some. However, the National Bureau of Economic Research did not identify a recession in the first half of 2022 due in large part to employment and consumer income remaining strong. With the Indicator hovering around 30, I thought it was only a matter of time before the U.S. economy would fall into an official recession and that the peak in the stock market at the end of 2021 would be the peak for the current business cycle.

What I failed to do was believe the Indicator. After all, the stock market always peaks after the Indicator levels off at a relatively low level and not before. I thought because of the pandemic, it would be different this time. Of course, it was not. Once I realized my interpretation of the Indicator was incorrect, I made the appropriate changes to the forecast, which in this case was extending the economic expansion at least through the end of 2024. That said, I still expect a recession—sometime. Adding to the confusion is the fact that the August reading of the Indicator broke out to the upside of the relatively narrow range it has been in for over two years. What

makes this unusual is that typically such a move by the Indicator occurs when equities are already in a bear market. That said, one week of stock price declines does not define a bear market.

Clearly, I did not predict COVID-19 and was shocked by the pandemic that followed. What was equally shocking was the extent of government response, including the relief provided to counter the economic hardships of the pandemic. Unfortunately, this relief effort had its own list of economic consequences to deal with, including inflation and labor force participation. Indeed, the recent improvement in such consequences tend to support the view that the U.S. economy may avoid a recession; once again, this seems at odds with the signal from the Indicator. In addition, the Federal Reserve cutting its federal funds rate target by 50 basis points at its recent policy meeting suggests that it is prepared to do what is necessary to avoid a recession. The question is whether it will do too much, too soon to avoid a reacceleration in inflation. Stay tuned.