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WEALTH MANAGEMENT

Inflection

Economic & Market Commentary
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As we head into the final quarter of 2024, we believe the U.S. is at an inflection point with respect to monetary policy, as we have discussed since the beginning of the year. Looking backwards, we experienced a steady and steep increase in the Federal Reserve's Fed Funds interest rate from March 2022 through August 2023, which took the upper band of that rate from 0.25% to 5.50%.That rate held until last month, when the Fed cut the rate ½ of 1% to 5.0%. The cut in rates is no surprise, and the magnitude of this first cut likely will not prove to be as important to the economy as the forthcoming cumulative decrease in the Fed Funds rate during this cycle.

The economy has demonstrated more strength than many of the surveys and leading economic indicators have forecasted. Much of this is due to the resilience of our consumption-based economy, powered by employed consumers with real wage gains, and invested consumers with rising portfolio income powered by increasing portfolio values. This is important because consumption makes up roughly 65% of our economic activity (St. Louis Fed). While economists still reference scenarios of an economic soft landing, hard landing, or no landing, one should consider the strong possibility that the Fed got it right, and we end up somewhere between a soft landing and no landing, meaning that economic activity continues at about this pace, with easier monetary policy improving the odds of this outcome.

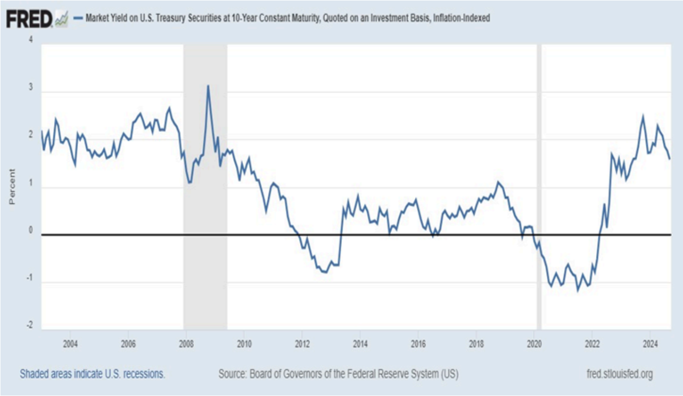
Clearly, the employment market has downshifted. New jobs filled are down about 20% from last year's pace, and the initial reports have been downwardly revised at twice the rate as last year (20% versus 10%). The obvious risk is that the downshift picks up speed, and what has been a strength, becomes a weakness for the economy. You will see increased attention to this data as economists sort things out, and rightfully so, as the employed consumer has been one of the pillars of strength for our economy.

The other mandate of the Federal Reserve is to maintain price stability. Prior monetary tightening was intended to put a lid on the quickening pace of rising inflation. This, in combination with other monetary policies has worked as the year-over-year increase in the headline Consumer Price Index (CPI) came in at 2.60%, down sharply from prior years. There has been and will be a difference between "goods" inflation and "services" inflation, with goods inflation being more driven by commodity prices, raw and intermediate goods prices, and services being more driven by labor costs. Goods inflation is well below target, while services inflation has remained a bit more stubborn. Looking ahead, trailing monthly data, combined with recent trajectory, shows a strong possibility that CPI for 2024 comes in at about 2%, and if the economy weakens going into the end of the year, it could be less.

As we are likely entering a lower inflation environment coupled with steadily decreasing short-term interest rates, we enter a different economic paradigm. Falling short-term interest rates reduce the interest expense for many smaller businesses where borrowing is more likely to be based on short-term ates. This can be viewed as additional wind in the sails for such companies. Companies may also experience falling goods, raw and intermediate materials prices, which would decrease operating costs, potentially widening profit margins. Companies large and small have benefitted from rising productivity based on applied technology and more traditional methods, which has boosted corporate income. FactSet reports that Wall Street analysts continue to expect rising profits with corporate earnings growth expected to come in at about 10.4% for 2024 and 15.0% in 2025.

Based on Federal Reserve comments, it is expected that the Fed Fund's rate drops to about 4.5% by year end, and to 3.5% by the end of 2025. This will put downward pressure on the interest rates of short-term investments such as money market funds and short-term bonds.Should historical correlations hold, money market yields could drop by about 1/3 by the end of 2025. Leading up to this inflection point, economic data since mid-April showed continued cooling in the labor market, much lower inflation, and weakening economic forecasts, which contributed to longer-term interest rates falling. The yield on the 10-year US treasury has dropped from about 4.70% at the end of April to about 3.75%, and it is possible that most of the downshift in longer-term interest rates is behind us, as future expectations are already "baked in" to current pricing.

If inflation averages 2.0%, a 3.75% interest rate on a 10-year US treasury offers a 1.75% real (after inflation) yield, which is close to the longer-term average when Great Financial Crisis and Covid related impacts are excluded. Income investors will likely need to be a bit more creative in seeking attractive interest income opportunities for the next number of years.



Inflation seems to have been backed into a corner and is not expected to rebound. However, the jobs market may be softening at a faster rate than desired, which could negatively impact future economic activity. We have another month of election related noise to contend with, and the armed conflicts in hotspots around the world are no closer to being resolved. In what has become a more policy driven economy, it is important to keep an eye on Monetary Policy, the expected Fiscal Policies, and how companies react to these policies and to changing economic activty with respect to investment and hiring decisions in the coming year.

All the best,

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Sources: Federal Reserve Bank of St. Louis, Bureau of Labor Statistics, FactSet