Economic & Market Update

Second Quarter 2024 Review & Outlook

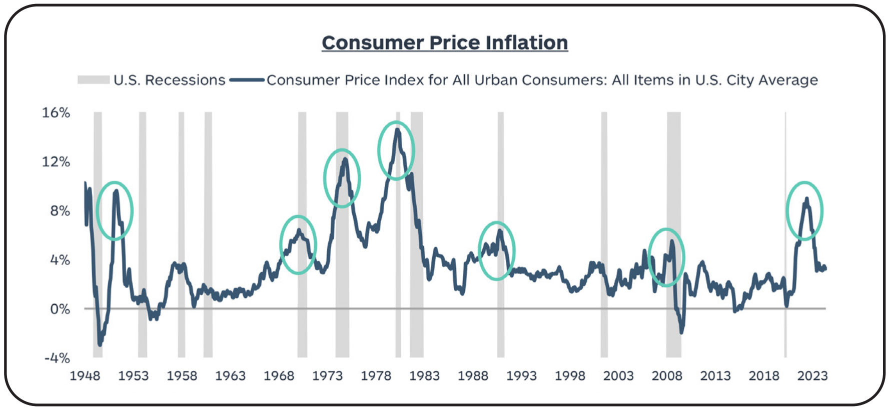
Second Quarter Review

PUTTING THE "SOFT" IN "SOFT LANDING"

After sticky inflation captured most of the focus in the first quarter, the second quarter brought some relatively weaker economic data that called into question key areas of economic resilience. While not quite enough to convince the Federal Reserve (Fed), markets seemed to take moderating labor markets and consumer spending as a sign that inflation will remain suppressed enough for rate cuts to begin later this year. In the meantime, while certain interest-rate sensitive pockets of the economy struggle, and others move from "very strong" to "strong," overall economic activity continues to chug along. As of this writing, the Atlanta Fed's GDPNow model is tracking for 1.7% growth in the second quarter (Q2), which would be a modest acceleration from the first quarter (Q1), when weak inventories and net exports limited growth to 1.4%.

A BUMPY ROAD TO 2% INFLATION

Reflecting on how far we've come, we must take a moment to acknowledge the relatively painless nature of the disinflation we have seen so far. After all, the U.S. economy saw the year-over-year Consumer Price Index (CPI) go from its peak of +9% in June 2022 back down to +3%, all while adding over $1 trillion (inflation-adjusted) to annual economic output, as well as over 100,000 new jobs each month along the way. This is not typical. Usually, when inflation spikes meaningfully, a recession is required to put a lid on price increases and ultimately push inflation back down. The last exception to occur was in 1951. Back then, supply disruptions from the Korean War and a rush of demand from consumers with fresh memories of WWII rations sent year-over-year CPI to nearly 10%. After solidifying its independence with the Treasury-Fed Accord in 1951, the Fed was able to regain control of interest rates that had been pegged artificially low to protect the value of war bonds. After rates were allowed to rise, inflation was back down to 2% by March 1952 and no recession was required.



Source: FRED

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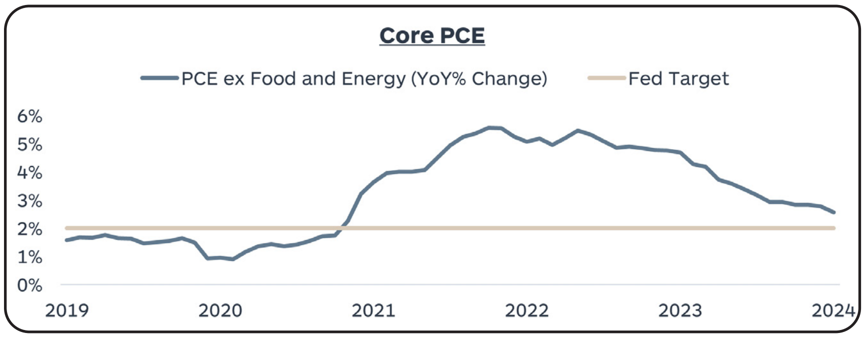
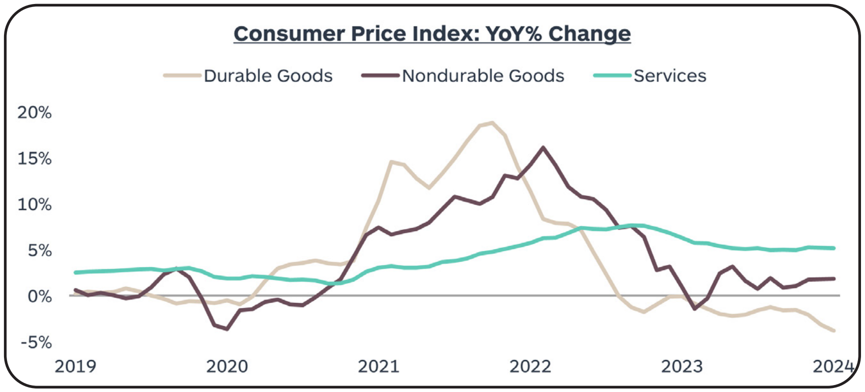
Since then, we've seen six cases of year-over-year CPI breaching 5% (including in 2021). In the first five instances, inflation didn't peak until a recession had already begun. So, at least within this context, "this time" has *already* been "different."

Of course, none of this says much about what to expect as we navigate the "last mile." Q2's three CPI releases all began with a "3," while the Fed has been clear that its ultimate goal for inflation is 2.0% (although Fed Chair Jerome Powell seems to be communicating that confidence in "a sustainable path to 2.0%" may be enough to begin easing policy). Fortunately, the core Personal Consumption Expenditures (PCE) price index (the Fed's preferred inflation metric) is closer to the target at 2.6% as of the end of May.



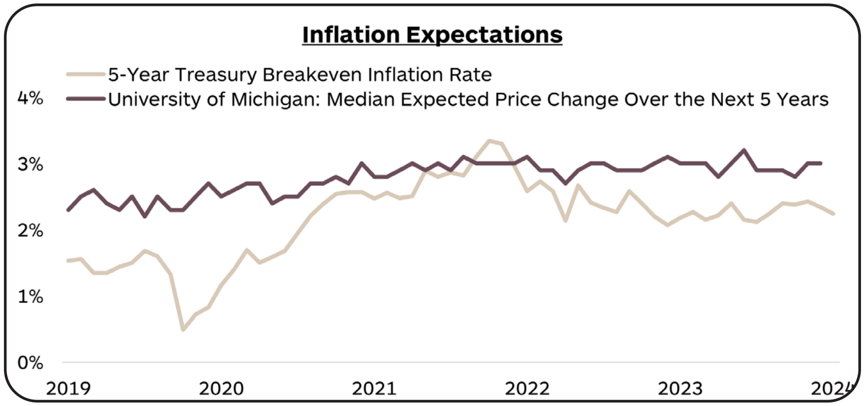
Source: FRED

With durable goods prices back to their longer-term deflationary trend, what is left behind are stickier components like shelter and services. Shelter inflation is currently being supported by housing shortages and measurement quirks, while services inflation is reacting to resilient consumer demand and solid wage growth (a major cost for service-related industries).



Source: FRED

Despite the recent bump along the road to 2%, longer-term inflation expectations remain anchored near recent historical averages.

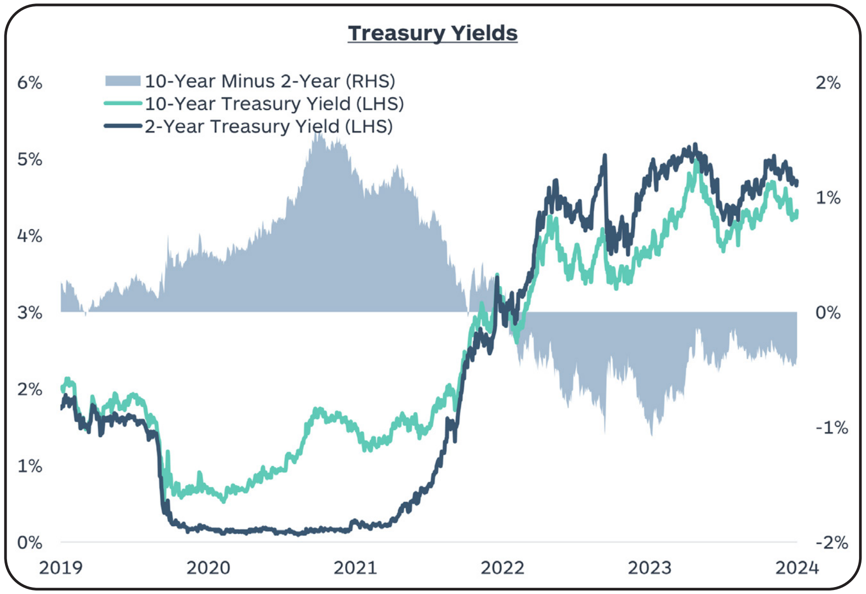


Source: FRED, University of Michigan

AWAITING THE CUTTING CYCLE

While policy rates were held in place during the quarter, the June Federal Open Market Committee (FOMC) meeting brought with it a new Summary of Economic Projections (aka “dot plot”). The latest release revised the FOMC’s median expectations for rate cuts in 2024 from three down to one (with a range of zero to two). The committee’s latest communication largely confirms the progression of market pricing in federal funds futures, which had gone from expecting six 2024 rate cuts in the beginning of the year all the way down to one or two.

Despite delayed rate-cutting plans, weakening economic data helped put a stop to the rise in longer-term interest rates. In April, 10-year U.S. Treasury yields peaked at 4.70% and moved lower throughout the rest of the quarter. By June 30, yields had settled at 4.37%.



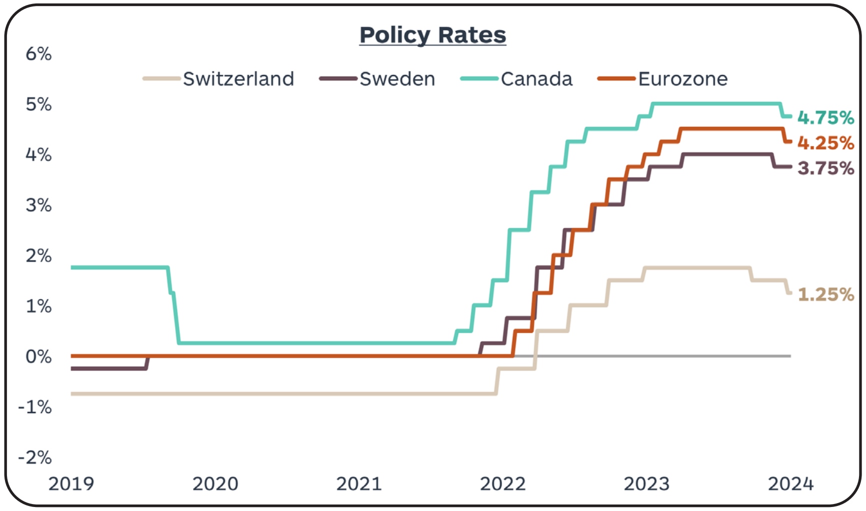
Source: FRED

THE INVERSION LIVES ON

With the 2-year U.S. Treasury yield at 4.72%, yield curves remain stuck in inversion. Often, inverted yield curves are resolved by way of rapidly falling short-term rates as some type of economic shock requires swift policy easing. As we pass the two-year inversion anniversary without such a crisis, short rates continue to reflect plans for a slow and steady easing cycle. Longer-term rates are attempting to balance the concepts of eventually lower short rates with sticky inflation and increasing future supply to finance large fiscal deficits.

GLOBAL POLICIES DIVERGE

While the Fed’s monetary policy has been on hold, relative weakness in other economies and better progress on inflation have allowed some central banks to jump ahead and begin cutting interest rates. The Swiss National Bank, Swedish Riksbank, Bank of Canada, and European Central Bank have all announced rate cuts, although the risk of sticky inflation led each to avoid fully committing to meaningful further cuts.

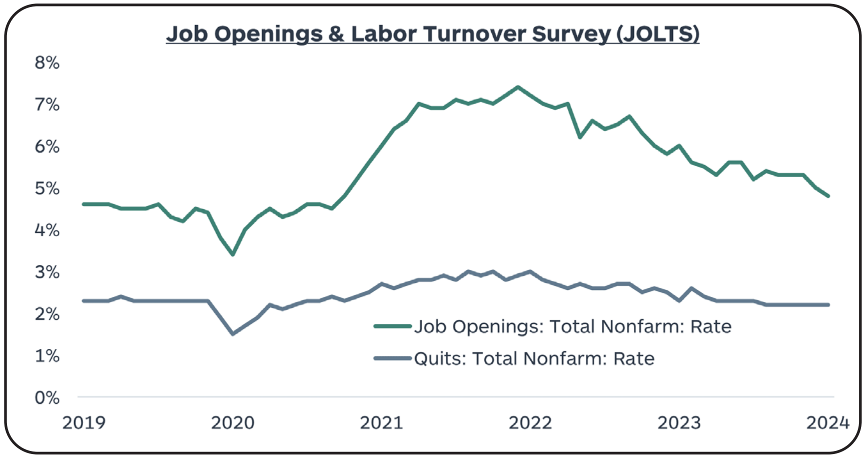


Source: FactSet

Like in the United States, any further easing from these central banks will need to be predicated by confidence that high inflation remains in the rearview mirror.

LABOR MARKETS GOING FROM "VERY STRONG" TO "STRONG"

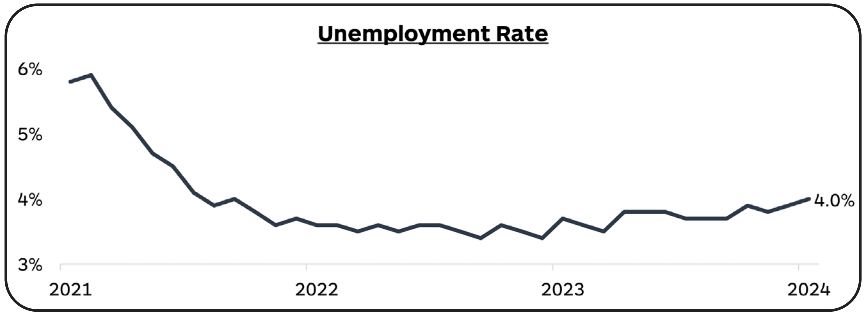
Back in the United States, supply and demand within labor markets are showing signs of converging through reductions in job openings rather than layoffs. So far, companies have adapted to tighter financial conditions by hiring less rather than firing more.



Source: FRED

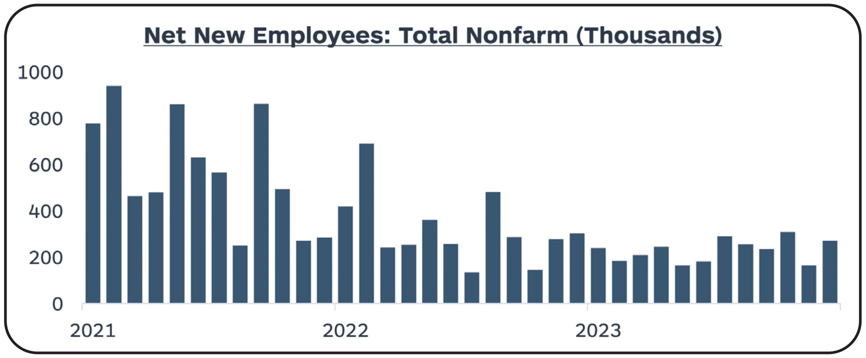
A dropping "quits" rate reflects marginally less optimism from employees on their prospects for finding a better job. This dynamic should help keep overall wage inflation in check, since job hopping has been well-documented as the best source of substantial wage gains.

When measured using the unemployment rate, the labor market also remains historically strong but may be showing some mild cracks as the jobless rate ticked up slightly to 4.0% as of the end of May.



Source: FRED

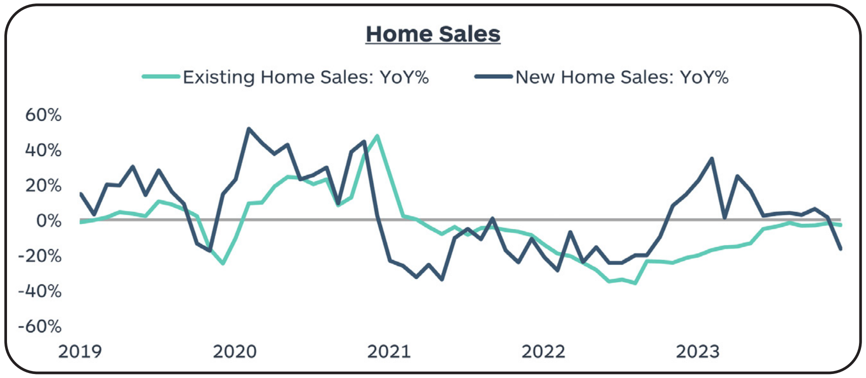
The mild increase has been attributed by some to recent influxes of immigration, which is increasing the pool of job seekers. Despite a modestly higher unemployment rate, job creation remains very strong, with over 1.2 million jobs created this year through May, according to the Bureau of Labor Statistics.



Source: FRED

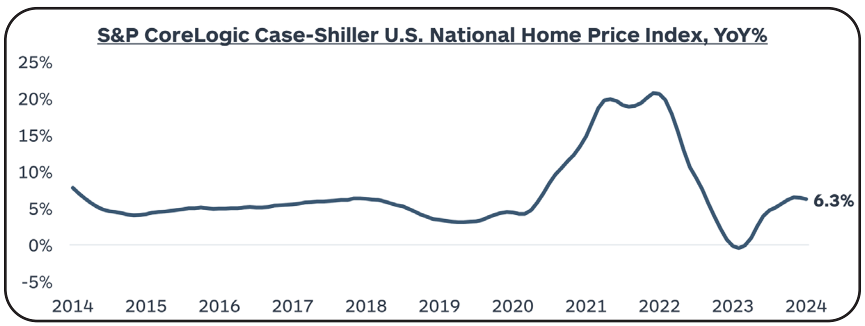
HOUSING MARKETS STILL HUNTING FOR EQUILIBRIUM

Housing market activity continued to struggle amid high rates and low affordability. Housing starts, building permits, and existing home sales continued to fall year-over-year.



Source: FRED

Despite tepid activity, the "lock-in effect" of existing homes continues to keep a tight lid on supply and allow for home prices to resume their upward march. With almost 40% of all homes mortgage-free and nearly half of those with mortgages enjoying fixed rates below 4%, homeowners are highly disincentivized to list their homes for sale, which leaves desperate home-seekers to fight over limited inventories.



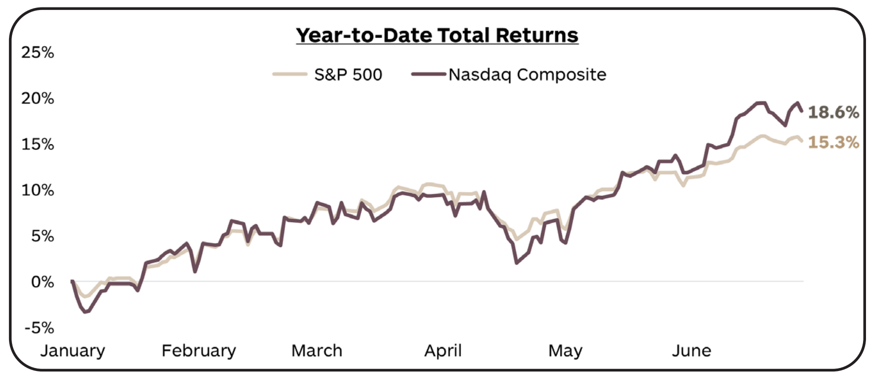
Source: FRED, S&P Global

With few existing homes available, homebuilders have cautiously stepped into a role of marginal supplier. Although they account for a small fraction of the overall housing stock, construction of new homes provides an important tailwind for economic growth across several sectors. Housing starts continue to fall from their 2021 peak but remain generally at or above pre-Covid levels.

Source: FRED

"HAVES" AND "HAVE NOTS" IN THE EQUITY MARKETS

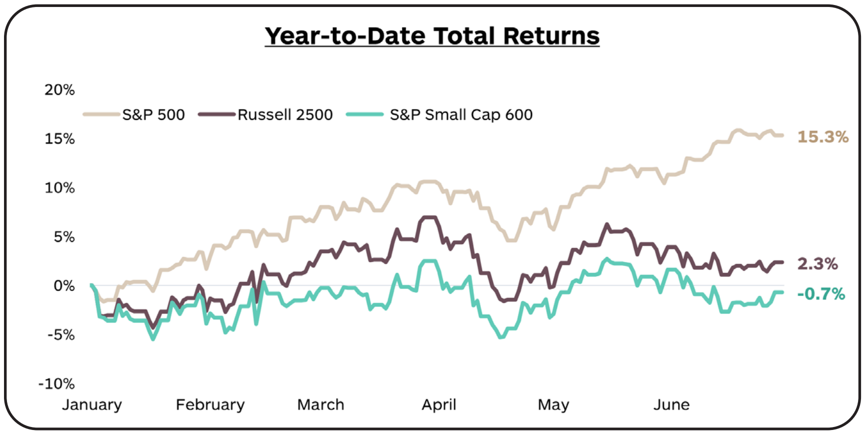
Equity markets posted a solid quarter at the headline level, but the story of limited breadth continues under the surface. Large cap technology stocks continue to forge along, emboldened by the game-changing promise of artificial intelligence (AI).



Source: FactSet

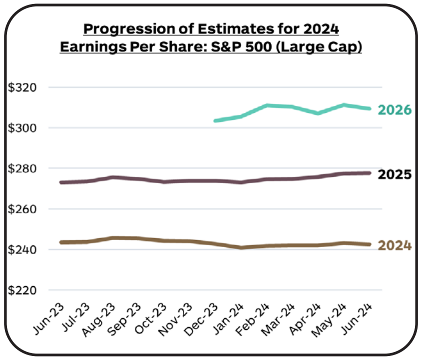
The proliferation and mind-boggling pace of progress for large language models like OpenAI's ChatGPT have started an arms race amongst "hyperscalers" who rush to build data centers and fill them with the graphics processing units needed to process large amounts of data. The main beneficiary? Nvidia, of course. The company's stock gained another 37% during the second quarter, driving its market cap past $3 trillion, which was briefly enough to dethrone Microsoft as the world's most valuable company. Though its valuation is by no means cheap, the company has again been able to back up its eye-popping stock performance with earnings growth of almost 600% year-over-year.

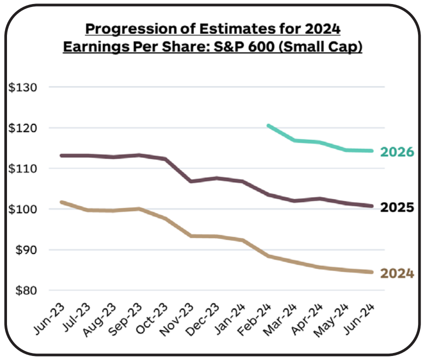
While the "AI trade" pulled the tech-heavy Nasdaq composite to an 8% quarterly total return, the average large cap stock (as defined by the S&P 500 Equally Weighted Index) was down 3% for the quarter. Meanwhile , smaller stocks continue to struggle, with the "smid cap" Russell 2500 Index down 4% and the "small cap" S&P 600 Index down 3% in the quarter.



Source: Morningstar Direct

Smaller companies seem to be perceived as struggling in an economic environment of sticky inflation and higher interest rates. With less pricing power, more debt, and less of an earnings cushion to absorb higher coupon payments, analysts are not yet convinced of small companies' ability to protect and grow profit margins in a potential "new normal" environment. In our opinion, a few Fed rate cuts will likely help. In the meantime, an already lowered fundamental bar, attractive valuations, and pessimistic sentiment all clear the runway for solid future performance.

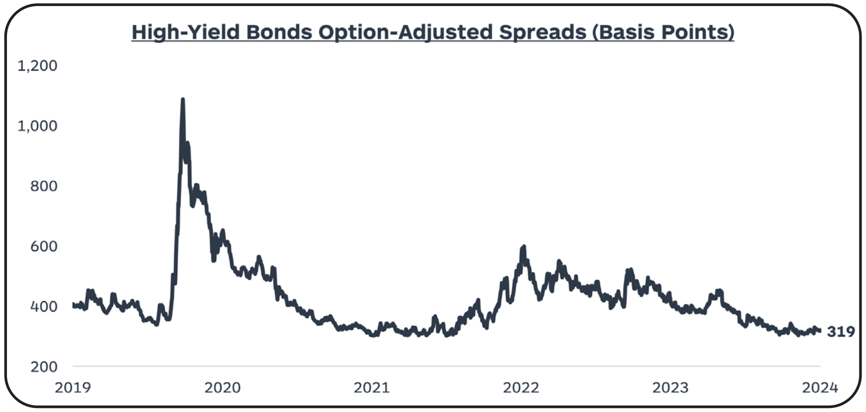




Source: FactSet

NO ALARM BELLS IN HIGH YIELD

Despite the relative underperformance of riskier equity cohorts like small caps, high-yield bond markets remain surprisingly sanguine. Even with sticky inflation, delays in Fed easing, and more recently, moderating economic data, high-yield spreads remain anchored near historical lows.



Source: ICE BofA US High Yield Index, FactSet

Default rates have ticked up from low levels, but they're not near a place that would be considered a symptom of broader systemic concern.

CHOPPY WATERS IN OVERSEAS MARKETS

International developed markets largely trailed U.S. large caps during Q2 in reaction to a weaker economic picture and lower corporate profit expectations. Japanese equities took a breather in Q2 but managed to hold onto impressive gains from Q1. Japanese investors are attempting to parse between anemic growth and a rapidly depreciating currency with shareholder reform and the beneficial impacts of a reignition of inflation. In emerging markets, China's economy and stock market remain highly volatile. Hope of an economic trough led to a dramatic bounce in Chinese stocks to start the year, but enthusiasm fizzled out in mid-May as it became clear that Chinese authorities were willing to offer only modest and sporadic fiscal and monetary support.

Source: FactSet

Outlook for the Third Quarter

U.S. ECONOMY DRIVEN BY JOBS AND FISCAL SUPPORT

The U.S. economy appears to be slowing just enough to revive dormant disinflationary forces, but not enough to provoke fears of recession. Jobs and wage growth should continue to be the primary driver of consumer spending though markets will be monitoring the slight weakness beginning to develop in weekly jobless claims and job openings to see if it leads to meaningful employment declines over the coming quarters. While the more cyclical income effect on consumer spending should always be the primary determinant of its magnitude, a developing secular dynamic supporting spending relates to the wealth effect and the increasing willingness to draw down excess savings, particularly among the recently retired members of the baby-boom generation who will likely continue to spend on experiences within the services economy. Another potential support to economic growth will be the greater fiscal spending that usually occurs in presidential election years when an incumbent is running for reelection. Recently announced student debt relief and greater defense spending due to heightened geopolitical risk should make its way through the economy over the summer months.

Businesses have been more restrained than consumers in their year-to-date spending patterns. But with no apparent overbuild in inventories and the need to invest in productivity-enhancing technology applications in a somewhat labor-constrained environment, capital spending should be supportive of economic growth through the remainder of the year. The housing sector has been pressured by high mortgage rates and high prices in a still-somewhat supply-constrained existing home sales market. Oversupply in the multifamily sector of the new homes market will likely be a constraining factor in the growth of the overall sector. A decline in mortgage rates appears to be needed for housing to add to gross domestic product (GDP) growth, but that is not likely to occur until sometime in the fourth quarter.

INTERNATIONAL ECONOMIES MORE STAGNANT

Heightened political drama in Europe could potentially lead to growing nationalism and protectionist policies, which are less amenable to the deficit and debt principles of the European Union. Concerns around growing deficits due to proposed fiscal spending and tax-cut initiatives are driving longer-term interest rates higher in several countries, which could choke off the burgeoning recoveries that had been developing across the continent. In an environment of greater trade constraints, Europe will need a notable increase in domestic spending to return to more normalized GDP growth rates.

The Japanese economy appears to have recovered a bit from its disappointing Q1 GDP decline. The primary catalyst for the improvement was continued depreciation of the Japanese yen, which made exports more attractive, but further support was provided by higher union- negotiated wages. With additional yen depreciation unlikely given the pending tightening of monetary policy, further recovery in the economy will be a function of healthy jobs and wage growth.

Given the structural headwinds of growing global trade protectionism, weak demographics, and a property recession, the Chinese economy will need ample government support to achieve stated growth targets. The support has yet to be enough to fully revive mainland markets where investors remain highly skeptical of the long-term commitment to the entrepreneur class and profit-driven enterprises.

CENTRAL BANK EASE

In a somewhat unusual turn of events, several central banks in continental Europe have begun the monetary easing process well ahead of the Fed as their respective economies are weaker and inflation is lower than in the United States. The ECB implemented its first cut of 25 basis points in June even though inflation is still above the 2% target. With inflation expected to remain on a declining path, we anticipate further rate cuts over the second half of the year to revive a stagnant economy.

The Bank of England remains reluctant to move ahead of the Fed and has so far kept its benchmark rate steady, but it appears inevitable that a cut will occur as early as the August meeting as economic growth is slowing. A few members of the central bank's Monetary Policy Committee have already voted for a rate cut.

Looking toward the Fed, there is growing comfort that goods price inflation has been eradicated, but services prices remain stubbornly high. With some relief starting to be seen in areas such as shelter and motor vehicle insurance, the Fed will await confirmation of continued progress before announcing the first cut—most likely at its September FOMC meeting. With no recession on the horizon at this time, the easing process should be very gradual as inflation continues to recede to the 2% target.

In Asia, the Bank of Japan (BOJ) never joined the tightening trend as it was cheering the long-awaited return of inflation to the Japanese economy. With the recent union wage settlement likely to lead to some element of demand-induced inflation, the BOJ will finally be able to begin the process of moving away from zero interest rates and extreme balance sheet expansion. The People's Bank of China will likely provide some monetary policy ease as the economy is growing slower than official forecasts, but Chinese central bankers are wary of excessive currency weakness and will largely defer to fiscal policymakers for most stimulus measures.

BOND MARKETS CAUTIOUS

Slower economic growth and the resumption of progress on lowering inflation should prevent any further spike higher in intermediate-term interest rates. With the Fed about to embark on a gradual easing cycle, short-term yields should begin to decline, but longer-term yields will likely remain in the trading range we've seen this year as the yield curve slowly returns to its normal upward slope. Greater issuance of Treasury securities to fund ever-growing deficits will also likely prevent a notable drop in intermediate yields.

Municipal supply continues to be robust, although it is expected to moderate as we head into the election cycle and as issuers wait for the first rate cut. Nationally, municipalities are in a strong financial position—credit upgrades have outpaced downgrades by more than 2-to-1 in 2024. Real yields and taxable equivalent yields are still quite attractive, and we would recommend beginning to extend duration to lock in these higher yields.

Interest rate spreads on high-yield bonds remain historically low with no recession in the forecast. Default rates are expected to remain low, but refinancing risk over the coming year may cause some spread widening with near-term caution advised around the asset class.

EQUITY MARKETS NEED BETTER BREADTH

With valuation multiples at current levels after a strong first half of the year, U.S. large cap equities appear fairly valued and may exhibit some volatility as prospective Fed ease has been largely discounted and investors eagerly anticipate the second quarter earnings season. Fortunately, it appears earnings growth rates should rise over the coming quarters to confirm current valuations. Better opportunities may exist in the more cyclical sectors and in the small- and mid-cap space where valuations are much cheaper and where some industries and sectors are emerging from recent downturns.

Despite the slowing in their domestic economies, European and Japanese equities should continue to be supported by robust growth in their export sectors, weaker currencies, and progressively looser monetary policies. These dynamics should attract investors to the relatively cheap multiples and allow developed international equities to at least match the return of those in the U.S. large cap space.

Emerging market equities remain anchored to the disappointing Chinese growth outlook, although investors are becoming more interested in neighboring India and some of the emerging Latin American markets. Additional monetary policy support is likely needed as a catalyst to drive outperformance in these markets.

COMMODITIES & CURRENCIES – SLOWING THE DOLLAR BULL

Barring any exogenous events that impact global supply, the energy markets are rather balanced between current production plans and global demand. This equilibrium should likely keep oil trading in a narrow range around current levels through most of the third quarter.

The implementation of recent central bank rate cuts and the anticipation of further cuts and eventual easing at the Fed has driven gold prices higher. After some consolidation of these gains over the summer months, gold may resume its advance in an environment of easier global monetary policies.

Anticipation of Fed easing should slow U.S. dollar appreciation against most other major currencies, although the relative strength of the U.S. economy and the notable interest rate differential in the bond markets will prevent any sharp sell-off from current levels.

WHAT THIS MEANS FOR INVESTORS

Global economies may be growing slowly, but they are still expanding, and the slower growth is helping resolve most global inflation issues. Geopolitical turmoil is likely the biggest tangible risk to this scenario given ongoing wars and domestic political upheaval in several countries. The upcoming U.S. congressional and presidential election adds another level of uncertainty that may cause some consolidation in risk assets.