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Economic & Market Update

September 2024 Outlook

Labor Markets Are Not Weak, but They Are Weakening

- After their persistent strength throughout the rate hiking cycle, labor markets seem to be finally moving back toward equilibrium. The Nonfarm Payroll report for July revealed a slower pace of hiring, adding 114,000 new jobs in the month, which was well below consensus estimates. The Bureau of Labor Statistics also revised down its previous initial reports, shaving off 818,000 new jobs between April 2023 and March 2024. Despite the downward revisions, our economy continues to add new jobs at an above-average rate (209,000 per month over the last 12 months, compared to a 21st-century average of 95,000).
- The unemployment rate also ticked higher in July to 4.3%. This unexpectedly high increase triggered the oft-discussed "Sahm Rule." This rule, introduced by economist Claudia Sahm in 2019, suggests that an economy is in a recession when the three-month moving average of the unemployment rate rises at least 0.5% above its lowest point over the prior 12 months. However, even Sahm herself acknowledged that the heuristic may be missing a key factor: the supply of labor. Digging into the unemployment report reveals that a notable contribution to increasing unemployment was from jobless individuals who recently joined or reentered the labor force. Immigration (which has been surging recently after grinding to a halt during the COVID-19 pandemic) likely played a part. Meanwhile, only about a quarter of the increase was attributed to "permanent job losers," a cohort that typically drives the increase during recessions (COVID was an exception, when "temporary layoffs" spiked). Limited layoffs may explain why initial jobless claims remain muted even as the unemployment rate rises. To be sure, employer demand for labor has fallen, as reflected by falling job openings in the Job Openings and Labor Turnover Survey. This may be a function of a "pull forward" in demand from prior years by employers who scrambled to hire amid labor shortages post-pandemic but seem hesitant to let those workers go. The result is a labor market that is finding a way to let off enough steam to alleviate wage pressures without triggering a vicious cycle between layoffs and consumption.

Inflation Approaches the Fed's Target

- Most measures of inflation continue to inch closer to the Federal Reserve's (Fed's) 2% target. Year-over-year inflation, as represented by the Consumer Price Index, slowed to 2.9% in July, the slowest rate since March 2021, when inflation was just beginning its climb to 9%. The core inflation rate (which excludes food and energy) was not far behind at 3.2%. The improvement came despite a slight bump higher in month-over-month shelter inflation, which has been the main culprit behind the recent "stickiness." Due to its lagging calculation methodology, shelter inflation is still expected to "catch down" to more timely measures of current rents. Falling wage costs are also contributing to the improvement, with average hourly earnings ticking down to 3.6% year-over-year in July. At the same time, rising productivity (2.3% annualized rate in the second quarter (Q2)) is giving employers more bang for their buck and should help them protect their margins even if wage inflation continues to outpace overall price increases. This was evident in Q2 as unit labor costs (which adjust compensation costs for changes in productivity) were up only 0.9% annualized for Q2.

Consumption Is Good Enough to Keep the Expansion Alive

- Despite cooling labor markets and normalizing wage growth, consumer spending continues to drive economic growth. July retail sales were up 1.0% from the prior month, driven primarily by a rebound in auto sales after a cyberattack took some car dealerships offline in June. The retail sales "control group" category, which feeds into the Personal Consumption Expenditures (PCE) component of gross domestic product (GDP), was up a respectable 0.3%, following up a solid +0.9% in June. In aggregate, consumers seem to be absorbing higher price levels in stride. However, some companies are noting that consumer preferences may be shifting, particularly in lower-income cohorts. All in all, consumption appears intact, with the Atlanta Fed's GDPNow model tracking PCE at around 2.6% for the third quarter (Q3) as of August 30.

The Fed Finally Commits

- The Fed took a major step by finally guiding markets toward September for the first steps in a cycle of policy easing. The minutes from the July Federal Open Market Committee meeting revealed that a "vast majority" of Fed officials saw a rate cut in September as appropriate, and that some even entertained the idea for the July meeting. Fed Chair Jerome Powell backed this up in his prepared remarks at the Fed's annual economic symposium in Jackson Hole by stating, "The time has come for policy to adjust. The direction of travel is clear." This language was unusually direct for a Fed chair that usually takes great care to not paint himself into a corner. He also acknowledged that risks have shifted from the "stable prices" side of the dual mandate to the "maximum employment" side, saying bluntly, "We do not seek or welcome further cooling in labor market conditions."
- With September locked in for the first rate cut, investors will now turn their attention to the pace and timing of cuts as well as the eventual terminal rate. For the September Fed meeting, fed funds futures are pricing in a roughly two-thirds chance of a 25 basis points (bps) cut and a one-third chance of a 50 bps cut. Through the end of 2024, futures imply about 100 bps worth of cuts.

Shifting Trends in Equity Market Leadership

- Equity market weakness driven by soft labor reports in July carried through to the first week of August. That weakness was exacerbated by turmoil in Japan, where a surprise rate hike and currency intervention by the Bank of Japan sent the Nikkei 225 Index down over 12% (in local currency terms) for its worst day since Black Monday in 1987. When domestic markets opened the next morning, the S&P 500 Index fell 3%, bringing its peak-to-trough drawdown to roughly 8%, while the CBOE Volatility Index spiked to a head-scratching 65 in premarket trading—a range typically reserved for deep crises and extreme volatility events. That Monday ultimately proved to be the low in the "almost correction," and equity markets spent the rest of the month crawling back to where they started.
- One notable feature in the downturn was a change of leadership within large caps. The tech-heavy Nasdaq Composite Index, which had been riding a wave of artificial intelligence enthusiasm and earnings dominance by the "Magnificent 7," had been handily outperforming up to that point. When markets rolled over in July, the Nasdaq turned from leader to laggard, falling 13% peak-to-trough, satisfying the common definition of a "correction." Meanwhile, the laggards on

the upside turned to leaders on the downside. The "average stock," as defined by the S&P 500 Equal Weight Index, only experienced a drawdown of about 5%, which implies that most of the pain was felt by the largest companies in the traditional index. The equal-weighted index ended the month at a new all-time high, while the traditional S&P 500 and Nasdaq Composite have yet to break their July highs.

- Q2 earnings season is mostly wrapped up. It was generally a strong quarter for the S&P 500, with about 5% revenue growth over Q2 2023, while expanding margins drove earnings growth to 11%. While tech earnings remained strong, we got our first hints of broader participation, with above-average growth also coming from the utilities, financials, health care, and consumer discretionary sectors. Looking ahead to Q3, companies are more cautious, sending growth estimates from 7.6% in June to 4.6%. Despite dampened expectations for Q3, calendar year growth estimates for 2024 remain solid at 11%, virtually unchanged from where they started the year.
- Two months into the third quarter, signs continue to accumulate that the broadening of the market rally may be sustainable. Quarter to date, returns on the cap-weighted S&P 500, equal-weighted S&P 500, Russell 2000 Index, and Nasdaq are tightly bunched together. Projected earnings for the second half of 2024 indicate that the 493 stocks in the S&P 500 beyond the Magnificent 7 will increase their contribution to overall earnings growth. Thus, the broadening of the market rally has fundamental support. September is seasonally a volatile month. Although the early August volatility has possibly brought forward that seasonality, volatility may increase from the looming presidential election, global military conflicts, and continuing, if lessening, concerns about economic growth. For the equity markets, we believe the Fed's clear pivot to rate cuts probably trumps all and should support a stably growing and broadening market return.

Interest Rates Fall as Treasury Curves Flirt With Un-Inversion

- Easing inflation, paired with a commitment by the Fed to begin cutting rates in September, drove a strong rally in bond markets, sending the 10-year U.S. Treasury yield down to 3.92% by month-end. Expectations for policy easing also sent the 2-year U.S. Treasury yield down to 3.92%, leaving yield curves flat to end the month. After an initial pop as equity markets were selling off in the beginning of the month, investment-grade and high-yield credit spreads retraced the move and settled back down near historical lows.

What This Means for Investors

- As focus shifts away from inflation, markets appear to be moving back to a "bad news is bad news" framework, where weak economic data sends stocks down and bonds up (i.e., yields down). This would mark a notable change from "bad news is good news," when weak labor and consumption data implied lower inflation, which investors treated as bullish given it gave the Fed a "green light" to ease. Reestablishing this negative correlation between stocks and bonds may ultimately be a healthy development from a total-portfolio perspective in that it would allow fixed income to regain its status as "portfolio ballast" during times of equity volatility. Although the direction of travel for labor markets may be concerning to some, overall levels remain generally healthy relative to history. With many of the post-COVID imbalances finally moving back toward equilibrium, policy easing should allow economic growth to continue near longer-term trends. This should continue to support strong (and broader) earnings growth in the coming quarters. Considering this, investors may need to rethink their aggressive expectations for rate cuts. Nonetheless, we remain constructive on the outlook for economic activity and financial markets.

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