FIRST QUARTER 2024
INVESTMENT COMMENTARY

Policy Uncertainty is the one Certainty to Expect in 2024

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2023 ended on a high note, punctuated by sharp rallies in both the stock and bond markets, tangible evidence that the economy is on a steady disinflationary path while avoiding a recession, and strong indications that the Fed is poised to cut rates in 2024. The soft-landing scenario that most economists and investors scoffed at earlier in the year now seems more likely to play out. This about-face in prospects has been strikingly echoed in the financial markets. Stocks recouped all their losses suffered in 2022 while market yields erased a good part of the surge over the first ten months of 2023. Indeed, an investor in the 10-year Treasury security who went into hibernation at the start of the year and awoke at its end might think that nothing of note occurred over the period. That's because the yield wound up at the same place it started, completing a round trip journey from 3.88 percent to just over 5 percent in October and back down to 3.88 percent on December 31.

Of course, the year was marked by seismic forces whose reverberations have yet to be determined. Geopolitical tensions escalated, with no end in sight for the war in Ukraine and a conflagration in the Middle East that threatens to widen beyond Gaza. Domestic political shenanigans took center stage for months, as the House Speaker was ousted and most legislation, including debt funding bills, remain in limbo. The failure of several regional banks in the spring heightened recession fears as well as recollections of earlier financial crises. Finally, while the last of eleven rate hikes likely occurred in July, their full effects on the economy have yet to play out, as most household and business borrowers locked in lower rates that prevailed before the tightening campaign got underway in March 2022. A big chunk of those loans will have to be refinanced at prevailing higher rates starting in 2024 or paid down, either of which will be a drag on activity.

As the curtain rises on 2024, it's highly unlikely that the economy will either fall off a cliff or stage a vigorous rebound in the foreseeable future. A $24 trillion economic behemoth does not change course on a dime, unless some unexpected external shock sends it off the rails, such as a pandemic. Although activity has held up considerably better than thought a few months ago, a slowing trend has set in that is expected to continue throughout the year. Likewise, inflation has fallen far more dramatically than anyone, including the Fed, expected, but the disinflationary trend should run into more resistance in coming months. The biggest uncertainty, in our view, is policy, particularly fiscal policy, which given the volatile political dynamics of the past several years is almost impossible to build into a reasonable model.

Fiscal Policy Held Hostage by Politics

Heightened policy uncertainty will characterize the start of the new year, with fiscal policy being the first source of unpredictability. US lawmakers will face back-to-back deadlines to fund the federal government and avert a government shutdown. Roughly a quarter of the discretionary budget will run out of funding after January 19, with the remaining three-quarters lapsing after February 2.

Congress is no closer to agreeing on top-line funding levels for fiscal 2024 than it was in mid-November when lawmakers passed a temporary funding measure that teed up these two upcoming deadlines. As a result, a partial shutdown beginning after January 19 is not out of the question. However, the following deadline in early February, which has a much larger share of the discretionary budget in its crosshairs, may be the mechanism needed to break a congressional impasse on government funding.

When funding lapses for the entire discretionary budget, we estimate that the resulting shutdown permanently cuts annualized real GDP growth in a given quarter by 0.1 percent for each week that it lasts. Given that only a quarter of the discretionary budget is immediately at risk after January 19, the hit to the first quarter growth from a partial shutdown lasting the entire second half of January would be much less than our rule-of-thumb would imply. However, all federal activities covered by discretionary appropriations would be affected if the impasse extends past February 2.

Even if lawmakers prevent a shutdown in early 2024 by passing another round of stopgap funding, they will still have to contend with an April 30 deadline to stave off automatic spending cuts. Under the Fiscal Responsibility Act – the debt-limit deal brokered by the White House and former House Speaker Kevin McCarthy – if the federal government is operating on short-term funding on January 1, defense and nondefense funding will be reduced by 1% relative to fiscal 2023 levels. However, the 1% cuts will not take effect until after April 30, so lawmakers will have a four-month grace period to successfully negotiate a full-year budget once the countdown clock to these across-the-board cuts begins at the start of the new year.

All told, the pieces are in place for partisan rancor to intensify in the new year, in keeping with historic norms. Importantly, 2024 is a presidential election year and political discord among US lawmakers, tends to increase ahead of federal elections. No matter what happens on Election Day, fiscal policy will be top of mind of investors in the months leading up to it due to the reinstatement of the debt limit and several expiring tax provisions at year-end. If lawmakers do not act, these looming tax code expirations will lead to meaningful tax increases for individuals in 2025. Simply put, policy uncertainty will rise throughout the year as households, businesses, and investors digest a steady stream of general election polls in the months leading up to Election Day.

Monetary Policy Set to Ease

Besides fiscal policy, heightened anticipation around future Federal Reserve actions will add to the sense of policy uncertainty early next year. The core personal consumption expenditure deflator, the Fed's preferred measure of inflation, has decelerated faster than the central bank expected. Since the December meeting of the Federal Open Market Committee, the Bureau of Economic Analysis' revised estimate of third-quarter GDP showed that core PCE inflation is making even swifter progress toward the Fed's 2% target; the core PCE deflator increased at an annual rate of 2 percent during the period down 0.3 percentage points from the prior estimate.

Given the progress in core inflation and certain disinflationary forces that are in the pipeline, the Fed is growing confident that it can achieve a soft landing. Consequently, Fed policy in 2024 is shaping up to be a 2019 redux, when it cut rates in a bid to prolong a record economic expansion amid a backdrop of rising trade tensions and slowing global growth.

That said, we still think that markets are too optimistic, pricing in the first interest-rate cut in March and as many as six throughout the year. Incoming data and communication from Fed officials in the new year will likely force markets to recalibrate their date of the first rate cut to later than March. Moreover, it is important to be mindful of the ever-present risk of supply-side shocks that could upend inflation expectations, progress in realized inflation, and, in turn, Fed policy. As an example, oil prices have recently ticked higher due to shipping disruptions linked to Houthi attacks in the Red Sea.

Strong Productivity Offset Wage Growth

Despite the plunge in the inflation rate from over a 9 percent peak in 2022 to 3 percent, as measured by the overall consumer price index, there is a widespread sentiment that the easy pickings are over and squeezing the last 1 percent out of the CPI will be much harder. While prices of many goods are falling, prices of services are still running too hot; many believe that the inflation retreat will stall out unless the underlying cause of service inflation, most notably labor costs, also comes down.

No doubt, prices of services are more closely linked to labor costs than are goods, whose prices are influenced more by the cost of materials, transportation, exchange rates and other nonlabor factors. Restaurants, bars, medical practitioners, barbers among many other service providers, rely mostly on workers to generate revenues and, hence, labor expenses have a major influence on how prices are set. While wage growth has softened over the past year, it is running above the pace consistent with a 2 percent inflation rate. Average hourly earnings are increasing by more than 4 percent and median wages for a worker on the same job over the past year are increasing by more than 5 percent from a year ago, according to the Atlanta Federal Reserve's Wage Tracker.

But a key reason these increases are not fully passed on to consumers is that productivity has also increased by at least as much. Output per hour in the nonfarm sector surged by 5.2 percent in the third quarter, which more than offset the increase in worker compensation. Hence, the cost per unit of worker output actually declined during the period. Indeed, over the past year, unit labor costs increased by 1.6 percent, which is comparable to the prepandemic pace and has declined for five consecutive quarters from 6.1% in the second quarter of 2022.

Slower Wage Growth Ahead

Clearly, the productivity surge over the past year is not sustainable, as it reflects special postpandemic influences, such as the rebound in output as supply chains healed. The AI revolution may be playing a role as well, but that is likely having more of a positive influence on stock prices than on output, although longer term its influence should increase. Past innovations, such as the widespread adoption of personal computers took decades before they had the broad, diffuse productivity-enhancing impact that lifts output in every sector. And recent seemingly game-changing developments, such as the near universal adoption of smartphones, have yet to have any discernable impact on productivity, either positive or negative.

It makes sense to measure true productivity trends over the course of a cycle. Stripping out the noise caused by the pandemic and its aftermath, productivity has increased by an annual rate of 1.5 percent since the fourth quarter of 2019, the same growth rate seen on average between the fourth quarter of 2007 and the fourth quarter of 2019. Assuming productivity growth is reverting to its longer-term trend of 1.5 percent, it would be necessary to slow nominal wage growth to around 3.5 percent to be consistent with the Fed's 2 percent inflation target. Many believe that the labor market is too tight and worker bargaining power too strong for that to occur over the foreseeable future. The recent outsized gains by UPS and auto workers would seem to bear that out. However, workers bargained for those gains to catch-up to past inflation, not expected inflation. One of the key successes of the Fed is that its aggressive rate hiking campaign kept inflationary expectations anchored. Recent surveys, in fact, reveal that consumer inflation expectations are receding.

That said, worker bargaining power is tied to conditions in the job market. While unemployment is still historically low, that's mainly because companies are not yet laying off workers. But overall labor conditions are easing, as unfilled positions are declining, fewer workers are quitting, people are coming off the sidelines to join the workforce and unemployed workers are taking longer to find a job, as reflected in a steady rise in continuing claims for unemployment benefits. This confluence of forces indicates that companies are cutting back hiring but are holding on to workers as they assess future staffing needs amid an expected slowing of economic activity. Workers are sensing this and as they see a weakening job market their wage demands are also easing. This unfolding scenario is looking ever more like a soft landing – a tapering off of wages and inflation without a recession-inducing spike in unemployment – which is precisely what the Fed is aiming for.

Nonetheless, we believe the financial markets are pricing in more and earlier rate cuts than the Fed will deliver. The disinflationary trend should continue, but it will be a slower grind from here as companies, particularly in the services sector, will be facing higher unit labor costs as worker pay lags the slowdown in productivity growth. The headline inflation numbers may well slip to 2 percent by the spring if only because measures of housing costs finally reflect the downtrend in market rents. But housing costs are not driven by broad cyclical forces and the so-called Supercore rate – core services excluding housing costs – that the Fed is closely monitoring is running at an annual rate of over 5 percent over the last three months. That too should ease this year, but not fast enough to warrant a March rate cut in our view. We think the Fed will strive to talk back against market expectations in coming months and not pull the rate trigger until later in the spring or early summer unless the economy exhibits far more weakness than we expect. The good news is that policy is pivoting away from belt-tightening just in time, setting the stage for a favorable backdrop for the fixed income market.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISON

U.S. Treasury Market				Total Return (%)	
	12/31/2022	9/30/2023	12/31/2023	4th Qtr	1Yr
6 Mo Bill	4.75	5.55	5.25	1.53	5.24
2 Year Note	4.43	5.05	4.25	2.49	3.65
5 Year Note	4.00	4.61	3.85	3.24	3.93
10 Year Note	3.88	4.57	3.88	6.87	3.21
30 Year Note	3.96	4.70	4.03	12.85	1.93

Municipal Bonds	Yield (%)			Total Return (%)	
	12/31/2022	9/30/2023	12/31/2023	4th Qtr	1Yr
Barclays General Obligation Index	3.80	4.10	2.94	7.79	5.62
Barclays New York Bond Index	4.13	4.34	3.19	8.64	7.32
Barclays California Bond Index	3.87	4.08	3.01	7.57	6.22
Barclays Revenue Index	4.20	4.44	3.35	8.15	6.89

Equities	Levels			Total Return (%)	
	12/31/2022	9/30/2023	12/31/2023	4th Qtr	1Yr
S&P 500	3839.50	4288.05	4769.83	11.68	26.26
DJIA	33147.25	33507.5	37689.54	13.09	16.18
Nikkei (Tokyo) US $ Terms	26094.50	31857.62	33464.17	11.55	21.77

Commodities	US $			Percent Change (%)	
	12/31/2022	9/30/2023	12/31/2023	4th Qtr	1Yr
Gold Comex Spot ($ per oz)	1824.02	1848.63	2062.98	11.60	13.10
CRB Future Com. Pr. Index*	277.75	284.5324	263.8254	-7.28	-5.01
W. Tx Int. Crude ($ per bbl.)	80.26	90.79	71.65	-21.08	-10.73

Currencies	Levels			Percent Change (%)	
	12/31/2022	9/30/2023	12/31/2023	4th Qtr	1Yr
Yen	131.12	149.37	141.04	5.58	7.57
Sterling	1.21	1.2199	1.2731	-4.36	5.36
Euro	1.07	1.0573	1.1039	-4.41	3.12

Global Bond Markets**	Levels			US $ Terms (%)	
	12/31/2022	9/30/2023	12/31/2023	4th Qtr	1Yr
German 10 year	2.57	2.84	2.02	11.81	10.70
Japanese 10 Year	0.41	0.76	0.61	7.74	-6.12
UK 10 Year	3.66	4.44	3.53	12.92	11.83
Barclays US Emerging Market	7.52	8.00	7.04	8.10	9.09

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices