SECOND QUARTER 2024
INVESTMENT COMMENTARY

Noisy Data Complicates Fed Policy But Won't Derail Rate Cuts

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With a presidential election looming, geopolitical tensions escalating, and a central bank considering a major shift in its policy stance, 2024 is shaping up to be an eventful year with a wide range of possible outcomes. So far, the financial markets are taking a "what, me worry?" attitude, as stock prices have hit new records and businesses have had little trouble raising huge amounts of funds in the capital markets. One reason for market complacency, of course, is that unfolding developments and the swirl of uncertainty facing the nation have hardly put a dent in the economy. The job market is still chugging along, incomes are rising, consumers are grumbling about high prices and interest rates but continue to spend, and household as well as business balance sheets are in good shape.

Simply put, recession fears that were so rampant last year have been put on the back burner as the economy seems able to weather anything thrown at it, including a pandemic, wars, inflation and skyrocketing interest rates since the spring of 2022. A sense of invincibility, however, is not an effective weapon against adversity. Indeed, history shows that the economy usually appears muscular in the months before a recession strikes, much like the current backdrop. But when things start to go bad, they tend to go bad quickly and are difficult to stop. That's not to say a burst of misfortune is inevitable. A soft landing where the stars align to bring about sustained growth, high employment, and low inflation may well be in the future for the U.S. economy; indeed, in contrast to a few months ago, many more economists believe that such a Goldilocks scenario has a chance of materializing.

But luck, as well as smart decisions, will need to play a role in the process. Luck would involve an easing of Mid-East tensions, limited economic ramifications from the Russia/Ukraine conflict, and a calm political process leading up to the November elections. Smart decisions will also be required of policy makers who are debating when and by how much to cut interest rates this year. However, smart decisions mean that the Federal Reserve needs smart data to guide it, and that may be difficult to obtain early in the year. That's when incoming data are corrupted by unpredictable winter weather and by the resetting of prices that may temporarily give a distorted picture of underlying inflation and income trends. To be sure, policymakers are not flying blind; but any misinterpretation of reality due to faulty information can lead to misguided policy decisions that have harmful economic effects down the road. Hopefully, spring will bring more clarity on the economy before it is too late.

The Fed Stays the Course

In the waning months of 2023, most economists thought that the economy was poised to roll over and would need the Fed to step in quickly to stave off a recession. After all, inflation had tumbled dramatically over the second half of the year, and the 2 percent target sought by policymakers seemed well within reach. The combination of expected slowing growth, the ongoing healing of supply chain bottlenecks, and the potential bite from the Fed's aggressive rate hiking campaign were coalescing into a receptive backdrop for the Fed to start cutting rates sooner rather than later.

As the calendar turned to 2024, however, some key data refused to follow the script. Both job creation and inflation came in hotter than expected in January and February, prompting the markets to rethink the wisdom of a growth-stimulating rate cut. To its credit, the Fed had steadfastly resisted calls for an imminent rate cut, clashing with traders who were pricing in not only an early reduction in rates but at least four more before the end of the year. Following the data for January and February, however, that divide between the Fed and the markets has closed; for the first time in a while both traders and policymakers are on the same page.

Unsurprisingly, at the March 19-20 policy meeting, Fed officials reaffirmed their “wait-and-see” approach, keeping the policy rate unchanged at the 5.25-5.50 percent range in place since last July, although it maintained its intention to cut rates three times this year. Financial markets viewed the post-meeting statement and dot plots as dovish, with 10-year inflation expectations increasing. The market’s reaction could be that the incoming data on inflation did not lead the Fed to use the opportunity to strike a more hawkish tone. However, the Fed's dot plot was awfully close to signaling only two rate cuts this year, which may have led to a different interpretation by financial markets. In fact, if one participant raised their dot for this year, it would have been enough to move the median projection higher. Remember, the Fed's dot plot is not set in stone, as it is a collection of participants' expectations for the appropriate path for the fed funds rate. These expectations can change based on incoming data.

Sticky Inflation

As always, the Fed is being data dependent. As Chair Powell reiterated at his post-meeting press conference, inflation is moving in the right direction (down) but not as quickly as hoped. By itself, that won’t derail the predicted rate cuts; inflation does not have to hit the 2 percent target for the Fed to pull the rate-cutting trigger, only which it is moving sustainably towards that goal. Unfortunately, the data over the first two months of the year suggest that progress on inflation front may have stalled, as both consumer and producer prices ticked higher. The personal consumption deflators released on March 29, which are the Fed’s preferred inflation gauges, also showed little progress, as both the overall and core PCEs remained stuck within the 2.5-3.0 percent range seen since late last year.

What’s more, job growth, as noted earlier, also came in stronger than expected. That, in turn, creates more paychecks, which should support demand and give businesses the ability to keep raising prices. No doubt, both the strength in the job market and hotter consumer price data have given the Fed less confidence that inflation will continue to retreat, something that Chair Powell noted in his post-meeting press conference on March 20. Both he and Fed Governor Waller confirmed on March 30 that there is no rush to cut rates, as the economy is holding up well and more evidence is needed that inflation is moving sustainably towards 2 percent.

But just as the Fed did not respond in knee-jerk fashion to the steep inflation retreat in 2023 by cutting interest rates, it is not about to overreact to two-months of firmer-than-expected price data by turning more hawkish. As Powell noted, it is unclear if the uptick in inflation in January and February is just a bump in the road, or something more durable. Since Fed officials did not change their prediction of three rate cuts this year that they put forward in December, they still believe that the inflation retreat will resume in the coming months. The road will be bumpier, but the last mile to 2 percent was always thought to be the hardest.

Suspicious Data

So why is the Fed downplaying the hotter inflation data over the past two months? For one, it is not sure that they reflect what is actually happening. Historically, the consumer price index in January and February increases faster than in any other month of the year. In the 10 years prior to the pandemic, the core consumer price index, which excludes volatile food and energy prices and is considered more representative of underlying inflation, increased by an average of 4.1 percent at an annual rate, much higher than every subsequent month and more than double the 1.5 percent average from March through December.

Another reason is that businesses reset prices in January to cover wage and other cost increases incurred over the previous year. While this is a recurring phenomenon, the statisticians usually do not fully remove the early-year bump in prices through the seasonal adjustment process. This statistical quirk extends into February because the Labor Department collects data for certain items every other month, depending on the goods and services and their location. The reliability of the winter readings is further diluted by unpredictable weather conditions, which were particularly harsh this January and may have depressed the response rate in the survey, pushing some outsized price increases into February.

That said, the Fed was undoubtedly irked by the upside inflation surprise over the first two months of the year, validating its decision to hold off on rate cuts. Some still believe that holding rates “higher for longer,” which is now the Fed’s playbook, runs the risk of overstaying a restrictive policy, sending the economy into a recession. However, policymakers believe that the ongoing strength in the job market diminishes that risk, particularly since wages are rising at a solid clip, generating the purchasing power to support consumption. As long as consumers continue to spend – which drives about 70 percent of total economic activity – the risk of a downturn is low.

No Rush to Cut Rates

That, of course, is where the rubber meets the road. Just as inflation and job growth came in surprisingly hot, consumers turned more frugal than expected to start the year. Retail sales slumped in both January and February and, barring a robust bounce in March, it looks like personal consumption will impart less of an impetus to GDP in the first quarter than it did in the last two years. To be sure, the early-year hiatus may be nothing more than consumers taking a breather, following their shopping spree over the holidays in the final months of 2023. What’s more, although they are shunning goods sold at retailers, households are still spending on services such as traveling, going to concerts (hello Taylor Swift), sporting events, and generally partaking in experiences that were delayed during the pandemic. Indeed, spending on services jumped in March, driving total real personal consumption up by a solid 0.4 percent in February, reversing the modest decline in January.

From our lens, consumers are not about to zip up their wallets and purses as real incomes are growing at a decent pace, thanks to solid job growth, and households in the aggregate are in good financial shape. The Fed is betting that these sound fundamentals will enable the economy to withstand the elevated level of interest rates for a while longer. Nor does the strength in the job market cause much of a concern to policymakers, despite the potential wage-price spiral that an overly tight labor market threatens to bring about. As Fed Chair Powell noted at the latest post-meeting press conference, the steepest decline in inflation last year occurred alongside accelerated job growth. Simply put, the strength of the economy last year was driven as much by expanded supply as demand. Goods became more available, immigration boosted labor supply and people returned to the labor force.

The Fed is counting on more supply-driven growth that will continue to ease wage and price pressures this year, paving the way for rate cuts. That’s why the upgraded forecast presented at the March 20 policy meeting included a higher growth outlook with only a modest uptick in inflation expectations, reflecting the stronger than expected consumer price data already in the books for January and February. That said, the Fed is understandably coy about when it expects to start the easing process, setting the stage for months of speculation in the financial markets, particularly surrounding incoming data that will no doubt spur more volatility than otherwise.

We agree that the firm readings on prices early in the year overstates actual inflation and the trend is likely heading lower. Besides the seasonal quirks mentioned earlier, there is a lot of disinflation in the pipeline, particularly for goods, and the elevated pace of housing costs – which had a big influence on the January/February inflation data – does not capture the significant slowing of market rents currently unfolding. They will, however, soon enter the official data and drag down the inflation rate later in the year. The widespread expectation is that the first rate cut is likely to come in June or July, a timetable that seems appropriate to us. By then, the Fed will have three more reports on inflation and jobs, which should give a more accurate picture of where the economy stands, and what policy changes will be needed.

There is some question as to whether the Fed would increase its 2 percent target if inflation appears to stall out closer to 3 percent later this year. That seems unlikely as its inflation-fighting credibility would weaken and stoke an unwanted disruption in the financial markets. From our lens, the Fed will not be put in that position as we expect inflation to move decisively lower over the second half of the year, reflecting slowing economic growth, moderating labor costs and weaker business pricing power. Although the decision to keep rates “higher for longer” is justified, there is still a strong sentiment among Fed officials to cut rates before conditions deteriorate too much and they fall behind the recession curve. Hence, we expect the first move by mid-summer.

Rates and Total Returns Quarterly And Annual Comparison

U.S. Treasury Market				Total Return (%)	
	3/31/2023	12/31/2023	3/31/2024	1st Qtr	1Yr
6 Mo Bill	4.88	5.25	5.32	1.25	5.35
2 Year Note	4.03	4.25	4.62	0.24	2.40
5 Year Note	3.58	3.85	4.21	-0.78	0.72
10 Year Note	3.47	3.88	4.20	-1.67	-2.20
30 Year Note	3.65	4.03	4.34	-4.06	-7.73

Municipal Bonds	Yield (%)			Total Return (%)	
	3/31/2023	12/31/2023	3/31/2024	1st Qtr	1Yr
Barclays General Obligation Index	3.25	2.94	3.29	-0.70	2.23
Barclays New York Bond Index	3.28	3.19	3.50	-0.73	3.21
Barclays California Bond Index	3.07	3.01	3.28	-0.42	3.15
Barclays Revenue Index	3.43	3.35	3.59	-0.27	3.54

Equities	Levels			Total Return (%)	
	3/31/2023	12/31/2023	3/31/2024	1st Qtr	1Yr
S&P 500	4109.31	4769.83	5254.35	10.16	27.86
DJIA	33274.15	37689.54	39807.37	5.62	19.63
Nikkei (Tokyo) US $ Terms	28041.48	33464.17	40168.07	20.03	43.25

Commodities	US $			Percent Change (%)	
	3/31/2023	12/31/2023	3/31/2024	1st Qtr	1Yr
Gold Comex Spot ($ per oz)	1969.28	2062.98	2229.87	8.09	13.23
CRB Future Com. Pr. Index*	267.73	263.8254	290.2913	10.03	8.43
W. Tx Int. Crude ($ per bbl.)	75.67	71.65	83.17	16.08	9.91

Currencies	Levels			Percent Change (%)	
	3/31/2023	12/31/2023	3/31/2024	1st Qtr	1Yr
Yen	132.86	141.04	151.38	-7.33	13.94
Sterling	1.23	1.2731	1.2624	0.84	2.33
Euro	1.08	1.1039	1.0789	2.26	-0.46

Global Bond Markets**	Levels			US $ Terms (%)	
	3/31/2023	12/31/2023	3/31/2024	1st Qtr	1Yr
German 10 year	2.29	2.02	2.30	-3.87	1.92
Japanese 10 Year	0.33	0.61	0.71	-7.20	-13.24
UK 10 Year	3.49	3.53	3.93	-2.85	3.37
Barclays US Emerging Market	7.36	7.04	7.04	1.53	9.21

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