FOURTH QUARTER 2024

INVESTMENT COMMENTARY

The U.S. Economy is Exiting the Fast Lane

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The U.S. economy is going through a transition phase and is settling into a more sustainable pace of growth, with next year being decent but unspectacular. In our view, the probability that we will enter a recession in 2025 is low but not zero. Some of the naysayers' doubts about the economy's durability are rooted in unreliable surveys (particularly of household sentiment, which have a heavy political bias) and the recent rise in the unemployment rate, which triggered the so-called Sahm Rule that suggests a recession has already begun.

The most important reason pointing to continued expansion is that the job market is expected to hold up. We do not anticipate a further rise in the unemployment rate due to a slowdown in labor force growth in 2025. Hence, fewer jobs will need to be created to absorb the supply of workers seeking to join the labor force. Layoffs of full-time workers should remain low, as employers remain stung by the labor shortages in recent years, and profits are healthy enough to cover staffing costs. There is sufficient firepower in the economy to keep revenues flowing at a sturdy pace.

Of course, the proverbial elephant in the room is the outcome of the presidential election and the composition of Congress. Presidents inherit an economy, and it often takes time before their policies begin to shape it. Our assumption is that there will be a divided Congress, which should deflect any major change in fiscal policy that would have a material impact on current trends. That said, the deficit will remain huge, and the unprecedented Treasury debt level will continue to grow, keeping a floor under inflation and interest rates. If we are wrong and a clean sweep of either party occurs, fiscal policy will likely become more expansionary, either via tax cuts or spending increases. More immediately, amid a race that is virtually a coin toss, uncertainty regarding the election outcome and its aftermath is poised to stoke heightened market volatility that is likely to intensify in the weeks leading up to November 5.

As for monetary policy, with the labor market and inflation close to their targets, 2025 should be a year of policy normalization. The Fed initiated the rate-cutting cycle on September 18, and the path towards a neutral rate, one that neither restricts nor stimulates activity, should continue. While the final destination remains uncertain, a steady dose of rate cuts is expected throughout next year.

Migrants Pump up the Labor Force

The Fed's decision to start cutting rates reflects a shift in priorities from worrying about inflation to deepening concerns over a weakening labor market. There has been much ado about the rise in the unemployment rate this year, from a 53-year low of 3.4 percent in 2023 to 4.2 percent in August of this year. A rise of that scale has never occurred outside of a recession, and many believe history will repeat itself. The odds of that happening, of course, are not trivial. Historically, when the job market starts to buckle, it eventually breaks, sending millions of workers to the unemployment lines and shutting down spending, resulting in a dreaded recession.

However, this cycle has broken the rules in several ways, and past patterns may be avoided this time as well. At issue is what is causing the increase in the unemployment rate. If the climb occurred because companies were laying off workers, cutting staff in response to slumping sales and revenues, the consequences would indeed be dire as paychecks would vanish and decimate household purchasing power. Clearly, that is not the case now.

Instead, the climb in the unemployment rate is mainly due to the labor supply growing faster than the demand for workers. Simply put, growth in the labor force has accelerated, and workers entering the market are having more difficulty finding a job, pushing up the unemployment rate. For the most part, the upsurge in migrants, both legal and undocumented, has been mainly responsible for the pickup in labor supply. Over the past several years, foreign-born workers have taken an ever-larger share of the labor force, accounting for almost 20 percent in August, up from a pre-pandemic share of 17 percent.

Immigration Tide is Turning

A dramatic climb in the unemployment rate would occur only if the labor supply continued to expand at its accelerated pace. That is not likely to happen if only the influx of immigrants is poised to slow considerably. High-frequency data from immigration court cases and border encounters suggest that immigration has slowed noticeably by midyear, and this will likely persist, owing mainly to a tightening of immigration policy by the administration. This, in turn, will put downward pressure on growth in the labor supply and, by extension, lower the bar for the number of jobs the economy needs to add to keep the unemployment rate steady. By our calculation, this breakeven pace of job growth declines from 150,000 – 175,000 a month to around 100,000 in 2025, which is almost spot-on with the recent pace of job growth.

Productivity Picking up the Slack

Still, with job growth slowing, so too would the economy, all other things equal, which in time lowers living standards. When fewer workers are running factories, staffing offices, or providing services to consumers, the nation's output of goods and services downshifts as well. However, that relationship only holds if labor productivity remains static. Clearly, that has not been the case over the past year.

Indeed, despite the slowdown in job growth in recent months, growth in GDP has accelerated, rising from an annual rate of 1.4 percent in the first quarter to 3.0 percent in the second. Moreover, the recent annual revisions from the Commerce Department reveal that the economy grew considerably faster than previously thought over the past few years, boosting GDP by 1.4 percent at the end of the second quarter above earlier estimates.

Simply put, labor is producing more output than before. Nonfarm productivity leaped by 2.7 percent over the past year, more than double the pace of a year ago, and more than a full percentage point over its long-term trend. That torrid pace is not expected to continue, but the good news is that the productivity trend may well have moved up a notch. There has been a sustained pickup in spending on software and research and development in recent years, which, in the past, has led to more robust productivity growth. A similar burst of investment spending occurred in the 1990s that generated more substantial productivity over the second half of that decade. We expect the recent pickup to sustain an above-trend pace of productivity, at least through 2025 as well.

Soft Landing Looks Promising

Not long ago, several respected economists asserted that getting inflation down to normal levels would require a recession. While the unemployment rate will likely creep higher next year, there is a better than even chance the economy stays afloat. As noted, the increases so far have occurred for benign reasons, as layoffs remain low and companies are still hiring – although at a slower pace than the labor force is growing. The risk is that as the jobless rate moves higher, anxiety increases and causes behavior change. People can talk themselves into a recession if the threat seems real enough.

However, we don't expect that to happen. One of the benefits of more robust productivity growth is that it enables employers to pay their workers more without damaging the bottom line. Hence, even with slower job growth, wages will continue to increase. Importantly, the gains in income will translate into more purchasing power because the productivity pickup allows companies to keep prices in check. Hence, labor costs will not be a source of inflation, nor would it impair profits, a win-win for both workers and businesses.

To be sure, lower-income unskilled workers are usually the first victims of a softening job market, and this cohort is already struggling with mounting debt burdens, resulting in rising delinquencies, and spending cutbacks. However, about 90 percent of personal consumption comes from middle- and upper-income households, whose purchasing power is bolstered by appreciating portfolios of stocks and bonds as well as burgeoning housing equity. This so-called wealth effect should continue to underpin household spending over the coming year. Indeed, homeowners are sitting on $35 trillion of untapped housing equity, which could readily be extracted as interest rates decline to support spending.

The Fed Goes Bold

Finally, just as the economy is transitioning from rapid growth stoked by a historically tight job market to a slower, more sustainable pace, so too is the Fed pivoting away from its restrictive policy. The half-point rate cut on September 18 raised some eyebrows among commentators (although it was fully priced in by the markets heading into the meeting) who see little risk in taking smaller steps until inflation moves closer to the 2 percent target. They believe the economy is strong enough to withstand higher rates a bit longer and worry that steep rate cuts could fuel a rebound in inflation, which would undercut the Fed's credibility.

Their concern may still be vindicated, but the Fed received key support for its decision in the subsequent report that showed the Fed's preferred inflation measure, the personal consumption deflator, fell to 2.2 percent in the year through August, just a tad above the 2 percent target. The core PCE deflator was stickier, edging up to 2.7 percent from 2.6 percent, but even here, the recent trend was supportive, as the pace slowed to an annual rate of 2.1 percent over the past three months.

Conversely, some believe the Fed waited too long to start its rate-cutting campaign and has fallen behind the curve, a notion supported by the Sahm Rule and some financial indicators, such as the reinversion of the yield curve. Time will tell which view is correct; we remain in the more optimistic camp, seeing an economy that is slowing but staying afloat amid continued disinflation. Again, there are wild cards that heighten the risk on both sides: more inflation if the election results in one-party rule, less growth if a geopolitical shock occurs, or if jobs and output are severely crimped by lengthy strikes among dockworkers and at Boeing. However, as Fed Chair Powell recently noted, policy is not on a preset course. If incoming data on employment or inflation deviates from expectations, it can either speed up the rate-cutting campaign or slow it down. We expect two additional quarter-point cuts this year and one every other meeting in 2025, a path that aligns with a soft landing scenario we expect to unfold next year.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISON

U.S. Treasury Market				Total Return (%)	
	9/30/2023	12/31/2023	9/30/2024	3rd Qtr	1Yr
6 Mo Bill	5.55	5.25	4.41	1.60	5.82
2 Year Note	5.05	4.25	3.65	2.86	6.58
5 Year Note	4.61	3.85	3.56	4.43	8.68
10 Year Note	4.57	3.88	3.79	5.80	10.77
30 Year Note	4.70	4.03	4.12	8.12	14.46

Municipal Bonds	Yield (%)			Total Return (%)	
	9/30/2023	12/31/2023	9/30/2024	3rd Qtr	1Yr
Barclays General Obligation Index	4.10	2.94	3.11	2.77	9.67
Barclays New York Bond Index	4.34	3.19	3.34	2.59	10.88
Barclays California Bond Index	4.08	3.01	3.10	2.77	9.87
Barclays Revenue Index	4.44	3.35	3.42	2.70	10.85

Equities	Levels			Total Return (%)	
	9/30/2023	12/31/2023	9/30/2024	3rd Qtr	1Yr
S&P 500	4288.05	4769.83	5762.48	5.89	36.33
DJIA	33507.50	37689.54	42330.15	8.72	28.85
Nikkei (Tokyo) US $ Terms	31857.62	33464.17	37919.55	-3.56	21.08

Commodities	US $			Percent Change (%)	
	9/30/2023	12/31/2023	9/30/2024	3rd Qtr	1Yr
Gold Comex Spot ($ per oz)	1848.63	2062.98	2634.58	13.23	42.52
CRB Future Com. Pr. Index*	284.53	263.8254	284.94	-1.90	0.14
W. Tx Int. Crude ($ per bbl.)	90.79	71.65	68.17	-16.40	-24.91

Currencies	Levels			Percent Change (%)	
	9/30/2023	12/31/2023	9/30/2024	3rd Qtr	1Yr
Yen	149.37	141.04	143.63	-10.72	-3.84
Sterling	1.22	1.2731	1.3375	5.77	9.64
Euro	1.06	1.1039	1.1135	3.94	5.32

Global Bond Markets**	Levels			US $ Terms (%)	
	9/30/2023	12/31/2023	9/30/2024	3rd Qtr	1Yr
German 10 year	2.84	2.02	2.12	3.80	8.42
Japanese 10 Year	0.76	0.61	0.85	1.91	0.94
UK 10 Year	4.44	3.53	4.00	2.51	7.79
Barclays US Emerging Market	8.00	7.04	7.13	5.82	16.93

Source: Bloomberg Financial Data

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

** Global Bonds Represented by Bloomberg Barclays Indices