Economic Outlook:
Rate Cut Initiated as Fed Gains Confidence in Disinflation, Fears Labor Market Cooling

September 2024

STIFEL

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The Drivers of the 2024/25 Outlook

- The Consumer
- Inflation
- Policy Decisions

Labor Market Conditions Cooling but Still Solid

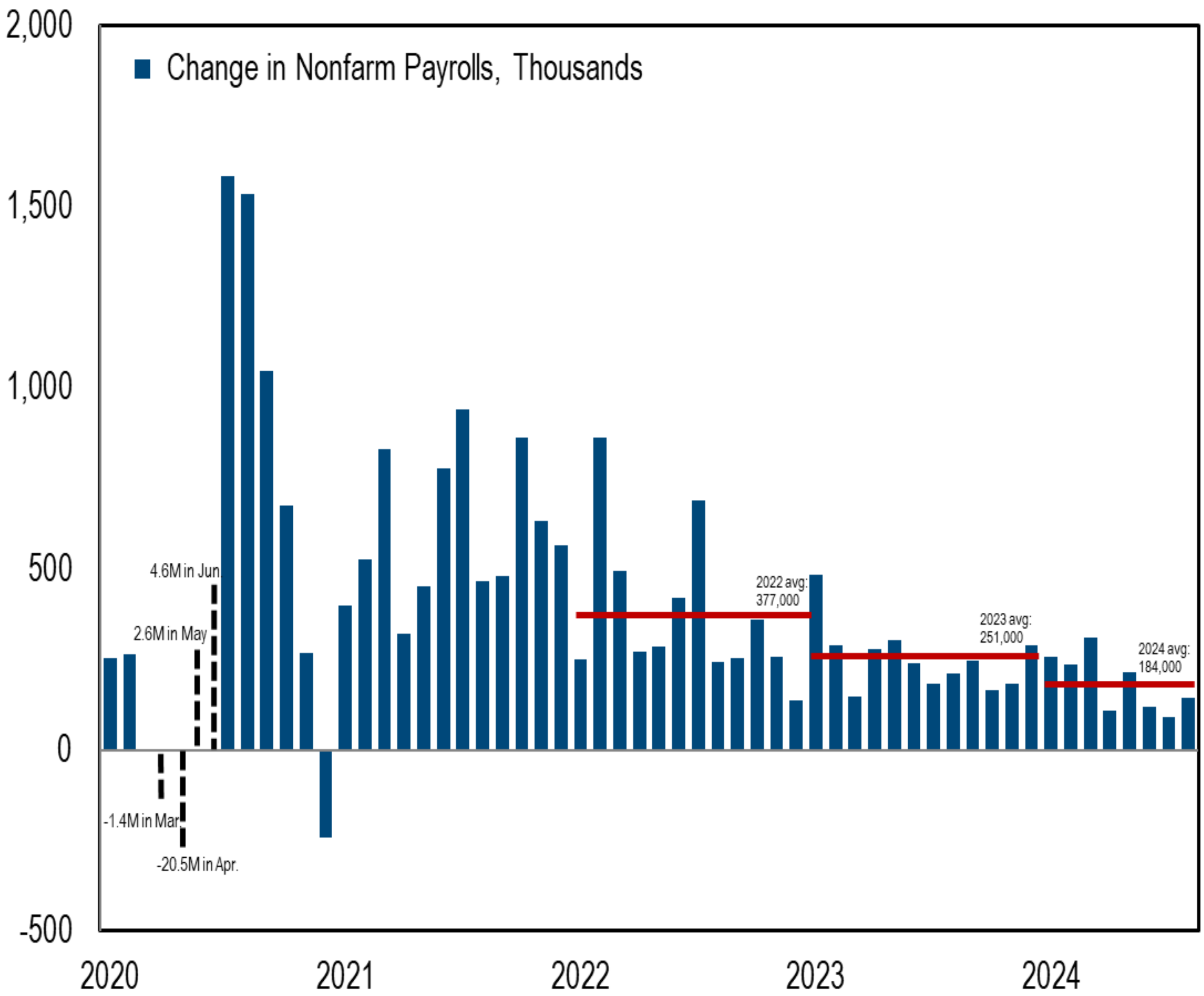
The U.S. economy remains on relatively solid footing with the consumer still proving relatively sound and resilient thanks to decent gains in the labor market

Nonfarm payrolls rose by **142k** in August, less than expected, albeit the strongest increase in three months

With earlier revisions to previous months, the overall change (August data + net revisions) was just 56k

For the full year of 2023, U.S. employers added **3.0M** jobs, a solid level of job creation, albeit down from the **4.5M** jobs added in 2022 and the **7.2M** jobs added in 2021 following the pandemic plunge of 9.3M in 2020, the largest decline on record, and more than the combined decline in 2008 and 2009

The Bureau of Labor Statistics (BLS) revised down the nonfarm payrolls figures by 818k in the 12-month period through March 2024



Source: Bureau of Labor Statistics/Haver Analytics

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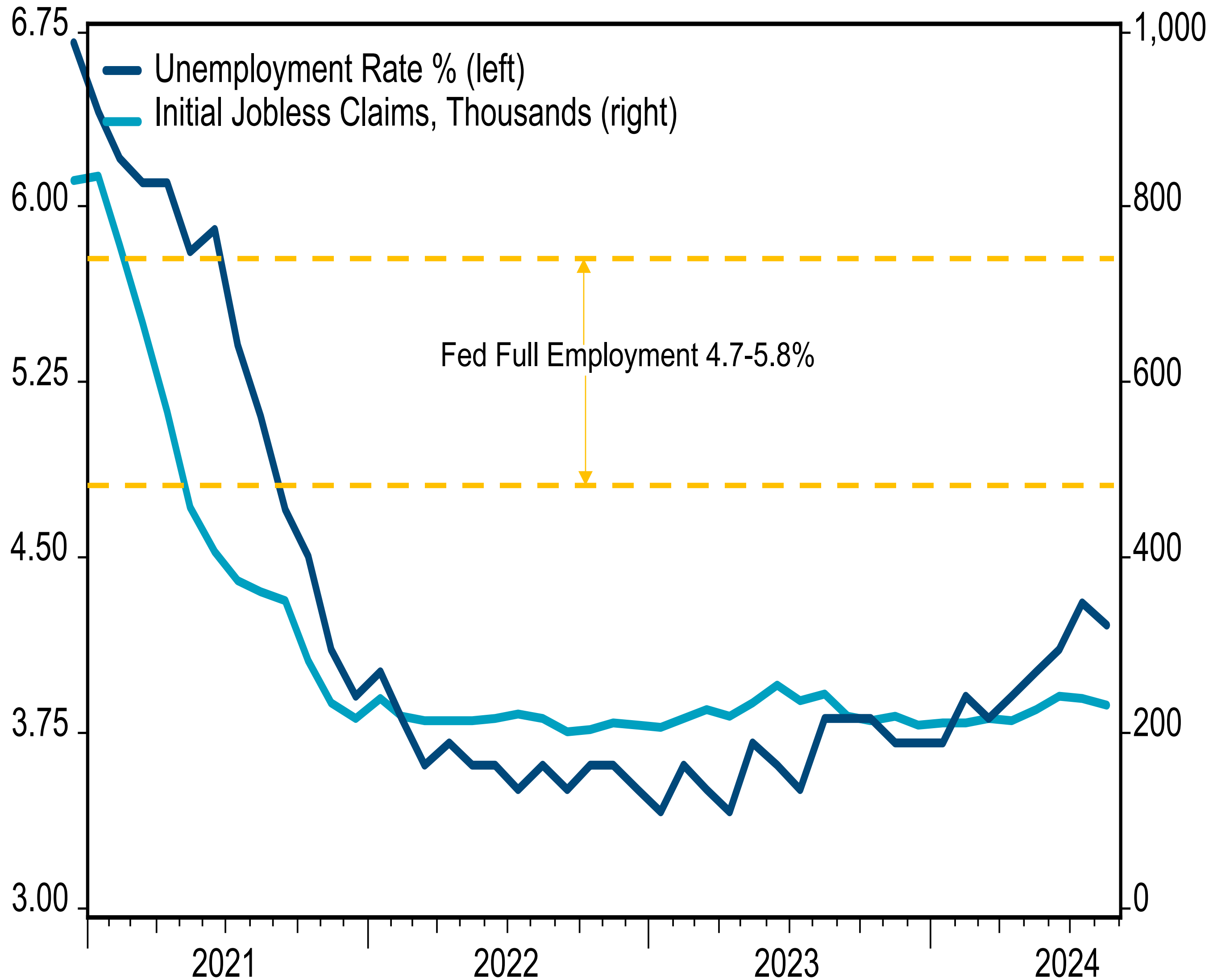
4.2% U.S. Unemployment Rate, Below Full-Employment Range

The unemployment rate has risen from earlier lows, although **labor demand continues to outpace labor supply**

Household employment rose by **168k** in August, and the labor force rose by **120k**, resulting in the unemployment rate falling from 4.3% to **4.2%** in August, a two-month low and well below the full employment range

The 57bps increase in the three-month average of the unemployment rate from the cycle low to present does trigger the Sahm Rule; yet, this rule has never been tested with nearly 8M job vacancies

Claims rose to 249k (Jul. 27) before falling to 219k (Sep. 14) well within the 187k to 261k range established since the start of 2022



Sources: Bureau of Labor Statistics, Department of Labor/Haver Analytics

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Average Hourly Earnings Still Positive

Disconnect between labor demand and labor supply continues to support solid wage growth

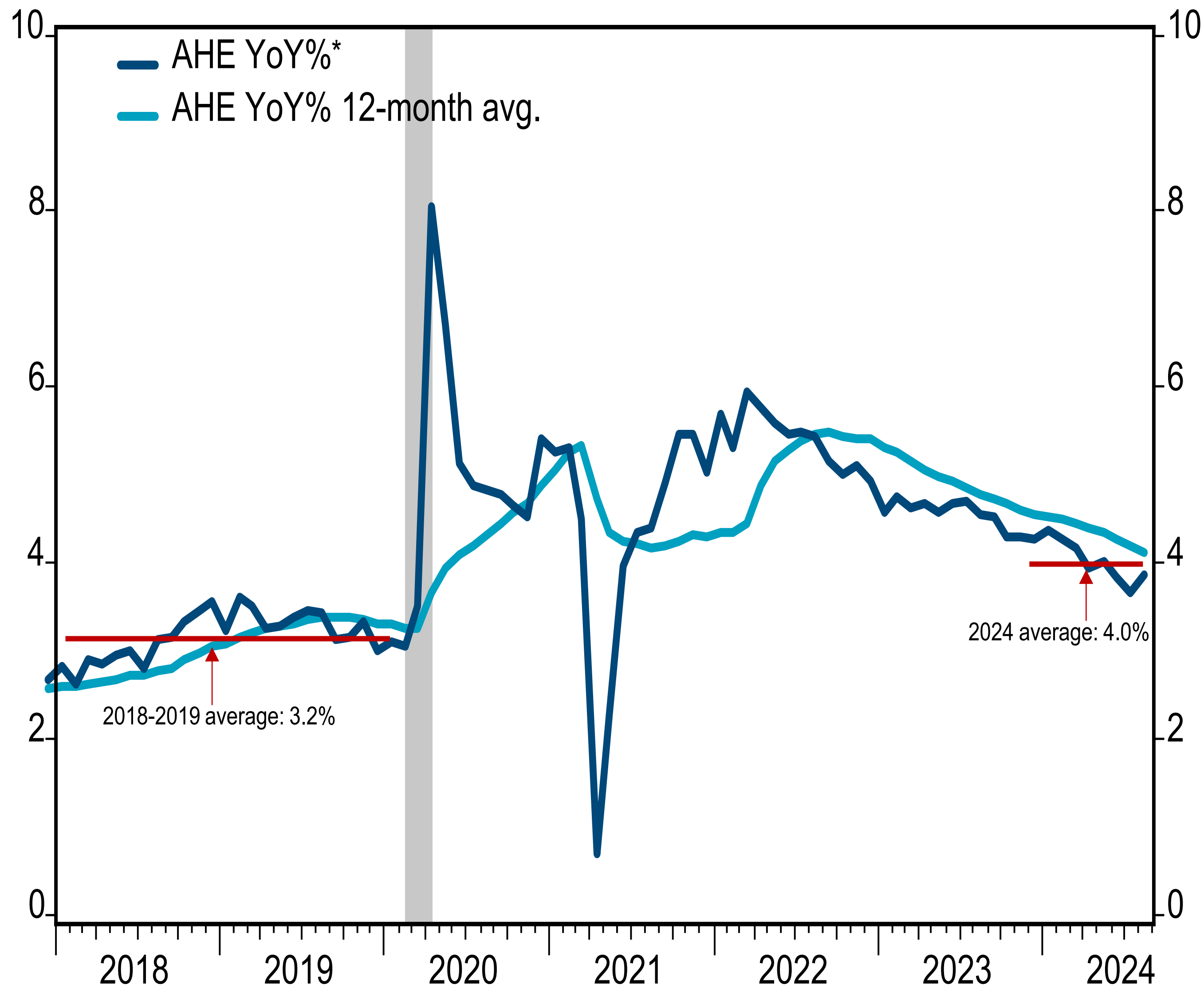
As businesses search for workers, compensation is elevated, although the trend appears to be moderating as businesses struggle to absorb costs

Average hourly earnings rose **0.4%** in August, following a 0.2% rise in July

Year-over-year, wages rose **3.8%** in August, up from a 3.6% gain in July

Longer-term, businesses may turn to technology or close doors

For now, costs are likely to remain elevated as long as labor remains scarce



Source: Bureau of Labor Statistics/Haver Analytics

*Does not include government assistance

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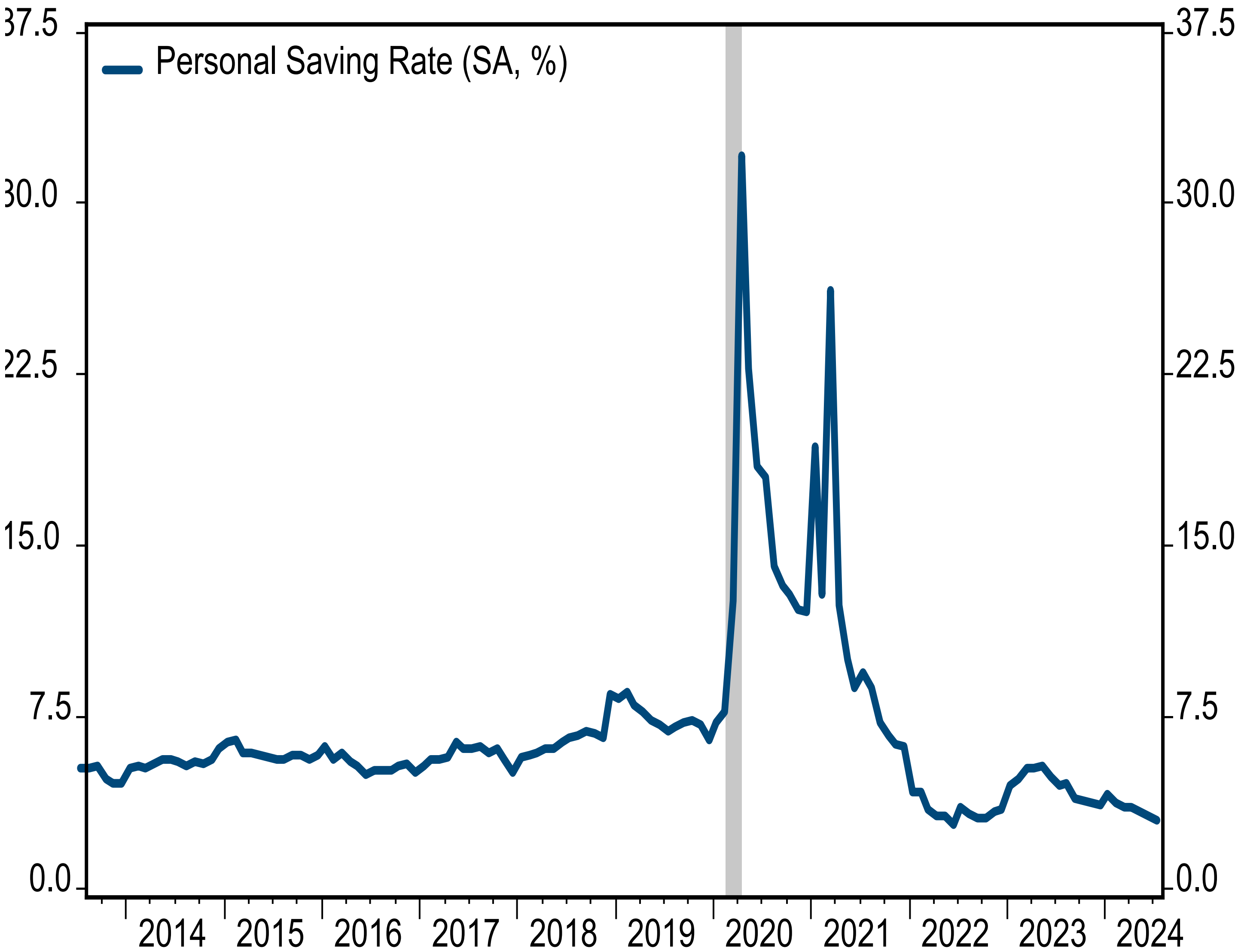
Trillions in Accumulated Support/Savings Much Depleted

Early on expansionary fiscal policy led to a massive accumulation of wealth

The U.S. consumer remains relatively solid with **$599B** in savings and a savings rate of **2.9%** as of July

Savings won't support potential workers indefinitely – already the savings rate has slowed, and the stockpile of savings is nearly depleted as fiscal support has expired and prices rise

Although higher rates are aiding the interest earnings on consumer behavior with trillions in money market funds and deposits earning 5.0% and 1.75%, respectively, totaling approx. $598B on an annual basis vs. $30B before the pandemic



Source: Bureau of Economic Analysis/Haver Analytics

Debt as a Percent of Income Near Record Low

Consumers are turning to alternative supports: (organic) earnings, savings, interest earnings (inorganic) wealth transfer, 401ks, credit cards

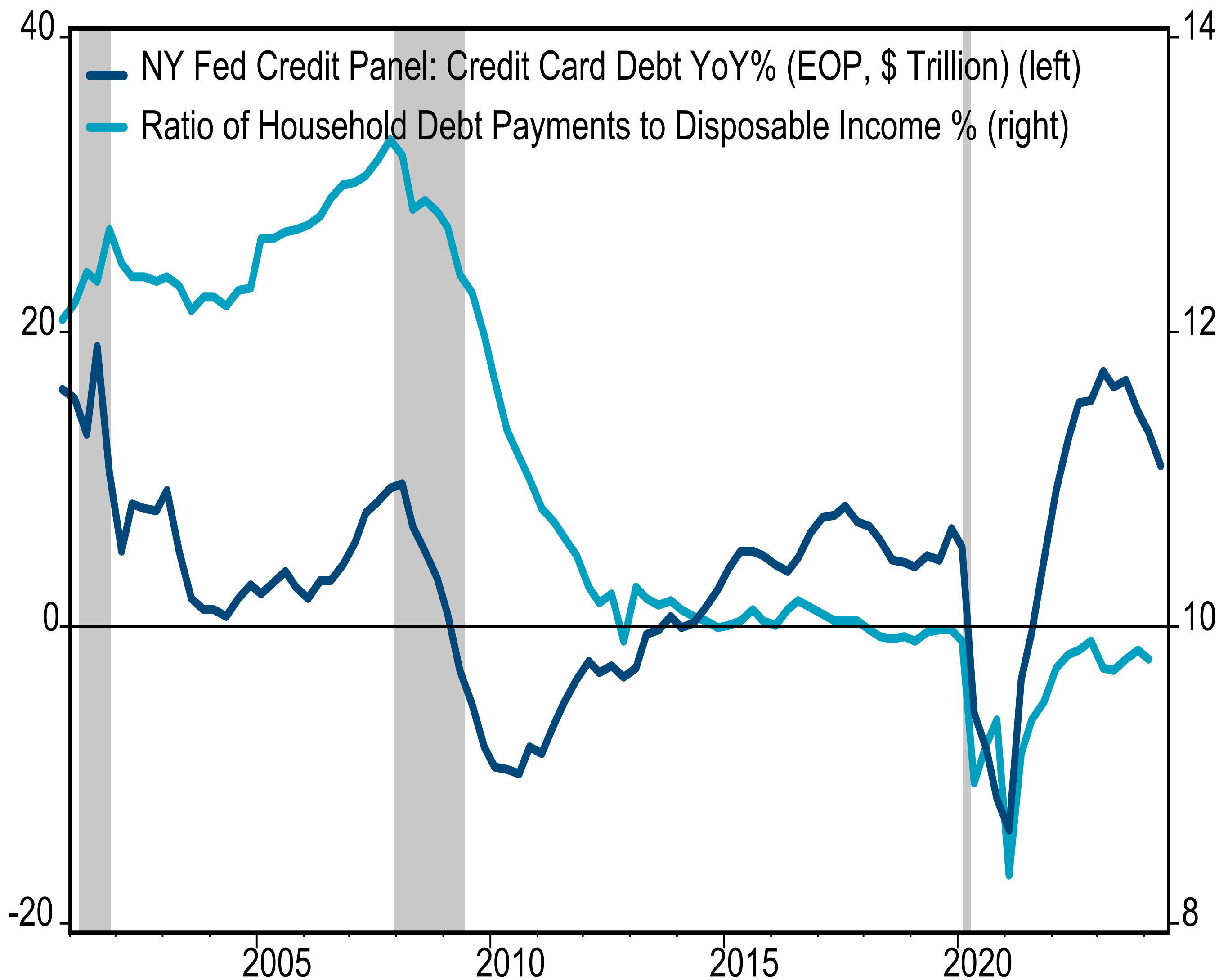
Credit card debt rose **10.8%** in Q2 from the year prior, following a 13.1% gain in Q1

401k hardship withdrawals are also on the rise with **3.6%** of workers, 5M accounts, taking a hardship withdrawal in 2023, up from 2% pre-pandemic

Most households are better positioned to take on at least some additional debt burden

Debt as a percent of disposable income remained at **9.8%** in Q1, near the lowest on record

After 3yrs of relief, student loan payments resumed in October 2023 for approx. 45M



Sources: FRBNY/Haver Analytics

Retail Sales Volatile With Broader Momentum Minimal but Positive

A loss of momentum has resulted in fewer dollars spent, higher nominal debt, and rising delinquency rates

Trillions in savings and upward momentum in wages helped consumers to offset a loss of fiscal support, but inflation is complicating the picture

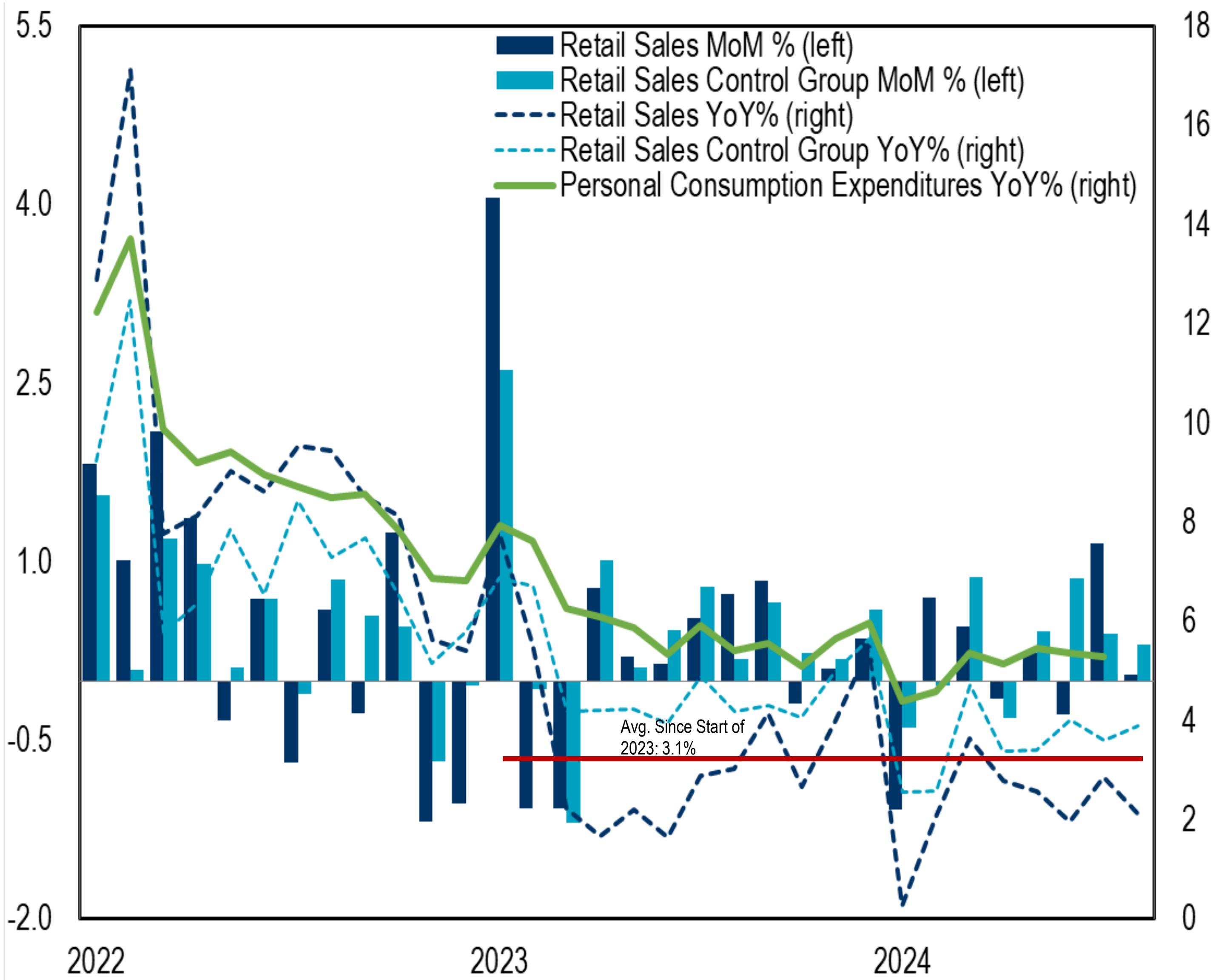
Large retailers report customers are cutting back as the balance sheet is becoming increasingly fragile amid rising costs and rates

Sales rose **0.1%** in August following a 1.1% jump in July

Year-over-year, retail sales rose **2.1%** in August, a two-month low

Control group sales rose 0.3% in August and rose **3.9%** year-over-year, the largest gain in two months

Personal consumption expenditures rose **0.5%** in July and **5.3%** year-over-year, a three-month low



Source: Census Bureau/Haver Analytics

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A Rise in Household Net Worth (For Some)

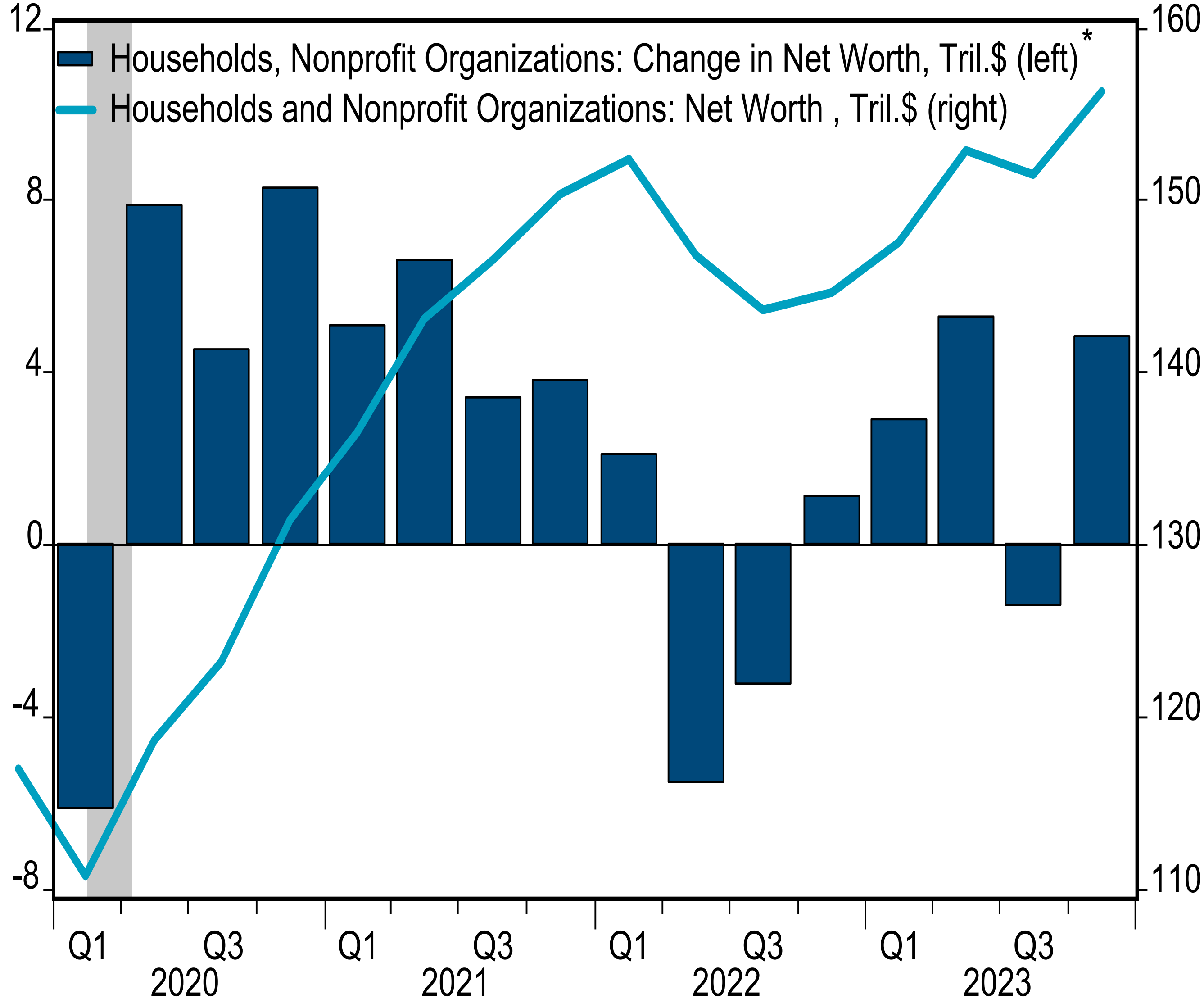
A change in spending patterns will not be symmetric across households

Household net worth has grown in the past few years

Net worth jumped by $5.1T in Q1, the largest quarterly increase since Q2 2023 to **a record $160.8T**

A net gain of **$16.2T** in household wealth since the start of 2023 suggests there still is a significant amount of borrowing and spending power in the economy

Home prices up 5.3%, or $2.4T, in 2023, bringing total value to $47.5T in value, and equity market up 18.4% year-to-date, with a total value of $47.4T (August 2024)



Source: Federal Reserve Board/Haver Analytics

*Household net worth represents the total value of assets (financial as well as non-financial) minus the total value of outstanding liabilities.

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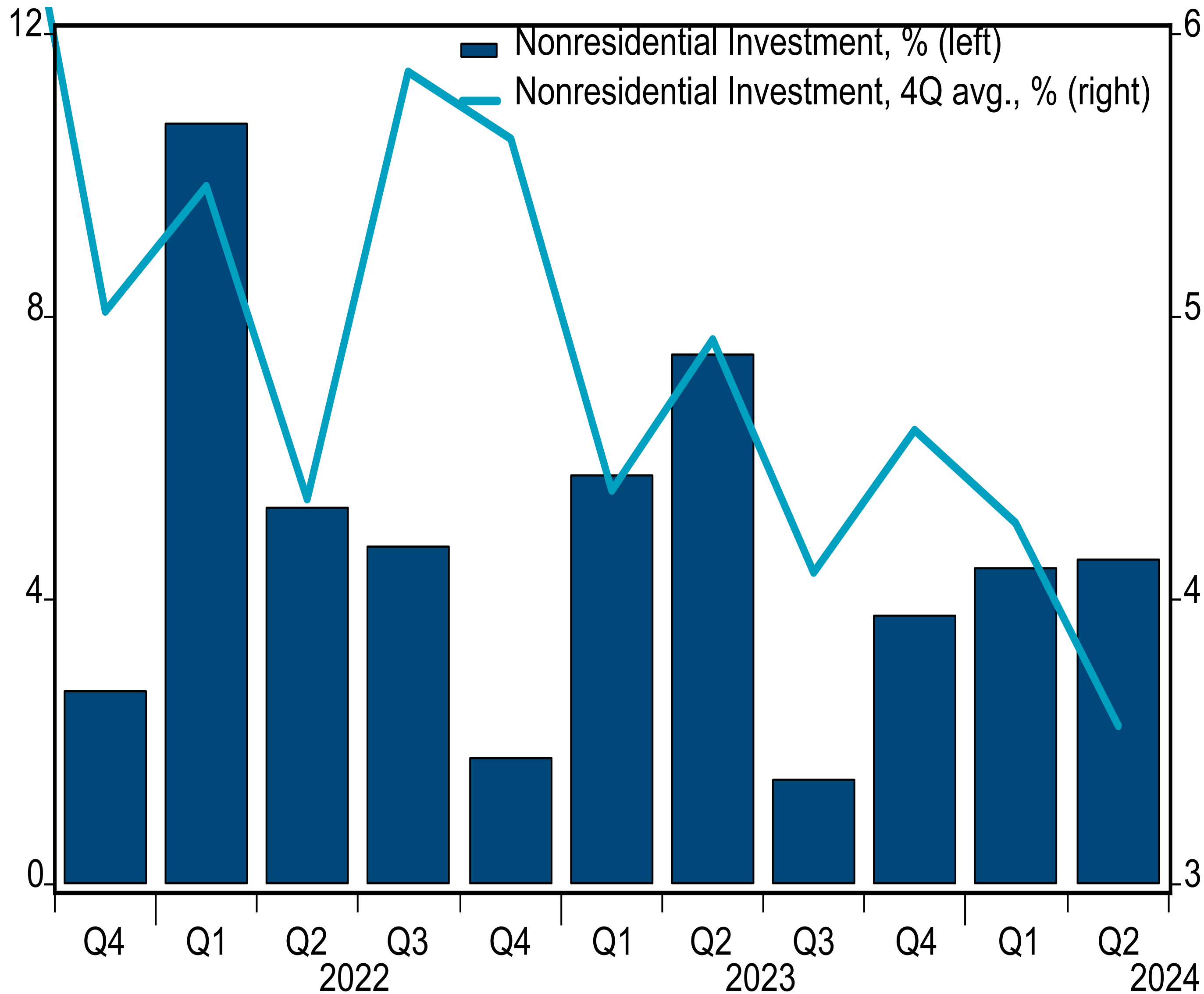
Waning Business Investment

Businesses will continue to struggle under the weight of higher prices, elevated costs of parts, materials, rents, and labor, along with a limited ability to pass on rising costs without the risk of losing market share

Nonresidential investment rose **4.6%** in Q2, up from the 4.4% rise in Q1 and the strongest gain in a year

Some corporations have already announced hiring freezes, cut down on investment or turned to AI for cost reductions



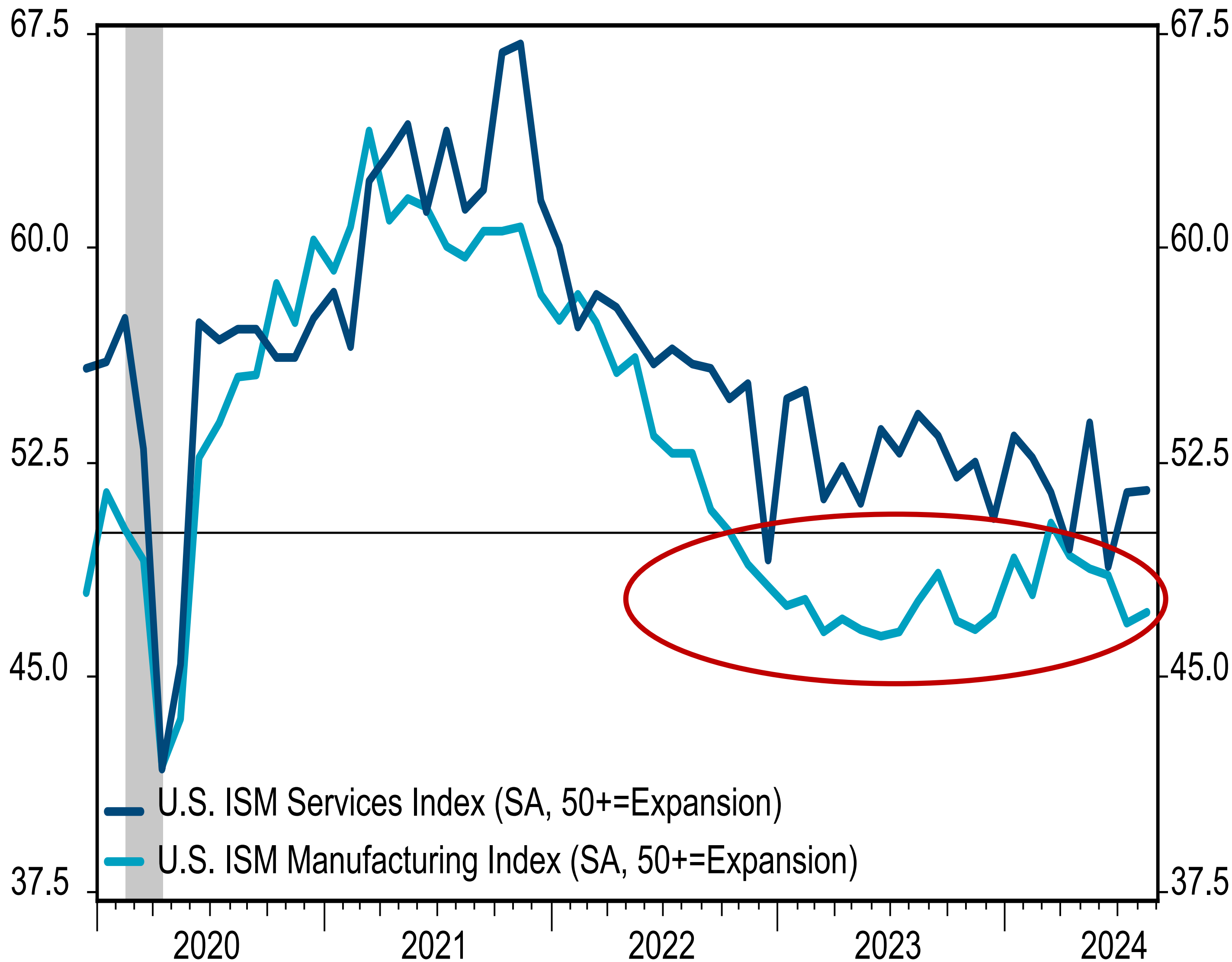
Source: Bureau of Economic Analysis/Haver Analytics

Manufacturing Activity Remains Lackluster, Services Activity Positive

Consumers are shifting from goods to a pre-pandemic preference for services/experience

The ISM Manufacturing Index declined from a near-term peak of 60.8 in October 2021 to **47.2** as of August 2024, **falling below 50 in November 2022**

The ISM Services Index, meanwhile, rose to **51.5** in August, a three-month high



Source: Institute for Supply Management/Haver Analytics

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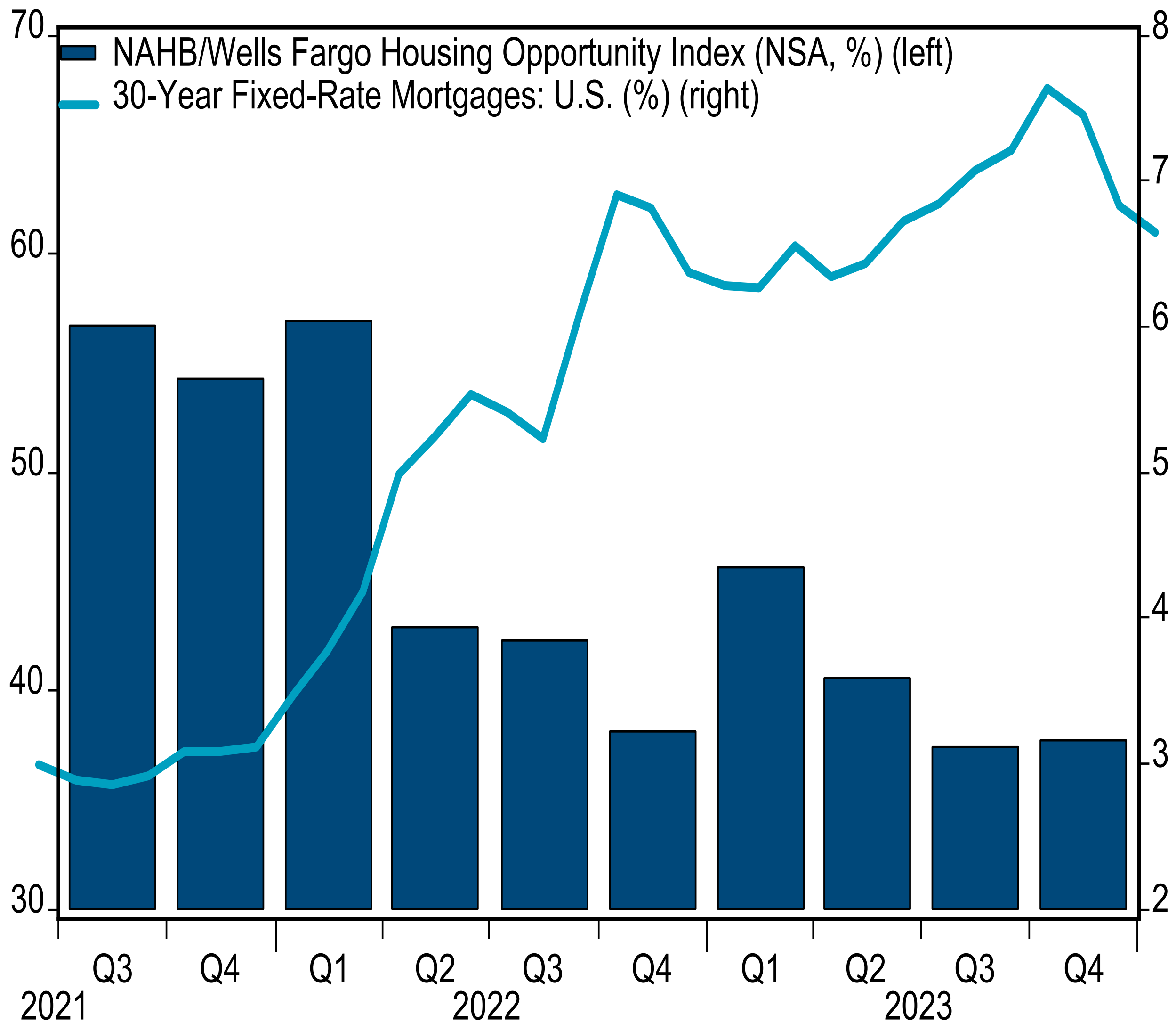
Household Affordability Near Record Low as Mortgage Rates Remain Elevated

Higher rates undermine affordability (entrance) and create a lock-in effect (exit)

According to RedFin, more than 90% of homeowners have a mortgage rate below 6%, while 82.4% of homeowners have a rate below 5% and 62% have rate below 4%, resulting in a lock-in-effect

This lock-in effect is precluding would-be-sellers from offloading or replacing current property ownership at the risk of resetting one's mortgage from 3% to just shy of 7%

The 30-year mortgage rate fell to **6.15%** in the week ending September 13, a two-year low



Sources: NAHB, FHLMC/Haver

*According to the National Association of Home Builders (NAHB)/Wells Fargo Housing Opportunity Index, just 37.7% of new and existing homes sold between the beginning of October and end of December were affordable to families earning the U.S. median income of $96,300.

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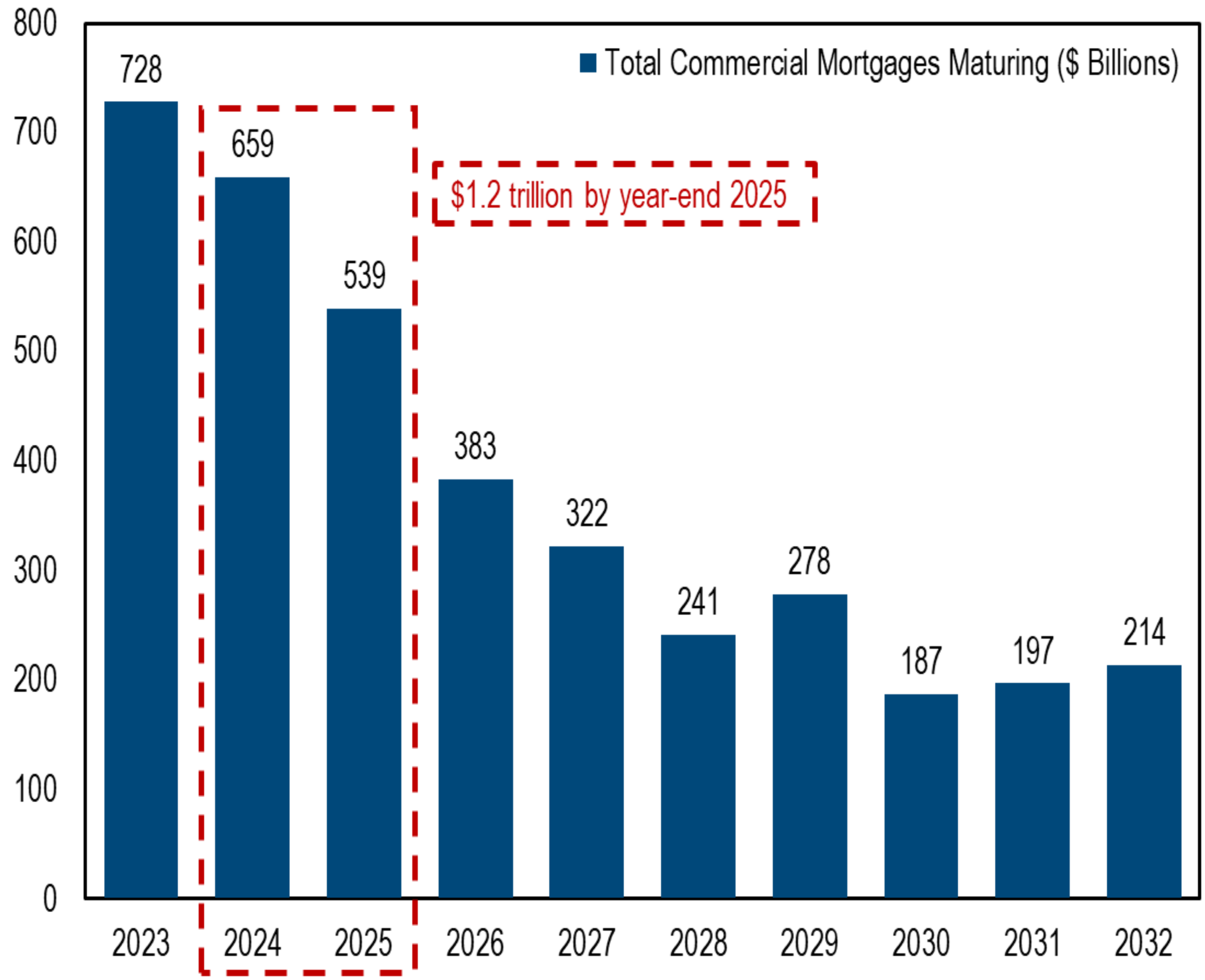
Trillions in Commercial Loans Set to Reset at Higher LTVs

Even with little reprieve in home prices or prices with rates higher for longer, CRE is the biggest near-term risk over 2024

By the end of 2025, **$1.2T** in commercial loans are slated to mature



Source: CRED iQ, MBA

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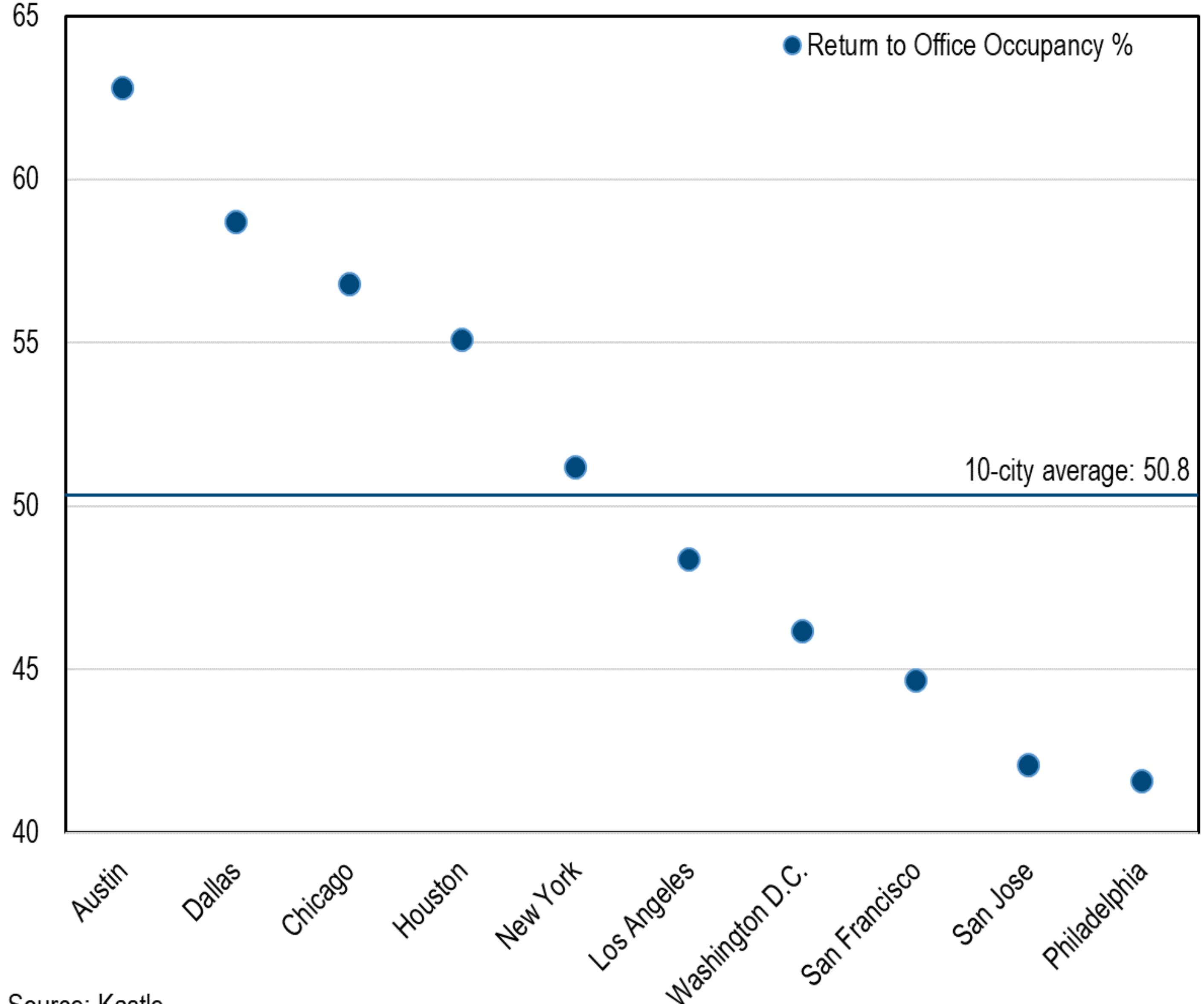
Return to Office Rates Complicate Commercial Real Estate Market Outlook

For the commercial market, as the work-from-anywhere environment has been wholly adopted, a change in structural preferences has resulted in a significant relocation of populations

For the downtown urban centers still experiencing at most a **40-50%** return to office rate, the population support will be more difficult to recapture

According to real estate data firm Trepp, **4.02%** of office loans that make up MBS are at least 30 days delinquent, the largest amount since 2018

Other areas, however, experiencing population booms will need further investment in commercial space to support the emerging growth and demand in everything from shopping centers to office spaces or alternative spaces for work, grocery stores and everything in between



Source: Kastle

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Higher Rates Likely to Weigh on Nominal Growth (While Avoiding Recession?)

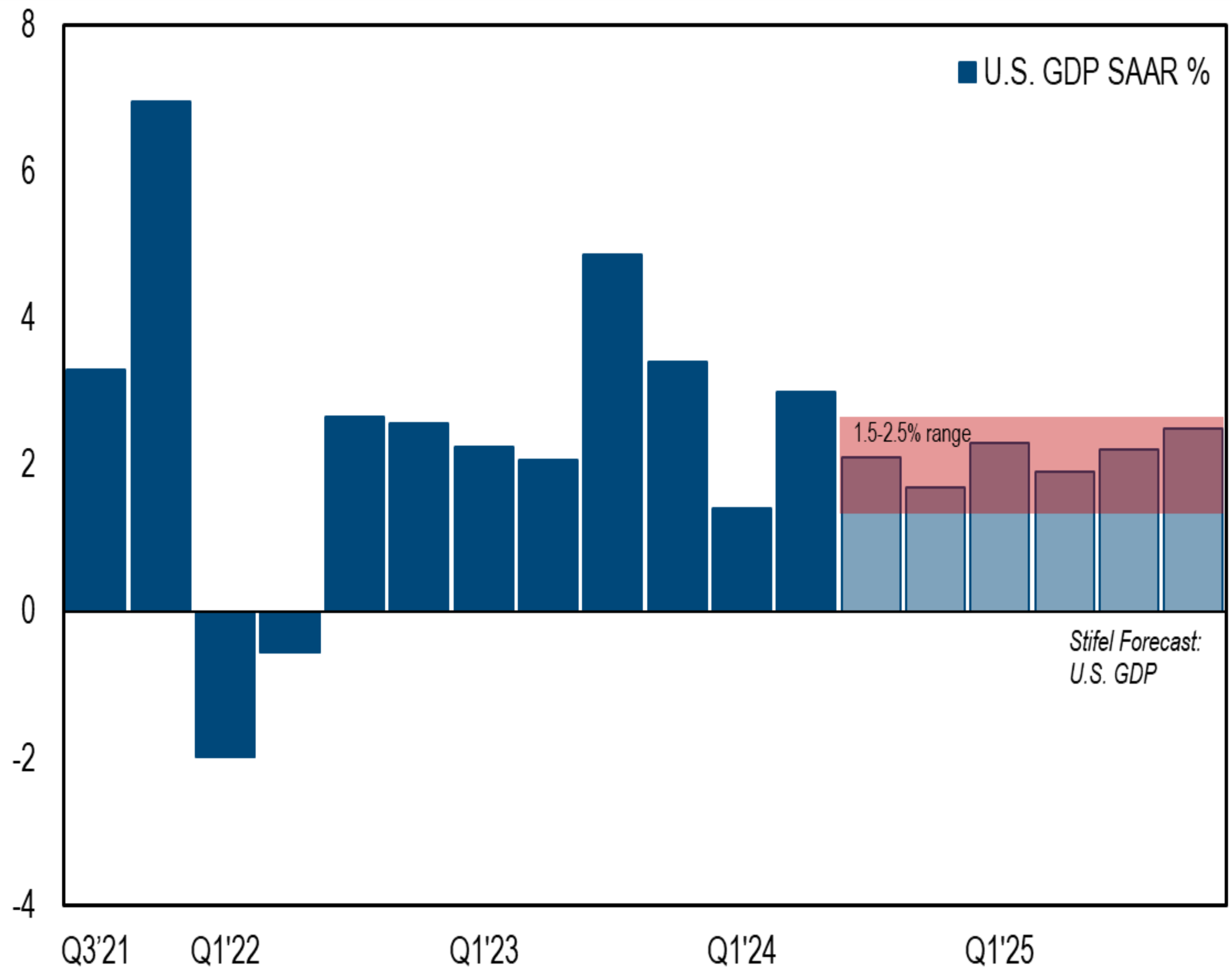
Given challenges, growth is likely to slow but remain positive as consumers are still spending and businesses are still investing with **the risk of recession at 25-30% for 2024**

GDP rose **3.0%** in Q2 2024, the strongest quarterly pace since Q4 2023

Excluding trade and inventories, final sales to domestic purchasers rose **2.9%**

The Fed revised its GDP forecast down from 2.1% to **2.0%** in 2024 with growth expected to rise **2.0%** in 2025, 2026, and 2027 before falling to 1.8% in the longer run

The unemployment rate forecast was revised higher from 4.0% to **4.4%** for 2024 and revised up from 4.2% to **4.4%** next year



Source: Census Bureau/Bloomberg/Stifel

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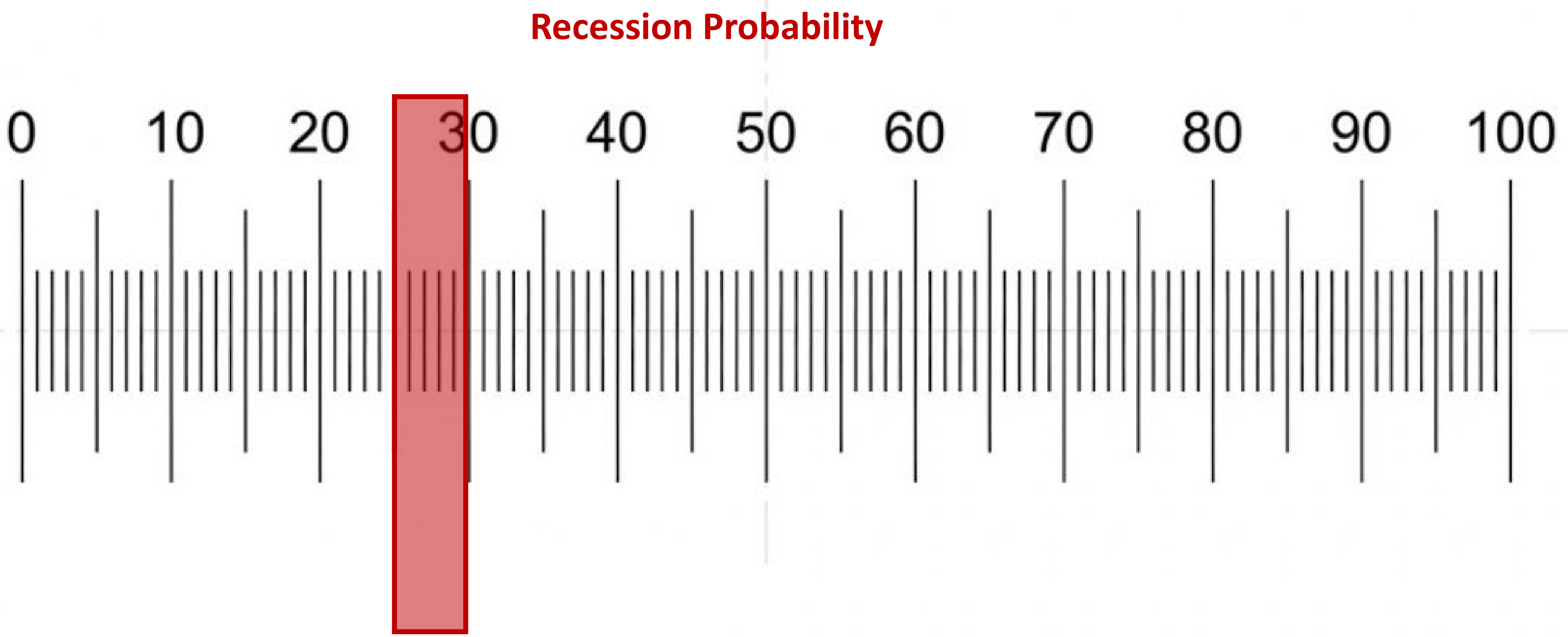
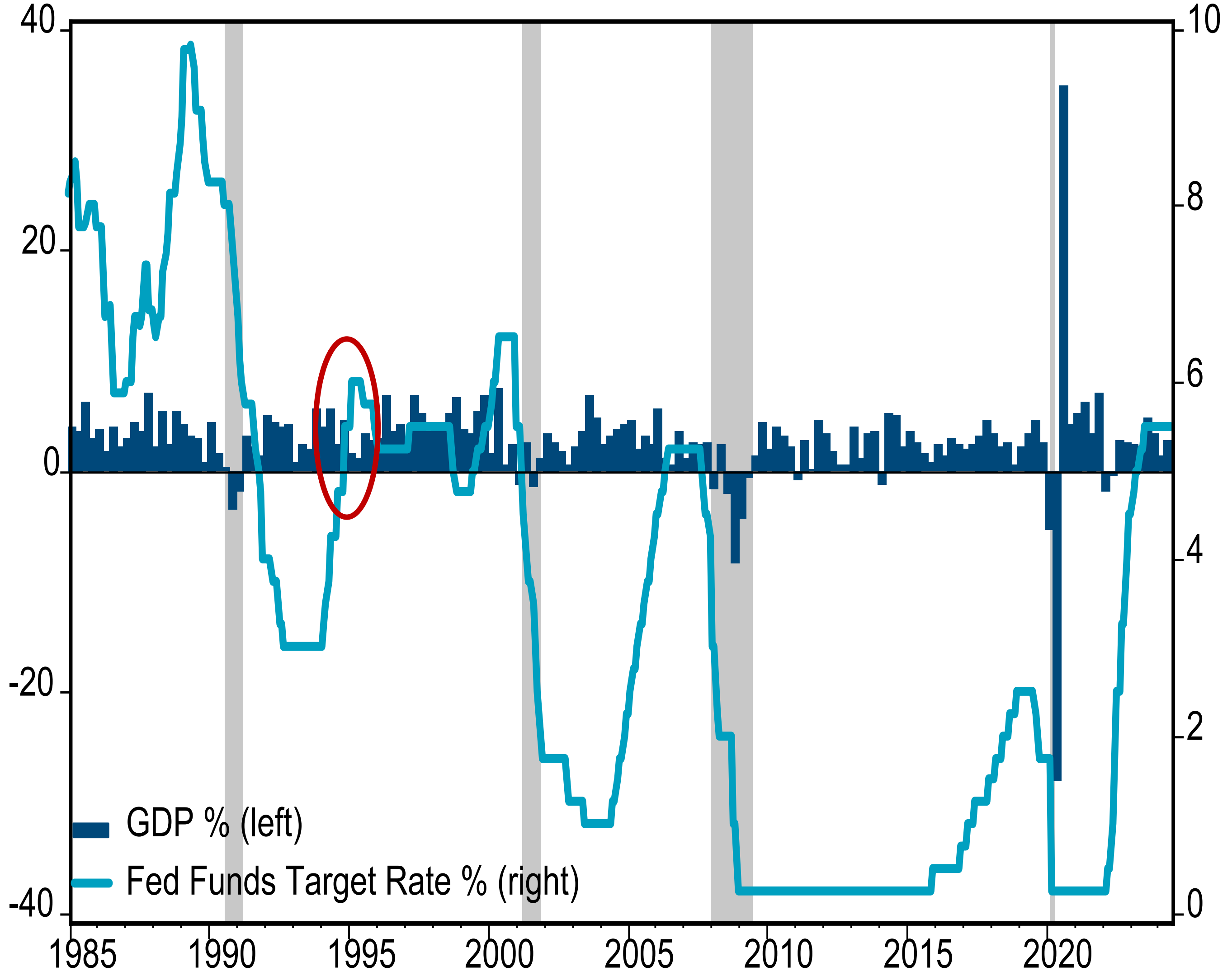
Recession Risk Remains Real but Fed Remains Focused on Soft-Landing



Soft Landing Only Achieved by the Fed Once in Last 60 Years

Over the last 60 years, the Fed has managed to achieve a soft landing only once in 1994-1995

The bigger concern and likelihood is not an outright downturn or outright recession, but a period stagflation as the economy slows to virtually a non-accelerating pace on average



Sources: BEA, FRB/Haver

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U.S. Debt Continues to Increase, Risking Pressure on Inflation, Longer-Term Rates

Rising federal deficits will expectedly result in a stubbornly elevated level of real rates over time

Wake up call short-lived amid prospects of easing

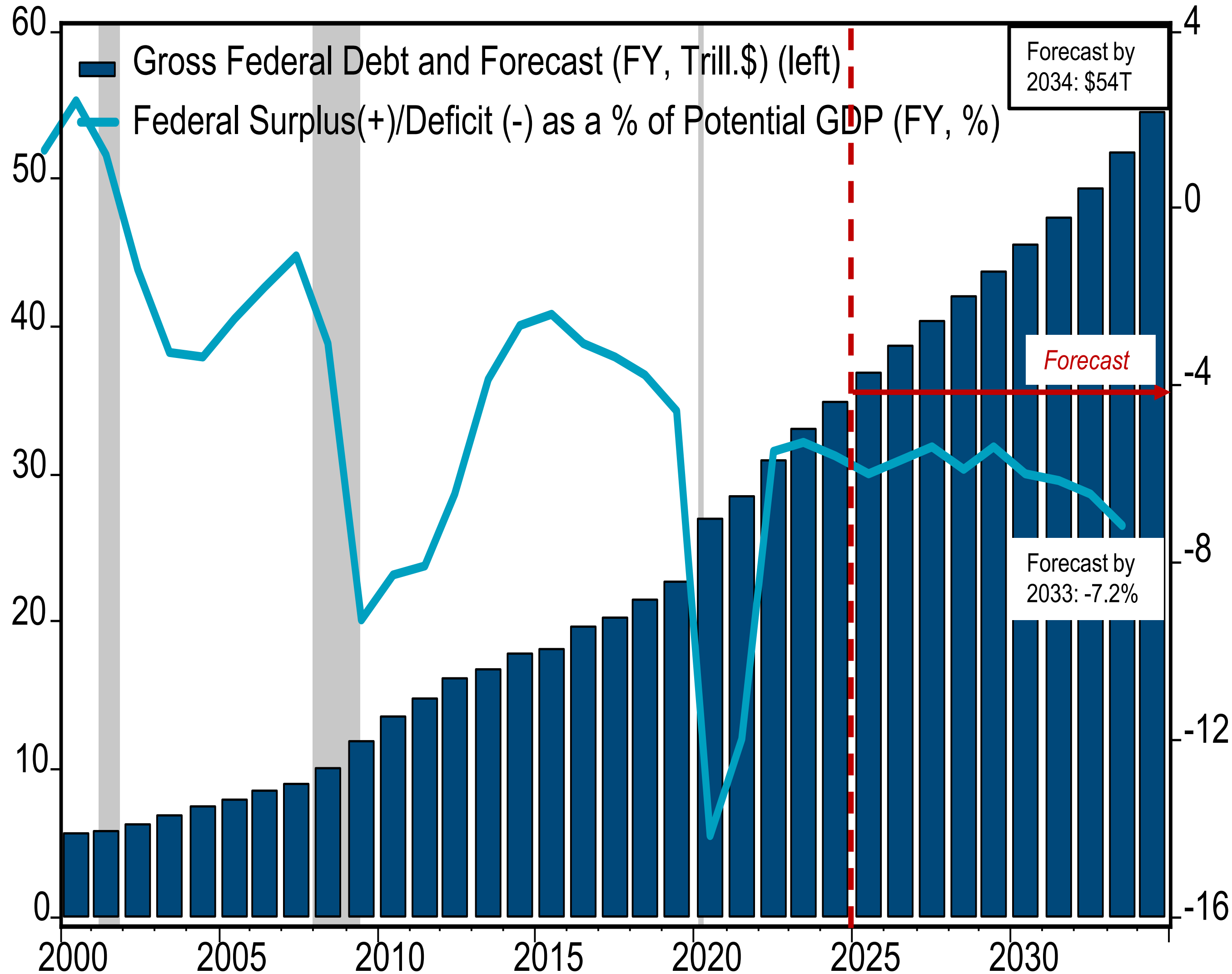
Deficits matter and will continue to reshape expectations for higher longer-term rates, complicate the Fed's pathway, and risk inflation

In FY 2023, the federal deficit was **$1.6T**, and 6.2% of GDP

The deficit is expected to remain elevated at 6.1% of GDP**, almost two times the historical norm**

The government balance sheet has grown to over **$34T** as of late

In March, Congress passed a $1.2T government funding package to fully fund the government through September



Source: Congressional Budget Office/Haver Analytics

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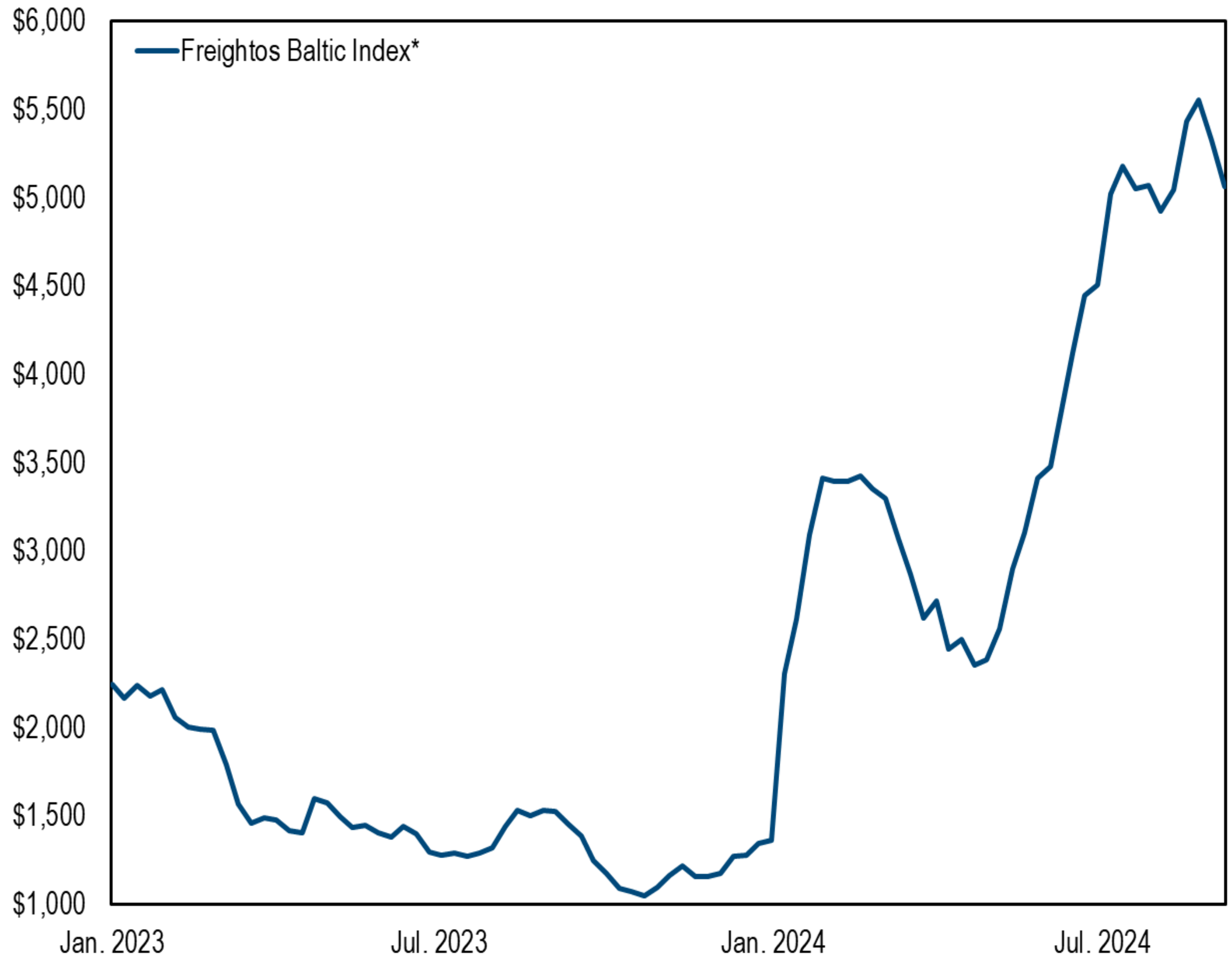
International Risks and Uncertainty Muddy the Outlook for Inflation, Policy

Global politics continue to shift perceptions, market metrics and potential policy directives

Any additional military response may not be enough to adjust policy but a renewed threat to prices – food, energy, shipping – could muddy policy pathway

Demand cooling and few supply-side reports of shortages but if prolonged, could move the inflation needle

There are reports of massive disruptions to shipping passages due to the conflict in the Middle East, with estimated costs rising over 119% on average since the start of the year for 40’ containers



Source: Bloomberg

*The index is a weighted aveage cost of a 40' container over twelve route indexes for ocean freight.

Trump vs. Harris Policies

Issue	Trump	Harris
Taxes	•Extend the Tax Cuts and Jobs Act (TCJA) of 2017. •Cut corporate the corporate tax rate to as low as 15%	•Raise taxes on individuals earning >$400k. Possibly extend TCJA for lower income brackets. •Tax investment income >$1 million as ordinary income. •Raise corporate income tax rate to 28% (proposed 35% rate in 2020). •Increase stock buyback tax to 4%.*Financial transaction tax.*4% "income-based premium" on household >$100k to pay for Medicare for All.
Healthcare	•Possibly try to repeal the Affordable Care Act.	•Expand ACA. *Medicare for All.
Trade	•Increase tariffs on Chines imports up to 60%. •10% global tariffs.•Likely to push for changes in US, Mexico, Canada Agreement as part of 2026 review.	•Maintain current tariifs on China. •"Not a protectionist Democrat" (2019). •Voted against USMCA based on climate concerns.

* Proposed as part of campaign for the Democratic nomination in 2020

Source: Stifel's Chief Washington Policy Strategist Brian Gardner

Far from Ideal Market Conditions with the Fed’s Price Stability Mission Not Yet Complete

- Bloated and growing government balance sheet
- A reduction in longer-dated yields
- Rising equity market valuations
- A more confident and *“spendy”* consumer
- High investor confidence for multiple near-term rate cuts
- International, geopolitics as well as domestic political risks

- **Solid assessment of the broader U.S. economy**

  "Recent indicators suggest that economic activity has continued to expand at a solid pace."
- **Some softening in labor market conditions**

  "Job gains have slowed, and the unemployment rate has moved up but remains low."
- **Improved assessment of inflation**

  "Inflation has made further progress toward the Committee's 2 percent objective but remains somewhat elevated."
- **Improved assessment of risk profile between its employment and inflation goals**

  "The Committee has gained greater confidence that inflation is moving sustainably toward 2 percent, and judges that the risks to achieving its employment and inflation goals are roughly in balance."
- <u>**Adjustment to policy based on progress on inflation and balance of risks (NOT ON A PREDETERMINED PATH)**</u>

  "In light of the progress on inflation and the balance of risks, the Committee decided to lower the target range for the federal funds rate by 1/2 percentage point to 4-3/4 to 5 percent."

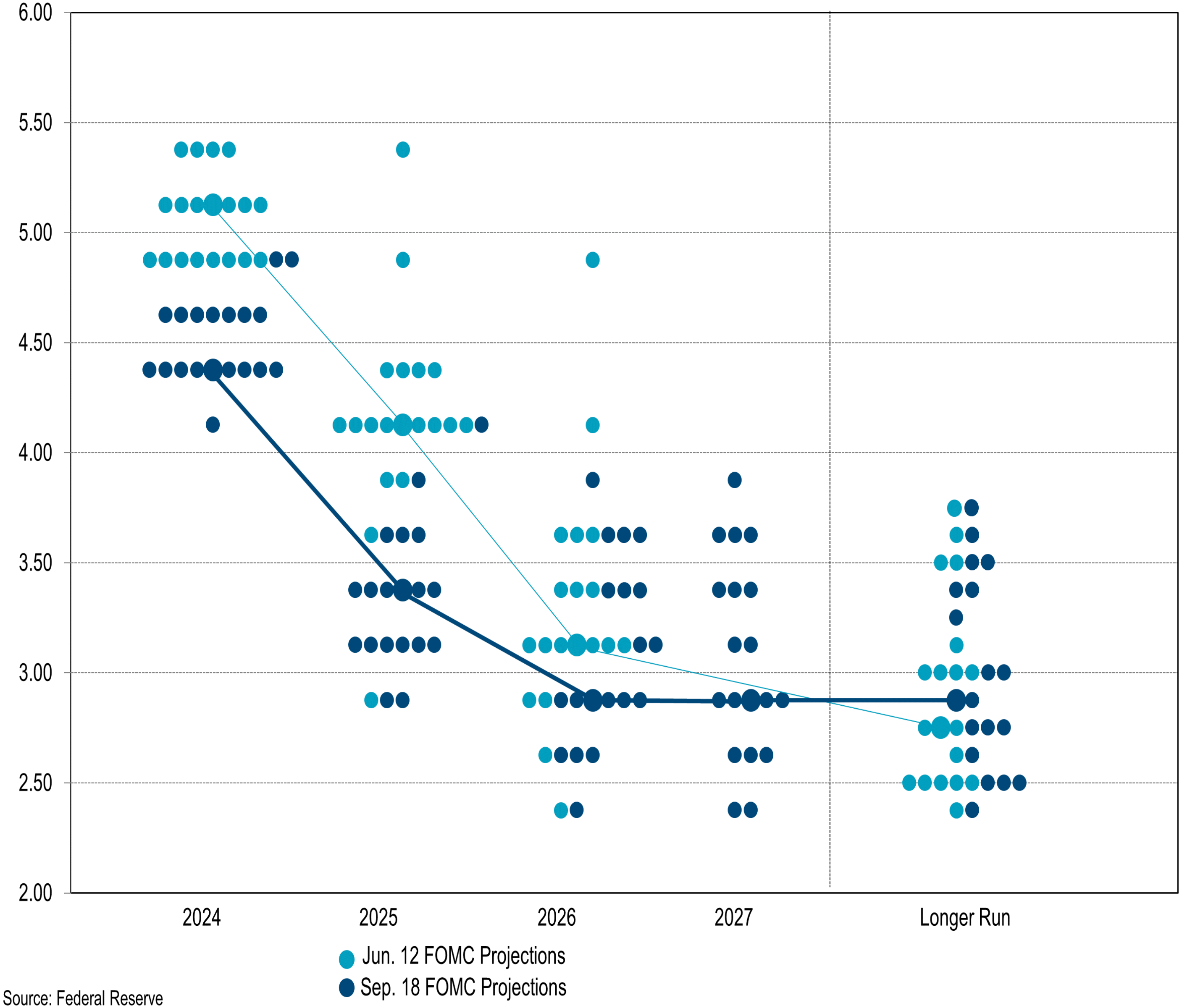
September Dot Plot Shows 50bps More in 2024, 100bps in 2025

The dot plot offered a welcome quantification of policy expectations with the majority of officials anticipating two more rate cuts by year-end, up from one indicated in the June release

While sizable downshift from June, the latest forecast if well shy of the market's expectations

The division in expectations, however, is notable with nine officials anticipating less than the median forecast and one expecting three rate cuts by year-end

Longer term, the Committee anticipates about 200bps in cuts by the end of 2027, taking policy to a proposed terminal level of 2.9%



Source: Federal Reserve

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- <u>Base case</u>: Fed on hold longer than expected amid sticky inflation

- <u>Slowly declining inflation</u>: Fed pursues lower rates at a tempered (25bps) pace, remaining above neutral beyond 2025 as the Committee *considers* but does not commit to action at every subsequent meeting.

Fed Likely to Move at a Controlled, Tempered Pace

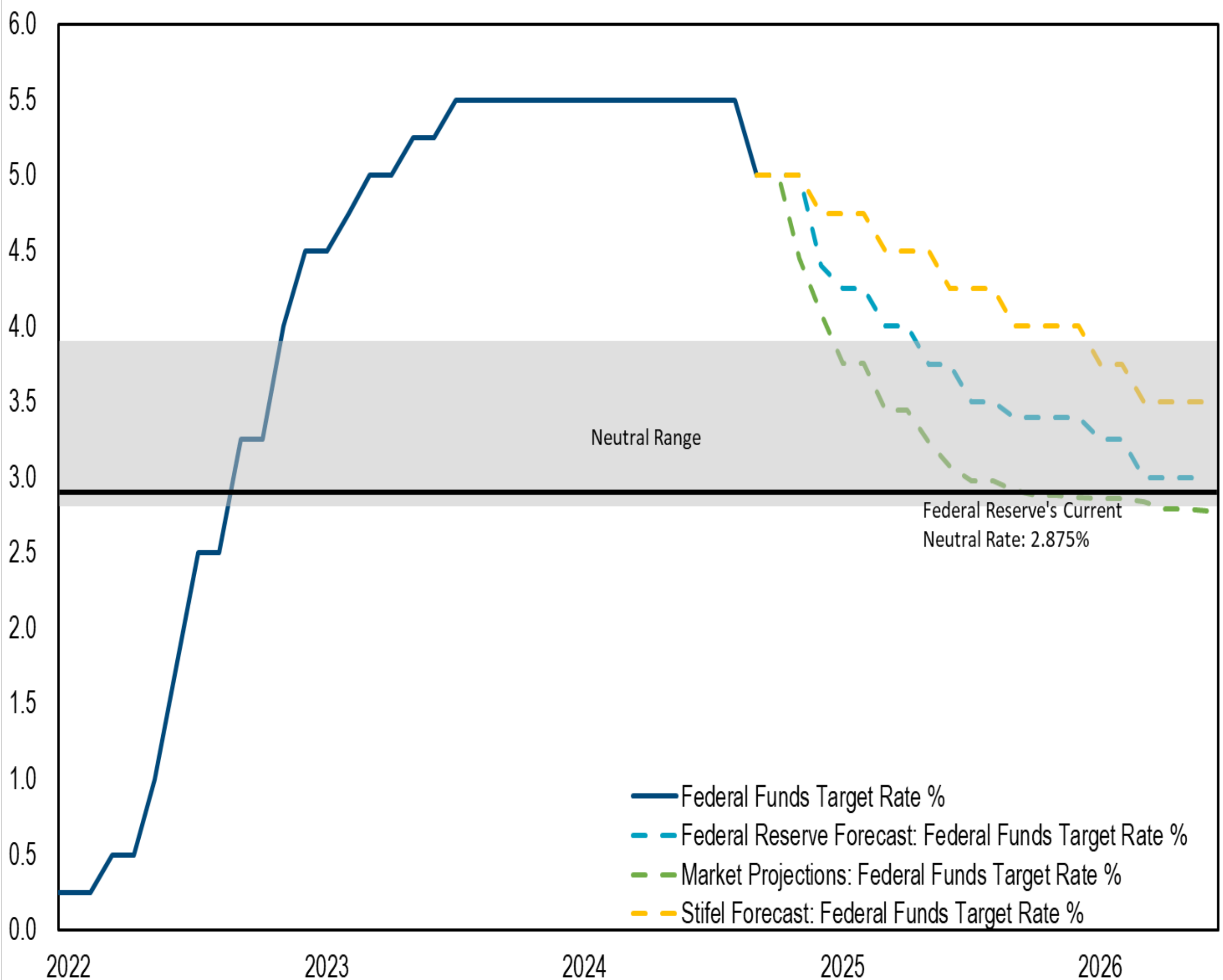
Investors continue to anticipate 71bps of cuts by year-end, and 122bps more in 2025

The risk to a 50bps cut is/was sending a signal of the Fed's intentions to rush back to an accommodative stance as opposed to unwinding policy firming toward neutral

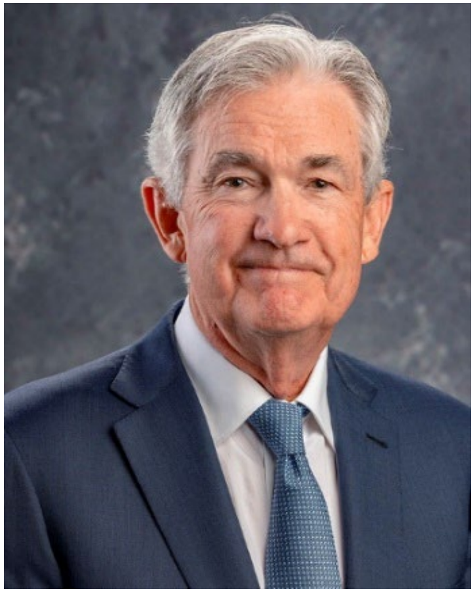
Amid a policy pivot, the pathway is still likely to disappoint investors looking for a rapid descent back to neutral or below

Even if inflation resumed a disinflationary trend, the pace of rate reductions will expectedly be slow and tempered, keeping the federal funds rate well above neutral through 2025

Fed officials expect the neutral rate to be 2.875%



Source: Bureau of Economic Analysis/Federal Reserve



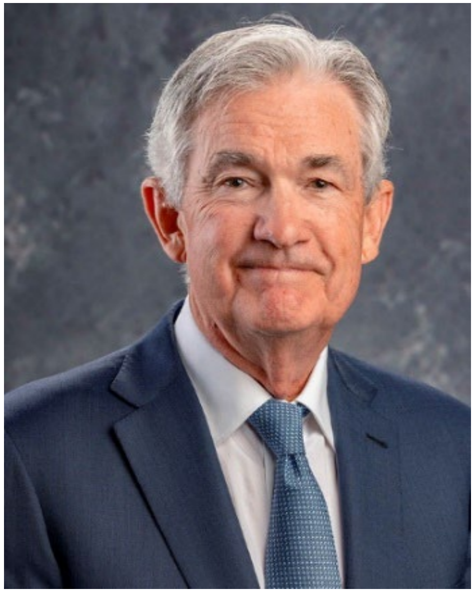
“There is nothing in the SEP that suggests the committee is in a rush.”

“I do not think that anyone should look at this and say, ‘Oh, this is the new pace.”

Federal Reserve Chairman Jerome Powell Speaking at FOMC Press Conference

September 18, 2024

Powell Notes Economy is *"Strong Overall"*



*"We made a good, **strong start** to this and that's really, frankly, a sign of our confidence."*

*"Our economy is **strong overall** and has **made significant progress toward our goals** over the past two years."*

*"…if you look back over the sweep of the year, that's a low, that's a **very healthy unemployment rate**."*

*"…the labor market is actually in **solid** condition"*

*"I **don't see anything** in the economy right now that **suggests that the likelihood of a recession**, sorry, of a downturn is **elevated**."*

Federal Reserve Chairman Jerome Powell Speaking at FOMC Press Conference

September 18, 2024

Inflation to Remain Uneven, Uncertain, Elevated….But Improving

Its all about the data, inflation data!

With the lack of further disinflation, there is nothing in the data to suggest the Fed will – nor should it – continue tight a more aggressive pace, potentially disappointing investors

The core CPI rose **0.2%** in August and **2.5%** YoY, **the slowest pace in more than three years. albeit unchanged from the pace in July**

Core services ex. shelter, meanwhile, rose 4.5% YoY, up from 4.4% in July

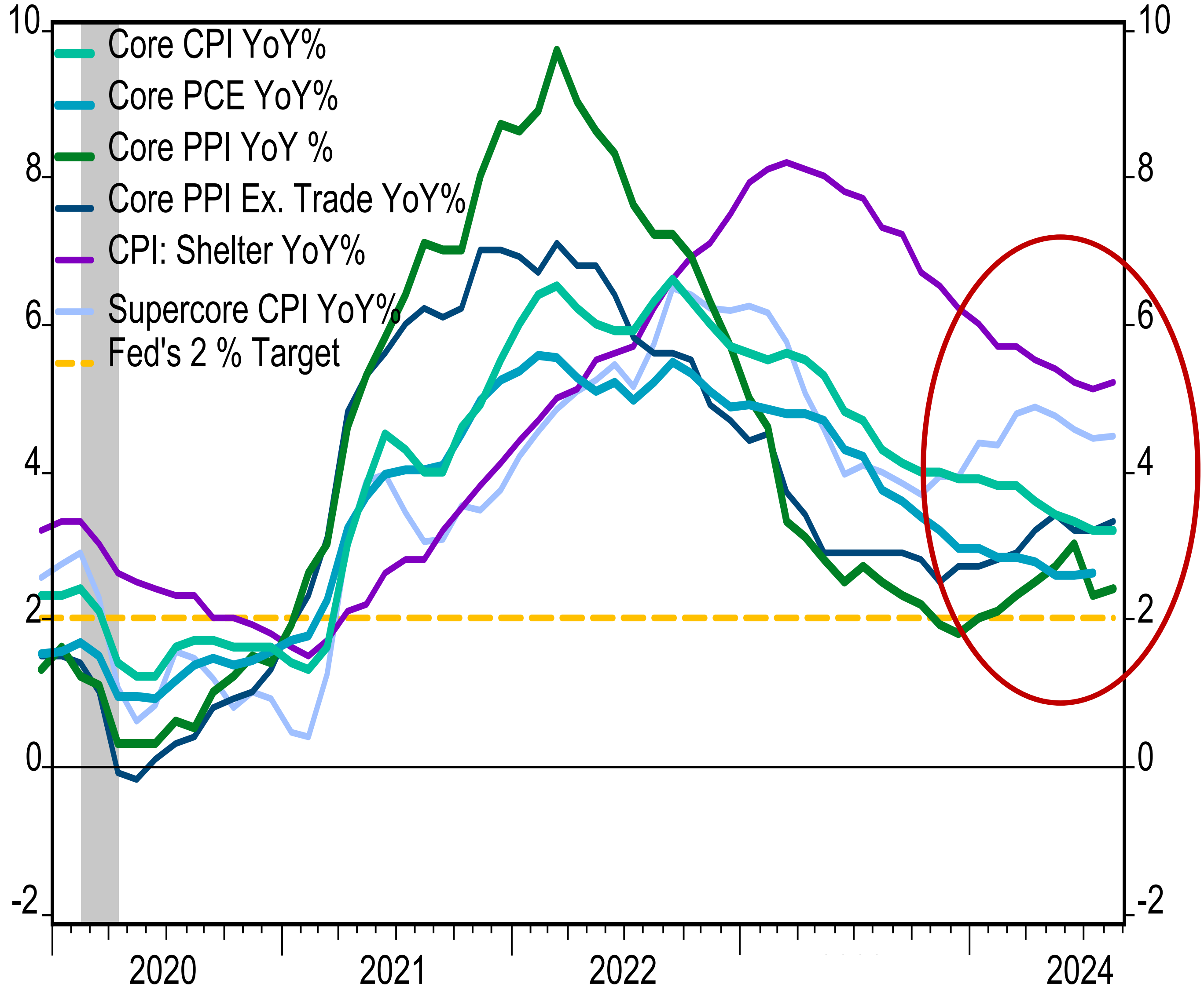
The PPI rose 0.2% in August and 1.7% YoY, down from 2.1% in July and marking the smallest annual increase since February

The core PPI rose 0.3% in August and rose 2.4% YoY, up from 2.3% in July and the largest annual gain in two months

The core PPI ex. trade rose 0.3% in August and 3.3% YoY, the hottest reading since May

The PCE rose 0.2% in July and 2.5% YoY, matching the gain in June

The core PCE rose 0.2% in July and 2.6% YoY for the third consecutive month



Sources: BEA, BLS, Haver Analytics

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