THOUGHTS OF THE WEEK
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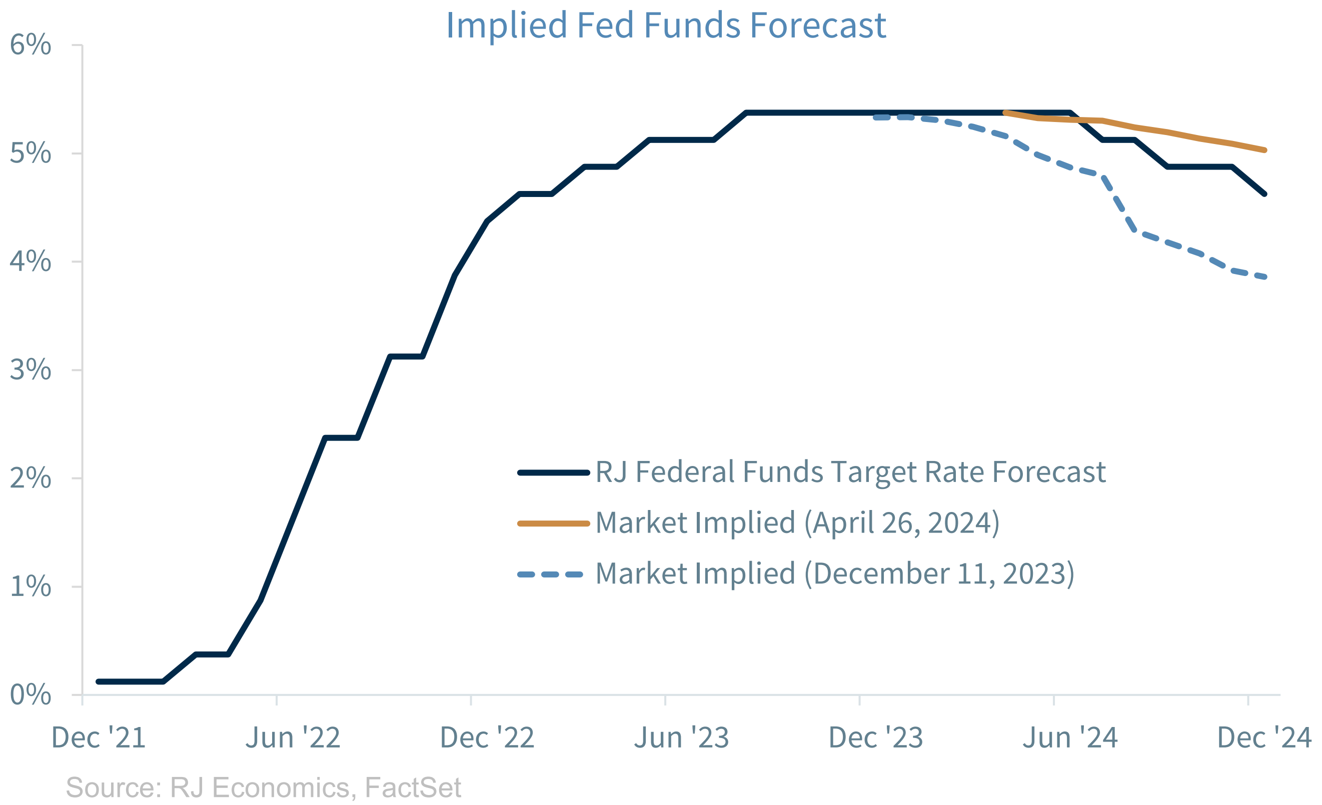
WEEKLY ECONOMICS

GDP, Inflation, and the Fed: Keep Calm and Carry On!

The reaction from markets to the release of Q1 2024 real GDP results has given every sector of the market another chance to give their own interpretation of what is coming regarding Federal Reserve (Fed) policy, inflation, and the federal funds rate. We have already started to hear that the Fed is not going to cut rates at all during the year; that it is only going to cut twice, or just once; that we are going into a stagflation process (we thought we had made the case clear that the current process has no similarities to the stagflation process of the 60s, 70s, and early 80s!), just because of a worse than expected quarterly PCE price index number; that we are going into a recession because the yield curve has been inverted for too long, etc. In fact, the latter group—yield curve inversion group—has been consistent over time.

The only problem with some of this group's thinking today is that while in the past they have argued for a recession and immediate interest rate cuts by the Fed, they seem to have jumped onto the 'stagflation' bandwagon, which argues that we will have a recession but with much higher inflation and no rate cuts. And then, there are those calling for the Fed to actually increase interest rates under the argument that it stopped rising interest rates too early.

What is important to remember is that this was the same market that was pricing in seven interest rate cuts in 2024 just four months ago!!

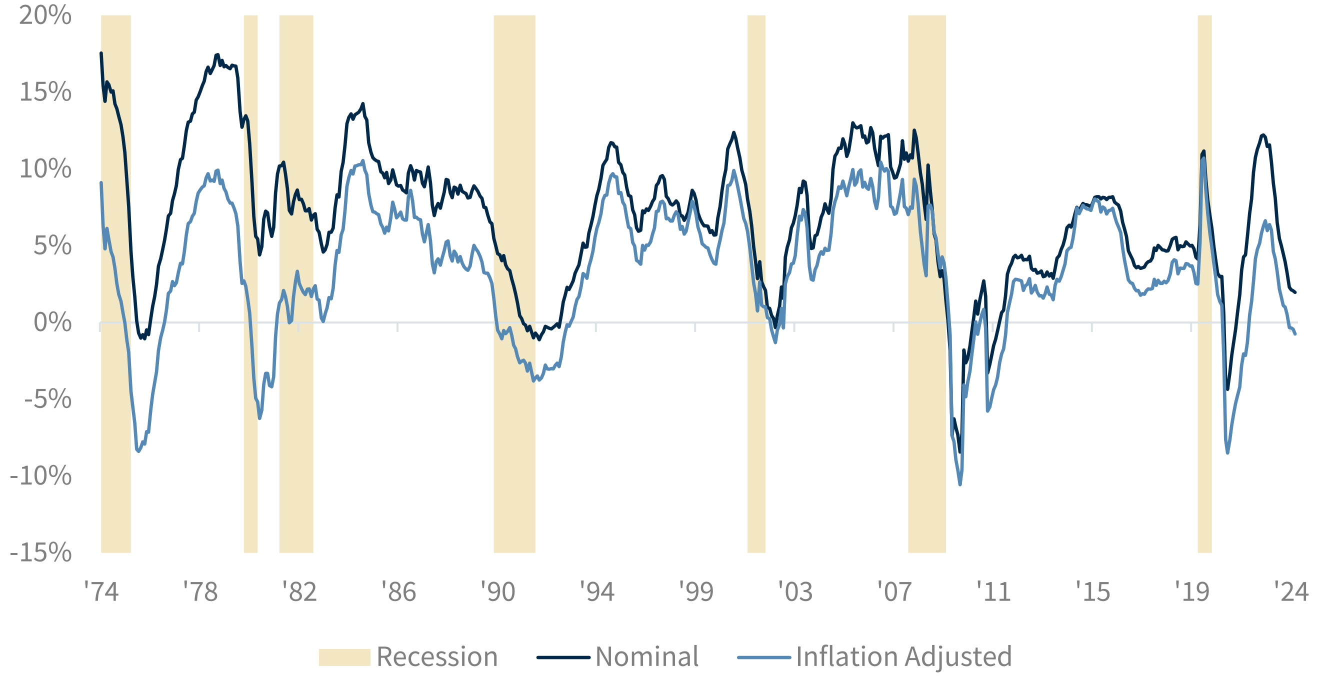


It is true that the rate of inflation during the first quarter of the year is not what markets were expecting, but we always said that the last stretch of the disinflationary process was going to be a long one. The Fed knows this, that is the reason why it expects to hit the 2% target in 2026, not today, not this year, not even in 2025. There is plenty of time for Fed policy to work its magic and the Fed has positioned itself to do that. It is true that the worse than expected result in the first quarter may delay the decision to start cutting interest rates to later this year. Please see the section on the following page where we discuss our changes. The truth is that nothing else has really changed from what we were expecting earlier this year or even last year.

Our expectation for the disinflationary process to continue during the year remains intact. Thus, the Fed will achieve its goals with current interest rates so there is no need to increase interest rates further, as some have started to speculate. Lending is almost flat and even credit card lending has started to weaken, which was the only component of lending that remained a concern for the Fed, as the graph below clearly shows. Furthermore, real money supply growth has remained in negative territory, which is what the Fed needs to keep inflation on its disinflationary path.

Real Lending: Loans and Leases in Bank Credit

(YoY % Growth)



Source: RJ Economics, FactSet

Perhaps one of the potential arguments for the Fed to increase interest rates today is if it wants to slow consumption, as higher interest rates increase the trade-off between consuming today versus consuming tomorrow. However, the Fed doesn't need to do that today because long term interest rates are moving higher anyway even as the Fed has kept the federal funds rate fixed. And this, if sustained, should do the trick for the Fed. Thus, even that argument for higher interest rates is not a compelling one today.

Furthermore, today's monthly personal income and consumption report for March confirmed our suspicions that yesterday's 1Q GDP report was a 'nothingburger' and that the Fed, and markets, should Keep Calm and Carry On!

Changes to Our Federal Funds Rate Forecast

After considering the higher than expected inflation print during the first quarter of the year we are making a slight change to our federal funds rate forecast. We are keeping, for now, our call for three rate cuts but we are changing our expectation for the first Fed cut to July rather than June. This will give us an opportunity to see June's dot-plot in order to gauge what effects, if any, first quarter inflation numbers have had on Fed members' views on the policy target. Thus, we are now expecting cuts in the federal funds rate in July, September, and December.

Economic Forecast:

	Actual					Forecast							Actual	Forecast	
	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	1Q25	2Q25	3Q25	4Q25	2023	2024	2025
Real Gross Domestic Product [1]	**2.2**	**2.1**	**4.9**	**3.4**	**1.6**	**0.9**	**1.0**	**1.6**	**2.4**	**2.6**	**2.1**	**2.5**	**2.5**	**2.1**	**2.0**
Real Gross Domestic Product [2]	1.7	2.4	2.9	3.1	2.9	2.6	1.7	1.3	1.5	1.9	2.2	2.4	2.5	2.1	2.0
Consumer Price Index [2]	**5.7**	**4.0**	**3.6**	**3.2**	**3.2**	**3.5**	**3.3**	**3.2**	**2.8**	**2.5**	**2.4**	**2.3**	**4.1**	**3.3**	**3.1**
Ex-food & energy [2]	5.5	5.2	4.4	4.0	3.8	3.6	3.6	3.5	3.0	2.6	2.5	2.4	4.8	3.7	2.5
PCE Price Index [2]	**5.0**	**3.9**	**3.3**	**2.8**	**2.6**	**2.7**	**2.6**	**2.7**	**2.4**	**2.2**	**2.2**	**2.2**	**3.7**	**2.6**	**2.3**
Ex-food & energy [2]	4.8	4.6	3.8	3.2	2.9	2.7	2.8	2.8	2.4	2.2	2.0	1.9	4.1	2.8	2.1
Unemployment Rate	**3.5**	**3.5**	**3.7**	**3.7**	**3.8**	**3.9**	**4.1**	**4.1**	**4.0**	**3.9**	**3.9**	**3.9**	**3.6**	**3.9**	**3.9**
Fed Funds Rate [3]	5.00	5.25	5.50	5.50	5.50	5.50	5.00	4.75	4.75	4.50	4.00	4.00	5.1	5.1	4.3

[1] Annualized Quarter-Over-Quarter Growth
[2] Year-Over-Year Percentage Change
[3] Upper Bound of the Federal Funds Target Range

Economic Forecast:

New Home Sales: New home sales defied expectations and bounced back in March after a steep drop in February. In contrast with existing home sales, which were lower earlier this month, new home sales continue to benefit from better deals as some builders offer reductions in prices and mortgage rate buydowns to attract more homebuyers. New home sales of single-family homes increased at a seasonally adjusted annual rate of 693,000, according to the US Census Bureau and the Department of Housing and Urban Development. This number was higher than the FactSet expectations for an increase of 670,000. Furthermore, the February number was revised down to 637,000 compared to an original print of 662,000. On a year-over-year basis, new home sales increased from 640,000 in March 2023. In regional terms, new single-family homes increased by 8.8% month-over-month and 8.3% compared to March 2023. All regions saw monthly increases while the Northeast remains the only region negative on a year-over-year basis, with a decline of 13.2%. Months' supply of homes at the end of March stood at 8.3 months, down slightly from the 8.4 months' supply recorded in February. The median price of new homes was $430,700 in March of this year, while the average sales price was $524,800. Sales of new single-family homes continue to remain resilient, with higher-than-expected sales in March despite tighter financial conditions. Additionally, while February data was revised lower from 662,000 to 637,000, both January 2024 and December 2023 were revised slightly higher.

1Q24 Real GDP: The weaker than expected outturn for real GDP during the first quarter of the year was a consequence of very strong growth in real imports of goods and services, very weak growth in exports of goods and services, and relatively weak government expenditures, especially federal government expenditures. However, the 'domestic' economy, that is, personal consumption expenditures plus investment were relatively strong. A drawdown in inventories also weakened the result during the quarter and could explain why imports of goods and services were so strong during the quarter. The only question is why are firms importing so much if goods consumption was negative during the quarter? One of the potential answers to this question, other than to replenish inventories, is that firms are expecting the economy to strengthen going forward. The advanced estimate for GDP growth during the first quarter of the year was weaker than expected, up 1.6%, quarter-over-quarter, compared to FactSet expectations for a 2.2% increase. Personal consumption expenditures (PCE) increased by 2.5% during the quarter and contributed 1.68 percentage points to GDP growth during the quarter, according to the Bureau of Economic Analysis (BEA). The goods sector of PCE was weak, declining by 0.4% during the quarter as durable goods consumption declined 1.2% while nondurable goods consumption remained flat. However, services consumption strengthened during the quarter, growing by 4.0% compared to a growth rate of 3.4% during the fourth quarter of last year. Government consumption expenditures and gross investment was very weak during the quarter, increasing by just 1.2% after growing by 4.6% during the fourth quarter of last year. The weakness came from a decline in federal government expenditures, which declined 0.2% during the quarter. Gross private domestic investment was strong, up by 3.2% during the quarter after growing by just 0.7% during the fourth quarter of last year. Fixed investment increased 5.3%, with nonresidential investment growing 2.9% while residential investment surged by 13.9%, the highest quarter-over-quarter growth rate since the first quarter of 2021. Exports of goods and services were very weak during the first quarter of the year, up only 0.9%, while imports of goods and services were very strong, up 7.2%, as goods imports surged by 6.8% while services imports surged by 9.0%. This meant that the contribution to GDP growth from net imports (i.e., exports minus imports), was -0.86 percentage points. The PCE price index increased by 3.4% during the first quarter of the year, up from an increase of just 1.6% during the last quarter of 2023. Strong growth in imports of goods and services as well as somewhat weak federal government consumption growth were the culprits for the weaker than expected growth in real GDP during the first quarter of the year.

Economic Forecast:

Pending Home Sales: The increase in the PHS Index in March, the second consecutive increase in this Index, points to improving conditions for existing home sales, which have remained a laggard lately compared to new home sales. Existing homeowners have been reluctant to sell their homes and give up very low mortgage rates on their current homes and face a much higher mortgage rate on their next home purchase. Pending Home Sales (PHS) increased by 3.4% during the third month of the year, according to the National Association of Realtors (NAR), after an increase of 1.6% during the month of February. FactSet expected a decline of 0.3% during the month of March. This was the second consecutive month of growth for the PHS Index. Out of the four regions of the country, three saw an increase in the month of March: the Northeast, the South, and the West, while the Midwest experienced a decline in the regional PHS Index, according to the release. The NAR Chief Economist, Lawrence Yun mentioned that March's PHS index was the strongest in a year "but it still remains in a fairly narrow range over the last 12 months without a measurable breakout." According to the NAR "The Pending Home Sales Index (PHS), a leading indicator of housing activity, measures housing contract activity, and is based on signed real estate contracts for existing single-family homes, condos, and co-ops. Because a home goes under contract a month or two before it is sold, the Pending Home Sales Index generally leads Existing-Home Sales by a month or two."

Personal Income: The details of yesterday's Q1 GDP report, especially on the inflation side, which rattled markets yesterday, are much better than feared, according to the monthly income and expenditures report. Although the headline PCE price index inched up on a year-over-year basis, from 2.5% to 2.7%, the more important core PCE price index, which excludes food and energy prices, remained unchanged in March compared to February, at 2.8%. This should be very good news for the Federal Reserve (Fed) and should, in a perfect world, improve yesterday's negative market reaction. Personal income increased as expected, by 0.5 percent in March while disposable personal income also increased by 0.5%. Personal consumption expenditures (PCE) increased by 0.8%, which was higher than expectations, according to the Bureau of Economic Analysis. In real terms, disposable personal income increased by 0.2% after falling 0.1% in February and remaining flat in January. Real personal consumption expenditures increased by 0.5%, the same rate of growth as in February after a decline of 0.3% in January. The price index for PCE increased as expected, up 0.3%, as did the core PCE, which excludes the volatile sectors of food and energy prices, according to the report. On a year-over-year basis, the headline PCE price index increased by 2.7% compared to a 2.5% reading in February while the core PCE price index remained unchanged, at 2.8% in March. The personal saving rate declined to 3.2% as a percentage of disposable personal income from a rate of 3.6% in February. The revisions to the PCE price index allowed the core PCE price index to remain unchanged in March compared to February on a year-over-year basis, which should be good news for the Fed even if the headline number increased slightly.

DISCLOSURES

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Consumer Price Index is a measure of inflation compiled by the US Bureau of Labor Statistics. Currencies investing is generally considered speculative because of the significant potential for investment loss. Their markets are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Consumer Sentiment is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.

Personal Consumption Expenditures Price Index (PCE): The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

The Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. A value above 100 signals a boost in the consumers' confidence towards the future economic situation, as a consequence of which they are less prone to save, and more inclined to consume. The opposite applies to values under 100.

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GDP Price Index: A measure of inflation in the prices of goods and services produced in the United States. The gross domestic product price index includes the prices of U.S. goods and services exported to other countries. The prices that Americans pay for imports aren't part of this index.

The Conference Board Leading Economic Index: Intended to forecast future economic activity, it is calculated from the values of ten key variables.

The U.S. Dollar Index is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. The Index goes up when the U.S. dollar gains "strength" when compared to other currencies.

The FHFA House Price Index (FHFA HPI®) is a comprehensive collection of public, freely available house price indexes that measure changes in single-family home values based on data from all 50 states and over 400 American cities that extend back to the mid-1970s.

The Pending Home Sales Index (PHSI) tracks home sales in which a contract has been signed but the sale has not yet closed.

Supplier Deliveries Index: The suppliers' delivery times index from IHS Markit's PMI business surveys captures the extent of supply chain delays in an economy, which in turn acts as a useful barometer of capacity constraints.

Backlog of Orders Index: The Backlog of Orders Index represents the share of orders that businesses have received but have yet to start or finish. An increasing index value usually indicates growth in business but shows that output is below its maximum potential.

DISCLOSURES

Import Price Index: The import price index measure price changes in goods or services purchased from abroad by U.S. residents (imports) and sold to foreign buyers (exports). The indexes are updated once a month by the Bureau of Labor Statistics (BLS) International Price Program (IPP).

ISM Services PMI Index: The Institute of Supply Management (ISM) Non-Manufacturing Purchasing Managers' Index (PMI) (also known as the ISM Services PMI) report on Business, a composite index is calculated as an indicator of the overall economic condition for the non-manufacturing sector.

Consumer Price Index (CPI) A consumer price index is a price index, the price of a weighted average market basket of consumer goods and services purchased by households.

Producer Price Index: A producer price index (PPI) is a price index that measures the average changes in prices received by domestic producers for their output.

Industrial production: Industrial production is a measure of output of the industrial sector of the economy. The industrial sector includes manufacturing, mining, and utilities. Although these sectors contribute only a small portion of gross domestic product, they are highly sensitive to interest rates and consumer demand.

The NAHB/Wells Fargo Housing Opportunity Index (HOI) for a given area is defined as the share of homes sold in that area that would have been affordable to a family earning the local median income, based on standard mortgage underwriting criteria.

Conference Board Coincident Economic Index: The Composite Index of Coincident Indicators is an index published by the Conference Board that provides a broad-based measurement of current economic conditions, helping economists, investors, and public policymakers to determine which phase of the business cycle the economy is currently experiencing.

Conference Board Lagging Economic Index: The Composite Index of Lagging Indicators is an index published monthly by the Conference Board, used to confirm and assess the direction of the economy's movements over recent months.

New Export Index: The PMI new export orders index allows us to track international demand for a country's goods and services on a timely, monthly, basis.

Gold is subject to the special risks associated with investing in precious metals, including but not limited to: price may be subject to wide fluctuation; the market is relatively limited; the sources are concentrated in countries that have the potential for instability; and the market is unregulated.

Source: FactSet, data as of 4/26/2024

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