Economic Outlook

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April 22, 2024

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Agenda

1. What We Got Wrong in the Last Forecast
2. Fed Policy and the Impact on Yields
3. Inflation Trends
4. How Strong is the Economy?
5. Conclusion

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When the Fed Started Hiking in March 2022, We Thought a Recession was Inevitable. What Did We Get Wrong?

A Partial List of Why the Recession Didn't Happen

- **The consumer has proven very resilient,** even as stimulus checks have long been spent. The pent-up demand after lockdowns continued much longer than most anticipated. **Recent wage increases and new jobs have kept the spending going.**
- **This unrelenting demand led to increased hiring and a virtuous cycle was established of demand begetting more hiring which begat more demand**. This "revenge spending" continues to this day.
- **Fiscal stimulus programs are providing steady investment into the economy.** The Infrastructure Act, the CHIPs Act, and the Inflation Reduction Act (mostly a climate change initiative) are providing direct investment and tax credits to spur private investment. **These are multi-year initiatives that will continue to provide stimulus.**
- **State and local governments are adding to payrolls** as long-deferred projects and initiatives are started, both with funds on hand and with debt financing.

Fed Policy and Impact on Yields

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When Will the Fed Cut?

- The March FOMC meeting featured updated forecasts for the economy and for rates. Somewhat surprisingly, **despite the hotter-than-expected inflation in early 2024, they retained the December forecast of three rate cuts for 2024. We expect that will be dialed back in the June forecast.**

- The trend of improving inflation has taken a hit so far in 2024 with both CPI and PPI coming in hotter-than-expected. While the seasonal adjustment excuse could be used for the January increase, February and March were equally as hot and that will delay rate cuts into the third or fourth quarter of 2024.

- **With three months of hot inflation data this year, and Powell has admitted disappointment in the recent trend. The Fed Funds Futures market now sees the first rate cut in September or November. Quite a change from the 2023 year-end expectations.**

Market's Latest Rate Projections – First Rate Cut Not Priced in Until Sept./Nov.

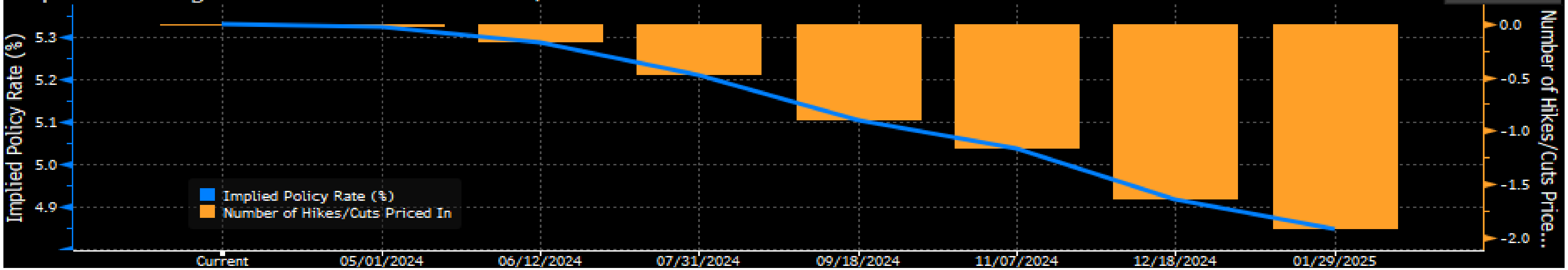
Region: United States »

Instrument: Fed Funds Futures »

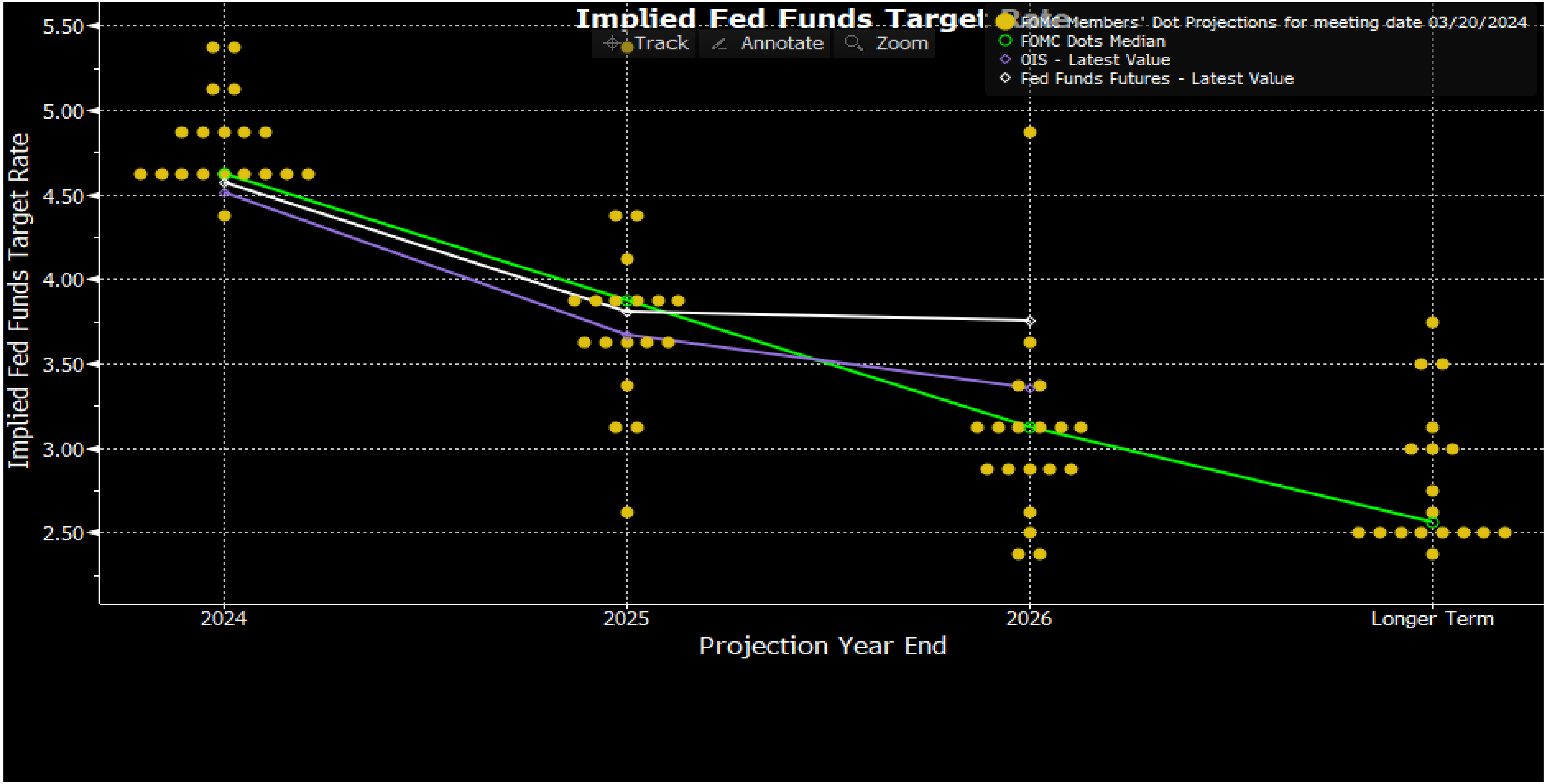
Target Rate	5.50	Pricing Date	04/17/2024
Effective Rate	5.33	Cur. Imp. O/N Rate	5.329

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
05/01/2024	-0.026	-2.6%	-0.006	5.322	0.250
06/12/2024	-0.171	-14.6%	-0.043	5.286	0.250
07/31/2024	-0.475	-30.4%	-0.119	5.210	0.250
09/18/2024	-0.902	-42.8%	-0.226	5.103	0.250
11/07/2024	-1.166	-26.3%	-0.291	5.037	0.250
12/18/2024	-1.645	-47.9%	-0.411	4.917	0.250
01/29/2025	-1.925	-28.0%	-0.481	4.847	0.250

Implied Overnight Rate & Number of Hikes/Cuts



Fed's March Rate Projections: Three Rate Cuts in 2024, 2025, and 2026 – This Will Change in June



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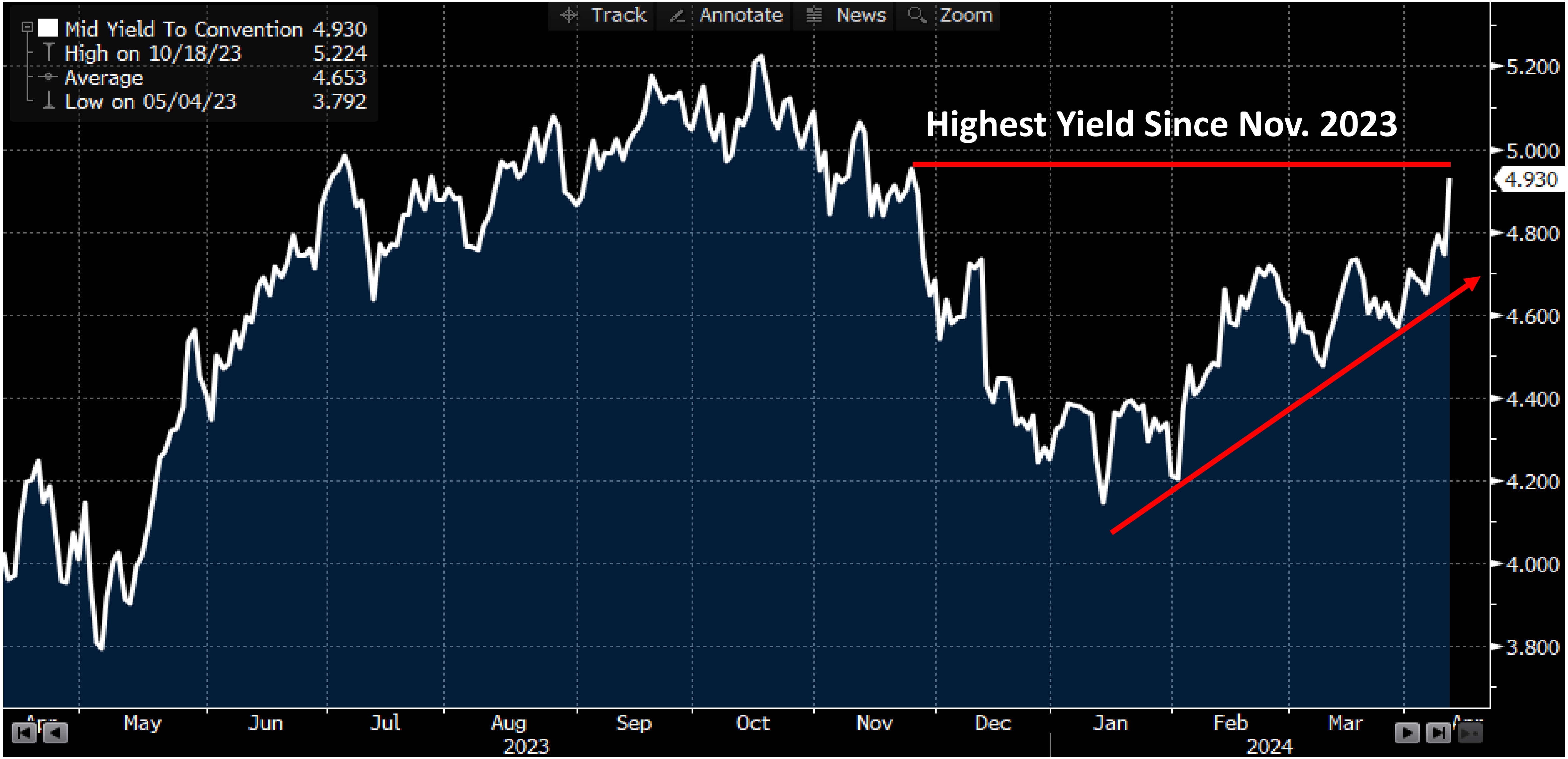
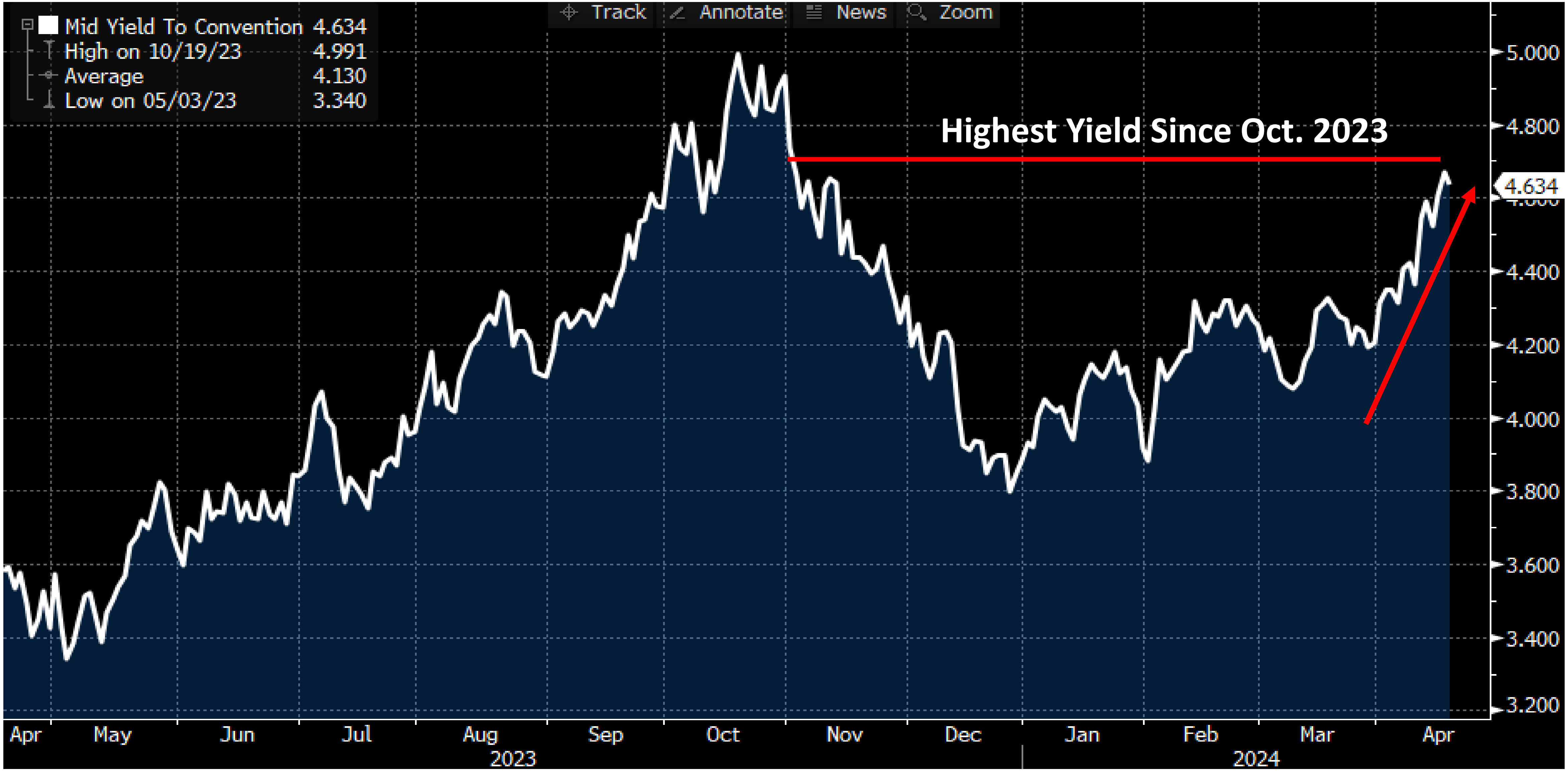
2Yr Treasury Yield Over Last Year – Climbing Once Again as Rate Cut Odds Get Pushed Out



10Yr Treasury Yield – Also Climbing Again on Lower Rate Cut Odds & Inflation Increase



The Anticipated June Rate Cut Train has Left the Station

What Does This Mean for Yields Going Forward?

- Shorter-term Treasury yields moved higher as three months of hot inflation data pushes out rate cut expectations. **Short-term yields will be tied to the prospect for rate cuts, or lack thereof.**

- Longer maturity Treasury yields have risen but remain below October cycle highs (4.99% 10yr Treasury). **We believe yields could still test the October highs but that would require continued strength in inflation and job growth**. Ultimately, we think yields eventually move lower due to:

    - Belief that the Fed persists with higher-for-longer until inflation nears its 2% target.

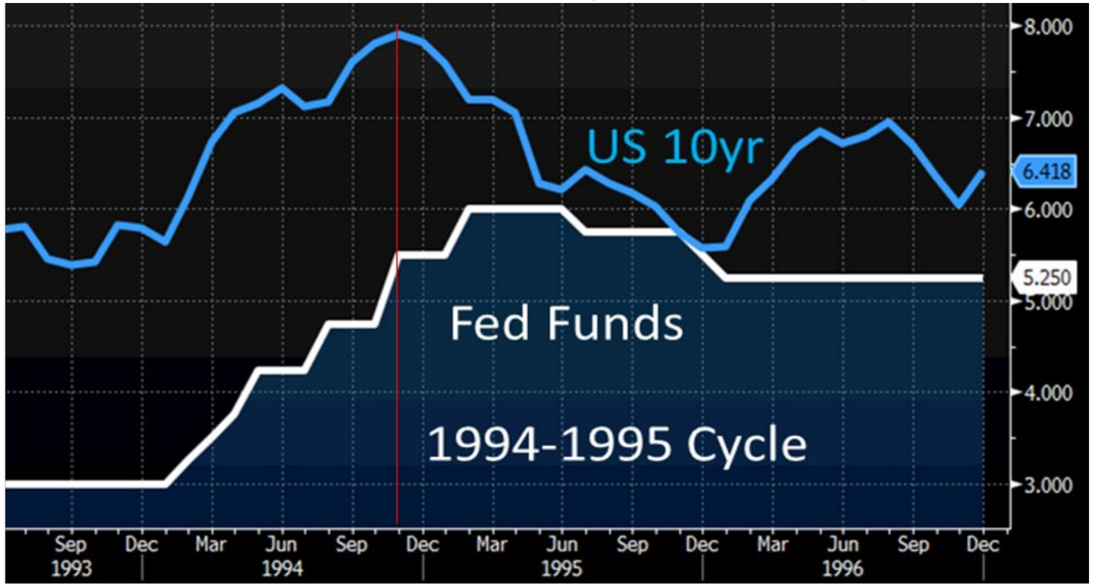
    - The cumulative impact of the rate hikes, and increasing market rates, should eventually ease consumer consumption slowing the economy. That will also ease inflationary pressures.

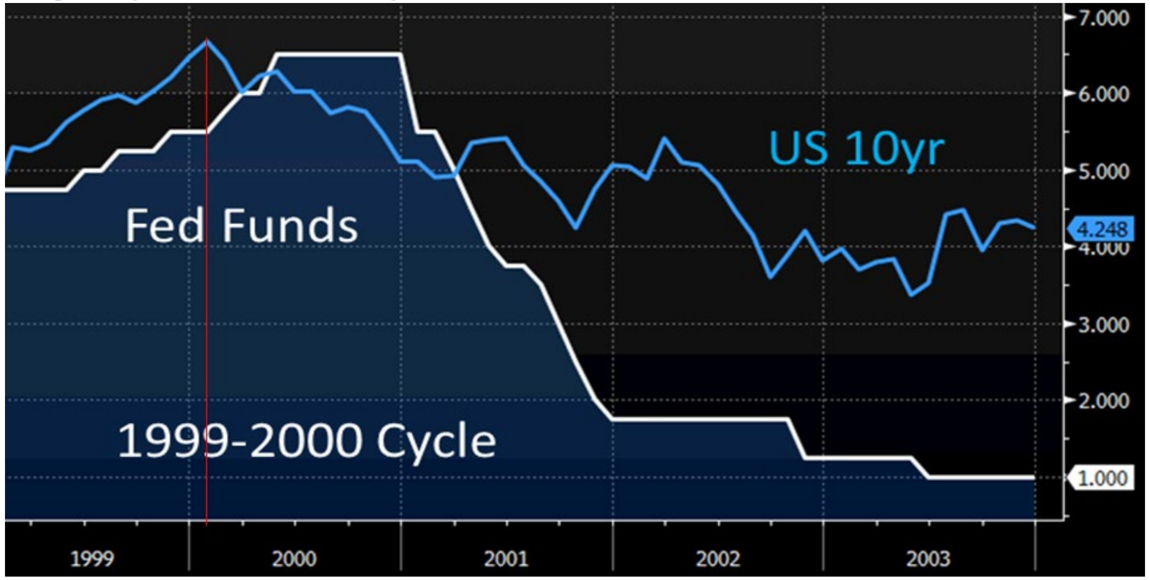
    - **The one fly in the ointment to stable or lower rates, is the increased supply of Treasury debt to finance our $2 trillion dollar budget deficits.**

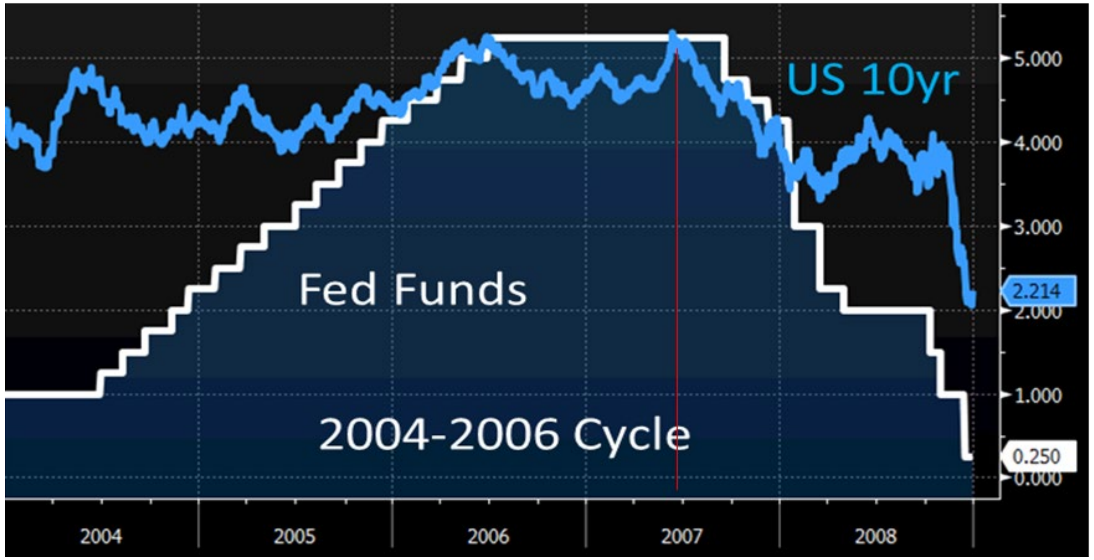
Current DC Action on Deficits

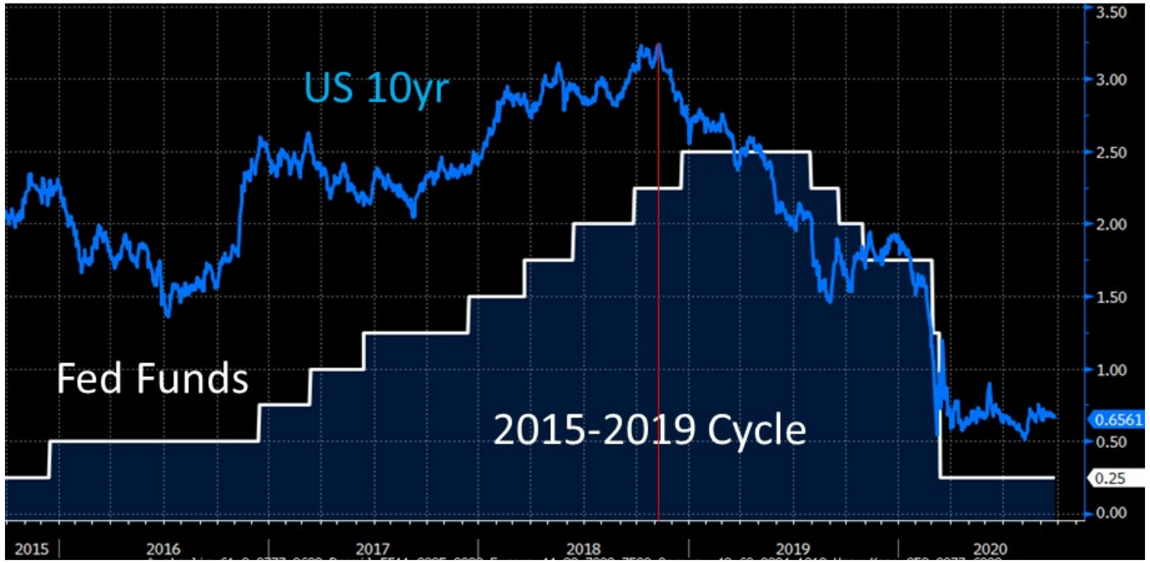
"What if we don't change at all ...
and something magical just happens?"

Fed Funds vs. 10yr Treasury in Prior Hiking Cycles – 10yr Leads Fed Funds Lower









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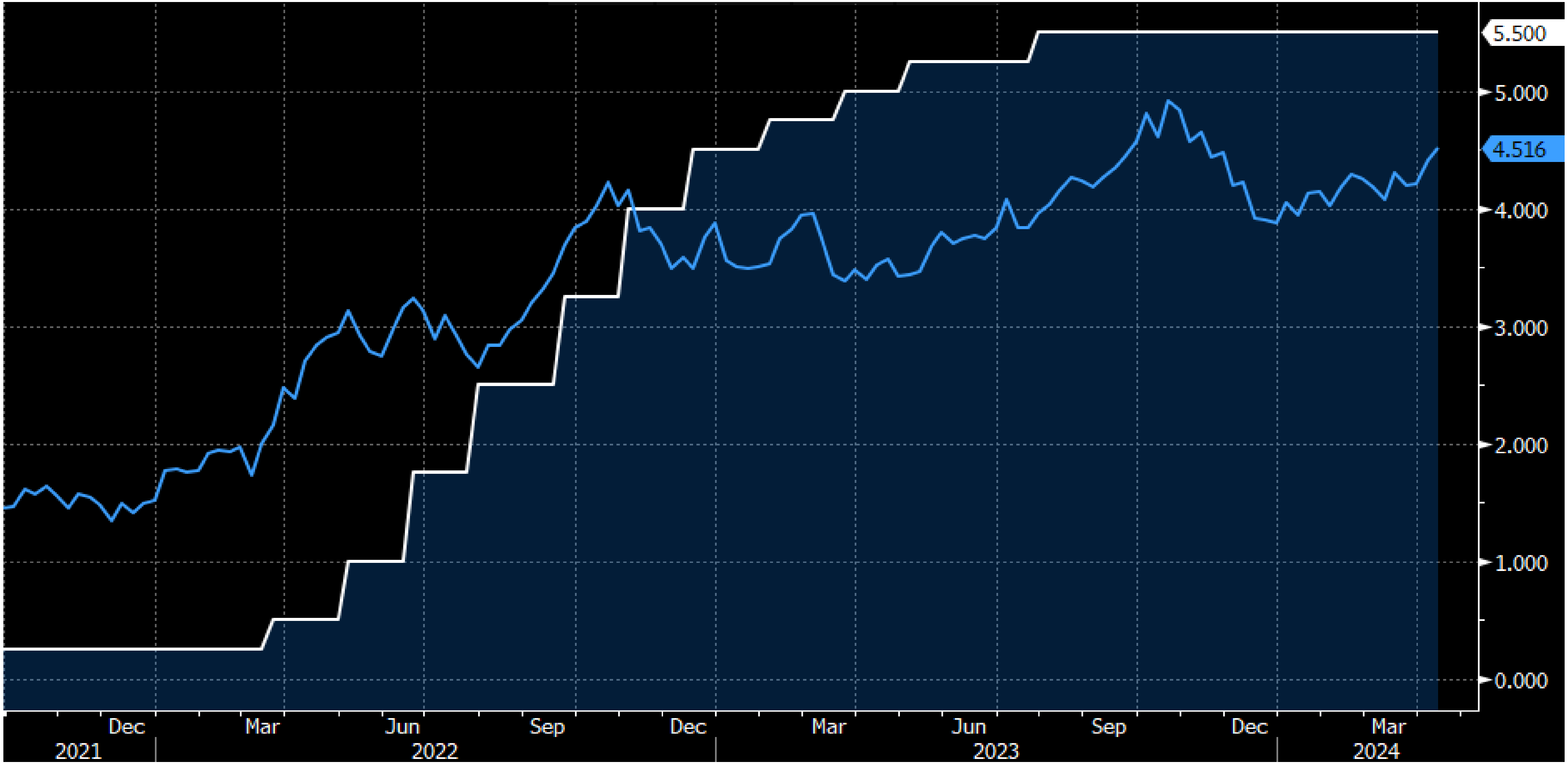
Fed Funds vs. 10yr Treasury Yield in Current Hiking Cycle – 10yr Yet to Head Lower



Inflation Trends

Tailwinds Turning to Headwinds?

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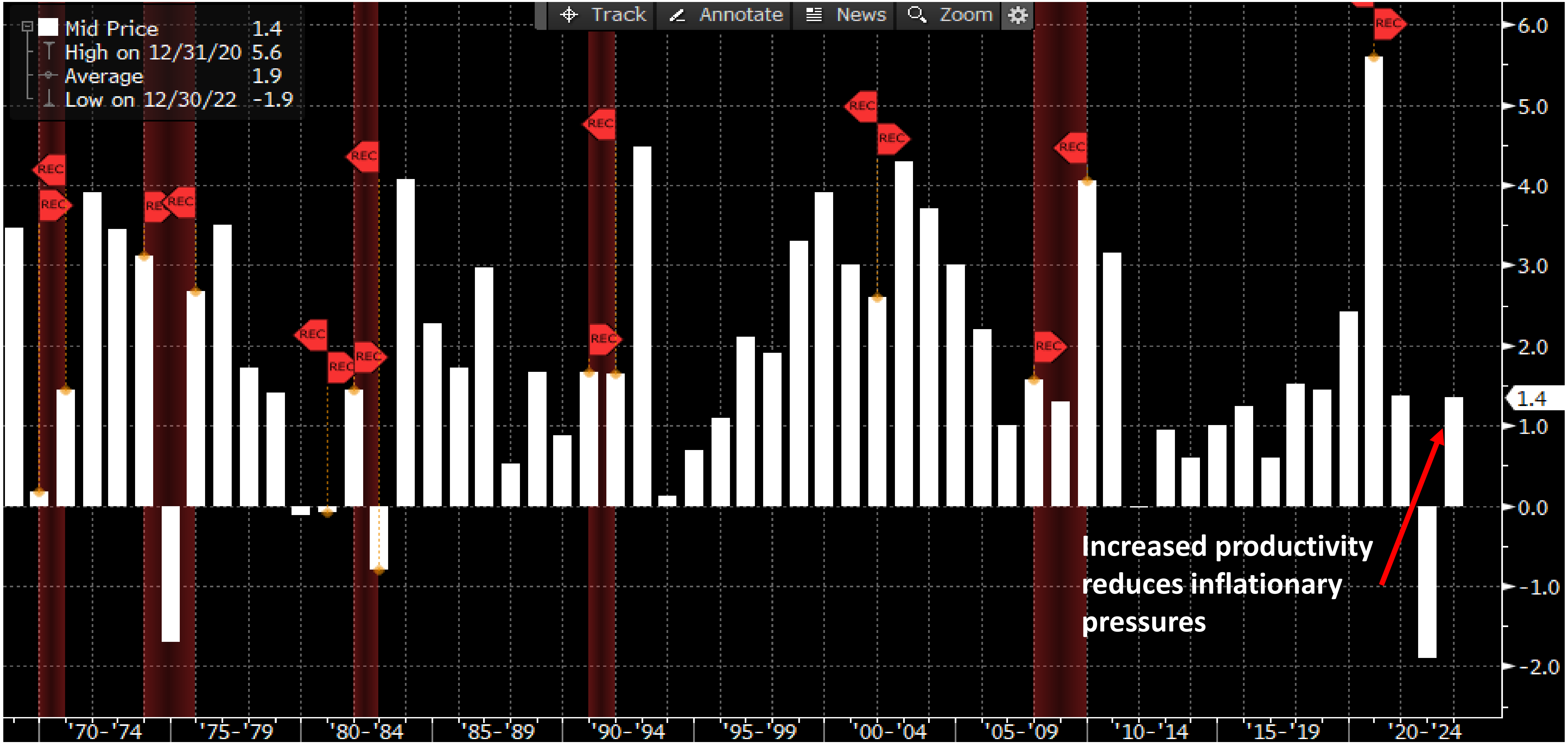
Positive Inflation Measures – Annual Productivity Back in Positive Territory after Rough 2022



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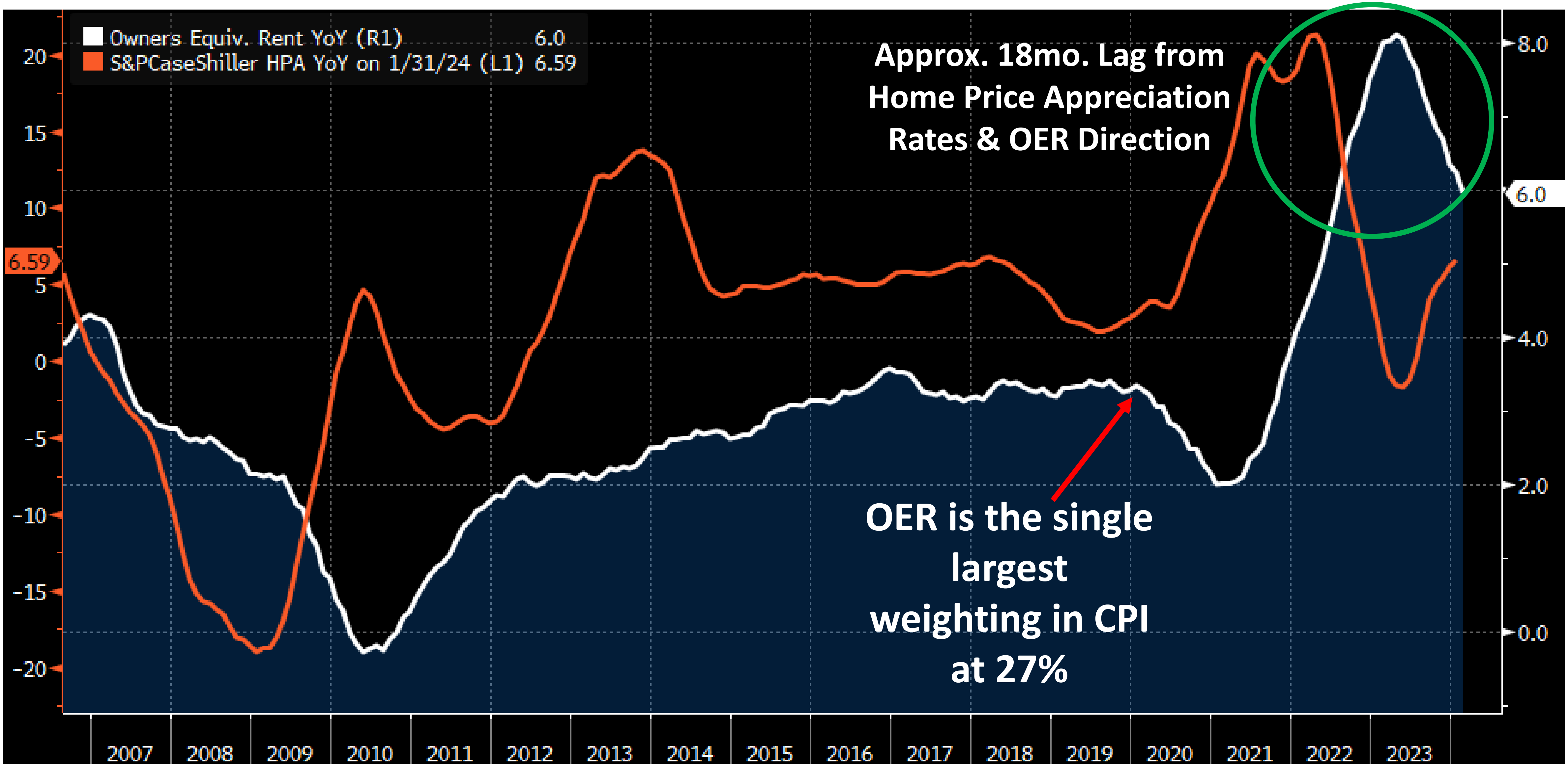
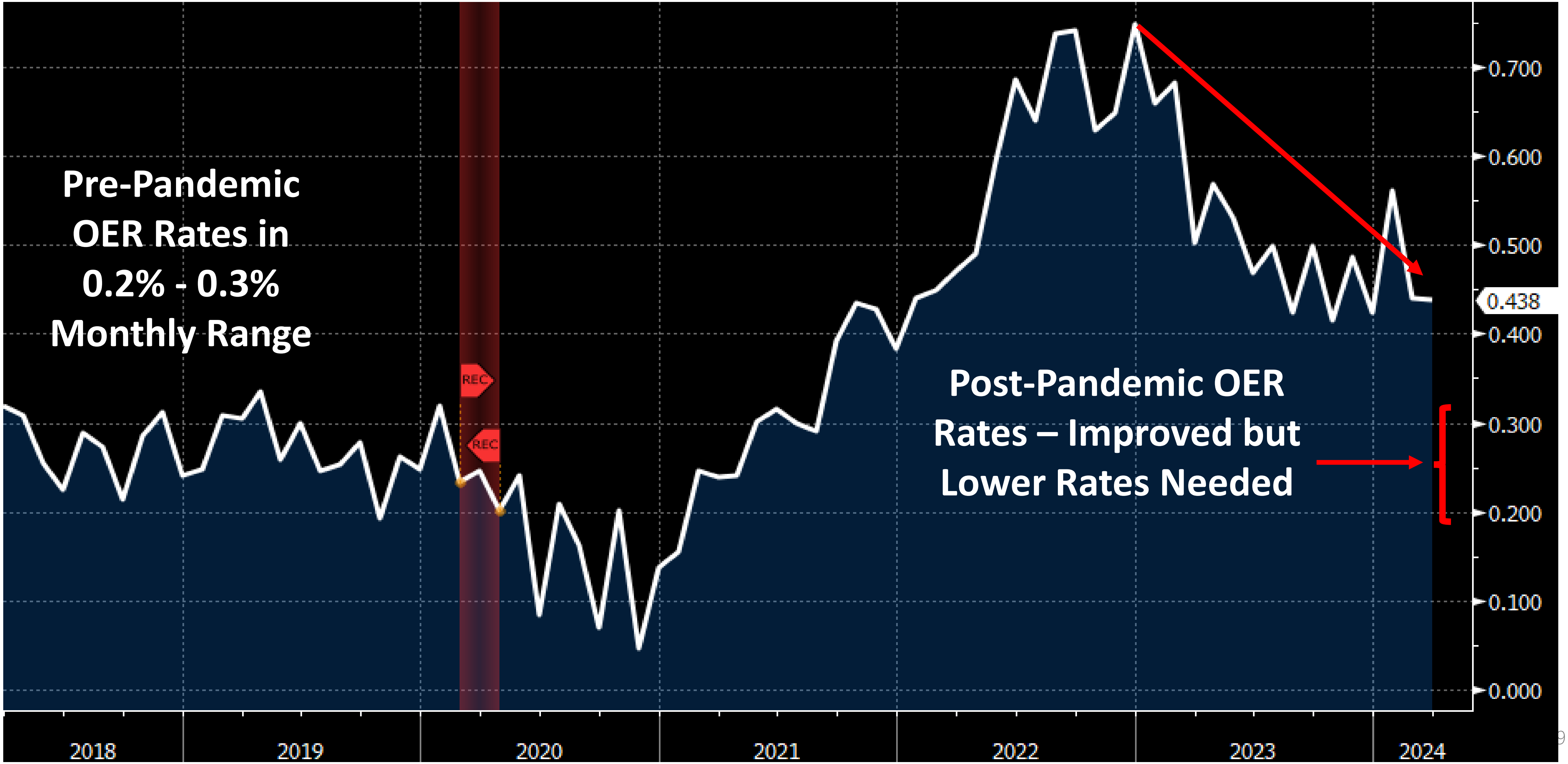
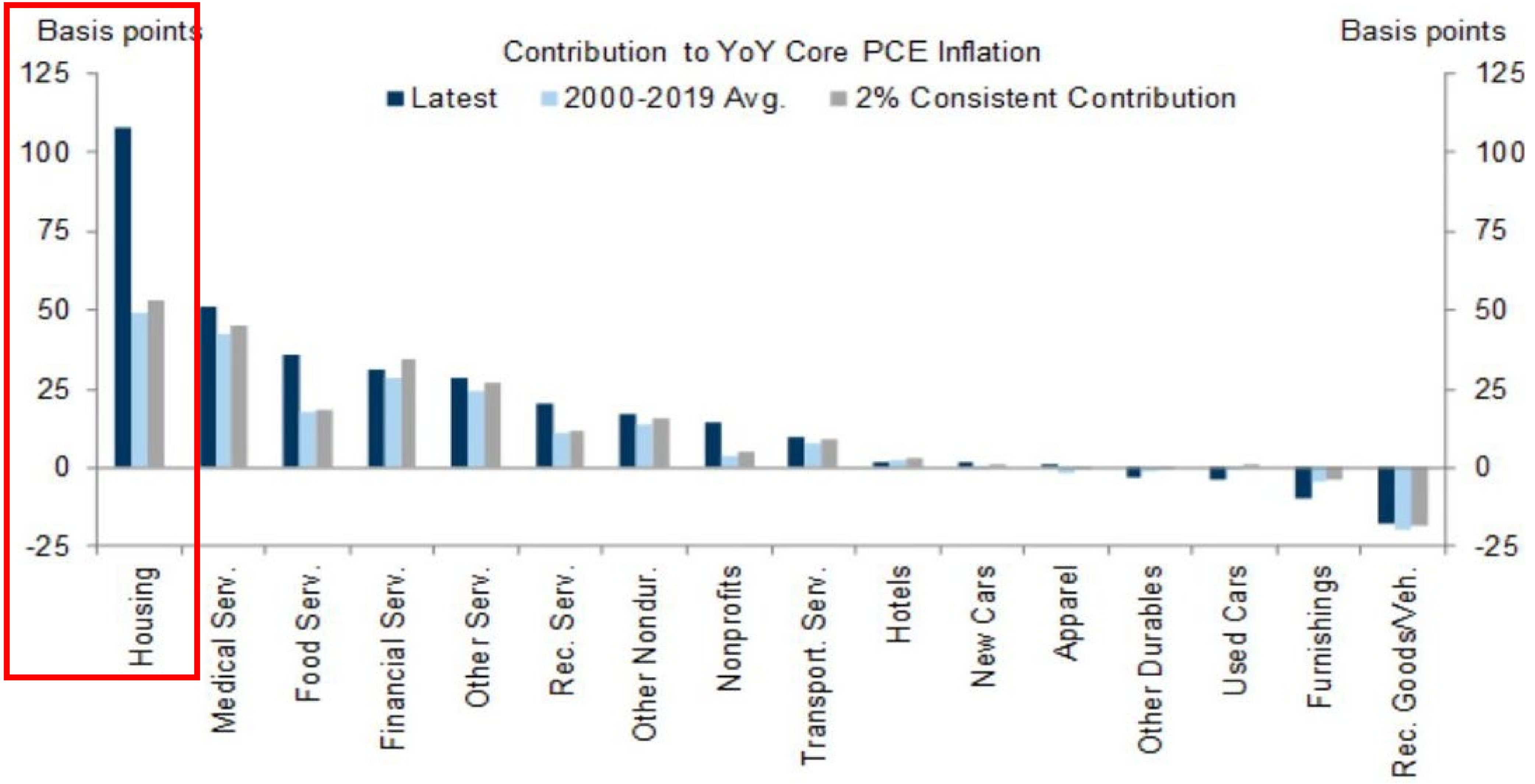
Positive Inflation Measures - Biggest Component of CPI – Owners Equivalent Rent – Is Finally Declining But More is Needed



Positive Inflation Measures – Monthly Change in OER: Improving But More Needed to Return to Pre-Pandemic Rates

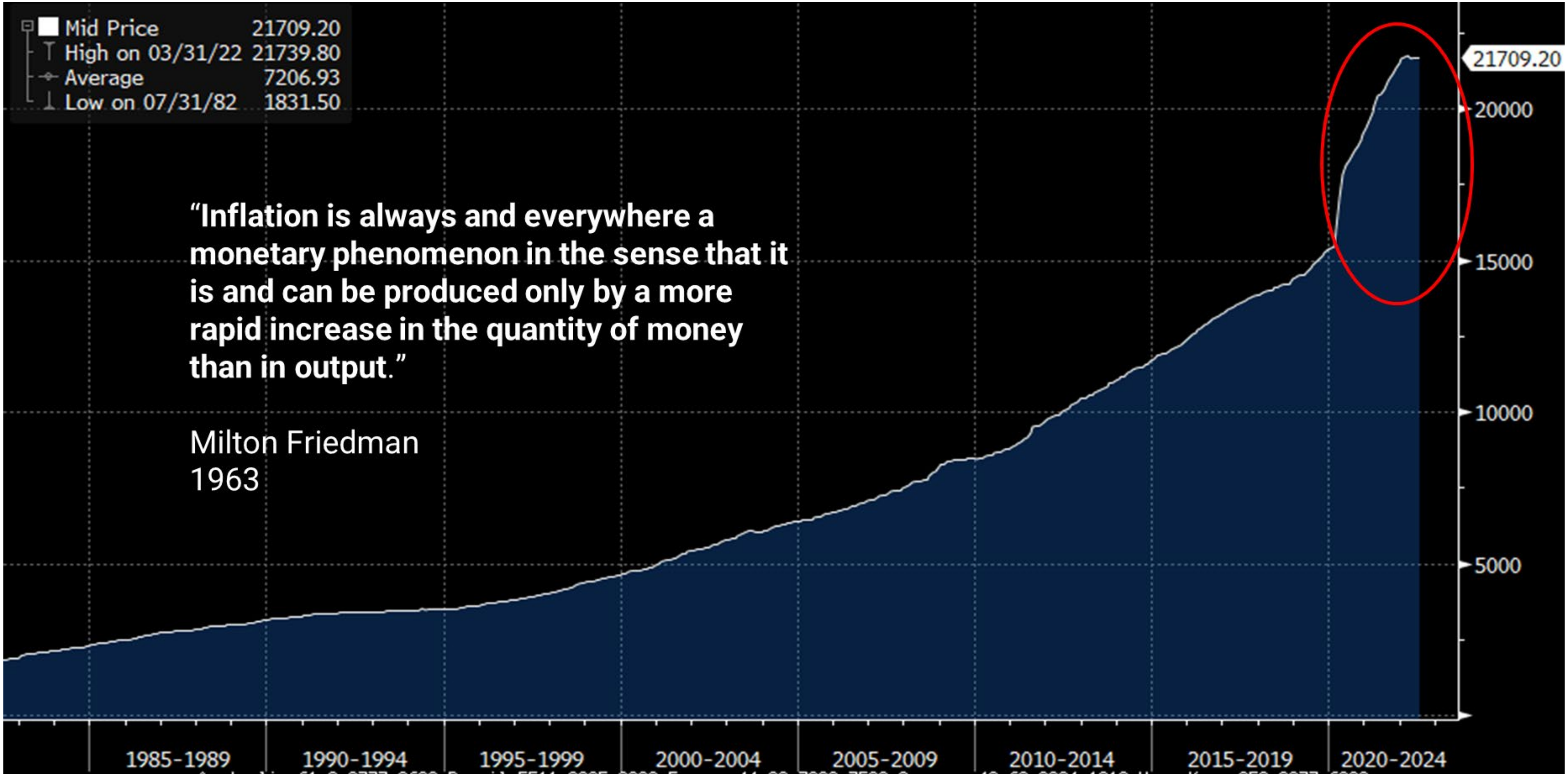


Housing Expense Easily Largest Contributor to Inflation



Housing Expense Easily Largest Contributor to Inflation

Fiscal Stimulus Easy to See in Money Supply Spike



Positive Inflation Measures – Money Supply Declining Since June 2022: Has Helped Lower Inflation

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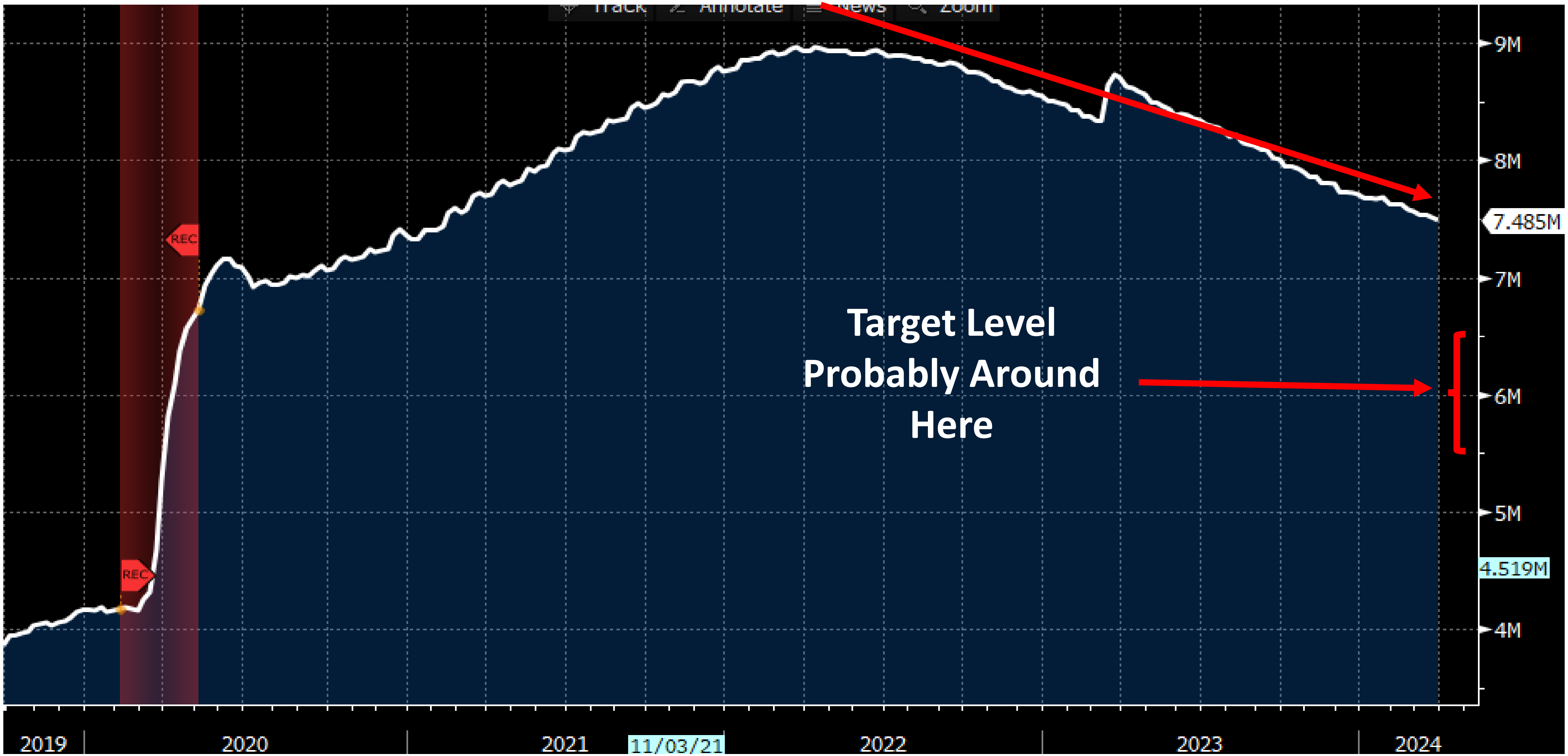
Positive Inflation Measures - Fed's Balance Sheet Shrinking Under QT as Funds Removed from Bank System



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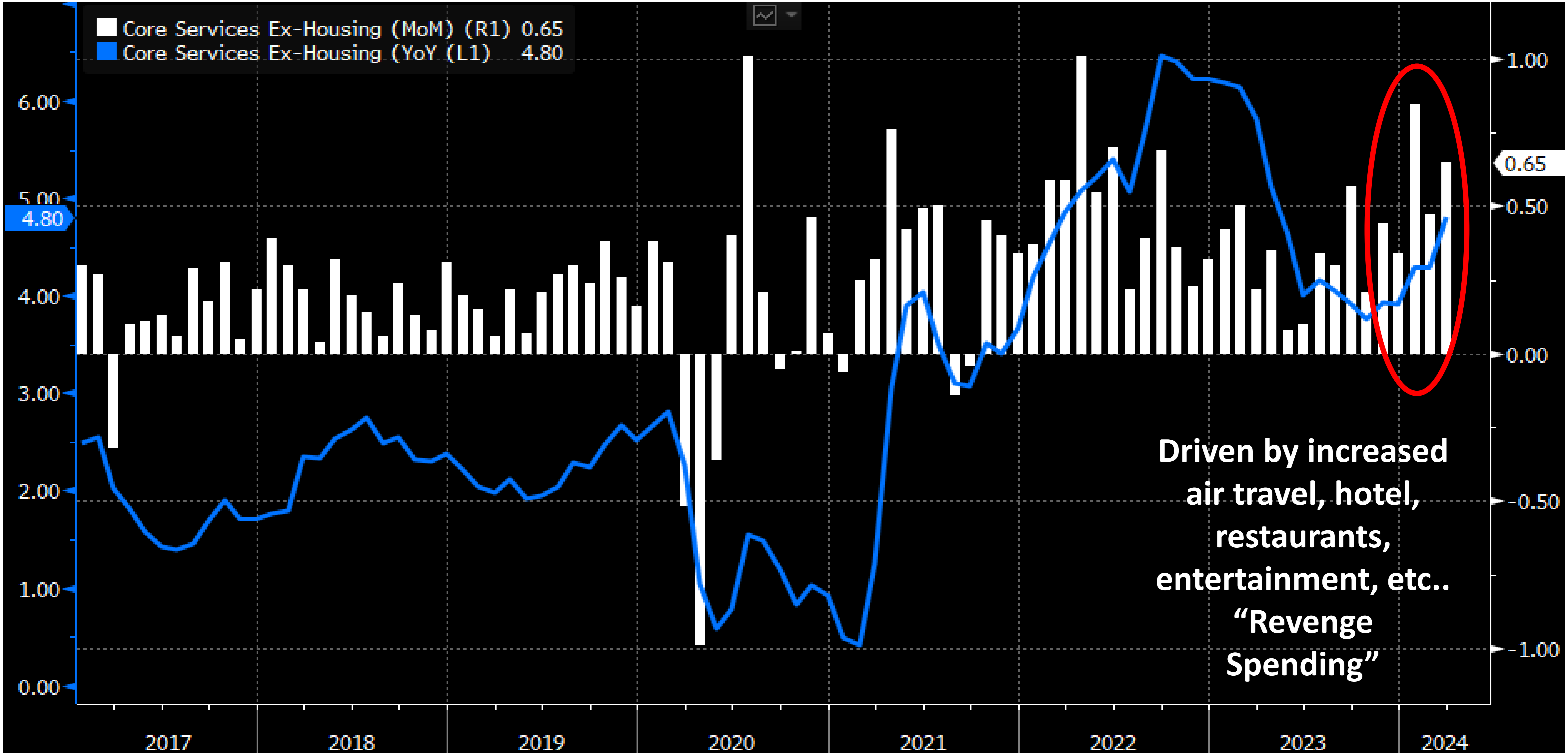
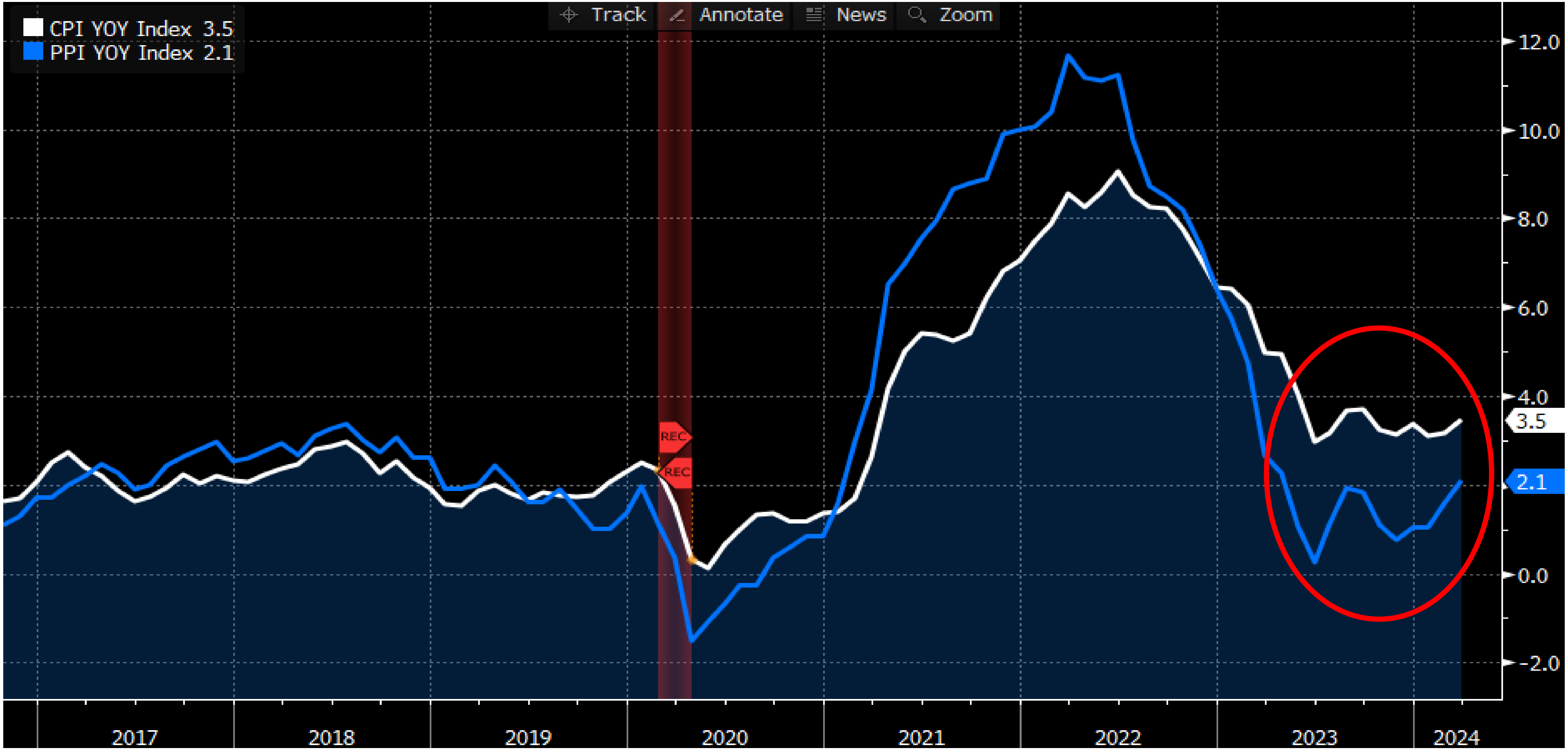
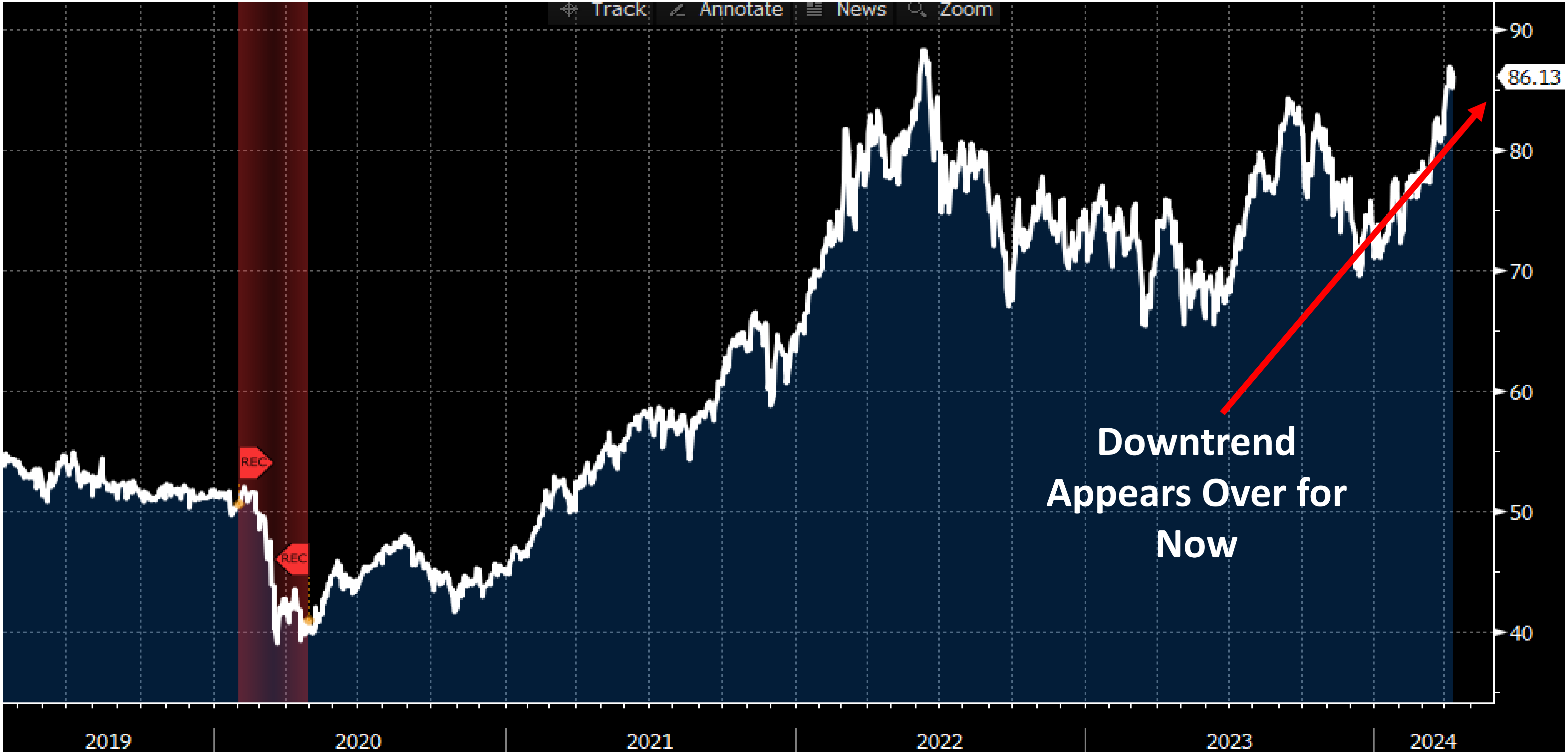
Negative Inflation Measures - Core Services Inflation Less Housing – Hotter in 2024



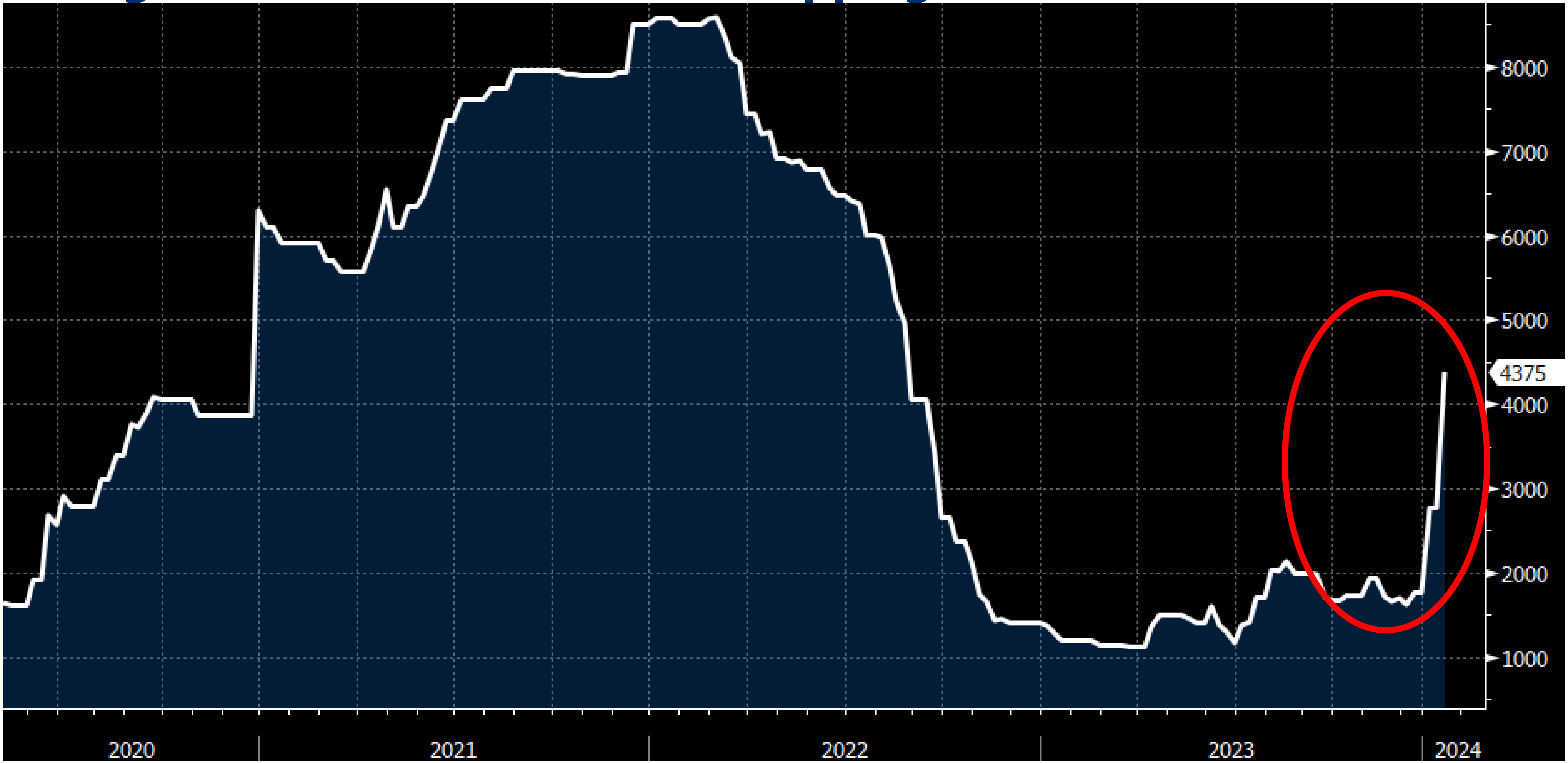
Negative Inflation Measures - PPI Deflation Story Seems to be Ending, Could Limit CPI Improvement



Negative Inflation Measures – Oil Prices are Reversing Higher, Will Complicate Lower Inflation



Negative Inflation Measures – Shipping Container Rates on the Rise



Negative Inflation Measures – Bloomberg Commodity Index Finally Trending Higher

Inflation Conclusion

Positive Inflation Factors:

- **OER is finally rolling over and that bodes well for continued improvement in inflation** given its heavy weight in the CPI/PCE index.
- **Money supply, while still too high from covid-era stimulus, is trending lower** via QT which should contribute to improving inflation.
- **Productivity turned positive in 2023** and that should ease inflation pressures.

Negative Inflation Factors:

- **Wholesale (PPI) deflation appears over** and commodity inflation, spurred by oil, is starting to lift again.
- **Service inflation has been the "sticky" piece as demand shifted from goods to services.** The most recent data continues to point to pricing pressure in this segment. This needs to cool for continued inflation improvement.
- **Geopolitical risk is increasing** with Israel/Hamas/Iran conflict joining with Ukraine/Russia War.

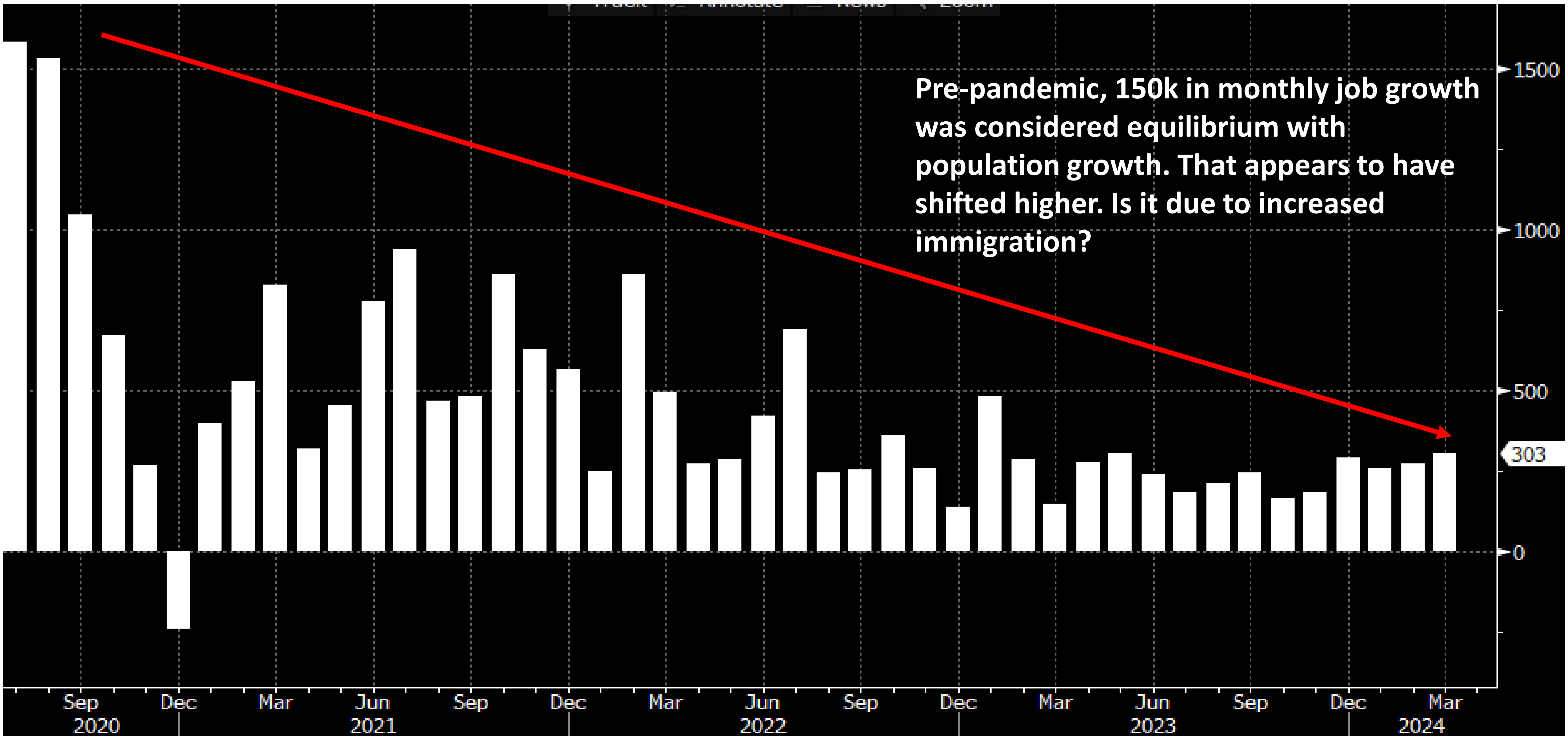
In conclusion, trend towards lower inflation was impressive last year, but getting from 3% to 2% will be tough given higher costs in the post-pandemic world, resurgence in commodity prices, increasing geopolitical risks, and service-side "stickiness".

Inflation Conclusion – Progress in 2023, Not So Much in 2024 – Don't Fight the Fed

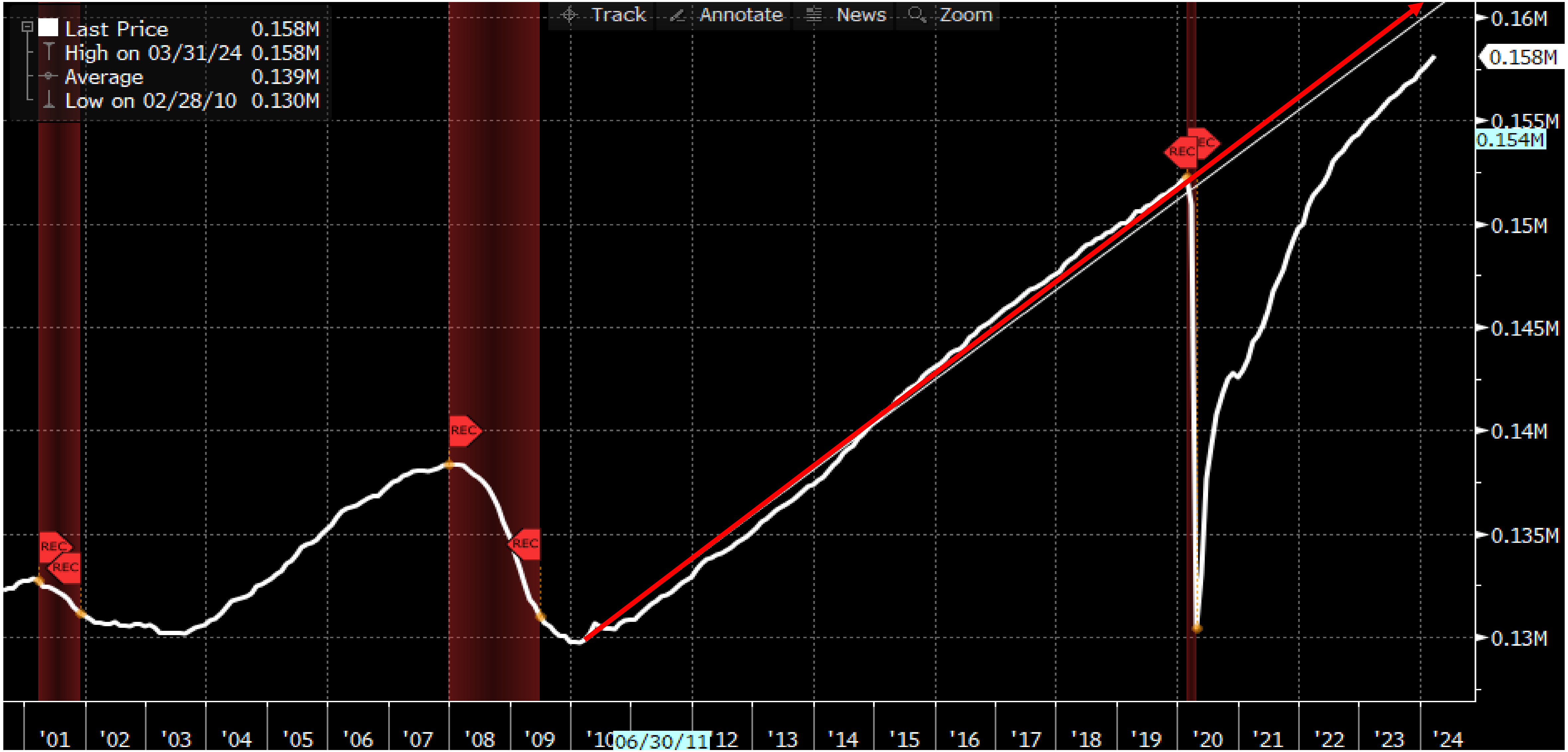
Economic Outlook

No Cracks Appearing Yet From Higher Rates

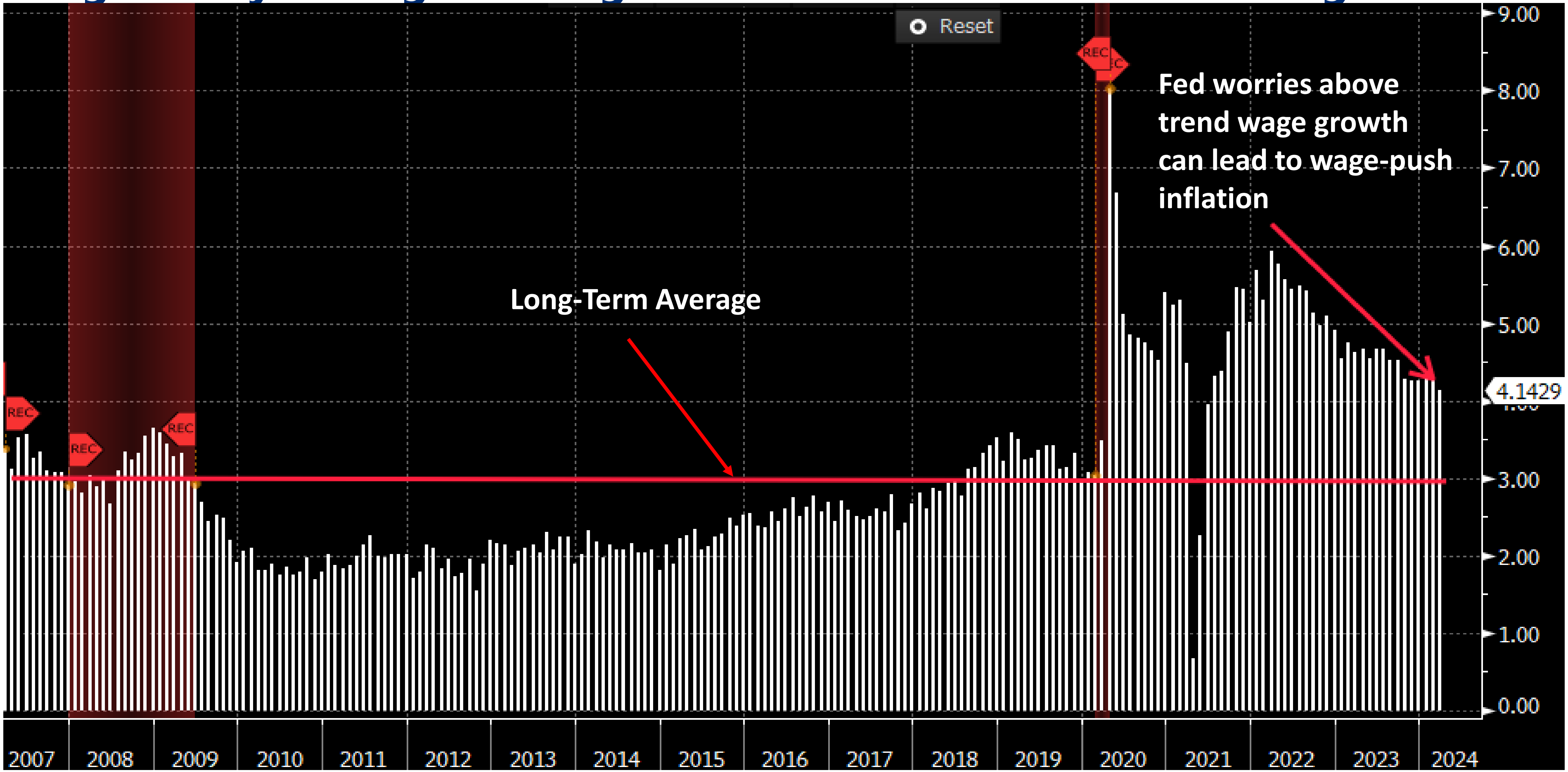
Monthly Job Growth is Slowing but Still Healthy by Historical Standards



Total Employed: Covid Job Losses Recovered and Approaching Pre-pandemic Trend

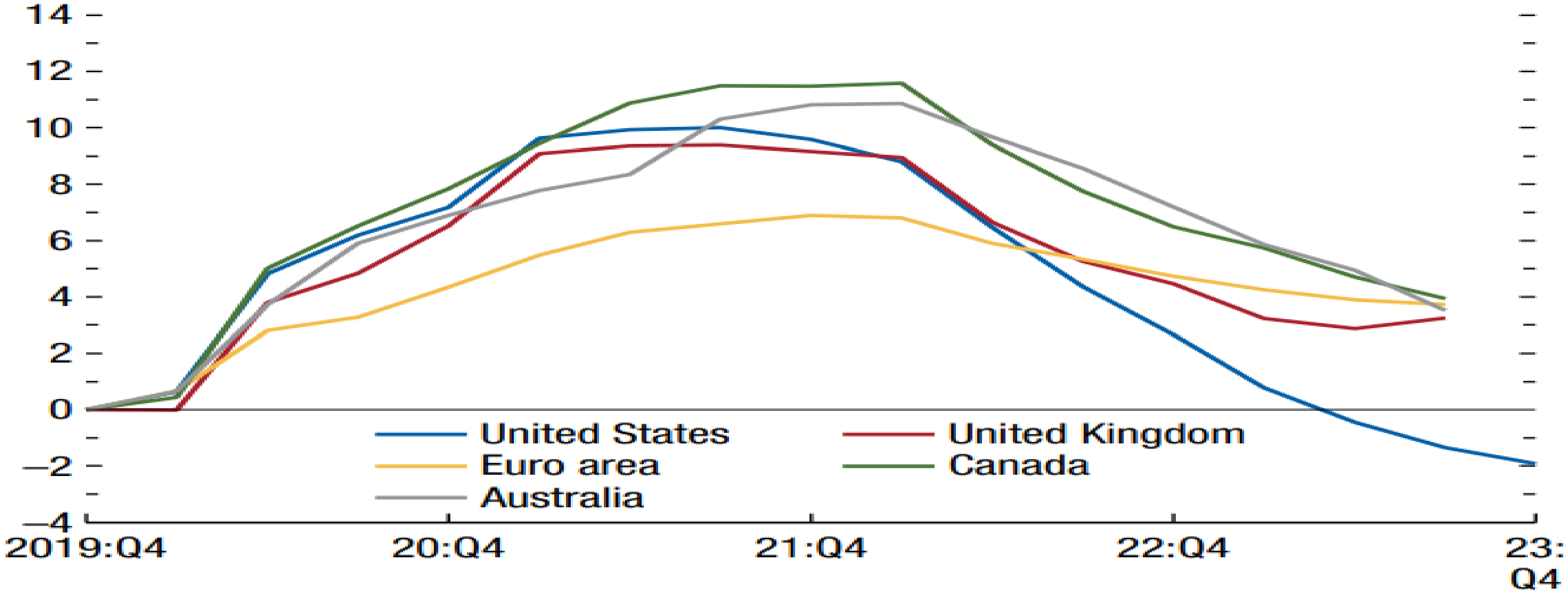


Average Hourly Earnings Trending Lower– Fed Wants this Closer to Long-Term Average



Savings From Pandemic are Declining vs. Other Developed Countries
Americans Love to Consume

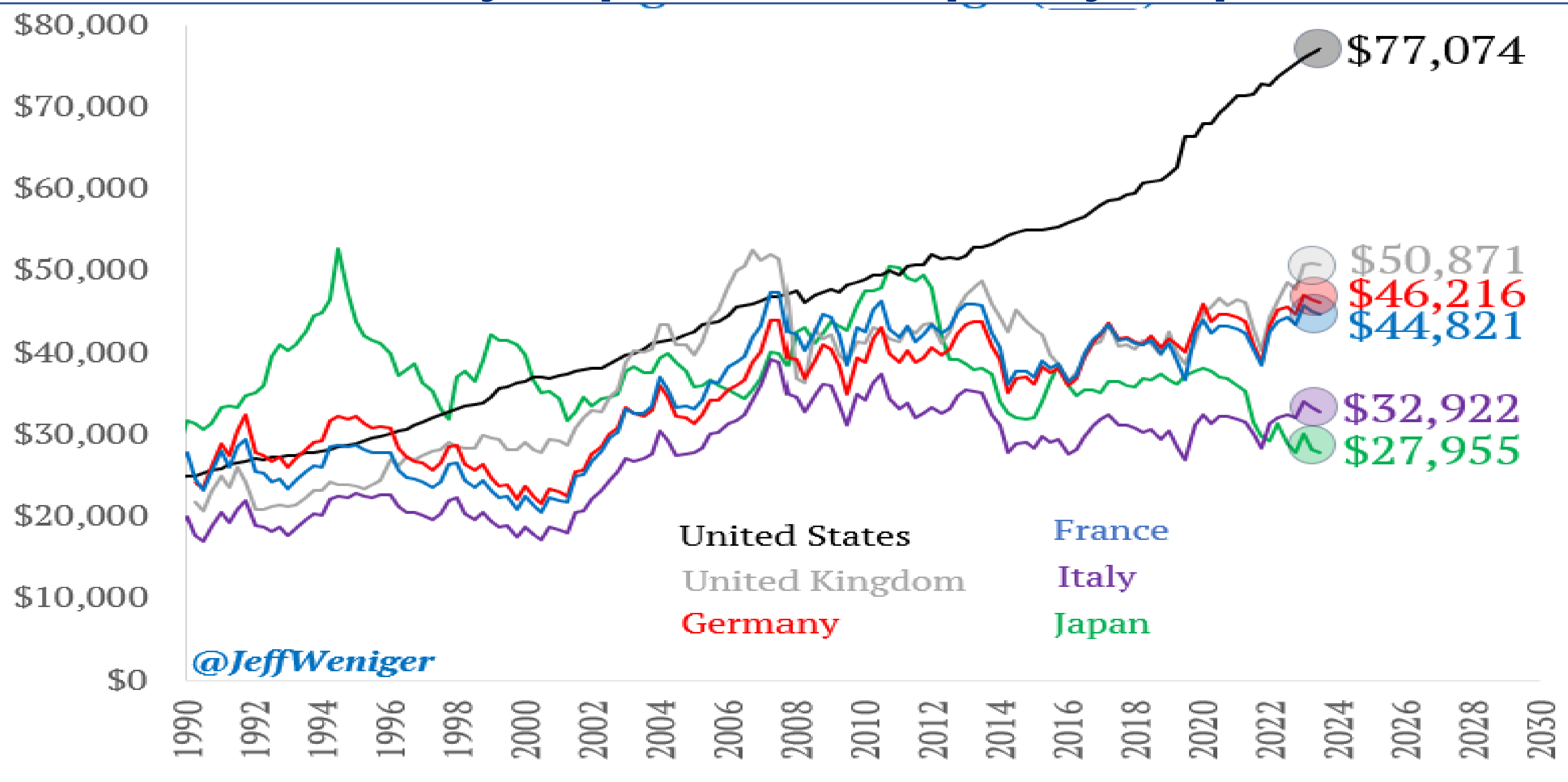
Figure 1.10. Savings from the Pandemic: Declining
(Percent of GDP)



Sources: de Soyres, Moore, and Ortiz 2023; and IMF staff calculations.
Note: Excess savings are calculated as the deviation from the predicted saving rate using a Hamilton trend. Accumulation starts in the first quarter of 2020. Euro area comprises France, Germany, Italy, and Spain.

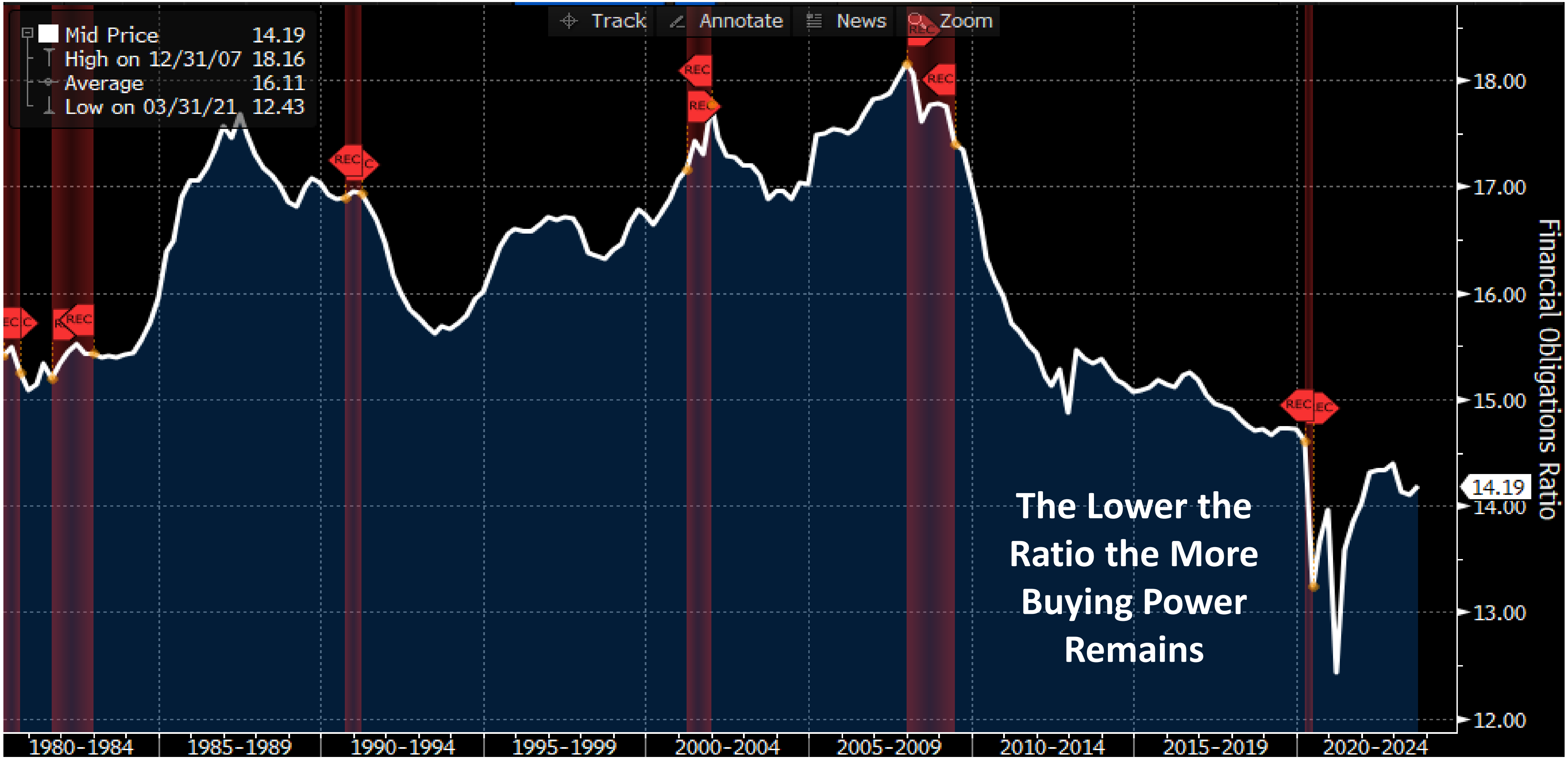
So, Is the Consumer the Proverbial Frog in a Pot of Soon-to-be Boiling Water?

Americans Earn More on Average Than Workers in Other Developed Countries Obviously Helps with the Propensity to Spend

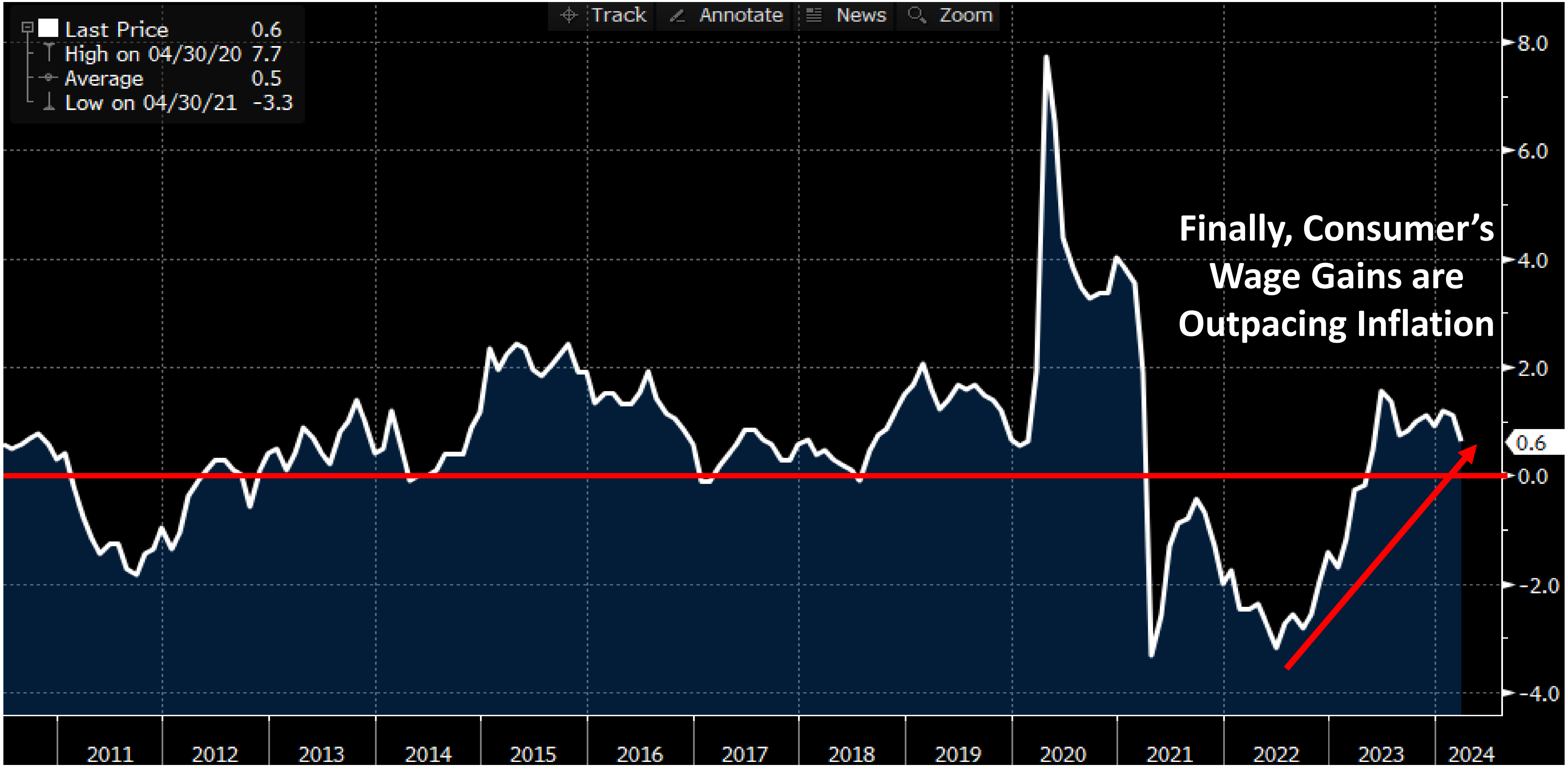


Source: Refinitiv, OECD, as of Q2/2024, with currency conversion as of 4/15/2024 exchange rate. File #0688

NY Fed Financial Obligations Ratio: Plenty of Buying Power Seems to Remain

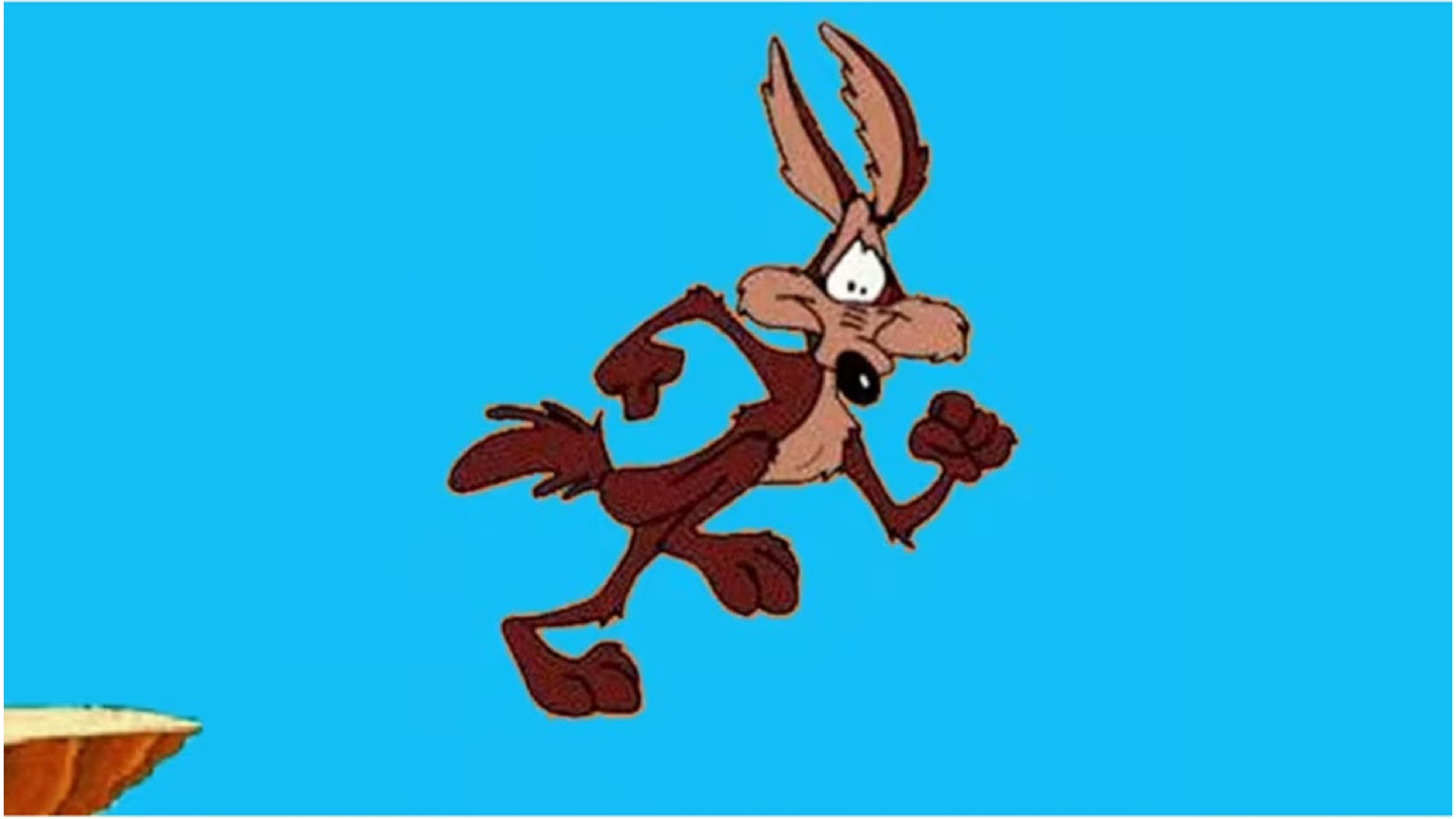


Real Average Hourly Earnings Trending Higher As Inflation Rates Fell in 2023

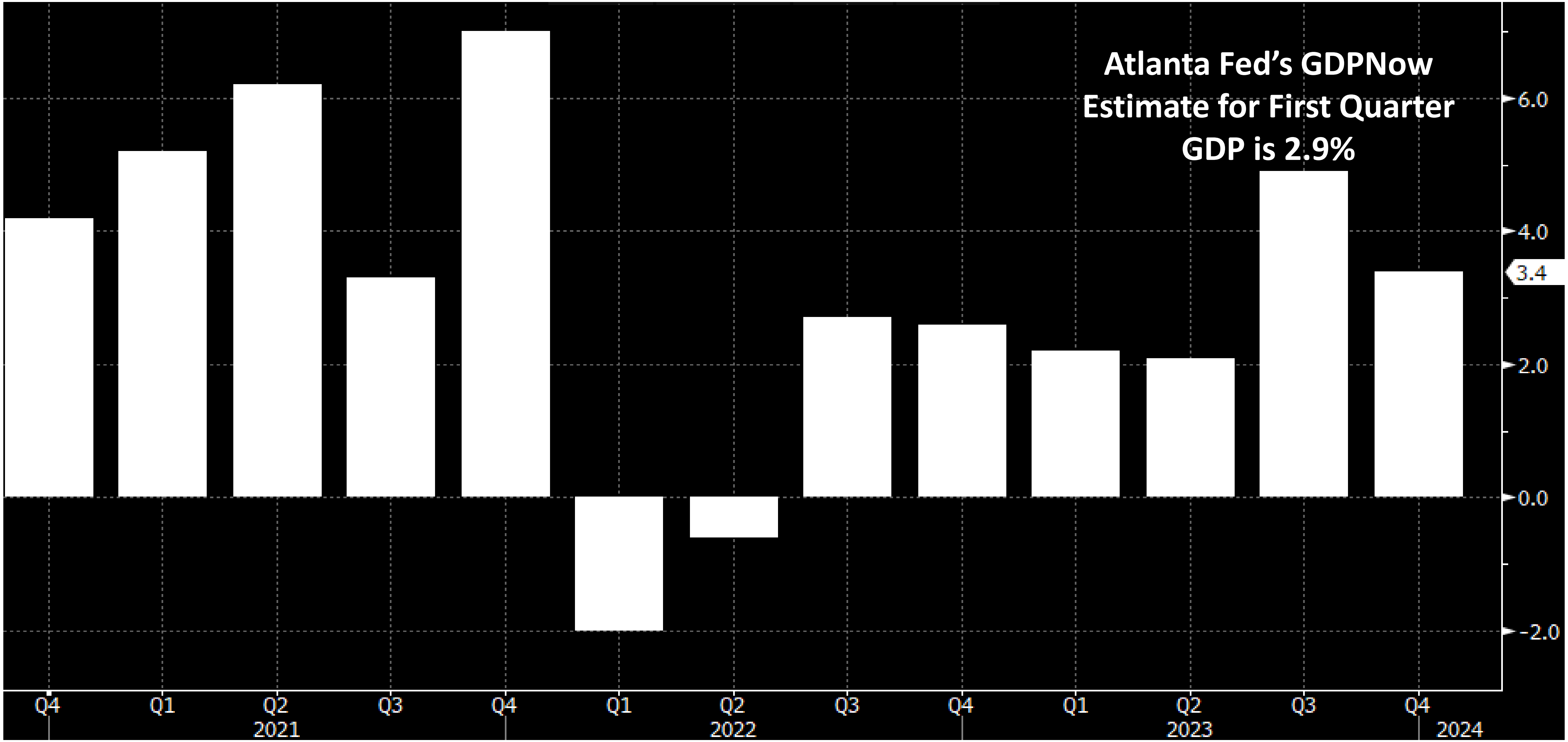


TSA Flight Boarding Totals: Consistently Ahead of 2019 Pre-Pandemic Levels
We're Still Traveling and Spending With Gusto – "Revenge Spending"

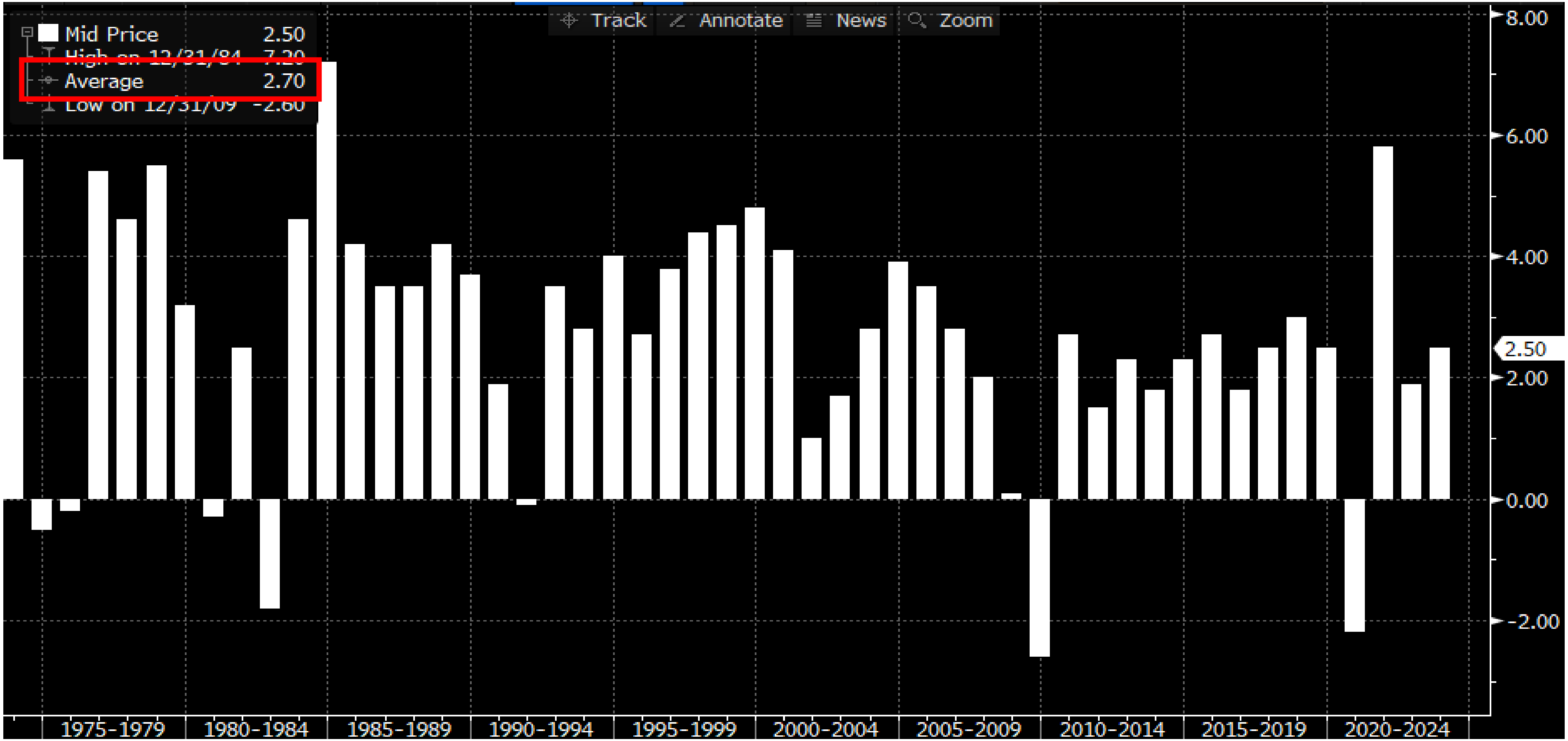
We Thought the Consumer Would Plummet After Stimulus Checks Were Spent – That Didn't Happen



Quarterly GDP (Annualized) Since Covid Lockdowns – No Signs of Recession Here



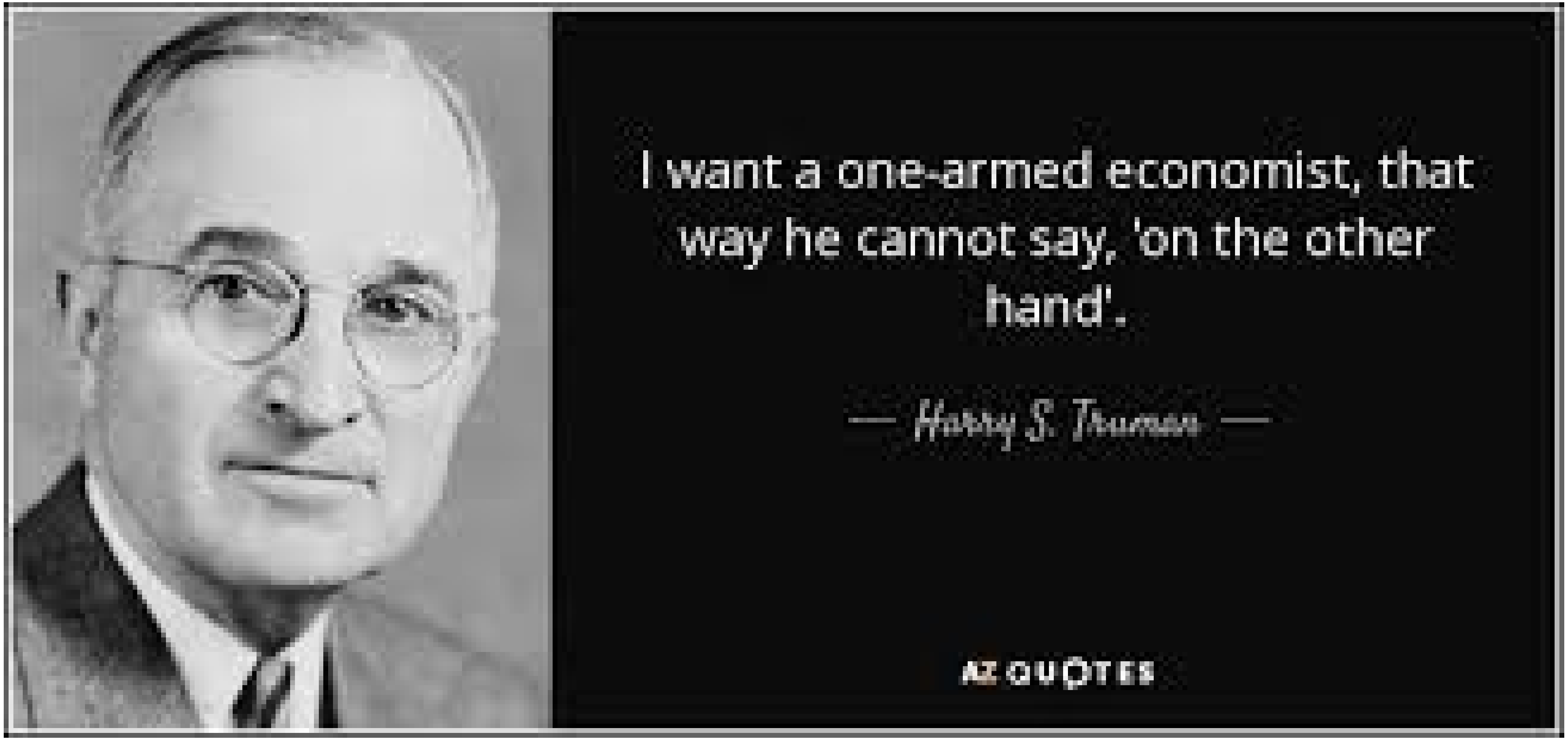
Annual GDP – Running Near 2.70% Long-Term Average



Conclusion

- The Fed avoids a recession with growth slowing modestly but remaining solid into next year.
- Despite restrictive monetary policy, fiscal policy is stimulative with three big programs: CHIPs Act, IRA, and Infrastructure Act all adding billions to the economy over the next several years. That will support economic growth for years to come.
- State & local governments are back in the spending game after years of austerity budgets following the scars from the Great Financial Crisis. As a consequence, government job growth has been strong.
- The last mile on inflation, from 3% to 2%, will be very challenging, if not impossible, given the post-pandemic higher-cost environment.
- Given that, and the stalled inflation improvement (tailwinds turning into headwinds) in 2024, we think a rate cut is a fourth quarter event with one 25bps cut for 2024.
- **On the other hand**, we wouldn't be surprised to see cuts forestalled for 2024 if inflation and/or job gains remain strong.
- **Short-term yields will trade with Fed rate expectations, while long-term yields should range trade at current levels with a bias lower as growth eventually slows.**

Final Thought



Questions?

Thank You

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