Stephens

VIEWPOINT

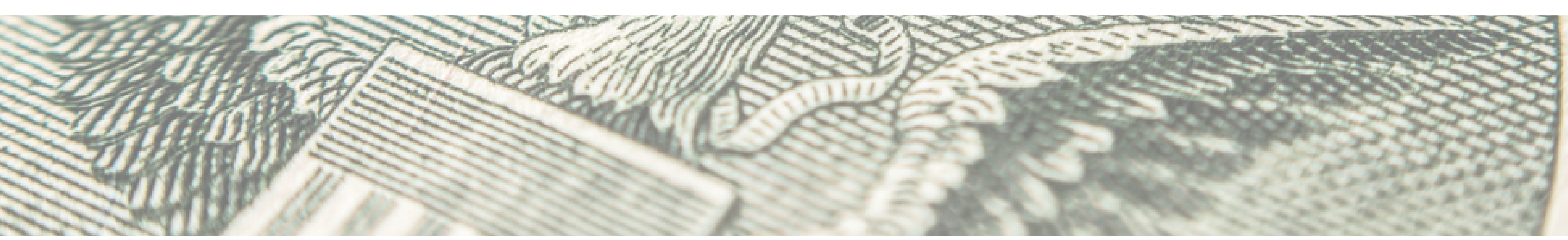
An Economic and Financial Commentary

By Thomas Goho, Ph.D.
January 2024

The start of 2024 finds economists and forecasters highly divided on the future course of the economy. Right now, the economy looks remarkably like it did in mid-2023. The economy has in many ways adjusted to the new interest rate environment created by Federal Reserve policy without insuperable damage. And still expectations about that course remain the same four scenarios that were discussed in our last newsletter. They are as follows:

- A soft landing in which growth will be weak but still positive over the next several quarters.
- A hard landing meaning negative growth for at least two consecutive quarters and the National Bureau for Economic Research (NBER) likely declaring an official recession.
- A no landing scenario in which the U.S. economy generates real GDP growth of the normal long-run growth rate of about 2%.
- A stagflation scenario with inflation well above the Federal Reserve target of 2% accompanied by very low growth: probably between -1% and +1.0% in the coming year and beyond.

There is a modicum of legitimacy in each of these viewpoints, and our goal is to clarify the current economic conditions and to place our "bets" on the economy for the next 6 to 12 months.



Economic Growth

American economic performance in 2023 aligned with its longer-term growth. Both the potential growth in real GDP and actual growth was about 2%. In the second and third quarter 2023, the economy grew at 2.1% and 5.2% respectively, very credible growth but less than 2021 in the aftermath of the Covid crisis of 2020.

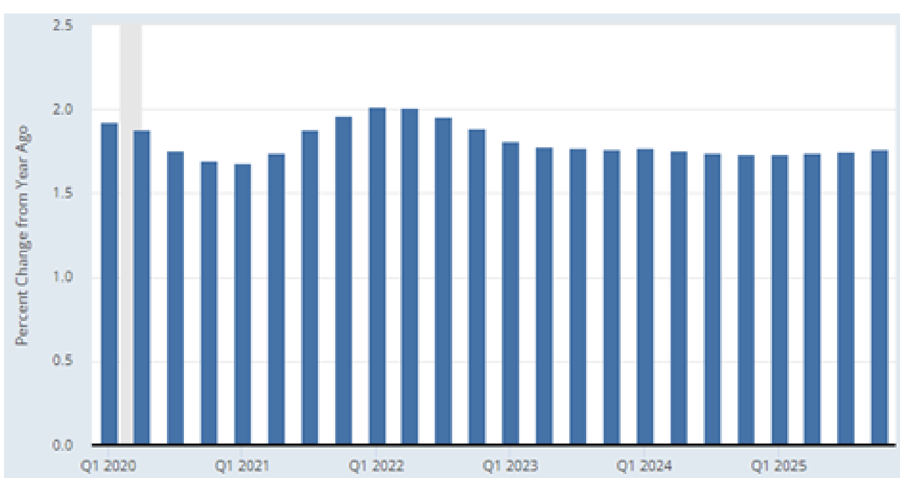
Figure 1: Real Gross Domestic Product (Real GDP), 2020 to Present.

A shaded area indicates a recession.

Source: Federal Reserve bank of St. Louis. Federal Reserve Economic Data (FRED). Extracted from database December 3, 2023.

The U.S. Congressional Budget Office (CBO) estimated that the American economy has the potential to grow slightly less than 2% per year, based on domestic productivity gains and increases in the size of the total U.S. labor force. (See Figure 2.)

Figure 2: Growth in Potential Real Gross Domestic Product (Real GDP), 2020 to 2025(estimated).

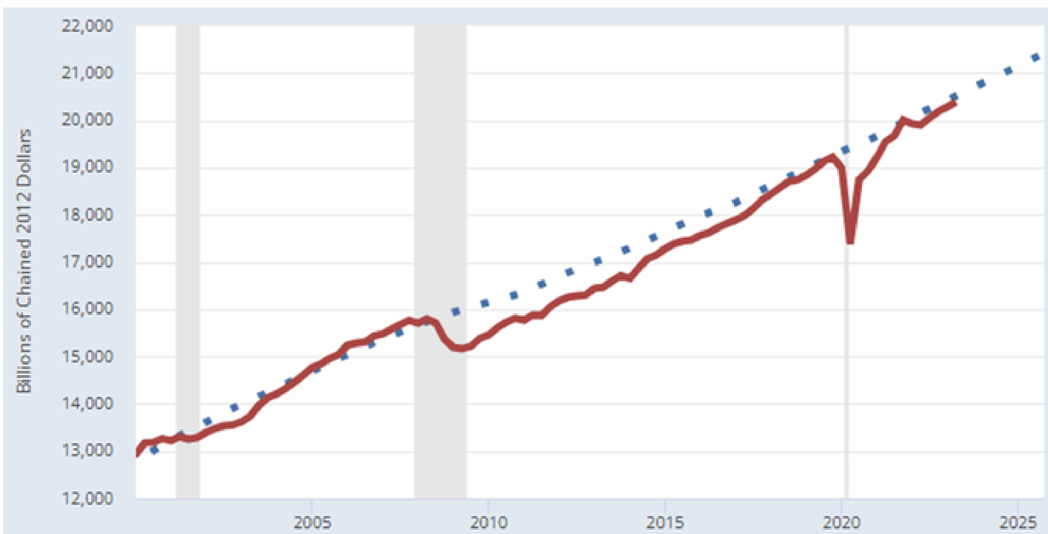


A shaded area indicates a recession.

Source: Federal Reserve bank of St. Louis. Federal Reserve Economic Data (FRED). Extracted from database December 3, 2023. (From U.S. Congressional Budget Office data).

If the CBO's analysis is correct, which we think it is, then the U.S. economy is operating at or near its potential. As of the end of the 2nd quarter 2023, the actual GDP was close to its potential of over $20 trillion. (See Figure 3.) As the economy approaches its potential growth limits, inflationary pressures on both labor and capital will intensify. This outcome is not positive for the Federal Reserve as it fights inflation.

Figure 3: Real GDP vs Potential Real GDP, 2000 to 2025 (estimated).



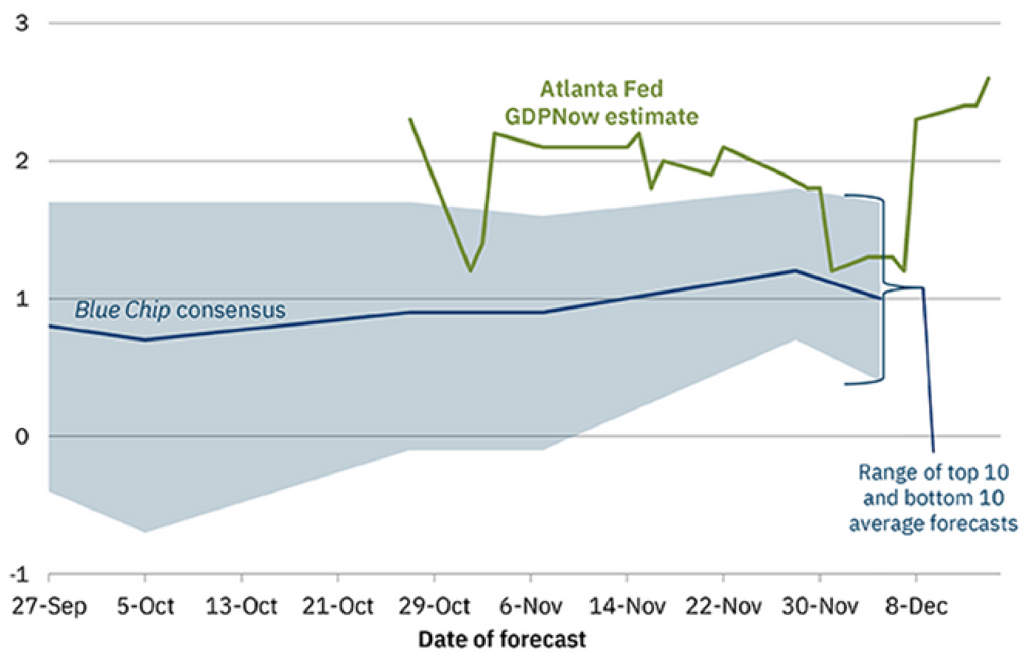
A shaded area indicates a recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED). Extracted from database December 3, 2023. (From U.S. Congressional Budget Office and U.S. Bureau of Economic Analysis data.)

From 2010 to 2020 the Federal Reserve had an easy monetary policy with a rapid expansion in its balance sheet combined with low interest rates. The chart above suggests why inflation did not emerge. There was substantial slack in the economy: a large gap between actual and potential real GDP.

Much of the gap between actual and potential real GDP has disappeared. If the Atlanta Fed's fourth quarter 2023 forecast is accurate, the U.S. economy remains on a 2.6% growth trajectory. It anticipates growth above the median estimates of a large group of economists.

Figure 4: Federal Reserve Bank of Atlanta's Forecast of Q4 2023 Growth in Real GDP.



Source: Federal Reserve Bank of Atlanta. Atlanta Fed GDPNow. December 14, 2023.

These forecasts for Q4 growth do not suggest a recession in the near term. But the forecasted growth above the long-term potential for the U.S. economy suggests the Fed will be under little pressure to lower interest rates.

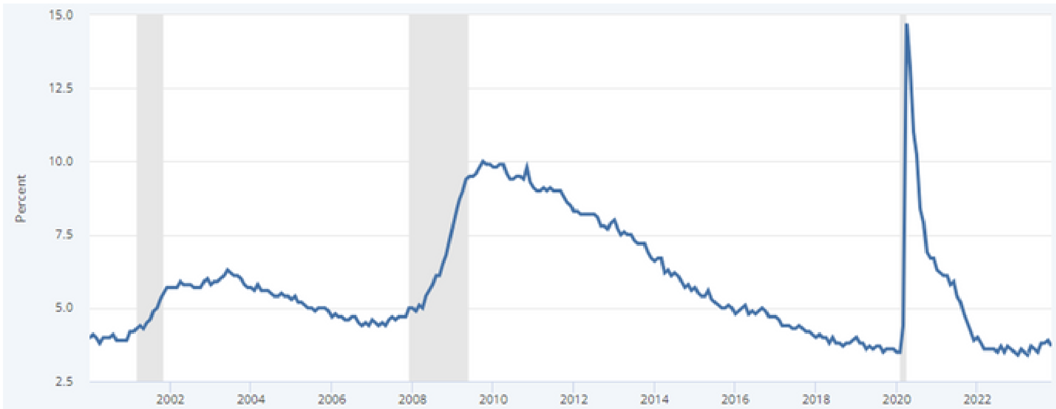
Best Guess About Economic Growth

The U.S. economy is not headed into a recession in the next one or two quarters. Will the economy slow in 2024 as the Fed's monetary tightening finally begins to slow economic momentum? Probably. In 2024, it is reasonable to expect an economic slowdown with growth likely to be about 1.5% instead of the recent 5%. We expect a soft landing in 2024. Our analysis does not suggest that the National Bureau for Economic Research will declare an official recession in 2024.

Labor Markets

Our optimism on the economy stems from labor market conditions. A metric monitored by the Federal Reserve is the unemployment rate. The current unemployment rate of 3.7%, which economists would call full employment, is a warning to the Fed that its monetary policy needs to remain restrictive. (See Figure 5.) Since early 2021 the Fed acted aggressively to raise interest rates to slow employment growth and reduce inflationary pressure on wages. Yet the unemployment rate remains at 3.7%.

Figure 5: U.S. Unemployment Rate, 2000 to Present.



Shaded area indicates a recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Date (FRED), Extracted from database December 3, 2023. (From U.S. Bureau of Labor Statistics data.)

The Fed's restrictive monetary policy is working as measured by the increase in the number of workers receiving unemployment benefits. (See Figure 6.) The number of workers receiving unemployment benefits has increased from a cyclical low of 1.3 million workers to 1.8 million in the most recent month. This later number does not indicate a significant deterioration in labor market conditions, especially when compared to all the data since 2000.

Figure 6: Continuing Claims for Unemployment Benefits by Unemployed Workers, 2020 to Present.

A shaded area indicates a recession.

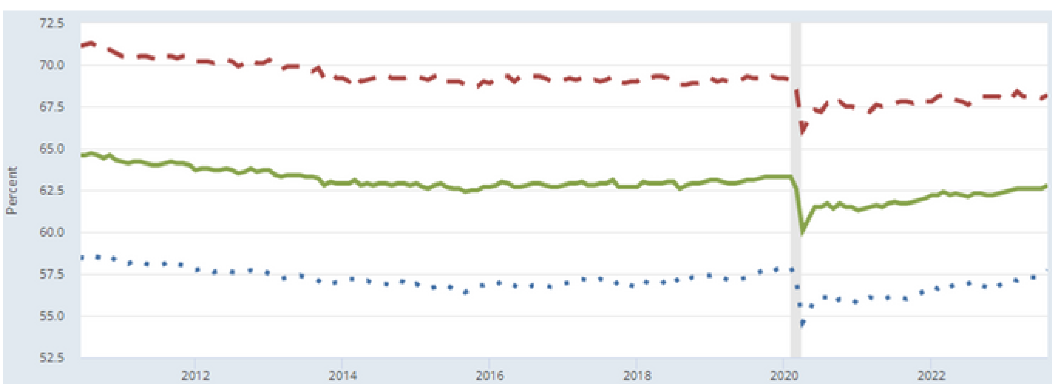
Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED). Extracted from database December 3, 2023. (From the U.S. Employment and Training Administration data.)

Another measure of employment conditions is the number of initial jobless claims for unemployment benefits. Claims have been about 225,000 per week. On an historical basis, this would indicate that labor market conditions are still relatively strong and not indicative of a decrease in economic activity. In healthy times, initial jobless claims average about 200,000 to 300,000 per week.

Another way to see the strength of the labor market is comparing the number of job openings to the number of unemployed workers. In November 2023, there were 8.7 million job openings compared to 6.5 million unemployed workers. During most of the 21st century the excess of job openings compared to unemployed workers has been relatively rare. Although the ratio of job openings to workers is declining, it is not indicative of an economy on the brink of a recession.

An encouraging sign in the labor market is the improvement in the labor participation rate, especially for female workers. (See Figure 7.) Women are now back in the labor force at a rate of 57.6%, about the same rate as it was prior to the Covid crisis. The same cannot be said for male workers, with 68.4% of prime working-age males employed compared to the pre-pandemic level of 69.2%. That 1% difference is significant because it represents 600,000 fewer male workers.

Figure 7: Total (Solid Line), Male (Dash), and Female (Dot) Labor Participation Rates, 2020 to Present.



A shaded area indicates a recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED). Extracted from database December 3, 2023. (From U.S. Bureau of Labor Statistics data.)

Any improvement in labor participation rates has the potential to reduce wage demands since more workers are employed or seeking employment. This improvement, whether male or female, should provide comfort to Federal Reserve policymakers.

Best Guess About Labor Market Conditions

We expect that labor markets in 2024 will require additional weakness for inflation to reach a level acceptable to Federal Reserve policymakers. Fed chairman Jerome Powell has stated repeatedly that "reducing inflation will likely require slower growth and some softening of labor market conditions." Little softening has occurred.

We at Stephens think that the Fed will achieve its goal of lower inflation via slower growth and weaker labor markets. However, this result will require a return to "normal" labor conditions where unemployment is about 4% to 4.5%, weaker but not a disaster for workers. In addition, higher labor participation rates should support the Fed's goal of muting inflationary pressures.

Prices and Inflation

Our biggest question in 2024 is when will inflation return to the Fed's target of 2%. The price levels that concern the Fed most acutely are moving in the right direction but more slowly than the Fed would like. The Consumer Price Index (CPI) dropped from almost 9% in July 2022 to 3.1% today. (See Figure 8.)

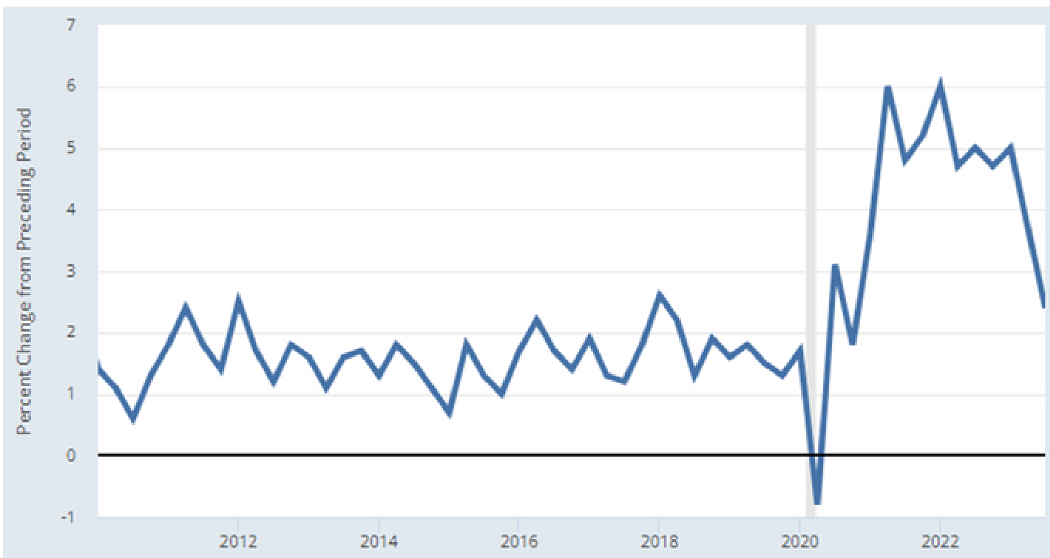
Figure 8: Consumer Price Index for All Urban Consumer, Price Change from a Year Ago, 2010 to Present.

A shaded area indicates a recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED). Extracted from database December 3, 2023. (From U.S. Bureau of Labor Statistics data.)

Can the Fed declare a victory given that inflation has dropped so much? No, not really. The Fed's hard work has just begun because the Fed is not focused on the CPI. Its attention is on a dynamic measure of inflation, the core Personal Consumption Expenditures price index (PCE) that excludes volatile food and energy prices. Prices measured by the PCE decreased from 6% in 2022, but prices are still increasing at a rate above the Fed's goal of 2% even excluding food and energy. (See Figure 9.)

Figure 9. Personal Consumption Expenditures, Excluding Food and Energy, 2010 to Present.



A shaded area indicates a recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED). Extracted from database December 3, 2023. (From U.S. Congressional Budget Office and U.S. Bureau of Economic Analysis data.)

An alarming pricing element remains: the rapid increase in service prices. These services include the cost of airline tickets, auto and homeowners' insurance, hair styling fees, housing, childcare, and myriad other services. Service prices are continuing to increase at an annual rate of 5.6%. (See Figure 10.). Since these expenditures constitute over 60% of household expenditures, it makes the Fed's problem more difficult than the headline numbers suggest.

Figure 10: Personal Consumption Expenditures Price Index: Services, 2010 to Present.

A shaded area indicates a recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED.) Extracted from database December 3, 2023. (From U.S. Congressional Budget Office and U.S. Bureau of Economic Analysis data.)

The analysis on inflation at the Federal Reserve Bank of Dallas removes not only food and energy from the CPE analysis but also extreme positive and negative price moves which might distort a true measure of inflation. The Dallas Fed has created a trimmed core inflation rate instead of using the widely known PCE. (See Figure 11.) In the six-month period from May 2023 to October 2023 the core PCE dropped from 4.0% to 3.0%. Yet the Dallas trimmed value is 3.6%, well above the broader PCE.

Figure 11: Trimmed 6-Month Mean Personal Consumption Expenditures Price Inflation, May 2023 to October 2023.

	May-23	Jun-23	Jul-23	Aug-23	Sept-23	Oct-23
PCE	4.0	3.2	3.4	3.4	3.4	3.0
PCE ex F&E	4.7	4.3	4.3	3.8	3.7	3.5
Trimmed mean	4.7	4.3	4.2	3.9	3.8	3.6

Source: Federal Reserve Bank of Dallas. "Trimmed Mean Personal Consumption Expenditures Price Inflation." August 2023. (From U.S. Bureau of Economic Analysis data.)

Even though inflation has subsided, the Dallas trimmed PCE rate is significantly above Federal Reserve's goal, indicating the Fed remains far from its stated objective of 2%.

Best Guess About Inflation in 2024

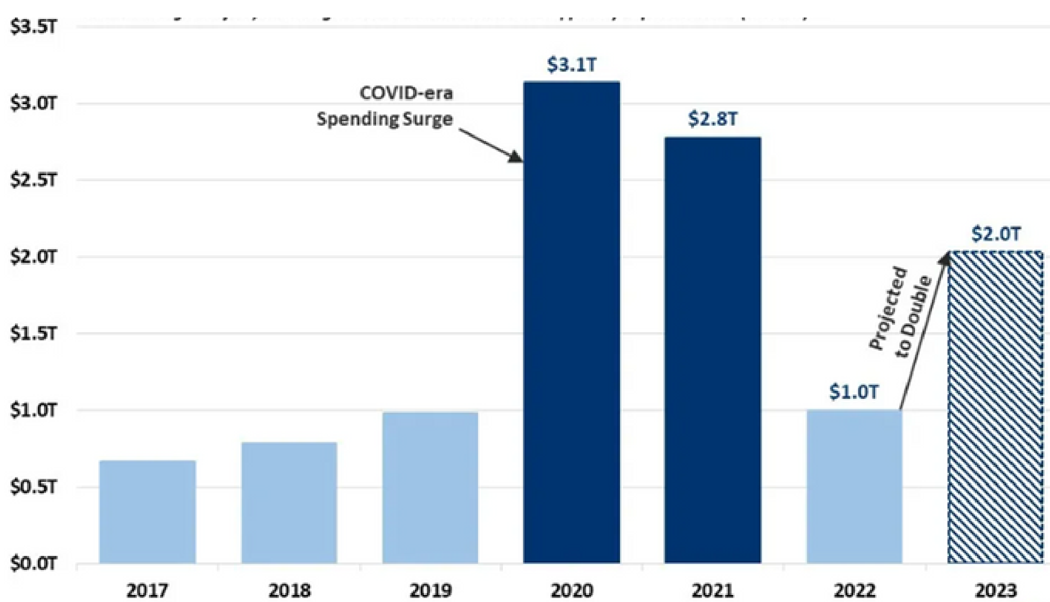
Federal Reserve policymakers created a difficult problem, and its dilemma will not be solved with 18 months of its monetary tightening and higher interest rates. The Fed needs a continuing commitment to monetary tightening and high interest rates through mid-2024 to see inflation reaching its target rate of 2%. Economic growth will slow, and labor markets will feel the impact of tight monetary policy.

We expect the Fed will not begin lowering target interest rates before late in the second quarter of 2024. This opinion is an outlier. Markets are anticipating rate cuts early this year. The Fed at its recent meetings indicated that it anticipated 3 policy rate cuts in 2024. Again, we expect these cuts will not begin until near the middle of 2024, not toward the beginning. And these cuts will occur slowly over 2024, not 3 cuts in quick succession.

U.S. Fiscal Policy in 2024 and Beyond

U.S. fiscal policy is a disaster waiting to happen because of the huge deficits being incurred by the federal government, and Americans will see this disaster unfolding. If one ignores the huge deficits during Covid and simply compares the deficit in 2019 to the most recent Federal deficit, it has more than doubled in 4 years from $1 trillion to $2 trillion. (See Figure 12.) According to the Congressional Budget Office (CBO) and the Committee for a Responsible Federal Budget (CBFB), the budget deficit has increased from about 3.5% of America's real GDP to about 7.4%.

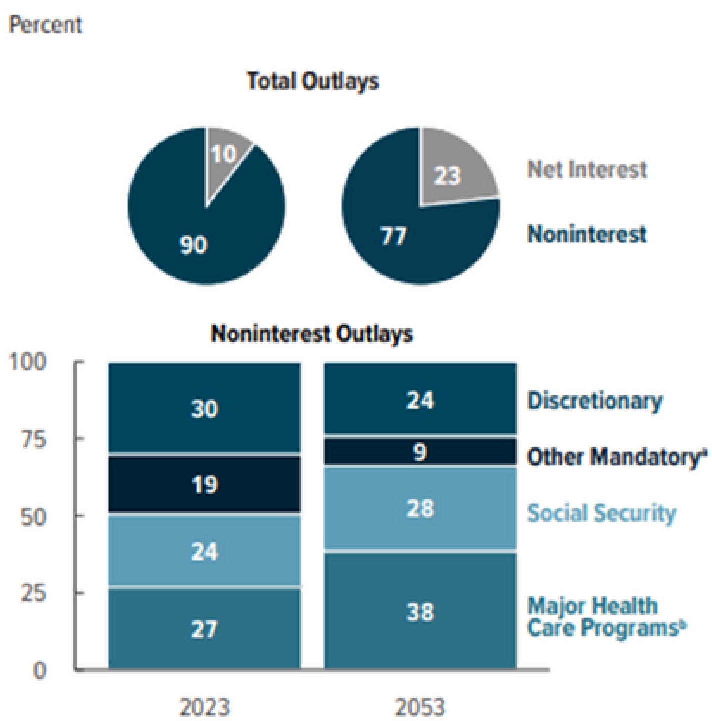
Figure 12: Federal Budget Deficits, 2017 to 2023, in Trillions of Dollars.



Source: Committee for a Responsible Federal Budget. "The Deficit Was Over $2 Trillion Last Year." September 12, 2023.

The U.S. Congressional Budget Office has painted a bleak future about America's ability to respond to the needs of future generations. The interest on Federal debt will likely consume about a quarter of the budget, up from the current 10%. Discretionary spending on education, energy infrastructure, national defense, disaster relief, and other important expenditures will drop from 30% of outlays to 24%. (See Figure 13.) These numbers are based on conservative estimates which are consistent with legislation currently embedded in Federal laws.

Figure 13: Composition of Outlays in the Federal Budget, 2023 (Actual) and 2053 (Estimated).

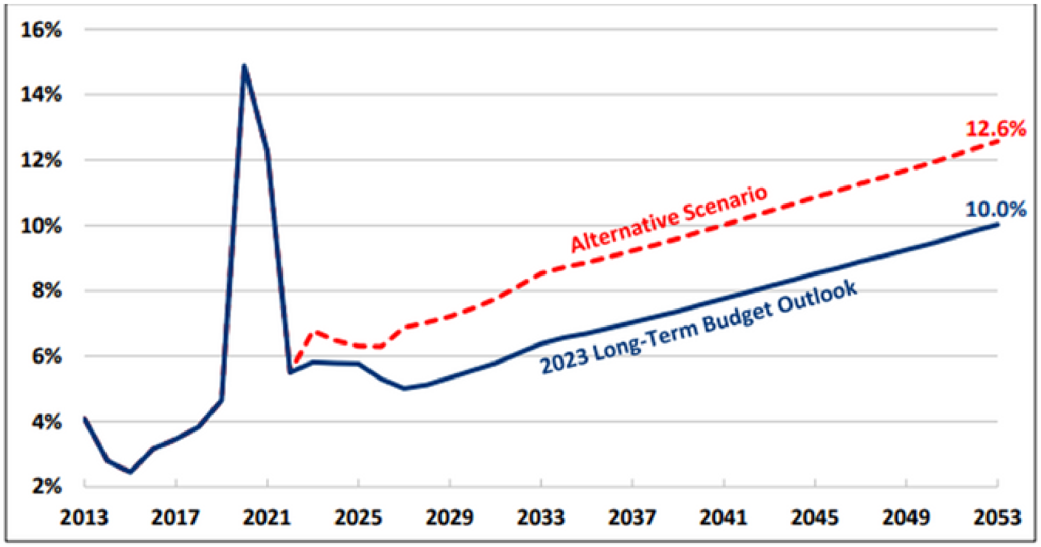


Source: U.S. Congressional Budget Office. The 2023 Long-Term Budget Outlook. June 2023. Page 16.

Two main policies could alter the projected future of the Federal budget outlays: less spending on mandated programs such as Social Security, Medicare and Medicaid or raising taxes on the "rich" who already pay a disproportionate share of Federal taxes. Neither option has much traction in the current divided political climate.

Future Federal budgets may be even bleaker than those described by the CBO. The non-partisan Committee for a Responsible Federal Budget (CRFB) concludes that the "CBO's 2023 Long-Term Budget Outlook continues to remind us of what we've known for some time, but our policymakers repeatedly ignore: the federal budget is on an unsustainable path." (See Figure 14.)

Figure 14: Adjusted Congressional Budget Office (CBO) to Reflect Economic Realities of the Federal Budget Deficit, 2013-2053. Annual Deficits as a Percent of Real GDP.



Source: Committee for a Responsible Federal Budget. "Analysis of CBO's June 2023 Long-Term Budget Outlook." Page 3. (Based on data from Congressional Budget Office's Long-Term Budget Outlook, June 2023.)

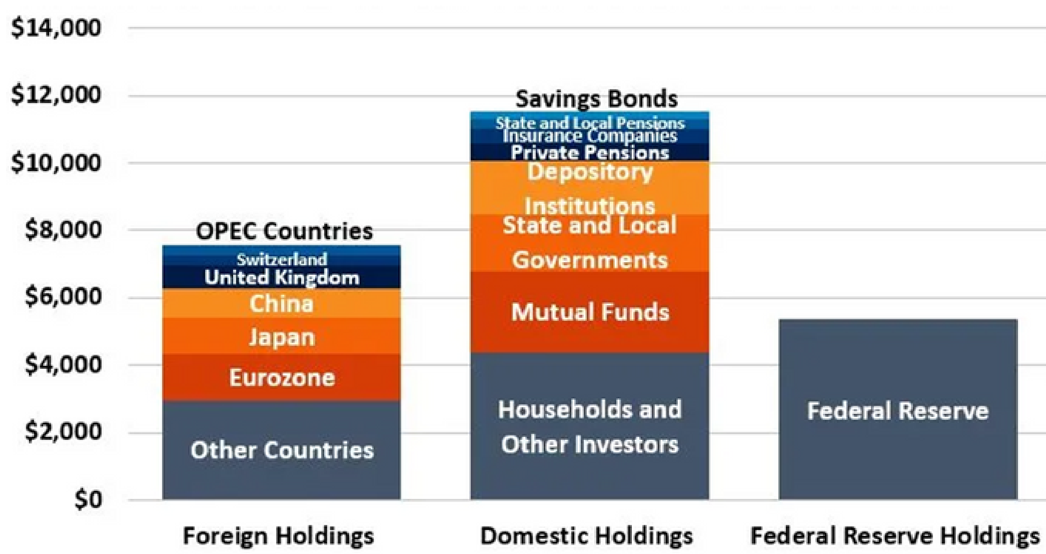
Notice that the CFRB's "Alternative Scenario" suggests a current problem, not one in the distant future. The markets are beginning to absorb what Stephens Inc. said in previous newsletters. Interest rates, which the Fed kept artificially low for years, are returning to higher "normal" levels. Inflation is unacceptably high, and the Fed has minimal wiggle room to prevent interest rates from moving higher and staying at "normal" interest rates.

Why are interest rates on the federal debt likely to remain at high rates which have not been seen in years? There are several reasons:

- The Federal Reserve is committed to shrinking its holdings of the Federal debt to staunch the high inflation. Therefore, it is not likely to be a significant net purchaser of that debt.
- Most major countries on the lefthand side of the figure below (see Figure 15.) are struggling with recessions or related economic problems. Thus, they are unlikely to be significant net purchasers of America's debt.
- American regional banks (depositories) are shrinking debt holdings as customers depart for higher interest rates elsewhere.
- Many state and local governments, after the initial flood of Federal covid money, are now facing mounting deficits. Again, they are less likely to be net purchasers of federal debt, except in their underfunded pension plans

Will the U.S. government be able to find buyers for its burgeoning debt now and in the near future? Absolutely. But it will be at interest rates that will put even more pressure on the federal budget.

Figure 15: Holders of U.S. Government Debt Held by the Public as of March 23, 2023, in Billions of Dollars.



Source: Federal Reserve, U.S. Department of the Treasury, and the Committee for a Responsible Federal Budget, as of March 31, 2023.

Best Guess About Fiscal Policy

Democrats and Republicans in Congress are unlikely to act in a bipartisan way. The fiscal morass described above is coming to fruition. Over the next 12 to 36 months, the U.S. fiscal problem will be apparent to most households, just as it is for potential home buyers who now pay 7% on the 30-year mortgage instead of 3%.

The future course of the economy is unlikely to alter the trajectory of the fiscal conditions. A hard landing would worsen the deficit and increase budget pressures. A recession will not improve federal budget conditions relative to the CBO's forecasts. A soft landing will leave the budget pretty much on its current trajectory. Any economic improvement will only slow impending fiscal problems.

Final Thoughts on the Economy in 2024

From the beginning of the fiscal crisis in late 2007 until the end of the Covid crisis, the Federal Reserve embarked on a Treasury bond and mortgage buying binge that only ended in April 2021. This binge allowed the Federal government to undertake its own massive deficit-spending programs. There were benefits from the binge which include at least four major economic consequences.

- Businesses and households were able to fund their operations at multi-decade low interest rates meaning low corporate bond rates as well as very low mortgage rates for homebuyers.
- The Federal government was able to borrow at rates close to zero which meant that incremental federal debt had a minimal impact on the budget deficit -- almost "free" money. Politicians in Washington love "free" money.
- The Federal government's massive spending helped to temporarily supercharge the economy. Workers benefited from numerous job openings that produced full employment.
- State and local governments received a huge cash infusion from Federal covid spending. In addition, with the strong post-covid economy, extra government tax revenues masked the true financial weakness of many governments around the country.

In 2023, households, businesses and governments received a lesson in economics. There is a real world of normal (and higher) interest and limited revenues for governments to spend without a price tag. This "new" world will emerge fully in 2024 and beyond.

Now the Federal Reserve is serious about taming inflation with the consequence of higher interest rates. Households and businesses have already begun the adjustment process. The big question mark is whether politicians in Washington, D.C. will accept this new reality. We at Stephens are pessimistic that these politicians are good economic thinkers.

Overall, most economic units will adjust to this new reality. The economy will be unsettled with:

- Slowing but modest growth of about 1.5% in 2024
- Slightly higher unemployment at about 4.0% to 4.5%, good but not great for jobseekers
- Nettlesome 3% inflation, a rate above the Fed's target rate of 2%
- Interest rates near normal which means a Treasury rate on the 10-year U.S. government bond of about 4.0%: no respite for homebuyers or corporate borrowers
- Massive Federal deficits which will provide a boost to the economy even as the Federal Reserve seeks to weaken labor markets
- Little or no growth in aggregate corporate profitability because of stubbornly high wages and modest growth

From a global perspective, America is doing better than other major economies. Our economy is not yet making a goal line stand against impending economic disaster. But America does need politicians in Washington who know how to create and implement a sound economic gameplan.

In the near term, let us celebrate with our families and friends and hope for a better environment in Washington in the new year.

Thomas Goho, Ph.D. is an Economic Contributor for Stephens Inc. He also served as the Co-Director of Stephens University at Wake Forest University.