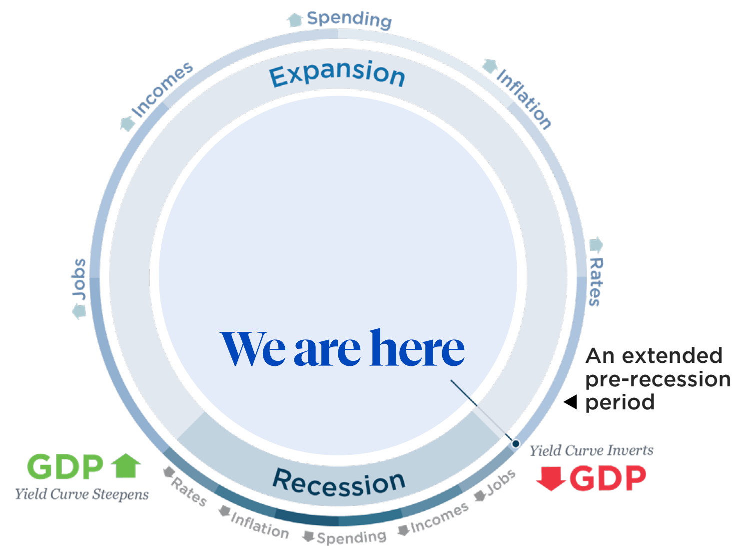
Economic & Financial Markets Monthly Review | December 2023

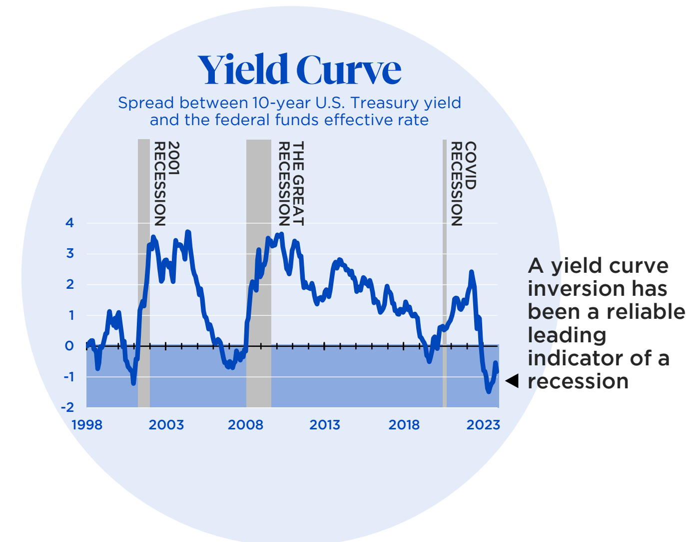
Uneasy outlook for 2024 as activity wanes

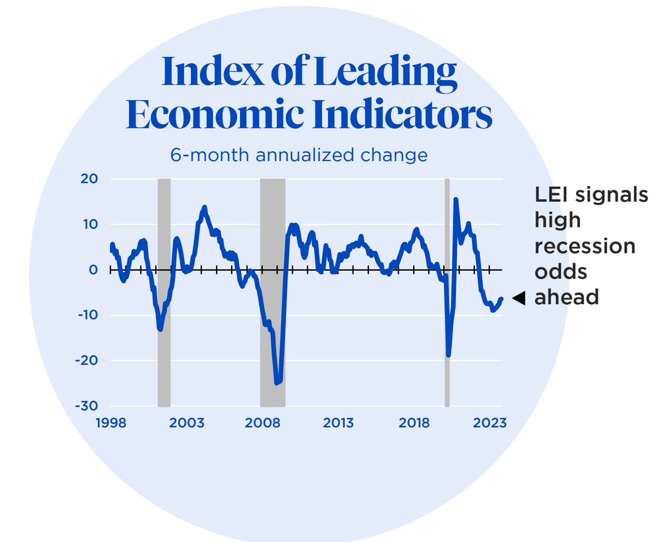
Economic Overview

Where is the economy now?

The fall brought a softer turn in the data as consumers cut back on purchases while firms in most sectors have reduced hiring. Financial conditions eased over the past month, although Fed rate cuts are not likely to start until mid-year. The economy still has enough momentum to hold off a recession for now, but further weakness is likely to result in a mild recession by mid-2024.







Where we are this month

What does this mean

Recession still likely in 2024

We expect slower growth in the fourth quarter of 2023 and the risk of a recession in 2024 remains elevated.

- Recent data point to deteriorating growth across multiple sectors in response to Fed rate increases, tighter bank lending standards, and declining profit margins.
- A projected recession in the first half of 2024 should be modest with limited job losses and business closures — especially compared to the severe impacts over the past two downturns.

Persistent yield curve inversion

The 10-year to fed funds rate spread inversion deepened again following the sharp retreat in long-term interest rates over November.

- The yield curve has been fully inverted for more than a year, in line with the typical lag period prior to the start of each recession over the past 50+ years.
- The sustained yield curve inversion is a strong warning sign for a recession, reflecting the bond market's elevated odds of a downturn over the next year.

Leading indicators = Recession

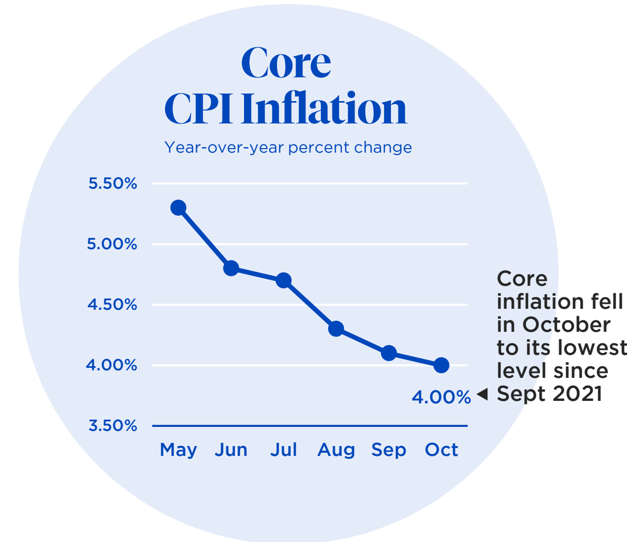
The Index of Leading Economic Indicators (LEI) suggests high recession odds in the year ahead with a negative 6-month annualized reading.

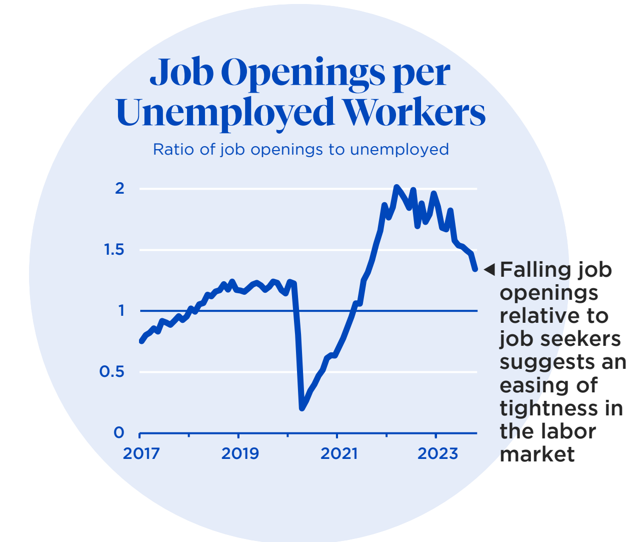
- This measure of the LEI has been a reliable recession signal, turning negative ahead of each downturn since 1960.
- The lag between the first negative reading and the start of the next recession is typically between 12 and 18 months. As of October, the 6-month annualized change in the LEI had been negative for 18 consecutive months.

Economic Review

Softer growth and inflation trends to end 2023

Although the overall labor market still appears to be moving forward at a decent clip, most industries show weaker momentum in hiring as the end of the year approaches. It will take some time for these trends to result in slower services inflation (particularly with an unemployment rate consistently under 4.0 percent), but there are clear signs of reduced inflationary pressure across the economy — which should dissuade further rate hikes from the Fed over this cycle.





Where we are this month

Still solid hiring in November

Nonfarm payroll growth climbed to 199,000 in November — a solid gain and in line with October's after accounting for the effects of the UAW strike.

Core inflation eases further

Year-on-year CPI inflation fell in October to 3.2 percent, while the core rate edged down to 4.0 percent.

Loosening in the tight labor market

The ratio of job openings to job seekers fell in October to 1.34 – the lowest level for this metric in over two years and well below the cycle peak.

What does this mean

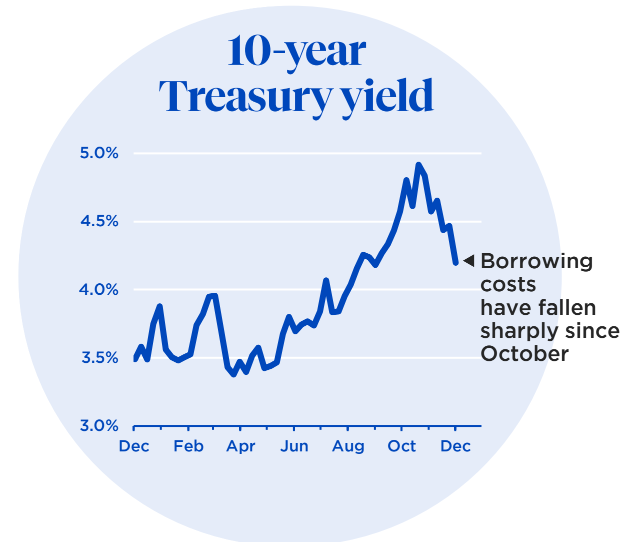
- Although total job growth was buoyant, nearly all the gains were in health care, leisure and hospitality, and durable goods manufacturing (due to the UAW strike ending); hiring has slowed significantly across most other industries as more firms cut expenses.
- Wages grew at a faster 0.4 percent clip in November and remained elevated with 4.0 percent growth over the past year. The unemployment rate fell 0.2 percentage points to 3.7 percent — a four-month low.

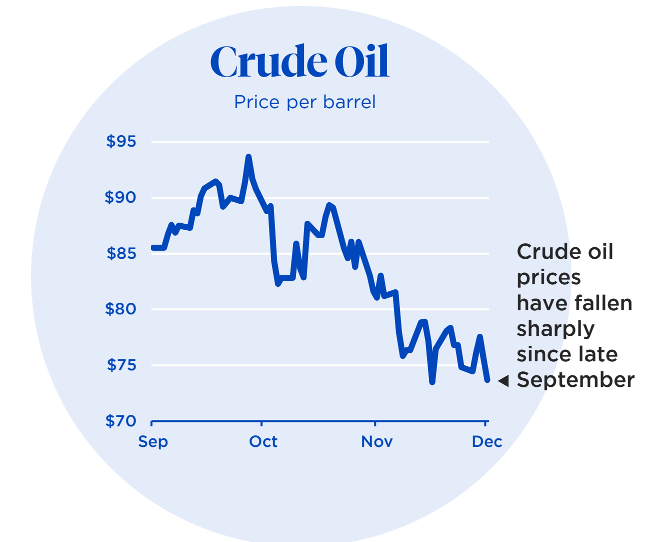
- Annual core services inflation has dropped in each of the last eight months, but at 5.5 percent remains very elevated.
- Much of the current inflationary pressure emanates from a few sectors of the economy. Transportation, recreation, and education services accounted for well over half of the Fed's favored supercore inflation (i.e., core services less housing) reading of 3.6 percent in October.

- Labor demand is finally easing, the current openings-to-unemployed ratio remains higher than before the pandemic — a time when the labor market was considered tight.
- This ratio has been sky-high for two years and has been a primary driver behind rapid wage growth. Its recent declines suggest that wage pressures should ease further in coming months.

Investors eagerly await the Fed policy pivot

The S&P 500 surged in November as investors grew more confident in a potential soft landing and now expect rate cuts to start in Q1 2024. While price pressures are cooling and there is more disinflation in the pipeline, Fed policymakers are unlikely to hit their inflation goal any time soon. We expect the Fed to wait until May 2024 before starting to cut interest rates. Financial conditions have unwound the tightening that began in mid-September, likely keeping some Fed officials from becoming too dovish in the near term.





Where we are this month

Equities sharply reverse course

The S&P 500 gained nearly 9.0 percent in November, more than regaining the losses in October and closing in on year-highs from over the summer.

Interest rates plunge

The 10-year Treasury yield plummeted to an average of 4.5 percent in November, although still elevated on a historical basis.

Oil falls to a four-month low

Crude oil prices declined in November despite high geopolitical tensions in the Middle East. West Texas Intermediate spot prices fell to $75 per barrel.

What does this mean

Equities

- Buoyant economic data, falling interest rates and signs that Fed officials are done raising rates were the catalysts underpinning the sharp rebound in equities. Energy was the only sector of the S&P 500 to not gain ground during November as oil prices slumped.
- Market valuation metrics rose last month as stocks became even more expensive. The P/E ratio for the S&P 500 averaged roughly 22 and held above its long-term historical trend.

Interest rates

- The 2-year Treasury note yield, which is more sensitive to Fed policy, fell as officials signaled they were done raising interest rates as long as the data suggest continued cooling of growth and inflation.
- While investors increasingly believe the Fed will lower rates early in 2024, those hopes are likely premature. We anticipate that the Fed won't start to ease policy until mid-2024 and that it will proceed gradually in the second half of the year.

Oil

- Lower oil prices suggest that domestic demand is cooling. Consumers are tightening their purse strings and businesses become more reticent to invest and hire amid uncertainty about the economic outlook.
- Cheaper energy costs, if sustained, will dampen price pressures in early 2024 and could help the Fed reach its inflation goal faster than otherwise would be the case.

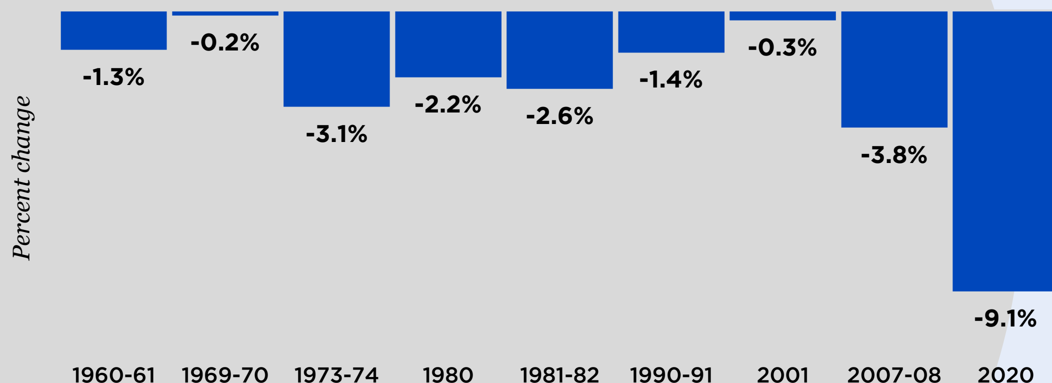
Outlook

Mild recession more likely than a severe one

Given the volatile conditions over the previous two downturns, a recession outlook might conjure thoughts of high unemployment rates and extensive disruptions for households and businesses. But history shows that the 2007-08 Great Recession and the 2020 Covid Recession are the exceptions, not the rule. Excluding these two events, the average peak-to-trough decline for real GDP since WWII during a recession was only 1.9 percent with about a two-percentage point increase in the unemployment rate.

There are many reasons to except that a potential recession in 2024 will even be less severe than average. Household and business balance sheets are still in solid shape, implying fewer business closings and personal defaults if the economy goes sideways. With labor conditions still tight, widespread layoffs are not predicted which should limit income and spending reductions. While a hard landing appears more likely than a soft one, a recession forecast may not be as dour as thought.

Peak-to-trough decline in real GDP during recessions



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Data as of December 2023

	2022 ACTUAL	2023 ESTIMATE	2024 FORECAST	2025 FORECAST	2026 FORECAST
REAL GDP	2.1%	2.4%	0.9%	1.3%	1.6%
UNEMPLOYMENT RATE	3.6%	3.7%	4.6%	4.4%	4.1%
INFLATION [1] (CPI)	7.1%	3.3%	2.8%	2.4%	2.1%
TOTAL HOME SALES	5.67	4.80	4.60	5.30	5.95
S&P/CASE-SHILLER HOME PRICE INDEX	5.8%	5.4%	2.0%	3.4%	3.2%
LIGHT VEHICLE SALES	13.8	15.4	15.1	16.1	16.5
FEDERAL FUNDS RATE [2]	4.25%	5.25%	4.00%	3.00%	2.50%
5-YEAR TREASURY NOTE [2]	3.99%	4.25%	3.75%	3.00%	2.90%
10-YEAR TREASURY NOTE [2]	3.88%	4.25%	4.00%	3.45%	3.25%
30-YEAR FIXED-RATE MORTGAGE [2]	6.42%	7.20%	6.30%	5.10%	4.60%
MONEY MARKET FUNDS	2.27%	5.09%	4.65%	3.40%	2.59%

[1] Percent change Q4-to-Q4
[2] Year-end

Mild recession in the outlook for 2024

Slower spending by consumers and businesses should drive a relatively short and modest recession — focused on the middle of 2024. The economic recovery should begin later in the year with lower interest rates and improved credit conditions spurring improved growth in 2025.

Fed easing likely to be later and slower

Lingering inflation concerns should keep the Fed on the sidelines for longer than usual, with an initial rate cut not expected until mid-2024. We foresee only moderately lower interest rates into 2025 as the Fed looks for clear signs that inflation will return to its 2.0 percent target.

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