THE PAUSE THAT REFRESHES?

Many feared recession in 2023. Instead, the U.S. economy growth rate actually accelerated – clocking in at 3.1% after posting a 0.7% growth rate in 2022. This stronger growth and continued labor market tightness have led investors to reset expectations for Fed policy. Markets now expect the first cut in May (we think June) and four rate cuts in all of 2024 (we think three). We believe less monetary easing; expected U.S. consumption moderation; and feeble Chinese/European recoveries will slow growth in 2024.

A refreshed economic expansion. Since the Fed's last rate hike (July 26 of last year), U.S. economic activity has accelerated with real economic growth averaging 4.1% in the second half of 2023 (versus 2.2% in the first half). More recently, the labor market has also reaccelerated – adding 353k jobs in January on top of the 333k added in December (versus an average of 204k in the six months before that). Refreshed growth and strong labor markets have also refreshed worries over inflation – notably the core services ex-housing inflation (a current focus of the Fed), which remains elevated at 3.3% over a year ago. We expect U.S. real economic growth will downshift to a 1.5-1.8% range (just below potential) and anticipate labor market strength will slowly fade – both in terms of demand (as judged by the continued steady reduction in job openings) and supply (as recent immigration growth slows). The resulting consumption headwind joins the downward gravitational pull of struggling European/ Chinese economies and the slight drag from less helpful central bankers than previously expected.

Rate cut delay. Fed and other central bank rate cuts are still expected this year, but Fed Chair Jerome Powell took a March rate cut off the table and other Fed speakers have pushed back against the rate cut euphoria that gripped markets late last year. Core inflation continues its steady return to the Fed's 2% target, with core prices 2.9% higher than a year ago (and only 1.9% higher over the last six months, annualized). But a major assist came from flat year-over-year goods prices; this can't be counted on again, especially given escalating risks to global shipping. We continue to believe the Fed will tread cautiously – in a data-dependent manner – and still expect the first Fed rate cut in June and three total rate cuts for all of 2024.

HIGH YIELD REMAINS ATTRACTIVELY PRICED

Higher interest rates have put high yield into a new, more attractive range of valuations relative to equities.

Source: Northern Trust Asset Management, Bloomberg. YTW = yield to worst. Earnings yield is the inverse of the price-to-earnings ratio based on next-twelve-month earnings expectations. Monthly data from 6/30/2014 through 1/31/2024. Historical trends are not predictive of future results.

BASE CASE EXPECTATIONS

Sticking the Landing

Global growth will move below trend but remain positive, supported by ongoing U.S. economic strength as labor market/consumer momentum has continued. Inflation will remain above target but continue to proceed toward 2%. Despite the constructive economic backdrop, high valuations temper risk-taking appetite.

A Slower Fed Transition

The Fed is almost certainly done raising rates, but market expectations for 2024 rate cuts remain too high (despite some recent moderation). While markets are still pricing in a 50/50 chance of a May start and five total 0.25% cuts in 2024, we continue to view a June start and three total cuts as the most likely outcome.

RISK CASE SCENARIOS

A Bad Goods Environment

Geopolitical tensions in the Red Sea (currently causing significant but manageable goods trade disruptions) intensify or broaden to the Persian Gulf (impacting oil supplies) – potentially causing stagflation.

Lagged Impacts

The market's enthusiasm for a soft landing proves to be misplaced as the cumulative effect of 5%+ rate hikes in two years starts showing up in economic functioning.

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