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Attempting that perfect landing

I've got a friend who is the classic nervous investor. He's the kind of guy who feels worse about losing 10% than he feels good about making 30%. Until a couple months ago, most of his money was sitting in cash. I was surprised when he recently informed me that he's "all in" on technology stocks. "The artificial intelligence revolution," he told me, "has arrived!"

My response: I too see the potential of AI. I believe that technological disruption and innovation will be a driver of the next great bull market. Nearer term, I think the Federal Reserve's (Fed) chances of navigating a soft landing are better now than at any point since 2022. However, it's as important as ever to remain diversified with a broad mix of stocks and bonds—and avoid the temptation to go "all in" on some best-case scenario.

We saw a historically strong rally to end 2023. The cooling inflation data combined with the Fed's dovish pivot at its December Federal Open Market Committee meeting caused the Standard & Poor's 500 Index (S&P 500) to soar 16% in just two months. Yields on 10-year Treasury bonds plunged from 5% to below 4%. The rallies were due largely to the emergence of the "immaculate disinflation" thesis, which would allow major central banks to cut rates significantly over the coming year.

In this note, we address the merits of the thesis. We believe recent economic data and Fed guidance have increased the probability of a soft landing. Probability, however, is not certainty. (Definition of a soft landing: when a central bank raises rates enough to cool inflation but not so much as to cause a recession). We expect inflation's grind towards the Fed's 2% goal to be bumpy. There's also a case for inflation staying above 2%, which could prompt the Fed to reevaluate its target or even its policy. Bottom line: We think the Fed would be justified to cut rates this year but not as aggressively as the market is predicting if we don't have a recession.

There is a path to a soft landing for the U.S. economy

Historically, recessions have followed periods of sustained rate hikes. Soft landings are rare. So far, however, this latest round of tightening seems to have cooled the economy just enough to reduce inflation but not so much as to trigger a decline in employment or economic activity.

One of the few examples of a successful soft landing occurred in the mid-1990s. In 1994, the economy was in its third year of recovery following the 1990-91 recession. The Fed was becoming concerned about a pickup in inflation and chose to hike rates by 300 basis points (bps), from 3% to 6%. (A basis point is 1/100th of a percentage point.) The Fed's aggressive policy included three 50 bp moves and one 75 bp hike. The Fed subsequently cut rates three times when it saw the economy softening.

The improbable soft landing was achieved, setting the stage for strong economic performance for the remainder of the 1990s, with steady inflation and a strong labor market.

The macro dynamics today have been trending in a direction somewhat similar to 1994-95

For starters, the labor market is healthy and has not been rattled by the rise in interest rates. Yes, labor demand is weaker now than a year ago, but the result has been a decline in the number of job openings, not a net loss of jobs.

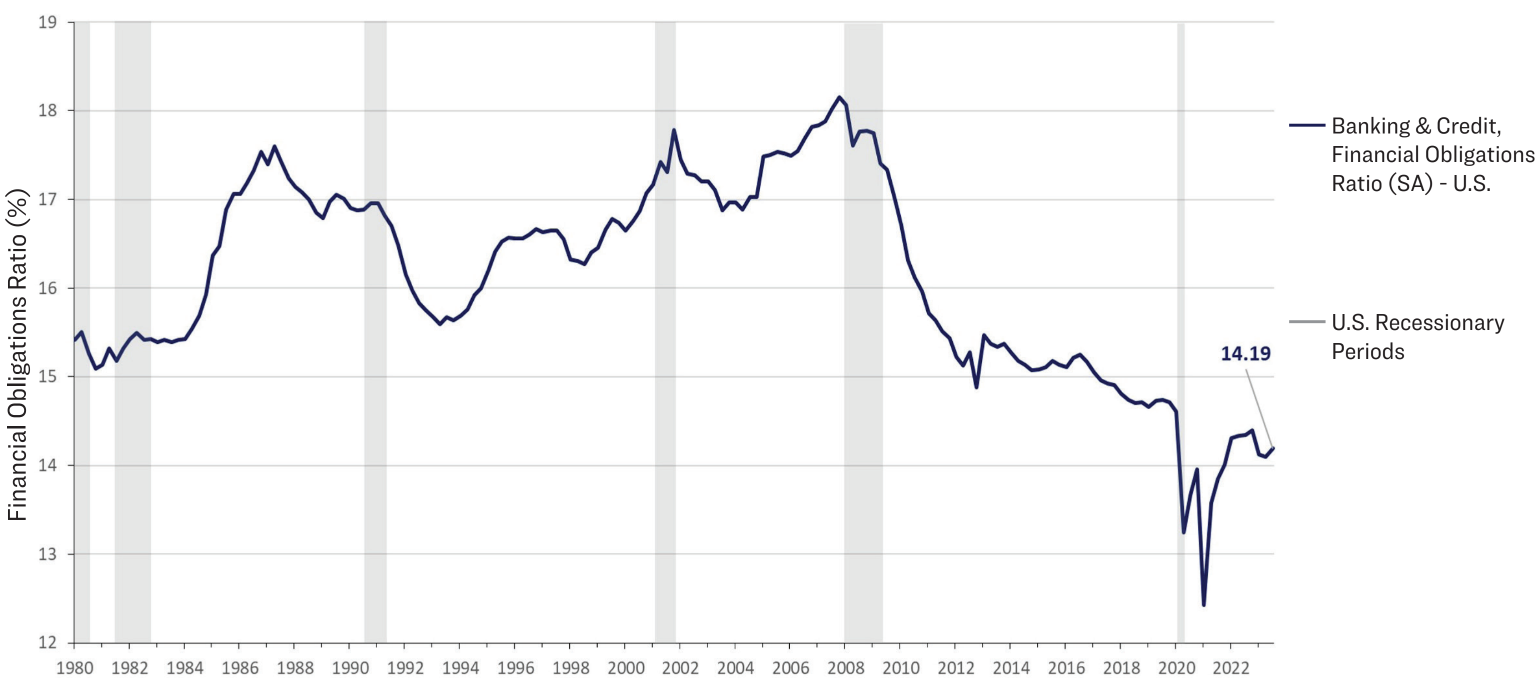
Similar to 1995, today's Fed is showing a willingness to pivot and pivot hard, before a major economic slowdown takes hold. This is quite unusual because, over its history, the Fed has not been as preemptive with rate cuts. Typically, the Fed turns dovish only when economic growth is weakening, job losses are rising or systemic credit events such as bankruptcies threaten the economy. The Fed's rationale for rate cuts today would be like that of the Greenspan Fed 30 years ago: Inflationary pressures have receded enough to accommodate an adjustment in monetary conditions.

Also, last year was proof that it is hard to bet against the U.S. consumer. With inflation moderating, real disposable incomes are rising. The impact is greatest for the low-income households that have been squeezed hardest by inflation, because a good portion of their spending goes towards food, rent and other essentials. The retail sales data for December was better than expected—up 5.6% on a year-over-year (YoY) basis—suggesting the economy is still enjoying strong tailwinds from consumer spending.

Finally, households and bank balance sheets are healthy enough to withstand a period of income weakness without triggering a major slowdown. Although delinquency rates on credit cards have risen, they still remain low. Debt service and financial obligation ratios for the American household remain among the lowest since the 1980s (Figure 1).

Figure 1

The financial obligations ratio is the ratio of household debt payments to total disposable income in the U.S. It measures how much household income is being spent on repaying debts and other financial obligations *(such as mortgages, HELOCs, auto loan payments, and credit card interest)*



Source: FactSet Financial Data & Analytics, data through September 29, 2023

That's the argument for immaculate disinflation. But there's also an argument for muddle-through growth or even a mild recession in 2024. Yes, recent data suggests that the prospects for a soft landing–i.e., for inflation to move lower without causing recessionary damage to the labor market–have increased. However, the possibility of a mild recession remains, and it's higher in our estimation than consensus believes.

We continue to monitor certain areas of risk, which could dent the soft landing narrative. Commercial real estate, for example, remains an area of concern. Office property prices, hurt by weak demand, will likely continue to fall; bankruptcies and forced sales could increase. Geopolitical uncertainties could diminish economic growth or reignite inflation. The Red Sea is an important global checkpoint with nearly 15%[1] of global seaborne trade passing through it. Attacks on container ships by the Houthis have caused ships to reroute cargos around the Cape of Good Hope, causing freight costs to increase, which in turn puts upward pressure on prices.

Inflation's trajectory and the Fed's response

The Fed is justified to cut rates this year, even if the economy does not enter a recession. The reason for this is that the real Fed Funds Rate (the rate adjusted for inflation) is at restrictive levels already. With inflation moderating, it could create an even more restrictive environment. To ensure that policy is not becoming more restrictive as inflation falls, it will be appropriate for the Fed to calibrate the Fed Funds rate lower. Over the past two years, the rate has increased +525 bps, an increase that typically precedes recessions. If the Fed can reduce the chances for a recession and still claim price stability, it will attempt to do so.

The Fed could also tap the brakes on another vehicle it has used to fight inflation—quantitative tightening (QT). The Fed has its own balance sheet. When the Fed sells assets off that balance sheet, it's known as quantitative tightening, and when it buys assets, it's known as quantitative easing (QE). Selling combats inflation because any money that investors spend purchasing the Fed's assets (often Treasury bonds) is money that cannot be spent on goods, services or private-sector investments. QE-related buying has the opposite effect, putting more money into the economy. Over the past two years, the Fed's balance sheet has shrunk by $1.3 trillion. Evercore estimates that these decreases are the equivalent of a roughly +100 bp increase in interest rates. So, if adjusted for QT, the Fed Funds Rate would be roughly 6.50% instead of 5.5%—a reason why the Fed is discussing potentially slowing the pace of balance sheet reduction in the not-so-distant future.

As we navigate inflation's last mile, it's important to consider the possibility that inflation fighters never quite reach the finish line. Structural shifts like a scarcity of labor, housing and commodities, as well as geopolitical ones involving the reshoring or friend-shoring of supply chains, could keep prices of everyday products higher than expected. That could lead to a "new normal" for inflation, one higher than the Fed's 2% target.

The Fed may respond to these dynamics by either tightening policy again or by steering its inflation target higher than the current 2% level. In fact, the Fed's aggressive dovish pivot in December may make 2% the lower limit in the longer-term inflation picture, rather than the upper limit, which was the case in the two decades prior to the pandemic.

But will the Fed deliver what investors want?

While rate cuts may be likely, there is a meaningful divergence between market expectations and probable outcomes. The futures market is betting on six rate cuts this year, starting in March. This seems aggressive, especially if the economy remains resilient. As we wrote in our 2024 Outlook, we think the path ahead on inflation will be bumpy, especially since the labor market remains quite strong.

The December labor market report showed that the economy added a solid 216,000 jobs. Job growth averaged 165,000 in the fourth quarter. That was weakest quarter of the expansion but still above what is required to meet the growth in population. Wages grew at a 3.7% annual rate last quarter, which was the weakest pace since late 2020 but still elevated. Real earnings rose in December year-over-year, extending a months-long streak in which wage growth modestly outpaced inflation. Finally, inflation ticked up in December, with the CPI rising 3.4%, the biggest rise in three months. Prices excluding food and energy cooled only slightly, coming in a bit firmer than expected.

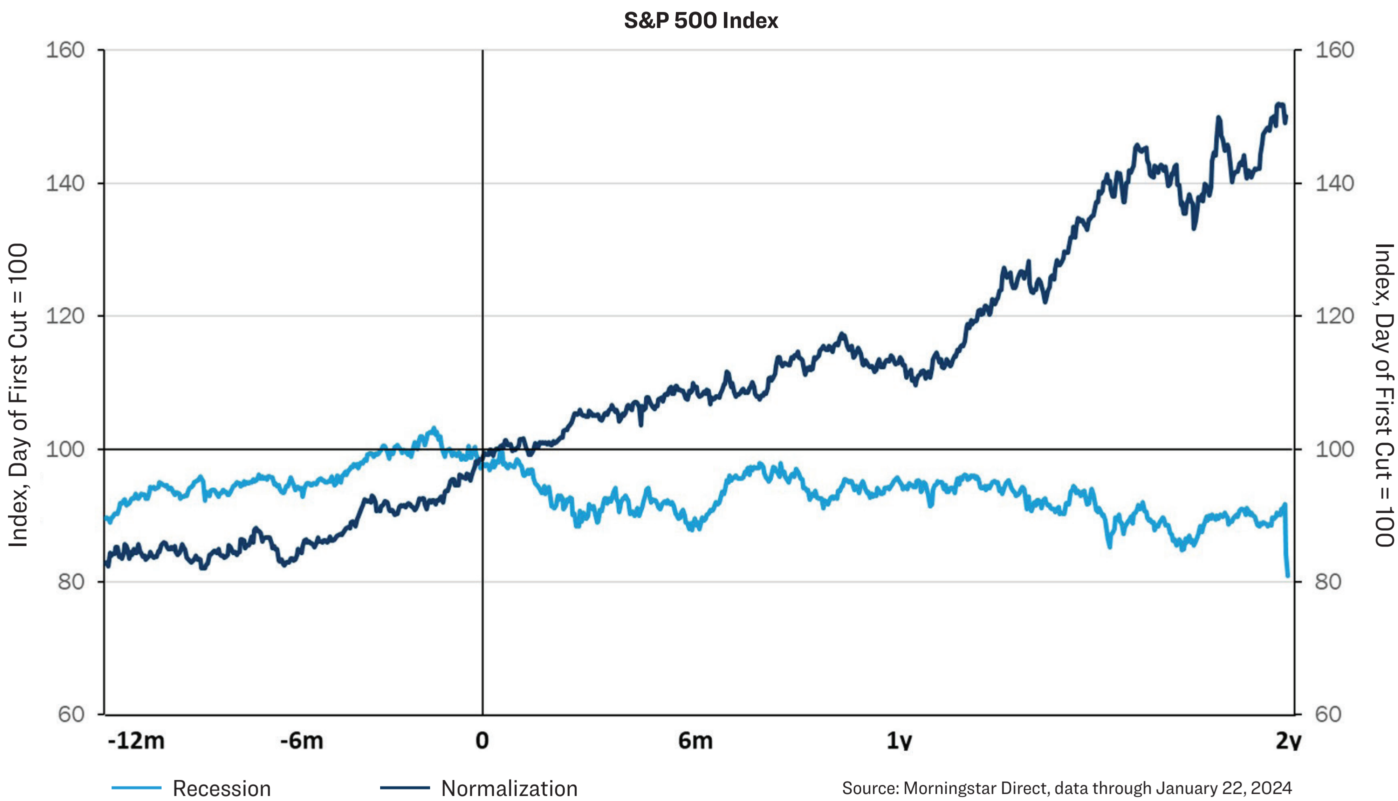
These conditions should make the Fed cautious against giving the market the six rate cuts it's counting on. If there is a recession, sure, six cuts would make sense. Barring that, we expect the rate-cut cycle to be more measured.

[1] Bank of America Global Research, "Global Economic Viewpoint," 1/12/24

The big picture is that the Fed is on the doorstep of an unlikely soft-landing. Inflation is coming down and growth is still resilient. If current trends hold, the Fed could begin cutting policy rates this year to normalize interest rates, which would be supportive of risk assets like equities. On the other hand, if the economic engine starts to sputter and the unemployment rate rises on a sustained basis, the Fed will begin cutting rates to defend the economy, leading to a flight to safety in the markets (Figure 2).

Figure 2

Stocks tend to rise into, and throughout, the easing cycle when Fed cuts are driven by a desire to normalize rates



Source: Morningstar Direct, data through January 22, 2024

Portfolio Strategy

In 2022, with stocks down 19% and bonds down 13%, a 60/40 portfolio of stocks and bonds lost 17%, its worst performance since the global financial crisis of 2008. In 2023, however, that same 60/40 portfolio enjoyed its best year since 2019, with an 18% total return buoyed by 26% returns for stocks and 5.5% for bonds. As tough as it was for some investors to stay invested after a dismal 2022, those who did were rewarded for their patience one year later.

We continue to believe in the proven performance of a diversified portfolio for long-term investors—a portfolio that is balanced and in sync with investors' unique financial goals and risk tolerances. This foundational asset allocation is the primary driver of investment outcomes. It can be complemented with tilts towards certain asset classes that boast attractive relative valuations, which have higher quality profiles and are well positioned to withstand potential policy mistakes by the Fed.

As markets recalibrate their expectations for rate cuts, it is possible that equity volatility will pick up given the now-higher valuations. The Nasdaq 100 has a forward price-to-earnings ratio of 24, and the S&P 500 sits at 20—both above historical norms. Long-term investors should not become bearish though.

Equities help provide long-term capital appreciation and, while more volatile than bonds, equities have outperformed bonds 85% of the time on a rolling 10-year basis since 1950[2]. Additionally, there is a record amount of cash—nearly $6 trillion—sitting on the sidelines in money market funds[3] (Figure 3). As rates fall, some of that could eventually find its way into bonds and equities, pushing up prices.

Figure 3

A record amount of cash is currently in U.S. money market funds

Source: FactSet Financial Data & Analytics, data through January 22, 2024

Based on individual financial situations, investors with excess cash and longer time horizons may consider U.S. equities, especially as volatility picks up and as we go through this reset period for inflation, corporate profits and monetary policy.

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[2] JPMorgan. 5 Considerations for investors in 2024
[3] Bloomberg

CIO PERSPECTIVES

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