Second Quarter 2024 Commentary

Vanderbilt's **economic outlook** continues to forecast sluggish GDP growth for the second half of this year with the possibility of a recession. In line with our previous forecast for GDP, growth is slowing. First quarter real GDP grew at 1.4% (year-over-year) down from the previous quarter's growth of 3.4%. This slowdown was mainly driven by declining estimates of consumption. The consumer (70% of GDP) is experiencing a falling savings rate with a rising level of debt. Credit card debt is a particular concern as rising credit lines have fueled rising credit balances. Delinquencies are on the rise. Recent economic indicators, though mixed, portray an economy with slowing momentum and a lower growth rate. Such metrics include: personal income was up 0.3% versus the previous month but down from 0.5% in March; personal spending rose 0.2% which was below expectations and slowing from 0.7% in March; the April savings rate of 3.6%, while unchanged from March, was well below the 12-month average of 5.2%; in real terms, consumption and disposable income both fell 0.1%; the Chicago Purchasing Managers Index was at its lowest level since May 2020 during the pandemic lockdown. The May payrolls report was mixed-while jobs and average hourly earnings rose; the unemployment rate unexpectedly increased from 3.9% to 4.0%. This is the first time in more than two years the jobless rate hit 4.0%. While we have had a strong and robust labor market, job growth has been more narrowly based. Government, healthcare and social assistance jobs made up nearly 60% of the country's 2.8 million jobs added over the last year. However, manufacturing has added a mere 20,000 jobs over the last year-a small fraction of that versus government, healthcare and social assistance jobs added. Jobs added in these categories has been fueled by government deficit spending. The recent narrow based jobs that rely on government transfer payments aren't the investment-based jobs that will sustain productivity growth.

Vanderbilt is forecasting that **disinflation** (i.e. a slower inflation pace) will continue although it will be volatile and sticky. Goods inflation has come down and services inflation is beginning to turn lower. Uncertainties arise from the volatility in the price of crude oil and the large UAW contract which could set a precedent for other industries. The core PCE (the Fed's preferred measure of inflation) recently came in at a 2.6% increase from a year earlier. The Fed's objective is 2%. Core PCE has declined from an approximate 5.8% rate in early 2022. While volatile and sticky, we believe disinflation will continue as shelter costs have begun to slow down and are reflected in the inflation data with a lag. The shelter component in CPI is much higher, near 40%, and should experience a significant decline as shelter costs decline. What matters more to most people is the price level. The Biden messaging efforts on the economy have so far been ineffective. In a recent Harris poll, the majority of Americans said they believe the U.S. is in a recession, that the stock market is down from last year and unemployment is at a 50-year high (not near a low). **None of these, of course, are true.** Part of the problem is that on average pay gains have not fully caught up with the jump in prices since the start of the pandemic. This has had a negative impact on consumer sentiment. The recent University of Michigan consumer sentiment survey unexpectedly had a significant decline.

Against an economic backdrop of slowing economic growth and continued disinflation we are maintaining our forecast of a single rate cut by the **Federal Reserve** in the second half of the year. Not too long ago there were forecasts for five to six rate cuts this year. Prior to any rate reductions the Fed wants to make sure they have confidence that inflation will be at a sustainable 2% level. The Fed is trying to balance the risk of cutting rates too soon versus keeping rates at current levels and triggering a slowdown that may not be needed to finish the inflation fight. There are two risks: (1) an economy normalizing from the pandemic ends up weakening further and eventually tips into a recession and (2) any rate cuts by the Fed to pre-empt

economic weakness instead reignites economic growth and asset prices in a way that sustains inflation above the Fed's 2% target. There are some questions as to just how restrictive Fed monetary policy has been.

The Fed's communication methods need improvement. FOMC participants make projections for the fed funds rate necessary to accomplish their forecast for inflation and economic conditions. These rate forecasts provide insight into how monetary policy is conducted and how the Fed may react when inflation and employment deviate from their outlook. The median for the members' economic projections may not be associated with the median rate forecast. The Fed's forecasting record has had shortfalls in that the policy rate projections often don't achieve the desired outcomes. Several modifications have been suggested. An improvement would be to publish anonymously a matrix of the members' forecast and their projections for the economy and inflation. Another is to include members' projections under different policy rate scenarios. The Fed would outline what it would do in the event their forecasts don't pan out. Helping the public understand how officials would respond to different economic outcomes is important to managing expectations and minimizing volatility during times of uncertainty. Another suggestion is for the Fed to comment more frequently on their balance sheet and how the Fed uses quantitative easing or tightening to supplement policy.

In a previous quarterly we outlined the current path of U.S. **fiscal policy** and the continuous large **deficits** and **debt** levels. We are going to look at some of the uncertainties and electoral ramifications pertaining to the debt level and economy. The projected 2024 deficit is 6% of GDP and near $2 trillion-a level that is unsustainable. Interest expense on the debt as of May 2024 has now surpassed both defense and Medicare expenditures. A third of the current deficit is going to pay interest-a combination of higher interest rates financing a larger amount of debt.

The upcoming election could have a significant impact on the deficit and debt levels. The 2017 Trump tax cuts will expire in 2025. Trump wants to maintain these tax cuts and has spoken of additional tax cuts if elected. Biden has proposed tax reductions for those below a $400,000 income level and a tax increase above this threshold. Trump's proposal would result in a further increase in the already large deficit/debt levels vis-à-vis Biden's proposal. This could result in further inflationary pressures and a potential tighter monetary policy from the Federal Reserve. Trump has stated he wants more control over interest rates thereby threatening the Fed's independence in setting policy. Biden has said he would protect the Fed's independence.

While $34 trillion is a very large debt level for the Federal government, it is less ominous than it might appear. Paul Krugman, the Nobel Prize economist, points out that the current level of debt as a percent of GDP is not unprecedented. It is the same as at the end of World War II, considerably less than the level for Japan right now and far below Britain's debt level at the end of World War II. None of these cases resulted in a debt crisis. Almost every debt crisis involved a country that borrowed in someone else's currency which left the debtor country vulnerable when lenders wouldn't continue lending-not the case with the U.S. If deficits get under control, debt as a percent of GDP. The CBO estimates the U.S. needs to increase taxes or reduce spending by 2.1% of GDP to get deficits under control. The U.S. collects a much smaller percent of GDP in taxes than most other advanced economies. An extra 2% would still leave the U.S. a low tax nation. The problem is that to implement a 2% reduction in the deficit through a combination of tax increases and/or spending reductions requires bipartisan cooperation. This is a characteristic that is in short supply in the current polarized Washington environment.

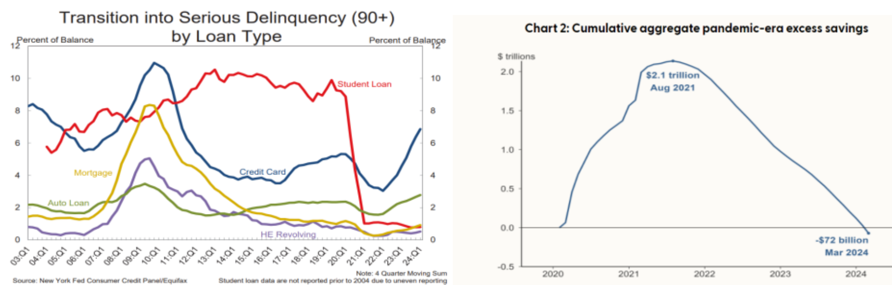
Another sector of the economy that could have an impact on the deficit and has electoral ramifications is **trade**, **globalization** and the use of **tariffs**. To stimulate its economy, China has ramped up and subsidized their manufacturing to export a broad array of goods around the world. China's exports rose in May at the

quickest in more than a year. The problem for China is these exports are beginning to face trade barriers from developed countries seeking to protect their local domestic manufacturers.

Trump has said he would implement higher tariffs, if elected, and will propose 60% tariffs for goods imported from China and 10% on all other imports. Trump recently even suggested he might consider replacing the personal income tax with fees from increased tariffs. Previous tariff increases were completely passed on to consumers and it is questionable the degree to which domestic manufacturing was protected. While Biden has increased tariffs, and there might be further increases in a second term, the increases would not be as large as those Trump has outlined. Tariffs are regressive and fall more heavily on lower income families. Tariffs on China are not meant to raise money for the Federal government but to reduce dependence on a foreign adversary and protect national security. Currently tariffs represent 2% of the value of imports and would skyrocket to 17% if Trump were to carry out his plan. Whereas Biden's latest tariffs would only add 0.2% to the effective tariff rate. It isn't clear what benefit could justify hitting the world with a 10% tariff-especially if the world retaliates. China and the U.S. have extensive economic ties. Sales in China amounted to 7.1% of revenues for the S&P 500 companies. In addition, there are large manufacturing facilities in China that U.S. companies utilize. Even if relations deteriorate further, the two countries have many incentives for pulling back from serious conflict. Globalization and free trade may have peaked and sacrificing some efficiency via tariffs may be necessary. However, taken too far tariffs will result in smaller markets and higher prices.

Fixed Income

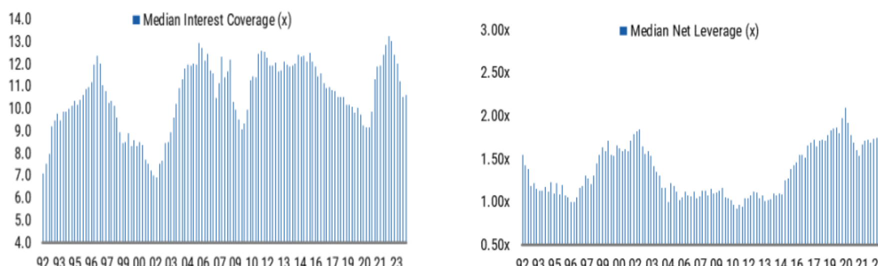
In general, mixed economic news caused interest rates to whipsaw from the start to the end of the quarter, settling at a place that pointed to an economic slowdown by year end. At the beginning of the quarter interest rates continued the backup that started earlier in the year as the financial markets were confronted with strong economic data suggesting that an economic slowdown may be averted, and the Federal Reserve could continue to postpone cutting rates. However, in the latter half of the second quarter the mood began to change as government data gradually took on a more somber tone with unemployment reaching 4% for the first time since January 2022, the consumer price index increasing less dramatically, consumer spending showing signs of weakness with retail sales data below expectations, and consumer delinquencies escalating, particularly in credit card loans whose variable interest rates have become prohibitively high for many households whose post-pandemic savings have been depleted (see charts below).



As a result, the 10-year treasury, which began the quarter at 4.20% and reached a high of 4.70% in April, was back down to 4.39% at the end of June. Likewise, the 2-year treasury went from 4.62% at the end of March to a high of 5.03% and back down to 4.75% at the end of June.

As the economy slows down, so should consumer price increase—an effect the Federal Reserve has been targeting with their current restrictive monetary policy. The effects of the recent slower price increases, or disinflation, have been reflected in the breakeven spreads offered by Treasury Inflation Protected Securities ("TIPS") which have signaled that the rate of future inflation is coming down.

A slowdown has also been brewing in corporate bond fundamentals, which have been weakening for some time. Interest coverage ratios that peaked in 2022, under a low interest rate environment, have been decreasing as the interest rates that corporate borrowers had to pay have increased and remained elevated. Likewise, leverage has remained high, although lower than before the pandemic. We expect that the combination of declining interest coverage with leverage will put pressure on corporate balance sheets.



At the heart of the economy's post-pandemic strength and recent weakness is the consumer, whose purchasing power has weakened for some time as savings have depleted while prices have remained elevated. A decline in purchasing power should eventually trickle down to lower prices, as consumer demand weakens. However, the consumer price index ("CPI") as measured by the Bureau of Labor Statistics ("BLS") has defied expectations by continuing to show a sticky, elevated CPI. The issue here is that the calculations that comprise the CPI are vulnerable to significant lags and therefore may not be representative of actual prices in the marketplace. These lags pose a problem for the Federal Reserve, which has stated that their analysis is "data dependent" and relies on CPI data in monetary policy decisions.

By design, all price information provided by CPI is lagging, but shelter, which is the largest component of CPI, ironically incurs the greatest lags. Shelter comprises 36% of the consumer price index, primarily made up of 8% Rent and 27% Owner Equivalent Rent (OER), which is an implicit rent, obtained through surveys of homeowners who provide a theoretical rental valuation for their homes. Since shelter leases are typically one year in length, the rent is locked in at a rate that may have prevailed a year before the shelter component of CPI is calculated. Therefore, in any given month, only 1/12 of rents are reset (as annual leases expire), even as the surrounding rental market fluctuates. As a result, assuming most leases are one year in length (although some are even longer), BLS shelter data averages a 6-month lag. In comparison to the lagging shelter data produced by BLS for CPI, real-time housing market sources have been indicating that rents are coming down. (See chart below). If real-time data were included in CPI, the resulting inflation indicator would likely tell a different story. However, since the Federal Reserve relies on this lagging indicator for its monetary policy decisions, we must wait for leases to expire and for rents to catch up with other declining CPI components.