Aegon Asset Management

Macro Research
December 2023

AEGON **INSIGHTS**

2024 US Macro Outlook: The (Fed's) tidal shift

The title of our 2024 outlook summarizes the recent pivot in the Federal Reserve's (Fed's) stance toward monetary policy. It has huge implications for the economy going forward, as the Fed's reaction function has shifted from one aimed at quelling outsized inflation to one looking to remove monetary restrictions and avoid recession. The boost to financial conditions should help offset the slowing growth trajectory and, as a result, should help keep the economy from dipping into a recession. Our base case is for sub-trend growth (in other words, a growth recession), as we believe the Fed will be much quicker to ease if the economy starts to wobble. The key will be whether inflation stays tame or not.

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Frank Rybinski, CFA, is head of macro strategy responsible for guiding the firm's global macroeconomic view as it pertains to tactical and strategic asset allocation. This includes analysis of the economy, interest rates, and the relative value between asset classes. In this capacity, Frank frequently appears in leading financial media outlets like Bloomberg, CNBC, Fox Business and the Wall Street Journal. Prior to his current role, Frank was a credit strategist for UBS Investment Bank. Prior to that, he worked as an analyst for ZT Zurich Trust in Zurich, Switzerland. Frank began his career as a trader for Spear, Leeds & Kellogg and held a similar position at The Royal Bank of Scotland. He has been in the industry since 1996 and started with the firm in 2008. Frank received his BA in economics from Boston College. He is a CFA® charterholder.

Aegon Asset Management economic forecasts

	2021	2022	2023e	2024e
GDP (real %, year over year)	5.8	1.9	2.5	0.9
Unemployment (%)	5.4	3.6	3.7	4.3
Core PCE (%, year over year)	3.2	5.2	4.2	2.5
Fed funds-upper bound (%)	0.25	4.50	5.50	4.50
10-year Treasury	1.51	3.88	3.88	4.00

As of December 31, 2023.

Why now?: The recent comments from various Fed officials clearly highlight concerns that the current restrictive level of policy could cause a recession. That was underscored by the November Beige Book which showed half of the 12 Fed districts were reporting economic contraction and that increased financing costs were posing a direct impediment to growth. The Fed does not want those narratives to become endemic to the broader economy, and recent inflation readings give it the necessary cover fire to make such a shift. In essence, the Fed has been singularly focused on fighting inflation for the past two years, but now the dual mandate (price stability and full employment) is coming back into focus.

The puppeteers: It is important to understand the key actors in the policy as it supports the underlying shift. Fed Chair Jerome Powell is a lawyer, not a trained economist. He is much more of a consensus builder within the Federal Open Market Committee (FOMC) than some of his predecessors. In contrast, Alan Greenspan was much more of a monolithic character at the FOMC. It was often his view and then everyone else's in the background. We mention this to emphasize that such a recent tidal shift in messaging from the Fed didn't come on one man's whim, but rather is the consensus thinking of the broader committee.

Rate-cut cavalry is en route: The first half of 2024 is likely to bring below-trend growth, which will continue to exert a disinflationary impulse through the system. It is this consistency of benign inflationary pressures that would give the Fed confidence that its 2% inflation trajectory is sustainable and, as a result, that its restrictive monetary policy can begin to unwind. The risk is that inflation will remain too high or come down too slowly and thus push out the commencement of the easing cycle.

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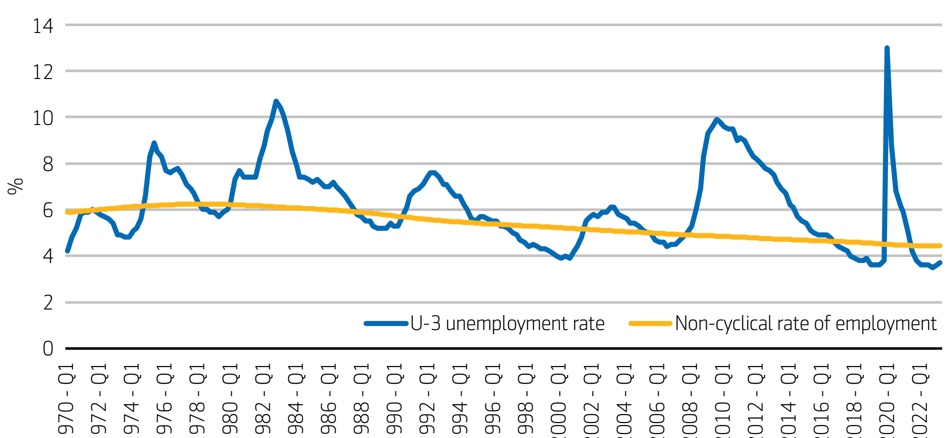
Cycle not going full circle: Typically, a rate-cutting cycle engenders early cycle business activity as the idled capacity that was accumulated during the slowdown is re-engaged. The unemployment rate chart on this page illustrates the oscillating profile of this premise: After a recession, the unemployment rate is typically well above the long-term natural rate. As companies expand and hire more workers, unemployment falls back towards the natural rate. Since the 2024 cycle won't start with an excessive amount of idled labor capacity, it will likely be more analogous to a mid-cycle environment.

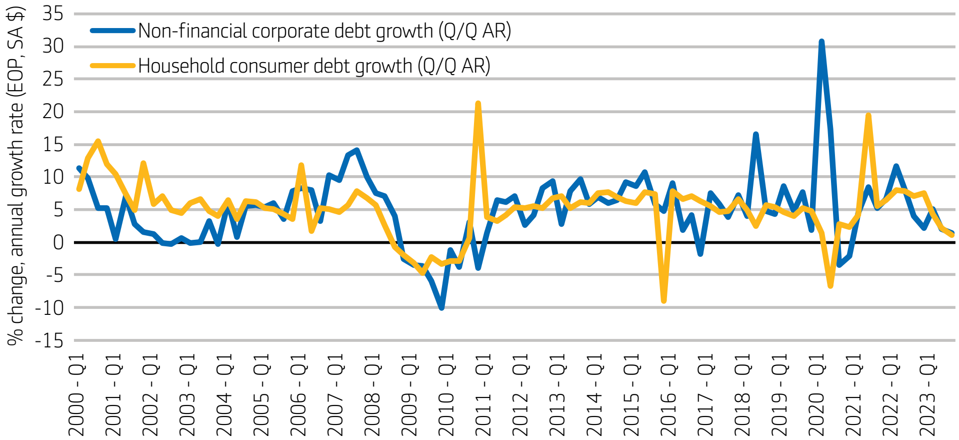
Unemployment rate



Sources: Bureau of Labor Statistics, Congressional Budget Office, Haver Analytics. As of December 2023.

Why sub-trend growth in 2024?: Because tight monetary policy is acting as it should. High policy rates have increased the funding costs for business and consumers alike and—on cue—debt growth for these two cohorts is slowing. The ease in financial conditions post the FOMC shift will definitely soften this downward pressure. But a more substantial move lower in real funding costs is needed to really put a strong wind to the economy's sails.

Corporate and consumer debt growth



Sources: Federal Reserve Board, Haver Analytics. As of December 2023.

Gaming the Fed's path: We forecast the Fed will reduce rates four times in 2024, starting at the July FOMC meeting and cutting each successive meeting through year end. Should developments on the inflation front be even more benign, then we can see a scenario where the Fed starts cutting in June. Such a move would bring the total cuts to five for 2024. The market currently is pricing March as the start date for cuts. We see this as very optimistic and it would likely require a precipitous economic decline in order to unfold.

Summing it up: Given how we see the macro backdrop evolving, we believe that policy rates have peaked and that a rate-cutting regime will be upon us in 2024. This pivot in the Fed's messaging has already boosted the rates market, as yields have rapidly declined as the market looks to game the timing of the coming rate cuts.

In real terms, the rate reset of the past few years has made the fixed income asset class more attractive, especially with real rates increasing as central banks get inflation back under control. Cash proxies like Treasury bills have offered attractive defensive returns with minimal credit risk while the Fed was on a one-way hiking path, destination unknown. However, as the risk of higher rates from here has all but diminished the conversation can pivot to one of duration preferences and risk appetites.

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2024 Economic outlook deep dive: Below we highlight some of the key economic drivers that shape the macro landscape in 2024.

Broad data summations like the Conference Board's leading economic indicators have rolled over and point to significant downside risks going forward. That jives with the recent trends upstream in the value chain as both regional Fed surveys and the national level ISM manufacturing index have displayed a slowdown in both backlogs and new orders—a sign that demand is softening.

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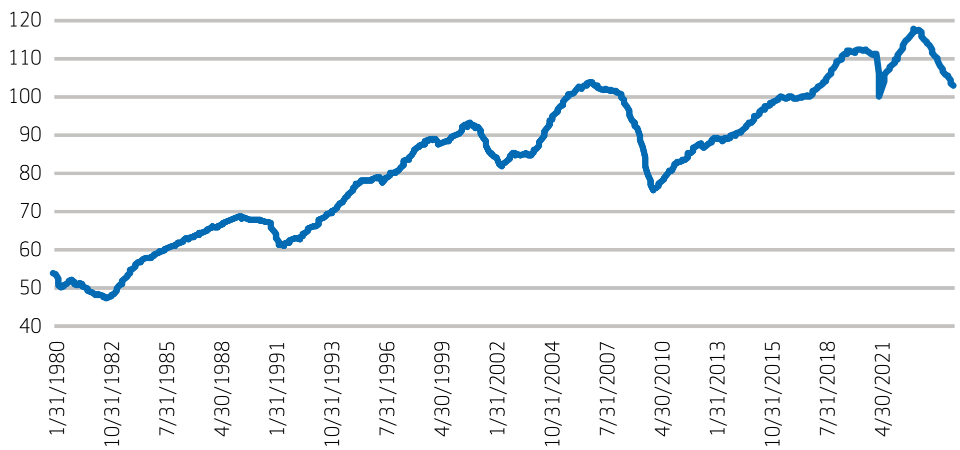
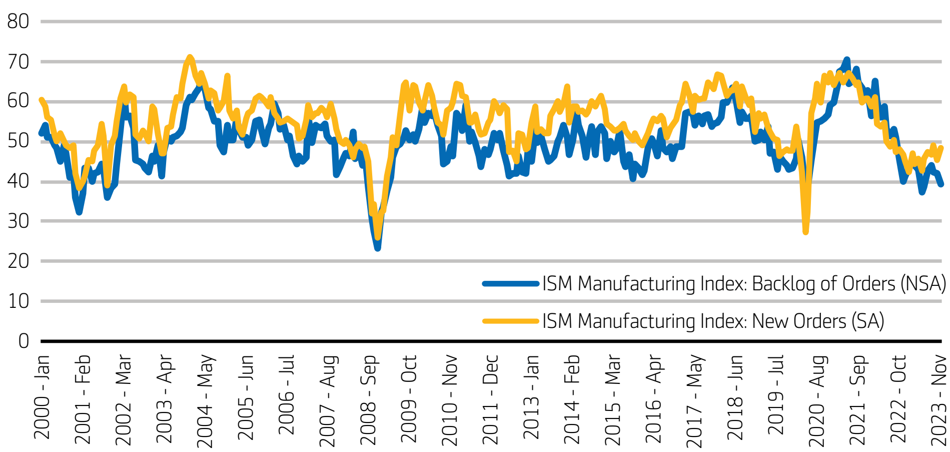
Leading Economic Index



Sources: Conference Board, Bloomberg, As of December 2023.

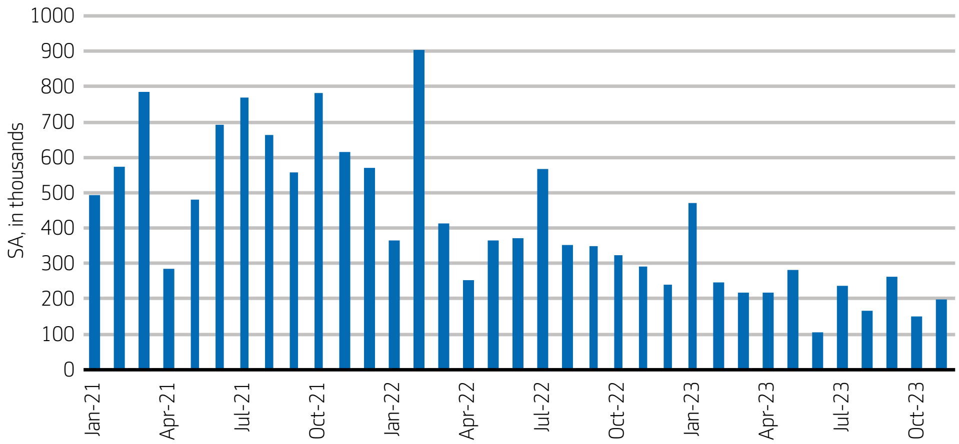
Institute for Supply Management (ISM) Manufacturing Index



Sources: Institute for Supply Management, Haver Analytics. As of December 2023.

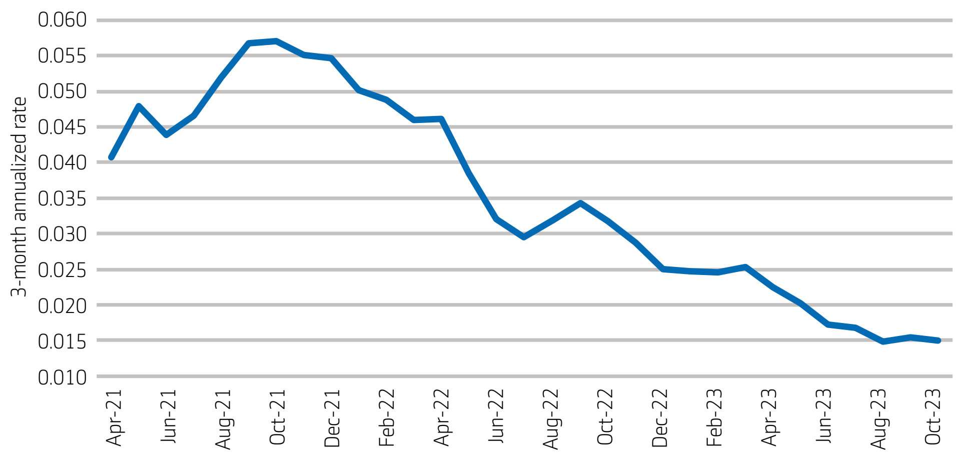
We believe the key determinate of the ultimate fate of the economy will be the labor market. While the labor market is clearly slowing, it has not been to the degree that we originally thought. If the pace of the slowdown in labor continues and/or accelerates, it will likely stem from a broad permeation of the notable shift in employer attitude first cited in the November Beige Book where companies "felt comfortable letting go of low performers." This marks a noticeable shift from the labor-hoarding mentality earlier in the cycle.

Monthly private payroll growth



Sources: Bureau of Labor Statistics, Haver Analytics. As of December 2023.

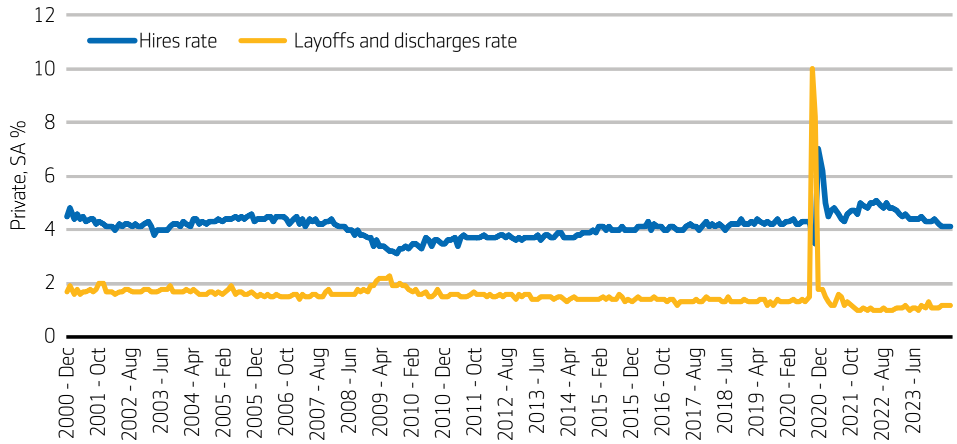
Payroll growth – 3-month annualized rate



Sources: Bureau of Labor Statistics, Haver Analytics. As of December 2023.

When we analyze the labor churn (JOLTS data) what we see is that the rate of hiring has actually moderated considerably and is now consistent with the average of the last cycle pre-Covid-19. What has not normalized as much is the rate of firing, which is still below pre-Covid-19 levels. In essence, firms aren't hiring that much compared to a year or two ago, but they aren't firing either. Thus, if the layoff rate begins to increase it could push the net payroll gains down substantially without any change in the rate of hiring.

Job openings and labor turnover survey (JOLTS)



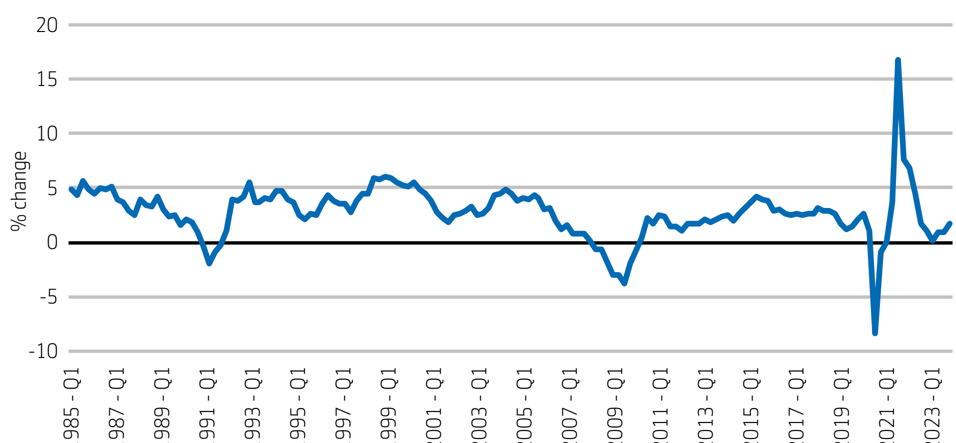
Sources: Bureau of Labor Statistics, Haver Analytics. As of December 2023.

The consumer has continued to spend during the expansion, benefiting from tight labor markets, cheap credit and excess savings built up during the pandemic.

Consumer trends: The consumer has continued to spend during the expansion, benefiting from tight labor markets, cheap credit and excess savings built up during the pandemic. However, the gains from the latter two drivers have largely dried up, which has increased the importance of real wage growth as the primary driver of spending going forward.

When we analyze the consumer, we like to combine the consumption of goods and services with housing—in essense, looking at all elements that capture the consumer's wallet. What we have seen is that the robust consumption of goods and services has been "subsidized" to a degree by a lack of spending on housing (residential investment spend in real terms has fallen back to 2016 levels).

Total consumer (consumption + house), year-over-year % change

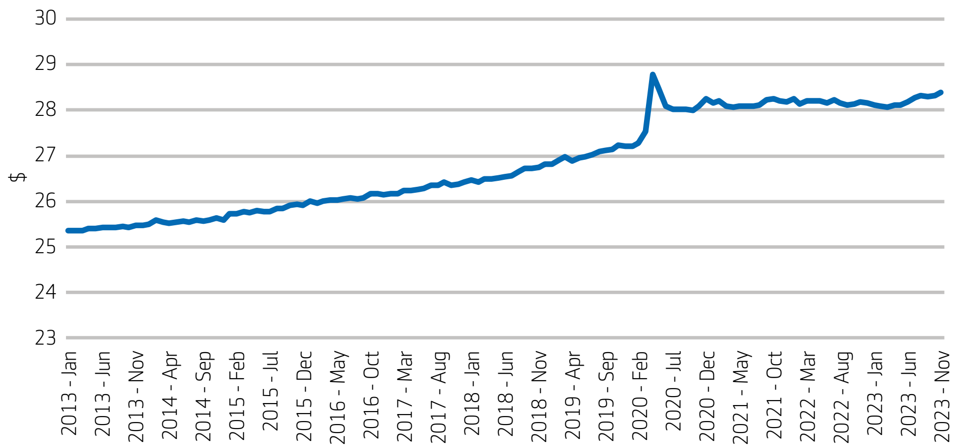


Source: Haver Analytics. As of December 2023.

Going forward, we are concerned about a pullback by the consumer due to the lack of growth in real spending power (nominal gains are roughly keeping pace with inflation), combined with more of their spending power going to service non-mortgage interest.

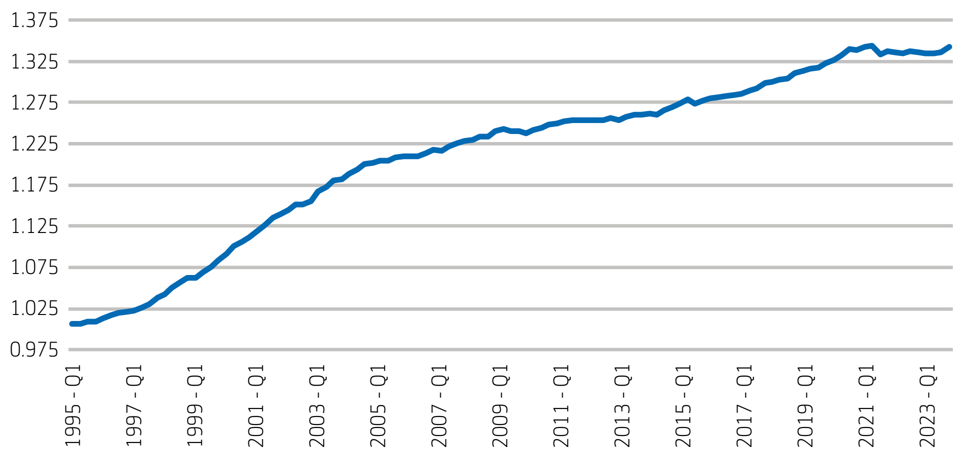
Asset Management

Private AHE: Deflated by core PCE



Source: Havre Analytics. As of December 2023.

Real ECI: Private workers

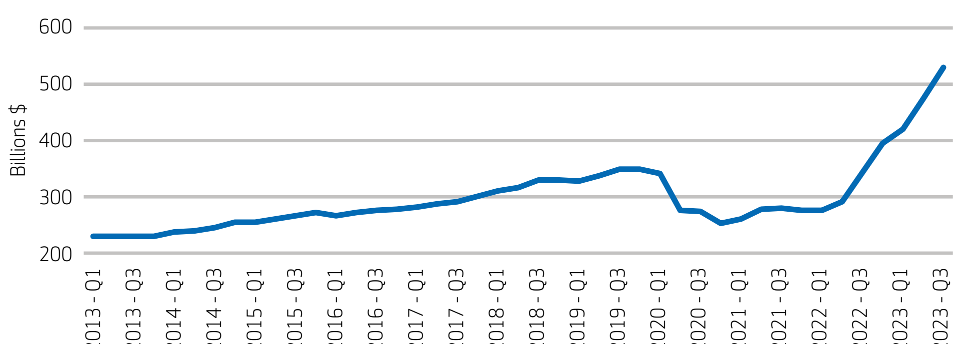


Source: Haver Analytics. As of December 2023.

The surge in non-mortgage interest payments is a huge tax on the consumer that bites into their real spending power.

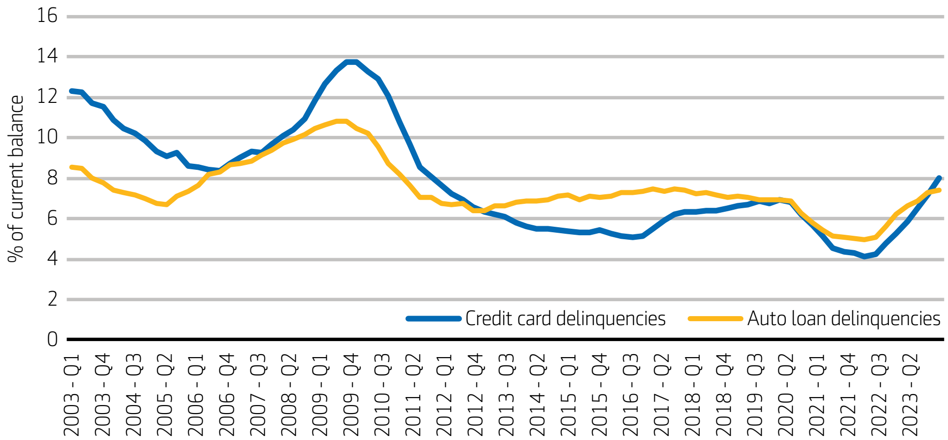
The surge in non-mortgage interest payments is a huge tax on the consumer that bites into their real spending power. It has almost doubled in a mere six quarters as consumer rates have climbed. And it is not surprising that credit delinquencies are rising.

Personal interest payments (non-mortgage), seasonally adjusted annual rate



Sources: Bureau of Economic Analysis, Haver Analytics. As of December 2023.

New York Credit Panel
New delinquent credit card and auto loan delinquencies

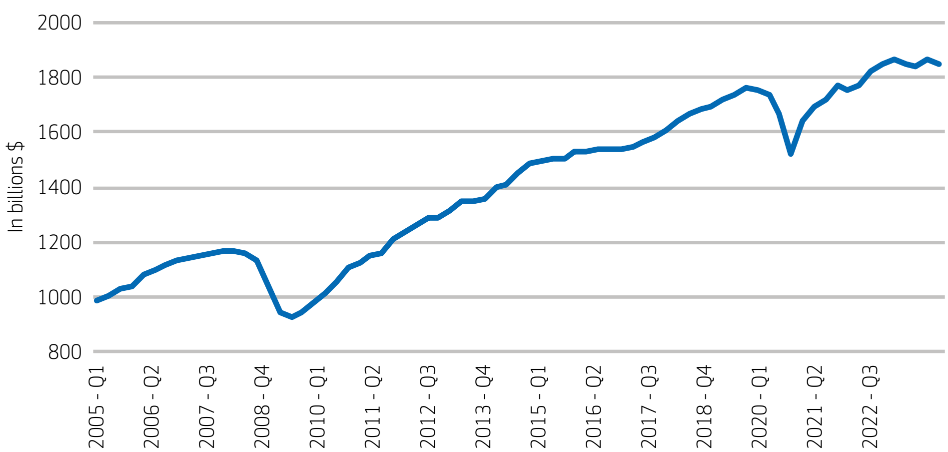


Sources: Federal Reserve Bank of New York Consumer Credit Panel, Equifax, Haver Analytics. As of December 2023.

The corporate side of spending is also showing signs of stress.

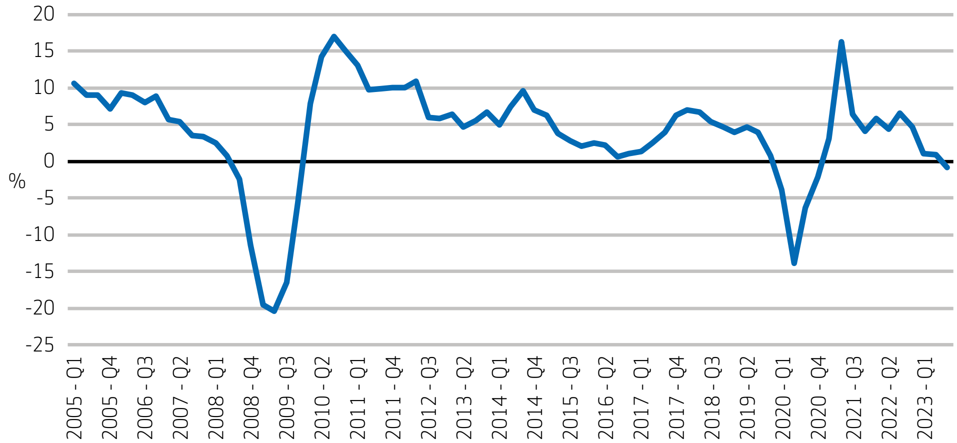
Capex cycle: The corporate side of spending is also showing signs of stress. Corporate spending on equipment and R&D is a gauge we use to see how much companies are investing in their growth. Together they account for more than half of overall capex spending. To that degree, companies' capex spending plateaued in 2023 and would likely need an acceleration in overall growth in order to warrant a better outlook. Interestingly, this slowdown is occurring a little early this cycle. It typically occurs during a recession as managers respond to profit pressures.

Capex: Equipment and R&D



Source: Haver Analytics. As of December 2023.

Capex: Equipment and R&D: Year-over-year change



Source: Haver Analytics. As of December 2023.

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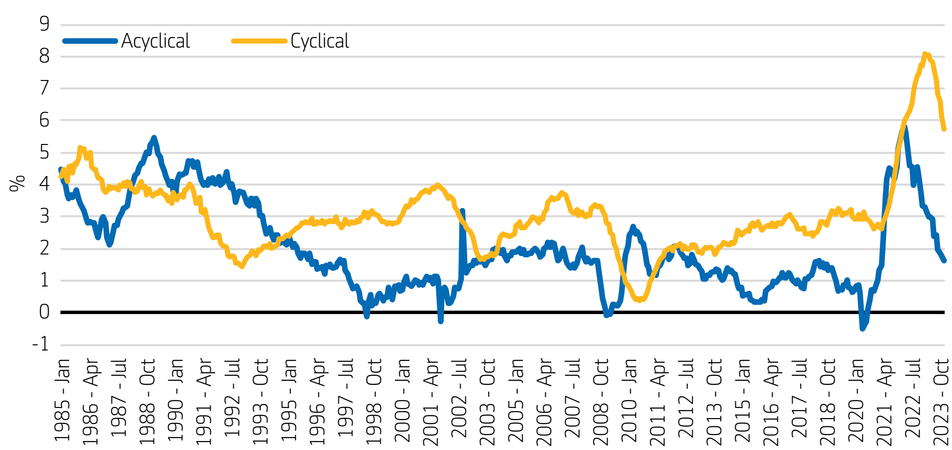
Inflation: The reason slowing aggregate demand is important is because it is arguably the key to slowing inflation to palatable levels. The San Francisco Federal Reserve breaks the core PCE into components that are cyclical (i.e., sensitive to aggregate demand forces) and acyclical (i.e., more industry specific). The acyclical side captured much of the supply chain issues due to Covid-19 and has largely normalized in tandem with supply chains. A continued moderation in aggregate demand will likely be required in order to reign in the cyclical side of inflation..

Cyclical and acyclical core PCE inflation, year-over-year % change



Source: Federal Reserve Bank of San Francisco, Haver Analytics. Data as of December 2023.

Inflation: Slice & dice

	% of Index	Month-over-month change	Month-over-month annualized rate	3-month annualized rate	6-month annualized rate	Year-over-year change
CPI-U	100%	0.10%	1.20%	3.80%	3.20%	3.10%
CPI-U: Core	80%	0.28%	3.50%	3.30%	3.70%	4.00%
CPI-U: Core, ex-Shelter	45%	0.16%	1.90%	1.50%	2.10%	2.10%
CPI-U: Core, ex-Shelter & Used Autos	42%	0.07%	0.90%	2.60%	2.10%	2.60%
CPI-U: Services, ex-Shelter	28%	0.44%	5.40%	4.90%	3.20%	3.90%
Cleveland Fed Trimmed Mean CPI	84%	0.27%	3.30%	3.70%	3.40%	4.00%
Cleveland Fed Median CPI	-	0.43%	5.30%	4.50%	4.60%	5.20%
PCE	100%	-0.07%	-0.90%	2.70%	2.50%	2.60%
PCE - Core	88%	0.06%	0.70%	2.20%	2.80%	3.20%
PCE - Core Services, ex-Housing	-	0.12%	1.50%	3.00%	3.20%	3.50%
Dallas Fed Trimmed Mean PCE	45%	0.13%	1.50%	2.80%	3.20%	3.40%
Cleveland Fed Median PCE	-	0.20%	2.40%	3.50%	3.50%	3.90%
San Fran Fed - Cyclical PCE Inflation	-	0.35%	4.30%	4.90%	5.30%	5.70%
San Fran Fed - Acyclical PCE Inflation	-	-0.12%	-1.50%	0.70%	1.30%	1.60%

Source: Haver Analytics. As of December 2023.

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