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PORTFOLIO ANALYSIS & CONSULTING

Charts and Smarts®

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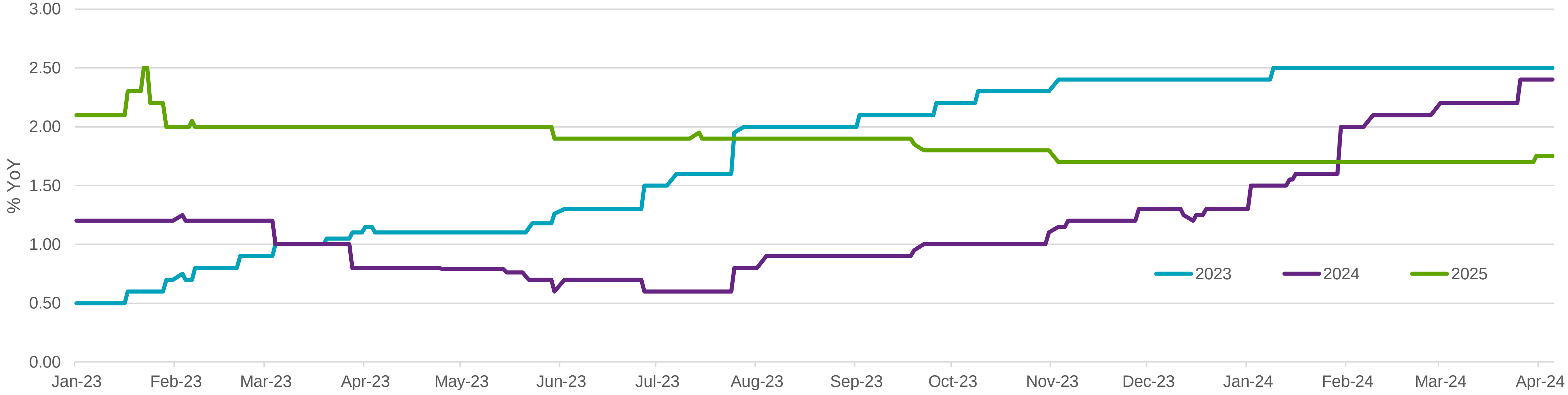
Blow Out

Consensus GDP Growth Estimates (5/31/23–4/29/24)

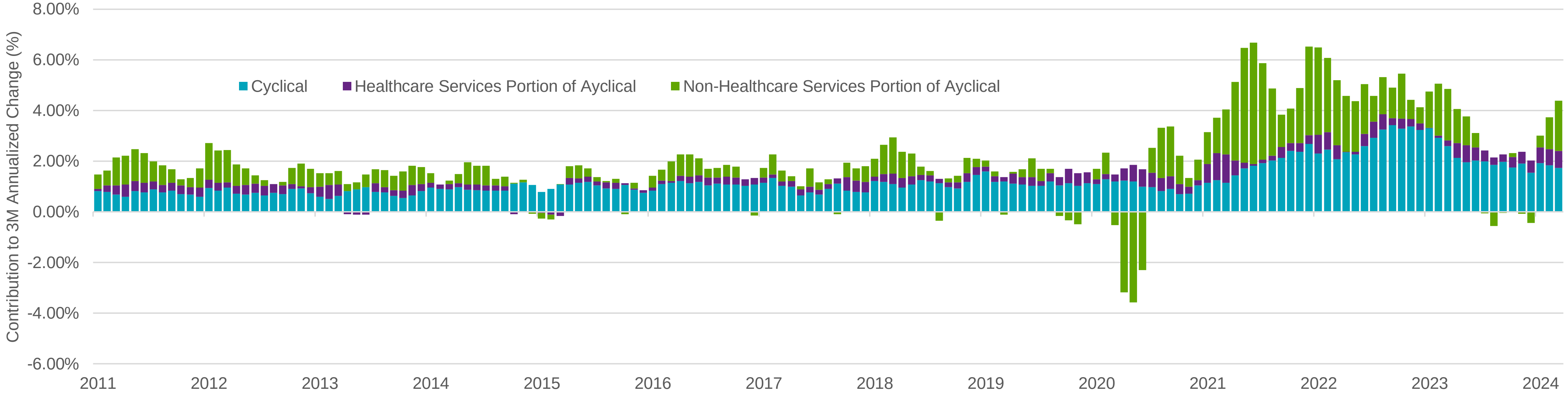


For what feels like years now, we've been arguing that growth prospects have been underappreciated by the consensus. We entered last year discussing the factors that were likely to support growth as we pushed through 2023: Fading fiscal drag, housing stabilizing, auto production inflecting higher, and a nascent capex cycle all helping to drive a recovery in growth, and a shift in the composition of growth from price to quantity. Despite the stronger data, recession calls continued to persist for much of last year as consensus continued to fear a looming recession and expected tepid growth to be the story of 2024. Since late last year, we have argued that recession calls would need to be finally written off, as growth expectations would need to be revised up markedly. Fast forward a few months, and that process has been precisely what we've seen play out in markets. At long last, the consensus has caught on to the fact that growth is likely to remain robust through 2024, and expectations that began the year at just over 1% real GDP growth for full year 2024 have now jumped all the way up to 2.4%. As we've highlighted in prior months, that shift in expectations has been a driving force behind the repricing witnessed in rates markets, but with consensus having caught up with reality, much of the juice has already been squeezed from that catalyst. Narratives of reaccelerating growth have given way to what looks to be strong, but stable growth for the balance of the year. While market participants continue to extrapolate strong growth into firmer inflation – an exercise that has proven risky given the disinflationary growth backdrop we've enjoyed for the past year – it appears that the growth impulse, with respect to rates, may have largely run its course. From here, growth risks are more balanced and evidence is mounting that that we've overshot in our inflationary pessimism. That suggests this redux of the third quarter rates selloff has likely reached its peak, and as the narrative pendulum swings back toward a soft landing view, yields are likely to settle down as well.

Source: Portfolio Analysis & Consulting, Bloomberg.

Prove Yourself

Cyclical vs Acyclical Inflation (1/31/11–3/31/24)

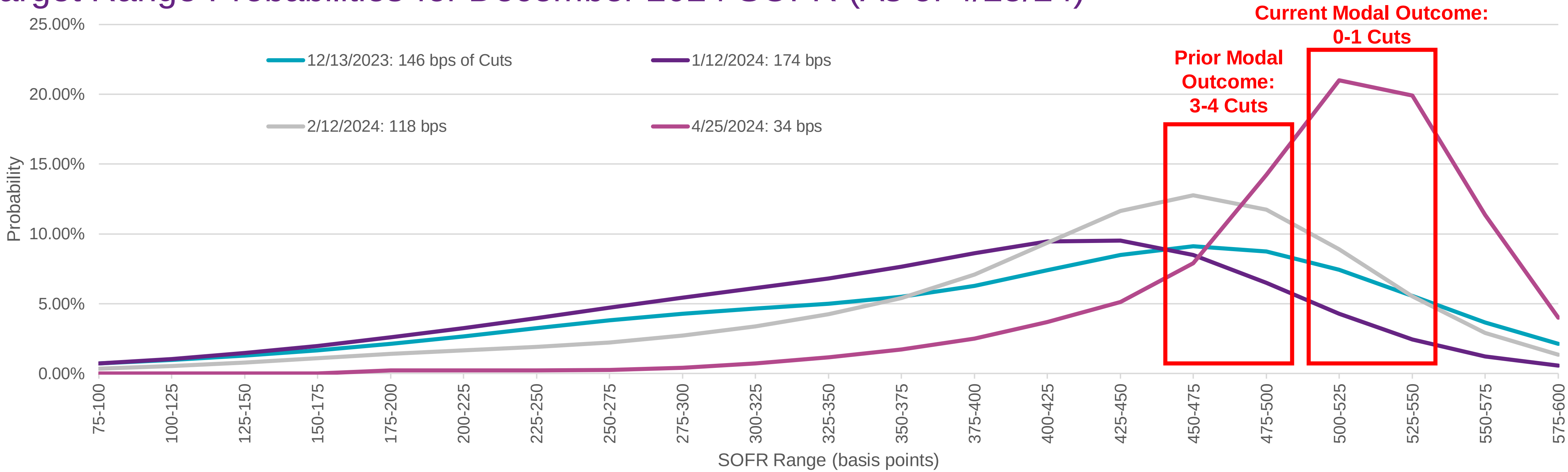


Speaking of the surge in inflation pessimism, much of the blame for the disappointing string of prints to begin the year seems to lie on the stronger-than-expected growth backdrop and the easing of financial conditions we've witnessed since the so called "Fed pivot" back in December. But, we highlight two dynamics with respect to this perception. First, the "pivot" wasn't one from the Fed, but rather from the market. The Fed's outlook and messaging has been relatively consistent and unchanged for months. Rather, it's been the market, which has a far more sensitive reaction function than the Fed, which has been pivoting from dovish to hawkish extremes, and back again. Second, if stronger growth and easier financial conditions have truly been the culprit behind the firmer inflation prints we've seen to start the year, shouldn't cyclical components of the inflation basket be driving the bulk of that firming? Decomposing the PCE basket, however, shows the exact opposite. After a modest bounce in January, the contribution to core PCE from cyclical components, those line items sensitive to the economic cycle and unemployment gap, have actually declined, while the bulk of the acceleration in 3-month annualized inflation has been driven by non-healthcare services' acyclical components. In other words, components that are more sensitive to industry-specific idiosyncratic factors have been driving the firmer inflation prints we've seen in 2024. This suggests that growth is not the underlying factor behind the unexpected reversal in the disinflationary process. Growth is not the Fed's enemy, and these dynamics further suggest that the market is likely extrapolating inflationary trends that may not continue given the disinflation that remains in the pipeline. Growth expectations that now accurately reflect trend growth and inflation expectations that have likely overshot to the upside, sets up a favorable skew for potential downside surprises for upcoming inflation prints which, should further put to rest inflation and rate fears that have reemerged in the narrative.

Source: Portfolio Analysis & Consulting, Federal Reserve Bank of San Francisco.

Karma Police

Target Range Probabilities for December 2024 SOFR (As of 4/25/24)

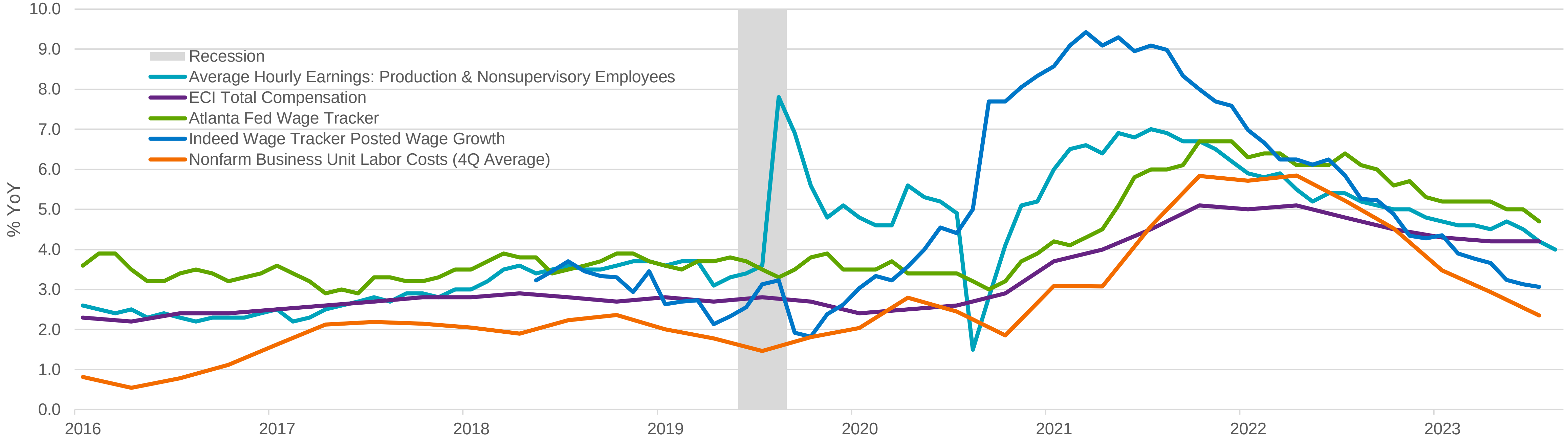


Putting the fundamentals together with market pricing for policy expectations further suggests the narrative has reached a breaking point. Recent inflation data certainly hasn't increased the Fed's confidence in returning to 2% to the extent that they're willing to begin easing, but the bar for the Fed to abandon its easing bias is much higher than the plateauing and pause in the disinflationary process we've seen so far; a theme driven home by Powell's comments at the May FOMC meeting. And so higher for longer continues. As always, the Fed stands ready to do whatever is necessary as the data dictates, but the next move remains a cut. Yes, hikes remain part of the distribution of outcomes, but that tail is far smaller than the market is already pricing and is conditional on far more of a deterioration in the data than we've seen to date. Pricing out cuts is one thing. Flipping to hikes is entirely another. With the modal outcome of market pricing suggesting just 0 to 1 cuts for the year and the right tail of incremental hikes rising up to over 15% entering the May meeting, it appears we've likely gone far enough to overshoot on rate pricing given that the data is unlikely to change the Fed's reaction function and easing bias. As the market has finally converged to reality on growth expectations and the risk for downside surprises on inflation prints growing in the months ahead, the fuel for higher yields is quickly running out. The narrative pendulum looks ready to come swinging back.

Source: Portfolio Analysis & Consulting, Federal Reserve Bank of Atlanta.

The Bends

Measures of Wage Growth (3/31/01–3/31/24)

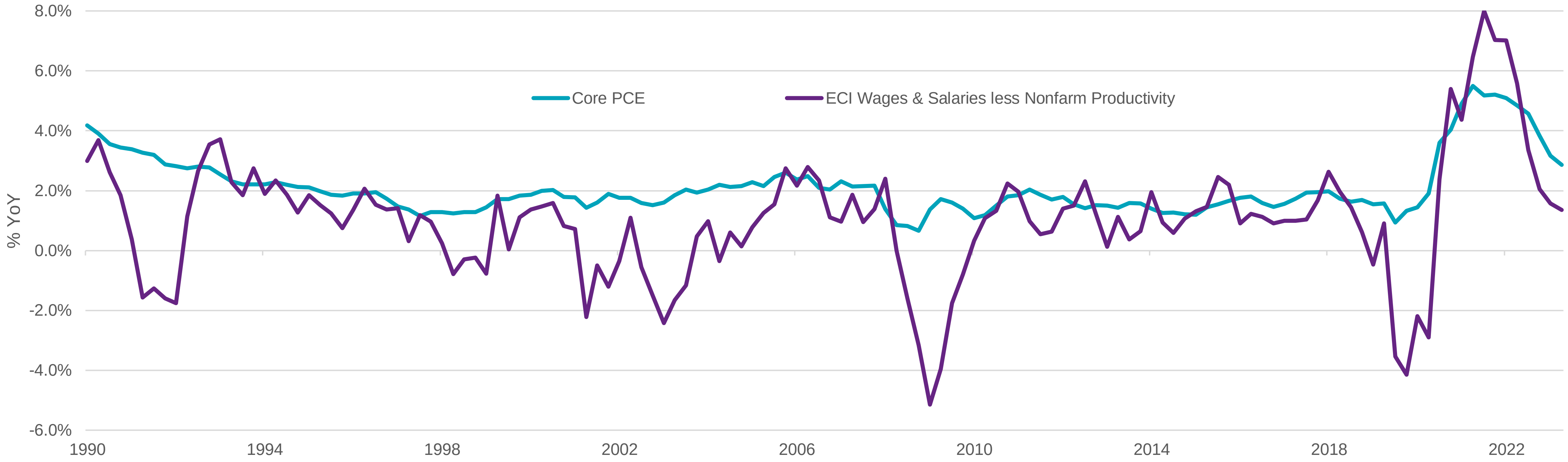


One of the biggest shifts from last year has been the status of the labor market moving from an inflationary driver to a disinflationary force. Labor supply and demand has come back into balance, churn has slowed, and wages have cooled. Almost anywhere you look, the trend is clear: easing labor market tightness translating to slowing nominal wage growth. The lone outlier in that trend was the most recent print for the Employment Cost Index (ECI), the Fed's preferred gauge of wage growth. The measure, which avoids the compositional distortions that affect other measures, seemingly threw a wrench into that disinflationary narrative as it marked it's fastest gain since Q1 2023. But it wasn't all bad. Within the ECI, the Fed focuses specifically on private wages and salaries excluding incentive pay occupations, and while the quarterly pace was indeed warmer than expected, it remains in a downtrend, with the non-seasonally adjusted series showing a sequentially lower seasonal peak for the typical Q1 surge. One print does not make a trend, and a single measure doesn't change the narrative when the body of evidence continues to clearly point to strong, but slowly easing, labor market that is no longer providing an inflationary impulse. Both the Fed and the data have been clear: strong growth and healthy labor markets in and of themselves aren't inherently inflationary. While some may be tempted to extrapolate strong economic data into an inflationary outlook, the best measure of inflation is inflation itself. While the first quarter certainly surprised many in the wrong direction, the disinflationary process is still very much alive, and easing labor markets remain a disinflationary driver.

Source: Portfolio Analysis & Consulting, Bloomberg.

Paranoid Android

Inflation = Compensation – Productivity (12/31/90–3/31/24)



While wages look to have further cooling in store in the quarters ahead, we very well may already be at levels of wage growth consistent with the Fed's 2% inflation target. We have been outspoken in our calls that productivity growth appears to have shifted into a higher regime. With the usual caveats that productivity is notoriously hard to measure, subject to material revisions, and a final verdict on the trend level of productivity growth will be unknown for at least a few years, it does appear that we have seen a sustained shift higher in productivity growth. Recall the identity we have harped on over the past year: inflation = compensation – productivity. Productivity is a powerful buffer to stronger compensation, and over the past year, productivity has grown nearly 3%. While the recent pace is likely overstating sustainable productivity growth to a degree, even a new trend closer to 2% to 2.5% would represent a material shift higher from the pre-pandemic trend of 1.5%. Do the math: Wage growth at 4.5% less 2.5% productivity gets you right back to the Fed's 2% inflation target. It may be too early to say that we've durably shifted to a 2.5% trend productivity growth environment, but a strong and maturing labor market handing off to the capital deepening of an emerging capex cycle is certainly cause for optimism. And if that trend shift proves to be sustainable, wages don't need to cool all the way back to pre-COVID levels to be consistent with the Fed's inflation target. We may already be there.

Source: Portfolio Analysis & Consulting, Bloomberg.

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