Northmarq

VIEWPOINT

SPECIAL MID-QUARTER EDITION

Economic Commentary:

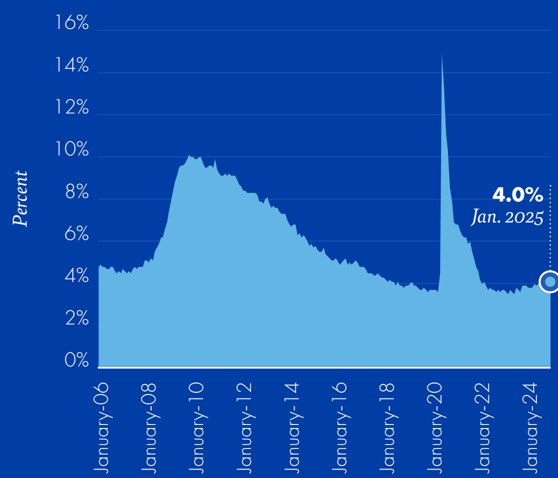
Understanding the Forces Shaping the Economy in Early 2025

February 2025

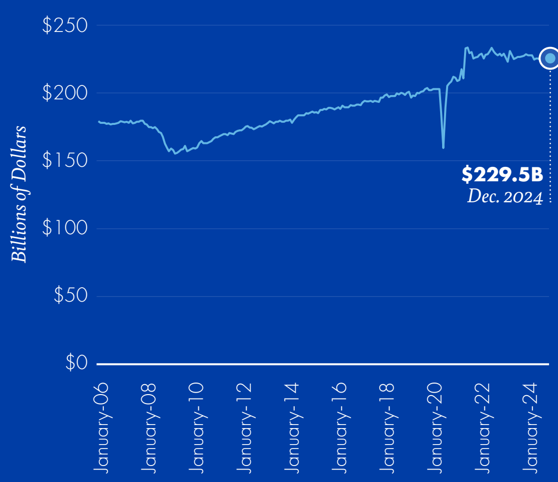
VIEWPOINT

GROSS DOMESTIC PRODUCT (GDP)

UNEMPLOYMENT RATE



RETAIL / FOOD SERVICE SALES



Source: Northmarq, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, U.S. Bureau of the Census

February 2025

Economic data for the year end of 2024 and the first few weeks of 2025 have generally been healthy. Unfortunately, these trends cannot be reliably extrapolated into the remainder of the year as many economic policies are changing. There are concerns about the impact to inflation and economic growth from some of the new administration's policies, and monetary policy is still in a restrictive mode, even if it is less restrictive than six months ago. A generous fiscal policy has been a major support for the U.S. economy the last few years, but the continuance of that governmental largesse is being called into question as the cost of our growing debt is becoming more expensive.

Inflation

The pause in improvement for year-over-year inflation measures continued in December. The headline Consumer Price Index (CPI) was up 0.4% with nearly half of the increase due to the biggest increase in energy prices since August 2023. That brought the year-over-year reading to 2.9%, up from 2.7% in November. Stripping out food and energy, the Core CPI was up 0.2% (the smallest increase since July) enabling the year-over-year figure to decrease to 3.2% from 3.3% in November.

The Core Personal Consumption Expenditure Index (Core PCE) for December came in at 0.2%, matching expectations, and keeping the year-over-year reading at 2.8%. This is the inflation measure that the Fed focuses on. The six-month trend is running at 2.3% annualized, and the three-month trend is 2.2% annualized. Inflation remains above the 2.0% target set by the Fed, but the overall trend is heading in the right direction.

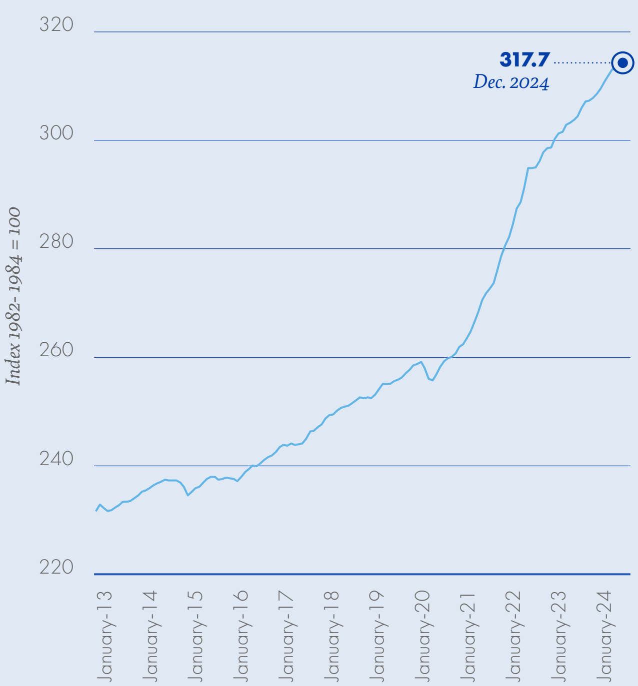
GDP, Consumer Spending & Lending

The first estimate of real GDP in fourth quarter 2024 showed the economy growing at a 2.3% annualized rate, down from the 3.1% reading for third quarter 2024. Real GDP in fourth quarter was supported by the strongest consumer spending since first quarter 2023 at +4.2% annualized. Government spending also provided support during the quarter and helped to offset the fact that investment contracted at a 5.6% annualized rate, largely due to the weakest spending on equipment since third quarter 2021.

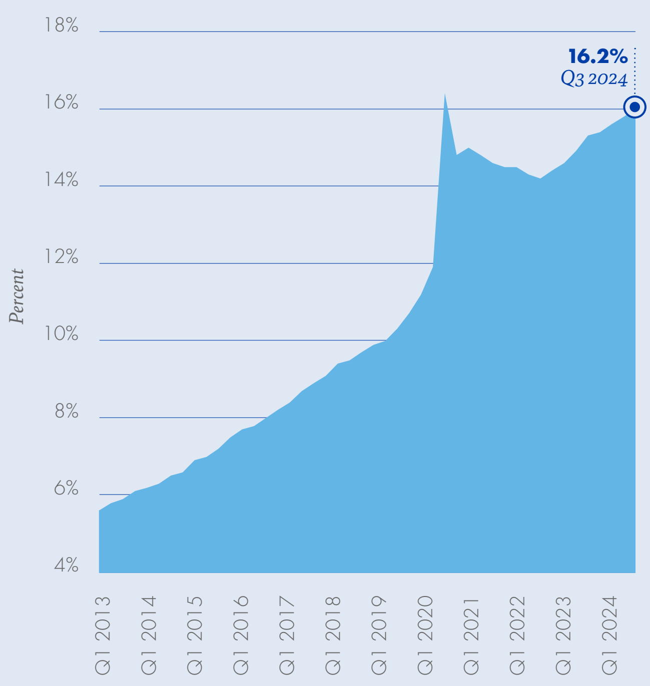
On a year-over-year basis, real consumer spending is growing 3.1%, but real disposable personal income is only growing at a 2.4% rate through December. On a monthly basis, real spending was greater than real disposable income in 10 out of the 12 months during 2024. Since savings necessarily make up the shortfall between spending and income, the personal saving rate fell from 5.5% in January 2024 to a two-year low of 3.8% in December. High-income households are the primary drivers of spending as they are the main beneficiaries of low unemployment, appreciating housing prices and the advancing stock market. Changes in any of these three supports would likely change the spending patterns of high-income households.

The January Senior Loan Officer Survey showed that the net percentage of banks are still tightening lending standards on Commercial and Industrial (C&I) loans, although that percentage is declining. Accordingly, there has been some small improvement in C&I volumes, but they remain subdued. Most of the improvement in C&I loan demand has come from large companies who generally have stronger balance sheets, as opposed to smaller companies. Regarding commercial real estate (CRE) loans, while lending standards remain tight, the net percentage of banks tightening lending standards for CRE loans fell to the lowest level since 2022 when the Fed started raising interest rates. Demand for CRE loans has consequently started to improve but will likely need further easing in interest rates to accelerate the recovery in this area.

CONSUMER PRICE INDEX (CPI)



E-COMMERCE RETAIL SALES (% OF TOTAL SALES)



Source: Northmarq, U.S. Bureau of Labor Statistics, U.S. Bureau of the Census

Manufacturing & Employment

The ISM Manufacturing index for January signaled expansion in the manufacturing sector for the first time since October 2022 with a reading of 50.9. The possibility of upcoming tariffs caused new orders, production and employment to increase. Out of the 18 manufacturing industries, eight reported growth in January, eight reported contraction and two reported no change. It remains to be seen if this momentum in manufacturing will persist now that tariffs are being implemented.

The January Employment report showed that non-farm payrolls increased 143,000 during the month, below expectations of a 175,000 increase. The previous two months, however, were revised up by 100,000, bringing the three-month average of payroll growth to the strongest level since March 2023. The unemployment rate declined to 4.0% in January, the lowest level since May 2024, as the number of unemployed fell by 37,000.

Average hourly earnings increased 0.5% in the month and 4.1% year-over-year, more than expected, but the average work week declined to 34.1 hours, the lowest level since March 2020. Combining the number employed with the hours worked results in the aggregate hours worked – that number contracted 0.2% in January which followed a 0.1% decrease in December. There was also an increase of 119,000 in the number of people working part-time, and the number of workers holding multiple jobs increased by 286,000, the largest increase in this metric since December 2022.

Taking a step back to look at the labor market for the year 2024, the Job Openings and Labor Turnover Survey (JOLTS) showed that job openings were down 14.5%, hirings were down 5.6% and quits were down 7.0%. The demand for labor has come off the boil, and employees recognize this as shown by the reduction in quits during 2024.

The preliminary report on fourth quarter 2024 productivity showed that productivity eased to a 1.2% annualized rate from the 2.3% rate in third quarter 2024. It is running 1.6% year-over-year. Unit labor costs increased at a 3.0% annualized rate in fourth quarter 2024. Together, these measures suggest that wage growth is in a range consistent with 2.0% inflation and are supportive of the Fed's current view that the labor market and wage growth are not a source of inflationary pressures.

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The Fed

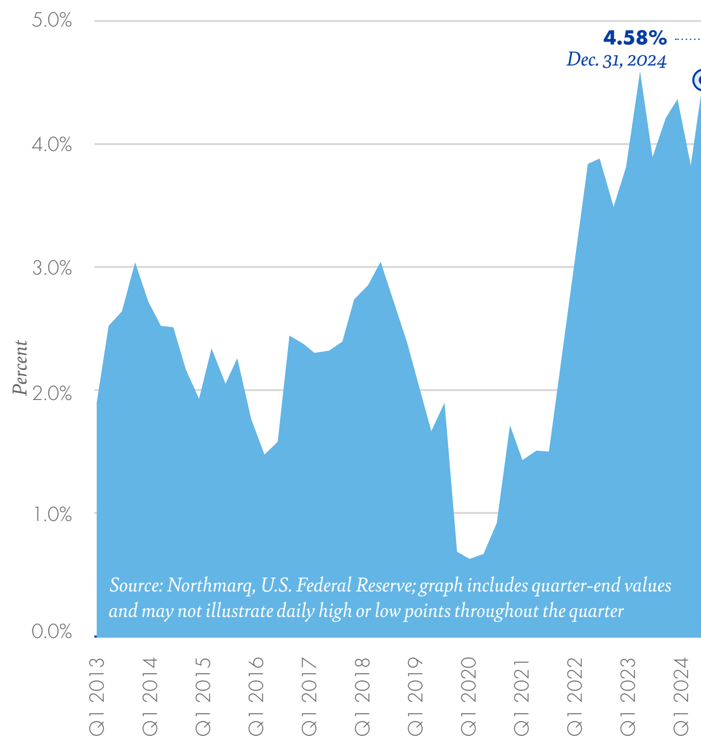
At the January 28-29 meeting of the Federal Open Market Committee (FOMC), the target range for the Fed Funds rate was held unchanged at 4.25% to 4.50%. Chair Powell made clear that Fed policymakers are in no rush to reduce interest rates further. He emphasized that policymakers are looking for more progress on inflation cooling toward the Fed's 2.0% goal, while recognizing that the current level of Fed Funds is having a restraining effect on the economy.

The Fed sees the labor market cooling, but not collapsing. This enables them to feel comfortable in pausing the rate cutting cycle as they await further progress on inflation. This also provides time for them to evaluate the policies of the new administration and their ramifications on inflation. The big question for the Fed regarding the new policies, particularly tariffs, is whether they will cause inflation to re-accelerate, or whether they will cause the economy to slow to a degree that will require more aggressive interest rate cuts.

Markets are pricing in only one interest rate cut in 2025, and that is expected to occur in late summer or early fall. Perhaps reflecting more concern that tariffs will cause economic activity to slow rather than increase inflationary pressures, the 10-year Treasury bond yield has fallen 30 basis points since mid-January and is back to the 4.50% level.

"Uncertain" is the most used adjective in describing the economic outlook for the coming year. This is causing the Fed to be particularly deliberate in their implementation of monetary policy, and that is likely to result in less interest rate relief until that uncertainty is resolved.

10-YEAR TREASURY RATE



Source: Northmarq, U.S. Federal Reserve; graph includes quarter-end values and may not illustrate daily high or low points throughout the quarter

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