VIEWPOINT

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Economic Commentary:

How Potential Policies of the New Administration are Creating Murky Economic Conditions

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Uncertainty about the implementation and impact of policies from the new administration is having multiple effects on everything from corporate purchasing and investment decisions to inflation expectations and resulting monetary policy. Nevertheless, current data continue to show that the economy is growing, inflation is moderating and the labor market is cooling. Planning for the coming 12 months, however, has become very challenging.

Inflation Trends

The decline in year-over-year inflation has paused, but the Fed feels that the trend is still moving in the direction of their 2.0% target – just at a slower pace than they had anticipated. Both the Consumer Price Index (CPI) and the Core CPI advanced 0.3% in November, bringing the year-over-year figures to 2.7% and 3.3% respectively. The sticky shelter component of the CPI has started to cool and is expected to exert downward pressure on the monthly CPI during 2025 as current data on rents are flat to down.

Importantly, the Fed's preferred measure of inflation, the Core Personal Consumption Expenditure Index (PCE) recorded its smallest gain in six months during November – an increase of 0.11%. That followed the two above target gains of 0.25% in September and October. The year-over-year reading of the Core PCE has ticked up to 2.8% from 2.7% in October, but that was due to the very weak readings in prices a year earlier.

GDP & Consumer Spending

The final reading on third quarter 2024 real GDP was 3.1% annualized, up from the previous estimate of 2.8%. Real consumer spending was the driving force, accounting for 80% of the 3.1% gain. Fourth quarter 2024 real GDP growth is expected to be a bit slower at 2.3%, but risks to that forecast are to the upside based upon recent data for December. Looking forward, uncertainties around the policies of the incoming administration cause the consensus expectations to assume a neutral growth rate of 2.0% for now.

Consumer spending remains strong although bifurcated. Stock market strength, improving housing prices and the strong labor market are primarily benefiting the upper income households. This is where most discretionary spending occurs. On the other hand, lower income households are still struggling with the high prices associated with the past inflation shock.

Real consumer spending (+2.9% year-over-year) has been outpacing real disposable income (+2.6% year-over-year) causing the personal saving rate to trend lower this year to 4.4%, well below its long-term average of 8.0%. However, household balance sheets remain strong overall, suggesting that the low savings rate can be sustained for now.

Manufacturing

The ISM Manufacturing Index had two months of gains in November and December, bringing the index to its highest level since March. Still, it remains below 50, indicating contraction. Only seven out of the 18 industry sectors (39%) posted any growth as of December, and this statistic has not been above 50% since August 2022. Concerns about the possibility of increased tariffs in the coming year are causing demand to be pulled forward as indicated by improved new orders and a buildup of inventories. Employment in manufacturing remains subpar, however, having been in contraction for the past seven months in this survey.

The Labor Market

The December Employment report saw a larger than expected 256,000 gain in non-farm payrolls and a drop back in the unemployment rate to 4.1%. Gains were concentrated entirely in the services sector. The unemployment rate ticked down to 4.1% due to a strong 478,000 increase in the household survey measure of employment, which outpaced the 243,000 rise in the labor force. The year-over-year change in average hourly earnings eased from 4.0% to 3.9%. This is consistent with the Fed's 2.0% inflation target given the recent trend in productivity growth of 2.0% year-over-year.

This solid Employment report shows that the labor market is cooling or normalizing, but not collapsing, and it will likely solidify the Fed's intentions to proceed with the slower pace of interest rate cuts it signaled at its December meeting.

The Job Openings and Labor Turnover Survey (JOLTS) release for November showed a slight increase in job openings, but its declining trend suggests a continued normalization of the labor market. Additionally, the hiring rate has fallen to its lowest level since 2010, but combined with a low pace of layoffs, net job growth remains positive. Over the last two years, the average length of unemployment has increased from 19.3 weeks to 23.7 weeks.

Projected Rate Cuts

At their recent December meeting, the Federal Open Market Committee (FOMC) sent a strong signal that the pace of rate cuts will slow from here, with their updated economic projections pointing to only two 25-basis point cuts in 2025, down from the four cuts projected at the September meeting. Some FOMC members are starting to factor potential policy impacts from the new administration into their forecasts. At the very least, this is creating more uncertainty in members' forecasts.

While the Fed views their dual mandates of price stability and maximum employment to be roughly in balance, they are more focused on inflation not declining as quickly as previously forecast. FOMC members are now forecasting inflation, as measured by the Core PCE, to be 2.5% at the end of 2025, up from their 2.2% forecast in September. They now project inflation returning to their 2.0% target in 2027, a year later than earlier projections. Regarding employment, they see the labor market as having softened, but still healthy overall, and able to tolerate a slower pace of rate cuts.

Markets are currently pricing in only one interest rate cut in 2025. That's a big swing from September when four or five cuts in 2025 were priced into the market. At the same time that expectations for interest rate cuts have declined, the yield on the 10-year Treasury bond has risen from 3.62% in September to 4.78%, the highest level since October 2023. It is unprecedented that the 10-year Treasury yield has increased over 100 basis points at the same time that the Fed lowered the Fed Funds rate by 100 basis points.

Outlook

The biggest determinant of long-term interest rates is inflation and inflationary expectations. Concerns about the possible inflationary impact of the new administration's policies are being reflected in the rising 10-year yield.

One other factor that is beginning to draw attention in the pricing of government debt is the fact that interest payments on U.S. government debt have risen from 12.6% of government revenues in 2021 to 23.6% of government revenues in 2024. Higher rates and higher debt will continue to be a challenge for fiscal policy.

The outlook for the path of monetary policy in 2025 is becoming murkier because of potential policies by the new administration and the appropriate response by the Fed. Consequently, as mentioned earlier, planning for the coming 12 months has become very challenging.

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