



MACRO COMMENTARY | July 2024

PORTFOLIO ANALYSIS & CONSULTING

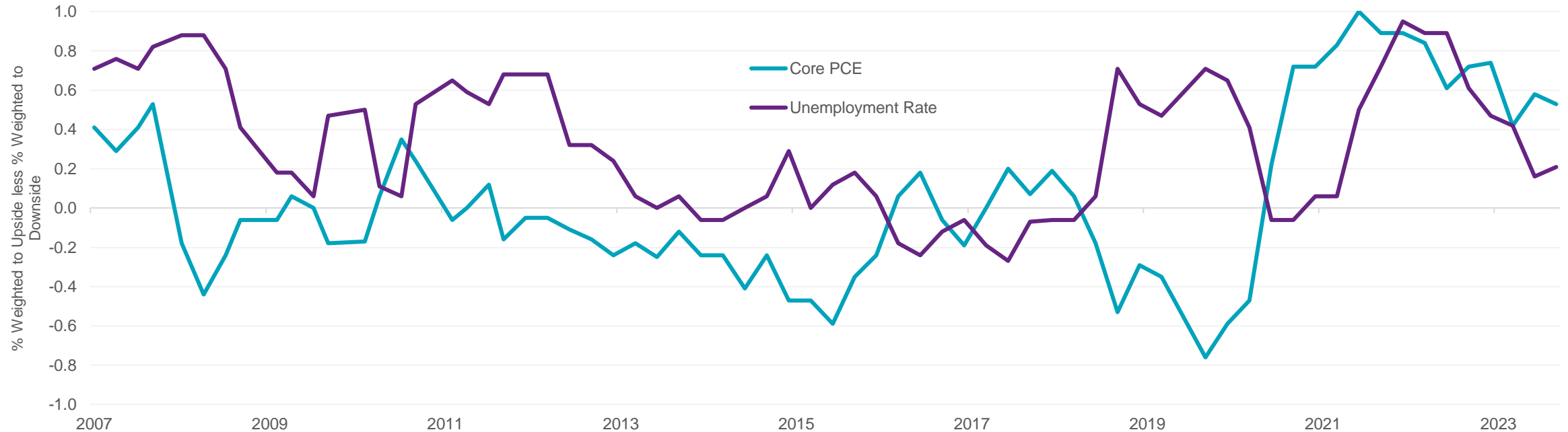
Charts and Smarts®

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Don't Keep Me Wonderin'

Diffusion Indices of FOMC Participant Risk Weightings (10/31/07–6/30/24)

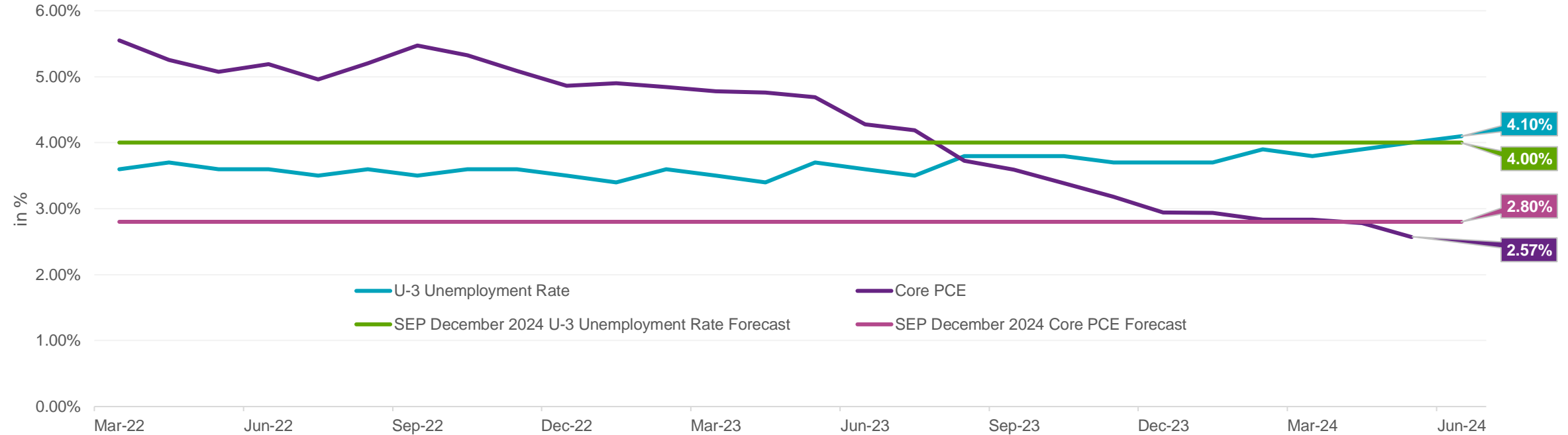


Central banks are in the business of risk management, balancing risks in a fashion to best achieve their mandate. For the Fed, that means price stability and maximum employment. When the labor market was tight and inflation still well above target, there was little to worry about in the way of tradeoffs. The job was easy: tighten policy and push inflation lower. But as the dual mandate has come back into balance, with inflation closing in on target and labor markets now rebalanced, the tradeoffs have become more critical. Recall that this is a Fed that has placed great emphasis on the social and economic benefits of maximum employment, an environment which helps to spur gains for the lower rungs of the labor market, the same cohorts that have suffered greatest from the inflationary experience, and stand to lose the most, should the Fed overstay its welcome in its efforts to push inflation back to target. While the Dot Plot receives the bulk of the attention in the Summary of Economic Projections (SEP), buried within it are insights into the FOMC's view of the balance of risks. Risks to the unemployment rate are modestly skewed to the upside, while risks to core PCE have made considerable progress moving back toward more balanced territory. The days of hawkish jawboning are long gone, and the Fed is explicitly not attempting to cause collateral damage to labor markets or the economy. Fed speak has only further confirmed this as labor markets have taken on much more prominence in recent rhetoric. Fed sentiment may be hanging onto the last vestiges of hawkishness in the wake of the Q1 surprises, but as the data continues to move decisively dovish and risks to the labor side of the mandate grow, expect the Fed's messaging to break dovishly over the summer months.

Source: Portfolio Analysis & Consulting, Federal Reserve.

Ain't Wastin' Time No More

Inflation vs Unemployment (3/31/22–6/30/24)

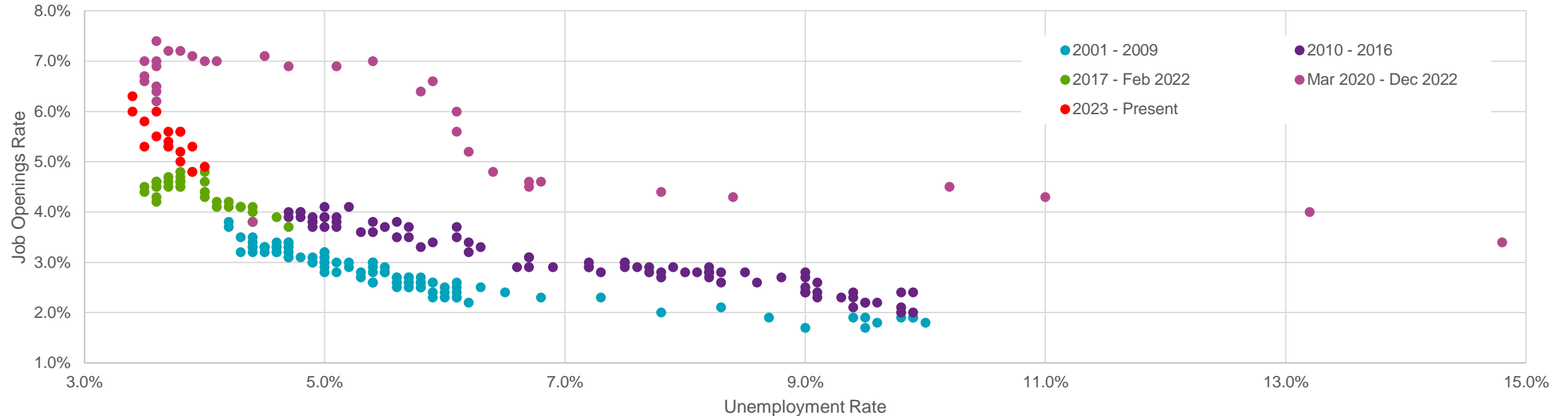


For all the focus on the Dot Plot, it's important to recognize that it is neither a promise nor a prescription of future policy, but rather a conditional forecast that reflects the FOMC members' expectations of economic outcomes under their view of appropriate policy. Should the actual data unfold differently than forecast, then the path of policy will be different as well. Comparing the incoming data to the committee's expectations, as evidenced in the Summary of Economic Projections, the case for two cuts beginning in September becomes clear. The two most important data points, with respect to the Fed's reaction function, are the unemployment rate and core PCE, hence their inclusion in the SEP. As of the most recent prints, core PCE is running 20 basis points below the median forecast for year-end 2024, while the unemployment rate has already ticked above the median forecast and sits just 20 basis points from the committee's estimate of the natural rate of unemployment. Base effects are indeed a consideration, with respect to core PCE, due to soft comps from the second half of 2023, but given the return of balance to both labor markets and the dual mandate, the Fed is likely to be far more responsive to upside surprises on the unemployment rate than to upside surprises on inflation moving forward. While Fedpseak has remained stubbornly hawkish, and somewhat overly data dependent as opposed to forecast dependent, the tide is beginning to turn. The Dot Plot may show only one cut for 2024 at the moment, but given the likely trajectory of inflation prints over the coming months, the July meeting will likely serve as the venue to begin laying the groundwork for the first of two quarterly cuts to commence at the September meeting.

Source: Portfolio Analysis & Consulting, Bloomberg, Federal Reserve.

Southbound

Beveridge Curve (1/31/01–5/31/24)

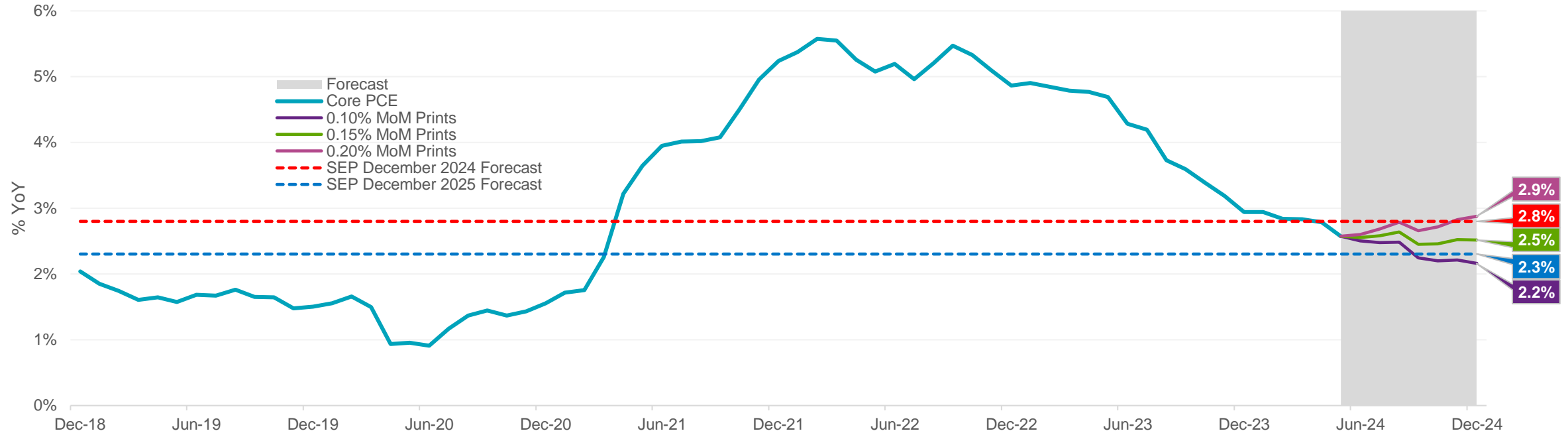


One of the most commonly circulated charts in recent weeks has been the Beveridge Curve. Even FOMC members, such as San Francisco Fed President Mary Daly, have cited the curve, which illustrates the nonlinear relationship between job vacancies, or labor demand, and unemployment. The Beveridge Curve has been central to soft landing arguments that suggested labor market tightness could abate without seeing unemployment move aggressively higher. That call has certainly been vindicated to date as the economy has moved down the vertical portion of the curve, unwinding excess labor demand without driving the unemployment rate higher. From here, however, the curve suggests the potential for greater tradeoffs between softer labor demand and unemployment. Further cooling in job openings likely suggest some incremental upside for the unemployment rate. There's certainly reason to remain optimistic as the bulk of the rise in the unemployment rate has been driven by slower matching, as entrants into the labor force have been met with hiring rates that are now well below pre-pandemic levels and not by rising layoff rates. That said, with economic growth moderating, the upside risks to the unemployment rate are growing. Despite the unique dynamics of this cycle, it's critical to keep in mind the inertial nature of unemployment, whereby once the unemployment rate starts rising, it tends to keep rising. To be sure, the labor market remains healthy and appears to be simply normalizing into a more sustainable and steady state, but the risks for the unemployment rate are clearly skewed to the upside, suggesting greater urgency for the Fed to begin recalibrating policy, even if only for risk management purposes.

Source: Portfolio Analysis & Consulting, Bloomberg.

Trouble No More

Potential Core PCE Trajectories (12/31/18–5/31/24)

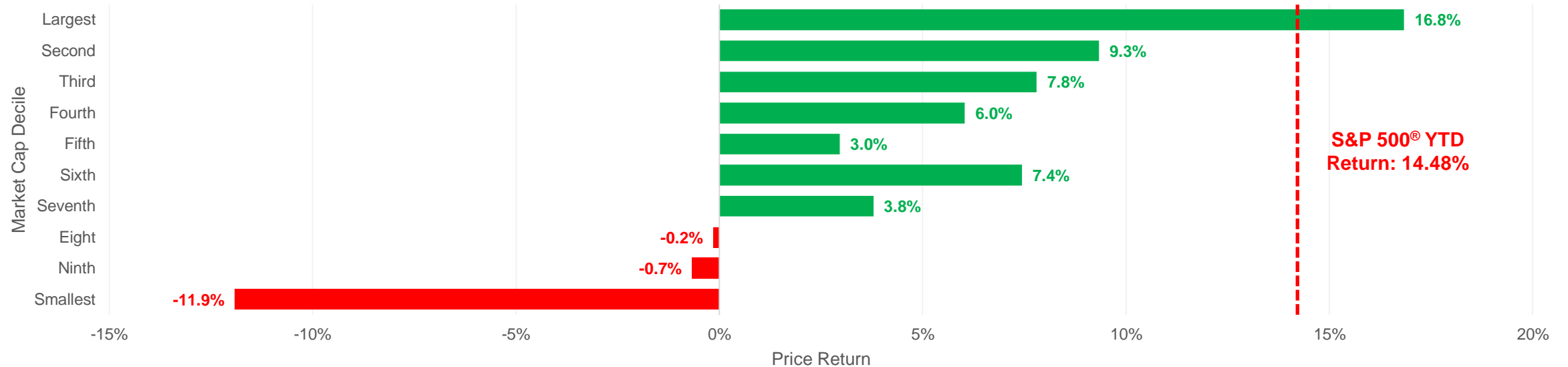


As we've stressed time and time again, the labor market is no longer providing an inflationary impulse to the economy and is now a disinflationary force. And the effects of that force are growing as the unemployment rate continues to tick higher. Whether that move has been driven by increasing layoffs or labor force reentrants matters little for the inflation outlook as higher unemployment ultimately translates to increased competition among job seekers, which places downward pressure on nominal wage growth and inflation. While there are those that continue to cling to the warm, first quarter prints to confirm their priors that inflation will remain stubbornly sticky, the evidence continues to mount that those months were outliers and not indicative of the underlying trend. Core PCE is running below the Fed's, and while base effects become more challenging over the coming months, core PCE looks likely to remain below the Fed's current year-end estimates and making further progress toward the 2% objective. Unit labor costs remain benign as the labor market has rebalanced, the stronger dollar continues to weigh in import prices, vehicle price deflation is set to continue, motor vehicle insurance is likely to meaningfully disinflate, and the long-awaited cooling in shelter costs looks to be getting under way. Year-over-year comps may be more challenging in the months ahead, but there remains a plethora of disinflationary sources to continue pressuring core PCE lower into year-end. While the Fed continues to cling to higher for longer, inflation and labor market data and the balance of risks clearly argue for the Fed to finally initiate its policy recalibration. Expect FedSpeak to shift rapidly as the data continues to make a clear argument for that recalibration.

Source: Portfolio Analysis & Consulting, Bloomberg.

Revival

S&P 500® Performance by Market Cap Decile (12/29/23–6/28/24)



While the macro narrative may remain hyperfocused on the inflation backdrop, the market narrative remains hyperfocused on the hyperscalers. The result of this myopic focus on the AI trade has helped to spur a redux of the narrow breadth fears that were so prominent at this time last year. Each time market leadership narrows, we predictably hear refrains that the market's advances are unsustainable and the indices are set for a correction. But breadth is much akin to valuations in the sense that they are not useful as timing tools, and only become obvious with the benefit of hindsight. Furthermore, the empirical evidence demonstrates that breadth tends to follow price. In other words, a narrow, but advancing, market tends to draw inflows and expanding breadth as investors rotate to laggards instead of narrow leadership catching down to weak breadth. What's more, for much of this year, participation hasn't been all that narrow, as the top 70% of companies by market cap have all posted positive average returns. Only the bottom 10% of issues by market cap have seen meaningful losses. Yes, returns have been top heavy this year as the mega-cap tech and AI adjacent names have powered higher, but that's the rule, not the exception. Narrow breadth only began to truly take hold in mid-May as growth concerns once again began to percolate, skewing investor demand toward the perceived safety of the mega-caps with fortress balance sheets and wide moats amidst a backdrop of rising macro uncertainty and slowing economic growth. In this sense, narrow breadth is neither surprising, nor a signal of impending doom. Instead, it's simply a byproduct of the reflexive demand preferences of investors. We may have more work to do before the growth concerns finally peak, but as growth ultimately proves more resilient than feared, a resurgence of the soft landing narrative is likely to drive a meaningful broadening in participation, which sees breadth finally catch up to prices that have been supported by those mega-cap names.

Source: Portfolio Analysis & Consulting, FactSet.

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