Asset Management

Macro Research
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AEGON **INSIGHTS**

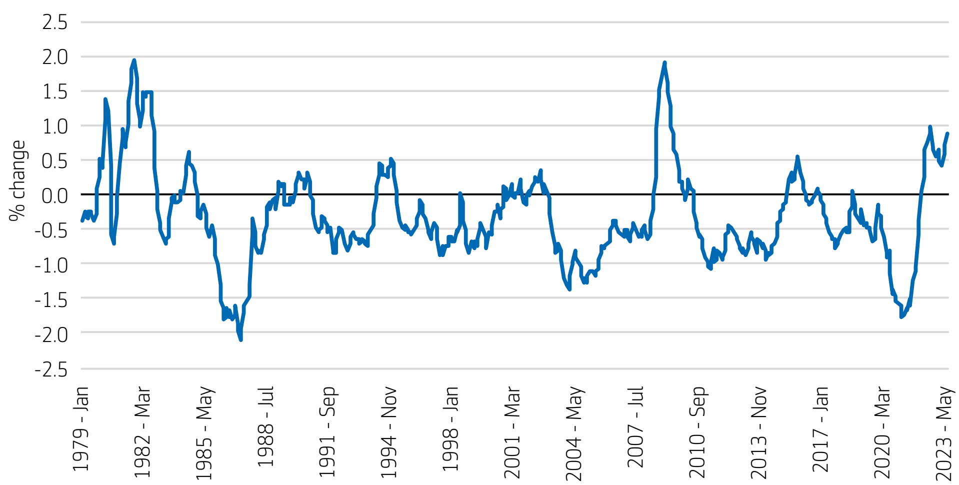
Macro musings: It's starting

Pockets of contraction are emerging in US economic activity. Specifically, in the November Beige Book, where half of the 12 Fed regions saw outright economic contraction in the period between October 7 and Nov 17. There was also a huge change in language from prior Beige Books, which had noted "moderate" and "modest" growth. That tone was echoed by the November Institute for Supply Management (ISM) business survey, which showed the manufacturing space contracting for the 13th straight month.

The week also saw a marked change in the tone toward labor. For the first time this cycle, both the Beige Book and the ISM noted that employers were "comfortable" reducing headcounts and "took more action" to do so. This was echoed in the Conference Board survey's labor differential. We'll get more data points on this topic with the November payroll report's release on Friday, but it appears change is afoot from the labor-hoarding mentality of not too long ago.

Higher financing costs are starting to work their way through. For the first time this cycle, two regions in the Beige Book cited the "increase cost of debt as an impediment to business growth." The speed with which this permeates the broader economy will be a key to the macro equation in 2024.

Exhibit 1: Financial conditions impulse on growth: Baseline 3-year lookback (% change)



Sources: Federal Reserve Board, Haver Analytics. Data as of October 31, 2023.

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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.

Our view

The comments in the Beige Book were quite pivotal and underscore a key relationship: The longer the Fed has to stay on hold at these restrictive levels, the more likely the negative effects accelerate in a non-linear fashion. This is the crux of the high-wire act the Fed is trying to pull off (i.e., Can it slow demand just enough to reduce the inflationary pressure, but not so much that it causes a contraction in output that stimulates a negative labor response).

"The economy's last stand" is the title of our forthcoming 2024 Macro Economic Outlook where we essentially frame the issue as: Can the economy hold up until the rate-cutting cavalry arrives? Our base case says no, as we see a mild economic contraction occurring during the first half of 2024 and contributing to a Federal Reserve rate cut in the third quarter of that year (while acknowledging that a June rate cut is a real possibility). Conversely, the consensus has massively reduced its GDP forecast for the first half of 2024 from about +1.5% earlier this year to an anemic +0.4% and +0.3% for first quarter and second quarter of 2024, respectively. Within that context the consensus has the Fed cutting rates in the second quarter of 2024, while the futures market is pricing about a two-thirds chance of a cut as early as March 2024.

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Reconciliation

We now seem to be converging on the first half of 2024 as the trough, albeit with a slight difference in magnitude. At this point, I'd give our base case two-thirds odds and the consensus case one-third odds.

I'd be remiss if I didn't mention the inflation data that was released last week: The personal consumption expenditures deflator, and all its derivatives, echoed the consumer price index data released a few weeks ago, which showed disinflationary trends taking hold and slowly broadening. The market is basically pricing in that these trends will accelerate and clear the decks for a Fed interest-rate cut in March. That's certainly possible, but we think premature at this point unless unemployment were to begin a step-change higher very soon.

Exhibit 2: Inflation - Slice & Dice (As of October 2023)

	% 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%	0.04%	0.5%	4.4%	3.2%	3.2%
CPI-U: Core	80%	0.23%	2.8%	3.0%	4.0%	4.0%
CPI-U: Core, ex-Shelter	45%	0.14%	1.7%	1.3%	2.4%	2.0%
CPI-U: Core, ex-Shelter & Used Autos	42%	0.20%	2.5%	2.5%	2.3%	2.8%
CPI-U: Core Services, ex-Shelter	27%	0.30%	3.6%	4.8%	1.9%	3.0%
PCE	100%	0.05%	0.6%	3.3%	2.8%	3.0%
PCE - Core	88%	0.16%	2.0%	2.2%	3.3%	3.5%
PCE - Core Services, ex-Housing	-	0.15%	1.8%	3.1%	3.6%	3.9%
Dallas Trimmed Mean PCE	-	0.22%	2.7%	-	2.9%	3.6%
Cleveland Trimmed Mean PCE	-	0.26%	3.2%	-	-	4.2%
San Fran Cyclical PCE Inflation	-	-	3.2%	-	-	6.1%
San Fran Acyclical PCE Inflation	-	-	1.3%	-	-	2.0%

Source: Haver Analytics

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