First Citizens Wealth™

Making Sense

Basis Points | September 10, 2024

A Normal Economy, If You Can Keep It

"Basis Points" provides our views on underlying themes for markets and the economy.

1. **Steady progress.**

Two years ago, the US economy was extremely imbalanced. Inflation was close to 10%, labor shortages were acute, and economic policy was alarmingly behind the curve. The Federal Reserve raised interest rates substantially, leading many to believe the economy would fall into recession. Instead, markets and the economy proved resilient against the shock of higher rates and today remain generally intact.

2. **Normal for now.**

The question for the next several months is no longer, "will the economy return to normal?" but rather "Can we keep it that way?" Since the Federal Reserve started hiking rates in Q1 2022, many have used the "soft landing" analogy to describe whether inflation would fall to an acceptable rate without too much damage to employment. Things are very much trending in that direction even though inflation is not exactly at the 2% target and the labor market is softer than it was a year ago. Going forward, in order to keep this normalcy businesses and households must stay healthy and upbeat in the face of greater uncertainty.

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3. **Falling behind again?**

Restrictive monetary policy remains the prominent outlier. At 5.5%, the Federal Reserve's overnight policy rate towers above estimates of current and expected inflation, which run closer to 2-3%. **Against this backdrop, the Fed's policy appears too tight, and we are sympathetic to views the Fed should – and might – use its dry powder and make significant cuts in coming months, including at its meeting next week.**

Market expectations – which have been volatile this year – see the Fed delivering 10 0.25% interest-rate cuts by the end of 2025, far more than the three cuts during the mid-cycle adjustments of 1995, 1998, and 2019. Reflecting these realities the 2s-10s yield curve, a popular yet ambiguous gauge, has normalized since Friday after over two years of inversion.

4. **It comes and goes in waves.**

After inflation dominated the market narrative earlier this year, focus has now shifted to the labor market. Many forecasters expect employment to remain healthy as the Fed embarks on its journey to normalize interest rates, and they may be right. **But job growth is clearly slowing, and looking at the long history of the labor market we see little precedent for the 4.2% unemployment rate – now up by 0.8% - just leveling off.** Data on layoffs and jobless claims have been fairly muted, but we will be watching these and other data on private sector hiring very closely in coming months.

5. **Volatile returns.**

Volatility has returned to US equity markets after being subdued for much of this year. Last month's 8.5% selloff is a reminder that drawdowns are common even in healthy equity markets. **Yet fundamentals such as strong expected corporate earnings growth and healthy margin expansion remain in place, and we remain constructive with a 12-month forward S&P 500 base case of 5,900.**

6. **Coinflip.**

Rather than parsing political polls, we turn to the wisdom of crowds and look to prediction markets for an assessment of likely election outcomes. Our read is that the presidential election looks like a very tight race. But it is the entire composition of government that matters for policy changes, and a divided-government outcome looks highly plausible. These results will matter significantly for the direction of policy next year — particularly around taxes — **but we still believe market fundamentals matter far more than politics for longer-term investors.**