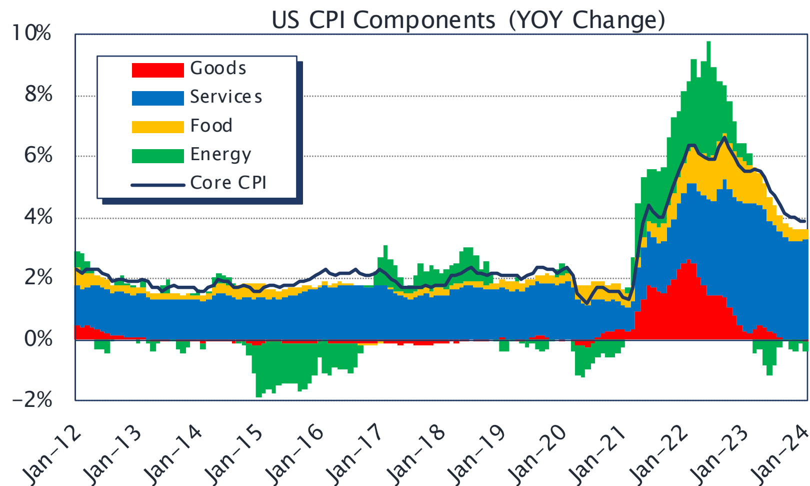
FEBRUARY 2024

# INVESTMENT UPDATE

Welcome to 2024, and what will it bring? Last year was a roller-coaster for bond investors, and was looking pretty bleak until a change in sentiment turned things around in the last few weeks of the year. As recently as early November, we were heading for a third consecutive year of negative total returns for the broad US investment-grade bond market, something not seen in more than 100 years. By the end of October, the year-to-date return of the Bloomberg Aggregate Index was -2.8%; long maturity bonds had performed even worse, with YTD returns for Treasuries with maturities longer than 10 years standing at -13.1% through October. Bleak, indeed.

But investors began to sense a shift in November, encouraged by improvements in inflation measures, despite warnings from economists that rising wages from the tight labor market and still-strong consumer demand would keep upward pressure on consumer prices. After two years of incessant Fed rate hikes and tough talk from Chairman Powell, it took a series of good inflation reports to bolster investor confidence that the Fed might be nearing the end of this tightening cycle, which had seen the overnight Fed funds rate rise more than 5% since early 2022. Of the two main measures of US inflation, the CPI and the PCE, core PCE showed the biggest drop in the last few months of 2023, falling from a year-over-year rate of 4.2% in the August report to 3.2% in December (it now stands at 2.9%). CPI showed more modest improvement over this period (falling from 4.2% to 3.9%), but the implication was clear: bond yields looked like they were topping out.




Investors (and some speculators, to be sure) piled into the bond market in November and December, sending prices up and pushing yields lower; benchmark 10-year Treasury yields dropped by more than 100 basis points between late October and year-end, pushing total returns for bonds comfortably into positive territory for the calendar year.

So 2023 ended on a high note, buoyed by expectations for the next phase of Fed policy, including cuts in the Fed funds rate and a slowing, and eventually a complete phasing out, of the Fed's balance sheet runoff. But is the market getting ahead of itself? Has the macro backdrop changed enough to justify a 100 basis point drop in longer rates?

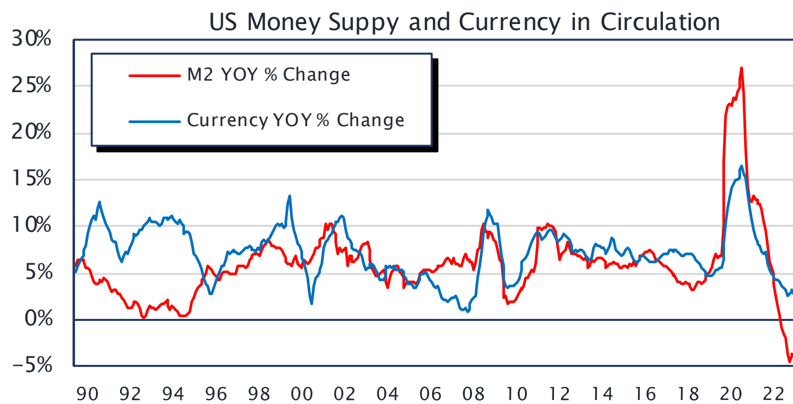
First, let's take a more detailed look at the inflation figures. As we mentioned earlier, there's been good progress on inflation measures over the past year, as shown on the chart on this page. However, as we've pointed out in recent *Investment Updates*, that progress has largely—especially in the CPI numbers—been attributable to normalization of Covid-era distortions caused by supply-demand imbalances, particularly for manufactured goods and certain commodities, including energy-related commodities. The chart on this page breaks the CPI down into its components, including "non-core" food and energy prices, as well as core goods and core services. You'll notice that pre-Covid, the US inflation picture had been sanguine for more than a decade, with little to no inflation among manufactured goods, and occasional blips in food and energy prices. Inflation, particularly core inflation, was mostly limited to core services, and even this component was low and stable at 1.5%-2.0% per year, year after year.

Covid brought massive changes to the US inflation landscape, as disruptions in production and transport of goods and even some services caused prices to soar. Matters were made worse with Russia's invasion of Ukraine in early 2022, as energy and food prices spiked amid shortages of crude oil and natural gas from the region as well as Ukraine's struggles to get agricultural commodities to market. As we'll discuss shortly, all this was exacerbated by US (and other countries') fiscal policies that flooded households and businesses with emergency funds to keep the economy ticking along.

# INVESTMENT UPDATE CONT.

Eventually, disrupted supply chains were repaired and shuttered factories reopened, allowing the imbalances between the supply and demand for goods and services to come back into alignment. But the chart on the previous page also shows that, at least for core services (the blue shaded area), the baseline is still nearly double the pre-Covid “run rate”—from an annual increase of 1.50-1.75% to 3.00-3.50% today. This is the “sticky” inflation you’ve no doubt read about, and this sticky inflation is the reason why the Fed is reluctant to ease up on its inflation battle.

Diving deeper into the core services category, we find there are three main areas contributing to the continued high levels of inflation: transportation services, recreation services, and shelter. Of these, recreation services is the smallest (3% of total CPI) while transportation services is roughly 6% of CPI; recreation is running at approximately a 6% annual inflation rate, while transportation is even higher, running at an annual rate of 9.5% inflation. But shelter is the biggest component within services, making up a whopping 36% of CPI, and currently rising in price by more than 6%. Shelter—which is mostly the cost to rent a place to live or the “owners’ equivalent rent” for those who own their homes—is the single most important component keeping CPI inflation high right now. It is also a slow-moving series, and is expected to stay elevated for the next few months; even though rent increases have slowed considerably over the past year, the owners’ equivalent rent component is notoriously “laggy.”




This puts the Fed in a tough position as it considers how to balance inflation and economic growth. There’s little risk right now in the Fed keeping its overnight funds rate at its current range of 5.25-5.50% as the US economy continues to grow at a reasonably strong pace. True, these higher overnight rates have raised the costs for some businesses, particularly those that rely on short-term financing to fund operations, including banks, builders, and importers, as well the entire housing market in general. But as we look across these industries, there has been surprisingly little damage as a result of the Fed’s policies, with the important exception of the regional US banks (many of whom also have looming commercial real estate issues). On the other side of the coin, if the Fed begins to ease its policies and starts cutting the funds rate now, it could stimulate an already healthy economy and re-ignite inflation, necessitating another round of rate hikes—exactly the outcome the Fed is hoping to avoid.

If there’s anything that could ease the Fed’s predicament, it’s that fiscal policy is finally coming into alignment with monetary policy. As mentioned earlier, trillions of dollars were provided to businesses and households during the pandemic, and while those funds haven’t disappeared, new money is no longer flowing freely into the US economy. As the chart on this page shows, US money supply exploded in 2020 as the Treasury printed money and fed it directly into individuals’ and institutions’ checking accounts. The result was the biggest growth in US money supply and currency in modern history.

Those funds are now shrinking on a year-over-year basis for the first time in the more than 60 years that monetary aggregates have been tracked. This raises some interesting questions, since we’ve never seen money supply growth fall below zero. Will this lead to a significant decrease in spending? We know, from years of direct experience, that ramping up the money supply often leads to excess demand, followed by higher inflation, but is the converse true? We don’t have the answer to that, but it’s reasonable to assume that, all else equal, a shrinking money supply will constrain demand. But given the extraordinary growth in M2 over the past few years, will the current small decrease in money supply have a measurable impact on spending? We can only watch and wait.

Watching and waiting is exactly what the Fed is doing as well. The Fed’s Open Market Committee is no doubt pleased by the recent drop in inflation and, even if progress is likely to slow, signs point to further improvements ahead. But even Jay Powell admits that the degree and timing of that improvement is uncertain, as he and other Fed officials have been pushing back against overly-optimistic expectations. Futures contracts are now pricing in four 25 basis point cuts in the funds rate in 2024, down from seven expected cuts six weeks ago. While monetary policy is more in balance today than at any other time over the past four years, Powell and company will have to be both patient in waiting for the data to confirm what the next steps should be and deliberate in the application of those policies.

We’re cautiously optimistic about the Fed’s ability to thread this needle, but also cognizant of the limitations and lags that accompany monetary policy. Nothing is certain when it comes to economic projections.