Economic Outlook:
Rate Cuts Delayed as Fed Awaits Further Inflation Improvement

June 2024

STIFEL

Lindsey M. Piegza, Ph.D.
Chief Economist

The Drivers of the 2024 Outlook

- The Consumer
- Inflation
- Policy Decisions

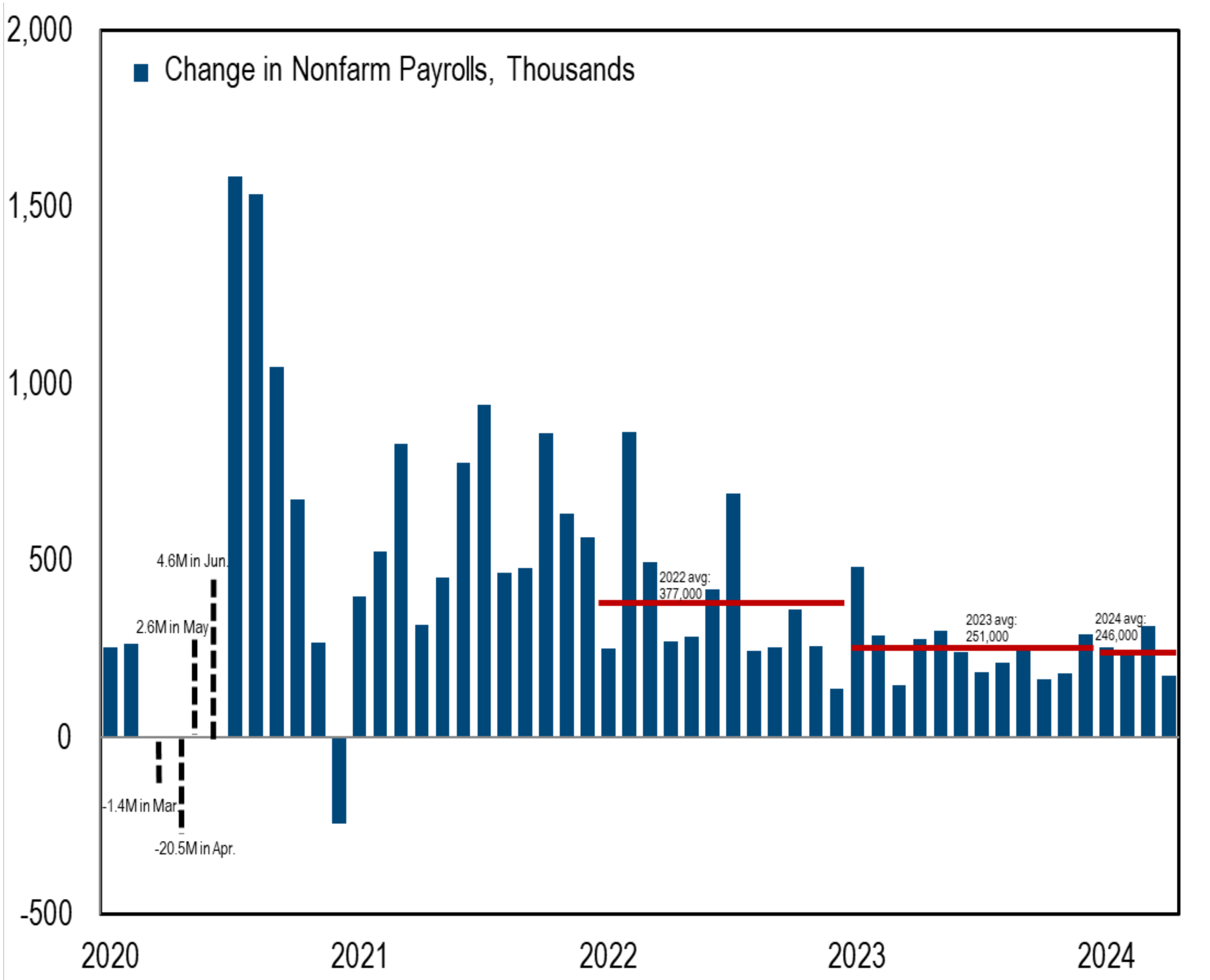
Labor Market Conditions Remain Solid

The U.S. economy remains on relatively solid footing with the consumer still proving relatively sound and resilient thanks to decent gains in the labor market

Nonfarm payrolls rose by **175k** in April, the weakest gain in six months and down from a 315k gain in March

With earlier revisions to previous months, the overall change (April data + net revisions) was 153k

For the full year of 2023, U.S. employers added **3.1M** jobs, a solid level of job creation, albeit down from the **4.5M** jobs added in 2022 and the **7.2M** jobs added in 2021 following the pandemic plunge of 9.3M in 2020, the largest decline on record, and more than the combined decline in 2008 and 2009



Source: Bureau of Labor Statistics/Haver Analytics

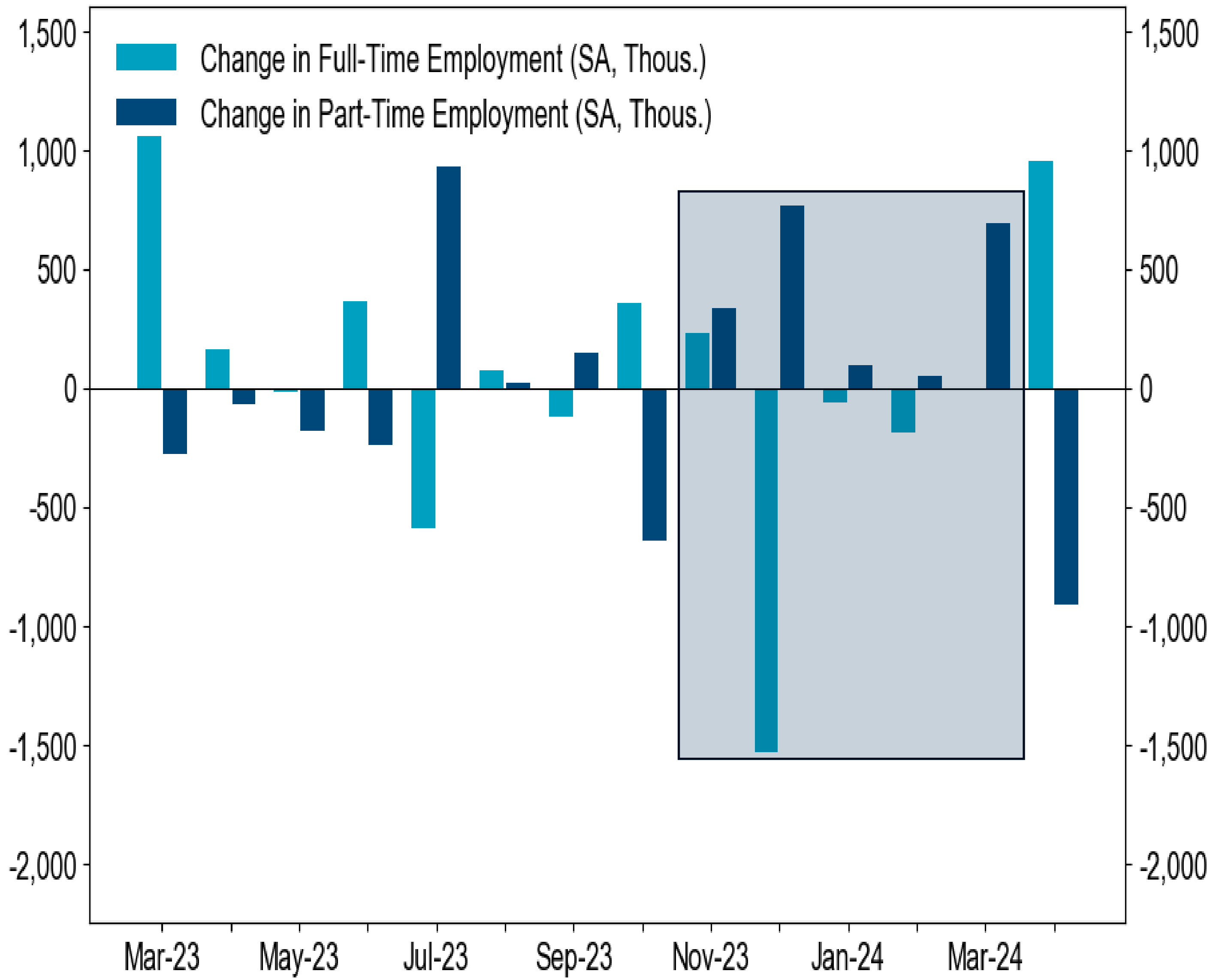
STIFEL | Fixed Income Capital Markets

Employment Gains Dominated By Part-Time Workers

In April, the number of part-time jobs dropped by **914k**, the largest decline since April 2020, taking the total to **27.7M**

Meanwhile, full-time positions actually rose by **949k**, following four consecutive months of decline, taking the total up from 132.94M to **133.89M** at the start of Q2

In fact, over the past year, the number of full-time workers has declined by 557K, while the total number of part-time workers has increased by 1.0M



Source: Bureau of Labor Statistics/Haver Analytics

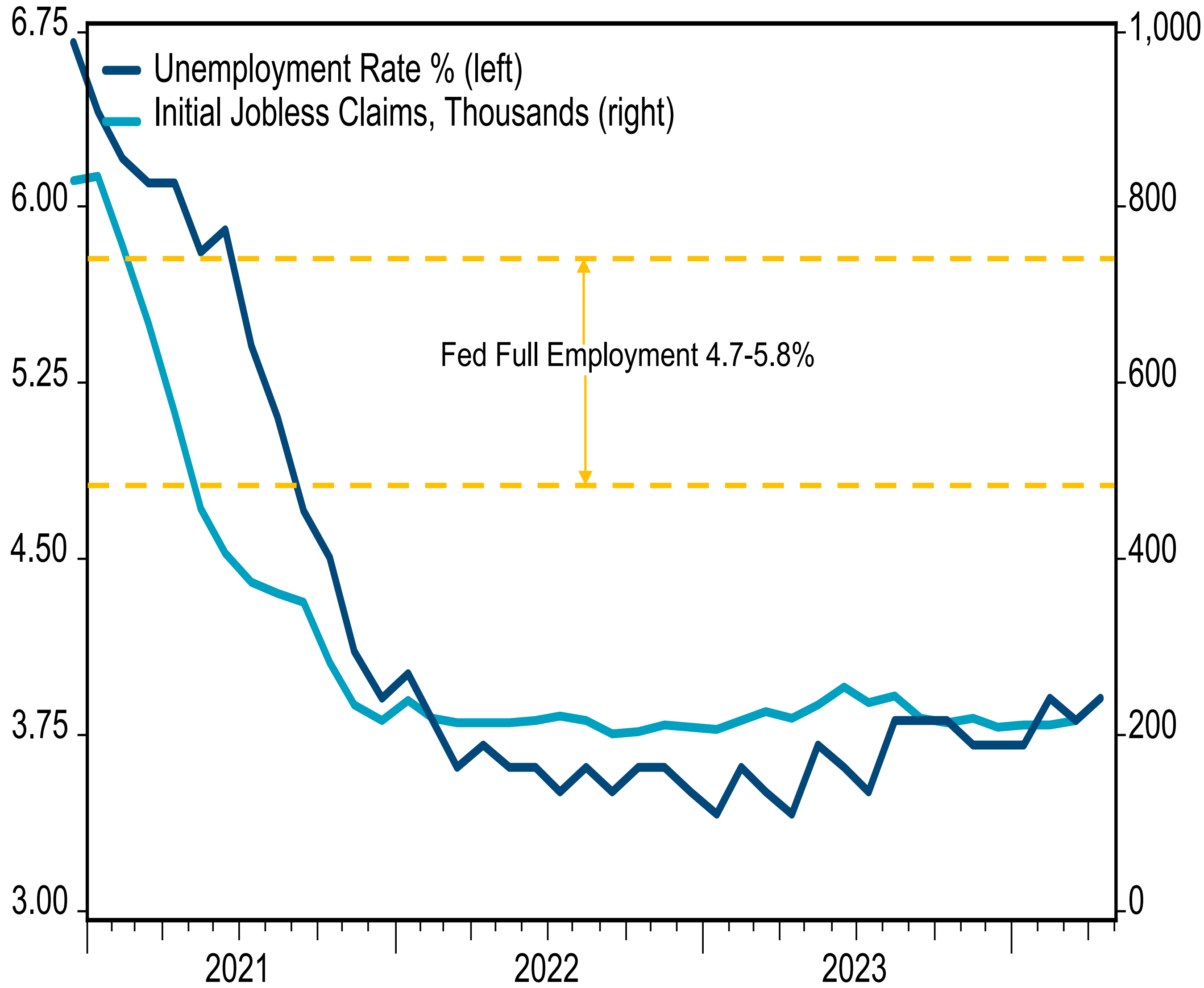
3.9% U.S. Unemployment Rate, Well Below Full-Employment Range

The ongoing low level of unemployment suggests ongoing tight labor market conditions with **labor demand outpacing labor supply**

Household employment rose by **25k** in April, and the labor force rose by **87k**, resulting in the unemployment rate rising from 3.8% to **3.9%** in April, a two-month high, albeit still near the lowest in five-decades

The decline in the unemployment rate from an earlier peak reflects more employment *and* sidelined workers

Returning workers will push unemployment rate higher



Sources: Bureau of Labor Statistics, Department of Labor/Haver Analytics

STIFEL | Fixed Income Capital Markets

Average Hourly Earnings Still Elevated

Disconnect between labor demand and labor supply continues to create wage pressures

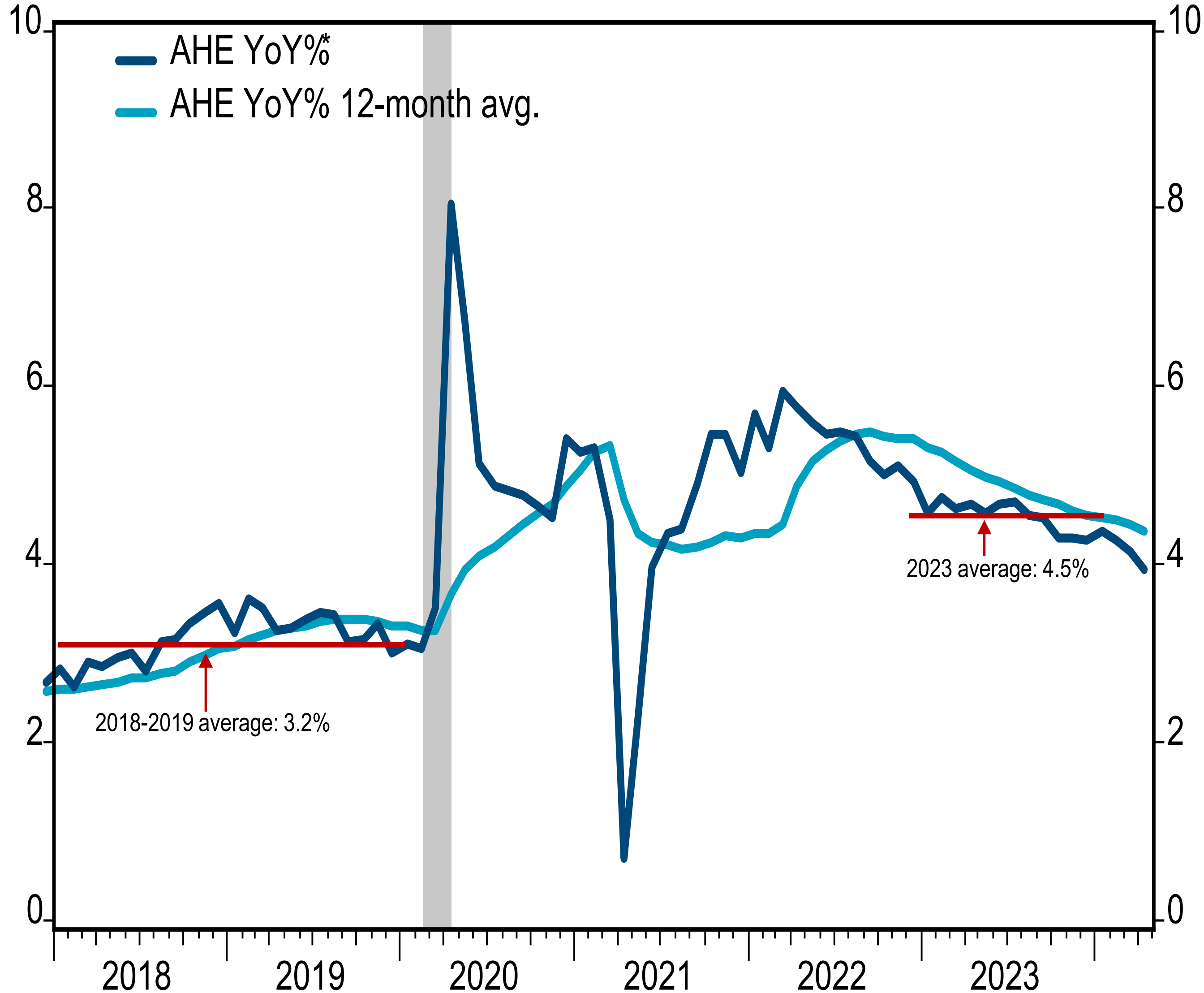
As businesses search for workers, compensation is elevated, although the trend appears to be moderating as businesses struggle to absorb costs

Average hourly earnings rose **0.2%** in April, following a 0.3% rise in March

Year-over-year, wages rose **3.9%** in April, down from a 4.1% gain in March

Longer-term, businesses may turn to technology or close doors

For now, costs are likely to remain elevated as long as labor remains scarce



Source: Bureau of Labor Statistics/Haver Analytics

*Does not include government assistance

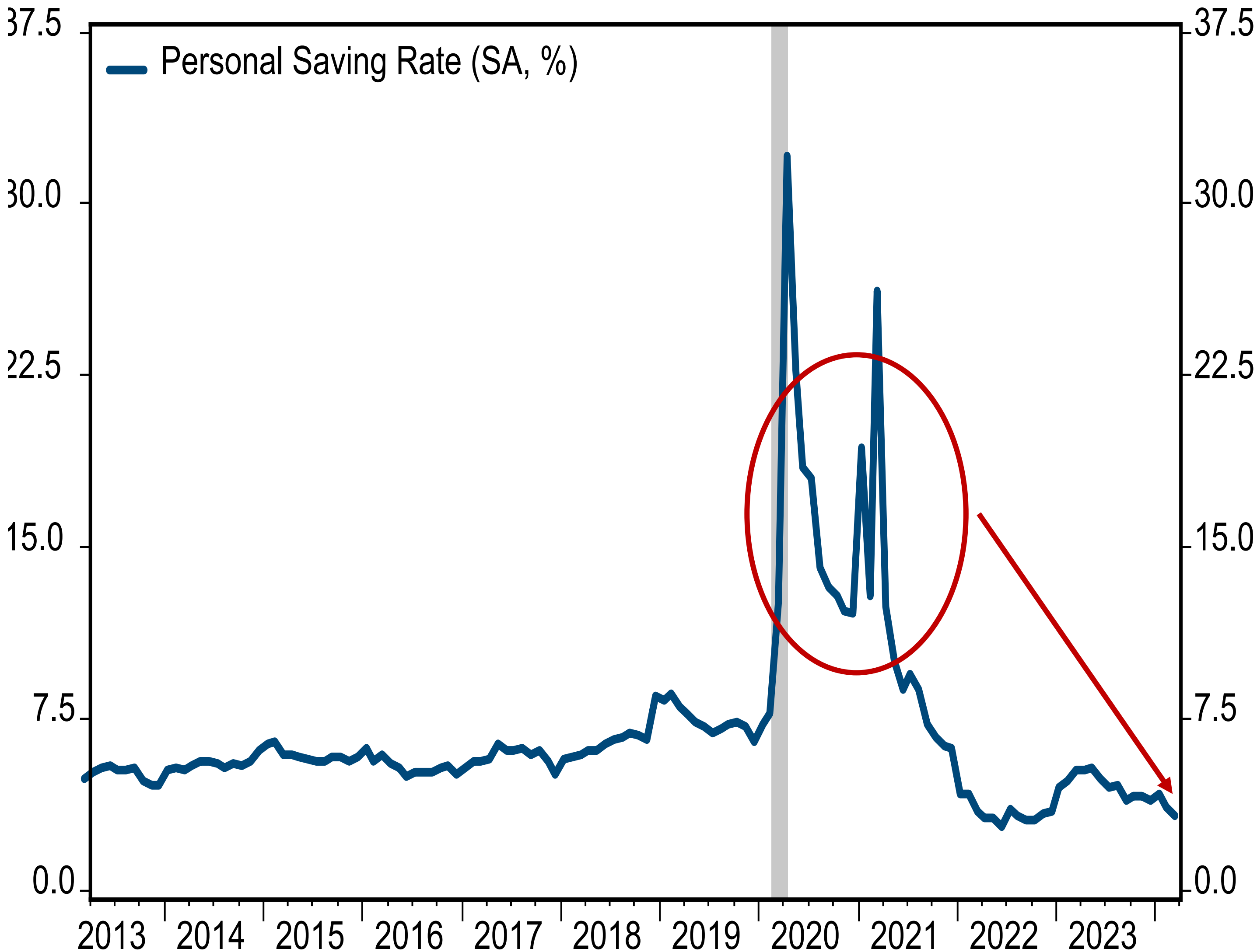
Trillions in Accumulated Support/Savings Much Depleted

Early on expansionary fiscal policy led to a massive level of wealth

The U.S. consumer remains relatively solid with **$671B** in savings and a savings rate of **3.2%** as of March

Savings won't support potential workers indefinitely – already the savings rate has slowed, and the stockpile of savings is nearly depleted as fiscal support has expired and prices rise

Although higher rates are aiding the interest earnings on consumer behavior with trillions in money market funds and deposits earning 5.2% and 2%, respectively, totaling $630B on an annual basis vs. $37B before the pandemic



Source: Bureau of Economic Analysis/Haver Analytics

Debt as a Percent of Income Near Record Low

Consumers are turning to alternative supports: (organic) earnings, savings, interest earnings (inorganic) wealth transfer, 401ks, credit cards

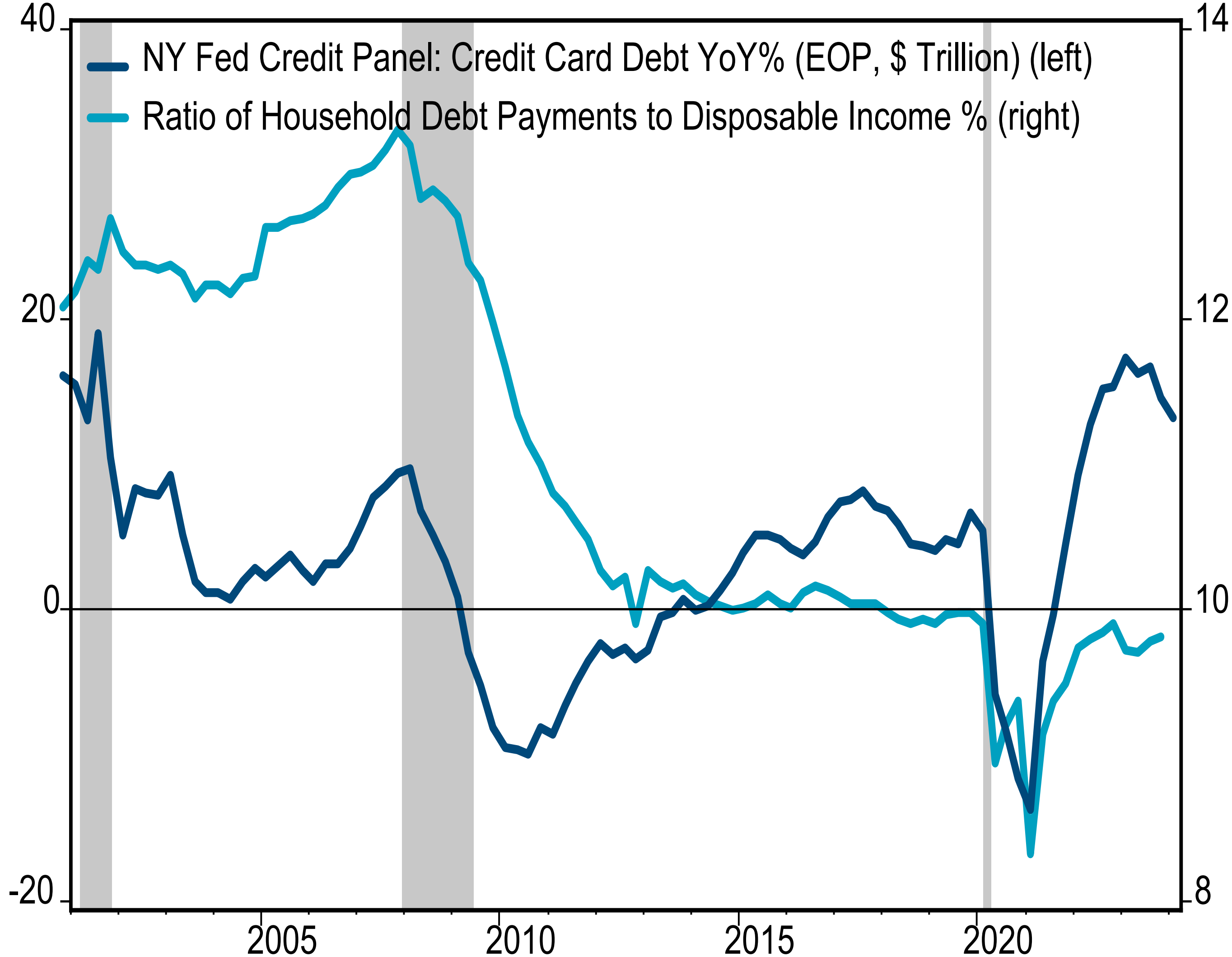
Credit card debt rose **13.1%** in Q1 from the year prior, following a 14.5% gain in Q4

401k hardship withdrawals are also on the rise with **3.6%** of workers, 5M accounts, taking a hardship withdrawal in 2023, up from 2% pre-pandemic

Most households are better positioned to take on at least some additional debt burden

Debt as a percent of disposable income remained at **9.8%** in Q3, near the lowest on record

After 3yrs of relief, student loan payments resumed in October 2023 for approx. 45M



Sources: FRBNY/Haver Analytics

Retail Sales Volatile With Broader Momentum Minimal But Positive

A loss of momentum has resulted in fewer dollars spent, higher nominal debt, and rising delinquency rates

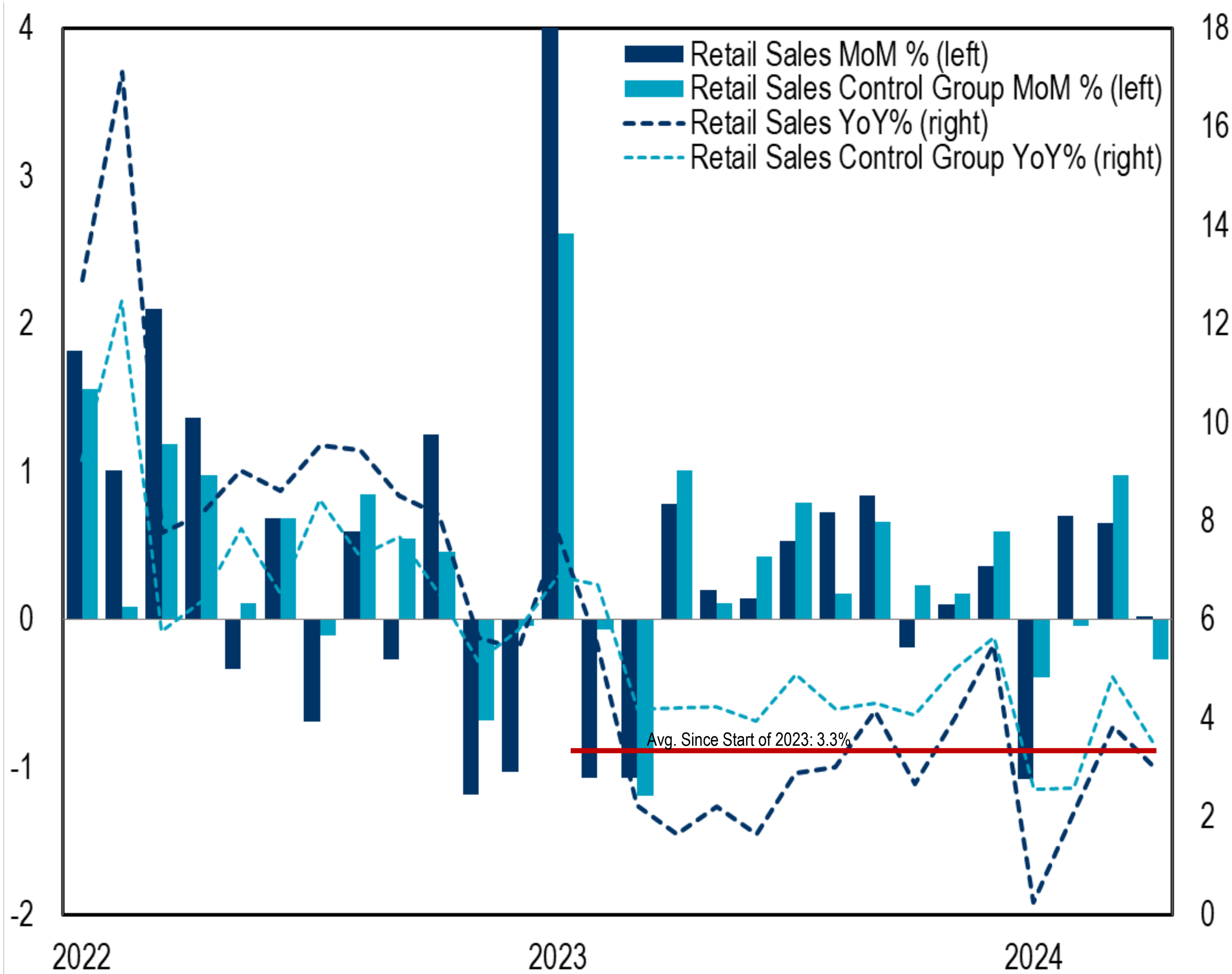
Trillions in savings and upward momentum in wages helped consumers to offset a loss of fiscal support, but inflation is complicating the picture

Large retailers report customers are cutting back as the balance sheet is becoming increasingly fragile amid rising costs and rates

Sales were flat in April following a 0.6% gain in March

Year-over-year, retail sales rose **3.0%** in April, a two-month low

Control group sales fell 0.3% in April and rose **3.5%** year-over-year, also a two-month low



Source: Census Bureau/Haver Analytics

STIFEL | Fixed Income Capital Markets

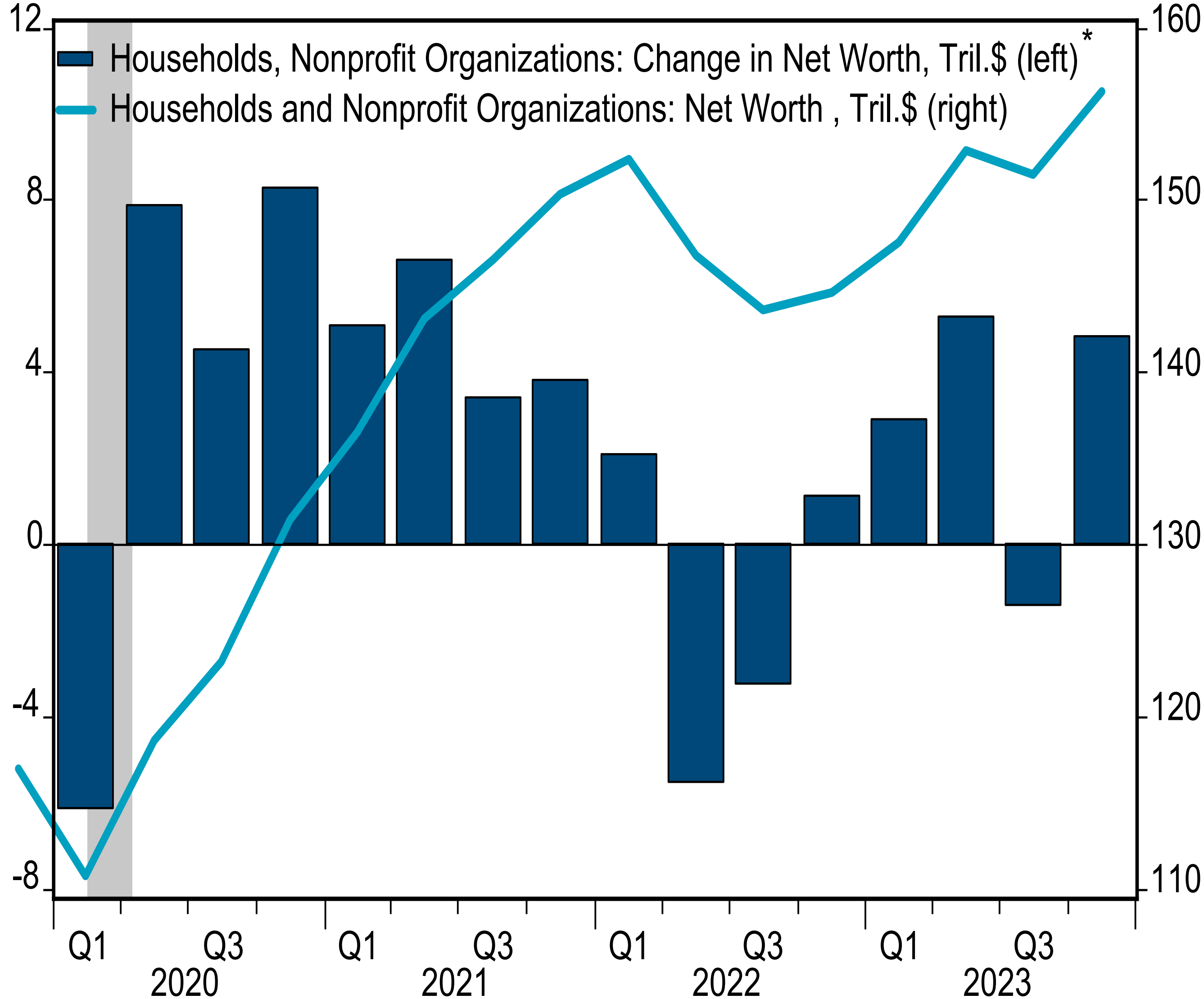
A Rise in Household Net Worth (For Some)

A change in spending patterns will not be symmetric across households

Household net worth has grown in the past few years, rising $2.9T in the first quarter of 2023 and $5.3T in the second

After a decline in the third quarter, however, net worth jumped by $4.8T in Q4 to **$156.214T**

A net gain of **$12T** in household wealth since the start of 2023 suggests there still is a significant amount of borrowing and spending power in the economy



Source: Federal Reserve Board/Haver Analytics

*Household net worth represents the total value of assets (financial as well as non-financial) minus the total value of outstanding liabilities.

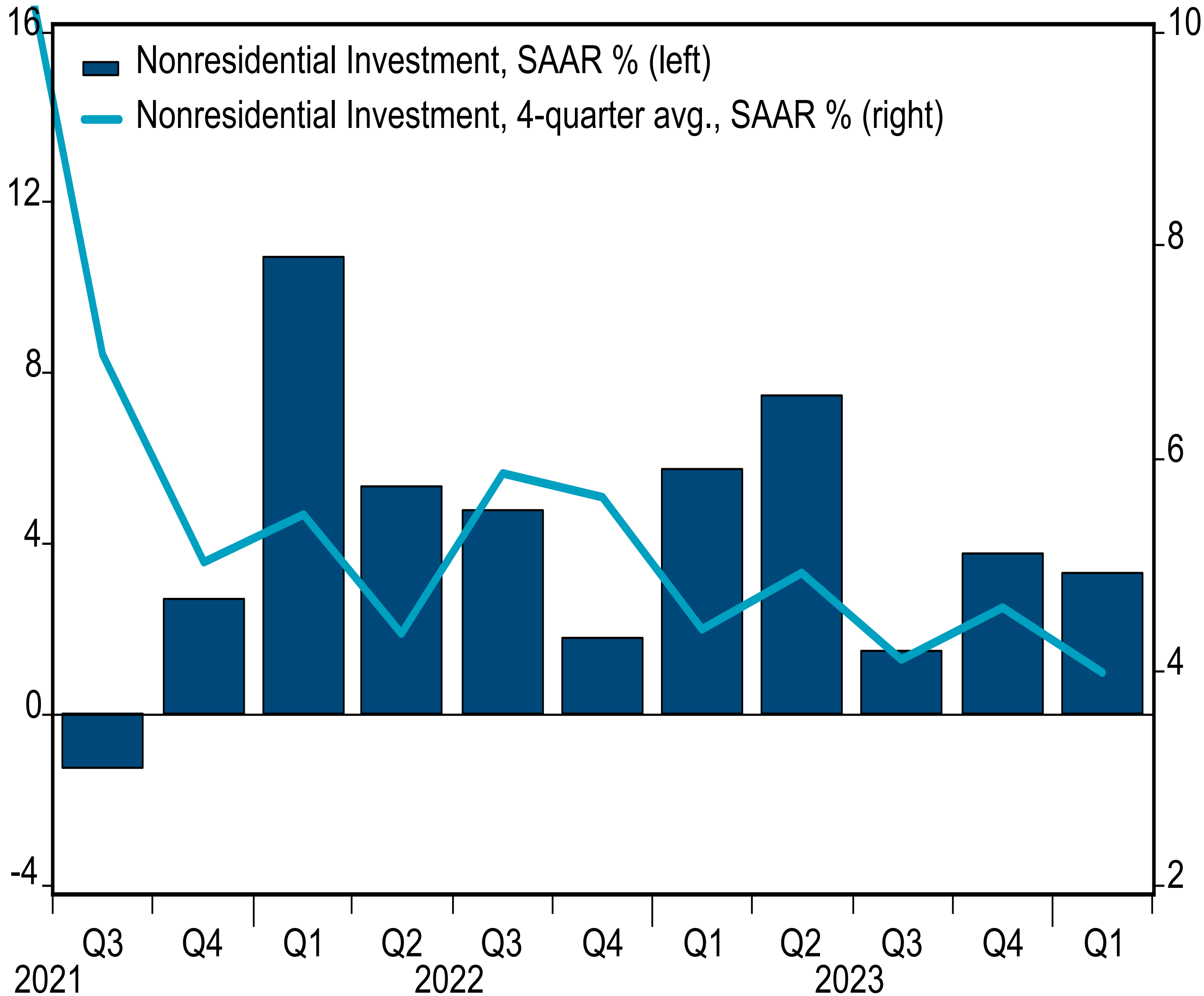
STIFEL | Fixed Income Capital Markets

Waning Business Investment

Businesses will continue to struggle under the weight of higher prices, elevated costs of parts, materials, rents, and labor, along with a limited ability to pass on rising costs without the risk of losing market share

Nonresidential investment rose **3.3%** in Q1 2024, down from the 3.7% rise in Q4 2023 and the weakest gain in two quarters

Some corporations have already announced hiring freezes, cut down on investment or turned to AI for cost reductions



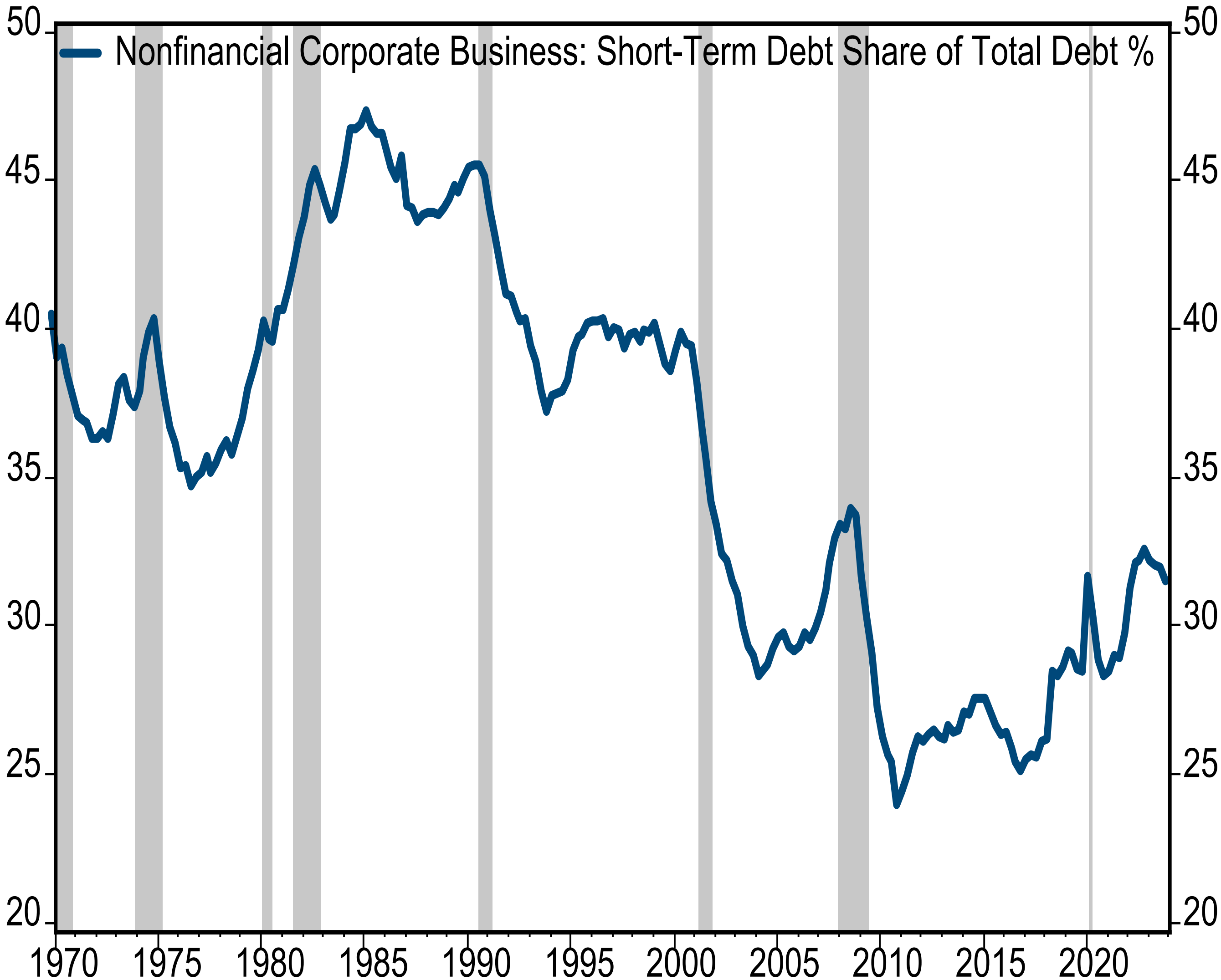
Source: Bureau of Economic Analysis/Haver Analytics

STIFEL | Fixed Income Capital Markets

Decline in Share of Short-Term Debt

Businesses have proven resilient

While rising somewhat in recent years, leverage in the non-financial corporate business sector broadly remains well below previous crisis levels with specifically a decline in short-term debt relative to total debt working to reduce corporate sensitivity to the Fed's interest-rate cycle



Source: Federal Reserve Board/Haver Analytics

STIFEL | Fixed Income Capital Markets

Manufacturing Activity Remains Lackluster, Services Activity Moves into Contraction

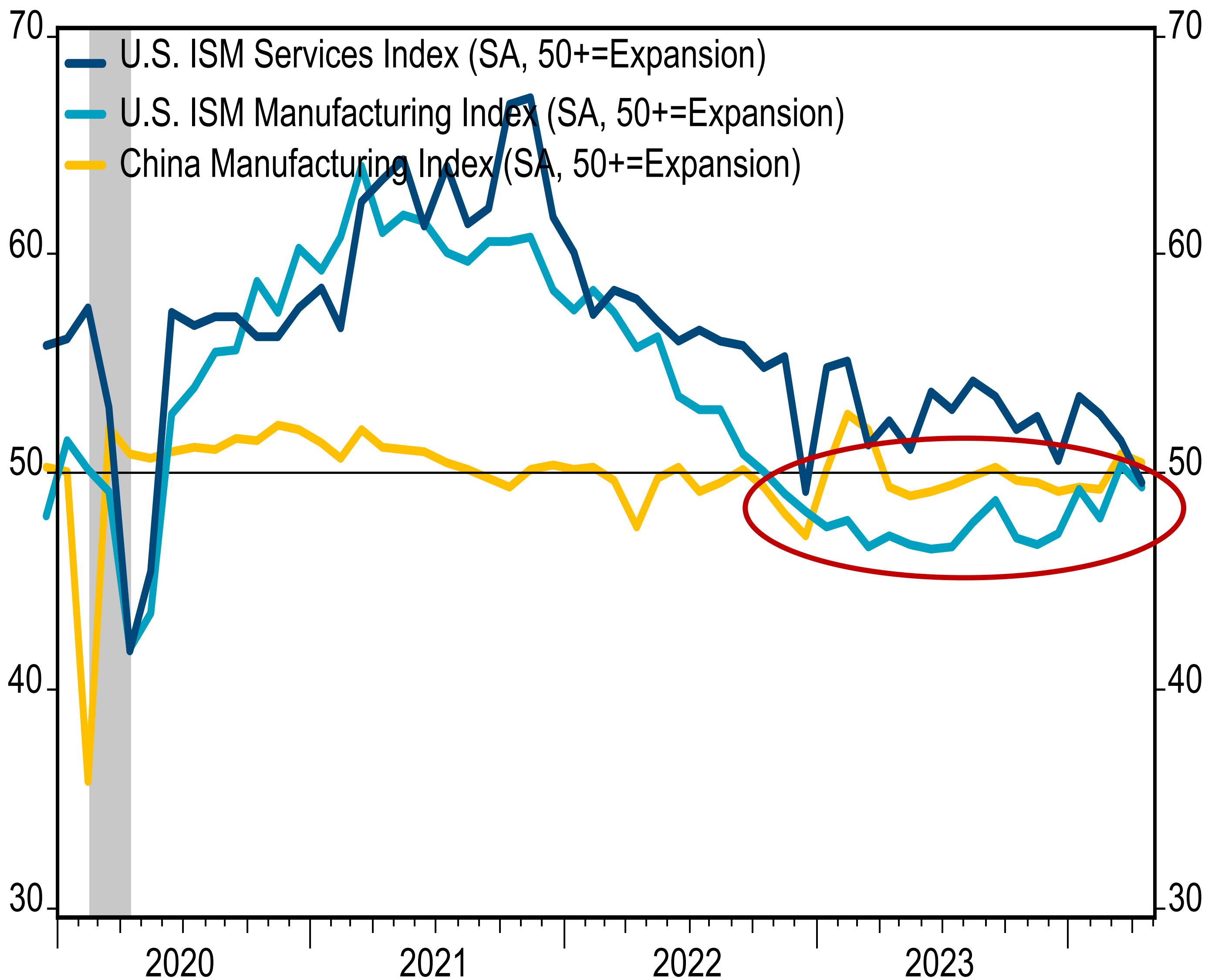
Consumers are shifting from goods to a pre-pandemic preference for services/experience

The ISM Manufacturing Index declined from a near-term peak of 60.8 in October 2021 to **49.2** as of April 2024

April's print follows a reading of 50.3 in March, the first monthly expansion after **falling below 50 in November 2022**

The ISM Services Index, meanwhile, fell to **49.4** in April, the first reading below 50 since December 2022

The China Manufacturing PMI fell to **50.4** in April, bouncing along breakeven since June 2021



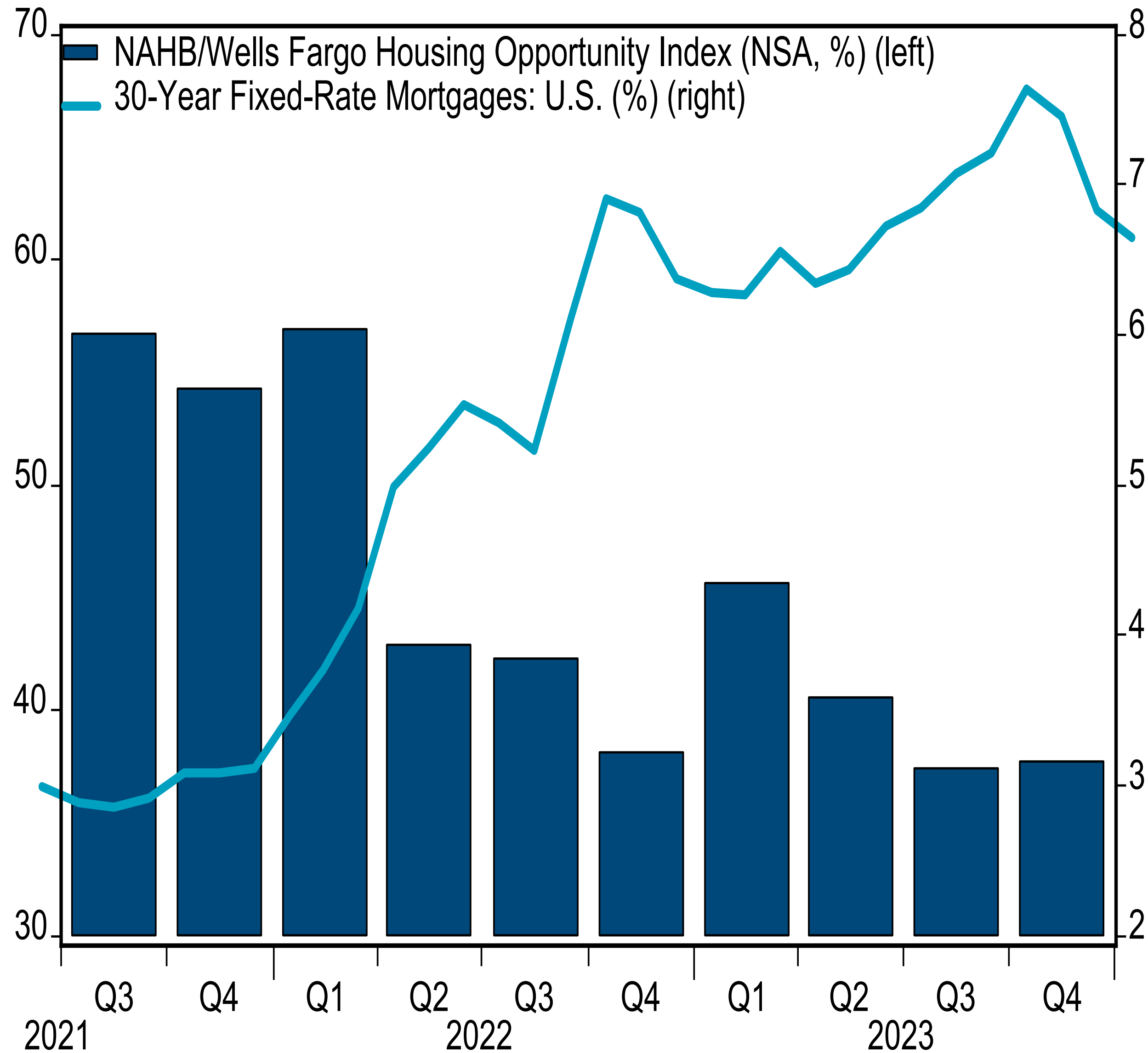
Sources: ISM, CFLP/NBS/Haver

Household Affordability Near Record Low as Mortgage Rates Remain Elevated

Higher rates undermine affordability (entrance) and create a lock-in effect (exit)

According to RedFin, more than 90% of homeowners have a mortgage rate below 6%, while 82.4% of homeowners have a rate below 5% and 62% have rate below 4%, resulting in a lock-in-effect

This lock-in effect is precluding would-be-sellers from offloading or replacing current property ownership at the risk of resetting one's mortgage from 3% to just shy of 7%

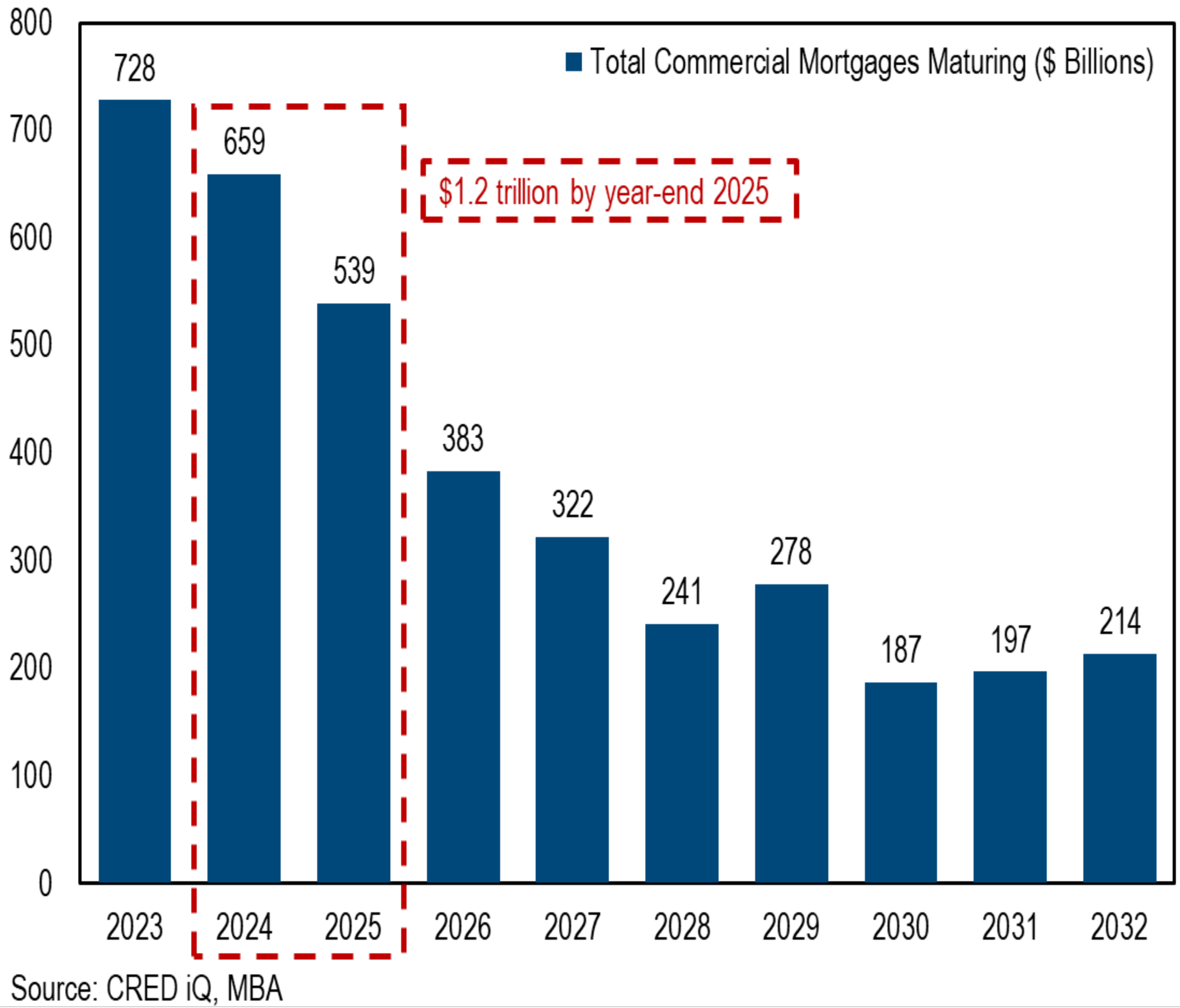


Sources: NAHB, FHLMC/Haver

Trillions in Commercial Loans Set to Reset at higher LTVs

Even with little reprieve in home prices or prices with rates higher for longer, CRE is the biggest near-term risk over 2024

By the end of 2025, **$1.2T** in commercial loans are slated to mature



Fixed Income Capital Markets

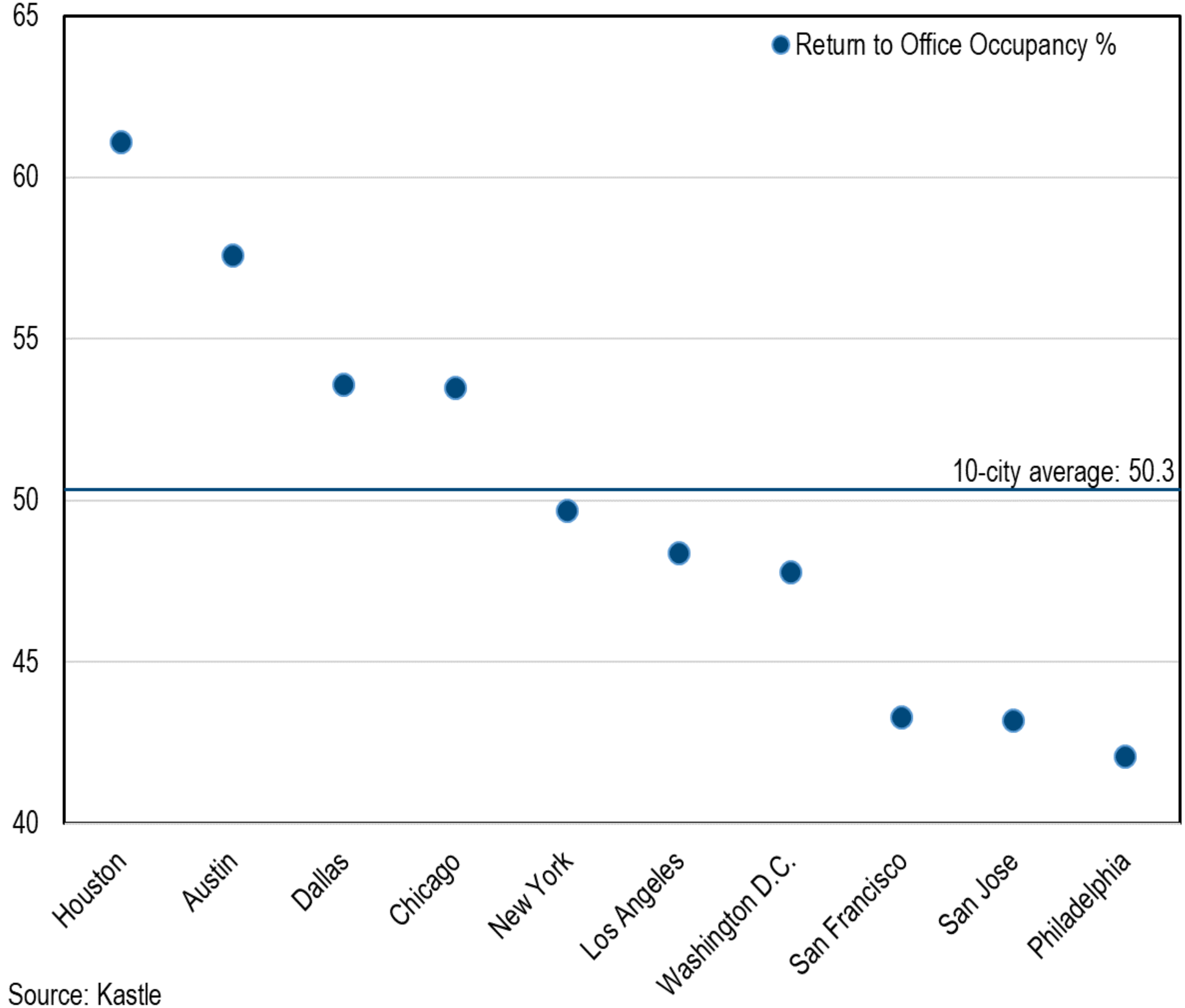
Return to Office Rates Complicate Commercial Real Estate Market Outlook

For the commercial market, as the work-from-anywhere environment has been wholly adopted, a change in structural preferences has resulted in a significant relocation of populations

For the downtown urban centers still experiencing at most a **40-50%** return to office rate, the population support will be more difficult to recapture

According to real estate data firm Trepp, **4.02%** of office loans that make up MBS are at least 30 days delinquent, the largest amount since 2018

Other areas, however, experiencing population booms will need further investment in commercial space to support the emerging growth and demand in everything from shopping centers to office spaces or alternative spaces for work, grocery stores and everything in between



Source: Kastle

STIFEL Fixed Income Capital Markets

Higher Rates Likely to Weigh on Nominal Growth (While Avoiding Recession?)

Given challenges, growth is likely to slow but remain positive as consumers are still spending and businesses are still investing

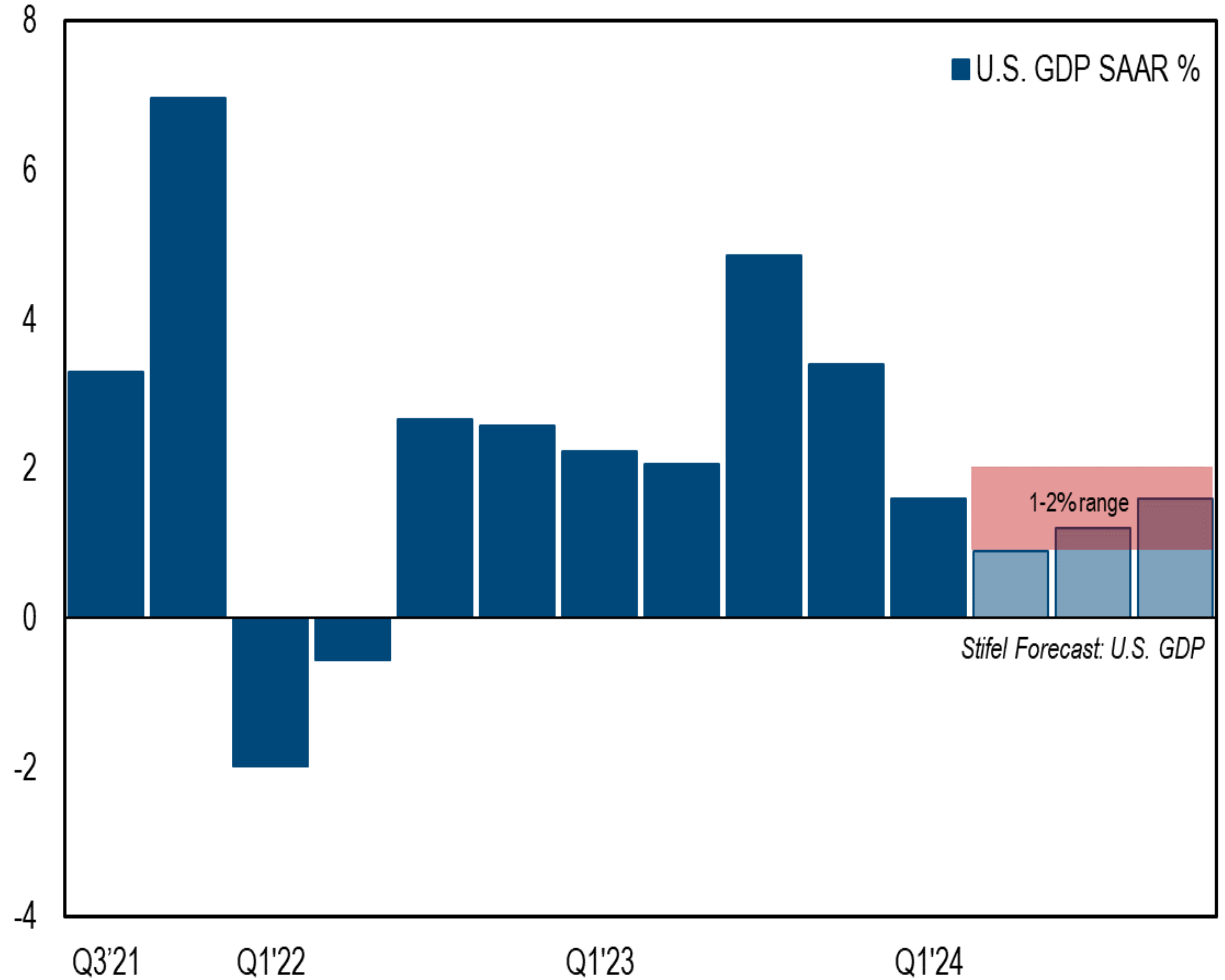
With an aggressive rate path, growth is likely to slow further with **the risk of recession at 20% for 2024**

GDP rose **1.3%** in Q1 2023, the weakest quarterly pace since Q2 2022

Excluding trade and inventories, final sales to domestic purchasers rose **2.6%**

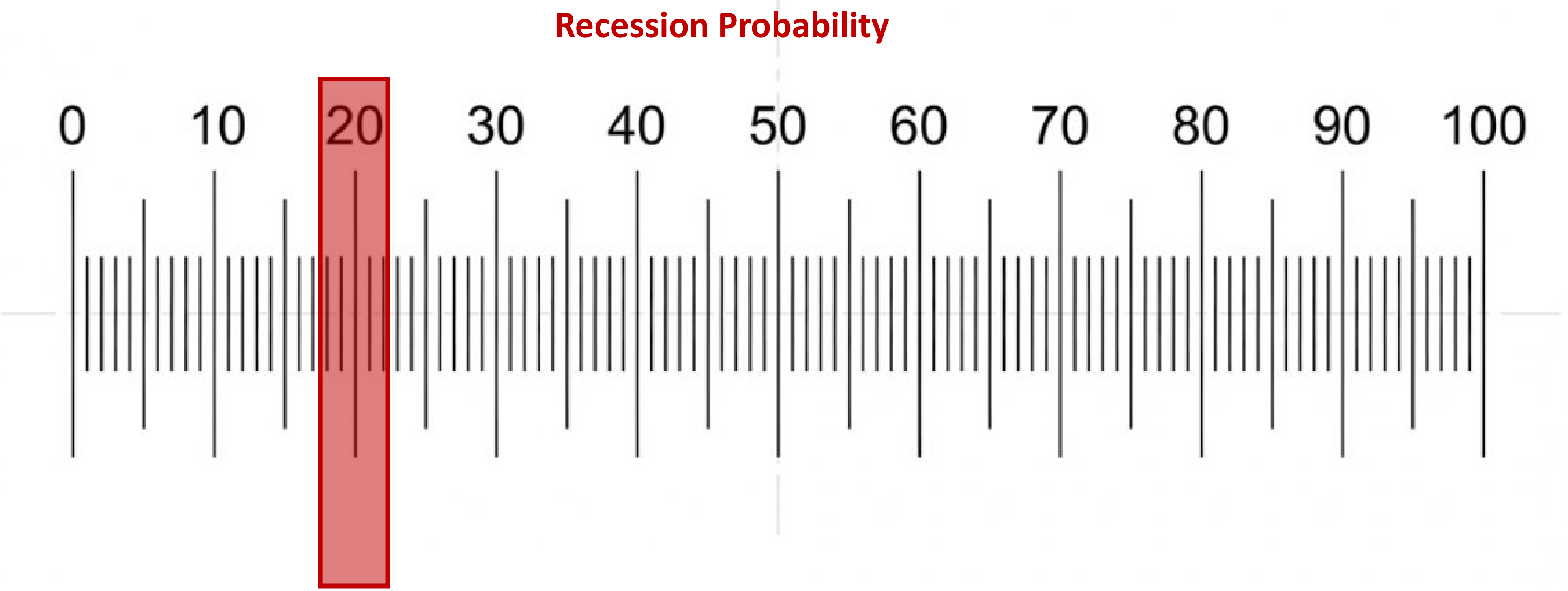
The Fed increased its GDP forecast from 1.4% to **2.1%** in 2024 with growth expected to rise **2.0%** in 2025, up from a 1.8% forecast in December

The unemployment rate forecast was revised lower from 4.0% to **4.1%** for 2024 year



Source: Census Bureau/Bloomberg/Stifel

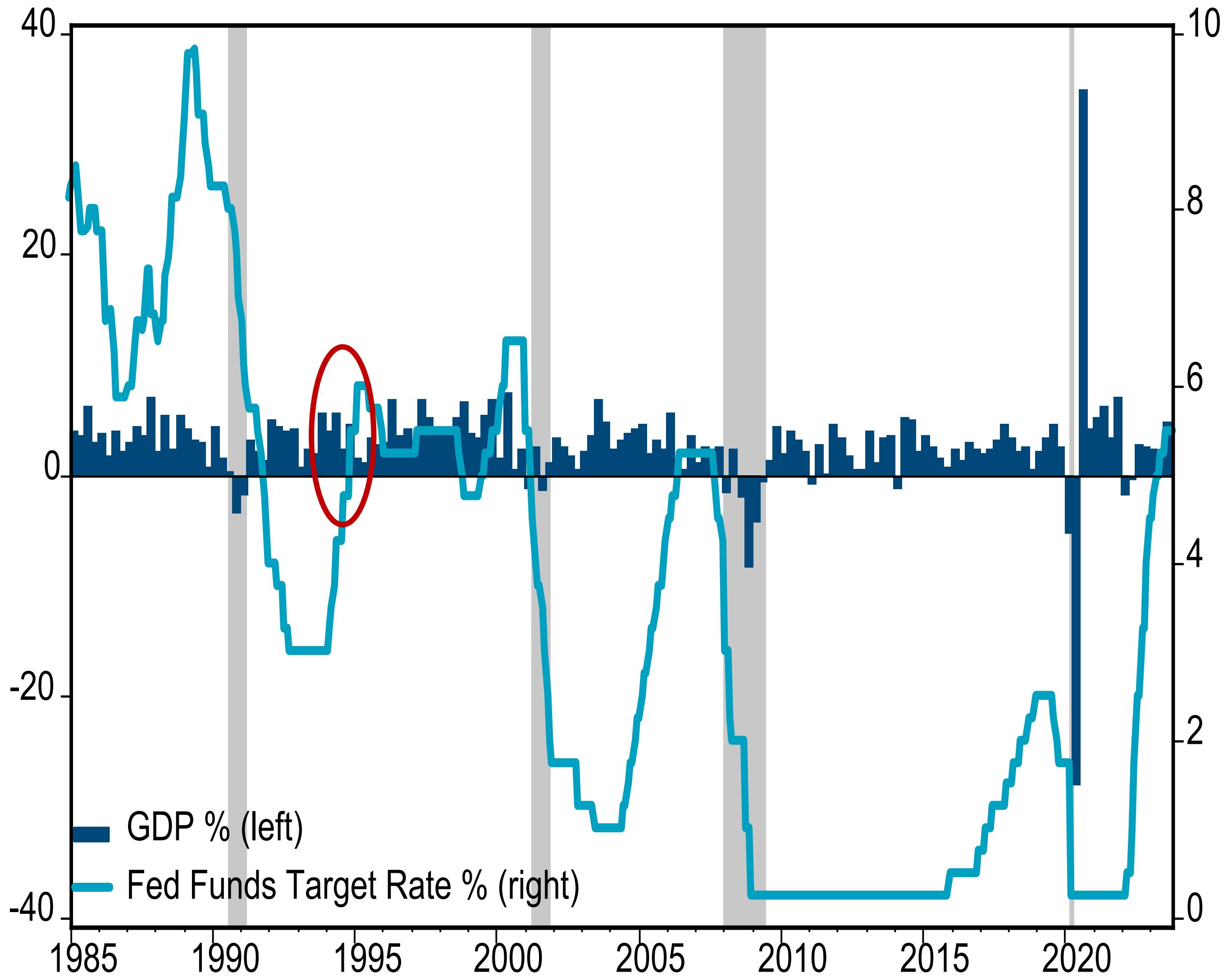
Recession Risk Remains Real But Fed Remains Focused on Soft-Landing



Soft Landing Only Achieved By the Fed Once in Last 60 Years

Over the last 60 years, the Fed has managed to achieve a soft landing only once in 1994-1995

The bigger concern and likelihood is not an outright downturn or outright recession, but a period stagflation as the economy slows to virtually a non-accelerating pace on average



Sources: BEA, FRB/Haver

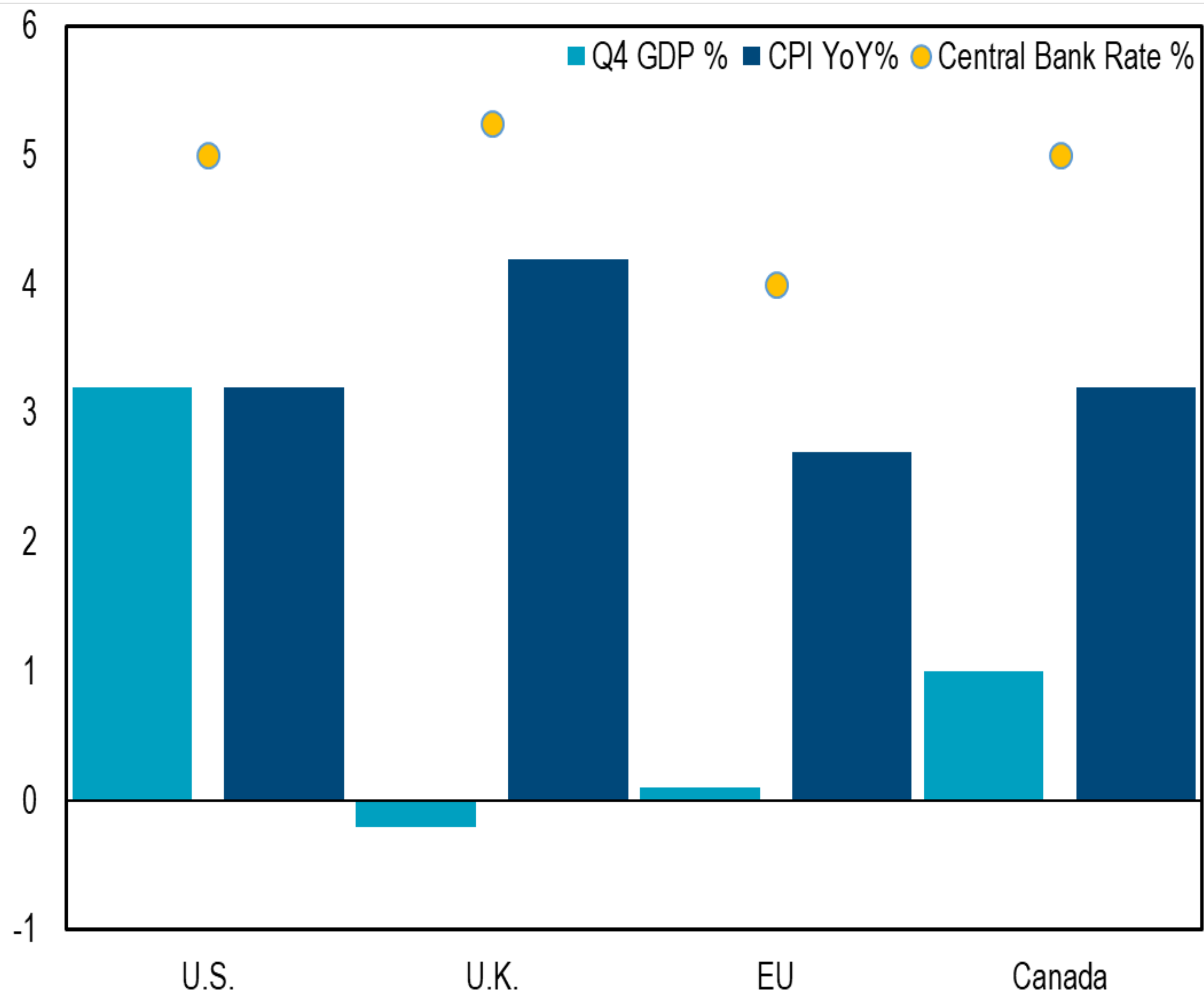
Developed Counterparts Facing Conundrum of Slower Growth and High Inflation

Global central banks face a conundrum of slower growth and still elevated inflation

The Bank of England (BOE) pushed rates to 5.25% with growth declining 0.3% in Q4 and inflation at 3.2%

The European Central Bank (ECB) raised its deposit rates to 4.0% with growth rising 0.1% in Q4 and inflation at 2.4%

The Bank of Canada (BOC), meanwhile, raised rates to 5.0% with growth rising 1.0% in Q4 and inflation at 2.9%



Source: Bloomberg

STIFEL | Fixed Income Capital Markets

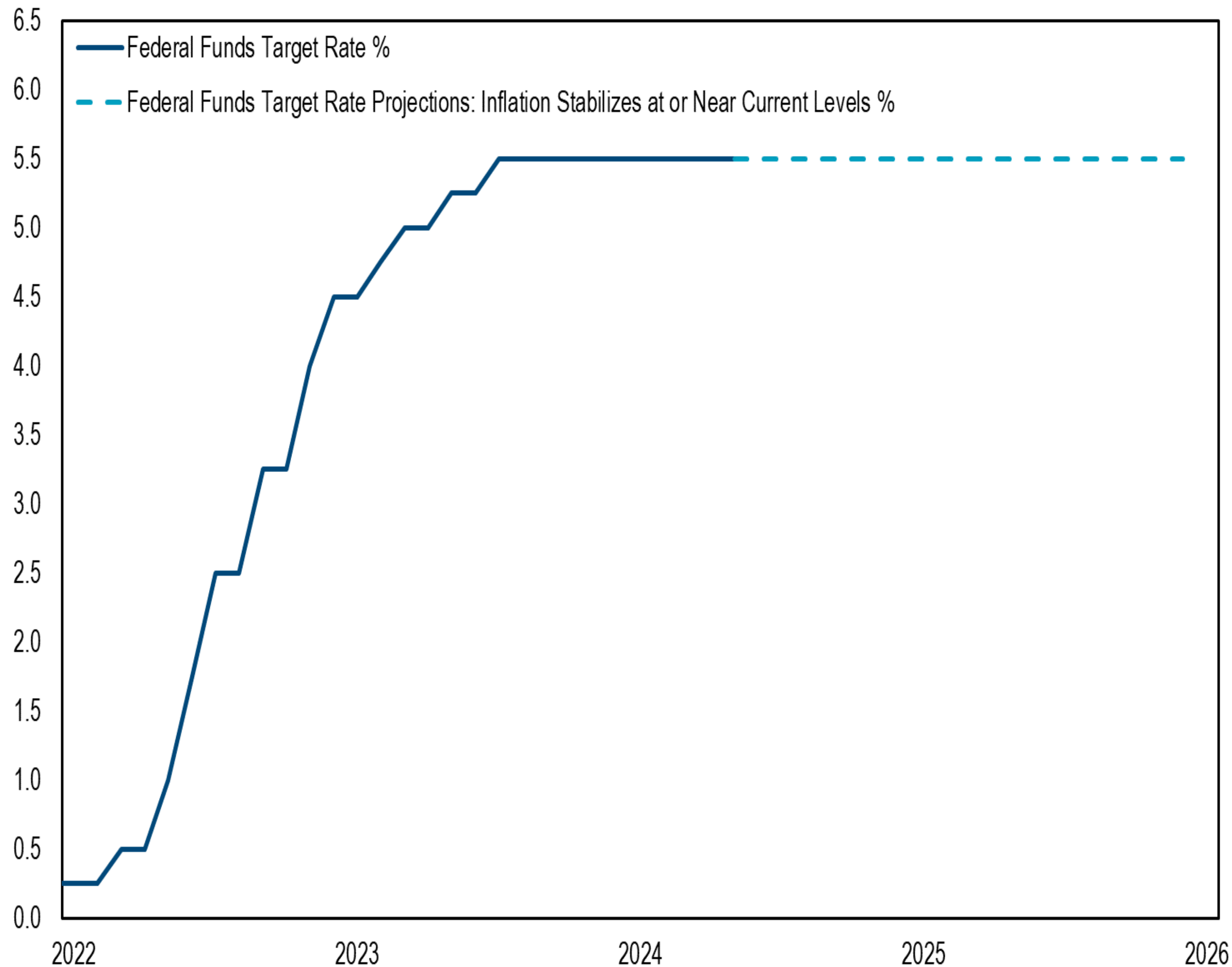
Fed Rate Cuts Delayed, Potentially Until 2025

The Fed continues to exercise patience, running the risk of allowing inflation to become embedded into the economy **which justifies higher for longer and calls into question the Fed's terminal rate decision**

With inflation elevated, the question becomes, **did the Fed raise rates high enough?**

The May FOMC statement noted an ongoing concern regarding inflation

The FOMC noted the risks of achieving both their inflation and unemployment goals *"have moved toward better balance,"* but *"there has been a lack of further progress toward the Committee's 2% inflation objective"*



Source: Bureau of Economic Analysis/Federal Reserve/Stifel

STIFEL | Fixed Income Capital Markets

10-Year Treasury Action Complicates Fed Policy Pathway

The earlier backup in longer-term rates offered a compelling case there was no longer a need for additional rate hikes

On October 23rd, the 10-year UST yield topped 5% for the first time since 2007

Chair Powell suggested investors may be focused less on future policy tweaks and more on fundamental shifts in market support in the context of fiscal deficits, quantitative tightening and domestic growth (expectations)

Thus, he said the recent increase in long-term yields *"doesn't seem to be principally about us doing more."*

However, if the rise itself is a reflection of a change in expectations regarding monetary policy, then according to Minneapolis Fed President Neel Kashkari, *"We might actually need to follow through on their expectations in order to maintain those yields."*

Source: Bloomberg

STIFEL | Fixed Income Capital Markets

U.S. Debt Continues to Increase Risking Pressure On Inflation, Longer-Term Rates

Rising federal deficits will expectedly result in a stubbornly elevated level of real rates over time

Wake up call short-lived amid prospects of easing

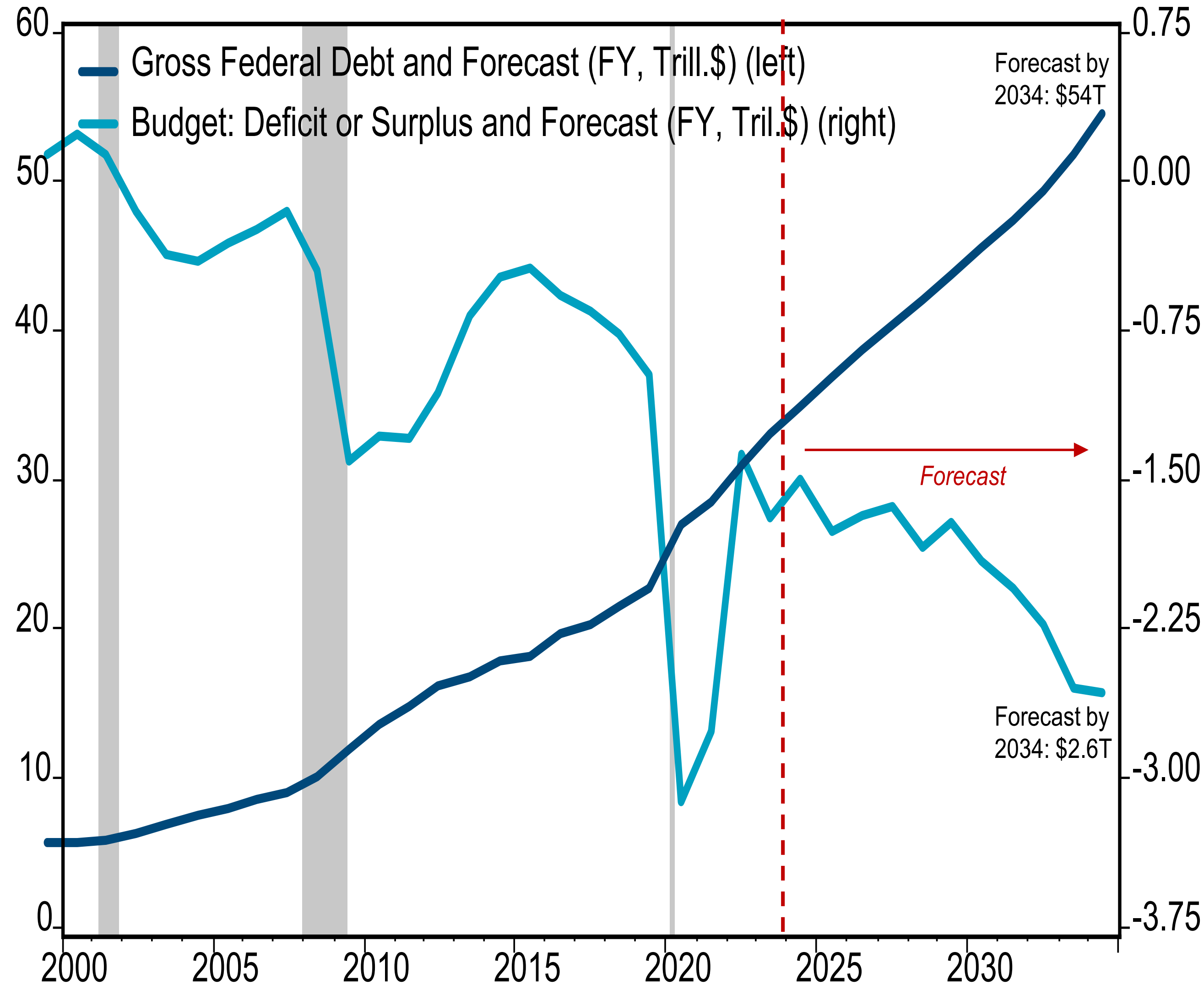
Deficits matter and will continue to reshape expectations for higher longer-term rates, complicate the Fed's pathway, and risk inflation

In FY 2023, the federal deficit was **$1.6T**, and 6.2% of GDP

The deficit is expected to remain elevated at 6.1% of GDP, almost two times the historical norm

The government balance sheet has grown to over **$34T** as of late

In March, Congress passed a $1.2T government funding package to fully fund the government through September



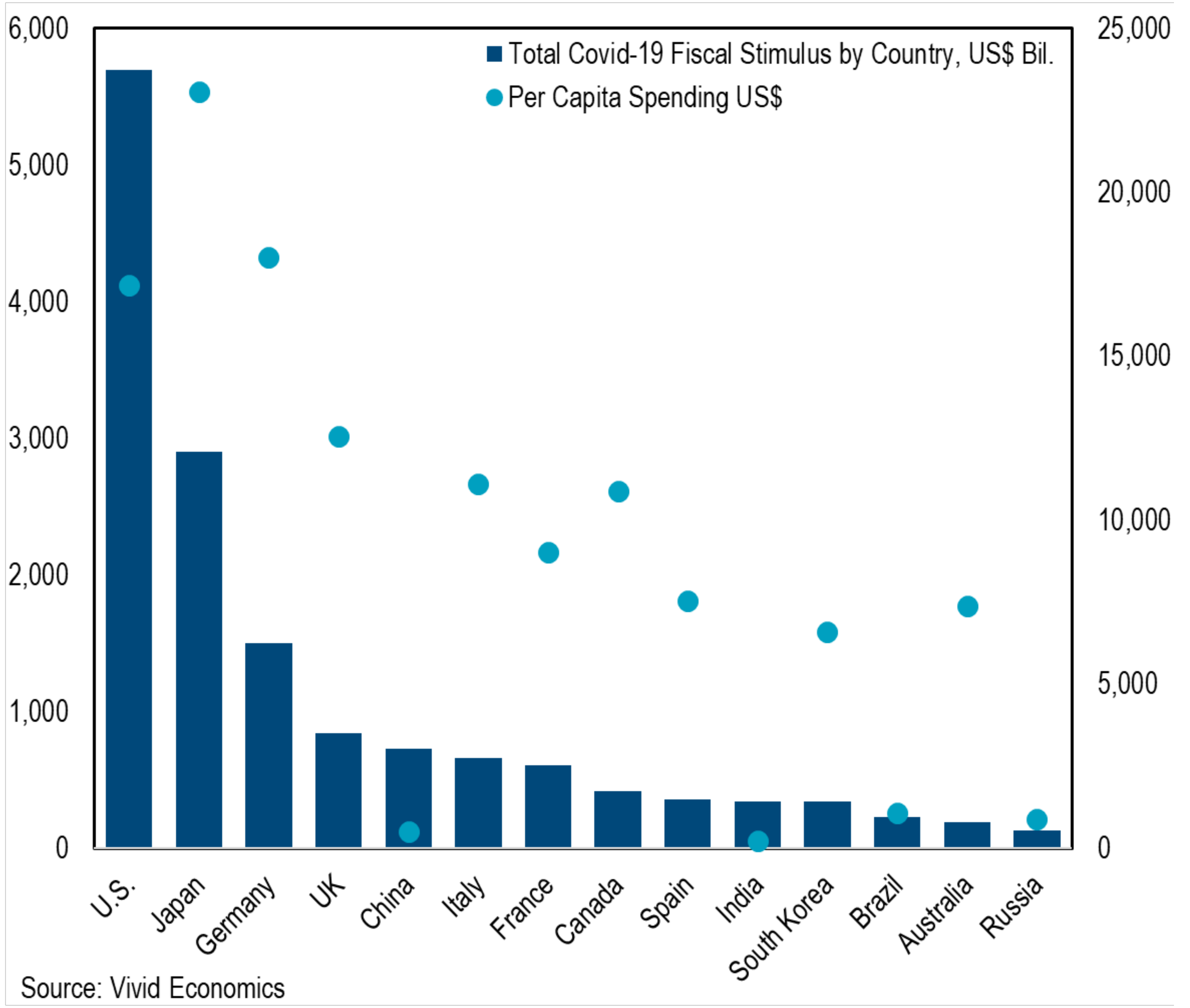
Source: Congressional Budget Office/Haver Analytics

Global Covid-19 Spending

Even without the IRA and the CHIPS and Science Act, the U.S. has spent nearly **$6T** in Covid relief grossly contributing to the nation’s inflationary concerns

Developed nations in total spent **$17T** on the pandemic with government spending becoming a greater share of GDP in every major advanced economy, a relentless expansion of government

The U.S., however, spent more than double the next highest spender with much in the way of direct payments, leading to higher inflation rates than almost anywhere else in the world



STIFEL | Fixed Income Capital Markets

Unprecedented Inflation Amid Massive Government Spending

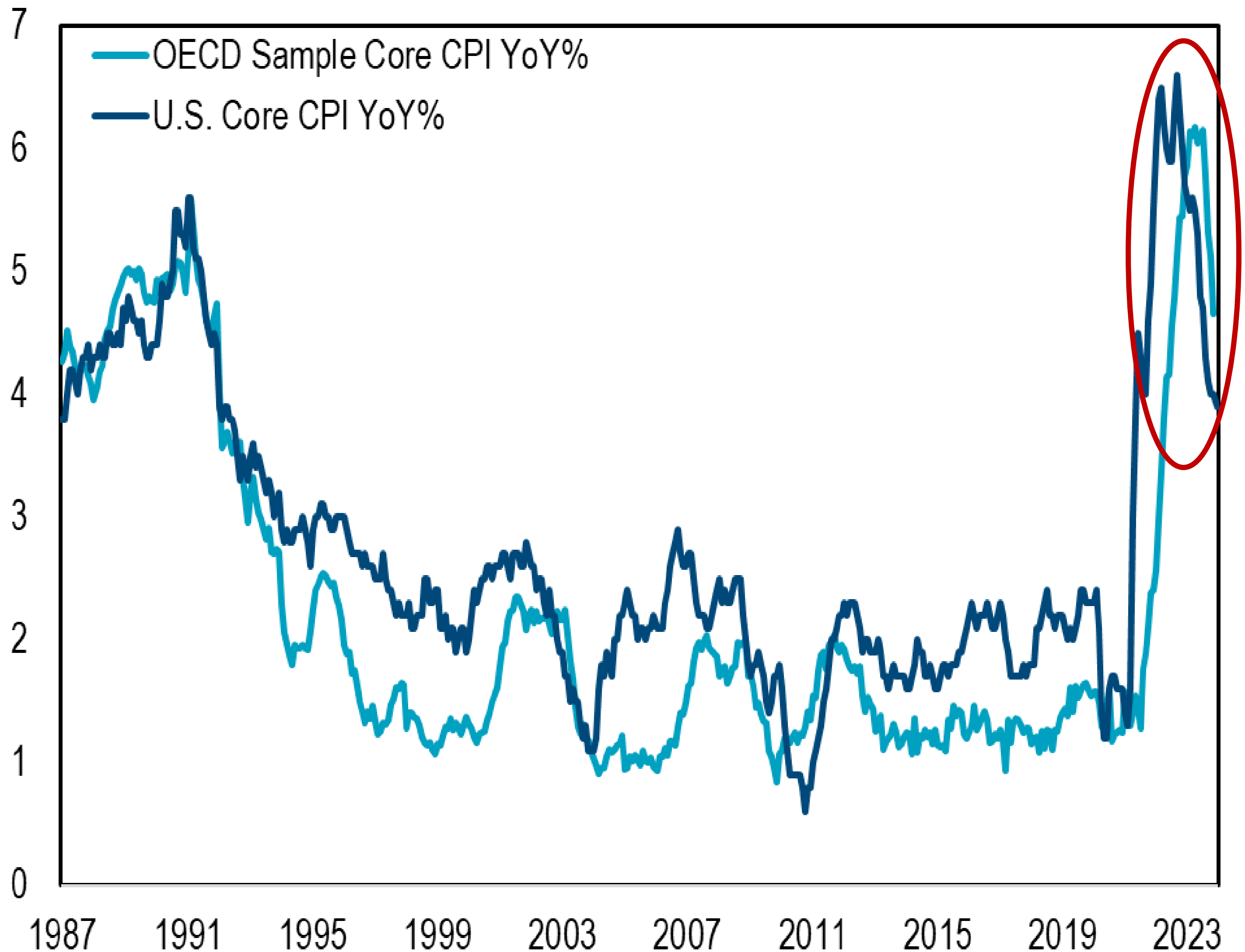
The global economy was reeling from supply-side constraints

U.S. inflation was exacerbated by fueling demand-side metrics and labor costs resulting from fiscal policy measures

Inflation has slowed, but prices continue to rise, and the risk remains to the upside, particularly from international factors

U.S. inflation no longer continues to outpace other countries, rising **3.6%** as of April vs. **4.7%** elsewhere in the developed world

U.K. inflation: **2.3%**
Eurozone inflation: **2.4%**
Chinese inflation: **0.3%**
Japanese inflation: **2.5%**



Source: FRED

*Sample includes: Canada, Denmark, Finland, France, Germany, Netherlands, Norway, Sweden, and the U.K.

STIFEL | Fixed Income Capital Markets

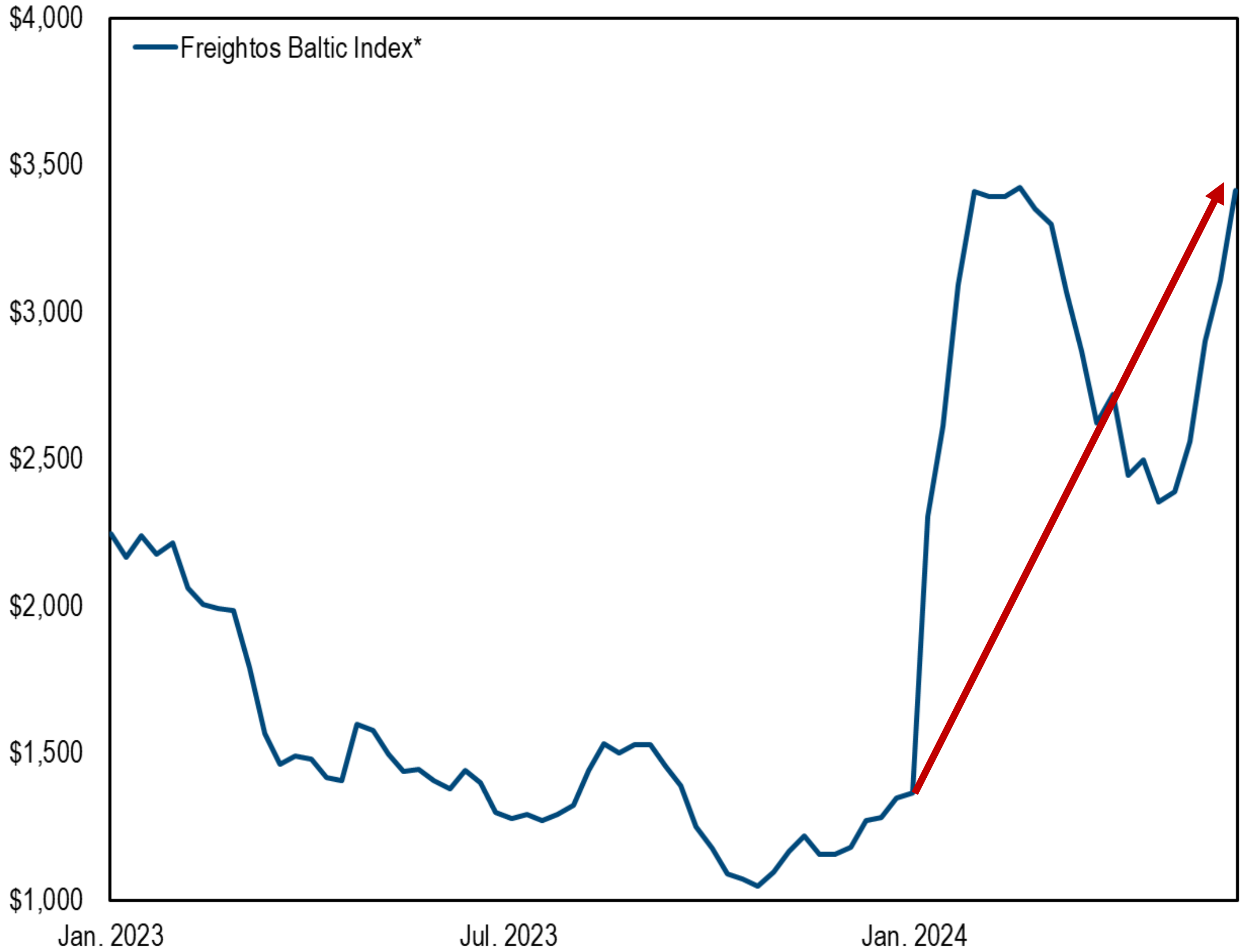
International Risks and Uncertainty Muddy the Outlook for Inflation, Policy

Global politics continue to shift perceptions, market metrics and potential policy directives

Any additional military response may not be enough to adjust policy but a renewed threat to prices – food, energy, shipping – could muddy policy pathway

Demand cooling and few supply-side reports of shortages but if prolonged, could move the inflation needle

There are reports of massive disruptions to shipping passages due to the conflict in the Middle East, with estimated costs rising over 130% for containers moving from North Asia to the U.S. East Coast



Source: Bloomberg

*The index is a weighted aveage cost of a 40' container over twelve route indexes for ocean freight.

STIFEL | Fixed Income Capital Markets

- Bloated and growing government balance sheet
- A reduction in longer-dated yields
- Rising equity market valuations
- A more confident and *"spendy"* consumer
- High investor confidence for a near-term rate cut
- International and geopolitics risks

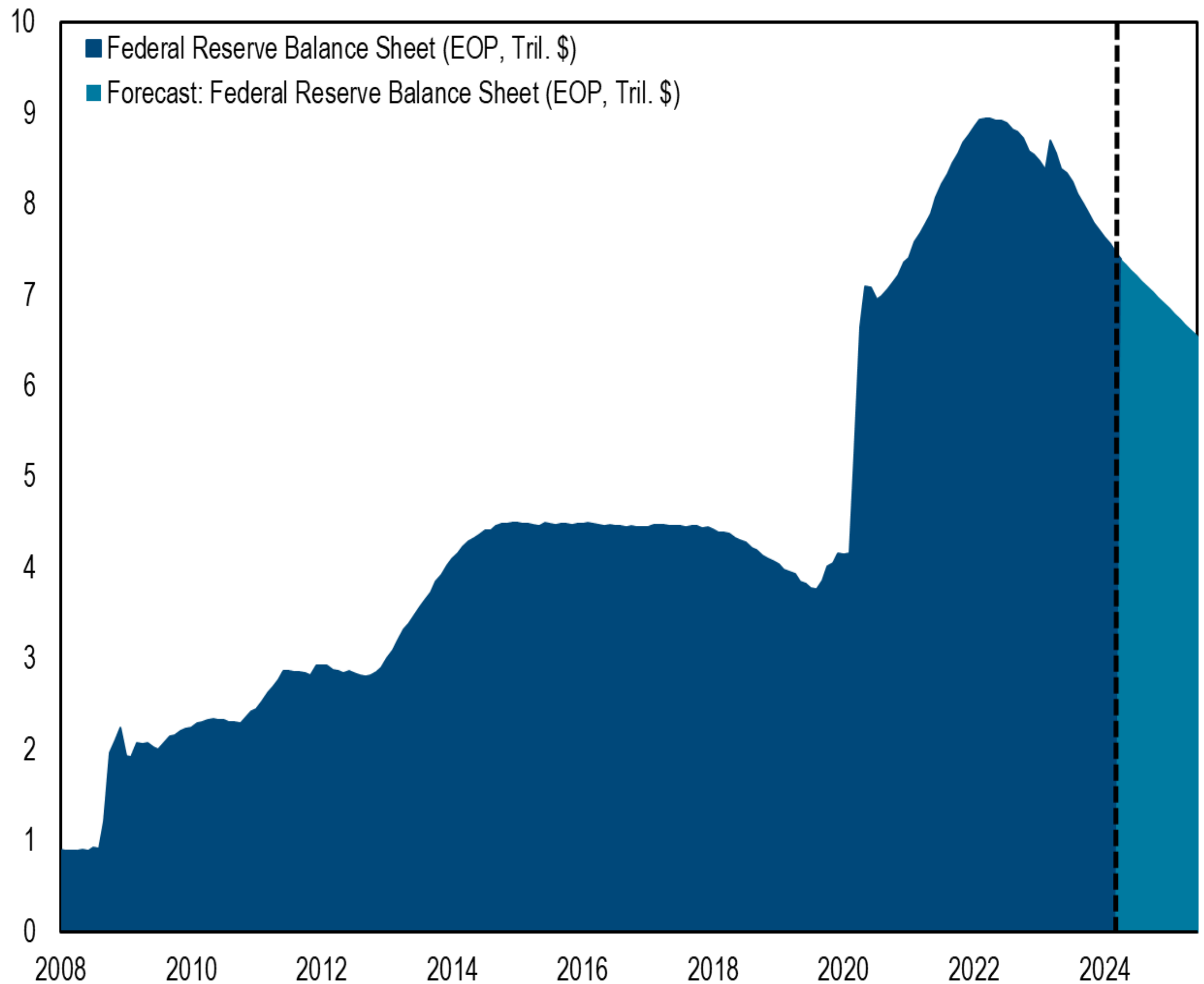
Policy Adjustment Focuses on Balance Sheet for Now

With the Fed's assessment of the economy little changed, the biggest adjustment came on the balance sheet with the Fed announcing specifics in terms of tapering quantitative tightening

The Fed will reduce the monthly redemption cap on Treasuries from $60 to $25 billion, and maintain cap on agency and MBS at $35 billion, skewing the future composition of the balance sheet back towards Treasuries

The Fed had been reducing the balance sheet by roughly $95 billion a month beginning in June of 2022

The motivation is to avoid *"market turmoil,"* potentially allowing the Fed to continue to shrink the balance sheet at a slower pace for longer



Source: Federal Reserve/Haver Analytics/Stifel

STIFEL | Fixed Income Capital Markets

Inflation to Remain Uneven, Uncertain, Elevated

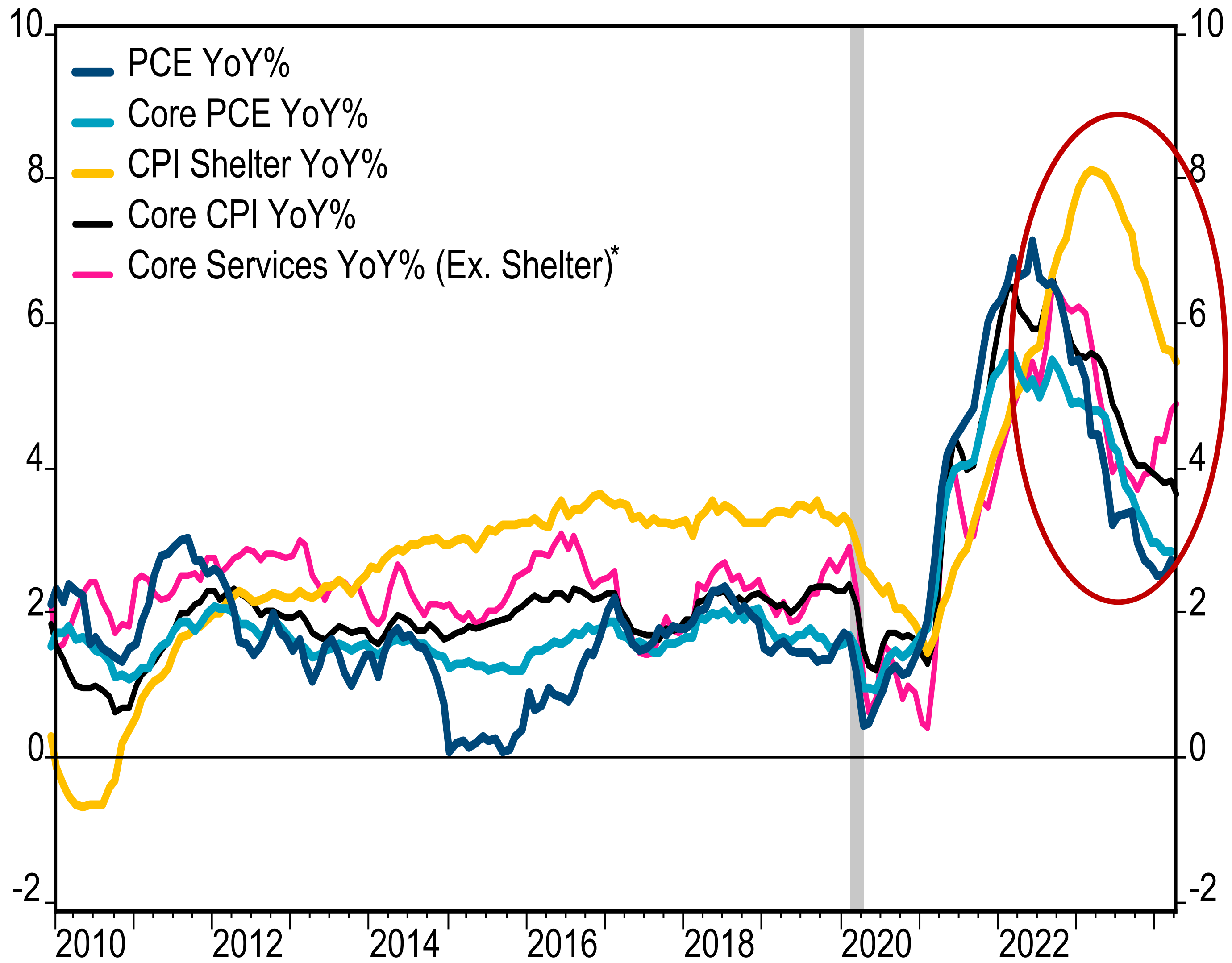
Balance sheet aside, when it comes to the Fed's next policy move, **its all about inflation!**

The core CPI rose 0.3% in April and **3.6%** year-over-year, a downtick from 3.8% in March

Core services excluding shelter, meanwhile, rose **4.9%** year-over-year in April, the largest annual gain in one year

The Fed's headline PCE forecast was revised was unrevised at **2.4%** for 2024 with the core revised up from 2.4% to **2.6%**

Inflation is expected to rise 2.1% in 2025 and remain above 2% until at least 2026



Source: Bureau of Labor Statistics/Haver Analytics:

*Core services inflation tracks healthcare, insurance, education, repairs, personal services, etc.

CPI: Details

Food prices were flat (0.0%) and rose **2.2%** over the past 12 months, while energy prices increased 1.1% in April rose **2.6%** year-over-year

Transportation prices rose 0.7% and **3.5%** on an annual basis

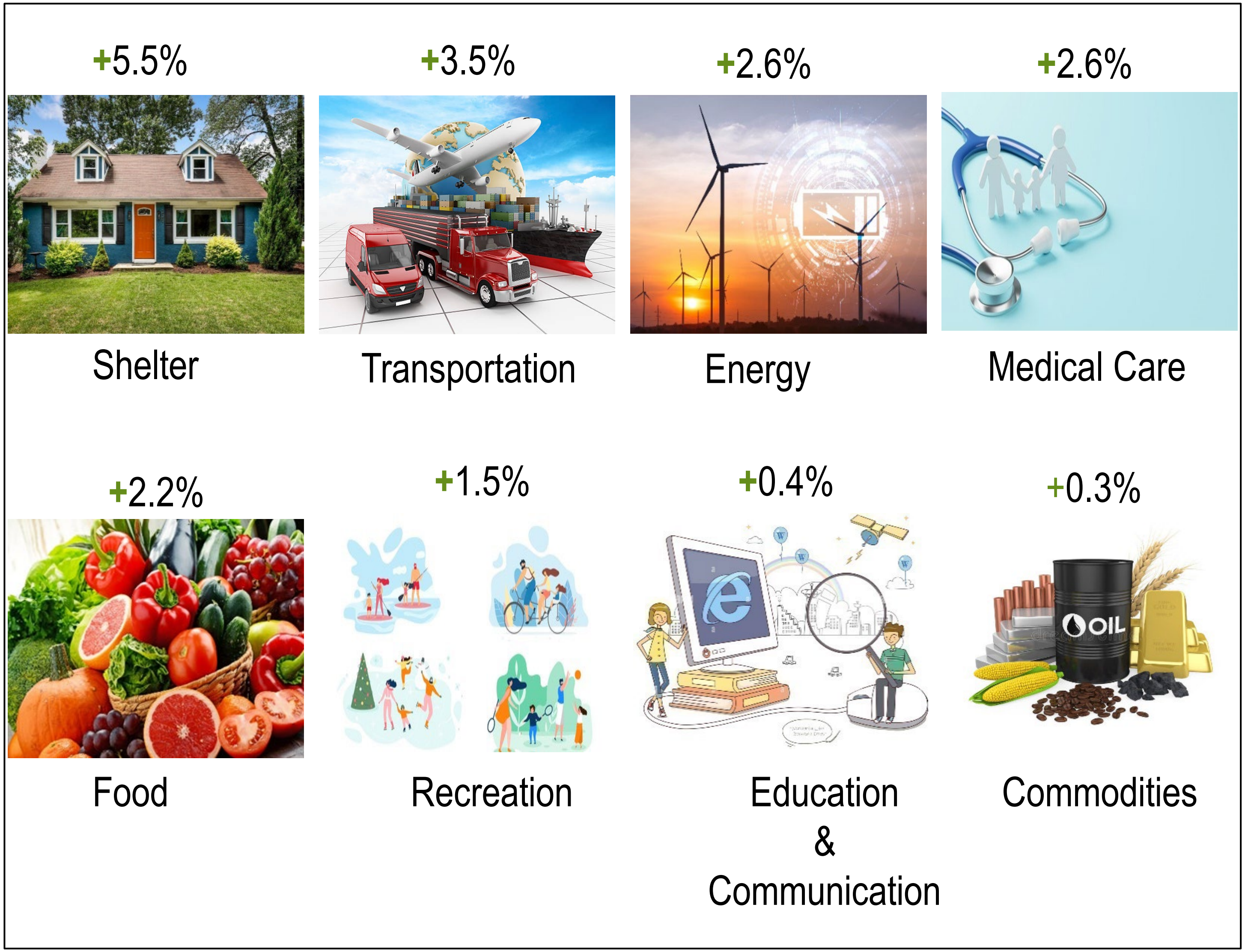
Shelter prices, meanwhile, rose 0.4% and **5.5%** annually

Also, medical care prices climbed 0.4% in April and **2.6%** year-over-year

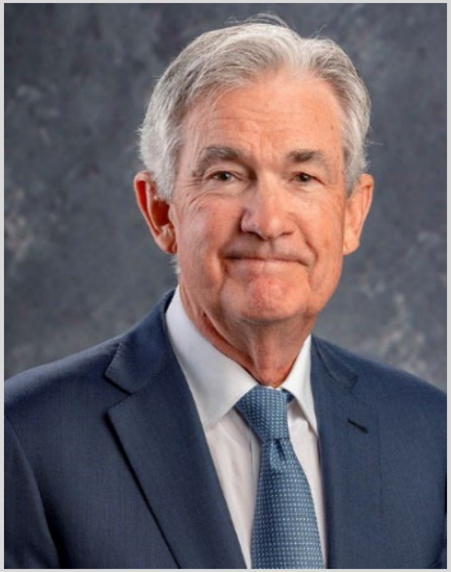
Commodities prices increased 0.2% in April and **0.3%** on an annual basis, and education and communication prices rose 0.2% and **0.4%** annually

Recreation prices gained 0.2% in April and **1.5%** over the past 12 months

CPI Categories YoY%, NSA



Source: Bloomberg/ Shutterstock



Given the economy and inflation are failing to evolve as expected, "*eventually*" may become a 2025 event

Is the Fed considering the scenario of higher inflation?
How long is the Fed really willing to remain on the sidelines with inflation above the 2% target level?

At what point is the Fed forced to shift from simply delaying rate cuts to actively considering rate hikes?

1. The Federal Reserve will remain on the sidelines for longer than previously expected.

*"…readings on inflation have come in above expectations. It is likely that **gaining such greater confidence will take longer than previously expected**."*

Federal Reserve Chairman Jerome Powell Speaking at the May Press Conference

May 1, 2024

2. Next move is still likely to be a rate cut.

*"I think **it's unlikely that the next policy rate move will be a hike.** I'd say it's unlikely. You know, our policy focus is really what I just mentioned, which is how long to keep policy restrictive."*

Federal Reserve Chairman Jerome Powell Speaking at the May Press Conference

May 1, 2024

STIFEL | Fixed Income Capital Markets

- Base case: Fed on hold through 2024 amid sticky inflation

- Stubbornly elevated inflation: May allow Fed to cut followed by an extended pause

- Slowly declining inflation: Fed pursues lower rates at a tempered pace, remaining above neutral beyond 2025

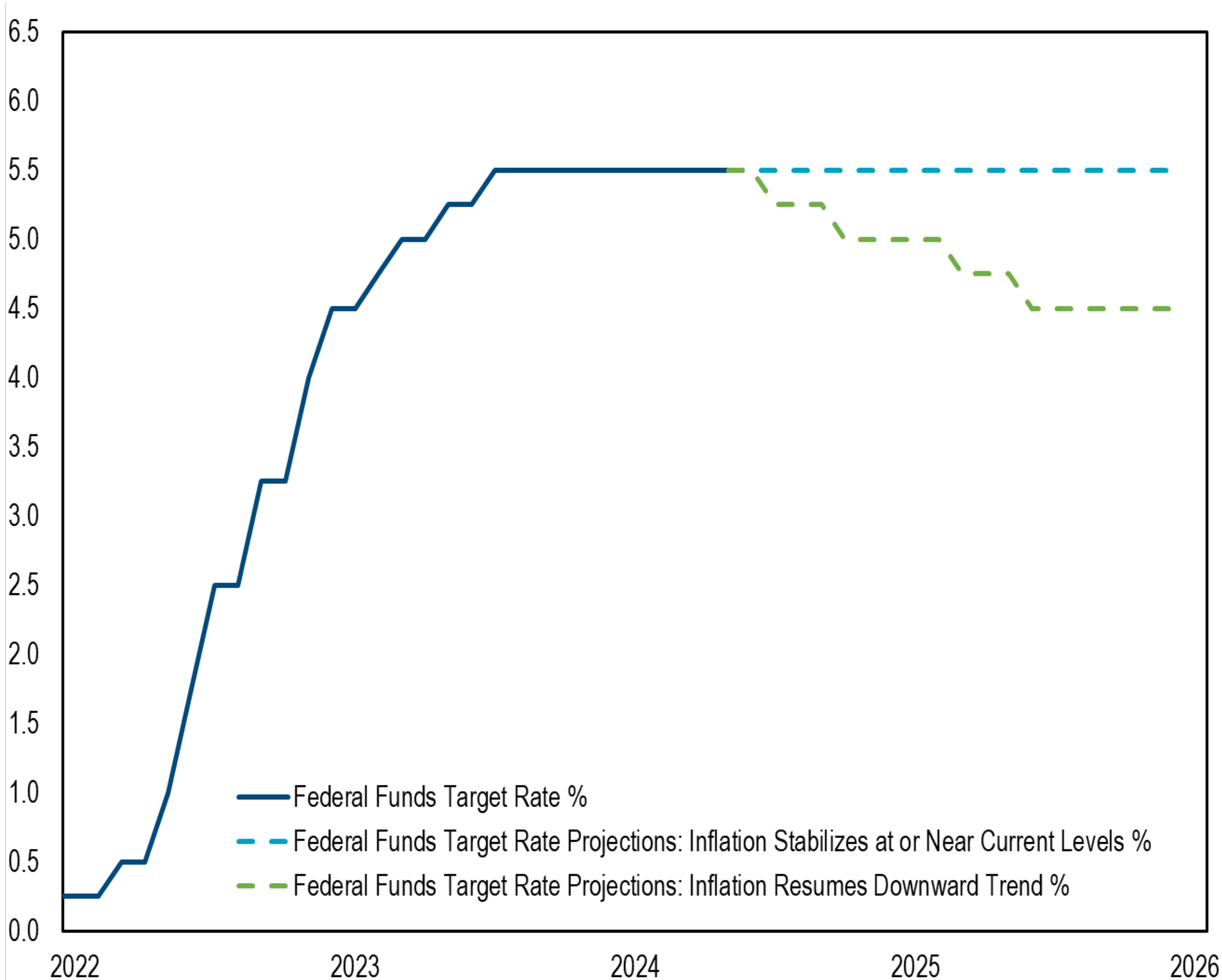
- A material rise in inflation: Fed likely to reengage

Inflation Stabilizes at or Near Current Levels vs. Resumes a Disinflationary Trend

If inflation remains at the current elevated levels – or even pushes slightly higher still – after one or two reductions, there is likely little more the Fed could offer

Meaning, at most, 50bps of relief in the near to medium term followed by a second-round extended pause on the sidelines

Even if inflation resumed a disinflationary trend, the pace of rate reductions would expectedly be slow and tempered, keeping the federal funds rate well above neutral through 2024

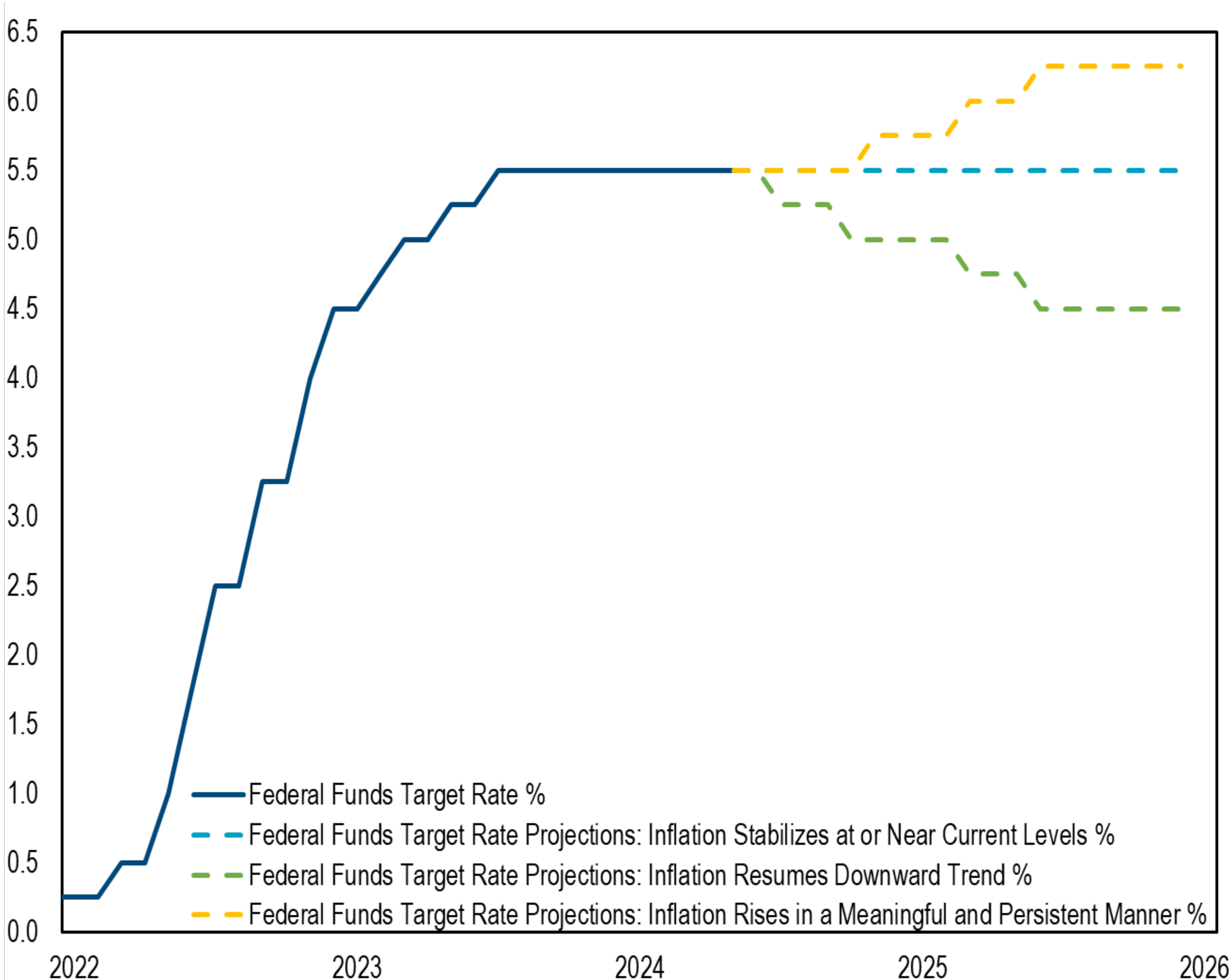


Source: Bureau of Economic Analysis/Federal Reserve

STIFEL | Fixed Income Capital Markets

Inflation Rises in a Meaningful and Persistent Manner

However, if inflation reversed course, the Fed may be forced to engage in additional rate hikes

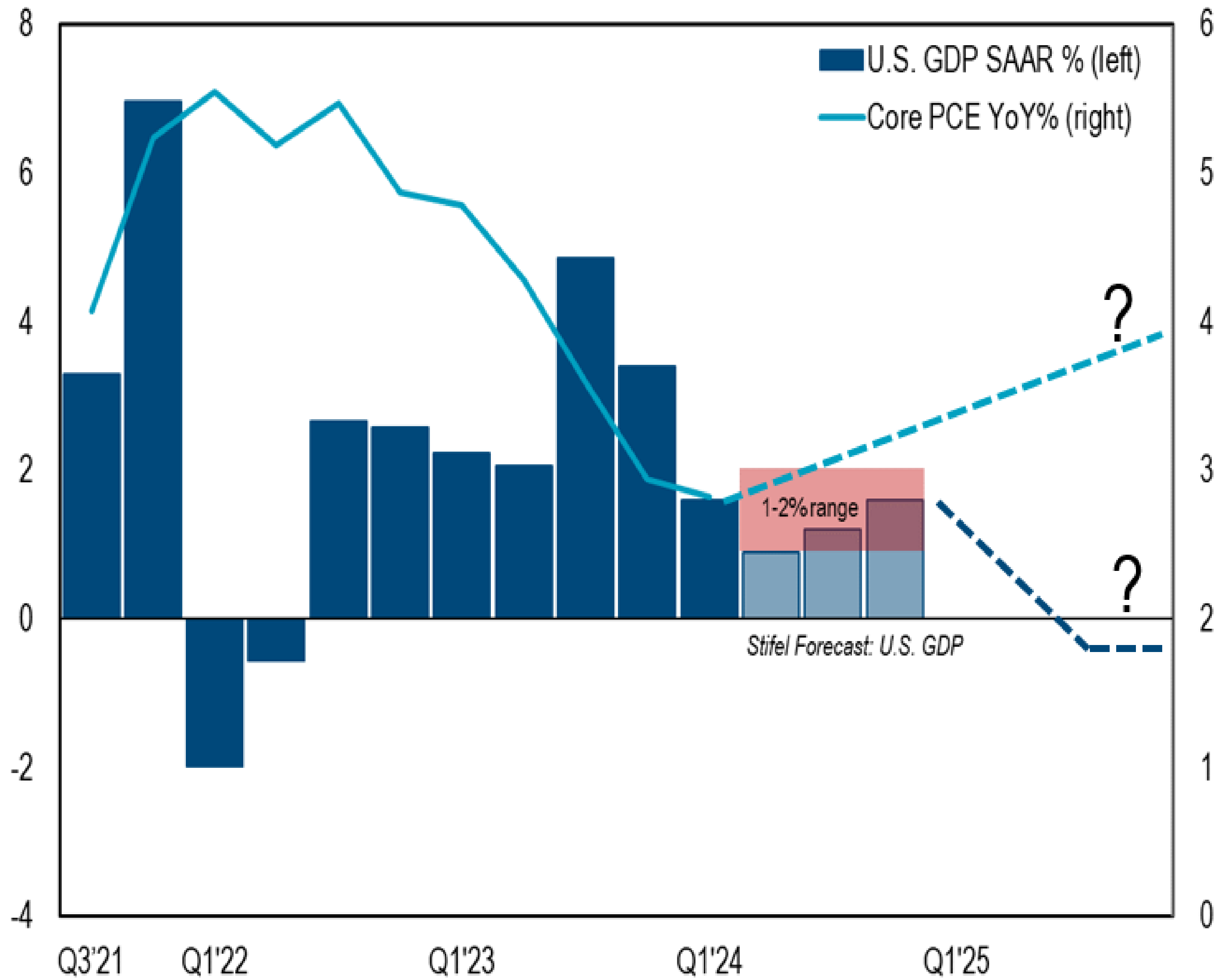


Source: Bureau of Economic Analysis/Federal Reserve

Stagflation Concerns

The longer the Fed tolerates above-target inflation, the more engrained price pressures will become and the more difficult to tame

With topline activity still growing but losing momentum, the window to tackle inflation against the backdrop of a *"solid"* economy is far from indefinite



Source: Census Bureau/Bloomberg/Stifel

STIFEL | Fixed Income Capital Markets

Thank you

- Aging Demographics:
  - Social security faces insolvency issues with 3 workers supporting a retiree as of now vs. 42 workers supporting a retiree in 1940.
- Growing Wealth Concentration:
  - The top 10% holds 69% of the wealth ($7.0M on avg.); bottom 50% holds 2.5% ($51k on avg.).
- Social Crisis:
  - According to the Department of Housing and Urban Development (HUD), there were around 582k or 0.18% of Americans experiencing homelessness in 2022.
- AI Job Replacement:
  - Generative AI could expose 300M full-time jobs around the world. (1)
- Productivity and Participation:
  - The work from home model has been found to lead to a 10-20% reduction in productivity. (2)

- Treasury Issuance:
  - The U.S. government debt has grown 94% in the last 10 years to $33T with debt servicing costs rising to 7.5% of the budget ($475B) and projected to rise to more than 10% of the budget by 2033.
- Dollar Dominance:
  - Elevated inflation, banking sector volatility, and the ongoing debt ceiling debate has undermined dollar dominance.
- International Weakness:
  - Europe is expected to grow at a less than 1% pace in 2023, with5.5% inflation; the U.K. is expected to grow 0.3% this year with 7.2% inflation. In 2024, GDP in Europe is expected to be 1.1% with 3.0% inflation, and GDP in the U.K. is expected to be 0.8% with 3.0% inflation.
- Commodity Reliance:
  - As of 2020, about 80% of the basic components in antibiotics come from overseas sources including China and India, and 20% of PPE comes from international suppliers.

Sources

- (1) https://economictimes.indiatimes.com/tech/technology/generative-ai-could-replace-300-million-jobs-goldman-sachs-report/articleshow/99085074.cms?from=mdr
- (2) https://www.theguardian.com/technology/2023/jul/11/ai-revolution-puts-skilled-jobs-at-highest-risk-oecd-says#:~:text=It%20added%20that%20highly%20skilled,indistinguishable%20from%20that%20of%20humans.
- (3) Stanford Institute for Economic Policy and Research study: https://drive.google.com/file/d/1kqbngD8pemqxAkZmWCOQ32Yk6PXK9eVA/view
- (4) https://www.waterworld.com/drinking-water/distribution/press-release/14297287/study-colorado-river-basin-lost-40-trillion-liters-to-climate-change
- (5) https://www.ers.usda.gov/data-products/food-price-outlook/summary-findings/
- (6) https://www.pgpf.org/blog/2022/11/how-much-does-the-united-states-spend-on-prescription-drugs-compared-to-other-countries#:~:text=According%20to%20a%202021%20study,Switzerland%20and%20the%20United%20Kingdom).

Disclosures and Disclaimers

The Fixed Income Capital Markets trading area of Stifel, Nicolaus & Company, Incorporated may own debt securities of the borrower or borrowers mentioned in this report and may make a market in the aforementioned securities as of the date of issuance of this research report. Please visit the Research Page at www.stifel.com for the current research disclosures applicable to the companies mentioned in this publication that are within Stifel's coverage universe.

The information contained herein has been prepared from sources believed reliable but is not guaranteed by Stifel and is not a complete summary or statement of all available data, nor is it to be construed as an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of investors. Employees of Stifel or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed within. No investments or services mentioned are available to "private customers" in the European Economic Area or to anyone in Canada other than a "Designated Institution". The employees involved in the preparation or the issuance of this communication may have positions in the securities or options of the issuer/s discussed or recommended herein.

Stifel is a multi-disciplined financial services firm that regularly seeks investment banking assignments and compensation from issuers for services including, but not limited to, acting as an underwriter in an offering or financial advisor in a merger or acquisition, or serving as a placement agent in private transactions. Moreover, Stifel and its affiliates and their respective shareholders, directors, officers and/or employees, may from time to time have long or short positions in such securities or in options or other derivative instruments based thereon.

Stifel Fixed Income Capital Markets research and strategy analysts ("FICM Analysts") are not compensated directly or indirectly based on specific investment banking services transactions with the borrower or borrowers mentioned in this report or on FICM Analyst specific recommendations or views (whether or not contained in this or any other Stifel report), nor are FICM Analysts supervised by Stifel investment banking personnel; FICM Analysts receive compensation, however, based on the profitability of both Stifel (which includes investment banking) and Stifel FICM. The views, if any, expressed by FICM Analysts herein accurately reflect their personal professional views about subject securities and borrowers. For additional information on investment risks (including, but not limited to, market risks, credit ratings and specific securities provisions), contact your Stifel financial advisor or salesperson.

Our investment rating system is three-tiered, defined as follows:
Outperform - For credit specific recommendations we expect the identified credit to outperform its sector specific peers over the next six months.
Market perform - For credit specific recommendations we expect the identified credit to perform approximately in line with its sector specific peers over the next six months.
Underperform - For credit specific recommendations we expect the identified credit to underperform its sector specific peers over the next six months.

Additional Information Is Available Upon Request

I, Lindsey Piegza, certify that the views expressed in this research report accurately reflect my personal views about the subject securities or issuers; and I certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this research report.

STIFEL | Fixed Income Capital Markets

STIFEL | Fixed Income Capital Markets