Caron's Corner Transcript – 3.26.2024

Take a Walk on the Supply Side

- Based on last week's meeting, the market read that the Fed was amenable to running the economy hotter than expected.
- But the Fed sees things differently.
- In fact the Fed believes improvements from supply side factors will allow for higher growth without the consequences of higher inflation.
- Putting it all together, the Fed seemed to signal they are going easy on inflation by keeping rate cuts intact, while expecting the economy to continue to run hot.
- Is this too good to be true? And if so, how is it possible?
- The answer is supply side economics, which we discuss in the audiocast.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Take a walk on the supply side. Clearly a reference to supply side economics. The market's readthrough from last week's Fed meeting was that they are amenable to running the economy hotter than previously expected, but they see it differently. The Fed believes improvements from supply side factors will allow for higher growth without consequences of higher inflation. Here's what happened.

The Fed unleashed animal spirits by signaling a tolerance of higher inflation, while at the same time upgrading their GDP growth expectations. In 2024 they upgraded growth by 0.7% to 2.1%, while keeping 2025 at 2.2% and 2026 at 2%, compared to their long-run potential growth estimate of 1.8%. Putting it all together, the Fed seems to signal they're going easy on inflation by keeping rate cuts intact, while expecting the economy to run hot. No surprise that risky assets, namely the S&P 500, rose to a new all-time high. Why? Because low inflation justifies a higher price to equity (PE) multiple of say 19.5 and upgrades to growth in terms of consensus for bottoms-up earnings of $276. This makes it more likely that by year end the S&P500 will be 5,350. Now this is not a forecast and let me repeat: this is not a forecast. It just makes the S&P500 at 5350 by the end of the year more probable. It's just a probability assessment. So lower policy rates and falling inflation not only supports multiples but it keeps longer-term bond yields low, which makes today's cash flows more valuable by increasing their present value. It also suggests a soft landing which makes lower-quality credit more attractive at current yields, despite tighter spreads. Now, does all of this sound too good to be true? How is it all possible? Well, it's all about supply side economics. Let's get into it.

With respect to the Fed rate cuts, one thing that we have to understand is that while the pace of rate cuts is in question, the path is almost certainly assured. While there is uncertainty as to whether cuts will start in June - or later - the market is confident that the path for Fed funds is lower from here. This is a reflection of the Fed's inflation fighting credibility remaining intact and may be the primary reason risky assets have remained buoyant despite the pace of rate cuts slowing. We still see three rate cuts priced in for 2024, reflecting the 4.6% median dot that the Fed discussed last week, despite the fact they upgraded their core PCE inflation target by 0.2% to 2.6% this year and 0.1% higher in 2025.

So higher inflation, but the Fed is still easy. In my mind it begs the question as to why would their median forecasts still call for three cuts when their inflation forecasts rose? Shouldn't they just cut two times this year and just stay “higher for longer” to counter the stubbornness of inflation not falling? Well, this is going to create great consternation for the market. Does it mean that the Fed is willing to accept higher inflation for longer and allow the economy to run hot? Do they fear a sharp rise in the unemployment rate and its trade off to keeping the jobs market strong? Well, I kind of agree with that. Is it because the Fed believes that 5.5% policy, which is their nominal Fed funds rate today, or 2.5% real policy, is dangerously high and they want to reduce the risk of a hard landing? Well, I would agree with that too. But does this trade off and risk mitigation come without risk? No, the risk is that it signals that the economy will run hotter and inflation risks will increase.

In the end the markets actually believe the Fed. If we look at 10-year breakeven inflation, it's still around 2.34%, with the 5-year/5-year year forward around 2.6%. All of this is really saying that with 10-year treasury yields holding relatively steady, the markets still believe that the Fed will get inflation under control. The path of policy rates is lower, but it's going to take more time. It's going to be slower. The path of rate cuts is not in question, but it may a bit slower than previously expected as we saw from the dot-plots in 2025 and 2026. But what didn't change was the market's consensus view of terminal rates, where policy rates will end this cycle. It's still around 3.25 - 3.50% sometime in 2026. This is what we mean by the pace of rate cuts being in question but not its path. The path is still headed towards 3.25 - 3.50%. That's the long-term stability of Fed Funds rates. In many ways, we can see this as the Fed's secret sauce to holding onto their inflation fighting credibility, while at the same time keeping their promise to cut rates, all of which is supportive of risky assets. So how is any of this at all possible? Why of course it's the magic of supply side economics.

What is supply side economics? Put simply, it's the right-ward push of the supply curve in the standard price/quantity chart. This allows for higher growth at stable-to-lower inflation. This is the benefit of higher productivity, and we're going to speak more about that in a moment, but think of it as higher quality growth on a more stable growth path with lower inflation. It's the opposite of demand side economics which reflects an overheating in the economy and where demand outstrips supply and growth comes at the consequence of higher inflation.

But let's get back to supply side economics. Recall what the economic identity actually is. It’s growth in labor supply multiplied by productivity, i.e., output per hours worked, and ultimately equals potential GDP. Remember that identity. The labor supply has been increasing, as we've seen a rise in the labor force participation rate, perhaps due to immigration, and productivity has been rising as well When we multiply those two things together you end up with a higher potential GDP. This is the way the Fed sees it. This means that their upgrade in 2024 GDP by 0.7% to 2.1%, a rise in potential growth, is non-inflationary and also justifies their GDP forecasts of 2.1% and 2% in 2025 and 2026 as non-inflationary. If the Fed is right, they're not running the economy hot at all because inflation should fall, despite higher growth estimates. This is how the math and economic theory actually works.

But will it actually work in practice? The impact on equity prices is that higher GDP equals higher earnings and lower inflation (lower rates), which leads to higher PE multiples. Combine the two and it creates a logical asset price response for higher equity prices. Said differently, the 19.5 PE times $276 earnings, which is the one-year forward estimate for 2025, starts to increase the probability of becoming more realistic. And yes, that is how you get to the more probable 5350 in the S&P 500. Once again, this is not a forecast, just an increase in the probability assessment.

Now onto fixed income and credit. Higher-yielding, lower-quality credit should also outperform as well for similar reasons. Mainly because it implies a less onerous rates or financing cost environment alongside stronger cash flows.

So what's the bad news? The market is already fully priced based on this news, and that's what the bad news actually is. Sure there can be an overshoot, but it's hard to envision a surprise of this magnitude in the second quarter like the one we got in the first. As a result, we may need to grow into these valuations over the coming quarters. Unless we get more positive surprises, we've been overweight equities and as a result we're starting to take some profits.

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