2Q2024 U.S. Economic Outlook

Highlights

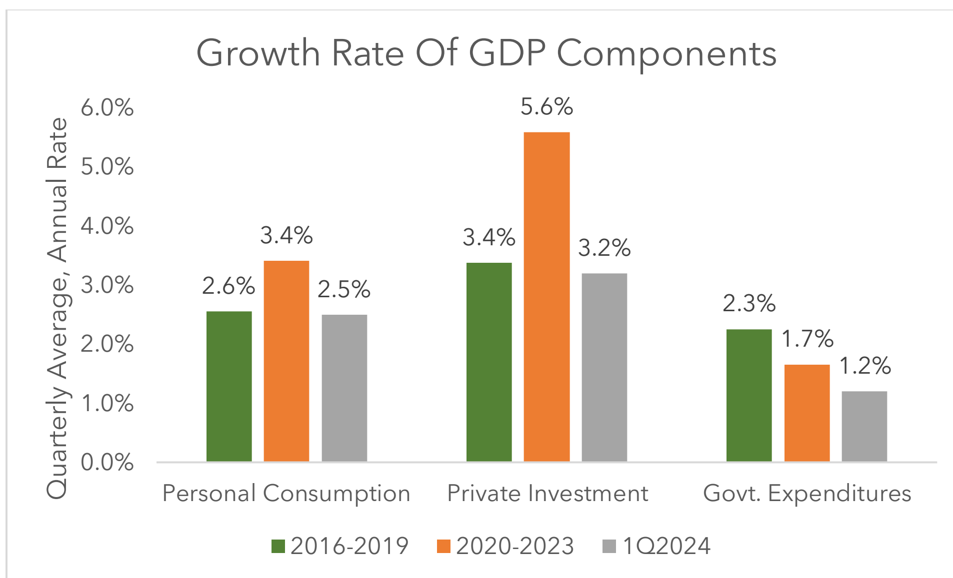
- Economy is normalizing.
- Inflation still decelerating.
- Fed risking a mistake.
- Rate cuts coming, inevitably.
- CRE would benefit from stability.

One quarter of the way through 2024, the US economy has performed largely as we expected. Economic growth has slowed from 2023's outsized, unsustainable pace, but remains healthy. Consumption's strong run continues. Private investment rebounded from a slow fourth quarter. Fiscal policy remains active, if not excessively stimulative. Inflation is decelerating, though slowly. And interest rates remain elevated. More broadly, we see an economy that is normalizing after some wild swings up and down over the last four years, not one that is simply slowing. As we move further away from the exogenous shock of the pandemic, those reverberations have lessened, and the economy is increasingly operating closer to pre-pandemic norms. But how should we think about the trajectory of the economy for the balance of the year under these conditions? And what could that mean for commercial real estate (CRE) and its own normalization after such an unusual period?

A More Sustainable Pace

In the first quarter, economic growth came in below expectations, at a 1.6% annualized rate. But the details prove more heartening than the headline figure suggests. Personal consumption, the main driver of the US economy, remained healthy even as it slowed a bit. During three of the prior four quarters (including the prior two) consumption grew by at least 3%. It took a slight step back to 2.5% during the first quarter. But that represents a more sustainable pace of spending. During the four calendar years leading up to the pandemic, 2016-2019, quarterly consumption growth averaged 2.6%, almost identical to the first quarter's rate. While consumption spending became distorted during the last four years due to the pandemic and related policy measures, those effects are gradually fading over time. In their place, traditional drivers of consumer spending are returning. First, the structural labor shortage is keeping the labor market tight, producing job gains and real wage growth, providing consumers with increases in disposable income. Second, even as excess savings from the pandemic era have wound down, household net worth continues to reach record-high levels, driven by the housing market and the public-equity market. Those gains are producing a strong wealth effect, which gives consumers confidence to spend by using current income and monetizing assets.

Private domestic investment rebounded during the first quarter. Interestingly, first quarter's growth of 3.2% closely mirrors the 2016-2019 quarterly average of 3.4%. Similar to consumption, investment spending also became distorted due to the pandemic, with investment rebounding strongly after plummeting during the second quarter of 2020. Additionally, government programs have also incentivized private investment over the last few years. The infrastructure bill, the CHIPS and Science Act, and the Inflation Reduction Act all helped to generate net additional domestic investment that represents more than a mere reallocation of investment from other countries to the US. Although some of the funds approved in these bills will get spent in later periods, we also expect investment spending to normalize. Increasingly, fundamentals such as corporate earnings, which remain elevated near record levels, should drive private investment. Relatedly, we expect growth in government spending to slow over time. With a divided Congress and an end to purely stimulative fiscal spending, moving forward government spending should contribute less to economic growth. That level of spending should stabilize at a heightened level but not grow at an accelerated rate.



Sources: BEA, Federal Reserve, BGO Research

Net exports, the last of the four main components of GDP, produced the main drag on growth during the first quarter. But three important points prove instructive. First, net exports frequently say more about consumption in the rest of the world than they do about the health of domestic exporters. Second, the strong dollar, driven upward by relatively high interest rates in the US, is proving nettlesome for US exporters but represents a windfall for foreign importers to the US. Third, the contribution to growth from net exports is highly variable but should become less of a headwind during the next few years as domestic growth slows while growth in other large economies accelerates. In sum, we still project GDP growth of roughly 2% this year and moving forward growth should tack toward a more normalized, sustainable pace.

Inflation In Focus

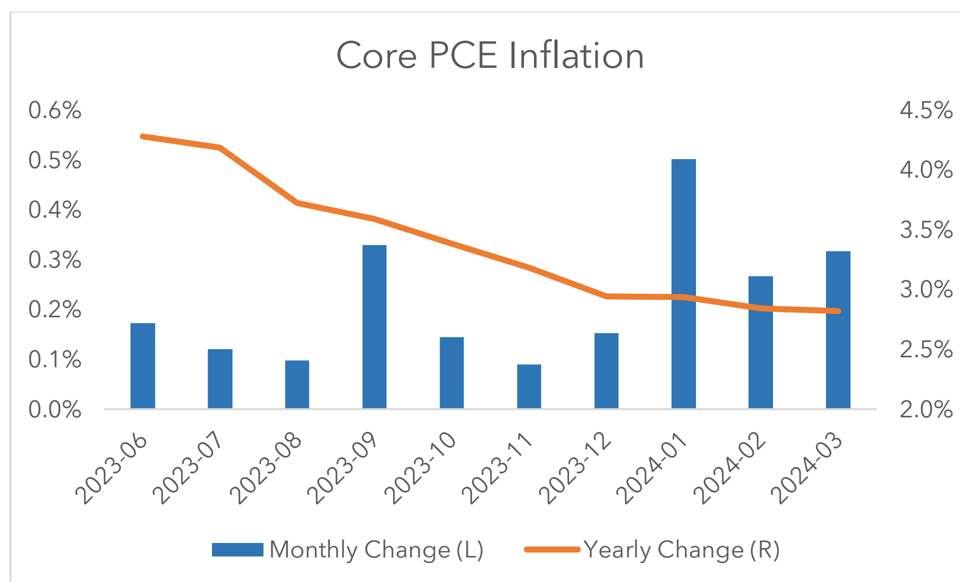
If economic growth is normalizing, one should also expect to see inflation normalizing as well. GDP represents the quantity in macroeconomic equilibrium while the overall price level represents, of course, the price. Typically, growth between the two is connected (excluding extenuating circumstances such as a supply shock). Inflation normalization is occurring as economic growth normalizes, but gradually. Despite the shortcomings of the major US inflation indexes, which we have frequently cautioned against in recent weeks, inflation is slowly heading back toward the Fed's 2% target rate. We remain concerned that the major inflation indexes are overstating shelter inflation. But the underlying trend nonetheless remains one of disinflation, even with the usual month-to-month variation in some inflation components.

Many factors are driving our inflation outlook. First, the pandemic-related disruption to the supply side of the economy continues to abate. While the global supply chain has not fully returned to pre-pandemic status, it has recovered significantly over the last two years. Second, as noted above, economic growth is slowing, in aggregate and across major components. Third, slower growth in shelter prices (ownership and rental) is filtering through to the major inflation

indexes, but with the usual lag. That dynamic is still unfolding. But it represents a self-fulfilling prophecy that should unfold over the coming quarters. Fourth, while the dollar remains strong the US is effectively importing disinflation, if not outright deflation, from the rest of the world. Fifth, despite the ongoing labor shortage, nominal wage growth is slowing as the labor market continues to ease following an inordinately strong period. Sixth, the money supply is generally shrinking, siphoning some liquidity out of the market. Seventh, even though it remains volatile, productivity growth is improving in recent quarters. Taken together, these factors present a powerful disinflationary force. We continue to argue that inflation remains overstated due to mismeasurement of shelter costs, but nonetheless we foresee further deceleration in inflation over the balance of the year and a gradual inching closer to Fed target.

The Race Is On

As we forecasted, the Fed left rates unchanged through the first quarter. We continue to believe that the Fed will not cut rates until the latter half of 2024 at the earliest and that the most probable outcome remains two cuts of 25 basis points (bps) each. Of course, forecasting the decisions of technocrats remains incredibly difficult, but with growth and inflation slowing such an outcome remains probable. Additionally, we would not expect to see much pullback at the long end of the curve until the Treasury market gains greater confidence that easing is coming soon.



Sources: BEA, BGO Research

But the Fed is seemingly utilizing "Janet Jackson" monetary policy – what have you done for me lately? Monetary policy decisions should focus on future outcomes, not prior occurrences. If the Fed waits for visible signs that it should cut rates it will already be too late to do so. Yet the Fed seems overly fixated on very recent observations, especially inflation. For example, in December when core PCE came in at 0.2% or below for 7 consecutive months, the Fed struck an incredibly hawkish tone which caused the market to start pricing in 5-6 rate cuts. Yet by the April meeting,

after core PCE had reaccelerated a bit, it walked back those dovish comments, suggested it might not cut at all this year, and market expectations for rate cuts fell considerably. Nonetheless, year-over-year core PCE continued to decelerate. And as noted above, evidence suggests – and our model forecasts - slower inflation ahead. The Fed's own model projects this as well. Maybe the Fed does not possess enough conviction in its own modeling. But the monetary policy risks have become asymmetrical. Even if somehow cutting rates marginally had some impact on inflation, the economy has already abundantly demonstrated that it can withstand higher inflation (which due to measurement errors probably got understated on the way up as well), even for a more prolonged period.

But the risk of leaving rates elevated for too long is clear and well established empirically. With inflation slowing, real interest rates have already turned positive to the tune of hundreds of bps. And with inflation overstated, real interest rates are higher than many believe. That proves critical because real (not nominal) interest rates restrain economic activity. Yet inevitably rates are going to have to decline. It remains a question of when, not if. Why? Because one of two scenarios will unfold. Either the slowing in shelter costs that has already occurred eventually filters through to the major inflation indexes, provides enough cover for the Fed, and it starts cutting rates. Or, the Fed will get fooled by mismeasured shelter inflation, leave rates too high for too long, slow the economy, and be forced to cut in order to avoid a recession or blunt the impact of one it caused itself. Ultimately, decreases in rates will help to stimulate the economy, and we continue to foresee the former scenario as more probable than the latter scenario. But the Fed is increasingly running the risk of making the classic monetary policy mistake of overtightening. The wrinkle in this cycle is that while nominal rates have not overtightened, which is what typically transpires, real interest rates are starting to overtighten as inflation cools.

What Will It Mean For CRE?

Migrating from a more volatile path to a less volatile one should prove beneficial to CRE. While the idea of rapid economic growth sounds great in theory, it frequently comes with caveats such as those of the last few years such as a pandemic and outsized fiscal stimulus. Something more sustainable and consistent, while less exciting, could help avoid some of the whipsaw impacts that occurred in CRE over the last few years. In certain property types, demand collapsed, then skyrocketed, and then slowed quickly. Such dramatic changes make it relatively easy for the market as a whole to make mistakes. By contrast, something more durable and consistent makes planning easier. That certainly does not prevent mistakes, but it helps to limit the quantity and the impact of them.

Of course, the CRE capital markets could also benefit from this increase in stability as well. The rapidly expanding economy produced outsized inflation, driving interest rates higher and producing all of the negative impacts on the capital markets that CRE is still contending with. Interest rates should prove no panacea to CRE as it works through issues caused by these dramatic swings of the last few years. But less volatile monetary policy would prove beneficial for both macroeconomic stability and CRE stability. Either extreme of interest rates, too high or too low, produces unintended consequences, many of which are negative. While the CRE

industry loves exceptionally low interest rates, it loves the inevitable increase from such low rates far less.

Risks and Closing Thoughts

Increased stability does not mean zero variation in economic performance. Business cycles will persist, idiosyncratic shocks will occur, and sometimes economic actors will make poor decisions. But instability and high variation breed uncertainty and at times economic ossification, similar to what the CRE market is enduring while it waits for the Fed to move on rates. The risk from the Fed and monetary policy is increasing the longer the Fed leaves nominal rates elevated. As inflation continues to slow and remains overstated, the higher real interest rates become and the greater their restraint on economic activity. But at this juncture, given the restraint that high rates are having on the CRE market, the downside risk to the CRE market is limited. Any negative impact from excess restraint would likely get partially if not fully offset from the benefits to the CRE capital markets as rates decline. That makes this cycle unusual from historical cycles, including the prior period of desynchronization between CRE space market and capital markets after the dot-com recession. We remain cautiously optimistic in our outlook, but the balance of risks has clearly swung toward leaving rates too high for too long.

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