Economic Weekly

Checking In On 4 Key Forecasts

July 29, 2024

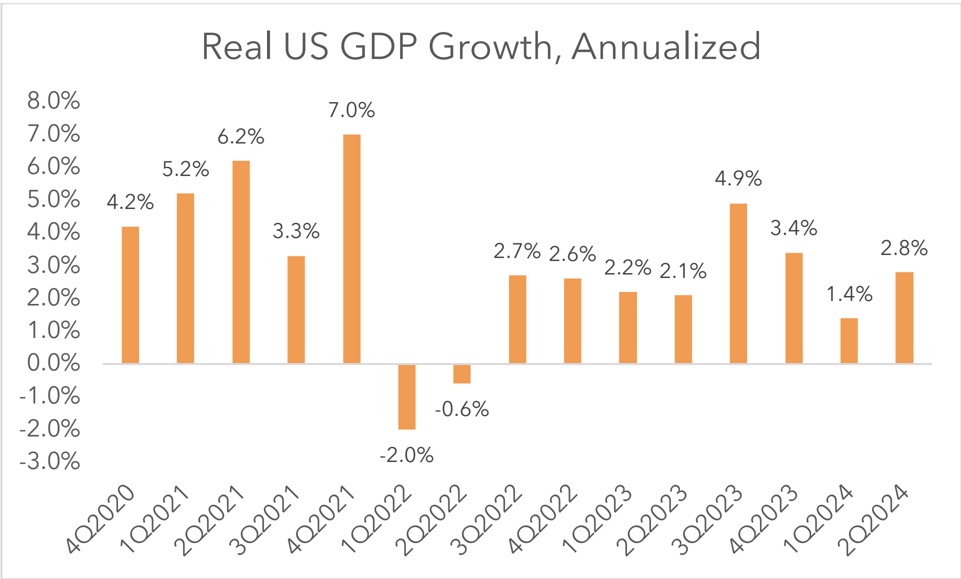
Highlights

- A recession is not inevitable.
- Inflation is dead.
- Fed won't cut before 2H2024.
- Tightening ends, CRE returns swing positive.

A few important data releases last week offer the perfect opportunity for us to check on some key forecasts that we have made since launching our external communications program 15 months ago. The current economic and commercial real estate (CRE) environment remains unique, making forecasting even more challenging than usual. Halfway through the year, let's look at these key forecasts and see where they currently stand.

A Recession Is Not Inevitable - May 2023

In truth we have held this view since the Fed began tightening in March 2022, but we will date our forecast from the start of our external communications campaign. Of course, the economy remains highly cyclical, and another recession will eventually occur. But we believed (and continue to believe) that unless the Fed really mismanages monetary policy, we should not expect a US recession to occur in the short run. Moreover, with the US economy constituting roughly 25% of the global economy, avoiding a US recession also means avoiding a global recession. Through the second quarter of this year, both economies have continued to expand and evade a downturn. We avoided the mistake of many who predicted the most widely forecasted recession, ever, in 2023. Why? We saw an economy that carried too much strength and momentum, driven by the power of US consumers, the largest single economic force on the planet. US consumers have benefitted from a tight labor market, pandemic stimulus, a strong wealth effect from rising equity and housing markets, and insulation against rising rates thanks to widespread refinancing that occurred before the Fed began raising rates. That allowed consumers to lock in a very low cost of debt, even for residential mortgages, for the long run.

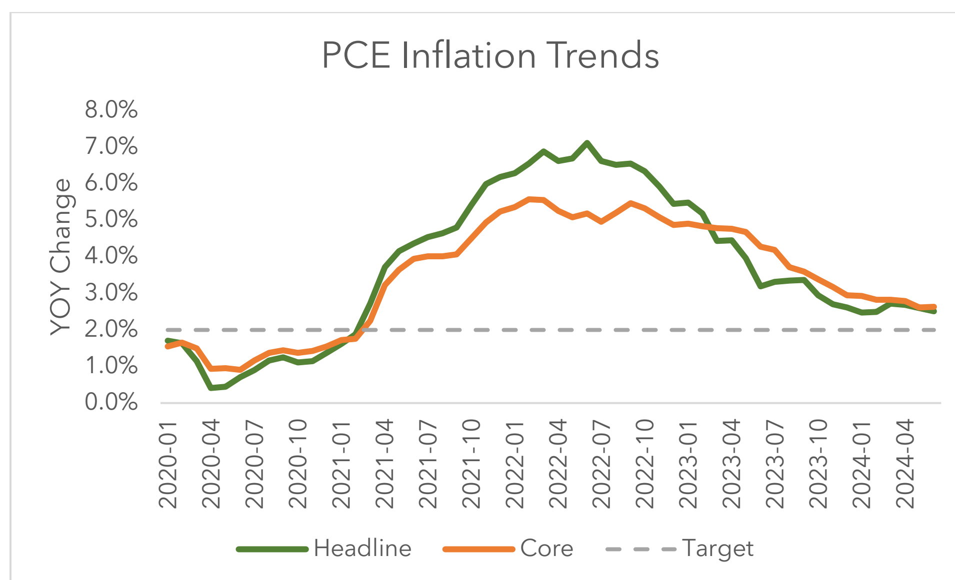


Sources: BEA, BGO Economics and Research

Current view: Both the US and global economies have avoided recessions, but the US economy is showing some signs of slowing. Unless the Fed leaves rates too high for long, and snatches defeat from the jaws of victory, the economy should continue to expand over any reasonable forecast horizon. A recession is still not inevitable.

Inflation Is Dead – January 2024

Of course, inflation will always exist in some form. But we meant that the pandemic-driven inflation that caused so much consternation had ended. Since peaking in mid-2022 inflation around the world has trended downward. By the late stages of 2023 it was clear to us that it had stopped climbing and would not return. We remain critical of the way inflation is getting mismeasured in the US, with housing inflation currently overstating all major inflation indexes. Nonetheless, the evidence from the major developed economies of the world that experienced high inflation is consistent and clear - inflation is dead and in most places is back at or near target rates. The US will take a bit longer than many other major economies to return to target because of the housing-inflation problem, but that remains a matter of timing more than any other issue. The Fed's preferred inflation index, the personal consumption expenditures (PCE) index (particularly the core subindex) is within shouting distance of target.



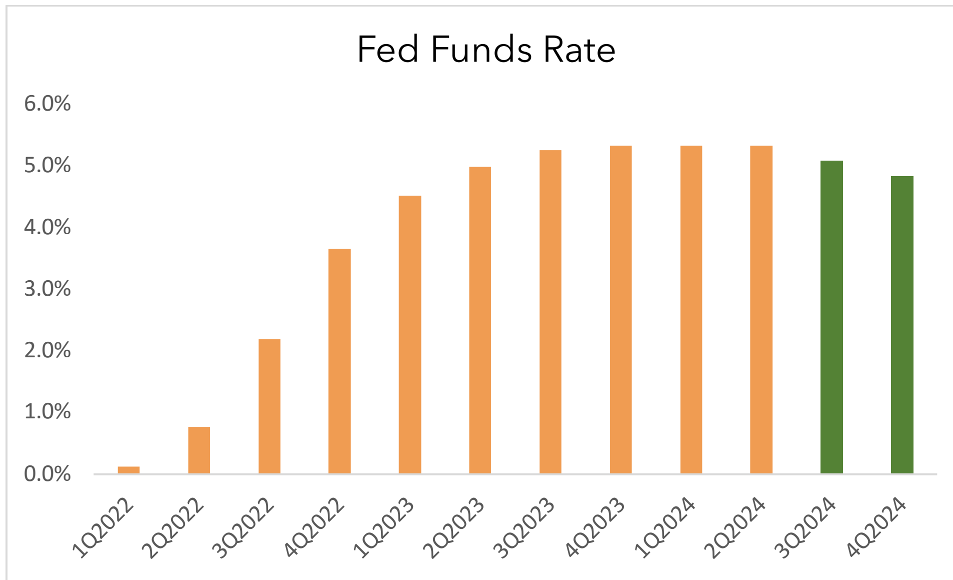
Sources: BEA, BGO Economics and Research

Current view: With the supply side of the economy largely healed and demand returning to more sustainable levels, there is no reason to expect a serious resurgence in inflation. It will remain stubborn in the US over the next year due to base effects and seasonal adjustments and it can always get disrupted by any number of idiosyncratic factors, including geopolitical events. But with the economy slowing and the Fed leaving rates elevated, inflation could fall below target if the economy hits a recession. The multidecade-high inflation from this cycle is dead.

Fed Won't Cut Until The Latter Half Of 2024, At The Earliest - December 2023

This forecast made us a notable outlier. When we shared this view in December, the market had become euphoric thanks to some tepid inflation readings that month and some dovish Fed

comments. Expectations raced ahead of reality, calling for five, six, seven, maybe even eight rate cuts, coming as soon as March. That felt like the markets and many prognosticators getting over their skis to us. As inflation proved a bit stubborn this year, these grand prognostications swung wildly, and the market went from expecting many rate cuts to zero rate cuts. All the while we remained steadfast in our predictions. We did not foresee the Fed cutting until the latter half of 2024 at the earliest and our median forecast was for two rate cuts of 25 basis points (bps) each.



Sources: Federal Reserve, BGO Economics and Research

Current view: The timing part of our prediction played out – the Fed did not cut rates before the latter half of 2024. But what about the number of cuts? Admittedly, predicting the actions of technocrats often proves more difficult than predicting many other economic metrics. So, a certain element of luck is needed here. Consequently, we aren't going to lose any sleep over the exact number of cuts in 2024. But through July, we see no reason to back away from our forecast now. If anything, this forecast looks just as correct now as it did when we first made it late last year, maybe more so. The Fed possesses more than enough evidence to start cutting – inflation is close to target, and the economy is slowing - and the balance of risks is tilting away from price stability toward full employment. The Fed likely won't cut when it meets this week and will probably wait until September at the earliest. But rate cuts really are a question of when and how many at this juncture.

CRE Returns Will Quickly Revert To Positive Territory Once Fed Stops Tightening - August 2023

Historically, total CRE returns revert back into positive territory quickly once the Fed stops tightening. We thought that would get delayed a quarter or two this cycle because of how quickly and aggressively the Fed raised rates, but we expected this phenomenon to occur again because nothing fundamental had changed about how the CRE economy works. And true to historical form, CRE total rates of return quickly reverted into positive territory once the Fed

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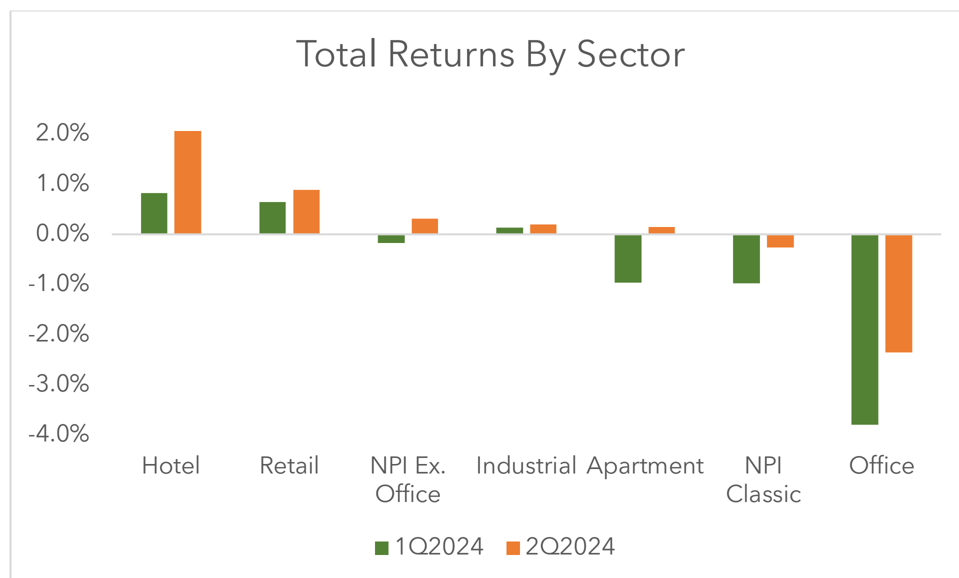
stopped raising rates in the third quarter of 2023. That did take a little bit longer than the previous six tightening cycles. And the office sector is causing some measures of total return to remain negative. But that's largely a function of the well-known idiosyncratic issues surrounding the office market, not something systematic about the overall asset class. Once we account for those idiosyncratic issues, we see that the total returns for the other major property sectors have already swung positive and if we exclude office, overall CRE returns have turned positive. Across all major property sectors returns are improving over time, even before the beginning of rate cuts.



Sources: NCREIF, BGO Economics and Research

Current view: The CRE economy has not changed fundamentally, and total returns quickly reverted back into positive territory. But the CRE market is not out of the woods just yet. Returns in a number of property sectors remain close enough to zero that they could tip back into negative territory. But with the Fed poised to start cutting rates sooner than later, that should turbocharge returns moving forward. Office will continue to lag, but even office has shown improvement in recent quarters. And rate cuts married with lower valuations mean even office returns could swing positive sooner than later.

Outlook From Here

Through midyear, these key predictions are holding up quite well. The crux of all of this remains the Fed. If the Fed cuts during the last third of year, as we believe it should, that should help the economy avoid slipping into a recession, help to stabilize inflation near target, and provide a strong boost to CRE returns. Check back for an update on our key forecasts.

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