3Q2024 U.S. Economic Outlook

Highlights

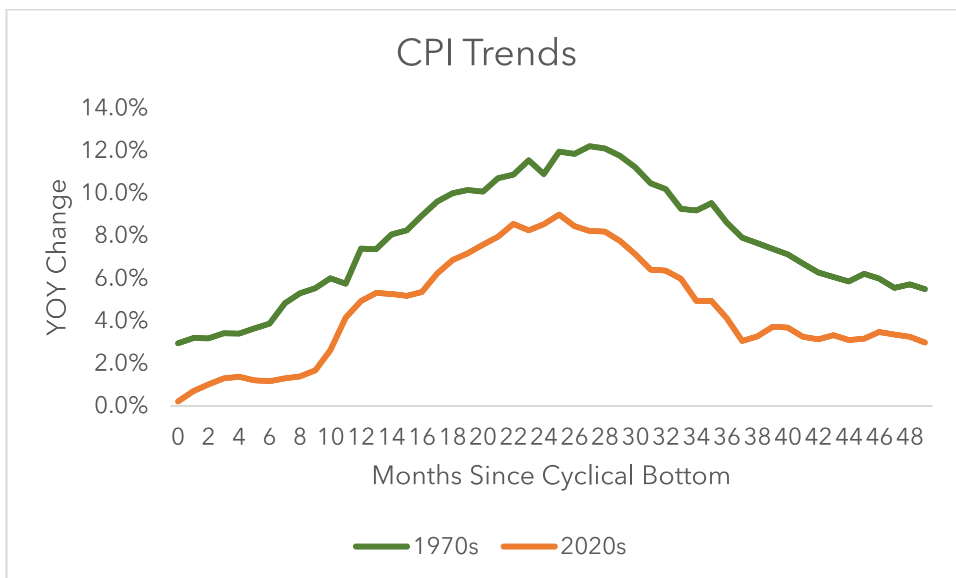
- Economic weakness overstated.
- Inflation less important.
- Labor more important.
- Fed should start cutting soon.
- CRE outlook remains favorable.

In the second quarter, US economic growth surprised to the upside. While that result looks like a bit of an anomaly, it nonetheless showed the economy's continued resilience as it normalizes after a burst of growth following the pandemic shutdown's sharp economic contraction during the second quarter of 2020. The economic expansion has now reached 4 years of age. At this stage of an expansion, economic growth should still be accelerating. Instead, it is stabilizing, more like the latter stages of an expansion. That does not mean that this expansion phase will end prematurely. But it does mean that the economy carries less momentum than it normally would at this stage and missteps could potentially prove more troublesome. The economy should continue to expand over any reasonable time horizon, but it will need to avoid careless errors from policymakers, especially the Fed. Can those be avoided? What should we expect as we head toward the end of the year? And how much will all of this matter for commercial real estate (CRE)?

Inflation Ghosts

The crux of the economy's fortunes remains the Fed and monetary policy. But the Fed's margin for error is shrinking and its window of opportunity to avoid a serious mistake is closing. The Fed remains focused on the key components of its dual mandate – price stability and full employment. Over the last two years, with the labor market exhibiting strength unseen for half a century and inflation hitting rates unseen since the early 1980s, the Fed predictably focused on price stability. But over the last two years inflation has decelerated considerably. Moreover, as we have repeatedly pointed out, the Fed is using mismeasured inflation to guide its monetary policy decisions. Housing inflation is still overstated in both the consumer price index (CPI) and to a lesser extent the personal consumption expenditures (PCE) index. Consequently, the Fed is currently chasing inflation ghosts that aren't actually there. Once we account for this housing issue, inflation is actually below the Fed's 2% target for both major inflation indexes, including the headline and core subindexes for both.

Moreover, there exists little risk of a resurgence in inflation even if the Fed starts cutting rates. Those pointing to the experience of the 1970s have a poor understanding of economics. Many differences exist between the economy of the 1970s and the economy of today. But we would highlight the two (arguably) most important. First, the US economy's dependence on oil has diminished considerably, with oil intensity (which measures the amount of oil required to produce one unit of GDP) down significantly. Relatedly, with the US now the dominant global producer of oil, spikes in pricing are more muted than in the past. Second, productivity growth plummeted in the 1970s. Today, productivity growth is not soaring (though we remain bullish on the outlook for productivity growth due to automation, AI, etc.), but it is holding up relatively well. Those two factors alone prevent a repeat of 1970s-style inflation. Therefore, the Fed is risking leaving rates too high for too long for nothing. In most of the rest of the developed world, which uses different methodologies and weightings of goods and services to calculate inflation, central banks are already cutting rates. With inflation in those parts of the world basically back at target and little risk of a 1970s-style reinflation, those central banks can focus on the other major portion of their mandates.

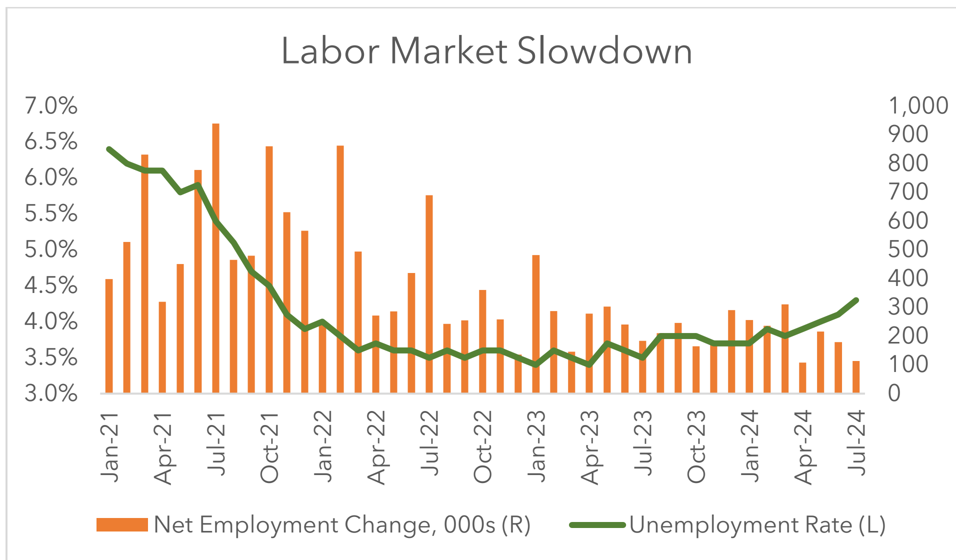


Sources: BLS, BGO Economics and Research

Labor Pains

In the case of the Fed, the other part of that mandate is full employment, which is becoming more of a risk. While recent disappointing data is overstating weakness in the labor market, the job numbers have been cooling, nonetheless. Job growth has slowed, wage growth has slowed, and the unemployment rate is up notably. The unemployment rate has increased enough to trigger the Sahm Rule, a guide for determining when an economy is entering a recession. That caused markets to spasm recently, with public equity markets plummeting and Treasury yields declining precipitously. Yet most economists, including us, think it is sending a false positive signal. Typically heading into a downturn, the unemployment rate rises because of permanent layoffs. This cycle that is not occurring. It is rising because supply of labor is growing faster than demand (itself facing slower growth) and also because of some noise in the data. Idiosyncratic disruptions such as the recent auto dealer systems issues and Hurricane Beryl have caused an increase in temporary layoffs. That overstated the increase in the unemployment rate in July. Initial unemployment claims remain low and are already moving past this idiosyncratic noise, signaling that the labor market remains stronger than the data suggests.

But we believe that the Fed would be wise to heed the warning sent by the slowing in the economy and labor market, nonetheless. With things already slowing and less cushion due to the uniqueness of this cycle, it would be prudent for the Fed to not only start cutting rates in September, but to also start signaling more clearly via forward guidance that it is now on a loosening path. That would not only help to avoid a downturn in the economy, but also help to shore up confidence that has been battered a bit recently, even if that seems a bit of an overreaction on the part of publicly traded markets.



Sources: BLS, BGO Economics and Research

Tilting Risks

Clearly, the balance of risks in the Fed's dual mandate are tilting away from price stability toward full employment. Inflation will remain a bit stubborn over the balance of the year due to base effects and seasonal adjustments but should remain benign and relatively near to its target rate, even with housing inflation being mismeasured. That, plus the experience of other major central banks that have already begun their easing cycles, should give the Fed enough cover to start cutting. Yet once again, the markets are getting over their skis and pricing in more aggressive cutting than seems likely or prudent. We still think two rate cuts of 25 basis points (bps) each remains the appropriate path forward for the fed funds rate. This path would not only set interest rates on a more constructive course but would also send the right signals to the broader economy and markets-- namely, that the Fed recognizes that the balance of risks is tilting, but it isn't panicking. But technocrats like those on the Fed's Open Market Committee keep their own counsel on rate decisions. Ultimately, rate cuts now seem a question of when and how many. The long end of the curve is already adjusting, and we would expect to see the curve normalize and steepen as a loosening cycle takes hold over the next 12-18 months.

The other signal comes from the drivers of the economy. Again, the economy is slowing but it is also shifting. US consumers remain the largest single economic force on the planet, but their contribution to growth is decreasing over time. Simultaneously, private investment is increasing with profit margins remaining healthy and interest rates past peak. Moreover, investment should get a shot in the arm going forward from lower interest rates. For the macroeconomy, that should mean more balance from the economy's two main components. We continue to forecast economic growth near 2% this year, but with some upside risk to our forecast if the Fed cuts more aggressively than we currently project.

What Will It Mean For CRE?

For CRE an economy exhibiting mid-expansion growth means less than it otherwise would. Typically, that would suggest lower demand and a restraint on property market fundamentals and income returns. But at this stage of the CRE cycle, supply is dictating terms more than demand. Until the supply cycle turns, demand (and by extension the macro cycle) will play a diminished role.

On the other hand, the CRE capital markets stand to benefit greatly, as we have discussed ad nauseum. Valuations and appreciation returns have already improved since the Fed stopped raising rates. Total returns have reverted back into positive territory as expected. And while transaction volume has not increased much, the number of deals up for review has certainly increased, even if buyers and sellers remain too far apart on pricing to reach agreement. We will have more to say in our quarterly CRE outlook later this month. But for now, economic tilting holds great potential benefits for CRE through the medium term.

Risks and Closing Thoughts

The economy is not in a recession, and one is still not inevitable or imminent. Weakness has been overstated and it has generated overreactions. But if the Fed doesn't move sooner than later, risk will become reality. Monetary policy remains the key risk and that won't change until it becomes far less restrictive. Economic growth should remain fairly stable over the medium term, proving some broad support to the asset class. But because of that stability we shouldn't expect the typical mid-expansion acceleration that boosts CRE demand. Nonetheless, CRE looks well poised to thrive in the economic tilting set to occur over the next year. Total returns should become more positive as appreciation returns increase as rates decline while income returns hold fairly steady in a more stable economic backdrop.

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