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MACROCOSM

2024: Deflation, Election, and No Recession

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It's going to be a strange year. A difficult year. A tricky year. But it will end well.

Most, not all, of our calls for the economy and the markets were fulfilled in 2023 (see "2023: Our Greatest Hits, Our Gravest Misses" December 29, 2023). As the new year begins, it's customary to lay out our new forecasts formally. But we evolve our forecasts constantly! So at the turn of the year, it's not a time to make *new* forecasts but to review the evolution of our durable themes at a high level and project them into the coming year.

We think four separate but interrelated themes will define the year:

- *The transformation of disinflation into deflation…*
- *…as the Fed starts easing rates…*
- *…in a presidential election year…*
- *…and still no recession.*

These themes mean:

- *Another good year for stocks, but with a big correction in the first half…*
- *…a struggle for bonds with a modest rally in the first half…*
- *…and still no recession.*

INFLATION INTO DEFLATION: Our monetarist model of inflation predicts that core CPI excluding owner's equivalent rent – *the best measure of underlying price stability – will be in outright deflation on a year-over-year basis in March* and will remain so for the rest of the year (based on the outright decline in the M2 money supply, which operates on inflation with a lag – see, among many, "Inflation Has Peaked -- Get Ready for Deflation" May 24, 2023).

- As the volatility of changes in the money supply has subsided following the historic tsunami of stimulus in 2020 and 2021, the lags in our model have no doubt lengthened. Our measure of price stability fell below the Fed's target for it three months ago – but the model says it should have happened *six* months ago. So we wouldn't be surprised to see outright deflation as late as June or July. *That said, inflation data below target – even before outright deflation arrives – will start the conversation about deflation. We*

Update to strategic view

US MACRO, FEDERAL RESERVE, US POLITICS, US STOCKS, US BONDS: Inflation has been conquered and will now turn into deflation. Below-target prints will become the norm, and outright deflation will show up in CPI by mid-year. The first Fed rate cut will come at the March FOMC, and the funds rate will end the year at 3-5/8%. Deflation will boost positive sentiment about the booming economy and help the incumbent president's re-election prospects, but we think the election will in fact be determined by the role of a third party. The Senate will easily be captured by the Republicans, assuring a minimum expectation of gridlock as a bulwark against anti-growth policy initiatives like those seen in 2021 and 2022. Stocks will have another solid year, making new highs in the first quarter and then enduring a sharp correction as the deflation narrative sets in. Long-term bond yields could briefly correct to as low as 3.5%, but something like 4% is a floor. Deflation will be a scare, but will prove to be salutary for growth. Again this year, despite the consensus, no recession.

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think it will have an odor of panic about it, reinforcing concerns that the lagged effects of the Fed's aggressive hiking regime of 2022 and 2023 will trigger recession, after Chair Jerome Powell has already begun to brag that it won't.

THE EASING REGIME: This will all play out *as the Fed commences a rate-cutting cycle*. The money market curve is now priced for the near-certainty that the first cut will come at the March FOMC. That's probably right.

- We are not saying that the rate cuts will come at first in response to deflation – although who's to say the Fed isn't already war-gaming that possibility. Consider: the goods sector of the Fed's preferred inflation gauge, the PCE price index, representing a third of the basket weight, is in outright deflation already, and has been three of the last six months, and below target for eight out of nine.
- *The Fed has every reason to cut rates now simply because inflation is no longer a sufficient threat* to justify an above-neutral policy rate that courts the risk of recession, and absent that outcome, pays the opportunity cost of foregone growth. *But we think the consensus will, as usual, prefer the darker interpretation*: the Fed will be seen as panicking because of deflation, and because of the impending recession it fears the deflation will trigger.
- *We offer more detail on our Fed policy outlook later in this report in the section on rates and bonds.*

THE ELECTION Of course there will doubtless be an even darker explanation – that the Fed is panicking all the more because a recession would risk the re-election of an incumbent president, and deflation fears will only inflame recession fears.

- How ironic. What better way to re-elect an incumbent than for a little deflation to dispel the pall that inflation has cast on what has been otherwise an economic boom? It's that pall that may well explain why, despite overall economic numbers that should propel the incumbent to a landslide re-election, the incumbent's approval ratings are among the lowest in history (see "For What It's Worth... TrendMacro's 2024 Presidential Election Model" December 11, 2023).
- *This would be the first time in history that a Fed rate-cutting regime designed to re-elect an incumbent president will actually make his re-election less likely – by fighting a deflation that would help him.*
- But setting political narratives about the Fed aside, for markets, there is one bedrock truth – *it is simply inevitable*, *given the map of state-by-state elections in 2024*, *that the Republicans will retake Senate control*.
- Of 34 seats up for election this cycle, only eleven have to be defended by incumbent Republicans. All are in solid red states, and only two are open seats (incumbents almost always win).
- But 23, more than twice as many, must be defended by Democrats. Three are in deep red states, including Joe Manchin's open seat in

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West Virginia. Five are in purple states, including an open seat in Michigan and a split-ticket situation in Arizona in which incumbent Democrat Krysten Sinema will be running as an independent. All in all, Cook Political Report rates eight at risk.

- *This means that whatever happens in the race for president or for control of the House, it is impossible for Democrats to have one-party control as they did in 2021 and 2022, years in which large anti-growth bills were passed on narrow party-line votes and even larger anti-growth bills were barely stopped thanks to courageous opposition from Manchin and Sinema. For growth, the worst case is off the table for 2025 and 2026.*
- *With this as a baseline, there is some chance that Republicans will also keep House control and take the presidency, in which case we could hope for extension of sunsetting tax cut provisions in the 2017 Tax Cuts and Jobs Act.*
- We won't belabor it here, but we remain convinced that there will be a robust third party presidential campaign, for which victory cannot be ruled out if the mainstream party candidates are the unpopular Joseph Biden and Donald Trump. At minimum such an effort could create a "contingent election," in which the president is chosen by the House and the vice-president by the Senate (for all the details on that, again see "For What It's Worth... TrendMacro's 2024 Presidential Election Model").

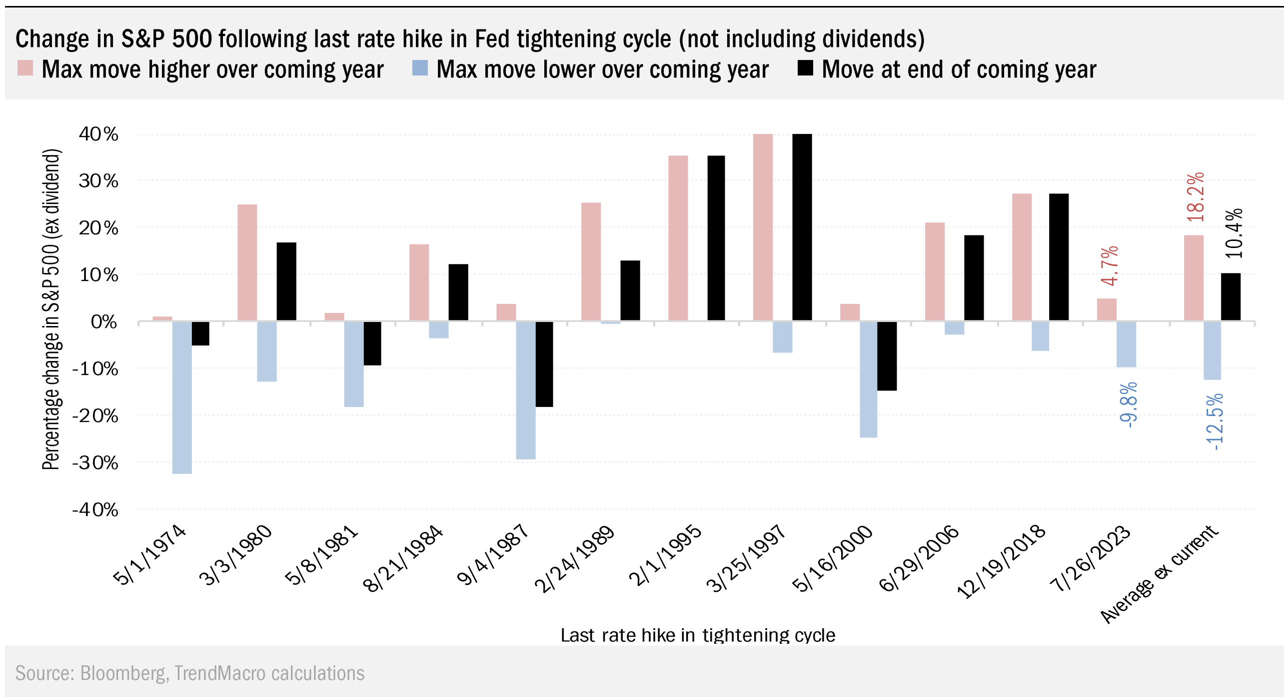
NO RECESSION The deflation won't cause a recession (throughout history, it's the opposite: recessions cause deflation). *From the consumer's perspective, deflation will put America on sale, and will come as blessed relief* after three years of hyperinflation following two generations in which no one had to think about inflation at all (see "On Wal-Mart's Deflation Call" November 16, 2023).

- The deflation will prolong and accelerate this economic boom. Setting aside random event-shocks, we see no cause to expect recession.
- At the same time, the extreme tightness of financial conditions that prevailed in Q3 and early Q4-2023 have eased considerably, taking pressure off debt-financed activity and bank stability. For example, the Bloomberg Aggregate Long Term MBS Index has, on a total return basis, recouped most of its losses over the last two years, and total bank credit has expanded by $178 billion since the March 2023 failure of Silicon Valley Bank, with 47% of it going to the commercial real estate sector.
- The most significant counterforce is the drawdown in cash savings by below-median households. At this point it stands at $167 billion, down from a record $2.1 trillion in August 2021 at the height of the stimulus era. The point isn't that low-end households are running out of money to spend (after all, until the pandemic it's always been zero; and the savings drawdown has driven a mass return to the labor force). The issue is that if any shock hits the economy, the most vulnerable households won't be bullet-proof against it as they were a couple years ago. The drawdown is not itself a recession

risk – it just removes a firewall against other recession risks actually causing a recession.

STOCKS With a salutary deflation, the Fed easing rates back to neutral, gridlock as a worst-case election outcome and no recession, *we have no reason not to expect a solid year for stocks*. As of this writing, the first couple days of the new year are off to a rocky start, for sure. But we think *Q1 is a likely time for a blow-off to new highs* as markets celebrate the end of the Fed's hiking regime, recognize it has not triggered the long-expected recession, and pick up on Powell's triumphalist attitude. *That would set the stage for a sharp correction – sharp, but only a correction* – setting in later this quarter as the deflation narrative takes hold.

- For what it's worth, stocks have been higher a year later, after the



Change in S&P 500 following last rate hike in Fed tightening cycle (not including dividends)

Source: Bloomberg, TrendMacro calculations

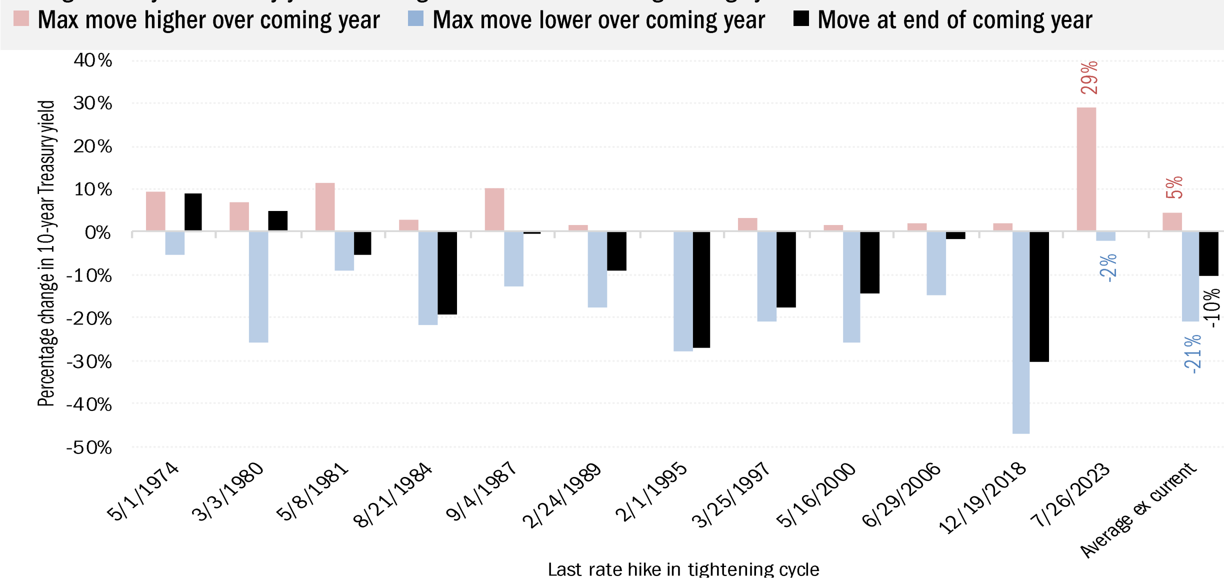
  end of a Fed tightening regime, in seven out of eleven cases from 1974 (please see the chart below). Across all eleven cases, the average return for stocks is 10.4% (ex dividends).
- In all but one case there were drawdowns along the way, some large and some small, averaging 12.5%. Since the end of the Fed's tightening cycle this time, on July 26, 2023 (see "On the July FOMC: The Most Unkindest Hike of All" July 26, 2023), there has already been a 9.8% drawdown. You could say we've already gotten the expectable drawdown under our belt.
- In all cases there have been rallies during the year from the last hike, some large some small, averaging 18.2%. So far the rally this time has been on the smaller side at 4.7%.
- We offer this history simply as context, not as a crystal ball. Let it be said only that, in stark contradiction to the conventional wisdom, stocks do not always perform badly when the Fed stops raising rates (the assumption that they do is based on the high likelihood of

recession that makes the Fed stop in the first place). Indeed, the average 10.4% return following the end of a tightening cycle exceeds the 8.8% return for the average 365-day period.

RATES AND BONDS With the Fed's tightening cycle over, an easing cycle in prospect, and deflation on the way, *we have to expect (as the market-implied consensus does) that rates are headed lower*.

- The fed funds futures curve puts the funds rate at 3-7/8% at the December 2024 FOMC, 1-1/2% percent below the present 5-3/8%, with the first of six cuts coming at the March 2024 FOMC. That's close to our own expectations (indeed, it's been close to our expectations for quite a while, and we're delighted to see the market and Fed catching up to what we have always seen to be reality – again, see "2023: Our Greatest Hits, Our Gravest Misses" December 29, 2023).
- At this point, if anything different than that, we would expect seven cuts for a year-end funds rate of 3-5/8%. That's not a million miles away from, but maybe on the high end of, what we would think of going forward as a neutral policy rate. *This is consistent with our idea that we have exited the "secular stagnation" or "new normal" era of persistently very low rates* (see "That Quarter, Those Yields, This Correction" October 27, 2023). Remember, in 2018, Powell's first hiking regime had to end at the then-lofty rate of 2-3/8%! *Going forward, higher rates seen before the Great Financial Crisis will be the "new new normal."*
- We think there is not all that much room below for long-term yields. Already far off the October highs slightly above 5%, the 10-year Treasury yield at 3.97% as of this writing is still at a level seen only for a few moments since the GFC. *If we are out of the era of "secular stagnation" and we have our "old normal" back, then the*

Change in 10-year Treasury yield following last rate hike in Fed tightening cycle



Source: Bloomberg, TrendMacro calculations

present yield at about 4% should be the floor going forward, as it generally was before the GFC, rather than the ceiling it has been since the GFC (see "Video: What you're not hearing about why a 4.5%-plus 10-year Treasury yield is actually a good thing" September 28, 2023). We can see a dip to 3.5% as a temporary *in extremis* move at some point this year, but that's as far as we want to go.

- That means that as the yield curve uninverts, as it always does when the Fed eases, the steepening will be driven from the short end as it always is (see "Video: What you're not hearing about the steepening yield curve" October 10, 2023).
- Historically, the 10-year yield has fallen a year later in all but two of eleven cases, on average 10% from its starting level on the day of the last Fed rate hike (please see the chart on the previous page). Starting at 3.86% at the July 2023 FOMC, that puts the 10-year at 3.47%.
- The average draw-down has been 21%, putting the 10-year at 3.06% (which is consistent with a lot of the forecasts we are hearing, including that of Jeff Gundlach, which we are taking as something of a consensus). That's a lot lower than we expect.
- So far, the better part of half a year since the last rate hike, the maximum draw-down has been only 2%, not 10%. And in the present cycle there has been an outstanding anomaly: a 29% back-up in yields, to 5.01%, since the tightening ended – by far the largest back-up in history (the average being just 5%; again please see the chart on the previous page).
- This is a highly unusual time in markets when we constantly point out how useless it is to expect fidelity to historical norms. We constantly mock allegiance to the yield curve – which, how appropriately, gave its recession warning on April Fools day in 2021 (we're still waiting). But this back-up in yields following the end of the hiking cycle stands out as an especially egregious norm-buster. It gives us some courage to think that this time it's different – yields don't have to fall a lot in this easing cycle. They will likely end the year higher, suggesting that in broad strokes 2024 will look something like 2023 – a volatile year in which stocks outperform bonds. To be clear, though, bonds don't face the existential risk they have faced since the pandemic: at 4%, the 10-year is a vastly different and less risky proposition that it was, say, at the outset in 2021 at 1%, or 2022 at 1.5%.
- As the deflation narrative kicks in, we don't see how long-term yields could fail to fall a bit from here – maximum, say, to 3.5% – even with very modest inflation expectations currently built into them. This would play out at the same time as the correction we are expecting in stocks. Both will be temporary, as the deflation scare proves to be nothing but a scare – that is to say, not that the deflation won't be real, but rather that it will prove to be salutary for growth.

NO RECESSION And did we mention, no recession?

Bottom line

Inflation has been conquered and will now turn into deflation. Below-target prints will become the norm, and outright deflation will show up in CPI by mid-year. The first Fed rate cut will come at the March FOMC, and the funds rate will end the year at 3-5/8%. Deflation will boost positive sentiment about the booming economy and help the incumbent president's re-election prospects, but we think the election will in fact be determined by the role of a third party. The Senate will easily be captured by the Republicans, assuring a minimum expectation of gridlock as a bulwark against anti-growth policy initiatives like those seen in 2021 and 2022. Stocks will have another solid year, making new highs in the first quarter and then enduring a sharp correction as the deflation narrative sets in. Long-term bond yields could briefly correct to as low as 3.5%, but something like 4% is a floor. Deflation will be a scare, but will prove to be salutary for growth. Again this year, despite the consensus, no recession.