Macroeconomic Update

Despite Q1 Setback, Lower Inflation and Fed Cuts Still Coming

The Fed's higher-for-longer approach should pay off, opening the door to cuts later this year.

Data on U.S. economic activity was surprisingly strong this year, continuing the trend of upside surprises seen in 2023. While first quarter real gross domestic product (GDP) growth was under 2 percent annualized, underlying domestic demand (consumption and fixed investment) rose at a 3.1 percent annualized pace, similar to the prior two quarters. Job growth also continued to beat expectations, rising at an average monthly pace of 246,000 this year, versus consensus expectations of sub-100,000 when the year started. With the peak impact of Fed tightening likely behind us, the economy should continue to expand but at a more moderate rate, gradually settling toward to a 1.5–2 percent pace in 2025.

One risk to continued economic growth is a new round of Fed hawkishness, should continued progress on inflation prove elusive. The core Personal Consumption Expenditures Price Index rose at a 3.7 percent annualized pace in the first quarter, a sharp acceleration following two quarters of inflation right on top of the 2 percent target. Despite this inflation setback, our read of the totality of the data continues to suggest inflation should soon settle back down. Indicators of labor market tightness show a better supply-demand balance, with wage growth cooling, labor churn falling, and immigration-led labor force growth helping to meet labor demand. Additionally, while market measures of inflation expectations have crept back up, most surveys of consumers and businesses show expectations are still trending down, matching pricing and wage setting plans in business surveys. Although bottom-up inflation analysis has been difficult in recent months, as some categories continue to "echo" pandemic price increases, we expect housing inflation and other categories that drove first quarter inflation to moderate in coming quarters, including a big gain in imputed financial services prices.

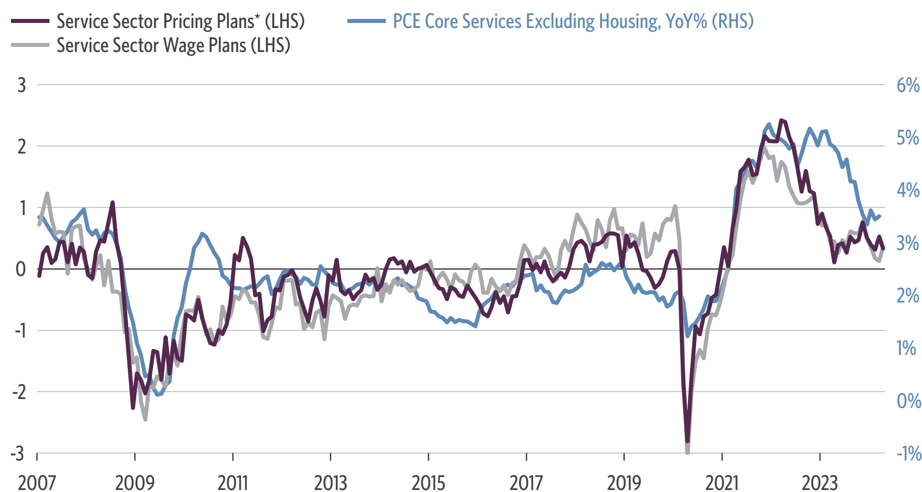
For now, the Fed has suggested that it will address any ongoing inflationary pressures by leaving policy at current rates for longer than initially projected, rather than by increasing policy rates further. The Fed has also embraced the view that the supply side of the economy is seeing strong growth, aided by immigration and productivity. This belief has led to a shift where robust economic activity is not seen as overly problematic.

With this backdrop, our base case is for Fed patience to pay off, with inflation slowing over the next several months to a sub-2.5 percent annualized monthly pace by the fourth quarter. That should open the door for the Fed to start cutting rates later this year, offsetting the growing strains from high rates and supporting the expansion.

By Matt Bush and Maria Giraldo

Despite higher than expected inflation in the first quarter, the data continues to suggest inflation should soon settle back down. Indicators of labor market tightness show a better supply-demand balance, with wage growth cooling, labor churn falling, and immigration-led labor force growth helping to meet labor demand.

Service Firms' Price and Wage Plans Point to Cooler Inflation



Source: Guggenheim Investments, Haver Analytics. Data as of 4.30.2024. *Pricing and wage plans represent average z-score since 2007 from the NFIB Small Business Survey and Dallas, Kansas City, New York, and Richmond Fed service sector surveys.

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