Macroeconomic Update

Fed Shifting to Easing Mode as Inflation and Labor Market Cool

Shift to Fed easing cycle helps brighten the economic outlook, but risks remain.

Economic conditions have been in a sweet spot recently, with solid real gross domestic product (GDP) growth, a labor market cooling toward a more sustainable pace even with layoffs remaining very low, and inflation arguably already back under the Fed's 2 percent target (see for example core PCE inflation over the last six months). Whether by design or just good luck, the most acute negative impacts from the Fed's tightening were largely cushioned by expansive fiscal policy in 2023. Meanwhile, inflation managed to cool significantly despite solid—but slowing—aggregate demand because the supply side showed rapid improvement, including both from international supply chains and expansion of the labor force.

As we look to the rest of 2024, the market seems to be extrapolating that this positive confluence of economic forces will continue to strike a perfect balance. That is a real possibility, particularly with the Fed making a more dovish shift and the associated easing in financial conditions taking some pressure off the economy. But in our view the long list of macroeconomic risks is underappreciated.

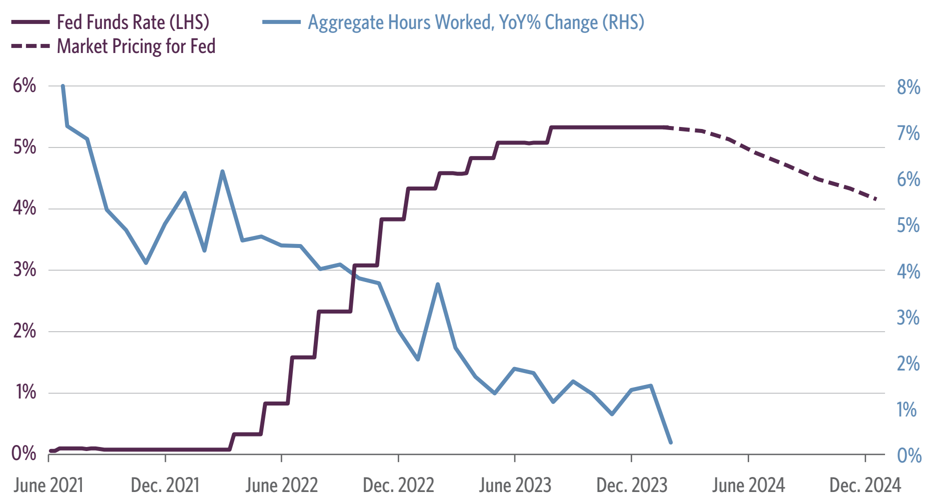
Chief among these risks is a further cooling in demand that transitions the economy from a gradual slowdown to an abrupt downshift. Job growth has been narrowly concentrated in just a few industries and could weaken further, especially now that the length of the workweek has been reduced aggressively. We also worry that the aggregate economic data are hiding stress under the surface in areas like small businesses, small banks, low-income consumers, and commercial real estate. We expect stress in these areas, many of which lie outside public markets, will stay relatively contained, but we are on watch for spillovers. And while not our base case, a risk in the other direction is that progress on inflation stalls or even reverses, whether due to new supply or commodity price shocks (increased shipping costs or higher oil prices from Mideast tensions come to mind) or demand not cooling enough.

The economic outlook has gotten more positive now that further Fed hikes are off the table and broad financial conditions are easing as substantial rate cuts are priced in. But with markets priced for such a benign outlook, we continue to expect volatility as risks of something upsetting the favorable growth-inflation mix remain elevated.

By Matt Bush and Maria Giraldo

Job growth has been narrowly concentrated in just a few industries and could weaken further, especially now that the length of the workweek has been reduced aggressively, which as our chart shows, has stalled the year over year growth rate in aggregate hours worked.

Can the Fed Stop Further Job Slowdown Without Reigniting Inflation?



Source: Guggenheim Investments, Bloomberg, Haver. Data as of 1.22.2024 for fed funds, 12.31.2023 for payrolls. Aggregate hours worked is average weekly hours x total employed workers.

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