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Q3 2024 Economic outlook

The summer before the election

Healthy momentum and maximum optimism are both driving market valuations to fresh highs. But monetary policy uncertainty will likely intensify, and regulatory, trade and budget deficit policies are all up for grabs in November, testing investor complacency.

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The economy starts the summer before the election with healthy momentum and maximum optimism priced into market valuations. Looking ahead, we expect growth to moderate and inflation to remain stubborn. Monetary policy uncertainty will likely intensify, and regulatory, trade and budget deficit policies are all up for grabs, testing investor complacency.

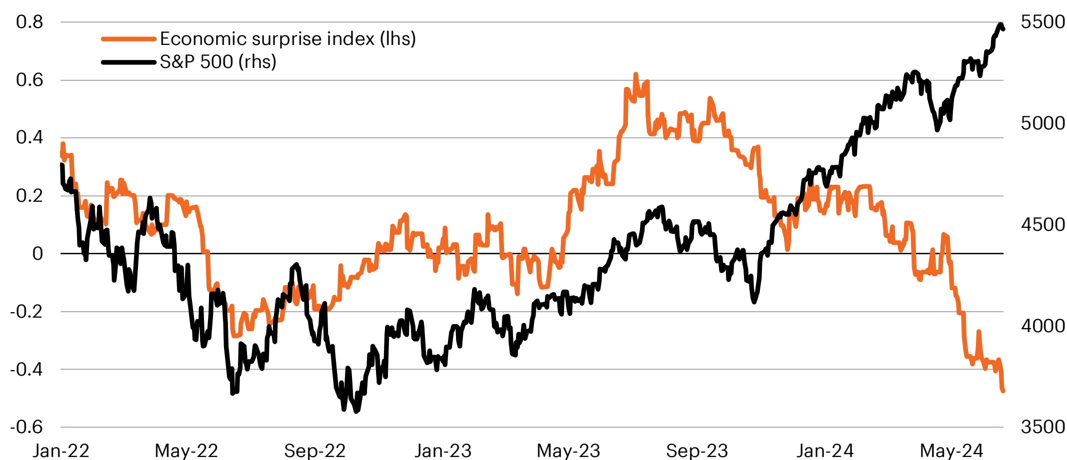
Key takeaways

- We expect an incremental slowdown in Q3 GDP growth and are watching the labor market closely.
- We look for one rate cut in Q4, as policymakers choose data dependence and patience.
- As the election nears, we expect market volatility to increase notably.

I like to start my quarterly outlook with an overarching theme connecting the economy and markets. At midyear, this connection is the maximum optimism for economic growth that is priced into markets—and how this confidence leaves markets vulnerable to any slowdown in growth, however incremental. The first half of the year was defined by a strong economy that once again far exceeded lackluster expectations at the beginning of the year. In January 2024, markets were expecting growth of 1.3% for the year. At midyear, growth has maintained a solid trajectory. In Q1, real GDP grew 1.3%, but excluding inventory and trade swings, domestic demand growth was 2.5%. Early estimates for Q2 are 3.0%, and personal consumption in Q1 was 2.0% versus 2.7% in 2023.

Today, market expectations around growth have arguably done an about-face to reoriented toward a strong economy. At midyear, markets expect real GDP growth of 2.4%, and analysts expect double-digit earnings growth for the next two years. While this backdrop of sentiment can only be described as maximum optimism, markets are starting to see something they haven't seen in some time: A wave of downside surprises in data. Over the last month, while equities have continued to race higher, the data have broadly disappointed versus expectations. Markets have skated past these data misses with growing complacency precisely because conviction is concerningly high that growth will stay strong far into the future, with no slowdown whatsoever.

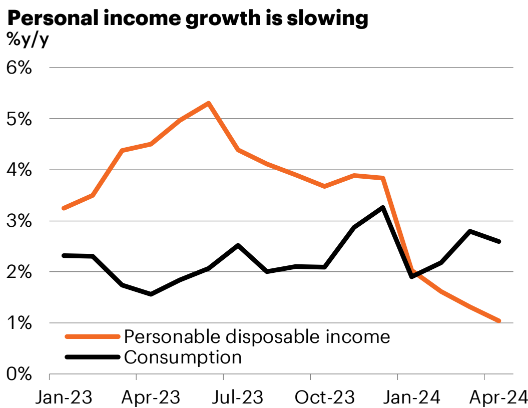
Data surprises erode support for equities



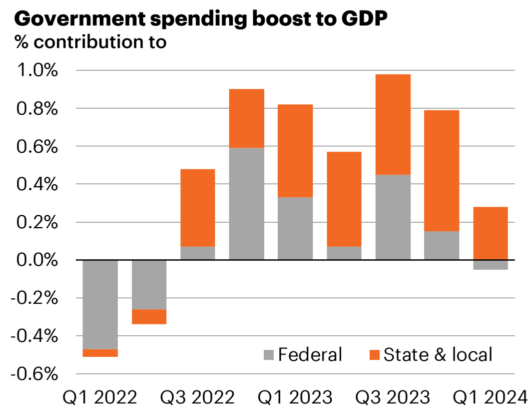
Source: Bloomberg Finance, L.P., as of June 22, 2024.

Slower growth, better balance and stubborn inflation

This is the backdrop for the third quarter. The consumer is the big engine that drives the economy, and the labor market remains a solid foundation of support. However, pandemic savings are largely exhausted, leaving consumption growth highly dependent on income growth, which has started to slow. Government spending has also been a powerful contributor to economic activity. The contribution to GDP has been significant, adding 8-tenths to growth in 2023 and 3-tenths in the first quarter. Government activity isn't limited to expenditures, as government hiring has also been strong for some time, and so far this year has accounted for 20% of the 1.3 million new jobs reported in the establishment survey. Looking ahead, we expect government spending to continue to fade in the second half of the year to a small positive or neutral, which will help growth decelerate from 2.5% to closer to 2.0%.

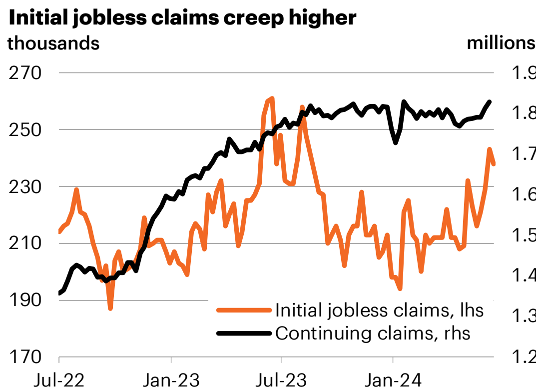


Source: Bureau of Economic Analysis, as of June 23, 2024. Both series are chain-weighted to adjust for inflation.

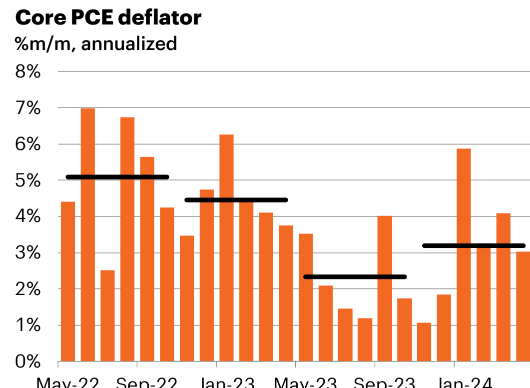


Source: Bureau of Economic Analysis, as of June 23, 2024.

In Q3 we expect the labor market to continue its renormalization from the COVID disruptions that caused so many indicators to hit—and linger at—all-time highs. This process is already underway. The unemployment rate has gently drifted up to 4.0% in May from a low of 3.4% in April of 2023. The JOLTS measure of job openings has moved closer into balance, with a May reading of 8.06 million solidifying a steady downtrend back toward the pre-pandemic two-year average of 7.13 million. It is critical not to interpret any of this as weakness in the job market. We are watching our favorite indicator of labor market health—initial jobless claims—like a hawk as it has recently edged higher. It is a weekly series that is choppy, but a reading closer to 280,000 would be a warning sign the labor market may start to actually cool. The unemployment rate is notoriously asymmetric, meaning it historically shoots higher instead of rising slowly. From a policy standpoint, there is a case when looking at the unemployment rate that the Fed has effectively achieved the rare soft landing.



Source: Department of Labor, as of June 23, 2024.



Source: Bureau of Economic Analysis, FS Investments, as of June 23,

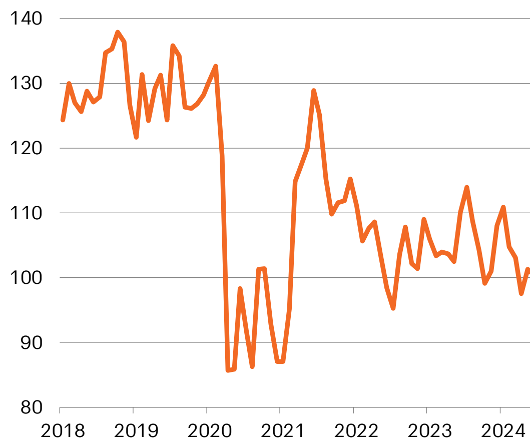
Inflation completes the outlook for the economy in Q3, and our view is unchanged: Inflation will remain stuck around 3% for the second half of the year. Inflation has moved lower since the acute readings of mid-2022, but the path has been choppy and uneven, and the pace of disinflation is slowing. We have long been saying the final leg down from 3% to 2% inflation will be the hardest. We detail our higher-than-consensus expectation for inflation, and why stubborn inflation will limit the Fed's room to cut rates as aggressively and programmatically as markets expect.

Countdown to the election

The November 5 election is already grabbing the attention of markets and investors. The June debate was earlier than any televised presidential debate in history, and campaign seasons grow longer and longer. The economic backdrop for the election is a surprisingly resilient economy that will likely see real GDP slow modestly in the second half but come into better balance with inflation still a lingering problem.

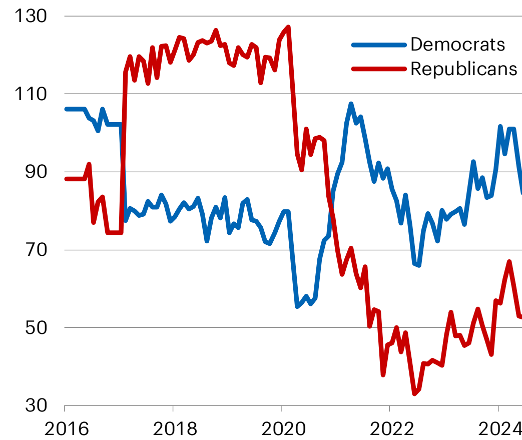
This fairly constructive view of economic growth is at odds with most polling on the economy, which is broadly downbeat. Consumer confidence has remained in the doldrums since the pandemic, and despite growth and employment being as strong as 2018–2019 levels when confidence was much higher. The picture is further clouded by a partisan lens. The economy, as a rule, does not shift quickly, but household's view of the economy does shift quickly, depending on party affiliation. It isn't just consumers that are downbeat—the Small Business Optimism index has been treading at multiyear lows.

Consumer confidence in the doldrums



Source: Conference Board, as of June 25, 2024.

Consumer sentiment shifts with elections



Source: University of Michigan, as of June 25, 2024.

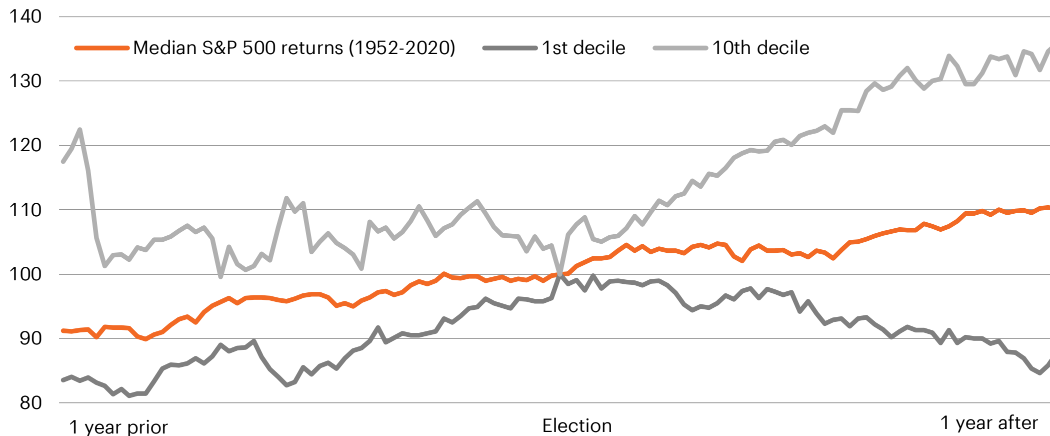
Two obvious culprits are likely the cause of economic gloom. The first is inflation. The rate of inflation has come down significantly, but the inflation sticker shock is still a clear and present pain point for every household budget. The price of groceries (food at home) is up 21% since the start of 2021, and car prices are up 20%. The Consumer Price Index is up 21% since January 2020. Most voters do not consider inflation enough to differentiate that inflation trending lower means that prices are still going to go up—just at a slower pace—and are not actually falling.

The second is housing affordability and availability. The rapid swing in mortgage rates from just below 3% to over 7% caused affordability to swing to the worst in 40 years. It has also frozen many homeowners in place with low fixed-rate mortgages, crushing supply. In many markets, even if a prospective buyer has the money to purchase a home, there is simply no inventory. At a national level, the number of homes on the market continues to be near the lowest on record. Neither of these factors are likely to improve much before the election.

Investors search for patterns in election results

It is difficult to sift a clear macro-market conclusion from election results. Both parties have been in power through bull markets, sell-offs and corrections. There is evidence that markets typically underperform in the months leading up to the election versus non-election years, and later make it up once any uncertainty around the election has cleared. And yet, at no time have we entered an election with market valuations at current levels.

Wide dispersion of market performance

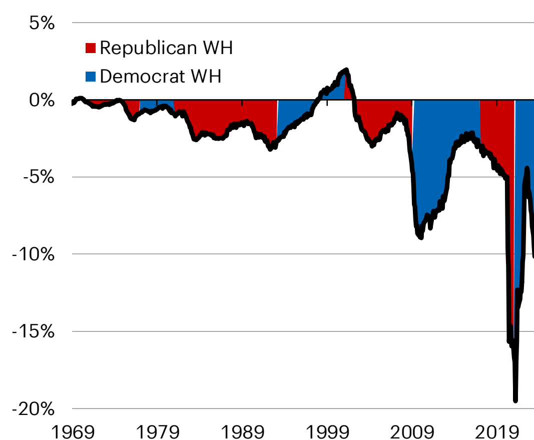


Source: Macrobond, FS Investments, as of June 23, 2024. Data reflect S&P 500 returns in election years only. 2008 market sell-off excluded due to significant volatility independent of election.

The key observable pattern around election is that volatility rises in the months leading up to election day, in both equity and bond markets. In our article on the election, we note that the volatility in 2020—an election which uniquely featured the same candidates—was significantly higher than the normal pre-election market jitters. We break down key policies that will be up for grabs, including taxes, regulation and trade policies.

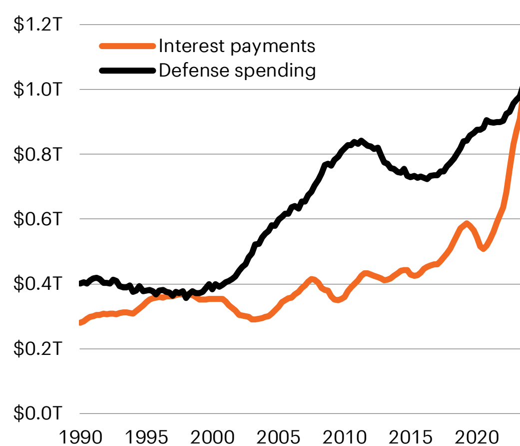
Investors are also increasingly focused on debt and deficit dynamics, although we would argue this is far greater than an election issue. Throughout decades, across administrations of both parties, the country has almost always run a budget deficit. This bad habit has led to the accumulation of $33 trillion dollars of debt outstanding, or almost 125% of GDP. In short, the budget is everyone's problem, and will take everyone working together to find a solution.

Government budget deficit %GDP



Source: Macrobond, Bureau of Economic Analysis, FS Investments, as of June 23, 2024.

Interest payments have spiked



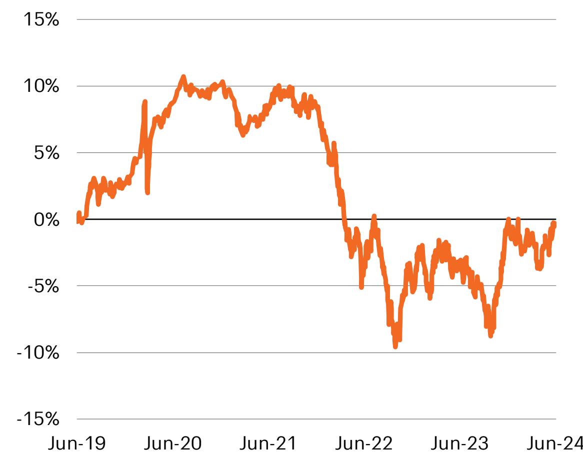
Source: Congressional Budget Office, Macrobond, as of June 23, 2024.

In 2023, the Treasury spent $658 billion on interest payments. In 2024, that number is projected by the Congressional Budget Office to rise 36% to $892 billion. And in 2025, interest payments are expected to be over $1 trillion. Already, interest payments have overtaken defense spending. Financial markets seem to be largely ignoring the long-run implications of **debt and deficit dynamics**, which include higher interest rates and less room for counter-cyclical fiscal response. We include an article detailing the scale of the issue and where to go from here.

Market optimism will face challenges in Q3

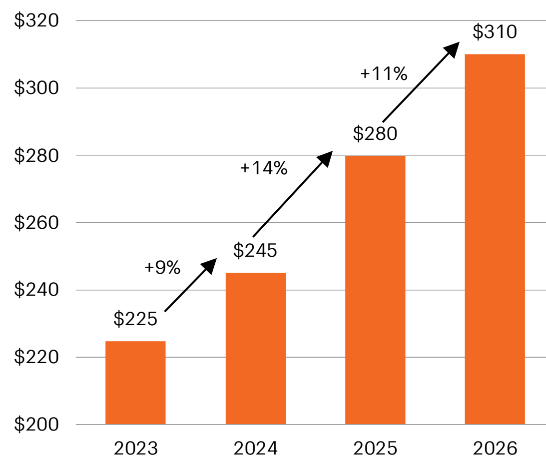
Despite a healthy economic backdrop, markets face some challenges in the coming quarter. Primarily, so much optimism is built into the implied market outlook that any downside surprise could hit performance. In the fixed income market, markets have interpreted the end of the Fed's rate hike cycle as a green light to pile back into duration because long-term interest rates usually fall when the Fed cuts rates. However, this misses a key differentiator of this cycle: Without a recession, the Fed is likely to move gradually to reduce rates. A healthy economy should, at some point, cause the inverted yield curve to renormalize. We expect more of a twist, with long-term rates trading in a wide range and likely retesting 5% sometime in the second half of the year. Investments in traditional fixed income have returned nothing over the past five years, and could be vulnerable to market complacency where rates are naturally headed lower.

Traditional fixed income returns underwhelm



Source: Bloomberg U.S. Agg Total Return, Bloomberg Finance, L.P., as of June 23, 2024.

S&P 500 consensus EPS estimates



Source: Bloomberg Finance, L.P., as of June 24, 2024.

Finally, we end where we started, with expectations. Equity market earnings expectations are for double-digit returns over years, not just over quarters. Valuations reflect this with the S&P 500 trading at over 20x forward price-to-earnings (P/E). In other research, we have discussed intensifying problems with high concentration within the broader index that has stretched to the highest on record. In the third quarter, volatility is likely to pick up ahead of the election. And we expect the economy to mildly underperform high expected growth. When peak optimism is the market's base case, any other outcome suddenly becomes a challenge.

Markets and elections: Bet on volatility

Key takeaways
- The clearest market pattern around election is heightened volatility in stock and bond markets in the months before the election.
- Volatility in the 2020 election was more acute.
- Many policies are up for grabs, including trade, tax and regulations.

The third-quarter focus on the election will intensify. Investors rightly question the economic and market implications under each outcome, but broad patterns are notoriously hard to find. In this highly unusual case, we have examples of both under each candidate's first term in the White House. Under former President Trump, the stock market rose an annualized 16% per year, and during President Biden's term, it has risen 13% per year (to date).

One clear pattern is that volatility historically emerges before an election. Stock and bond markets don't seem to reach much until the months directly preceding an election. This general observation is more exaggerated in the 2020 election, when volatility spiked much more than usual. We argue that investors should expect this pattern to reemerge later this year.

Many policies will be impacted by the election. Protectionism is now a bipartisan issue. Trump roiled markets with protectionist rhetoric in 2016 and quickly imposed tariffs, and Biden has not rolled back a single tariff on China that Trump imposed. Indeed, in May 2024, he announced a fresh round of more tariffs. It seems a virtual certainty that either administration would keep up this trend.

The Tax Cut and Jobs Act of 2017 expires on December 31, 2025, with significant ramifications. In November, the Senate seems highly likely to change to Republican control, and the outcome in the House is highly uncertain. If Trump wins the White House with Republicans in control of Congress, this will likely be extended. As a candidate, Trump has offered up even further tax breaks, but as we write in a later article, deficit dynamics are becoming too large to ignore.

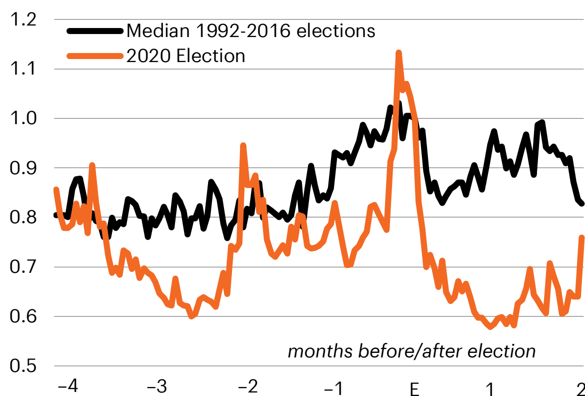
Should President Biden be reelected, he would likely be negotiating around the extension of the TCJA). He has said he will not raise taxes on families earnings less than $400,000 a year, and could try to make a deal to incrementally increase the corporate tax rate from 25%. Some other items up for discussion could be bracket expansion, and the state and local tax (SALT) exemption.

Regulation is a fairly binary outcome: President Biden will be more of the same, whereas Trump will make significant rollbacks.

Both candidates—and both parties—want a strong economy. Excluding 2020, real GDP grew 2.8% per quarter on average during Trump's presidency and has grown 2.9% on average (so far) during President Biden's. While history has not shown a pattern of economic dislocation around elections, business investment may well be dented by heightened economic uncertainty. This election is likely to be extremely close and like the 2016 election, may keep volatility elevated in the months ahead of the event.

VIX spikes around election

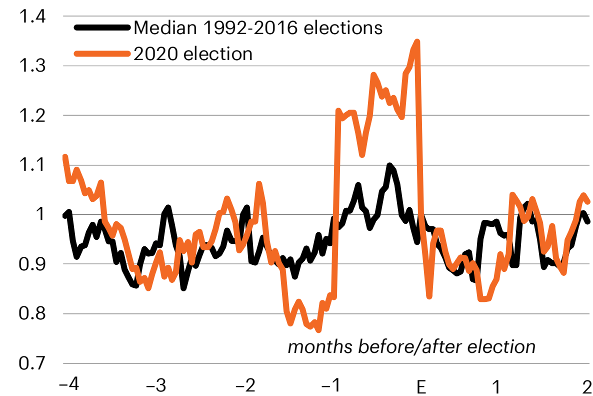
Indexed to election = 1



Source: Bloomberg Finance, L.P., FS Investments, as of June 18, 2024.

MOVE spikes around election

Indexed to election = 1



Source: Bloomberg Finance, L.P., FS Investments, as of June 18, 2024.

Inflation: Still a game of whack-a-mole

Key takeaways
- Progress on disinflation has slowed, and inflation has become stuck around 3%.
- Beyond consumer prices, wage growth also remains higher than before the pandemic.
- Month by month, one-off factors are blamed for inflation. This whack-a-mole may persist.

Trying to make sense of inflation picture is difficult. There are many indicators, each with their own idiosyncrasies. Pipeline indicators like PPI and import prices, and myriad wage measures are also part of the puzzle. Not to mention surveys of consumer and business inflation expectations. We are sticking with our forecast that inflation will remain stuck above 2% for the second half of the year.

Two conclusions are clear. First, progress on disinflation has slowed. A year ago, the phrase "miraculous disinflation" was ubiquitous, used to express the idea that inflation would just dissipate like a bad patch of smog. This was misguided. The initial causes of inflation such as car prices, durable household goods and food have fallen. But other sectors remain problematic, mostly on the services side, including owners' equivalent rent, which is still tracking 5.7% in CPI (We devoted a separate article to the nuances of housing, rent and inflation).

Inflation has slowed from the acute environment of mid-2022, but CPI was 3.3% y/y in May, and has averaged 3.3% y/y since June of last year. Core CPI has come down to 3.4% y/y, but it has been a 10-month process to fall 5-tenths.

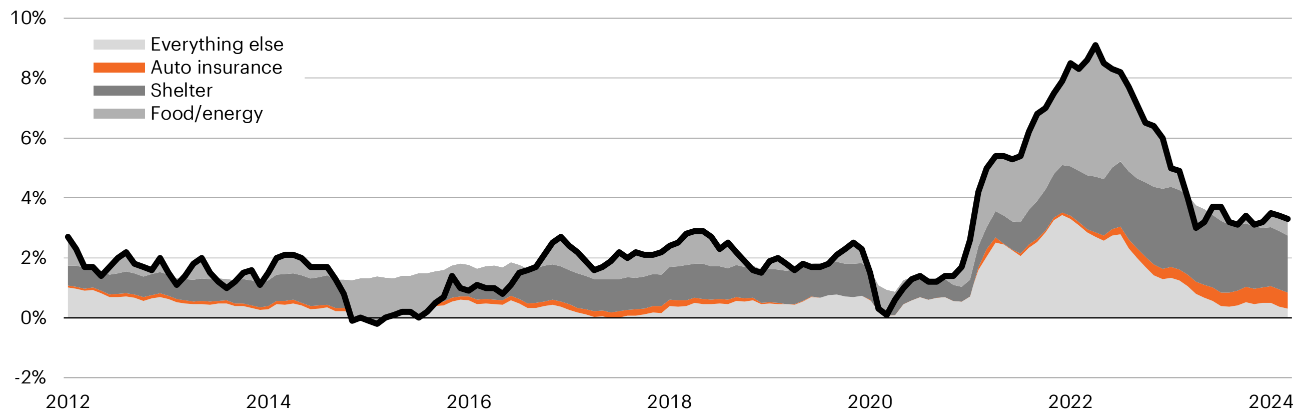
There is still a sense that just when inflation falls in one troublesome category, it flares in another. This whack-a-mole has been a theme since the pandemic. As an example, vehicle prices surged then fell, only to be followed by auto repair costs that peaked at 14% y/y in January 2023, and most recently auto insurance costs have risen to 23% y/y. This category carries a small 2.9% weight in the index, but has had a meaningful impact.

The second conclusion is when zooming out from individual data series, the entire inflation system is still far out of the narrow 2% lane it occupied for two decades before the pandemic. Wage pressure have been as stubborn as consumer prices. Average hourly earnings stalled out around 4% y/y, and the employment cost index rose to 4.4% y/y in Q1.

The downtrend in inflation expectations has also stalled, and in some cases, reversed. The University of Michigan sentiment survey of inflation expectations remains choppy, but the one-year measure rose two months back to 3.3% in May. The New York Fed's measure of one-year inflation expectation notched back above 3% in April and May as well.

None of this adds up to a reacceleration of inflation. But our outlook that inflation will end the year at 3.0% reflects several factors. We expect rent inflation to remain higher than pre-COVID, keeping upward pressure on core inflation. We also expect wage growth to remain elevated. None of this precludes a rate cut, but inflation will likely be stubborn and choppy enough to keep the Fed rate cut program slow and highly data dependent.

CPI and shifting drivers, %y/y



Source: Bureau of Labor Statistics, FS Investments, as of June 23, 2024.

Housing and rent: Gimme (cheaper) shelter

Key takeaways

- Shelter costs have surged and been a primary driver of inflation since 2021.
- Understanding rent inflation remains a key challenge for policymakers.
- Sharply higher rates have sapped appetite to build new units, potentially driving another wave of cost increases down the road.

The rising cost of shelter has been a core component of the inflationary pressures—and consumer unease—that developed over the past three years. The interaction of home prices, mortgage rates and rents is among the most important macro trends today and could dictate the future of policy—both in the short- and longer-term.

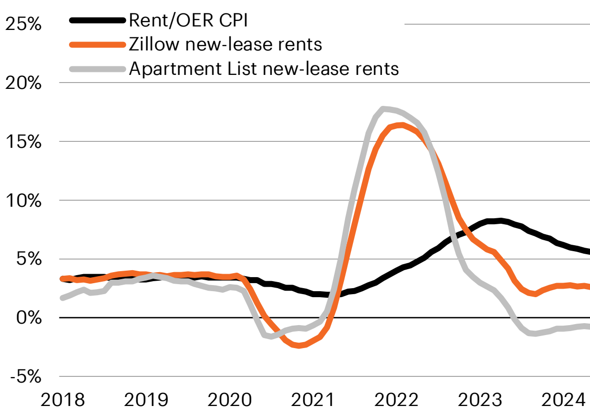
The rapid rise in shelter cost can be traced back to the 2010s. Construction of new housing flagged after the Global Financial Crisis as demand was slow to return. The number of housing units built counted roughly half of what would be expected, and for those who did purchase homes, nearly all obtained long-term, low-rate mortgages. These trends accelerated during the pandemic as interest rates remained near all-time lows through much of 2021.

Housing demand surged as the economy rebounded. Stimulus checks augmented incomes, and the massive millennial cohort was finally ready to buy homes. The issue, however, was that few new units—either apartment or single-family—were being delivered, and as rates rose in 2022, few existing homeowners were willing to sell and give up their rock-bottom rate. The result is apparent: Rents are up 29% since the start of 2021 according to Zillow, and home prices have risen 34% despite the sharp rise in mortgage rates. Put simply, the combination of strong demand with under-building and low interest rates from 2010–2021 has been the primary cause of high shelter costs.

The impact shows up in the inflation data. While home prices do not feed directly into CPI, rents and "owners' equivalent rent" do, and make up about one-third of the Price Index. Since 2022, shelter CPI has risen 17% and accounted for almost half the rise in overall CPI. However, there is an important caveat—these measures tend to lag the "true trend" in market rents by a year or more due to the CPI methodology. Indeed, looking at real-time measures of rents would suggest rent growth has plummeted as a surge of new apartments are finally completed.

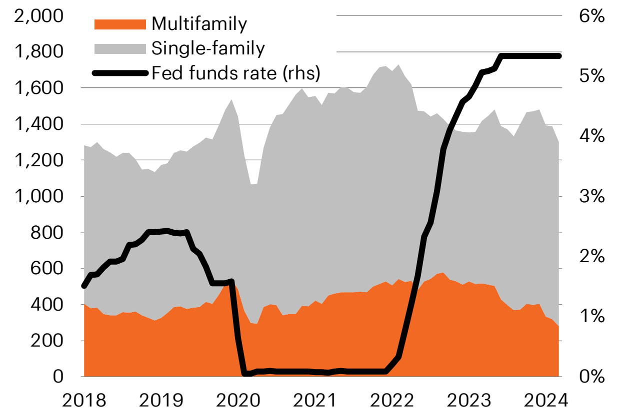
This continues to vex policymakers. Even today, shelter accounts for 57% of the y/y rise in headline CPI. As the months progress, we can assume shelter inflation will continue to come down, though the magnitude and duration are uncertain. The larger issue is the Fed's rate hike cycle has challenged developers and caused another plunge in new construction starts. This is likely to create a paucity of new units being delivered over the next 2-3 years, potentially reigniting shelter inflation. And with housing affordability at record lows, more and more people figure to be relegated to renting for longer.

The lagged effect of rents on CPI
% year-over-year rise in apartment rents



Source: U.S. BLS, Zillow, Apartment List as of May 31, 2024.

Higher rates have stunted construction
Thousands of units, AR 3mma



Source: U.S. Census Bureau, Federal Reserve, as of May 31, 2024.

Fed Policy: Keep calm and wait for cuts

Key takeaways

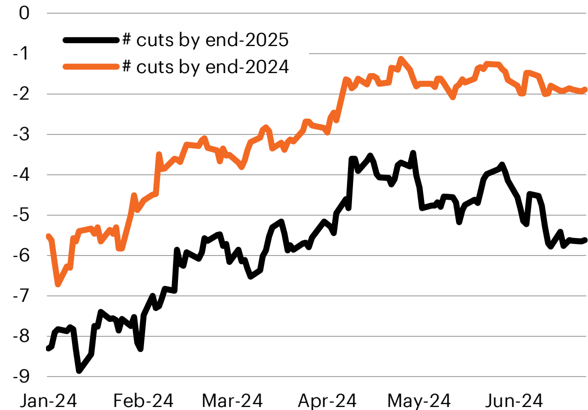
- Rate cut expectations have narrowed to between one and two cuts in 2024.
- We expect one rate cut in the fourth quarter, given stubborn inflation and strong markets.
- The Fed is often active in election years, and even near the election.

Market expectations have settled into a narrower range of outcomes for the Fed in the remainder of the year, and since April, have been toggling between pricing in one to two rate cuts. We continue to believe the Fed will cut only once this year and expect them to wait until after the election, with a November 7 (two days after voters decide) or December 18 date.

It was always clear market expectations of almost seven rate cuts at the start of the year were unrealistic unless the economy weakened materially. What is remarkable in hindsight is how well markets have absorbed the pricing out of aggressive rate cuts. Higher-for-longer earnings have created insulation for equity markets in this higher-for-longer interest rate environment.

The Fed's intention is to cut rates. Our forecast has been that these will be surgical rate cuts—think a nip and a tuck—under the right market and economic conditions. As markets have priced Fed rate cuts out of 2024, they have pushed cuts into 2025. The Fed's

Fed rate cut expectations

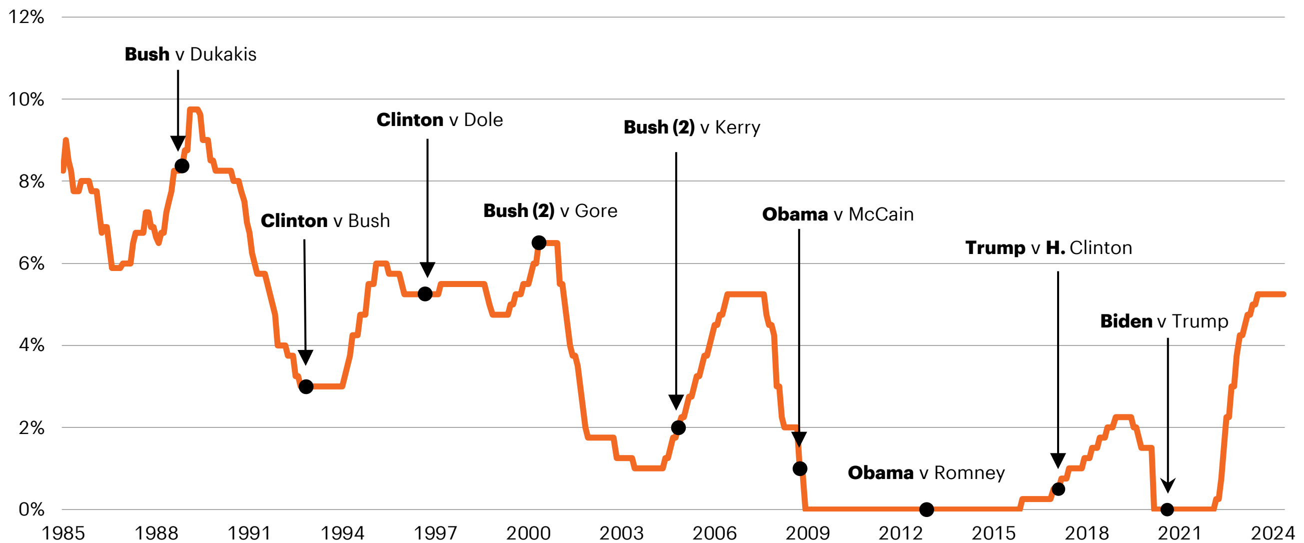


Source: Bloomberg Finance, L.P., as of June 23, 2024.

dot plot now includes a median one rate cut in 2024 and four rate cuts in 2025. We expect the Fed to continue to move more slowly than markets expect, however, and to remain data dependent for all of next year. In other words, don't expect one rate cut per quarter on autopilot.

The election crowds the Fed's calendar. The Fed is staunchly politically independent, and therefore elections should not factor into their rate decision. And yet, if the choice is between a cut at the September 18 meeting and waiting until after the election, we tend to think they would wait. If the economy remains roughly the same as it is today, and equity markets remain at or near record highs, there is no urgency to cut rates.

Federal Reserve policy and presidential elections



Source: Federal Reserve as of June 23, 2024. Electoral college winner in bold.

Debt and deficits: Everybody's problem

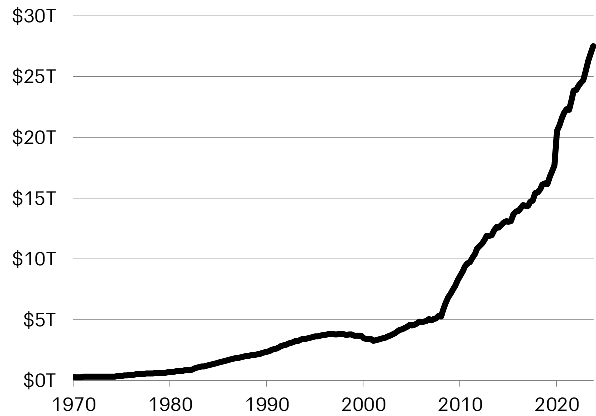
Key takeaways
- Debt, deficits have reached a tipping point.
- We model three yield curve scenarios to illustrate the looming scale of the problem.
- Investors should be wary of complacency in traditional fixed income: Long-term rates may move higher despite a likely Fed rate cut.

Over decades, the U.S. government has almost entirely operated by running an annual deficit and issuing debt. Today, total debt outstanding is $33 trillion, or almost 125% of GDP. Total debt held by the public is $26.2 trillion, just about equal to GDP. The word "unsustainable" has been used for decades as this debt accumulation has happened unabated. And yet, as interest rates have jumped out of their 15-year low-yield era, there is the sense that a tipping point has occurred.

In 2023, the government paid $658 billion in interest payments. In 2024, that is estimated to rise 36% to $892 billion, and be over $1 trillion in 2025. This is the vicious cycle that now looms. Higher interest payments will mean larger deficits, which will require more debt issuance and drive up interest rates. And higher interest rates cause the upward spiral.

We model three yield curve scenarios for illustrative purposes: The Congressional Budget Office (CBO) base case; an old normal, which is the average of the 1990s; and secular stagnation, which approximates the late 2010s. In the first two scenarios, the outcome is dramatically higher net interest payments as a share of GDP. While secular stagnation is more palatable through the lens of debt dynamics, it would hardly be good news for growth or corporate profitability.

U.S. government debt outstanding

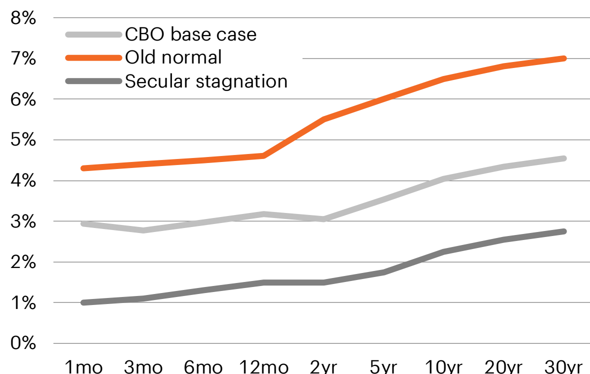


Source: U.S. Treasury, debt held by public, as of June 23, 2024.

Markets today seem to be largely unbothered by the implications of these hypothetical forecasts. Our view that long-term interest rates have likely not peaked, despite possible Fed rate cuts, is based in part because of these debt dynamics that will require massive issuance in coming quarters (and years). The economic implications are also problematic. Net interest payments are now more than defense spending. These payments do not employ anyone or build anything. Indeed, much of these funds go abroad to other countries.

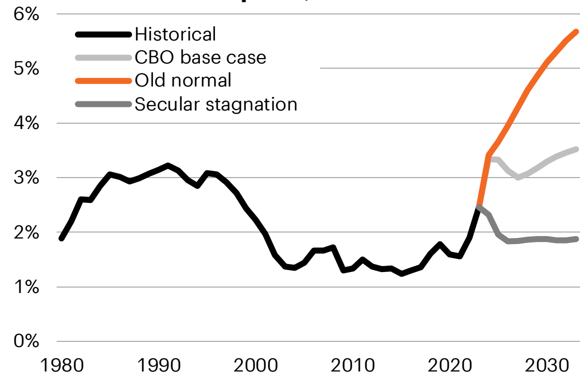
Hard choices are ahead, no matter which candidate wins. The government will have less room to help the economy or do much beyond mandatory spending on social security and Medicare. If the deficit is everybody's problem, then everybody will be needed to help find a solution. For investors, it is critical to create a portfolio that guards against complacency in traditional bond markets. Long-term interest rates could yet move higher, further dampening already paltry returns.

Yield curve scenarios in 2030



Source: Congressional Budget Office, FS Investments, as of June 23, 2024.

Annual net interest expense, % GDP



Source: Congressional Budget Office, FS Investments, as of June 23, 2024.

Equities: Higher earnings growth for longer

Key takeaways

- Stocks have surged since end-2022, with the S&P 500 up nearly 50% during that time.
- The top 7 stocks sourced two-thirds of the gain in the first half of the year.
- A belief in higher-for-longer earnings growth has allowed investors to justify valuations.

Stocks continued their ascent during the first half of 2024 and extended the current bull market to 18 months, a period during which the S&P 500 has gained 46%. While healthy growth in earnings has been a crucial aspect of the strong run of performance, a rise in the forward P/E ratio of 4.5x has delivered the bulk of the returns. Today, valuations rival levels from late 2021, when the 10-year Treasury yield was 270 bps lower.

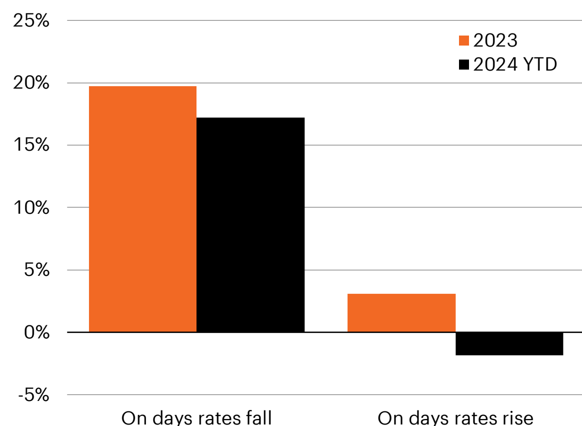
If concentration of performance was the story of 2023, it has only grown more extreme this year. Nvidia, now the largest stock in the world, drove one-third of the S&P 500 return by itself, and the rest of the Magnificent 7 firms provided another third. The top 10 stocks now account for 37% of the index weight and, even more importantly, roughly half of index risk.

Undoubtedly, fundamentals are a major source of optimism. After margin compression caused a blip in 2023, S&P 500 EPS growth has reaccelerated and is expected to tally 9% this year, almost half of which is to be delivered by the Magnificent 7. Higher earnings for longer is the central thesis allowing the market to sail past higher rates for longer. Investors expect no earnings slowdown on the forecast horizon—EPS growth is estimated at 14% in 2025 and 11% in 2026. In a way, we think the market is justifying today's lofty multiples by pricing stocks based on 2026 EPS; 17.5x earnings isn't nearly as deterring as 21.5x.

While we do believe a solid economy will continue to support fundamentals, we also see signs of froth. The market put/call ratio—a signal of investors' concern about downside protection—fell to its lowest level since last year, and the VIX has declined to a post-COVID low. The risk mood in markets, which we describe as asymmetric to the upside, can be seen in the left chart below. For a second consecutive year, markets have reaped almost all their gains on days interest rates have fallen, while holding steady on days in which they rise.

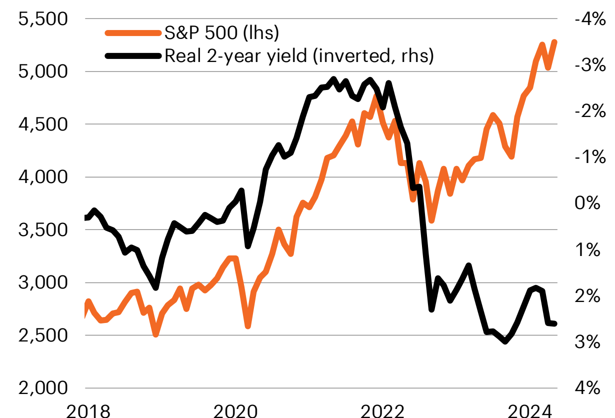
What could roil this quiescent environment? Because today's multiples are being justified by tomorrow's earnings expectations, anything that calls into question those growth rates would be cause for material concern. This could come in the form of a macroeconomic slowdown, but just as powerful could be something that undermines the AI fervor. While the market being expensive may not be determinative of when a correction could come, we believe it could very well be determinative of how sharp one may be. In addition, there is evidence that market volatility tends to be heightened around elections, usually beginning in mid-Q3.

S&P 500 cumulative performance attribution



Source: Bloomberg Finance, L.P., as of June 19, 2024.

Stocks and rates have diverged



Source: Bloomberg Finance, L.P., as of May 31, 2024.