WEST SHORE BANK

Price stability and maximum employment are the dual mandates of the Federal Reserve (Fed). These mandates were at the opposite ends of the spectrum entering 2022. Inflation (price stability) was out of control due to government spending programs, severe COVID-related global supply chain disruptions, and a red hot labor market (maximum employment).

Before COVID, there already was a labor market imbalance with the stove knob set on medium-high. Post COVID, this imbalance was turned to high as demand for workers abruptly far exceeded supply which drove up average hourly wages, and in turn, business labor costs exacerbating inflation. It is estimated that between seven to eight million workers voluntarily left the labor market after COVID lockdowns.

To bring “transitory” (remember that?) inflation under control, the Fed needed to slow the economy and cool off the labor market by raising rates. They aggressively raised the fed funds target rate 11 times from +0.25% to +5.50% between March 2022 and July 2023. Inflation peaked at a 40-year high of 9.0% in June 2022 and began to gradually, and fairly consistently, move lower. This inflation trend set the stage for the “anticipated rate cut” market rally which began in the fourth-quarter 2022 and continues today.

Table 1 – Stock Index Total Returns – as of September 30, 2024

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
S&P 500	2.14	5.89	22.08	36.35	11.91	15.98	13.38
NASDAQ	2.76	2.76	21.84	38.64	8.84	18.81	16.13
MSCI Emerging	6.68	8.72	16.86	26.05	0.40	5.75	4.02
Dow Jones Industrial	1.96	8.72	13.93	28.85	9.97	11.78	12.03
S&P 400	1.16	6.94	13.54	26.79	7.47	11.78	10.32
MSCI Developed	0.92	7.26	12.99	24.77	5.48	8.20	5.71
Russell 2000	0.70	9.27	11.17	26.76	1.84	9.39	8.78

After the last rate increase in July 2023, the Fed put rate hikes on hold to see if their policy would in fact reduce demand. While the rate of inflation continued to slow, the economy and labor market however, proved to be more difficult. Despite the rate increases and much higher household costs, the softening of economic demand took much longer than expected due to the resiliency of the consumer. The Fed remained patient as they felt policy was restrictive enough and that the economy would eventually weaken while inflation continued to trend towards their 2% target.

Although there were certainly bumps along the way, as time went on the Fed grew more confident that the risks associated with their dual mandate were becoming more balanced. Upside risks to inflation diminished greatly from the high levels of 2022 and downside risks to a weakening, albeit still solid labor market, were increasing. Many labor measures were moving in the desired direction including the unemployment rate ↑, weekly average hourly earnings ↓, participation levels ↑, and monthly job gains↓.

With more balanced mandate risks, and nearly two and half years after rate hikes began, the Fed felt it was appropriate to “recalibrate” policy and cut the fed funds target rate by +0.50% in September to +5.00%, which was larger than +0.25% expected.

When asked about the unexpected 50 basis point cut and whether they have fallen behind policy wise, Fed Chair Powell noted “While many measures show the labor market is weakening, it is still in solid condition and want to keep it there. Think of the 50-basis point move as a commitment to make sure that we don't fall behind. With an appropriate recalibration of our policy, we can continue to see the economy growing and that will support the labor market."

Last quarter, as it was becoming more evident that the Fed was going cut rates, bond yields moved lower across the curve and the yield curve continue to flatten and eventually steepened after being inverted for over two years. Yields on the 2-Year and 10-Year treasury notes fell from 4.72% to 3.64% and from 4.37% to 3.79%, respectively. We expect the yield to continue to steepen, more so with the 10-year moving higher into the 4.25%-4.75% range. The 2-year could move somewhat lower but most of the rate cuts are already baked in and the Fed projects a neutral rate of 3.0%. The historical spread between 2's and 10's is a positive 1.25% which should put the 10-year in the highlighted yield range.

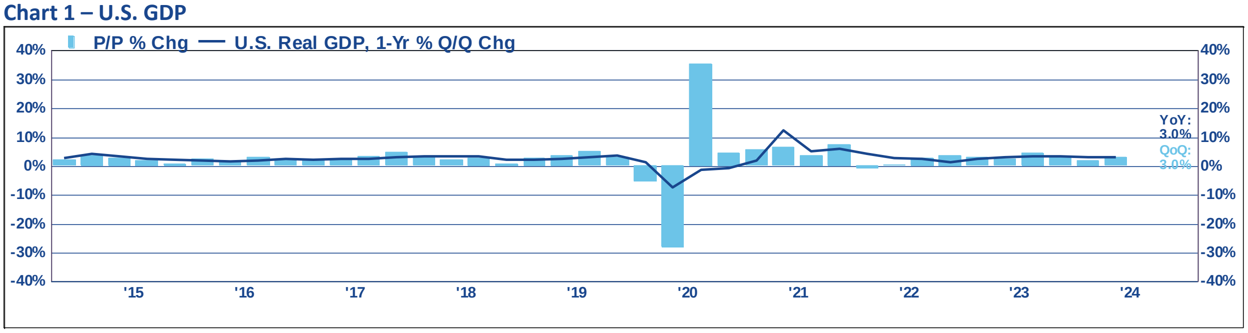
Table 2 – Fixed Income Index Total Returns – September 30, 2024

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg High Yield	1.62	5.28	8.00	15.74	3.10	4.72	5.04
Bloomberg Inter Gov't/Credit	1.08	4.17	4.68	9.45	0.17	1.26	1.96
Bloomberg U.S. Aggregate	1.34	5.20	4.45	11.57	-1.39	0.33	1.84
Barclays Michigan Muni	0.86	2.44	2.53	10.40	0.02	1.43	2.68
Bloomberg Municipal	0.99	2.71	2.30	10.37	0.09	1.39	2.52

The Fed is trying to ensure an economic "soft landing" and that the economy does not slip into a recession. One could easily take the other side of this narrative and argue that the Fed is making a policy mistake by cutting rates while the economy is still expanding at a solid pace.

Since 3Q2022, the U.S. GDP has expanded for eight consecutive quarters and, as aforementioned, the consumer has been the stalwart of growth. Consumer spending, which historically accounts for 2/3rds of the economy, rose at a +2.8% annualized pace with both goods and services advancing. Spending on durable goods such as appliances and cars outpaced services growing at a +5.5% annualized pace. Although services comprises a much larger portion of the economy than the manufacturing of goods, goods spending signals consumers are more confident in buying higher-priced items, even with much higher financing costs.

Chart 1 – U.S. GDP



Consumer strength is seen in industry association reports as well. According to the Association of American Railroads Rail Industry Overview, "August 2024 saw the highest U.S. rail container originations ever and the most total intermodal originations since May 2021, driven higher by increased port activity and resilient consumer spending." The report also highlighted that growth in goods outpaced services for three straight months, consistent with the most recent U.S. GDP report.

Consumer resilience is also seen in the travel and hospitality space as both airline traffic and hotel bookings are very solid. On July 7, 2024, the TSA posted its highest ever daily check-in rate at 3.0 million while hotel reservations in the month of July saw a +5% increase over already lofty 2023 levels.

These reports show that consumers and the U.S. economy are doing well, and it appears the economy is on pace for a ninth consecutive quarter of growth. The Federal Reserve Bank of Atlanta's GDPNow currently forecasts 3Q2024 economic growth at +2.5%. The Fed acknowledges that the economy is growing at a moderate pace and that the labor market is still solid. They also reiterate that future policy moves will be data dependent and based on the changing economic outlook. They also believe that whether the economy strengthens or weakens, they are in a good position to adjust policy accordingly to manage mandate risks.

Going forward, we expect the Fed to move more cautiously with rate cuts and do not expect the pace of rate cuts to remain at 0.50% but at 0.25%. Since the FOMC meeting in September, many economic readings have come in higher than expected including labor market measures. This will likely shift Fed policy to more guarded than aggressive.

The U.S. economy is still solid and supportive of continued earnings growth. The combination of Fed rate cuts and normalized earnings growth bodes well for future market gains. Our strategy continues to favor overweighting stocks while keeping a slightly underweight and shorter duration defensive position for bond allocation. With regional wars intensifying and entering the home stretch of the presidential cycle, we expect market volatility to increase near term.

Prepared by Perry Adams – SVP & Director – West Shore Bank Wealth Management – October 4, 2024

Sources: FactSet, Bureau of Economic Analysis, TSA, Federal Reserve, Association of American Railroads, American Hotel and Lodging Association, Federal Reserve Bank of Atlanta