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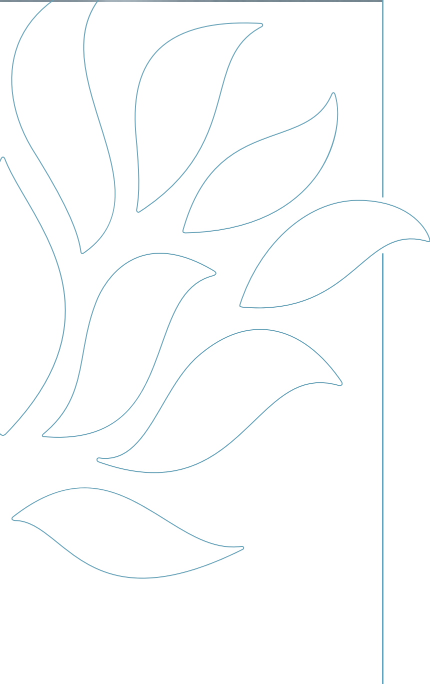
The Possibility of an Economic Soft Landing



Could This Time Be Different?

By Brian SOMMERS, CFA
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THE U.S. FEDERAL RESERVE cut interest rates at their September meeting by 50 basis points to keep the economy growing and stabilize a weakening job market. The cut came after the Fed raised rates a total of 11 times from March 2022 through July 2023 in an effort to reduce high inflation. In total rates were raised by 5.25 percent.

At the beginning of this year, I noted there were two potential paths the economy could take in 2024. There was the distinct possibility higher rates would cause growth to slow to the point where a recession would occur. Alternatively, if growth didn't slow and inflation remained high, the Fed would be forced to keep rates high to prevent a resurgence of inflation at the risk of causing a recession in 2025.

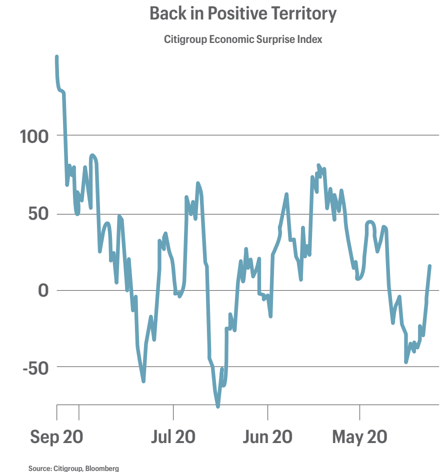
However, there was another occurrence that I did not give much of a chance. The third scenario was that growth could slow just enough for inflation to come down but not too much to cause a recession. This has historically been a very rare occurrence.

A study by Princeton economist Alan Blinder, a former Fed vice chair, showed that since 1965 there have been 5 other time periods when the Fed hiked rates by at least 4.00 percent. The only one of these rate hiking cycles that ended in a soft landing was in 1969. All the other rate hiking campaigns of this magnitude resulted in a recession.

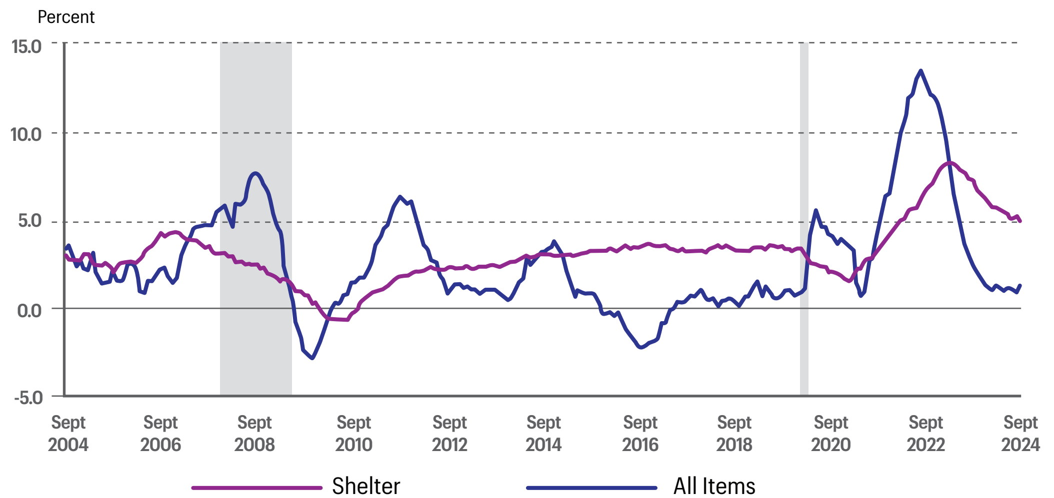
While there are still many hurdles to overcome before claiming victory, there is the possibility that this time could be different. So far, the economy has proven to be very resilient while the excesses in savings and supply bottlenecks left over from the pandemic have largely been resolved. Inflation has come down while economic growth and employment have remained strong. GDP for the second quarter came in at 3.0 percent, and the Atlanta Fed's GDP estimate for the 3rd quarter is 3.1 percent.

So far, the economy has proven to be very resilient.

Economic indicators are surprising to the upside, more often than not, for the first time since April:



The consumer price index, a broad gauge measuring the costs of goods and services across the U.S. economy, increased a seasonally adjusted 0.2 percent for the month of September, putting the annual inflation rate at 2.4 percent. Both readings were 0.1 percentage points above the Dow Jones consensus, but still 0.1 percentage points lower than August and the lowest since February 2021.



A labor market that appeared to be softening grew by a more than expected 254 thousand in September. Fears that a softening labor market would lead to lower consumption growth have lessened, but caution is warranted. One month does not make a trend, and at times in the past there have been substantial downward revisions the following months. There will need to be another month or two of solid employment gains before the strength is confirmed.

However, the stronger economic data means that the probability of a recession is lower than previously thought. Earlier this year the minutes of the Fed's meetings showed the Federal Open Market Committee (FOMC) that establishes monetary policy was primarily concerned about the risk of a recession. But in their September meeting the Fed noted that "the risks are balanced" between a recession and a revival of inflation due to a still-hot economy.

What was different this time that might have enabled the Fed's rate hikes to slow down economic growth but not tip the economy into a recession? It appears that the dislocations from the COVID-19 pandemic were the primary sources of the issues causing inflation. In response to the pandemic-induced economic shutdowns, almost every government in the world attempted to support domestic demand by giving money to individuals and businesses. Also, most countries with a central bank cut interest rates to levels that were at or near zero. The surge in inflation was the result of both fiscal policy (pumping money into the economy) and monetary policy (keeping interest rates near zero) at a time when supply chain disruptions created a scarcity of goods for consumers.

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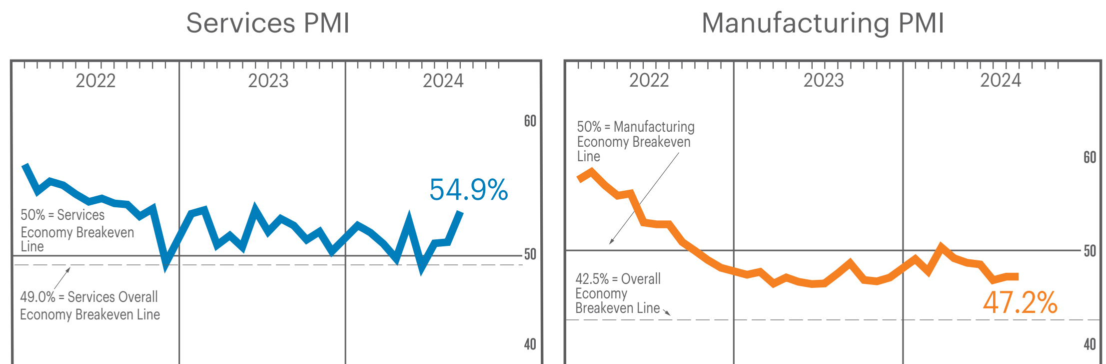
After global economies reopened and supply chains began to clear, the stimulus boosted the economy more than expected, and the demand for jobs was so strong that the U.S. economy had millions of unfilled positions. The Fed's rate hikes have helped reduce inflation while only cutting these unfilled jobs.

To a large degree, the strength in the economy has been driven by consumer spending on services such as travel and entertainment. In September the Services Purchasing Manager Index, which measures activity in the services economy, registered its highest level since February 2023. Typically, spending on services does not drive economic growth. But consumers flush with savings leftover from the pandemic stimulus continued to spend much more than anticipated.

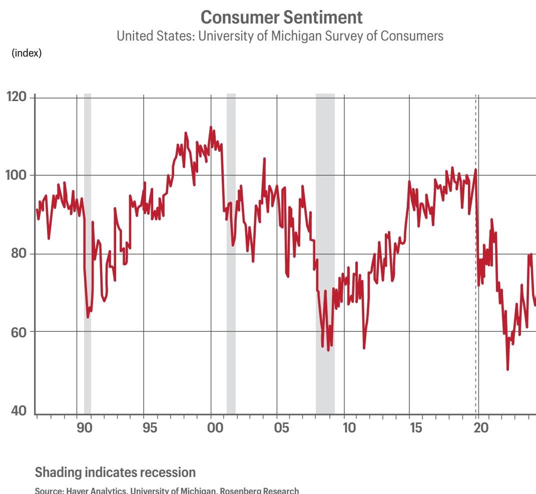
Manufacturing activity, however, had been indicating an economy that was weakening at a fast rate. In the U.S., the manufacturing sector usually drives economic growth, but it has been contracting for the better part of the past two years. After breaking a 16-month streak of contraction, by expanding in March, the Manufacturing Purchasing Manager's Index (PMI) contracted for the sixth consecutive month in September.



Source: The Institute for Supply Management

The manufacturing sector might need to rebound if a recession is to be avoided in 2025. Growth in manufacturing activity is typically a good sign for future economic growth because of the multiplier effect it has as it provides a significant source of demand for goods and services in other sectors of the economy.

A manufacturing recovery would offset a potential slowdown in consumer spending on services, which may finally run out of steam. Even though inflation is coming down and growth remains resilient, other worries are casting somewhat of a gloomy feel to the current environment. Consumer Sentiment surveys show that consumers were more pessimistic than expected in September, raising some questions about the continued resilience of consumer spending.



Although the employment numbers have been strong, the number of people who are working part-time is rising because they can't find a full-time job. Consumers, especially those with lower income, are still struggling with depleted savings, higher debt, higher prices, and fewer hours worked. The average person hasn't seen the benefit of lower interest rates yet, and there are worries that the wars in the Middle East and Ukraine will cause energy prices to spike higher. Eventually, these issues could cause even higher income consumers to curtail their spending before lower interest rates provide some relief.

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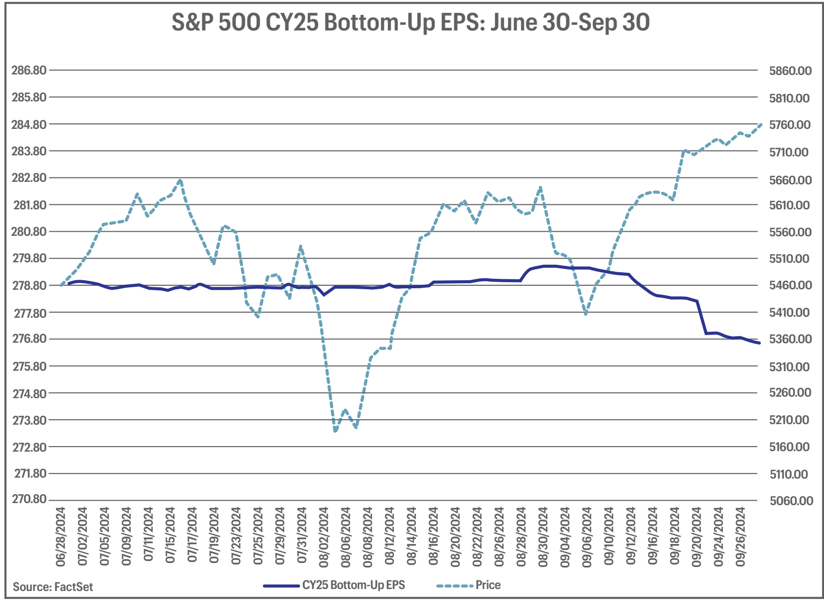
Still, whether the economy falls into a short recession or growth remains modestly positive in a soft-landing scenario may not matter to most people. If the Fed continues its patient approach and its rate cuts are gradual, the economy might enter and exit a recession without most people even realizing it.

A recession or soft-landing distinction also may be irrelevant for stock prices, which continued to rise heading into the final months of 2024. The increased likelihood of a soft-landing has increased investors' willingness to take on the risk of buying equities. However, valuations for the market have become quite expensive, especially given the level of uncertainty that still exists.

The Shiller P/E ratio of companies in the S&P 500 Index, which is the price-to-earnings ratio for companies in the S&P 500 based on average inflation-adjusted earnings from the previous 10 years, is above the 90th percentile

using data going back to 1989. While this measure is not a good tool to try to time the market (such a tool doesn't exist), it still provides an indication that risk taking might be at an extreme level, which would warrant more caution when investing in the stock market.



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As stocks have been getting more expensive, the expectation for their earnings for 2024 has been falling. On a fundamental basis, the support for the current valuations appears to be deteriorating. Overall, the expected earnings of companies in the S&P 500 Index for 2024 has been downgraded while stock prices continue to rise. Most of the increase in earnings for these companies is expected to come from margin expansion, not an increase in demand. Also, earnings growth continues to be concentrated in a handful of companies, primarily the Mag 7. All the growth in earnings for companies in the S&P 500 Index is being driven by just four sectors — Technology, Communication Services, Utilities and Financials.

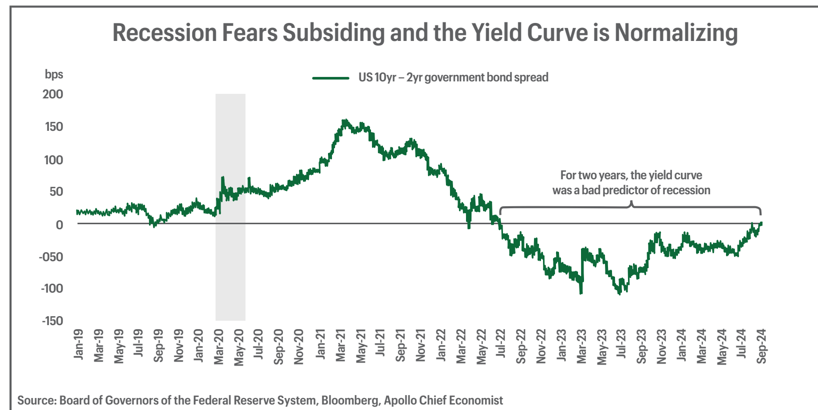
Corporate earnings results for the third quarter could be the key for stocks if they are to hold on to their gains. Analysts expect aggregate earnings per share growth of 4.2 percent for the third quarter. For the calendar year of 2025, corporate earnings are expected to be up over 14 percent. These are somewhat optimistic expectations, and the market appears to be valued based on companies achieving those results.

If that earnings growth is achieved, then the current valuations could be justified. But if earnings growth in aggregate falls short of those numbers, the disappointment could lead to some volatility in the stock market. As we head toward the end of the year, most investors are overweight in equities, so it is possible that these concerns could cause investors to rebalance their portfolios by reducing their equity exposure. Caution seems warranted in the current environment.

In the bond market, in September U.S. Treasury interest rates decreased for the fifth straight month across the curve. The front end declined more than longer maturities and the Treasury yield curve de-inverted (as measured by the difference between 2 year and 10-year maturities) for the first time in over two years.

Caution seems warranted in the current environment.

Longer term rates jumped at the start of October as both the 50-basis point cut and the strong jobs report was interpreted as a reduced chance of recession, which makes risk assets like corporate bonds and equities more attractive relative to Treasuries. A yield curve that is no longer inverted is consistent with a lower probability of a recession.



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Brian Sommers, CFA

Principal and Chief Investment Officer, HBKS® Wealth Advisors

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