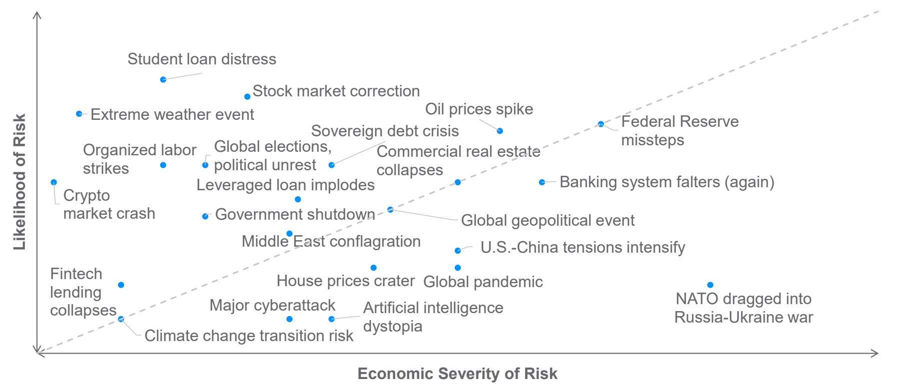
March 2024 Quarterly Economic Outlook

BY COLIN SEITZ

Macroeconomic outlook

The U.S. economy is performing well, and near-term prospects are good. This has become a mantra for us as the economy remains resilient. It is early in the first quarter, but our tracking estimate for annualized real GDP growth in the quarter is just less than 3%. The job market also continues to produce lots of positions, with payrolls increasing by an average of nearly 250,000 jobs per month over the past year. Unemployment remains firmly below 4%, as it has for the past two years, and all demographic groups are enjoying the low joblessness. Annual inflation is hovering near 3%, which is still above the Federal Reserve's target, but the rate has moderated consistently since peaking in mid-2022, and the Fed's target is coming into view.

Chart 1: Fed Misstep Is the Most Serious Risk to the Sanguine Outlook



Source: Moody's Analytics

Good economic data notwithstanding, it is premature to conclude the economy has soft-landed, and that will remain so until the Fed lowers interest rates. The fed funds rate target of 5.5% is well above the Fed's own estimate of the equilibrium rate or so-called r-star—that rate consistent with monetary policy neither restraining nor supporting growth—of 2.5%. Fed officials have also made it clear they are in no rush to begin lowering rates, as they want to be absolutely sure inflation is headed back to target. Policymakers seem to prefer the risk of waiting too long to lower rates and significantly weakening the economy or even precipitating a recession, rather than risk cutting rates too soon and allowing the economy and inflation to rev back up, which would end up even more badly for the economy.

The risk that the Fed makes a misstep and fails to appropriately calibrate monetary policy remains the most serious threat to our sanguine economic outlook (see Chart 1).

The Fed has made mistakes before. Most notably, it misjudged by waiting too long to begin raising rates off the zero lower bound in early 2022 as the economy quickly rebounded from the pandemic. Inflation surged and the Fed was forced to play catch-up by aggressively ramping up rates, which it did through mid-2023.

The Fed's mistake was to significantly deviate from its own tried-and-true reaction function. When setting monetary policy, the Fed considers how near the economy is to full employment and inflation to its target, whether inflation expectations of investors and consumers are well-anchored, and whether so-called financial conditions are consistent with the Fed's policy stance. We have econometrically estimated the Fed's reaction function based on Fed interest rate decisions dating back to when Paul Volker became Fed chair in 1979. That was the last time the Fed was battling uncomfortably high inflation.

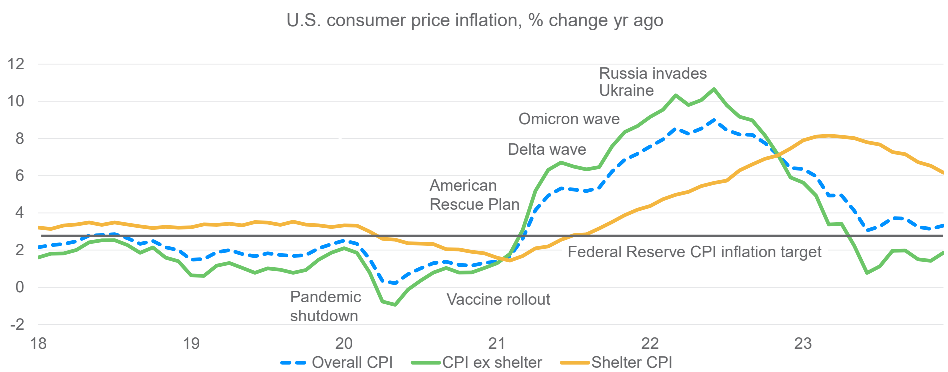
If the Fed had set policy consistent with its reaction function, by the start of 2022 the funds rate would have already been at 2.5%, equal to the Fed's estimate of r-star. Instead, the funds rate was still pinned to the zero lower bound, and inflation gained traction. In fairness to Fed officials, early 2022 was an extraordinarily tumultuous and uncertain time. The Delta and Omicron variants of COVID-19 continued to wreak havoc, scrambling global supply chains and the labor market. Also, Russia's invasion of Ukraine and its fallout on global energy and agricultural prices had just begun. Given the heightened uncertainty, policymakers felt it appropriate to err on the side of providing too much support to the economy. Which they did. It is understandable the Fed misjudged the inflation threat and waited too long to raise rates, but it was a misjudgment, nonetheless.

Policymakers now risk committing another policy error in waiting too long to begin cutting interest rates. Based on our estimated reaction function, the current funds rate target should be closer to 4%. This is still well above any estimate of r-star, including ours, which based on our estimated reaction fund is near 3%.

The funds rate should be set meaningfully higher than r-star, as inflation is still above the Fed's target, but it should be set well below the current 5.5% funds rate. This conclusion rests on the view that the economy is operating at full employment and growing at its potential. Low and stable unemployment, which has barely budged for the past two years at just less than 4%, is testament to this. Any concern that recently strong GDP and job numbers mean the economy is growing above its potential, threatening to push it beyond full employment and reignite inflation, is misplaced.

The GDP numbers almost certainly overstate the economy's growth. Gross domestic income, which is the sum of the income and profits earned by households and businesses—and conceptually equals GDP—is growing much more slowly than GDP. Indeed, the difference between GDP and GDI, which is known as the statistical discrepancy, has rarely been as wide. While GDI is likely depressed for a number of technical measurement issues, correcting for them and averaging with GDP provides a more accurate picture of the economy's current growth rate, which is just more than 2%, consistent with our estimate of the economy's potential growth rate and stable unemployment.

Chart 2: Inflation Heads Back to the Federal Reserve's Target



Sources: BLS, Moody's Analytics

Job growth is strong, but labor supply is more than keeping up. Indeed, if anything, the job market has softened in recent months, as evidenced by the recent sharp decline in hours worked, less hiring by businesses and quitting by workers, and a steady decline in temporary jobs. Layoffs are low, but they are off bottom, and corporate layoff announcements have picked up. Moreover, it would not be surprising if job gains were ultimately revised lower, as response rates to the Bureau of Labor Statistics' surveys have been falling steadily and are about as low as they have ever been. This is a problem endemic to most government and private industry surveys, given survey fatigue and respondents' concerns about privacy and cybersecurity.

Further supporting the view that the Fed should begin cutting rates is the steady moderation in inflation. Indeed, aside from the growth in the cost of housing services, inflation has already returned to the Fed's inflation target, at least as measured by the consumer price index (see Chart 2).

With market rents flat to down during the past year—and likely to remain soft given all the multifamily supply set to hit the market this year and further push up vacancy rates—housing costs, which are tied to rents, should slow substantially in coming months. Aside from an unexpected spike in oil prices or widespread disruption to global supply chains, inflation will be back consistent with the Fed's target by year's end.

This begs the question of the desirability of the Fed's 2% personal consumption expenditure inflation target. When the target was effectively adopted in the mid-1990s, it seemed reasonable as the economy's potential growth and interest rates were higher. The Fed could aggressively cut rates in a recession and still avoid the zero lower bound. Not so now. Potential growth and interest rates are lower than they were then; the Fed is more likely than not to hit the zero lower bound in a downturn and would thus need to engage in quantitative easing.

Of course, QE is a vexed way of easing policy since it is unclear how large an impact it has on interest rates. It also generally requires the Fed to purchase mortgage securities, opening the Fed to criticism that it is targeting the housing market for support, which is effectively engaging in fiscal policy. Adopting a higher inflation target, for example, 3%, would go a long way to addressing this issue. Indeed, if the Fed adopted an inflation target de novo today, Fed officials would likely coalesce around a target meaningfully higher than 2%.

Policymakers have no intention of doing this. They have not even hinted along these lines, since doing so could unhinge inflation expectations. Expectations are well-anchored around the 2% target. For bond investors, this is evident in one-year, five-year forwards, and breakevens on Treasury Inflation Protected securities, and for consumers in responses to surveys conducted by the New York Federal Reserve and the University of Michigan (see Chart 3).

Low and stable inflation expectations are necessary to ensure that workers' wage demands and businesses' price hikes are consistent with the target. It is only prudent for the Fed to contemplate changing the inflation target once inflation is firmly at target. However, having said this, it is imprudent for the Fed to risk keeping rates too high for too long and sacrificing the economy on the altar of a 2% inflation target that few believe in.

Although the estimated appropriate funds rate is well below the current rate, strongly suggesting policymakers should begin cutting rates at the March meeting of the Federal Open Market Committee, if they were to move, they should also signal that they plan to lower rates slowly and methodically—perhaps cutting by 0.25 point each quarter until the funds rate is back close to r-star. On this trajectory, the funds rate would return to most estimates of r-star by mid-2026.

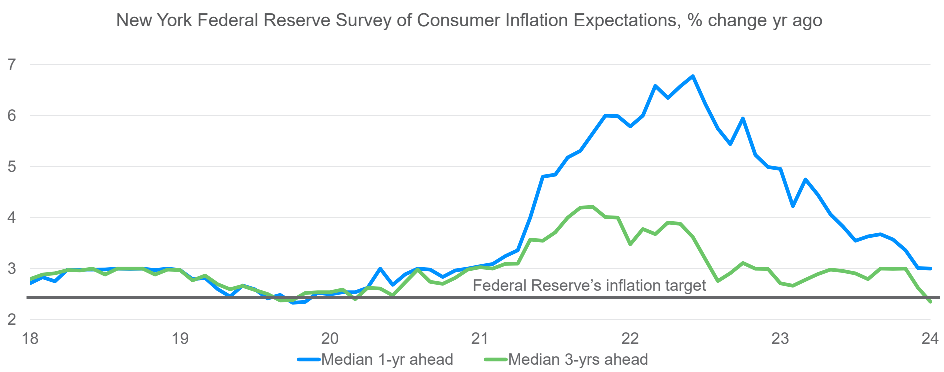
To be sure, this likely would pump up the stock market and push down long-term interest rates, as according to federal funds futures, investors do not put greater-than-even odds on a rate cut until the June FOMC meeting. Financial conditions would ease, but probably not by much, since only a few weeks ago investors were strongly discounting a March rate cut, and not enough of one to change the outlook for the economy and inflation.

It would also ease the pressure on the nation's fragile banking system. The operating environment for banks and nonbank financial institutions is challenging: The inverted yield curve is putting pressure on net interest margins (the difference between the bank's funding costs and their lending rates); the tightening of bank underwriting since last year's banking crisis is slowing loan growth; credit quality is weakening, especially for commercial real estate loans that account for close to one-fourth of bank assets; and regulatory costs have risen sharply in the wake of the crisis (see Chart 4).

It is not difficult to construct scenarios in which a fissure in the financial system quickly expands into a fault line, precipitating another crisis. This time, the Fed and other regulators may not be able to quickly calm panicked depositors and investors.

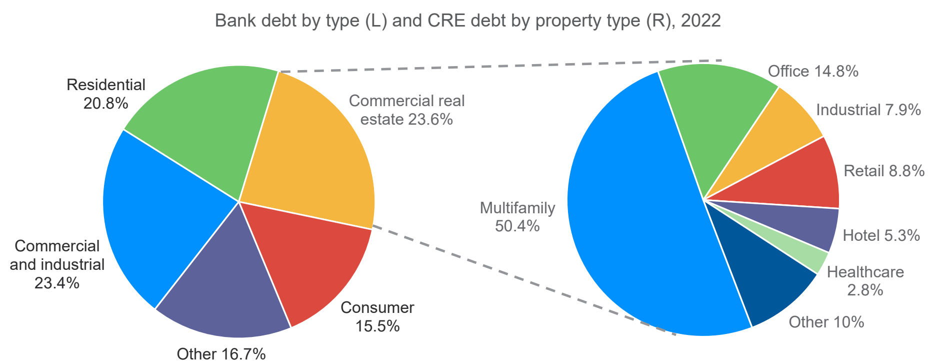
It appears increasingly likely the Fed will soon achieve its dual mandate of full employment and low and stable inflation. Therefore, it is increasingly untenable for the Fed to maintain the 5.5% fed funds rate, which is 3 percentage points above the Fed's own estimate of r-star. While it would be desirable for the Fed to begin cutting rates at the next meeting of the FOMC in a few weeks, we expect policymakers will wait until the May meeting. They will then cut the funds rate by 0.25 point at every other FOMC meeting, more or less, through spring 2026. Whether Fed officials move in March or wait until May probably will not make much difference, but there is a not-inconsequential risk that they will wait too long. The longer they wait, the greater the chance the economy may falter for reasons that are increasingly difficult to defend.

Chart 3: Inflation Expectations Are Well-Anchored



Sources: NY Fed, Moody's Analytics

Chart 4: Banking System Is Vulnerable to Commercial Real Estate



Sources: Federal Reserve, Mortgage Bankers Association, Moody's Analytics

Sonoma County outlook

Sonoma County's economy turned in a strong 2023, with job growth outpacing that in the state and nation by a considerable margin. On the back of a strong second half of the year, year-ago job growth closed out last year near 3%, well above both California and the U.S. average (see Chart 5).

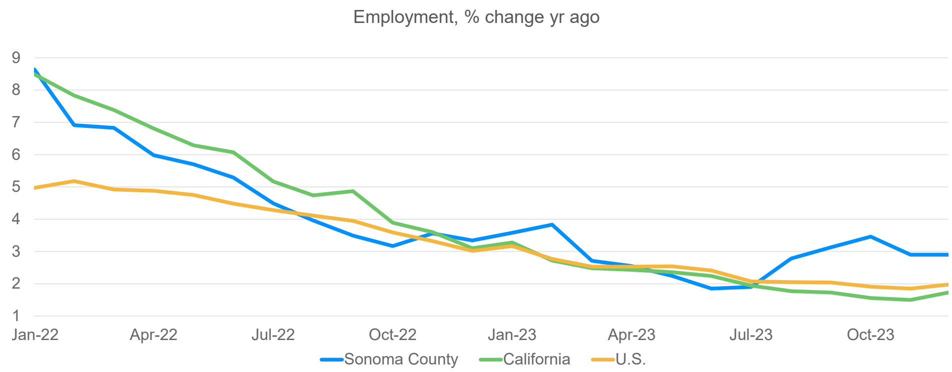
While the progress is commendable, there are indications that growth is overstated, with the more accurate but lagged Quarterly Census of Employment and Wages pointing to a much weaker first half of the year. The payroll data indicate steady growth in the first half of the year. However, the QCEW data show only modest job growth through June, to the tune of less than 0.5 percentage point year over year (see Chart 6). Annual benchmark revisions will likely reveal slower growth through the first half of 2023 and show that Sonoma County's economy is bending from the same pressures as the national economy, where job growth slowed through much of this year.

Among Sonoma County's key industries, the benchmark revisions will take a large bite out of manufacturing. Manufacturing, according to the QCEW, struggled throughout the first half of 2023, contracting nearly 6% on an annual basis as of the end of the second quarter, while the payroll data showed a much more modest decline. Inflation pressures and rising input costs for the food and beverage industry likely forced some producers to trim their payrolls more than previously anticipated. Despite a weaker start to the year, there are reasons to be optimistic about how the second half of the year unfolded. Food prices are declining, and decreasing input costs for Sonoma County food manufacturers will be a tailwind. Consumer spending on food will also climb slightly higher given decreasing inflation pressures. Beverage manufacturers will also benefit from these same trends, and a strong grape harvest in 2023 will drive further gains. Both the quality and tonnage of the California grape harvest will keep price growth muted, benefiting Sonoma County wineries. Visitor arrivals and spending will remain strong given a resilient U.S. labor market, and tourism spending on visitation to local wineries and breweries will provide another boost.

Furthermore, Sonoma County's leisure/hospitality industry looks to be on stable footing. The QCEW data indicate an even stronger first half of last year than the payroll data. Arrival numbers at Charles M. Schulz airport rose 4% in 2023 and were especially strong in the fourth quarter, which suggests that demand for vacations is holding on better than expected. Still, consumer spending is expected to slow through this year as the nationwide economy settles into a slower pace of growth. Job gains will fall short of the pace seen last year and income growth will downshift as the labor market loosens slightly. As a result, job growth in leisure/hospitality nationally will also slow given decelerating income growth and moderating consumer spending. However, Sonoma County's wineries, parks and world-class weather ensure it will still garner a considerable share of tourism spending and keep payrolls ticking modestly higher.

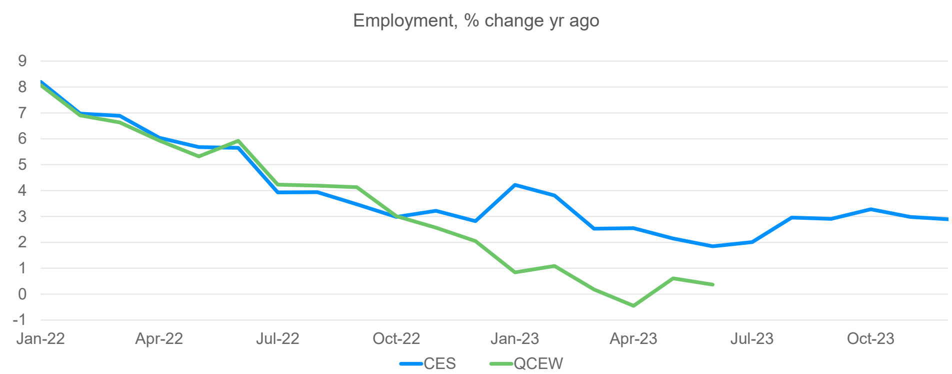
The largest obstacle that Sonoma County continues to face is its demographic challenges. Sonoma County has now shed residents in six consecutive years, leaving the population 4% smaller than it was in 2016. This puts Sonoma County's population losses among the 20 largest of metro areas and divisions nationally. Yet this is still milder than in neighboring Napa County and San Francisco. The chief reason for the net out-migration of residents stems from affordability challenges. Housing affordability in Sonoma County ranks among the lowest nationally; its high costs have pushed residents to relocate in lower-cost areas in the state and region. Sonoma County's net migration losses moderated in 2023 (see Chart 7) as net out-migration of residents slowed to its lowest level since 2016.

Chart 5: Sonoma County Outpaces the State and Nation



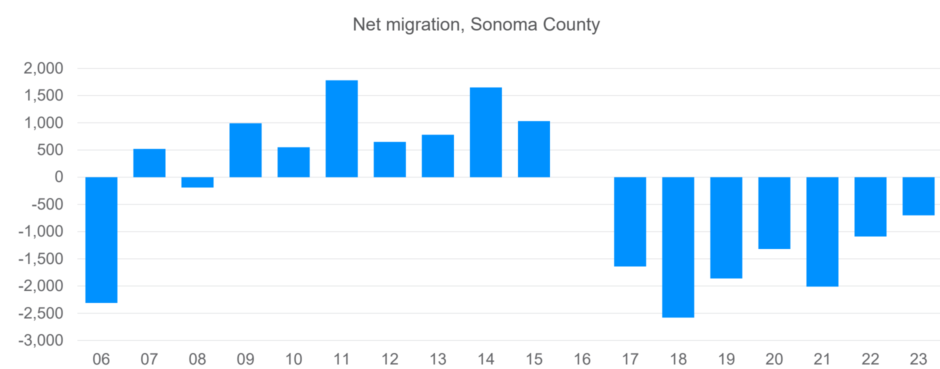
Sources: BLS, Moody's Analytics

Chart 6: QCEW Paints a More Downbeat Picture



Sources: BLS, Moody's Analytics

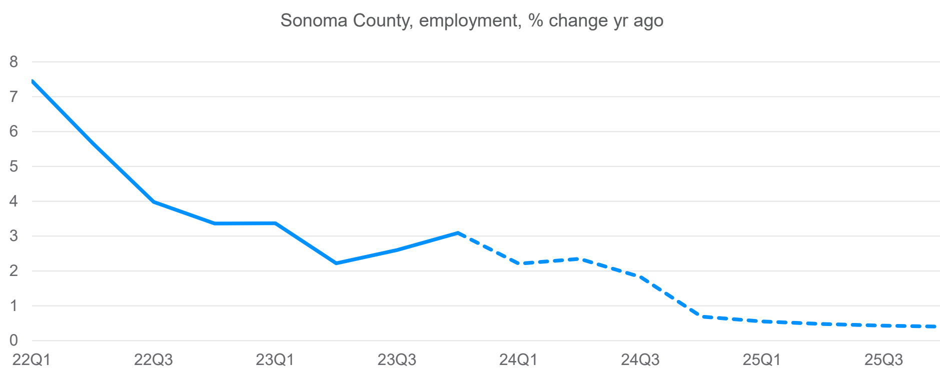
Chart 7: Improving Housing Affordability Drives Improvement in Migration



Sources: Equifax, Moody's Analytics

The deceleration in out-migration can be attributed to two main causes. Migration slowed across the country during the year, with fewer moves overall compared with the previous two years. With interest rates rising rapidly during the past year, a lack of housing inventory was made more severe because of the "rate lock" effect, which kept more would-be movers tethered to their homes, reluctant to give up favorable fixed-rate mortgages. The slower pace of out-migration from Sonoma County suggests that lock-in effects kept more Sonoma County residents in place.

Chart 8: Job Growth Will Slow



Sources: BLS, Moody's Analytics

The second reason for slowing out-migration is Sonoma County's relatively favorable housing affordability compared with neighboring metro areas. While the county's housing affordability still ranks poorly nationally, affordability has improved moderately in the past year and compares favorably to some of the larger coastal metro areas nearby. Twice as many people moved from Napa County to Sonoma County in 2023 versus 2022. Napa County is one of the handful of metro areas where housing affordability ranks worse than in Sonoma County.

Sonoma County's near-term outlook is secure, though the economy will expand at a slower pace than last year (see Chart 8). As the national economy slows, tourism will settle into a reduced pace of growth but will still drive modest advances. Unfortunately, weak population growth will outmuscle the advantages of a high quality of life and an educated workforce, relegating the county to a slightly below-average performer relative to California.

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