

The Yield Curve Normalization Head Fake

December 18, 2023

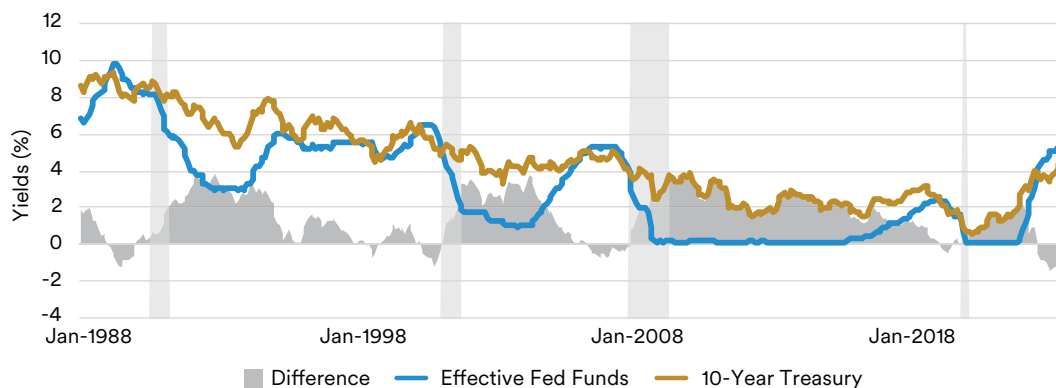
As we sit at the end of a surprisingly buoyant year, and a surprisingly spendthrift consumer, we look toward a hard landing in the first half of 2024 as the Fed’s rate hikes come to bear. As 2023’s unfinished business—recession, inflation, yield curve normalization, and the absorption of a higher rate environment—gets resolved, we expect more benign conditions to begin to take hold toward the end of 2024.

It’s still too early for a recession, according to the yield curve.

In November, the spread between the Fed Funds rate and the 10-year Treasury yield returned to the deeply inverted position of late summer as the 10-year yield fell. About half of this decline was a reversal of the term premium gains we saw in October, and the other half was the market pricing in rate cuts in the first half of the year.

We feel the market is pricing in rate cuts for too early in the year. Ordinarily, the Fed starts cutting in advance of a recession and the yield curve normalizes right before recession onset (see chart 1). But we think this time may be different—the yield curve may take some time to normalize after recession onset.

Chart 1 | Yield Curve Usually Normalizes Right Before a Recession: This Time May Be Different.



Note: shading denotes recession
Source: Federal Reserve, Haver, NBER, and MIM

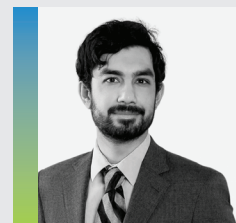
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First, this Fed has been particularly slow to switch policy paths given its heavy emphasis on data dependence. Second, a delayed cutting cycle may actually make sense: if the Fed wants to ensure that inflation is in fact vanquished, they will need to wait a little longer than usual. In the last several recessions, high inflation has not been a particular problem, and the Fed has had little reason to wait.

Finally, this is the first recession in which forward guidance is fully available. The Fed only began publishing the current incarnation of its Summary of Economic Projections in 2007, one month before the GFC recession began, and only added the Fed Funds projections to the economic variables in 2015. The yields on the 10-year may already have a lot more information priced in than they might have had in prior business cycles.

Given the current trajectory of unemployment and yields, we expect yield curve normalization and Fed Funds cuts around mid-year 2024, which would be after we expect the recession to start.

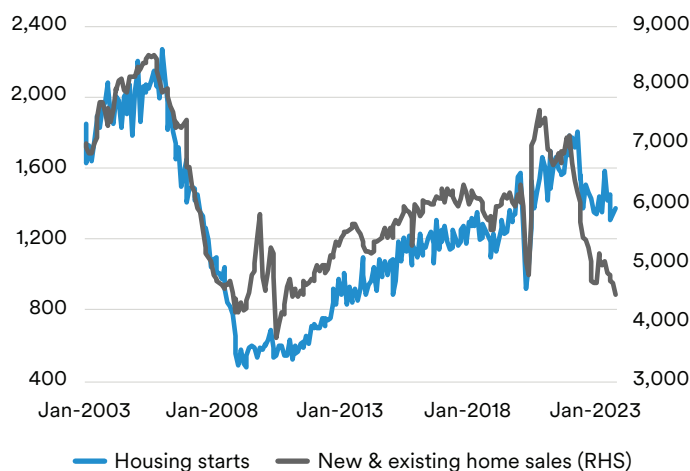
Housing: A Rebuilding Year

Housing remains a sticking point for inflation. Shelter prices remain the single biggest impediment to 2% inflation, with November inflation showing a 6% annualized inflation rate on shelter.

A key problem is the shortage of housing.

Housing starts tends to track transaction levels quite closely. As transactions fall, the incentive for building new houses falls (see chart 2). In the current environment, builders face the additional difficulty of high rates.

Chart 2 | Housing Starts Have Fallen Even Amid a Housing Shortage



Source: Census Bureau, National Association of Realtors, Haver, MIM

The one glimmer of hope is that housing starts haven't fallen quite as quickly as transactions. There is some stabilization of the pace of new home building, which could improve the supply in the medium term, but getting houses ready for sale takes time so this process will likely play out over months. In the meantime, home sales prices continue to rise and contribute to inflation.

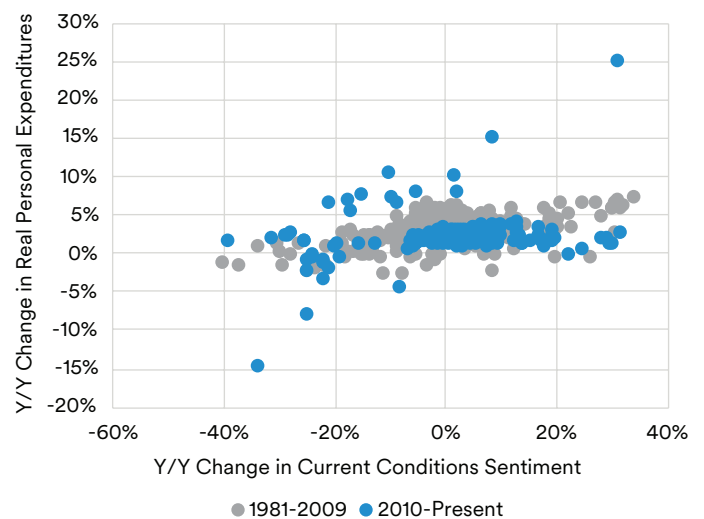
Ironically, a way to reduce shelter inflation is for the Fed to reduce the Fed Funds rate. But the Fed would balance that possibility with the possibility that cuts could reaccelerate economic activity.

Focus on What Consumers are Doing—Not on What They're Feeling

In December, the University of Michigan's Consumer Sentiment survey increased to 69.4, a 13% jump that undid four months of declines. This doesn't necessarily mean that consumers will spend more money.

Traditionally, consumer sentiment has been viewed as insight into how consumers will spend and drive GDP, but in the last 10 years or so, this relationship has become more tenuous. Looking at monthly datapoints from 1981 to present, the relationship between year-over-year changes in University of Michigan's current conditions index and the year-over-year changes in real personal consumption expenditures has become much more volatile.

Chart 3 | Consumer Sentiment Is Less Related To Spending Than It Used to Be



Source: University of Michigan, BEA, Haver, MIM

As a result, these recent increases in consumer confidence may not necessarily indicate that consumers will continue to spend through the new year, especially when other indicators of consumer health such as credit usage and loan delinquencies put consumer health into question.

Risks to the Outlook

We continue to recognize mitigating factors that work against our call for a recession in the first part of 2024. First, labor market robustness could continue to support consumer spending even as other sources of strength like government support and excess savings fade. Second, the manufacturing sector may be showing signs of recovery, partly due to President Biden's industrial policy bills, even as the services sector remains strong beyond the summer's "revenge spending" era.

U.S. Outlook Summary

We continue to expect a recession in 2024. We believe the Fed is done with rate hikes this cycle. However, next year we expect 150bps of Fed Funds rate cuts beginning around midyear 2024. Even absent a recession, the Fed is likely to cut, as it eases from the current tight conditions.

Given our call for a recession in the first half of the year, we expect unemployment to rise. Our projected increase in the unemployment rate would be a particularly mild response, given that prior recessions have seen unemployment rate increases of at least 2 percentage points, and reflects the unusually tight labor market conditions.

MIM Forecast

| U.S. | 2023 | 2024 |
|-----------------------------------|------|------|
| GDP | 2.1 | 0.0 |
| CPI | 3.0 | 2.8 |
| 10 Year | 4.00 | 4.00 |
| Policy rates (upper bound) | 5.50 | 4.00 |
| Unemployment | 4.0 | 4.6 |

Note: GDP is annual average growth rate, CPI is Q4 year/year, 10 year is year-end, policy rate is the upper bound year-end rate.
Source: Metlife Investment Management

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