First Citizens Wealth™ Making Sense

Basis Points | January 14, 2025

Good News Travels Fast

1. Resilience

Friday's employment report for December announcing a quarter-million new jobs and a lower unemployment rate underscores the US economy's defiance of low expectations last year. Before Friday, several factors already suggested the balance was tilted in this direction. GDP likely grew 2.7% in 2024 (vs. the 1.3% expected a year ago), and forecasted recession risk is down to 20% from 50% last January.[1] Financial conditions are still easy despite over two years of notionally tight monetary policy. Consumer spending stayed firm, supported by a staggering $50 trillion increase in household net worth since 2020. With these factors already reinforcing a narrative of economic resilience, it is the labor market that has been one of the main wild cards. **It is now harder to argue that the labor market requires accommodation from policymakers. And with the economy strong and inflation still too high, the balance of risks looks quite different compared to a few months ago.**

2. We Like Good News

The US economy is stronger than expected yet equities are down over 4%,[2] leading many to recite the adage that "good news is bad." Why? Equity investors are keenly focused on interest rates, and as recently as a month ago, markets expected the Federal Reserve to carry on with its monetary easing campaign this year. But today the prevailing view is that a stronger economy and firmer inflation have now put the central bank on hold. Yields are higher across the curve, unsettling investors who anticipated more favorable interest expenses and discounted future cash flows. Higher rates can also adversely affect market multiples as investors may associate the moves with a greater chance of economic or financial disruption. We think these factors mostly explain the recent step down in equity prices, but **as longer-term investors, we will gladly be takers of good fundamental news rather than bad.**

3. This Cycle Is Different

The Federal Reserve has cut its overnight policy rate by 100 basis points since September, but in those four months the benchmark 10-year Treasury yield has not fallen; in fact, it is *up* by 117 basis points.[3] This pattern is unprecedented in modern economic history and is a conundrum for policymakers and investors. It is important to remember that the Federal Reserve controls short-term rates, but longer-term rates like the 10-year Treasury and 30-year mortgage depend on a host of other factors like growth and inflation expectations as well as government debt dynamics. One way to think about this is to ask if Federal Reserve rate policy has had much of an effect on the economy, and if the "long and variable lags" of monetary policy have made their way through the system. But another is

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[1] Source: Bloomberg.
[2] The S&P 500 is down 4% from its December peak. Small- and mid-cap stocks are down closer to 10% from their peaks.
[3] See Nov. 4: "The Fed Cut Rates. Why Are Bond Yields Higher?"

to recognize that this is not a typical boom-bust business cycle where the private sector responds primarily to the Fed's policy changes. **The economy is still normalizing from one of the greatest shocks in decades and from trillions of dollars of fiscal and monetary stimulus. Old playbooks are typically of very limited use in economic and market analysis, but they likely have even less to offer investors and analysts today than usual.**

4. Uncertainty Abounds

Uncertainty has been elevated with little abatement since 2020. We think the trend continues with more, not less, uncertainty in two main respects. **First, as we argued in our** [2025 Market Outlook]**, even though market and economic fundamentals largely remain in place, there is little room for error given lofty expectations**. Many investors have assumed inflation will fall reasonably quickly to 2%, the financial sector will withstand elevated rates, corporate earnings will justify high valuations, and margins will continue to expand. **Second, beyond the fundamental outlook, economic policy is also highly uncertain, with the incoming Administration pledging to make significant changes to tax policy and international trade**. On taxes, many see tax cuts as the base case, but the Republican Party has an ultrathin margin in Congress and sweeping change may be difficult. On international trade, the Administration generally has wide-ranging authority to enact tariffs, but the range of outcomes and their economic effects are so wide that it is currently not possible for markets to set expectations with any reasonable degree of confidence.