



# Downward revisions to forecasts for US central bank rate cuts in 2025

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The combination of resilient GDP growth, an uptick in inflation and uncertainties over likely public policy changes including tariffs and immigration, have triggered downward revisions to forecasts for US central bank rate cuts in 2025, though an additional 25-basis point rate reduction later this week to support the cooling labor market is viewed as a near certainty. Indeed, Fed Chair Powell noted earlier this month that the economy is stronger now than the Fed expected in September when it began reducing interest rates and appeared to signal his support for a slower pace of interest rate cuts ahead saying, “The US economy is in very good shape and there’s no reason for that not to continue...the downside risks appear to be less in the labor market, growth is definitely stronger than we thought and inflation has come in a little higher. So the good news is that we can afford to be a little more cautious as we try to find neutral.”

In response to these revised interest rate expectations, bond yields have drifted higher, the US dollar has strengthened and shares of cyclical and interest rate sensitive equities have seen some selling pressure as investors have given greater weight to the possibility Fed officials may keep interest rates higher for longer, and the economic expansion next year may turn out be narrower than hoped for. Predictably, shares of a handful of mega cap A-I related tech companies, seen as having assured earnings growth prospects in a slower growth environment, have shown a resurgence following a lull since midyear, driving cap weighted stock market indices to new all-time highs as the rest of the market lagged.

### Inflation

Progress in reigning in inflation virtually stalled last month as the consumer price index of goods and services (CPI) rose by 2.7%, the most in seven months. Prices of core consumer goods excluding food and energy, which had been falling or flat for about a year through August, increased at the fastest month-over-month pace in 18 months. The increase was led by a jump in vehicle prices as cars and trucks damaged by recent hurricanes were in demand, and consumers are reported to have stepped up purchases of big-ticket items to front run potential tariff-related price increases in 2025. Core goods prices rose 0.3% in November, the fourth consecutive month of higher prices, holding year-over-year core inflation at 3.3%, in line with most expectations. On the brighter side, long-awaited evidence that services prices, particularly for housing would slow, finally emerged. The pace of housing cost increases cooled, and rents increased 0.2%, the smallest gain since July 2021, after rising 0.3% in October. Owners’ equivalent rent, a measure of the amount homeowners would pay to rent or earn from their property, rose 0.2%, the smallest gain since April 2021 following a 0.4% increase in October. Thus, residential rental prices as captured in the CPI might finally be displaying the slowdown long flagged by real-time rent prices. Whether these recent CPI trends toward higher goods and moderating services prices will

persist remains to be seen.

Meanwhile, while the Labor Department's index of producer prices (PPI) increased at the highest rate in five months in November, the easing costs of services such as airline fares offered hope that the disinflation trend will persist despite recent stalled progress. The PPI rose 0.4% in November. Producer prices are up 3.0% versus a year ago. A surge in the price of eggs amid an avian flu outbreak accounted for much of the larger-than-expected rise in producer inflation. Other details of the PPI report for last month were mostly favorable, prompting economists to lower their estimates for the Personal Consumption Expenditures index (PCE), the Fed's preferred inflation gauge, which last showed a 12-month inflation rate of 2.3%, or 2.8% on a core basis.

Supporting the case for moderating inflation, the Bureau of Labor Statistics reported US third-quarter labor costs grew 0.8%, less than initially reported 1.9% gain, after a downwardly revised decline in the prior three months, adding to evidence the job market is no longer the source of inflationary pressure.

***While the policy makers may take solace in the improvement in CPI services and housing inflation, the persistence of core PCE closer to 3% than 2% complicates upcoming decisions for the Federal Reserve which began lowering its reference rate in September in response to signs of a cooling labor market. But data shows progress on inflation has halted in recent months, leaving open the possibility that the Fed could pause rate cuts in January.***

## Jobs

As expected, the November employment report showed job growth bounced back somewhat from the weather-and strike-depressed October reading resulting in a 132,000 average increase in employment over the two months. Employment growth rebounded by 227,000 following an upward-revised 36,000 gain in October. While the trend in job growth has clearly weakened, pay growth remains solid, as average hourly earnings rose another 0.4% last month and is up 4.0% over a year ago. Importantly, the three-month average annualized nominal growth of labor income was 5.5%. So, adjusting for inflation of 2-3% still leaves positive real income growth of 1-2% supporting rising consumption.

Of greater importance to Fed officials was the uptick in the unemployment rate to 4.25% which is just a shade below the prior cycle-high reached in July. Given the low response rate in the household survey, if only an additional 23 respondents had classified themselves as unemployed, the unemployment rate would have been reported as 4.3%. With the participation rate slipping a tenth to 62.5%, the employment-to-population ratio came down two ticks to 59.8%, the lowest reading since early 2022. Aside from the unemployment rate increase, an analysis shows some other details of the Labor Department's report warrant concern. The number of permanent job losers increased to another cycle high of 1.893 million. The flows data show a declining number of unemployed flowing into employment, and a cycle high staying unemployed between months. Mirroring these trends, the median duration of unemployment spells increased another 0.5 week to 10.5 weeks.

In addition to the in-line November jobs report, the October Job Openings and Labor Turnover Survey (JOLTS) data continue to indicate that the gradual labor market loosening is being driven by slower hiring rather than layoffs as the layoff rate fell from 1.1% in September to 1.0% in October, where the rate has been within that low band every month since early 2023. The historically low level of layoffs is anchoring the labor market and the broader economy through higher wages, driving consumer spending which accounts for over 70% of GDP.

***With Fed policy still restrictive, the largely in-line jobs reports have reinforced our expectations policy makers will cut rates another 25 bps this month.***

## **Forward Looking Business Surveys**

While the Institute for Supply Management (ISM) surveys for November showed their usual recent divergence between strong services and still-weak manufacturing, the all-industry reading of the Purchasing Managers Institute (PMI) of 54.9 is consistent with at or above-trend 2-3% GDP growth this quarter.

**ISM Manufacturing Index** which accounts for 13% of GDP, rose to 48.4 in November, exceeding the consensus expected 47.5. (Readings above 50 signal expansion; readings below 50 signal contraction.) The major measures of activity were mostly higher last month. The new orders index increased to 50.4 from 47.1 while the production index rose to 46.8 from 46.2. The employment index increased to 48.1 from 44.4 while the supplier deliveries index fell to 48.7 from 52.0. The prices paid index fell to 50.3 in November from 54.8 in October.

US factory activity continued to decline in November. The index remained below 50 for the eighth consecutive month and has done so for 24 of the last 25 months. The good news is that orders expanded in November for the first time in eight months. However, the rebound in demand appears to have been split between industries, as some companies paint an optimistic order outlook while others say business remains slow and anticipate that trend to continue. Some companies have been able to scrape by despite weak demand by focusing on their order backlogs, which, in retrospect, were artificially high, boosted by pent-up activity from the COVID years. Of the eighteen manufacturing industries surveyed, three reported employment growth in November, while ten reported a decline.

**ISM Non-Manufacturing Index** which accounts for about 70% of GDP, fell to 52.1 in November, the slowest pace in three months, lagging the consensus expected 55.7. (Readings above 50 signal expansion; readings below 50 signal contraction.) The major measures of activity were all lower in November. The business activity index declined to 53.7 from 57.2 and the new orders index fell to 53.7 from 57.4. The employment index declined to 51.5 from 53.0 and the supplier deliveries index fell to 49.5 from 56.4.

Activity in the US services sector continued to expand in November but at a slower pace. The index declined to a three-month low. The drop in the index can be attributed to lower readings in all major measures of activity. The business activity index and new orders index both declined to 53.7 in November but remained above 50, signaling expansion. The supplier deliveries index fell into contraction at 49.5 (signaling shorter wait times) after hurricanes and port strikes inflated readings of the index in October.

**University of Michigan sentiment index** continued to slowly increase through early this month, rising from 71.8 to 74.0 buoyed by the end of election uncertainties. Much of the December rise reflected respondents saying current conditions were good and that now was a good time to buy household goods because tariffs would make them more expensive later.

**Front Barnett Proprietary [Economic Model](#)**, designed to signal a change in the direction of the US economy six to nine months in advance of an inflection point, remains above trend signaling expansion ahead.

## Equity Investment Policy

There has been no change in equity investment policy. Portfolios under our supervision remain fully invested within their policy guidelines, having participated in the equity market's strong performance this year. As long-term investors, looking beyond the ever-present near-term economic uncertainties and the short-term volatility inherent in equity investment, clients' accounts are well-diversified, balanced between large cap growth and value investments, tilted toward growth which is our long-term bias. Our investment platform also includes small cap domestic equities as well as modest allocations to international developed and emerging market investments. Recall that Front Barnett management uniquely blends core, high quality, large cap growth and value investments in portfolios under our supervision, positioning them to grow over the course of market cycles during which the broader market may favor either the growth or value style for a time, potentially smoothing returns over the longer term.

The case for equity ownership continues to be strong. The economy remains on solid footing and is fundamentally sound. The US banking system is extremely well reserved and is expected to benefit from a more favorable regulatory regime under the incoming administration. Corporate balance sheets are strong. Despite questions regarding timing, interest rates are headed lower benefiting risk assets. The society is awash with liquidity; household's excess savings are estimated to exceed one half trillion dollars. Public policy changes including deregulation, new incentives for investment, and lower corporate and individual tax rates will support future profits growth. There will be greater certainty around estate planning issues. Merger and acquisition activity is expected to recover as new regulators take over. And the benefits of new technologies, including A-I, will begin to flow through to the broader economy, enhancing productivity and, by some estimates, eventually add as much as 0.8% to GDP growth.

Despite some weakness in interest rate sensitive and cyclical manufacturing industries, as well as among many small cap companies, the US economy continues to grow at an above-trend rate, driven by resilient consumer spending, underpinned by stimulative fiscal policies and the return to growth of the M2 measure of money. Third quarter earnings exceeded expectations, coming in roughly 8% higher than they were a year ago. The prospect of further monetary policy easing, albeit at a slower pace than expected earlier, increases the odds of a soft landing for the US economy where a broadening of economic growth is still expected next year.

The likelihood the next leg of the current expansion will be broader-based should cause a sustainable shift in investors' preferences away from the handful of high-priced mega-cap A-I related stocks that have dominated the market this year. The beneficiaries of this shift will be a broader range of stocks whose performance has lagged year-to-date. The broadening trade that began in June has stalled as investors first focused on election uncertainties and, more recently, on the probability further interest rate cuts will not be as steep as expected earlier. We expect the broadening trend to resume as investors refocus on the outlook for 2025.

***Stocks are richly valued following their run in the wake of the election results. The cap weighted S&P500 is selling at 23x forward earnings, at its highest reading since 2021. A-I related mega cap tech stock valuations are even more stretched at an average of 37x earnings. The S&P500 equal weighted index, which treats the returns of lesser capitalized stocks the same as those of their larger cohorts, is not cheap at 18x forward earnings but more reasonably priced, leaving room for a further market rerating. That said, over the near term, with the stock market making new highs daily and "animal spirits" on the rise, we would not be surprised to see a cleansing 5-10% sentiment-driven pullback in the cap***

***weighted S&P500 early next year.***

## **Fixed Income Investment Policy**

The 2.5+ year target duration for laddered corporate bond portfolios under our management remains unchanged. Benchmark 10-year US treasury bond yields bottomed on September 18 and have since rebounded about 75 basis points to 4.40%, largely reflecting concerns over growing deficits and the possibility interest rates may remain higher for longer due to the strong economy. We believe the recent backup in rates presents yet another opportunity to lock-in attractive rates near 5.0% on high quality corporate bonds with short duration. Accordingly, new cash and the proceeds of maturities of existing holdings are being reinvested to fill out portfolio ladders.

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Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. Definitions: Personal Consumption Expenditures Index (PCE): A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. Conference Board’s Confidence Index: The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. ISM Manufacturing Index: The ISM manufacturing index or purchasing managers’ index is considered a key indicator of the state of the US economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation’s factories. ISM Non-Manufacturing Index: The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index

based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives.

**S&P 500 Index:** The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the US.

**S&P 500 Growth Index:** The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500.

**S&P 500 Value Index:** The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.

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