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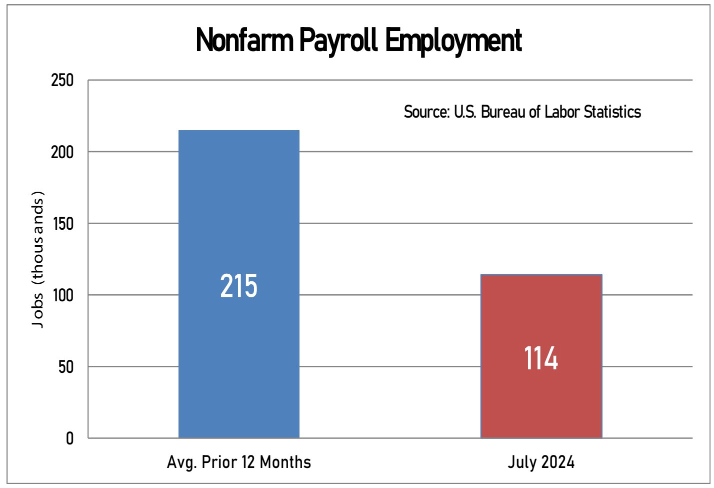
Countering the Recession Narrative

The recently released slowing payroll report has caused a stir, with the benchmark 10-year yield dropping to 3.8%. The bond market is pricing in nearly five rate cuts between now and year end and more into 2025. While we think 2-3 rate cuts will come to pass by year end, we think the bond market has gone too far too fast.

As far as we can tell, the argument for cuts is a marshmallow of ideas which together conspire to paint a picture of a suddenly weak economy that's about to fall off a cliff. We will address each rule of thumb in turn:



Slowing Jobs Gains:
While job creation slowed, it is still job creation not job destruction. And if jobs are created, then disposable income is rising, strengthening the outlook for future consumer spending. Some observers then seem to think that a momentum of job creation/destruction is necessarily self-reinforcing with future job losses ahead. We disagree. After all, what a 0.7% rise in the unemployment rate simply means when coupled with job creation is that more people are getting jobs but, yes, even more now are in the work force and wanting jobs.

Lagged Impact:
Lags in the impact of interest rate increases have been cited by some economists, and they are also embedded in the Fed's taking credit for reducing inflation. However, proponents of this thinking spent 2023 and early 2024 overreacting to every economic wiggle, anticipating a recession which never came. Are they right this time? Perhaps, but we know of no economist who predicted that there would be no impact through 2Q24 but would then hit all at once in 3Q24.

Weak Consumer:
There are anecdotal reports of CEOs in high profile, consumer facing businesses reporting that the consumer is wilting. But, on the other hand, there is also evidence of strong demand in other consumer channels, like cruise lines and hotels. And real consumer discretionary income – the ultimate guide post that spending is tethered to – remains strong. Unless the savings rate goes up on a sustained basis, the consumer will have money to spend and will do so.

Sahm Rule:
Some are dusting off the Sahm Rule, which predicts that a recession will necessarily occur when the unemployment rate has risen at least 0.5%. While the historical record behind the Sahm Rule is strong, keep in mind that the restrictive impulse in the recessions of 1974, 1980, 1982, 1990, 2007, 2020 were all much stronger than the Fed has administered to date. During those recessions we witnessed shocks such as interest rates over 20%, oil price shocks, a global financial crisis, and a pandemic. It's only natural that recessions would have occurred in response to those causes. We believe those experiences are distinguishable from today when we perhaps have restrictive interest rates only to the tune of 2% or so.

Fed Press Conference:

While not exactly an economic indicator or theory, we note that the press conference was something of a victory lap by Powell on inflation, much akin to the December 2023 press conference, which proved premature. It's understandable that the questioning would have focused exclusively on the likelihood of a September rate cut, but the real action for bond investors is in the number of rate cuts, not the start date. And the press conference's near-exclusive focus on when the Fed will start lulled the market into forgetting about asking where the Fed will stop. Much like in 1Q24, we believe the Fed hawks will use their upcoming speeches to clean up the market's overexuberance.

Conclusion

In short, concerns about weakening economic activity seem overblown to us and seem to turn on distinguishable rules of thumb or momentum-based approaches to economic indicators. We remind readers that unwarranted fears about a recession using some variant or cocktail of the above theories have been present with us since 2022, when the Fed started raising interest rates. And we further suggest readers look abroad for economic metaphors. Developing market economies raised interest rates well ahead of developed market economies like the US, and they haven't fallen off a cliff. And the Euro area had its own pocket of weakness this year and has accelerated from no-growth to modest-growth – applying any of the above theories would have incorrectly predicted a self-reinforcing recession, which is what observers in the US seem to be pricing in today.

Bruce H. Monrad is chairman and portfolio manager of Northeast Investors Trust (NTHEX), a no-load, high-yield fixed income fund whose primary objective is the production of income. Bruce is among the longest-tenured bond fund managers in the industry, having run Northeat Investors Trust for more than 30 years.

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CONTACT: 1-800-225-6704 (M-F 9:00am - 4:45pm EDT); Bmonrad@northeastinvestors.com

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