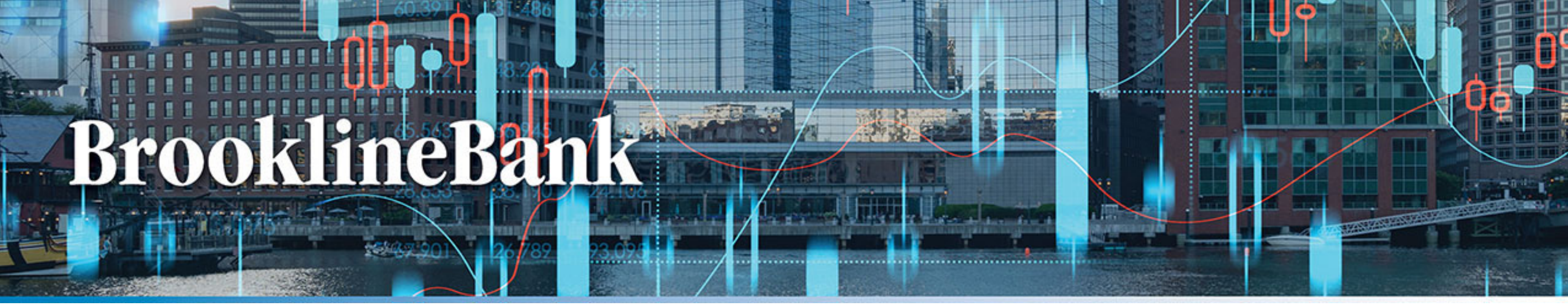
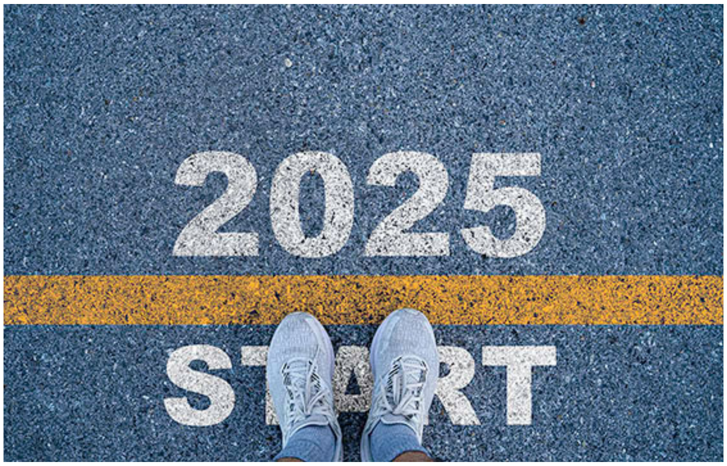


New Year, New Challenges

The Federal Reserve cut interest rates for the third time in its three-month-old easing cycle that started with a robust half-point reduction in September. The latest quarter-point cut won't be the last, according to predictions made at the December 17-18 policy meeting. The question is, are we closer to the beginning or to the end of the rate-cutting cycle? If we are still in the early stage, the next question is what is the ultimate landing spot – i.e., the so-called neutral rate that the Fed believes neither juices nor stifles growth in a stable inflation environment? Predictions of that rate are all over the place, which is not surprising as it is a moving target that's changed dramatically over the years.

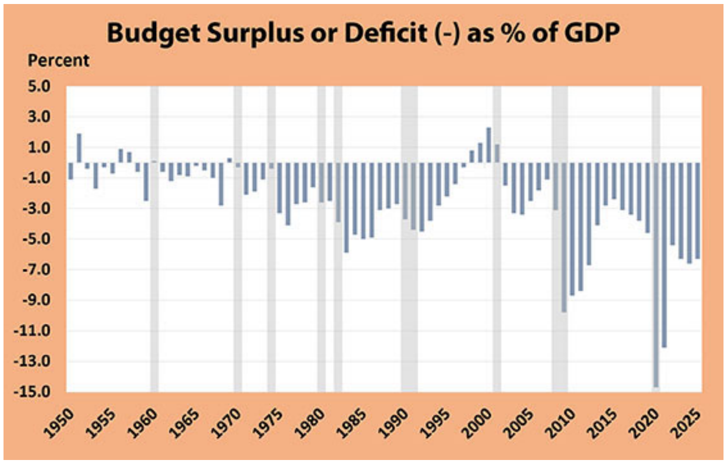


The Fed did announce that more rate cuts are coming, but not as many as expected a few months ago. That's because the economy keeps chugging along, and inflation remains stubbornly higher than the central bank thought would be earlier in the year. As that notable baseball/philosopher Yogi Berra famously noted, "it's tough to make predictions, especially about the future." We would add that it's just as hard to assess what is happening now, as incoming data are mostly backward looking. What's more, government statisticians who compile the data are coping with ever-lower response rates from the sources providing the data. But as Fed Chair Powell has repeatedly said, we deal with the cards we have. Hopefully, the deck is not utterly misleading, resulting in bad policy decisions that can lead the economy in the wrong direction.

In addition to potential missteps by the central bank, there is also the uncertainty surrounding fiscal policy. Will the tax and spending intentions of the incoming administration be contractionary or expansionary? The proposed spending cutbacks would argue for the former, while lower taxes would argue for the latter. Then there are the much-touted tariff increases, which could go either way depending on the response of trading partners. Keep in mind that the President proposes, but Congress disposes when it comes to spending and taxes, so campaign promises are not cast in stone. Simply put, speculation over monetary and fiscal policy will be a popular parlor game over the next several months, which sets the stage for heightened volatility in the financial markets. The good news is that the economy is heading into the policy maelstrom with a good head of steam and is likely to exhibit the resilience it has displayed through past fogs of uncertainty.

Tough Talk On The Budget

One of the top priorities of the incoming administration is to bring the Federal budget under control. The huge deficit financing underway since the COVID recession has sent the budget deeply into the red. According to the latest estimates by the Office of Management and Budget, the U.S. deficit will exceed 6 percent of GDP in fiscal 2025 for the third consecutive year, an extraordinary share during expansions and high employment. Over the past 30 years, which includes the Great Recession and the steep, but brief, COVID recession, the deficit averaged less than 3 percent of GDP.



Scott Bessent, the nominee for Treasury Secretary, has called for slashing the deficit to 3 percent of GDP by the end of President-elect Trump's second term. The incoming President has also tapped Elon Musk and Vivek Ramaswamy to jointly lead the newly created Department of Government Efficiency, commonly referred to as DOGE, to assist in the effort, and Musk has floated the eye-grabbing figure of $2 trillion in spending cuts. Unsurprisingly, there is a growing perception that federal outlays will be reined in significantly. However, not everyone is fully buying into the tough talk.

For one, $2 trillion in spending cuts, which would amount to a third of the federal budget, is unrealistic. During the campaign, Trump promised to protect Social Security and Medicare, which together make up a third of federal spending. Net interest on the debt accounts for another 15% of spending, and interest payments cannot be missed. For another, during his first presidency, Trump reliably requested more funding for the Departments of Defense, Veterans Affairs, and Homeland Security. It's hard to believe that these three departments would be on the chopping block, which removes another 20% of spending from any budget-slashing effort. Simply put, two-thirds of federal spending would be off limits. Massive cuts to the remaining third of the budget would be a tough sell for members of Congress, who time and again have hesitated to cut even small programs they believe benefit their constituents.

Muted Economic Impact

Nearly two months have passed since the election and the policy landscape under the incoming administration remains uncertain. The Republican-controlled Congress might squeeze some savings out of the budget, but it's questionable as to whether it will have a material impact on economic growth. It's likely that modest spending cuts will be mostly offset by lower taxes, rendering the fiscal impact a wash. The higher probability of tariff increases, however, could be felt, particularly in the form of higher prices.

True, the tariffs imposed during the first Trump presidency – which were largely retained under the Biden administration – did not have a significant impact on inflation, which remained well under control until COVID hit. But the tariffs then were imposed on a far more limited scale than is now being proposed. Many believe that the aggressive tariff proposals are more of a negotiating tool to force trading partners to meet certain conditions unrelated to trade, such as tightening borders and clamping down on illegal drug trafficking. That notion has merit.

What's more, an adverse reaction in the financial markets or in the polls might also cause a reassessment by the administration. Keep in mind that someone has to foot the bill linked to higher tariffs. Companies will either pass on the additional costs of imports to consumers – boosting inflation – or they will absorb the costs, leading to lower profits. Neither would be favorably received by consumers or investors. Again, there is a lot of uncertainty hanging over the policy landscape, so time will tell how the incoming administration's plans shape up, and how they play out.

The Other Policy Lever

To be sure, monetary policymakers will not sit idly by as events on the fiscal front unfold. The Federal Reserve, however, is in somewhat of a bind. Like everyone else, it too does not know what will be coming out of Washington in 2025, and is reluctant to base policy decisions on speculation. That said, the message sent at the December 17-18 policy meeting suggests that some officials expect more inflation than otherwise, due to higher tariffs and deportations that could reduce the labor supply and boost wage growth.

Hence, even as it cut rates by another quarter point, as expected, at the meeting, it also signaled that it would not be lowering rates as many times next year as predicted in September, the last meeting that included a Summary of Economic Projections (SEP), which the Fed does every three months. The median expectation of the 19 members of the rate-setting committee is for two cuts rather than the four penciled in three months earlier. True, the shallower path of rate cuts was expected in the financial markets, as both economic growth and inflation were running hotter than predicted a few months ago. But investors still reacted poorly, as stock prices tumbled, and bond yields spiked in the immediate aftermath of the meeting.

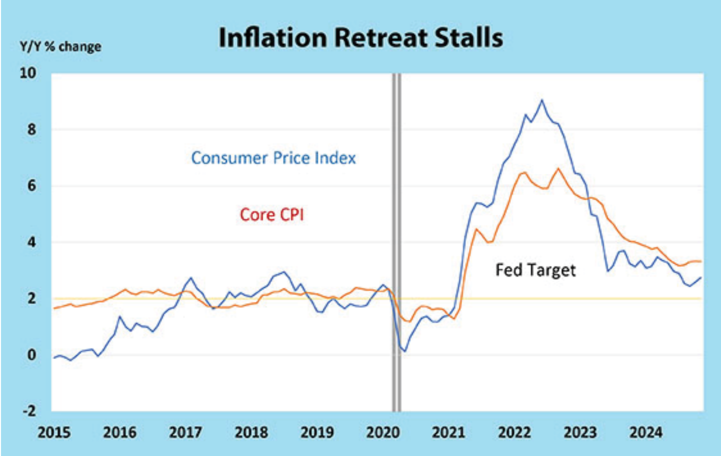
It's unclear if the negative market reaction was a case of "buy on the rumor and sell on the news" or something deeper. Curiously, the outlook for growth and employment in 2025 hardly changed from the predictions made in September. GDP was revised up by a slim 0.1 percent and the unemployment rate was revised down a tick from 4.4 to 4.3 percent. Despite the small moves in these fundamentals that drive inflation, the forecast for inflation in 2025 was revised significantly higher, to 2.5 percent from 2.1 percent in the September SEP. This implies that subjectively at least, some Fed officials view the Trump's tariff and proposed deportations as having an inflationary impact.

Lessons Learned

So, where do we go from here? If one thing is clear from the experience over the past several months, nothing should be taken for granted. Back in September, when the Fed cut rates by a jumbo half-percent, conditions looked dire. Many thought that the aggressive rate hikes in 2022 and 2023 aimed at curbing inflation would, in time honored fashion, also send the economy into a recession. Indeed, those expectations looked prescient over the spring and summer, as job growth slowed, consumers were pulling back, and household confidence was sinking. Importantly, inflation cooled significantly, moving rapidly towards the Fed's 2 percent target.

Understandably, the Fed's priorities shifted, from focusing on curbing inflation to keeping the job market – and the overall economy — afloat. Even as conditions stabilized during the fall, policymakers thought it prudent to take out insurance against the risk of recession, cutting rates by smaller amounts in November and December. But it soon became clear that the economy was holding up much better than the Fed expected and, critically, that the retreat in inflation hit a wall, remaining stubbornly elevated well above the Fed's 2 percent target in recent months.

Unsurprisingly, the mindset of the Fed is changing once again. The latest decision on December 18 was dubbed a hawkish rate cut because it came with a stern message from Chair Powell that the path of future rate cuts will be shallower than predicted in September. Powell correctly noted that the economy's resilience enables policy to move more cautiously, a tacit admission that the aggressive rate hikes in 2022 and 2023 did not inflict as much pain on the economy as expected. Hence, the risk of keeping rates higher for longer has diminished.



At the same time, inflation is proving stickier than thought, smoldering rather than simmering, which could be rekindled if rates are cut too far. As we enter 2025, the lesson to take from 2024 Is that policy makers should remain flexible and forecasters should be humble as things could change in a hurry.

Brookline Bank Executive Management

Darryl J. Fess
President & CEO
dfess@brkl.com
617-927-7971

Robert E. Brown
EVP & Division Executive, Commercial Real Estate
rbrown@brkl.com
617-927-7977

David B. L'Heureux
EVP & Division Executive, Commercial Banking
dlheureux@brkl.com
617-425-4646

Leslie Joannides-Burgos
EVP & Division Executive, Retail and Business Banking
ljoannides-burgos@brkl.com
617-927-7913

KEY FINANCIAL AND ECONOMIC INDICATORS

*FINANCIAL INDICATORS**

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Prime Rate	7.81	8.00	8.30	8.50	8.50	8.50	8.50	8.50	7.81
3-Month Treasury Bill Rate	4.42	4.51	4.72	5.20	5.20	5.24	5.25	5.25	4.42
5-Year Treasury Note Rate	4.23	3.91	3.50	4.16	4.16	4.32	4.50	4.56	3.50
10-Year Treasury Note Rate	4.36	4.10	3.72	4.25	4.25	4.31	4.48	4.54	3.72
30-Year Treasury Bond Rate	4.54	4.38	4.04	4.46	4.46	4.44	4.62	4.66	4.04
Tax-Exempt Bond Yield	4.11	4.00	3.83	3.87	3.94	3.94	4.00	4.11	3.36
Corporate Bond Yield (AAA)	5.14	4.95	4.68	5.12	5.12	5.13	5.25	5.28	4.68
Conventional 30-Year Mortgage Rate	6.81	6.43	6.18	6.85	6.85	6.92	7.06	7.06	6.18
Dow Jones Industrial average	43717	42494	41491	40086	40086	38904	39129	43717	36948
S&P 500 Index	5930	5792	5621	5538	5538	5415	5235	5930	4685
Dividend Yield (S&P)	1.23	1.28	1.31	1.31	1.31	1.33	1.36	1.48	1.23
P/E Ratio (S&P)	27.0	26.0	26.3	25.7	25.8	25.6	24.7	27.0	23.0
Dollar Exchange Rate (vs. Major Currencies)	126.5	123.8	122.1	123.7	123.7	124.0	122.2	126.5	120.2

* Monthly Averages

ECONOMIC INDICATORS

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Housing Starts (Thousands of Units)	1289	1312	1355	1379	1262	1329	1315	1568	1262
New Home Sales (Thousands of Units)		610	738	690	707	672	672	738	610
New Home Prices (Thousands of Dollars)		437	427	406	429	414	414	437	406
Retail Sales (% Change Year Ago)	3.8	2.9	2.0	2.0	2.9	2.0	2.6	5.00	0.2
Industrial Production (% Change Year Ago)	-0.9	-0.5	-0.8	0.0	-0.5	0.9	0.0	0.9	-1.2
Operating Rate (% of Capacity)	76.8	77.0	77.4	77.9	77.6	78.2	78.1	78.4	77.0
Inventory Sales Ratio (Months)			1.38	1.38	1.37	1.38	1.38	1.38	1.36
Real Gross Domestic Product (Annual % Change)			3.1			3.0		3.2	1.6
Unemployment Rate (Percent)	4.2	4.1	4.1	4.2	4.3	4.1	4.0	4.3	3.7
Payroll Employment (Change in Thousands)	227	36	255	78	144	118	216	310	36
Hourly Earnings (% Change Year Ago)	4.0	4.0	3.9	3.9	3.6	3.8	4.0	4.3	3.6
Personal Income (% Change Year Ago)	5.3	5.5	5.1	5.2	5.4	5.4	5.5	6.0	5.1
Savings Rate (Percent of Disposable Income)	4.4	4.5	4.1	4.4	4.4	4.8	4.9	5.5	4.1
Consumer Credit (Change in Blns. Of Dollars)		19.2	3.2	4.6	23.9	2.3	9.6	23.9	-2.4
Consumer Prices (% Change Year Ago)	2.7	2.6	2.4	2.5	2.9	3.0	3.3	3.5	2.4
CPI Less Food & Energy (% Change Year Ago)	3.3	3.3	3.3	3.2	3.2	3.3	3.4	3.9	3.2
Wholesale Prices (% Change Year Ago)	3.0	2.6	2.0	2.1	2.4	2.9	2.5	3.0	1.0