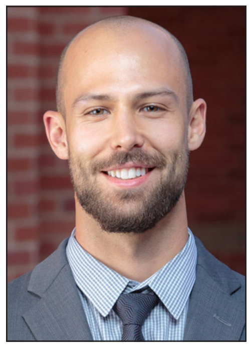
SEPTEMBER 2023 ECONOMIC COMMENTARY by Colton Krueger, Economic Analyst

SEPTEMBER 18, 2023

Over the past year, inflation has cooled, and the labor market has loosened, in line with the Federal Reserve's intended outcome when they began aggressively raising rates. Remarkably, the economy has continued to steadily grow, largely due to robust consumer spending. As we assess the most recent quarter, expectations are that the economy has sustained a healthy growth trajectory, with estimates for the third quarter GDP hovering around 3%. However, looking ahead, the favorable tailwinds from consumer spending are likely to diminish, and economic growth is expected to moderate. In fact, there is growing concern that with the Fed's monetary tightening measures taking effect across the economy, we may even be on the brink of a mild recession next year.



The labor market is gradually returning to its pre-pandemic pace, stepping back from the unprecedented growth observed in 2021-2022. In August, the economy added 187,000 jobs, coinciding with an increase in the unemployment rate to 3.8%, up from 3.5% the previous month. The rise in unemployment is attributed to growing labor force participation rates, which increased by 0.2% last month. The participation rate now stands at 62.8% - the highest level since February 2020 and marking a substantial 270 basis point increase from the low of 60.1% reached in April 2020.

As the labor market softens, labor costs are also declining. In August, average hourly wages experienced a modest 0.2% increase, marking the slowest monthly growth rate since early 2022. Wages are 4.3% higher than they were a year ago but have decreased from the peak growth rate of nearly 6% observed in March 2022. On an inflation-adjusted basis, wages are 0.5% higher than a year ago.

The modest wage increase marks the first time in six months that wage growth failed to keep pace with inflation. In August, the Consumer Price Index registered a 0.6% increase, primarily driven by surging gas prices, and is 3.7% higher than a year ago. This represents the strongest monthly increase in over a year. Meanwhile, Core CPI, which excludes food and energy, rose 0.3% and is now 4.3% higher than a year ago, down from 4.7% in July. While August marked an uptick in inflation, it is more likely an isolated event than a return to sustained high inflation. Over the last three months, Core CPI has grown at an annualized rate of 2.4%, edging closer to the Fed's target of 2%.

Other sectors of the economy are also showing signs of softening. While housing market prices have remained relatively stable, there has been a notable decline in activity. In July, existing home sales dropped by 2.2%, and they are down 16.6% compared to the same period last year. The ISM Manufacturing Index is also a cause for concern, having recorded ten consecutive months in contraction territory, marking the longest sustained period of contraction observed outside of a recession. Additionally, consumer sentiment remains relatively depressed, with the University of Michigan index slipping by two points in September to 67.7. While this is an improvement from the low of 50 recorded in June 2022, it remains significantly below the pre-pandemic high of 101 reached in February 2020. The decline in sentiment suggests that consumers are growing more apprehensive about the current state of the macroeconomy. Interestingly, consumers appear less concerned about inflation, with long-term inflation expectations dropping to 2.7%, down from 3.0% in August.

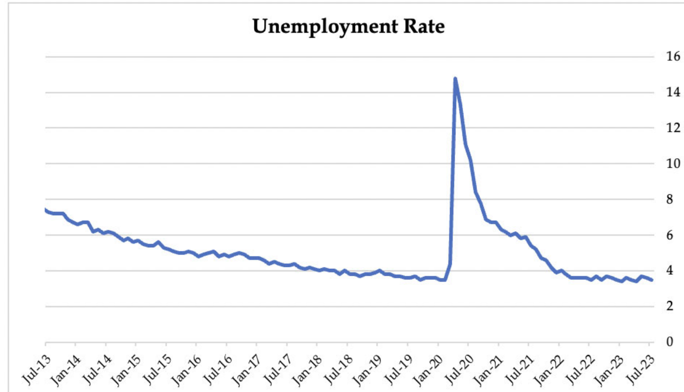
An FOMC meeting is scheduled for September 20th, during which the Fed will address the status of monetary policy and the state of the economy. Despite the recent uptick in inflation during August, given the softening in parts of the economy, the prevailing expectation is that the Fed will maintain the overnight rate at their current target range of 5.25-5.50% and refrain from further rate hikes.

Another factor contributing to the Fed's caution on further rate hikes is the persistent deep inversion of the yield curve. Currently, the 2-year Treasury yield stands at 5.02%, while the 10-year yield is at 4.33%, resulting in an inversion of -69 basis points. This level of inversion has remained relatively steady since last December. What has notably changed is the short end of the yield curve, which has become pronouncedly inverted. At the beginning of the year, the 1-month Treasury bill and the 1-year Treasury bill displayed a normalized relationship, with the 1-year yield sitting 55 basis points higher than the 1-month. However, this dynamic shifted in May, and to this day, the 1-year Treasury bill continues to yield less than the 1-month, signaling an unusual and concerning inversion at the short end of the yield curve.

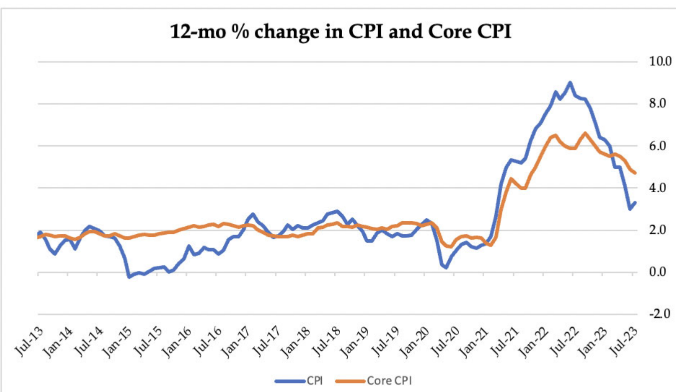
Although predictions of a looming recession have been circulating for over a year, the forthcoming quarters are expected to bring a slowdown in economic activity, with the potential for GDP to contract. Wages are only marginally outpacing inflation, and several headwinds, such as the resumption of student loan payments and tightening credit conditions, have created significant obstacles for consumer spending. With the prospects of slowing consumer spending, a lackluster housing market, and moderated job growth, the next six months are likely going to be difficult for the economy. One potential silver lining is that inflation should continue to ease. This means in the event of a recession, the Fed will be able to lower interest rates, potentially mitigating the severity of the downturn and making it relatively mild in comparison to historical recessions.

ECONOMIC CHARTS

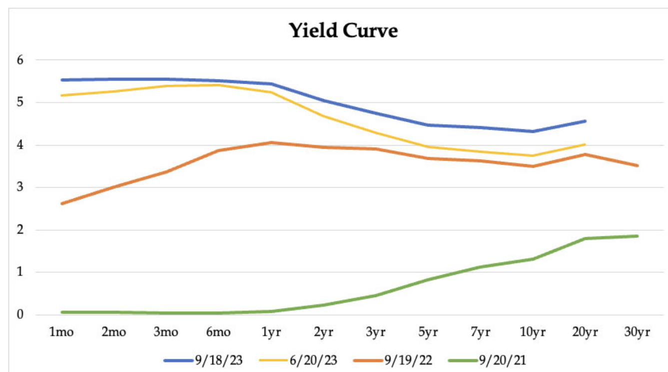
Real Annualized GDP



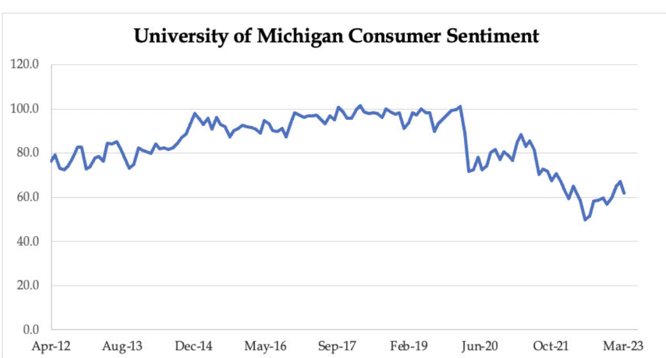
Unemployment Rate



12-mo % change in CPI and Core CPI



Yield Curve



University of Michigan Consumer Sentiment