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AUGUST 2024 ECONOMIC COMMENTARY by Colton Krueger, Economic Analyst

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While concerns about a potential recession and economic discontent persist in media headlines, overall, the economy remains resilient, supported by a strong labor market and inflation trending towards the Federal Reserve's 2% target. However, there are indications that the Federal Reserve may be lagging in lowering interest rates, a delay that has historically hurt the economy.

The US economy expanded by 2.8% in the second quarter, driven by robust consumer spending and increased business investment in equipment. Despite concerns over inflation's impact on consumers, spending remains a key driver of economic growth. While inflation has posed challenges, especially for lower-income households, overall consumer health is strong, supported by wage growth outpacing inflation, a robust labor market, and gains in the stock market along with high-interest income benefiting households.

The stock market reacted negatively to a softer-than-expected July jobs report, released in early August, which showed an increase of 114,000 jobs—below the anticipated 175,000—and downward revisions for June. The unemployment rate rose from 4.1% to 4.3%, its highest since October 2021, and triggering the widely followed Sahm Rule. This rule, based on historical data, suggests that the economy has entered a recession whenever the three-month average of the unemployment rate rises by 0.5% or more from its low point in the previous 12 months. Currently, the three-month average stands at 4.1%, up from a low of 3.6% last August. While rising unemployment warrants attention, it's crucial to consider the broader labor market context. The recent increase in the unemployment rate reflects a rebound from historically low levels and is not being driven by widespread layoffs, as evidenced by ongoing job gains. Instead, the rise stems from more individuals entering the labor market – illustrated by a 1.3 million increase in the labor force over the past year. This influx of workers will help mitigate inflationary pressures by intensifying job market competition among workers and moderating wage growth, which is a significant contributor to inflation.

As the market digested the latest employment report and July's consumer price index (CPI) figures were released, it quickly rebounded. The CPI report confirmed that inflation is progressing towards the Federal Reserve's 2% target, with the headline CPI showing a year-over-year increase of 2.9%, down from 3.0% in June. Over the past three months, CPI has grown at an annual rate of 0.4%. Core CPI, which excludes food and energy prices, increased by 3.2% year-over-year, slightly lower than June's 3.3%. Excluding housing from core CPI, inflation has risen by 1.8% over the last year. These figures reinforce the belief that the economy remains on track for a soft landing, aiming to curb inflation without causing a recession.

Steady declines in inflation, paired with a labor market that, although showing signs of weakening, is still expanding, have positioned a probable interest rate cut for September. If implemented, this would be the first cut in over four years. With the Federal Reserve scheduled to meet on September 17-18, the consensus in the market is that a cut will occur; the debate centers on whether it will be a -25 or -50 basis point cut.

Recent movements in the yield curve suggest that a rate cut of -50 basis points or more may be justified. The ongoing inversion across various Treasury durations continues to disrupt incentives and historically signals economic challenges ahead. The Federal Reserve has maintained the federal funds rate target at a 23-year high of 5.25%-5.50% for over a year. Since the last rate hike in July 2023, the yield curve has further inverted, particularly at the short end. In July of last year, the yields for the 1-year, 2-year, and 10-year Treasuries were 5.40%, 4.91%, and 4.26%, respectively. Currently, these rates stand at 4.43%, 3.99%, and 3.82%, indicating respective declines and further inversions as compared with the overnight rate. To normalize the overnight rate and the 1-year rate, the Fed would need to reduce rates by -100 basis points.

The Federal Reserve's prolonged high interest rates have taken a toll on various sectors of the economy. Single-family homebuilding declined by -14.1% in July, marking its lowest level since March 2023. Existing home sales also dropped by -2% year-over-year, reaching a record low. The ISM manufacturing index fell by -1.7 percentage points from June, contracting for the 20th time in the last 21 months. Additionally, the Conference Board Leading Economic Index decreased by -0.6% in July, marking the fifth consecutive monthly decline. These indicators clearly show that elevated interest rates are adversely impacting the economy.

While concerns about a potential recession persist, recent economic indicators underscore the resilience of the U.S. economy. Supported by a robust labor market and inflation trending towards the Federal Reserve's target, the economy appears to be navigating towards a soft landing. However, prolonged high interest rates have strained sectors such as housing and manufacturing. The continued inversion of the yield curve further signals economic challenges ahead, necessitating timely and decisive action from the Federal Reserve. As we approach the Fed's upcoming meeting in September, the focus shifts to how aggressively and swiftly the Fed will cut rates to reduce economic pressures in order to sustain growth.

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