Weekly Economic Update—December 5th, 2022

Recession watchers received a bucketful of information this week which, despite conflicting evidence, probably hardened their view that the economy is heading for a downturn at some point next year. That said, they must be scratching their collective heads to interpret the swirl of events that unfolded in recent days. Their befuddlement can be traced to both policy statements as well as incoming data that depict a bipolar economy. From a policy perspective, Fed chair Powell made it perfectly unclear what to expect. He sounded a calming note in a widely covered speech this week when he suggested that future rate increases would be smaller than the last four outsized .75 percentage point hikes, confirming market perceptions that the next policy meeting later this month would produce a scaled-back half-percent increase. But he also reiterated his commitment to rein in inflation at any cost, noting that the path of rate hikes would be longer than previously thought and would likely end at a higher terminal level as well.

The prospect of a more gradual pace of rate hikes buoyed expectations of optimists that the Fed was taking a more cautious approach in its inflation fight, opting to assess the impact of previous rate hikes on the economy before moving ahead with further tightening. But Powell gave no indication that the process would stop if inflation remained stubbornly high, noting that there is still a long road ahead before inflation retreats to the 2 percent target. What's more, a key sticking point that makes reaching the target particularly challenging is the continued strength in wage growth; Powell believes that as long as wages are increasing so far above prepandemic levels as they are, there is little chance that inflation would be brought to heel. The implication is that the job market needs to weaken considerably to curtail wage growth, and nothing is more endemic to a recession than a rise in joblessness.

Simply put, the Fed chair gave little indication that policy would veer away from its rate-hiking campaign even if it brought on a recession, albeit one that hopefully would be mild. As it is, if a recession does occur it would certainly be no surprise to anyone. Indeed, by at least one measure this would be the most anticipated recession on record. According to the latest survey of professional economists conducted by the Philadelphia Federal Reserve Bank, the highest share of respondents expects a recession over the next twelve months than any time since the survey began in 1969. While the survey was taken in mid-November, other cyclical indicators have since confirmed the downbeat sentiment of economists. Most notably, the yield curve inversion has deepened considerably, with the gap between two-year and ten-year Treasury yields reaching the widest since 1981.

But what about the economic data? Here the readings are far less conclusive and provide vexing challenges for the Fed to interpret. One thing is clear: the economy is not on the cusp of a recession. Consumers are spending and incomes are growing at a sturdy pace and most tellingly, the job market continues to run hot – too hot for the Fed's comfort. Friday's employment report stunningly confirmed this trend. In November, employers added 263 thousand workers to payrolls, much stronger than the 200 thousand expected by the forecasting community and way above the roundly 100 thousand needed to keep up with population growth. The good news is that the November increase does reflect a cooling in job growth as it followed an upward revised 284 thousand increase in October and was the smallest gain since April 2021.

But workers are still in the driver's seat. The unemployment rate remained at a drum-tight 3.7 percent and the acute labor shortage is driving up wages. Much to the chagrin of the Fed, average hourly earnings increased by a robust 0.6 percent last month, matching the strongest monthly increase since December 2020. Powell noted in his comments that it's particularly important to see wage growth in the service sector slow as it has more of an influence on prices than do wage changes in the goods sector, which is less labor intensive. Unfortunately, that was far from the case last month. All the wage increases in November, and then some, originated in the services sector, where average hourly earnings increased three times faster than in the goods sectors. Over the past three months, wages in service industries jumped by a 6.2 percent annual rate compared to 4.4 percent in the goods sector.

Ideally, the Fed would like to see wage growth cool to the 3-4 percent range, which after allowing for 1-1 ½ percent productivity growth, would be consistent with a 2 percent inflation rate. Neither side of that equation is close to being met. Productivity is slumping, as companies are using more workers to generate a unit of output, and wage increases are handily exceeding the 3-4 percent trend. It's important to remember that the service sector is less productive than the goods sector and employment in the service sector is the main engine driving job growth. Of the 263 thousand increase in nonfarm payrolls last month, 226 thousand, or 86 percent, were hired by service providers.

Despite the ongoing strength in jobs and wages, there are caveats to the latest employment report that suggest a less resilient economy – and less hawkish Fed policy—than is otherwise indicated. In recent weeks, the headlines have been replete with reports of widespread layoffs in the tech sector, extending well beyond the beleaguered crypto firms to mainstream companies in the industry. Yet these layoffs do not show up in the latest jobs data. In November, payrolls in the Computer Systems Design & Related Services sector increased by 8 thousand following a 10 thousand increase in November. That's barely changed from the 9 thousand average increase over the previous twelve months. These layoffs may well start to show up in the next jobs report.

Likewise for manufacturing, where companies added 14 thousand jobs in November following a sturdy 25 thousand gain in October. Yet the Institute for Supply Management reported that its manufacturing members slipped into a recession last month, with its index of manufacturing activity slipping below the 50 threshold for the first time since May 2020. And contrary to the jobs report, the survey's subcomponent of employment revealed that manufacturers reduced headcount during the month. The other innards of the survey point to further weakness on the goods-producing side of the economy. New orders are down as is the backlog of unfilled bookings even as a meager 33 percent of industries in the sector are reporting growth, the lowest share since the height of the pandemic recession in the spring of 2020.

The unfolding weakness in manufacturing reflects what is shaping up as a bipolar economy that has large pockets of weakness amidst a broader expansion supported by ongoing strength in consumer spending. The latter was highlighted by this week's report on personal income and consumption, which featured stronger than expected increases on both sides of the ledger in October and underscores our revised forecast, which now envisions a peppier growth rate in the fourth quarter than previously thought. It also, along with the latest jobs report, tilts the Fed towards a more hawkish stance than otherwise, although the odds are it will dial back the next rate hike to .50 percentage points.

That said, there was some good news on the price front in this week's batch of data, which gives the Fed cover to go slower on its rate-hiking campaign. The most striking trend is the complete reversal of the pandemic-era climb in raw material prices as evidenced in the ISM report of manufacturers. There, the prices paid by manufacturers fell to the lowest level since May 2020, suggesting that inflation on the commodities front at least was indeed transitory. A similar, but less pronounced, slowdown was also indicated on the consumer level, as the monthly increases in both the headline and core personal consumption deflators slowed in October. Still, both are running well above the Fed's 2 percent target over the past year, which should keep the Fed's foot on the brakes over the foreseeable future. From our lens, the cool-down in prices will continue next year, reinforced by the belated slowing in housing costs. But by then the extended series of Fed rate increases, diminished household savings, a profits squeeze along with a sinking manufacturing sector will have taken a big enough bite out of economy to bring on a recession.

FINANCIAL INDICATORS

INTEREST RATES	Dec 2	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.31	4.15	4.03	0.06
6-month Treasury bill	4.67	4.70	4.53	0.10
3-month LIBOR	4.77	4.74	4.57	0.18
2-year Treasury note	4.29	4.51	4.72	0.60
5-year Treasury note	3.66	3.87	4.33	1.13
10-year Treasury note	3.49	3.70	4.12	1.35
30-year Treasury bond	3.55	3.73	4.15	1.69
30-year fixed mortgage rate	6.49	6.58	6.95	3.11
15-year fixed mortgage rate	5.76	5.90	6.29	2.39
5/1-year adjustable rate	6.06	5.95	5.81	2.53

STOCK MARKET				
Dow Jones Industrial Index	34,429.88	34,347.03	32,403.22	34,580.08
S&P 500	4,071.70	4,026.12	3,770.55	4,538.43
NASDAQ	11,461.50	11,226.36	10,475.25	15,085.47

COMMODITIES				
Gold ($ per troy ounce)	1,811.40	1,755.00	1,684.30	1,785.10
Oil ($ per barrel) - Crude Futures (WTI)	80.34	76.55	92.55	66.89

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average- Past Six Months or Quarters
Nonfarm Payrolls (November) - 000s	263	284	269	323
Unemployment Rate (November) - Percent	3.7	3.7	3.5	3.6
Average Hourly Earnings (November) % chg.	0.6	0.5	0.4	0.4
ISM Manufacturing Index (November)- Index	49.0	50.2	50.9	51.5
Personal Incomes (October) - % change	0.7	0.4	0.3	0.5
Personal Consumption (October) - % change	0.8	0.6	0.7	0.6

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