Weekly Economic Update—May 1st, 2023

The House Republicans finally submitted a bill that would raise the debt ceiling, ushering in round 1 in what shapes up to be a protracted fight, as the Senate Democrats are sure to duck the opening salvo. So far, the financial markets appear unfazed by the prospect of an ugly battle poised to go down to the final round, estimated to be early summer. Quite possibly, the combatants will not settle the score until a major market incident sends a scare into the proceedings. Aside from a spike in Treasury bill yields on issues scheduled to mature around the drop-dead date, there is more of a "what me worry" sentiment among investors than a "woe is me" attitude. Stocks added to their hefty year-to-date gains this week, continuing to rally on Thursday and Friday after House Speaker McCarthy submitted his debt-ceiling proposal.

Unsurprisingly, both sides are digging in, each believing they have the upper hand. Democrats believe Republicans would get blamed for a confidence-shattering debt default that sends the economy into a deep tailspin. Republicans, in turn, may bank on the time-honored observation that incumbant administrations take the blame for a recession that occurs on their watch, particularly if it unfolds in an election year. Most, including us, expect a mild recession to begin in the third quarter and end before it is still fresh in the minds of voters next year. But like most observers, our base case forecast does not account for a first-ever debt default that could generate unpredictable, and perhaps longer-lasting aftershocks.

No doubt, a protracted acrimonious battle over the debt ceiling would be an external shock that further complicates the Federal Reserve's efforts to achieve a soft landing. As it is, incoming data provides enough mixed messages to keep policymakers on edge. Nothing in this week's reports changes the widespread expectation that the Fed will raise its policy rate by a quarter point again at the May 3 FOMC meeting. But whether another hike in June is in the cards is still an open question. The economy continued on a growth trajectory in the first quarter, as real GDP increased by a 1.1 percent annual rate, the third consecutive quarterly gain following a contraction in the first half of last year. While the headline growth rate was the weakest of the three quarters, it masks considerable strength at its core as the slowdown primarily reflected a 2.3 percentage point drag from inventory drawdowns, although declines in business equipment spending and residential outlays also contributed to the slower headline growth rate.

However, the economy's main growth driver accelerated during the first quarter, as consumer spending surged by a 3.7 percent annual rate, the strongest gain since the second quarter of 2021. That, combined with modest increases in business spending on structures and in government outlays more than offset the inventory drag, resulting in a sturdy 2.9 percent increase in real final sales to domestic purchasers following no change in the previous quarter. Importantly, the pickup in core growth was accompanied by elevated inflation readings, as both the overall personal consumption deflator and the core PCE rose at a faster pace during the quarter. Clearly, the combination of strong consumer spending and sticky inflation during the first quarter suggests the Fed still has more work to do, pointing to another rate increase in June.

But the GDP report provides a rear-view picture of the economy's performance, as the entire strength occurred in January when sizeable cost of living adjustments and seasonal quirks boosted incomes and consumer spending. Since that opening month, the economy has lost a lot of steam, undercutting the need for more rate hikes. Friday's income and spending report for March underscored the loss of momentum at the end of the quarter as consumer spending stalled out during the month, both in nominal and adjusted for inflation. The dip in real spending in March followed an even larger setback in February, highlighting the front-loaded boost in consumer spending during the first quarter. That said, households still have the firepower to keep their wallets open, as personal incomes rose another 0.3 percent in March, the same as in February, as the ongoing strength in the job market continued to boost wages and salaries.

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Importantly, wages outpaced the 0.1 percent increase in prices last month, which together with lower taxes, enabled the the entire gain to flow into real disposable income, which also increased by 0.3 percent. But as noted, consumption stalled during the month, so households channeled the entire income gain into savings. The personal savings rate increased 0.3 percent to 5.1 percent, the highest in fifteen months. That could be viewed as a positive influence for future consumption, as it boosts the financial wherewithal of households to spend more. From our lens, however, it represents just the opposite, as mounting headwinds, including reduced credit availability, higher borrowing costs, persistent inflation and growing recession fears, are encouraging consumers to build up precautionary savings.

Simply put, the economy's growth engine is downshifting, and we expect it to move into a lower gear this quarter before shifting into reverse starting in the third quarter. The timing of the inflection point from growth to contraction is fluid, depending on how well the job market holds up and how tight credit conditions become in the wake of the banking panic that is still not fully resolved (bank emergency borrowing from the Term Funding Program increased $3 billion in the latest week, boosting the total to $89.3 billion). True, the economy lost considerable momentum as the first quarter progressed, and the GDP growth rate of 1.1 percent fell below the economy's long-run potential of about 2 percent. But the job market, while also slowing, continued to generate paychecks far above its prepandemic pace, sustaining a healthy rise in labor compensation.

It's unclear which trend the Fed will prioritize later in the year. The financial markets are betting that the expected rate increase next week will be the last of the tightening cycle and foreshadow a series of rate cuts before the year is out, believing the Fed will pivot as the economy descends into a recession. But the Fed has given little inclination that it is about to abandon its official stance of keeping rates "higher for longer" until inflation is brought to heel. We look forward to the guidance the Fed will provide at its upcoming meeting to see if that wall of resistance is starting to crack a bit. Some progress on the inflation front can be seen in recent data, but there is still a huge distance between the current rate and the Fed's 2 percent target. A key wage metric the Fed monitors closely, the Employment Cost Index, increased 4.9 percent in the first quarter from a year ago, with wages and salaries rising by 5.0 percent. The Fed believes that wage growth needs to slow to about 3.5 percent to be consistent with a 2 percent inflation rate, assuming 1.5 percent productivity growth.

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FINANCIAL INDICATORS

INTEREST RATES	Apr 28	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.06	5.07	4.65	0.81
6-month Treasury bill	5.03	5.04	4.71	1.40
3-month LIBOR	5.30	5.27	5.13	1.28
2-year Treasury note	4.00	4.17	3.78	2.65
5-year Treasury note	3.49	3.67	3.41	2.96
10-year Treasury note	3.42	3.58	3.78	2.86
30-year Treasury bond	3.68	3.78	3.65	2.93
30-year fixed mortgage rate	6.43	6.39	6.42	5.10
15-year fixed mortgage rate	5.71	5.76	5.68	4.40

STOCK MARKET				
Dow Jones Industrial Index	34,098.16	33,808.96	32,237.53	32,977.21
S&P 500	4,169.48	4,133.62	3,970.99	4,131.93
NASDAQ	12,226.58	12,032.46	11,823.96	12,334.64

COMMODITIES				
Gold ($ per troy ounce)	1,999.20	1,994.10	1,981.00	1,896.90
Oil ($ per barrel) - Crude Futures (WTI)	76.63	77.95	69.20	104.13

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Real GDP (Q1) - % change, Saar	1.1	2.6	3.2	1.9
Durable Goods Orders (March) - % change	3.2	-1.2	-5.0	0.2
New Home Sales (March) - 000s	683	623	648	625
Personal Income (March) - % change	0.3	0.3	0.6	0.5
Personal Consumption (March) - % change	0.0	0.1	2.0	0.4
Personal Savings Rate (March) - Percent	5.1	4.8	4.5	4.4

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