Weekly Economic Update—May 30th, 2023

No one would argue that the Fed's rate-hiking cycle is nearing an end, but that terminal date is looking more elusive with each data point. A pause in the cycle at the June meeting is still the mostly likely bet; but rather than a bridge to cuts, it is looking more like a skip before the Fed hikes again in July or at a subsequent policy meeting. Even traders are pulling back on the rate-cut bets, pricing in smaller reductions over the second half of the year than expected a few weeks ago. Indeed, as of Friday the financial market had priced in less than a 50 percent probability the Fed would lower rates by the end of the year.

The markets reassessment of what the central bank might do reflects recent hawkish comments of Fed officials as well as the strength of incoming economic and inflation data. To be sure, recession expectations still dominate most forecasts, including ours, as strengthening headwinds will undercut the forces stoking the upside surprises in recent data. The most prominent of these is the muscular spending behavior of households, which started the second quarter with considerably more firepower than expected. The solid increase in April retail sales reported last week was a portent of that strength, but the more comprehensive income and spending report on Friday not only confirmed but amplified it. Simply put, consumers came storming out of the gates in the second quarter.

Personal consumption, which includes the much larger service component that was missing from the retail sales report, leaped by 0.8 percent in April, swamping the slim 0.1 percent gains in February and March. Except for the weather-induced spike in January, the April advance was the strongest since last June. Importantly, the spending increase was not all due to higher prices. Real outlays advanced by a sturdy 0.5 percent and are on track for a 3.1 percent annual growth rate in the second quarter. Unless spending falls off a cliff in May and June, the economy's main growth driver should power GDP to a stronger gain in the second quarter than the upwardly revised 1.3 percent registered in the first.

The strength of consumer spending alone would be enough to bolster hawkish sentiment at the Fed. But the accompanying inflation data provided even more ammunition for officials clamoring for additional hikes. The personal consumption deflator, which is the Fed's preferred inflation gauge, reaccelerated in April, posting a 0.4 percent increase following a 0.1 percent advance in March. A 0.7 percent jump in energy prices led the way, but the core deflator that excludes volatile food and energy prices also rose 0.4 percent, up from a 0.3 percent advance in March. Over the past year, the overall deflator increased by 4.4 percent and the core deflator by 4.7 percent, faster than the 4.2 percent and 4.6 percent, respectively, in March.

The year-over-year increase in the core deflator, which is more representative of underlying inflation trends, has been stuck within a narrow range of 4.6 and 4.8 percent for six consecutive months. That's not much progress in wrestling inflation down to the Fed's 2 percent target. Clearly, the latest report won't sit well with the Fed. However, it is unlikely to deter it from skipping a rate hike in June. If nothing else, a pause is justified by the tightening in lending standards following the stress in the banking system. Changes in lending standards affect the economy with a lag but respectable studies indicate that the recent tightening in credit conditions is equivalent to a little more than a quarter point rate hike by the central bank. That said, if inflation remains sticky, the Fed won't hesitate to resume tightening later as it can't very well declare victory on inflation, which is the overriding mandate at the current time.

That said, there are two sides of the ledger in the personal income and spending report. While the latter depicts ongoing strength that is keeping the economy's growth engine humming, the income side is pointing in the opposite direction. True, nominal incomes also posted a respectable increase in April, rising by 0.4 percent compared to 0.3 percent in March. But that increase did little to enhance household purchasing

power, as inflation – whether measured by the overall or core deflator – gobbled up the entire amount. Hence, real incomes were stagnant last month. What's more, income growth lagged the increase in spending which, as noted, leaped by an outsize 0.8 percent in April. As a result, consumers had to dip into savings to finance their purchases, lowering the savings rate to 4.1 percent from 4.5 percent in March.

It's important to note, however, that the savings rate is a residual that reflects the difference between what consumers earn and what they spend in any given month. It tells us nothing about how much savings households have accumulated over the years and what they have on hand now. Nor does it provide information about other sources that go into household balance sheets, such as bond and stock holdings. Why this is important is because households have built up a sizeable financial cushion since the outbreak of Covid in 2020, thanks to copious government stimulus payments, much of which could not be spent because of pandemic restrictions, and the torrid rebound in job growth and incomes from the Covid-induced recession in the spring of 2020.

While estimates vary, a recent study by the Federal Reserve calculates that households still retain $500 billion in excess savings over and above what would have been socked away based on savings trends prior to the Covid outbreak. Hence, while inflation is eroding household purchasing power, consumers still retain a financial cushion to sustain spending for a while longer, perhaps through the end of the year. The question is, how much of that cushion would actually be used for that purpose. The Fed's study concluded that even low-income households have some excess savings left over, but upper income individuals hold the bulk of those funds, which are likely to be treated as wealth rather than for spending purposes. Hence, while excess savings will act as a buffer for spending, it is not an inexhaustible source of purchasing power.

As a result, income growth will be the driving force behind consumer spending in coming months, and the sturdy gains seen over the past year are set to slow. We will be getting a fresh jobs report next Friday, which is expected to confirm anecdotal evidence that companies are cutting back hiring, setting the stage for slower increases in wages and salaries. Household sentiment is already on a sharply downward path, punctuated by Friday's downbeat reading in the University of Michigan Survey for May, which reveals a major pullback in spending plans as well. Some of the depressed mood reflects angst over the debt ceiling saga, and the doomsday tidings that a U.S. default threatens to cause. But household expectations about economic prospects have been deteriorating for a while, and it is only a matter of time before they start to behave accordingly.

Clearly, the recent upbeat data on consumer spending and, to a lesser extent, business investment on equipment, indicates that the economy is staying above water, pushing back the timing of the widely expected recession. But the lagged effects of the Fed's aggressive rate hikes since early last year, the tightening of credit conditions following the banking turmoil, and the latest readings on corporate profits, which revealed a decline for the second consecutive quarter in the January-March period, represent gathering headwinds that will be hard for the economy to overcome. Ordinarily, the Federal Reserve would be expected to short-circuit a pending downturn by slashing interest rates, something that until recently the financial markets widely expected. But with inflation still stubbornly high, it would take an abrupt –and surprising – turn for the worse, particularly in the job market, for the Fed to undertake such a rescue operation. It would take more than a mild recession – which we expect – to sway the central bank from keeping interest rates elevated for the rest of the year. The good news is that the persistent strength of consumer spending keeps hopes for a soft landing alive.

FINANCIAL INDICATORS

INTEREST RATES	May 26	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.27	5.24	5.06	1.06
6-month Treasury bill	5.40	5.33	5.03	1.52
3-month LIBOR	5.46	5.38	5.30	1.57
2-year Treasury note	4.56	4.26	4.00	2.47
5-year Treasury note	3.93	3.74	3.49	2.72
10-year Treasury note	3.81	3.68	3.42	2.75
30-year Treasury bond	3.96	3.93	3.68	2.97
30-year fixed mortgage rate	6.57	6.39	6.43	5.10
15-year fixed mortgage rate	5.97	5.75	5.71	4.31

STOCK MARKET				
Dow Jones Industrial Index	33,093.34	33,426.63	34,098.16	33,212.98
S&P 500	4,205.45	4,191.98	4,169.48	4,158.24
NASDAQ	12,975.69	12,657.90	12,226.58	12,131.13

COMMODITIES				
Gold ($ per troy ounce)	1,946.70	1,979.40	1,999.20	1,850.60
Oil ($ per barrel) - Crude Futures (WTI)	72.89	71.71	76.63	115.07

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
New Home Sales (April) - 000s	683	656	631	640
Personal Income (April) - % change	0.4	0.3	0.3	0.3
Personal Consumption (April) - % change	0.8	0.1	0.1	0.5
Personal Savings Rate (April) - Percent	4.1	4.5	4.3	4.0
Durable Goods Orders (April) - % change	1.3	3.4	-2.7	0.3

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