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Weekly Economic Update—July 5th, 2023

The “waiting for Godot” recession is being pushed back further with each data release, lifting the odds the Fed will step on the brakes even harder than thought a few weeks ago. At the central bankers’ symposium in Sintra, Portugal this week, Fed chair Powell sounded even more hawkish than he did in the press conference following the June 16 FOMC meeting. Not only did he confirm the likelihood of two more rate hikes signaled at that presser, but he also hinted that the rate trigger could be pulled in two consecutive meetings, in July and September. That, of course, leaves the door open for more tightening moves in the two remaining meetings this year.

The odds of more than two increases this year are low and we still believe that it’s a close call between staying put and increasing one more time. That said, the Fed chair’s hawkish comments are understandable considering the upside surprises in incoming data that are imparting more heft to the second quarter than predicted by policymakers or the consensus of economists. What’s more, the economy came out of the starting gate this year with considerably more swagger than previous estimates revealed. Real GDP staged an above-potential 2 percent annual growth rate in the first quarter, revised up from the earlier tally of a 1.3 percent pace. That’s an outsize revision for a third estimate of the economy’s output; its muscular increment is diluted only by the frail reading on the income side, as gross domestic income fell by a 1.8 percent annual rate during the period, although that too was revised up from a 2.3 percent decline. Still, such a wide divide between the output and income sides of the economy always stirs debate over which is a more reliable measure of the economy’s performance. One way to sidestep the issue is by averaging the performance of the two sides of the ledger. This exercise produces a slim 0.1 percent growth rate for the period, which is hardly a barn-burning pace that warrants a stiff cooling off response from the Fed.

Importantly, the income weakness is not victimizing households as real disposable income leaped by an upwardly revised 8.5 percent in the first quarter, the strongest in two years, underscoring the brawny purchasing power that is driving stronger-than- expected personal consumption. What’s more, the upward revision in incomes also left households with more savings than previously estimated, imparting more firepower to spend in the second quarter. Conversely, businesses suffered the brunt of the income weakness in the first quarter, as profits from current production fell by $121.5 billion and margins came under pressure, as unit profits among nonfinancial corporations fell for the first time in four quarters. This may be a sign that companies are not able to fully pass rising labor costs through to consumers. In a tight labor market, that dynamic poses a challenge to employers: accept smaller margins for the sake of retaining workers or push back on wage demands and risk losing workers to a wave of voluntary quits. Given the lofty profits companies have enjoyed throughout most of the post-pandemic recovery, some margin compression can readily be tolerated. But the stock market is not priced for a profits squeeze over an extended period, which sets the stage for a slide in market values unless corporate pricing power strengthens.

That, unfortunately, would also set the stage for persistent inflation, which the Fed is determined to bring down. At the Sintra forum, Powell noted that the 2 percent target is not likely to be reached before 2025. Interestingly, that would be a speedier timetable than outlined in the dot-plots at the last policy meeting, when the median forecast among officials was for core PCE inflation to recede to 2.2 percent that year. Unsurprisingly, Powell believes the tight labor market, spurring upward wage pressure, is a key obstacle to a faster decline in inflation. That, in turn, underscores the widespread view the Fed will not stop hiking rates until something in the labor market breaks. So far, it hasn’t; at best, it is bending. A recent survey of CEOs by the Conference Board indicates that nearly half the employers of major companies plan to hold on to

workers over the next year, despite a deteriorating growth outlook. The hoarding instinct is bolstered by expectations that any pending recession would be mild, and the risk of overstaffing is outweighed by fears of rehiring difficulties when the economy recovers.

The Fed hopes to change that attitude and persuade workers that their jobs are at risk, tilting their priority away from bigger pay raises to job security. Just how far the Fed is willing to go to change the mindset of businesses and labor is unclear, but the increasingly hawkish stance of policymakers suggests more of a willingness to accept a recession for the sake of restoring price stability. That tradeoff may reflect a greater sense among Fed officials that its policy tools are more effective in lifting the economy out of a recession than in bringing inflation to heel. Such thinking is clearly influenced by recency bias and downplays the risk of sending the economy into a harder downturn than the soft landing the Fed still hopes to bring about. It's important to remember that the Fed has been battling high inflation for only the past two years whereas it had struggled against the tug of disinflation – punctuated by fears of deflation – over the previous twenty years.

While two or more rate hikes would increase the odds of a hard landing, there are compelling reasons to believe the Fed won't go that far. Even the more hawkish officials recognize that policy changes take time to filter through to the economy and are willing to pause to see how the lags play out. There are more than enough indications to suggest that patience would be rewarded. True, most incoming data have surprised on the upside, defying expectations that a recession is just around the corner. We concur with that assessment and pushed back the expected start of a recession from the third to the fourth quarter. With the economy's main growth driver, consumers, keeping the motor running, it is hard to see the expansion expiring anytime soon.

That said, consumers are showing signs of fatigue following the outsize 4.2 percent spending burst in the first quarter – among the strongest quarterly increases over the past twenty years. After a strong start this quarter, personal consumption increased by a slim 0.1 percent in May. Adjusted for inflation spending was unchanged and is on track for a 2 percent growth rate in the quarter. Importantly, the May reading came in a tad weaker than the consensus forecast, which is the first time in a while that a key economic indicator surprised on the downside. But consumers are not about to zip up their wallets entirely, as they still have considerable firepower to sustain spending for a while. For one, the income side of the ledger is showing strength, as personal income increased by a respectable 0.4 percent, lifted by a sturdy 0.5 percent increase in wages and salaries, the strongest gain since January, reflecting the still-hot pace of job growth.

For another, households have a padded savings cushion to draw on, and even added another $64 billion to the total last month, lifting the savings rate to 4.6 percent from 4.3 percent, matching the highest rate since January 2022. To be sure, the fact they saved more by spending less may be more a sign of weakness than strength, reflecting a desire to build up precautionary savings as a buffer against uncertainty. But we suspect that most of the increase is accruing to upper-income households who tend to treat their savings as wealth and use it less for spending purposes than those further down the income ladder.

Simply put, the economy is still running on most cylinders. While consumer spending stalled last month, other sectors are taking up the slack, at least for now. Businesses are stepping up investment outlays, as evidenced by the unexpected strength in capital goods orders and shipments in May; even the rate-sensitive housing sector is showing more resilience than expected, with new home sales surging by more than 12 percent last month, boosted by the slim pickings in the resale market. With growth in the second quarter holding up better than expected and inflation only grudgingly receding – and still well above the Fed's target – the odds of further rate increases by the Fed have increased.

However, the recent strength in activity is not sustainable, in our view, as the consumer pullback in May is a portent of more weakness ahead. The lagged effects of higher borrowing costs, slower job growth, and reduced credit availability in the wake of the recent banking turmoil should all take a toll on household willingness and ability to spend. Once consumers turn over, so too will the economy. It remains to be seen if these portents morph into reality in time to prevent an overcorrection by the Fed. History suggests

otherwise, which heightens the odds that a recession, although delayed, is poised to get underway in the foreseeable future.

FINANCIAL INDICATORS

INTEREST RATES	Jun 30	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.32	5.30	5.38	1.67
6-month Treasury bill	5.45	5.41	5.47	2.48
2-year Treasury note	4.90	4.75	4.51	2.84
5-year Treasury note	4.15	3.99	3.85	2.89
10-year Treasury note	3.83	3.74	3.70	2.89
30-year Treasury bond	3.87	3.81	3.89	3.12
30-year fixed mortgage rate	6.71	6.67	6.79	5.70
15-year fixed mortgage rate	6.06	6.03	6.18	4.83
STOCK MARKET				
Dow Jones Industrial Index	34,407.60	33,727.43	33,762.76	31,097.26
S&P 500	4,450.38	4,348.33	4,282.37	3,825.33
NASDAQ	13,787.92	13,492.52	13,240.77	11,127.85
COMMODITIES				
Gold ($ per troy ounce)	1,926.80	1,929.90	1,964.60	1,810.10
Oil ($ per barrel) - Crude Futures (WTI)	70.50	69.31	72.00	108.40

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
New Home Sales (May) - 000s	763	680	657	668
Durable Goods Orders (May) - % change	1.7	1.2	3.3	1.1
Personal Income (May) - % change	0.4	0.3	0.4	0.4
Personal Consumption (May) - % change	0.1	0.6	0.1	0.3
Personal Savings Rate (May) - Percent	4.6	4.3	4.6	4.1

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