Weekly Economic Update—July 17th, 2023

Inflation took center stage this week, and the news was all good – for the Fed, consumers, households, and the administration. No doubt, there are still skeptics who question the sustainability of the disinflationary trend underway over the past year. But it is alive and well and giving off compelling signs that it is here to stay. Importantly, inflation's retreat is occurring alongside a resilient economy, boosting expectations that the Fed may guide the economy into the elusive soft landing, despite the most aggressive rate-hiking campaign in forty years.

True, the greater-than-expected slowdown in June's consumer price index reported this week will not deter the Fed from its well-telegraphed intention to raise rates again later this month. The markets are pricing in more than a 90 percent probability of a quarter-point hike at the July 25-26 FOMC meeting, giving the Fed ample cover to follow through. However, the prospect of a second rate increase at subsequent meetings that Fed officials signaled at the June meeting now looks less likely – or necessary – given the benign inflation reports this week. There is still more than a percentage point to go before inflation reaches the Fed's 2 percent target but evidence of a sustained retreat towards that target would, as Chair Powell has repeatedly noted, be enough to halt rate hikes. With the annual headline inflation rate falling for 12 consecutive months through June, that certainly looks like a sustained trend.

To be sure, the steep fall in energy prices over the past year contributed mightily to the slide in headline inflation, to 3.0 percent in June from 4.0 percent in May. But the disinflationary trend is spreading throughout the basket of goods and services that consumers buy. The core CPI, which exclude volatile food and energy prices, increased 0.2 percent in June from May, matching the slimmest advance since February 2021. Indeed, it was the first time since the onset of the current inflation cycle in January 2021 that both the headline and core CPI rose by 0.2 percent or less from the month before. It was also the first time that both the year-over-year and three-month annualized increase in the consumer price index had a handle below 3 percent since November 2020. The unrounded increase in the headline CPI over the past year is 2.97 percent.

One downside to lower inflation is that it increases real borrowing costs unless interest rates also decline by a corresponding amount. It didn't in June. Although the Fed kept rates unchanged at its June meeting, the 1 percentage point decline in the annual inflation rate means that the real policy rate increased by that amount. Hence, policy continued to tighten even as the Fed temporarily moved to the sidelines. Market rates also increased during the month, with yields from 2 years out to 30 staging significant increases, although they have retreated so far this month amid an improving inflation backdrop and lowered expectations of future rate hikes.

Still, it would be premature to conclude that the expected rate increase in July will be the last of the tightening cycle. We believe it will be, but there is a strong sentiment among policymakers that their mission will not be accomplished until the economy – and particularly the job market – shows more signs of weakness. As long as consumers have the wherewithal to keep spending, businesses will strive to push through higher prices to cover rising costs and protect the bottom line. Just as lower inflation lifts real interest rates it also boosts real household incomes, providing consumers with more purchasing power to keep spending. Indeed, wages have increased faster than inflation for four consecutive months, lifting real worker earnings above year-earlier levels for the first time since March 2021. For non-management workers, whose earnings have been rising faster than the general workforce, the boost to real incomes has been even more impressive, standing 2.2 percent above year-earlier levels in June compared to 0.7 percent for all privatesector workers. This trend has gone a long way towards reducing income inequality during the post-pandemic recovery.

Clearly, the Fed is not unhappy with the rise in real incomes, particularly for lower-wage workers, and recognizes that the least paid would be the first to be laid off if the economy slips into a recession. Yet it views the tight labor market and upward wage pressure as being the main obstacle preventing a faster decline in inflation. The hope is that massive layoffs can be avoided if cooling labor conditions restrain wage demands as workers become more concerned about job security. There are signs that this is happening. Fewer workers are voluntarily quitting their jobs, unfilled job openings are falling and, as revealed in the June employment report, job growth is slowing. Indeed, in four of the past five months, nonfarm payrolls have increased at about the same 1.5-1.9 percent annual rate seen during the 2010-2019 expansion. In 2022, nonfarm payrolls increased by a monthly average annual rate of 3.2 percent. Some encouraging signs can already be seen among small businesses, as the latest NFIB survey shows that that only 36 percent of firms raised wages over the past three months, the smallest share in more than two years.

The Fed believes that a slowdown in payroll growth to about 100 thousand a month, about half the 209 thousand increase in June, would prompt workers to curb wage demands. If that does the job, it clearly would be consistent with the soft landing the Fed hopes to bring about. However, major economic changes rarely unfold in a linear fashion and we suspect the job market gears will shift more drastically as the lagged effects of the Fed's rate hikes takes an ever-bigger toll on economic activity. Before the year is out, we expect that layoffs will be greater than hires, resulting in an outright contraction in payrolls. The extent of the job losses, in turn, would be more consistent with a hard landing should the Fed overshoot the mark and raise interest rates again after the expected move later this month.

No doubt, the July 25-26 meeting will see a robust discussion among Fed officials regarding the future path of policy, with more willing to take a wait and see approach before hiking rates again in September than was the case prior to this week's benign CPI and producer price reports. Several officials still issued hawkish comments even after the reports were released this week, hinting at a skip in September but noting that November was very much on the table for another increase. There are several more job and inflation reports scheduled before that meeting. Unless there is an unexpected reacceleration in inflation, something that a sudden shock akin to the pandemic would bring about, we believe that the rate-hiking cycle will end this month.

FINANCIAL INDICATORS

INTEREST RATES	Jul 14	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.41	5.36	5.23	2.34
6-month Treasury bill	5.48	5.48	5.32	2.87
2-year Treasury note	4.75	4.96	4.72	3.13
5-year Treasury note	4.05	4.37	3.98	3.05
10-year Treasury note	3.83	4.07	3.77	2.92
30-year Treasury bond	3.93	4.05	3.86	3.08
30-year fixed mortgage rate	6.96	6.81	6.69	5.51
15-year fixed mortgage rate	6.30	6.24	6.10	4.67
STOCK MARKET				
Dow Jones Industrial Index	34,509.03	33,734.88	34,299.12	31,288.26
S&P 500	4,505.42	4,398.95	4,409.59	3,863.16
NASDAQ	14,113.70	13,660.72	13,689.57	11,452.42
COMMODITIES				
Gold ($ per troy ounce)	1,959.30	1,930.50	1,970.70	1,706.50
Oil ($ per barrel) - Crude Futures (WTI)	75.26	73.67	71.44	97.57

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Consumer Price Index (June) - % change	0.2	0.1	0.4	0.1
Core CPI (June) - % change	0.2	0.4	0.4	0.4
Producer Price Index (June) - % change	0.1	-0.4	0.1	0.0
Consumer Credit (May) - $blns	7.2	20.3	19.1	16.5