Weekly Economic Update—July 24th, 2023

The sky is not falling, disappointing the army of Chicken Littles who were convinced the economy was poised to descend into a recession at any moment. That moment has morphed into hours then months and now -- many believe -- never. Instead of falling, a growing sentiment is that the skies will turn cloudy, spilling some rain on a parade that has been more festive than anyone expected. We are not as upbeat as the expanding segment of trend-followers, but it is hard to ignore the economy's resilience, particularly its main growth-driver, consumers. That said, we still believe the headwinds – elevated interest rates, tighter credit conditions, depleting savings and easing labor conditions – will ultimately prove too powerful for the economy to overcome, leading it to the much-hyped recession.

To be sure, it would be foolhardy to dismiss the possibility that policymakers can guide the economy onto the elusive soft landing and avoid large job losses that typically result from a long and aggressive battle to tame inflation. Just as the Federal Reserve has been blindsided by the economy's resilience despite the most rapid rate hikes in nearly four decades, it is also pleased by the dramatic slide in headline inflation over the past year. Even some Fed officials acknowledge that the path to a soft landing has widened in recent months. After all, if inflation is well on its way to hitting the Fed's 2 percent target the need for continued rate increases after the expected hike at next week's policy meeting is greatly reduced. That, in turn, would remove a major growth-retarding influence that more rate hikes would impose on the economy.

But the Fed is not convinced that the astonishing drop in headline inflation – to 3 percent in June from a peak of over 9 percent a year ago—is either sustainable or reflective of the underlying inflation trend. Indeed, some widely respected economists view the drop as transitional disinflation, helped by temporary forces linked to the unwinding of pandemic-related supply disruptions as well as the initial shock on energy and food prices from the war in Ukraine. The disinflationary impact of those forces has just about run their course and some may even reverse. Russia's blockade of grain shipments out of Ukraine, for example, is a potential source of higher food prices. More broadly, after plunging from more than 12 percent early last year to under 1 percent this February, inflation in core goods prices has stabilized and even creeped up a bit.

From the Fed's point of view, the low-hanging fruit has been picked and the challenge now is to tackle the underlying pressures that are keeping inflation from traveling the last mile down to its 2 percent target. The economy's resilience is one source that is keeping prices stickier than otherwise. There is an adage that says the cure for high prices is high prices, suggesting that consumers will stop buying things when they get too expensive, forcing sellers to rescind price hikes to recapture sales. To be sure, inflation has clearly squeezed the budgets of many households, prompting more selective buying habits, particularly among lower income consumers. But for the most part, higher prices have not crimped aggregate demand, as consumers have broadly accepted higher prices and kept on shopping.

That resilience continues to be on full display in the latest retail sales report, released this week. Total sales did come in a tad weaker than expected, rising a slim 0.2 percent over May, the weakest reading in three months. But that comes off an upwardly revised 0.5 percent advance in May. It also equals the 0.2 percent increase in the consumer price index that month, so once again consumers readily kept up with inflation. Importantly, the overall increase was held back by falling gasoline sales, reflecting for the most part ongoing price declines at the pump. Excluding gasoline and other volatile items, such as autos, and building materials, the so-called control group of sales that feeds directly into the GDP calculations increased by a sturdy 0.6 percent, double the increase in May. That punctuates a solid increase in real consumption during the second quarter, underpinning what is shaping up to be another above-trend growth in GDP for the

period. Recall that growth in the first quarter was revised up to 2.0 percent from 1.3 percent and incoming data is tracking a similar pace for the second quarter.

Simply put, with consumers – the economy's main growth driver – still chugging along, the Fed understandably believes that there is sufficient demand firepower to keep a flame under inflation. By this metric, the year-long effort to bring demand and supply into better balance, a requisite condition to tame inflation – still has a ways to go. Keep in mind too that the retail sales report mostly captures the goods side of the economy. Spending for services, which is much larger than goods purchases, will be revealed in the more comprehensive report on incomes and spending later this month. If, as is widely expected, people are still embarking on a wave of "revenge" shopping that was denied them during the pandemic lockdowns, that report should also come in on the strong side. Judging by the Taylor Swift phenomenon concert sales are still booming. Likewise, TSA data shows that people are eagerly catching up with postponed travel plans.

And while the Fed is closely monitoring the demand side of the ledger, it is laser focused on the major source of increased purchasing power, the job market. As we have pointed out in recent weeks, worker pay is finally outpacing inflation, imparting a boost to real disposable incomes. That's a key impetus to spending, particularly if it is accompanied by plentiful job opportunities, giving workers the income security to keep their wallets open. By all accounts, the job-creating engine is still humming, with payrolls growing faster than the Fed deems consistent with slowing wage gains. And while the headlines are replete with layoffs at tech and financial firms, these workers are apparently easily finding jobs elsewhere. First-time applications for unemployment benefits, after a modest pop a month ago, have resumed their decline in recent weeks and are hovering near record lows.

Given this backdrop of sustained consumer spending and a still robust labor market, it is hard to see the economy on the cusp of a recession, as many feared a few months ago. The question is, can the retreat in inflation continue even if the economy continues to expand, bringing on the elusive soft landing that would be the Goldilocks outcome the Fed hopes to achieve. As noted at the outset, some believe the path to that scenario has widened, raising the odds that the next rate hike expected at the July 25-26 meeting will be the last of the Fed's tightening cycle. From our lens, the jury is still out regarding future policy moves, but we are not believers in the immaculate disinflation implied by the soft-landing scenario.

Granted, the odds the Fed will go ahead with more rate hikes later this year have declined. At this point, we believe that the quarter-point increase expected next week will likely be the last of the cycle, leaving the terminal rate within a range of 5.25-5.50 percent. At the last meeting in June, policymakers signaled two more increase, which would raise the final rate to 5.50-5.75 percent. Some believe that the Fed will skip a meeting before hiking rates again, much as it did in June, and then hike again in November or December. It will be interesting to see if the policy statement released after next week's meeting provides a clue to the Fed's thinking regarding future plans. Clearly, there are several who prefer a wait-and-see approach to monitor the lagged effects of past rate increases.

However, even if the Fed moves to the sidelines for the remainder of the year, as we expect, the damage is already in the pipeline. Most of the data depicting economic strength are backward looking, particularly the jobs data. Layoffs may be low because companies are hoarding workers to avoid the rehiring difficulties that bedeviled them during the post-pandemic recovery. But they are cutting worker hours instead, resulting in a surge in involuntary part-time jobs in June. This is cutting into weekly earnings and forcing households to tap into savings to sustain purchases. But those savings are rapidly depleting, and consumers are relying more on credit cards to fill the gap. A worrying sign is that credit card defaults are rising, and lenders are starting to clamp down on this form of borrowing, as reflected in the Fed's latest survey of bank lending officers.

The cut in worker hours is the first sign that job growth is poised to slow in coming months, foreshadowing outright layoffs early next year. Meanwhile, the fall in inflation should continue, pulled down by falling rents that is already unfolding in many markets, although it will probably not hit the 2 percent target until late

2024. But as inflation continue to fall, so too will wage demands as workers become ever more concerned with job security. Job hopping has already slowed and the gap in pay between job switchers and stayers is narrowing. There is a good chance that the Fed will recognize these growth-retarding forces in time and keep its finger off the rate-hiking trigger. That may not prevent the economy from sliding into a recession early next year, but it enhances the probability that the downturn will be mild.

FINANCIAL INDICATORS

INTEREST RATES	Jul 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.42	5.41	5.30	2.38
6-month Treasury bill	5.48	5.48	5.41	2.86
2-year Treasury note	4.86	4.75	4.75	2.99
5-year Treasury note	4.10	4.05	3.99	2.85
10-year Treasury note	3.84	3.83	3.74	2.76
30-year Treasury bond	3.90	3.93	3.81	2.97
30-year fixed mortgage rate	6.78	6.96	6.67	5.54
15-year fixed mortgage rate	6.06	6.30	6.03	4.75
STOCK MARKET				
Dow Jones Industrial Index	35,227.69	34,509.03	33,727.43	31,899.29
S&P 500	4,536.34	4,505.42	4,348.33	3,961.63
NASDAQ	14,032.81	14,113.70	13,492.52	11,834.11
COMMODITIES				
Gold ($ per troy ounce)	1,963.80	1,959.30	1,929.90	1,724.90
Oil ($ per barrel) - Crude Futures (WTI)	76.87	75.26	69.31	94.94

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Reail Sales (June) - % change	0.2	0.5	0.4	0.4
Industrial Production (June) - % change	-0.5	-0.4	0.6	0.1
Housing Starts (June) - 000s	1,434	1,559	1,348	1,416
Building Permits (June) - 000s	1,440	1,496	1,417	1,438
Existing Home Sales (June) - mlns of units	4.2	4.3	4.3	4.3

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