Weekly Economic Update—July 31st, 2023

The Fed's decision to hike rates again last week was widely expected and, importantly, the right choice given the economic and inflation backdrop prevailing at the time of the FOMC meeting. Data released in the two days since the meeting buttress the credibility of the move and leaves open the possibility of another increase in upcoming meetings. We continue to believe that this will turn out to be the last increase of the 16-month tightening cycle but recognize the prevailing bias among some policymakers to err on the side of going too far rather than prematurely loosening the reins. Nothing so far, has caused them to change that bias, particularly since recession fears are receding ever further into the background.

Indeed, if cooling economic activity is a key determinant of whether the Fed will step back from future rate hikes the data this week were not cooperative. The day after the FOMC meeting, the Commerce Department released its initial report card on the economy's performance in the second quarter. By most measures, it performed better than expected. Adjusted for inflation, GDP staged a robust 2.4 percent growth rate, outpacing the 2.0 percent increase in the first quarter. The underlying details were just as impressive. Real consumption did slow from the first quarter's outsize 4.2 percent growth rate, slipping to a still-respectable 1.6 percent pace. But the first-quarter's surge was all front loaded, compressed into a weather-related spike in January. The monthly gains tailed off significantly in the following two months, but the weak handoff to the second quarter was merely a head fake, as consumer spending rebounded in April and ended the second quarter on a solid note.

Importantly, the second quarter's GDP report featured something that was missing in the first quarter—a solid increase in business capital outlays. Business spending on equipment leaped by a sturdy 10.8 percent, the strongest gain since the first quarter of 2022, following two quarterly contractions, including an 8.9 percent setback in the first quarter. Spending on structures also posted a solid gain for the third consecutive quarter, increasing by 9.7 percent, following outsized increases of 15.8 percent in each of the previous two quarters. These robust outlays, which may well be supported by the infrastructure spending bill, are not consistent with a business mind-set that is gearing up for a recession.

Still, while business investment spending adds heft to the economy's growth rate, it also boosts the economy's output potential and, hence, contributes to the Fed's mission to tame inflation, albeit the positive effects will take time to unfold. Usually, capital spending is one of the first sectors to fall as the economy heads into a recession. But outlays on buildings and equipment contributed almost a full percentage point to the 2.4 percent growth rate in the second quarter, just a tad under the impetus provided by consumers, which account for 70 percent of GDP. That's a tradeoff the Fed would gladly accept as less demand and more capacity is a sure-fire recipe for disinflation. Not only does it portend more physical capacity, but stepped-up spending on capital equipment also improves productivity, which is a win-win for workers, as stronger productivity sets the stage for real wage increases.

To be sure, a deep recession would slash profits and put the kibosh on investment spending. However, not only did the economy put in a much stronger performance than expected in the second quarter, but it also ended the period with considerable momentum, underscoring the widespread sentiment among economists – including us – to push back the likely timing of the recession. The Fed's own staff now disavows the recession call it made in June, as confirmed by Jerome Powell at the post-meeting press conference this week. No doubt, there are still some who believe the economy is experiencing a Wile E. Coyote moment – suspended in thin air and poised for a sudden and steep drop. But the ground underneath the economy is looking much firmer heading into the third quarter than thought a few weeks ago, thanks to the solid underpinnings provided by consumers and businesses.

Households are keeping their wallets wide open as confirmed by the June personal income and spending report released on Friday. Unlike the end of the first quarter when real consumer outlays retrenched in the final months of the period, personal consumption ended the second quarter with a full head of steam, advancing by a sturdy 0.4 percent, the strongest since that aberrational jump in January. Even if consumers take a breather over the summer, the die is cast for another gain in the third quarter. That's because the level of outlays in June stood comfortably above the average of the second quarter. Hence, even if consumers keep spending level in July through September, the average for the period would rise by an annual rate of more than 1 percent above the second quarter.

Likewise, capital spending is not about to collapse in the third quarter and overwhelm the positive thrust from consumers. Not only did shipments of nondefense capital goods orders excluding aircraft – a proxy for equipment spending – end the quarter at a higher level than the average for the period, but new orders also forged ahead for the third consecutive month in June. That said, the shipments data may overstate the forward momentum in capital spending as they have increased faster than new orders for five consecutive months, reflecting the unclogging of bottlenecks that are allowing shipments to catch up with older bookings. The catchup phase is over, as unfilled orders have been shrinking since last September, albeit at elevated levels.

The question for the Fed is to determine how much higher, if at all, it needs to lift rates to tamp down growth – and speed up the disinflationary process. Clearly, policy makers are surprised by the resilience of consumer and business spending in the wake of the most aggressive rate-hiking campaign in nearly forty years. In retrospect, the excess savings households accumulated from generous fiscal transfers and unspent funds during the pandemic are playing a larger role in supporting spending than expected. The astonishing rebound in job growth from the pandemic-induced recession as well as the extent of labor hoarding that still prevails have also been a major surprise. The savings cache is shrinking, and the job market is loosening up a bit, trends that will sap some steam from the economy's momentum over the second half of the year.

But the bite from the Fed's aggressive rate hikes may also be taking longer than usual to restrain activity for another reason. Simply put, households and businesses have locked in low borrowing costs when they raised funds – or refinanced existing loans – at the rock-bottom rates that prevailed before the Fed started its tightening campaign. Indeed, despite rising debt burdens in recent years, net interest payments by corporations have fallen considerably over the past five years, including a particularly sharp drop from pre-pandemic levels. But while this has freed up cash to spend on labor and capital, it is not a permanently open spigot, as these low-yielding debt obligations are gradually coming due and will need to be refinanced at the much-higher existing rates. According to some estimates, about half of the debt owed by less credit-worthy companies are maturing over the next two years.

So far, credit defaults have been contained and credit spreads have been surprisingly narrow. We suspect, however, that as the lagged effects of higher rates restrain growth and lenders tighten credit standards, these firms will fall on hard times and be forced to rein in spending. And while homeowners who locked in mortgage rates at 3-4 percent may not be perturbed by the current near 7 percent financing cost, they are keeping their homes off the market for that very reason, constricting supply and sales activity in the housing market. It may take longer than expected, but we believe the economy faces some gathering headwinds that will steadily erode its strength and usher in a recession, if not this year than in early 2024. The good news is that the disinflationary trend has legs, which along with the ebbing of the economy's resilience should short-circuit additional rate increases by the Fed.

FINANCIAL INDICATORS

INTEREST RATES	Jul 28	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.43	5.42	5.32	1.67
6-month Treasury bill	5.49	5.48	5.45	2.48
2-year Treasury note	4.88	4.86	4.90	2.84
5-year Treasury note	4.17	4.10	4.15	2.89
10-year Treasury note	3.95	3.84	3.83	2.89
30-year Treasury bond	4.01	3.90	3.87	3.12
30-year fixed mortgage rate	6.81	6.78	6.71	5.70
15-year fixed mortgage rate	6.11	6.06	6.06	4.83
STOCK MARKET				
Dow Jones Industrial Index	25,459.29	35,227.69	34,407.60	31,097.26
S&P 500	4,582.23	4,536.34	4,450.38	3,825.33
NASDAQ	14,316.66	14,032.81	13,787.92	11,127.85
COMMODITIES				
Gold ($ per troy ounce)	1,958.80	1,963.80	1,926.80	1,810.10
Oil ($ per barrel) - Crude Futures (WTI)	80.67	76.87	70.50	108.40

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Real GDP (Q2) - % Change, Saar	2.4	2.0	2.6	1.3
Durable Goods Orders (June) - % change	4.7	2.0	1.2	1.2
Personal Income (June) - % change	0.3	0.5	0.3	0.4
Personal Spending (June) - % change	0.5	0.2	0.6	0.6
Personal Savings Rate (June) - Percent	4.3	4.6	4.3	4.4

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