Weekly Economic Update—Aug 7th, 2023

It's notable that an expanding list of forecasters are pulling away from recession forecasts (we are not there yet), as the economy continues to exhibit more resilience than most expected. More significant, however, is that CEOs are also upping their sights for the economy, according to Bloomberg, and aligning their budgets with their more upbeat thinking. Their assessment, of course, has more influence on the real world than that of economists, as they're the ones who do the hiring and make the investments that contribute mightily to the economy's performance. As the latest GDP report for the second quarter highlights, consumers are still the main growth driver, but businesses are clearly doing more of the heavy lifting. Spending on equipment, structures and intellectual property accounted for 41 percent of GDP growth in the second quarter, the strongest contribution since 2018.

It can be argued that the more spending muscle businesses flex, the greater the odds of a recession because it encourages the Fed to continue raising rates until something breaks and brings down inflation. But it can also be argued that increased investment spending spurs stronger productivity, which enables the economy to grow faster without stoking inflation. Indeed, this is the logic that the then Fed Chair Alan Greenspan used in the late 1990s when he kept rates unchanged for four years amid a productivity-fueled growth surge that unfolded in a generally tame inflationary environment. To be sure, it would be a mistake to interpret the eye-popping 3.7 percent spike in productivity during the second quarter as a sign the economy is returning to that 1990s Goldilocks environment. The quarterly changes tend to be very noisy, and the second quarter productivity surge assumes virtually no job growth during the period, which we know wasn't the case.

That said, there is a great deal of controversy over why inflation has receded quite dramatically this year even as the economy has grown at an above-trend pace. Some of the reasons are obvious and have nothing to do with productivity – falling oil prices, easing supply-chain constraints and normalization of consumer spending, relieving pressure on goods prices. Take out pandemic-related influences as well as the disruptions caused by the war in Ukraine, and underlying price trends are less favorable although still moving in the right direction. Still, it is fair to ask if the disinflationary trend can be sustained even as the economy continues to grow amid an historically tight job market. This is the question that policymakers will be grappling with in coming months, and the latest jobs report for July does not make the task any easier. It does, however, depict an economy that an ever-increasing number of forecasters believe is heading for a soft landing.

Simply put, the latest jobs report is as close to a Goldilocks outcome as could be hoped. For one, it pushes recession fears further onto the back burner. The economy generated 187 thousand new jobs in July, well above growth in the labor force and the working-age population. Statistically speaking, anyone looking for a job could find one, something that a previous report on labor turnover confirmed. At the end of June, that report showed there were 1.6 job openings for every unemployed worker. With the job-creating engine still chugging along at an above-trend pace, the economy is not about to fall off a cliff, as the consensus of forecasters earlier this year firmly believed would be happening just about now. One of the few major sectors to cut jobs was manufacturing, where payrolls contracted by a miniscule 2 thousand last month. Clearly, the economy has not yet succumbed to the Fed's aggressive rate hikes nor the banking turmoil in the spring that stoked recession fears earlier in the year.

For another, the jobs report provides encouraging news for inflation doves, who believe the Fed should take its finger off the rate-hiking trigger. While the job market is still humming along, it is doing so at a gradually slowing pace bereft of the upside surprises that prodded the Fed to raise rates at every meeting

until June of this year. The 187 thousand increase in nonfarm payrolls last month was below the consensus forecast of 200 thousand and followed a downwardly revised increase of 185 thousand in June. Successive months of downward revisions is a time-honored sign that the demand for labor is easing. It also indicates that restoring a balance between the demand and supply for workers is within sight, something that would ease upward pressure on wages.

The June and July readings for payroll growth were the first to come in below 200 thousand since the recovery began in early 2020. Over the previous four months, payrolls increased by an average of just under 300 thousand a month. What's more, fewer industries are adding workers. In July, 57.2 percent of industries expanded payrolls, down from 58.8 percent in June and 64.6 percent at the start of the year. And even as fewer industries are hiring, they are also cutting back on worker hours. The average workweek was trimmed to 34.3 hours from 34.4 in June, equaling the low for the cycle. Employers are understandably cutting hours instead of laying off workers in deference to the hiring difficulties they encountered amid the acute labor shortages in 2021 and 2022.

On balance, the latest jobs report provides more reasons for the Fed to leave rates unchanged at its upcoming policy meeting on September 19-20. Indeed, Atlanta Fed president Bostic reasserted his view that the Fed should be done hiking rates. However, Bostic is not a voting member on the FOMC this year and there are still more reports to digest before the next meeting convenes, including another jobs report (for August) and two inflation reports. Any upside surprises could easily tilt the balance among voting officials towards another rate increase, if not in September than at the November confab. Keep in mind that most FOMC members expect to raise rates one more time this year, according to the latest set of projections made in June. Fed chair Powell gave no indication there was a change in sentiment at the press conference following the July FOMC meeting.

But the latest employment report had something for everyone, including the inflation hawks. Most notably, it depicted a job market that is still historically tight and generating hefty wage increases. The unemployment rate dipped to 3.5 percent from 3.6 percent, staying within the narrow 3.4-3.7 percent band that prevailed in the final months of the pre-pandemic expansion and not previously seen since the late 1960s. Meanwhile, companies are still paying up to lure new workers and prevent existing workers from quitting. Average hourly earnings increased by 0.4 percent in July, matching June's increase and sustaining the year-over-year pace at 4.4 percent. That's still too strong for the Fed, which would like to see wage increases slow to 3.5 percent to be consistent with its 2 percent inflation target.

However, average hourly earnings are not a reliable measure of worker pay because it is influenced by compositional changes in the workforce. That might be having a bigger impact than usual now as layoffs are more pronounced in high-paying than lower paying sectors. In July, for example, the biggest contraction in payrolls occurred among information and business and professional services, two of the highest paying sectors in the economy. Other measures of worker pay that are not skewed by compositional changes, such as the employment cost index, reveal an ongoing slowing trend, although not enough of a slowdown to comfort the Fed. Still, the trend is encouraging, and we believe the Fed will decide that more patience is warranted at its upcoming meeting, prompting it to move to the sidelines for the rest of the year. That prospect is gaining support in the forecasting community and is contributing to the growing sentiment that a soft landing is more likely than not. However, we still believe that the lagged effects of the Fed's rate hikes together with tightening credit conditions have yet be fully felt and will likely tilt the economy into a recession around the turn of the year.

FINANCIAL INDICATORS

INTEREST RATES	Aug 4	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.41	5.43	5.36	2.50
6-month Treasury bill	5.46	5.49	5.48	2.87
2-year Treasury note	4.78	4.88	4.96	3.22
5-year Treasury note	4.14	4.17	4.37	2.77
10-year Treasury note	4.05	3.95	4.07	2.84
30-year Treasury bond	4.02	4.01	4.05	3.07
30-year fixed mortgage rate	6.90	6.81	6.81	4.99
15-year fixed mortgage rate	6.25	6.11	6.24	4.26
STOCK MARKET				
Dow Jones Industrial Index	35,065.62	35,459.29	33,734.88	32,803.47
S&P 500	4,478.03	4,582.23	4,398.95	4,145.19
NASDAQ	13,909.24	14,316.66	13,660.72	12,657.55
COMMODITIES				
Gold ($ per troy ounce)	1,978.20	1,958.80	1,930.50	1,792.40
Oil ($ per barrel) - Crude Futures (WTI)	82.62	80.67	73.67	88.53

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (July)	46.4	46.0	46.9	46.7
ISM Services Index (July)	52.7	53.9	50.3	52.5
Nonfarm Payrolls (July) - 000s	187	185	281	223
Unemployment Rate (July) - percent	3.5	3.6	3.7	3.6
Average hourly earnings (July) - % change	0.4	0.4	0.3	0.4

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