GPA GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—September 11th, 2023

To the chagrin of the administration, recent polls reveal that the public has a dim view of the economy, with most households seeing it heading in the wrong direction despite generally upbeat data on jobs, income and, yes, inflation, which looms as the biggest concern among respondents. But the grim view held by the public is not as ubiquitous in business surveys, many of which report that things are just fine – and getting even better. The latest example is the survey of service providers by the Institute for Supply Management (ISM) whose index of activity shot up 1.8 points to 54.5 in August, the highest in six months and well above the consensus forecast. Most had expected a slight drop, consistent with the general view that the economy was cooling off.

Since the service sector accounts for about 75 percent of GDP and almost as high a share of employment, its upbeat reading is clearly worth noting. That said, just as the downbeat sentiment among households is not a reliable barometer of their actual behavior, so too is the survey of businesses not a dependable indicator of spending and hiring practices. After all, consumer spirits have been in the doldrums for some time; yet households have kept their wallets and purses wide open, supporting a sturdy growth in consumption through the second quarter and early in the third. One issue with business surveys is that respondents tend to view things through a rear-view mirror, and it may take time to recognize conditions are changing. Many believe that businesses are hoarding labor – imparting artificial strength to the job market – reflecting recent worker shortages that are heightening fears of rehiring difficulties down the road. But a better balance between labor demand and supply is emerging. As that trend continues amid softening sales and revenues, the hoarding impulse should wane and morph into outright layoffs.

The lagged effects are starkly evident in the ISM survey around the Great Recession. The index of service-sector activity hovered above the 50 threshold that separates expanding from contracting activity in four of the first eight months of 2008, when the downturn was well underway. Likewise, the index did not fall decisively below 50 until the fourth month of the 2001 dot-com induced recession. That's not to suggest a stealth recession is currently unfolding under the radar of service-sector firms. But the big jump in the employment component of the index may well reflect overly ambitious perceptions of staffing needs in coming months. That said, the competition for workers remains intense, and rising labor costs are driving up prices paid in the service sector, a combination that is sustaining the hoarding impulse as well as contributing to the sticky inflation the Federal Reserve is striving to bring down.

Keep in mind also that while the broad currents, as measured by GDP, may still be moving at a brisk pace, the rising tide is not lifting all boats. A deeper dive into the economic waters indicates that a rolling recession is underway, with some sectors already sinking. Manufacturing activity has been slumping for some time, weighed down by the post-pandemic normalization of consumer spending, as households have shifted purchases from goods to services. The same ISM survey that depicts a blistering pace of service-sector activity paints just the opposite picture for the manufacturing sector. It's companion index of manufacturing activity has remained in contraction territory (under 50) for ten consecutive months through August, something that has happened only once outside of a recession. That outlier occurred in 1995 when the Fed successfully navigated the economy on to a soft landing, which a growing number of economists believe it is well on its way to accomplishing again.

We are not in that camp yet, but it's important to note that the service sector has an even greater influence on the economy now than it did in 1995. As a share of GDP, for example, consumer spending on services has increased from about 40 to 46 percent over the period. Hence, the service sector constitutes a critical buffer against the Fed's aggressive rate hikes, which have a far bigger impact on goods purchases than on

services. No doubt, the resilient consumer demand for services this year has contributed mightily to the economy's ability to plough ahead in the face of the Fed's tightening policies. But the influences underpinning that resilience are waning, and we suspect that by later this year their impact will be further diminished, putting the economy on the cusp of a recession.

For one, the formidable cash balances provided by copious government stimulus payments during the pandemic as well as the unspent funds during lockdowns are running out. Estimates vary as to how much is left, but several studies suggest that the well will run dry before the end of the year, if not during the current quarter. Since more of those savings were in the hands of lower-income households than previously thought, the spending drag from the depletion of financial resources might also be greater than expected. The enhanced savings held by upper-income households are more likely to be treated as wealth rather than for spending purposes.

With less savings to draw on, consumers will rely more heavily on income growth to support spending. The astonishing job-creating engine that has powered a vigorous rebound in paychecks from the pandemic recession is still chugging along but running on fewer cylinders. Job growth has cooled noticeably in recent months, companies are listing fewer vacancies, both in absolute terms and relative to job seekers, workers are quitting less frequently, and the wage premium for switching jobs has almost vanished. While some service-sector industries are still facing worker shortages – particularly in health care and leisure and hospitality – they are the least financially equipped to offer the higher salaries needed to attract workers. As noted earlier, a better balance between the demand and supply of labor is well underway, which is taking some pressure off the rise in labor costs that, in the eyes of the Federal Reserve, is a key hurdle preventing a faster decline in inflation, particularly in services.

The good news for workers is that inflation is receding faster than wages, which still bolsters the purchasing power of their paychecks. That's also good news for the Fed, as it advances soft-landing prospects by cushioning the growth-retarding impact of a tightening policy. After all, the goal is not to curb growth just for the sake of curbing growth, but to bring down inflation. If that is happening amid a growing economy, so much the better. But there are potholes lining the road towards that Goldilocks scenario. The disinflationary trend, at least on the headline level, has received a major assist from easing gasoline prices over the past year, but that influence has been abruptly reversed as oil prices have shot up by 25 percent over the past three months. Crude oil quotes are hovering just under $90/barrel, the highest since last November. Retail prices at the pump are following suit, as motorists are paying 25 percent more for regular gasoline in early September than at the start of the year.

Just as the decline in gas prices served as a tax cut for consumers, the turnaround can be seen as a tax increase. Worse, the inflation boost caused by higher gasoline prices is not something the Fed can counteract, as the recent upsurge is fueled by supply cutbacks recently announced by Saudi Arabia and Russia, two major oil producers. Nor is oil the only culprit threatening the supply chain – and inflation – as a potential UAW strike of 150 thousand autoworkers if a settlement is not reached in mid-September would severely disrupt assembly lines, short-circuiting the rebuilding of inventories that have yet to recover from pandemic era chip shortages. Simply put, the threats to both growth and inflation remain very much alive, underscoring the noncommittal messages conveyed by Fed officials regarding the future course of interest rates.

FINANCIAL INDICATORS

INTEREST RATES	Sep 8	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.46	5.44	5.43	2.96
6-month Treasury bill	5.53	5.50	5.49	3.55
2-year Treasury note	4.97	4.87	4.89	3.56
5-year Treasury note	4.41	4.30	4.30	3.40
10-year Treasury note	4.27	4.19	4.15	3.32
30-year Treasury bond	4.34	4.30	4.26	3.45
30-year fixed mortgage rate	7.12	7.18	6.96	5.89
15-year fixed mortgage rate	6.52	6.55	6.34	5.16
STOCK MARKET				
Dow Jones Industrial Index	34,576.59	34,837.71	35,281.40	32,151.31
S&P 500	4,457.49	4,515.77	4,464.05	4,067.36
NASDAQ	13,761.53	14,031.81	13,644.85	12,112.31
COMMODITIES				
Gold ($ per troy ounce)	1,942.60	1,966.20	1,945.70	1,727.60
Oil ($ per barrel) - Crude Futures (WTI)	87.23	86.05	83.04	86.10

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
ISM Services Index (August)	54.5	52.7	53.9	52.4
Consumer Credit (July) - $blns	10.4	14.0	0.0	11.7

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