Weekly Economic Update—September 25th, 2023

Amid a slim calendar of economic data, all eyes were on the Federal Reserve's policy meeting this week as well as what Chair Jerome Powell had to say about the confab at the post-meeting press conference. The headline news that the Fed would not raise rates came as no surprise, as that was the bet by traders and commentators heading into the meeting. Any deviation would surely have upset the financial markets, something that the Fed usually tries to avoid. That said, the markets were hardly a model of tranquility following the meeting, as stock prices slumped, and yields surged throughout the maturity spectrum to levels not seen since before the financial crisis in 2007. While the Fed's decision to hold rates steady confirmed expectations, so too did the unwelcome news that the Fed is inclined to hike another time this year and keep rates higher for longer next year as well. That hawkish bias was not entirely surprising, but the confirmation embedded in the Summary of Economic Projections by the 19 members of the policy committee still landed like a bombshell. Sometimes seeing the writing on the wall is more impactful than having confidence beforehand what is likely to occur.

Essentially, officials upgraded their growth forecast for the US economy, which underpinned their collective mind-set that higher rates could be both tolerated and needed in 2024 and 2025 compared to their expectations made in the previous projections released in June. While projected inflation for this year also fell relative to what was expected three months ago, that did not deter policy makers from thinking more needs to be done to wrestle inflation down to their 2 percent target. Powell noted that the improved inflation trend underway was pleasantly surprising, but still fretted that easing up on the brakes risk undoing the progress made so far. The ghost of the 1970s still haunts the Fed, stoking fears that a premature easing before inflation is fully vanquished risks reigniting the embers and a stronger fire that would require a tougher response to extinguish the flames.

Understandably, the Fed is relying heavily on incoming data to make its decisions. Clearly, the economy has held up much better in the face of the rapid climb in interest rates than expected. Revised data on GDP scheduled in coming weeks may well show that activity was not as strong this year as thought; but the Fed plays with the cards it is dealt, and the deck so far is tracking another solid growth rate in the third quarter, exceeding the pace of the first half of the year. True, most of the heft was front-loaded as most indicators since July, including the all-important jobs data, has tapered off. But despite ominous forward-looking signals, such as the deeply inverted yield curve, sagging consumer and business sentiment and persistent negative readings from the Conference Board's leading economic indicators, there is scant hard evidence that the economy is on the cusp of a recession.

It's important to remember, however, that the Fed's projections are just that – projections, not a contract that is punishable if the terms are not fulfilled. To be sure, if the projections and policy responses turn out to be egregiously – and repeatedly -- wrong, the Fed's credibility would be undermined, and its actions would be punished by recalcitrant financial markets. Recall the bond vigilantes that forced the Fed to raise interest rates before it was ready to do so. But to its credit, the Fed's latest projections has bought an army of believers out of the woodworks, as the surge in market yields suggests that investors genuinely believe the Fed will follow through with its intention to keep rates higher for longer. At this juncture, the markets are following the Fed's lead, not leading it.

However, the Fed's intention to keep rates "higher for longer" is only credible if its economic projections hold true. This, of course, is where the rubber meets the road, as the fog of uncertainty can derail the best laid plans. And while uncertainty increases the longer the time horizon, in this case things can easily go awry over the next few months, if not weeks. The list of potential disruptive events that can throw a wrench

into the economy's performance is long. The UAW strike is already sending tremors through the auto industry and the union is poised to expand work stoppages beyond the three plants it has already struck. The length and breadth of the strike will determine how much of an impact it will have on the manufacturing sector, as the effects reverberate through ancillary companies that supply parts to the automakers.

Even if the strike is settled sooner rather than later, it will feature a hefty wage increase for workers, throwing a brighter spotlight on labor cost pressures that the Fed believes is a key obstacle in the last leg of the inflation fight. Virtually all measures of labor costs are running well above the 3.5 percent annual increase deemed to be consistent with a 2 percent inflation rate, after accounting for productivity gains. In the worst-case scenario, a prolonged strike takes a major toll on activity and still results in a hefty wage increase, a recipe in microcosm for stagflation that would greatly complicate the Fed's decisions. Importantly, a prolonged strike would also short-circuit efforts by the industry to rebuild inventory on dealer lots that remain far below normal levels. Like the broader supply chain disruptions that helped launch the inflation cycle early in the post-pandemic recovery, a further reduction of inventories would result in higher prices on autos than otherwise.

Nor is the outcome of the UAW strike the only uncertainty clouding the near-term outlook. The prospect of heightened financial turbulence looms amid a confidence-rattling government shutdown if House Republicans do not agree on a continuing resolution by September 30 to fund the government. A shutdown means that government workers would temporarily lose their paychecks and, importantly, low-income households would lose food stamp payments, a cutoff that portends an abrupt hit to consumer spending as these recipients have little in the way of savings to tide them over. As of Friday morning, talks were still at an impasse, and lawmakers went home for the weekend without a deal. Odds are market jitters will intensify as the calendar moves closer to the month-end next week.

Meanwhile, tens of millions of households are required to start repaying student loans in October, which will crimp budgets and pose some drag on consumer spending. As well, pandemic relief payments for childcare are about to be cut off, which not only saps spending power of affected parents, but could also keep many from returning to the labor force. Finally, it's hard to ignore the spike in oil prices that has spurred a sharp increase in prices motorists are paying at the pump. The headlines make this out to be an inflation trigger that adds support for the Fed's "higher for longer" mantra on interest rates. However, higher fuel prices also constitute a tax increase for millions of drivers, posing another potential drag on spending. The Fed's upgraded growth forecast for 2024 looks beyond these near-term impediments, but we believe they are potholes that will make for a bumpy ride in coming months and, most likely, stifle the economy's momentum early next year.

FINANCIAL INDICATORS

INTEREST RATES	Sep 22	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.48	5.47	5.49	3.19
6-month Treasury bill	5.53	5.52	5.56	3.90
2-year Treasury note	5.11	5.04	5.08	4.21
5-year Treasury note	4.58	4.46	4.44	3.99
10-year Treasury note	4.45	4.34	4.22	3.69
30-year Treasury bond	4.53	4.42	4.28	3.61
30-year fixed mortgage rate	7.19	7.18	7.23	6.29
15-year fixed mortgage rate	6.54	6.51	6.55	5.44
STOCK MARKET				
Dow Jones Industrial Index	33,963.84	34,618.24	34,403.03	29,590.41
S&P 500	4,320.06	4,480.32	4,410.43	3,693.26
NASDAQ	13,211.81	13,708.33	13,593.35	10,867.93
COMMODITIES				
Gold ($ per troy ounce)	1,945.20	1,945.20	1,941.30	1,651.70
Oil ($ per barrel) - Crude Futures (WTI)	90.34	91.34	79.80	79.43

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average- Past Six Months or Quarters
Housing Starts (August) - 000s	1,283	1,447	1,418	1,410
Building Permits (August) - 000s	1,543	1,443	1,441	1,467
Existing Home Sales (August) - mlns	4.04	4.07	4.16	4.22

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