Weekly Economic Update—October 2nd, 2023

September is shaping up to be the worst month for stocks this year, but the bleeding slowed at the end of the month thanks to some welcome news on the economic front on Friday. To be sure, the political environment continues to cast a dark cloud over the economic landscape, as a government shutdown is almost a certainty as of Friday afternoon. That prospect means government workers will be missing paychecks for as long as the shutdown lasts, and wide swaths of the public will suffer because of the absence of services that they would otherwise receive. It also means that the statistical gathering agencies in Washington will not be publishing key data, such as on employment and consumer prices among other reports that will cause policymakers at the data-dependent Fed to "fly blind" as they face critical decisions regarding interest rate moves.

As the calendar turns to October, the shutdown is one of several ongoing shocks that are expected to sap the economy's momentum in coming months. The autoworkers strike is poised to expand and throw a wrench in assembly lines, just as the industry is struggling to rebuild lean inventories on dealer lots. Like the government shutdown, the longer it continues and spreads to more plants, the greater will be the repercussions for the broader economy. Meanwhile, the restoration of student loan repayments will sap the purchasing power of millions of borrowers, and the cutoff of Federal payment to childcare providers will put a further squeeze on the budgets of parents, particularly in low-income households. Finally, oil prices are approaching $100 a barrel and sending prices at the pump higher. So far, its main effect has been to drive up headline inflation and undercut consumer confidence. But the longer fuel prices stay elevated, the more likely that the dollars spent at service stations will be diverted from other spending purposes.

These shocks, by themselves, should not constitute enough of a drag to send the nation into a recession. Incoming data strongly suggest that the economy entered the fourth quarter in solid shape, tracking a growth rate of at least 3 percent in the third quarter. A $22 trillion behemoth doesn't just fall off a cliff unless an existential shock – like the pandemic that abruptly locks down activity – unexpectedly strikes. None of the shocks seen so far meets that condition, and all have been telegraphed well in advance. That said, the tailwinds underpinning the third-quarter's growth are fading, and it is highly likely that the peak for the cycle is now in the rear-view mirror. Whether it will be the last quarter to feature a positive growth rate remains to be seen, but the thrust from consumers, the economy's main growth driver, is already losing steam and is poised to weaken further.

That trend was amply revealed in Friday's personal income and spending report – which stands to be the last key government report if the shutdown persists much beyond the weekend. As noted at the outset, the final report for the month provided some positive news, particularly for the Federal Reserve. The Fed has been striving to cool demand in its inflation fight through its aggressive rate-hiking campaign. But it has met a wall of resistance so far, as evidenced by the sturdy growth indicated by incoming data for the third quarter. But the personal income and spending report confirms that the third-quarter strength was front-loaded with its main thrust coming in July. In dollar terms, consumers kept their wallets open, staging a solid 0.4 percent increase in consumption in August, following an eye-opening 0.9 percent surge in July. However, prices rose almost as much, so real spending edged up by only 0.1 percent. Again, since the slim gain in August comes off such a high base in July, the quarterly growth rate will still come in on the strong side.

Just as important is where the money came from to support spending. Like the spending side, household incomes also showed a respectable gain, growing by 0.4 percent, the strongest in five months. But higher taxes and inflation wiped out the entire increase, and then some. Real disposable incomes actually fell in August for the second consecutive month. That means consumers had to dip into their savings to finance their purchases. Hence, the personal savings rate fell to 3.9 percent from 5.3 percent in May. Interestingly, the comprehensive revisions to the national income accounts released this week reveals that households retained considerably more income and savings than initially thought in recent years. The increased savings – as much as $1 trillion was added to savings balances – suggests that consumers have more firepower to keep on spending.

However, we do not have a revised reading on who holds these incremental savings. We suspect that most of it is in the hands of upper-income individuals, who tend to treat these funds more as wealth rather than for spending purposes. Given the sharp increase in gas, food and housing costs, which account for a larger fraction of low-income budgets, it is more than likely that the savings of this cohort has been mostly depleted. That, along with the surge in borrowing costs and student loan repayments should put a dent in the purchasing power of all but the wealthiest households going forward. Whether the crimp on spending will be strong enough to send the economy into a recession remains to be seen, but a pronounced slowdown starting in the fourth quarter is more likely than not.

For the Fed that is seeking a soft landing, the slowdown in real consumption last month is good news, with the caveat that it does not portend an outright cutback in spending, which would almost surely translate into a recession. Assuming that a downturn is not in the cards, the Fed has to be happy with the inflation readings coming out of the personal income and spending report. As expected, the spike in gasoline prices did drive up the personal consumption deflator, which increased 0.4 percent in August, double the July increase and the largest monthly increase since January. But the core deflator, which excludes volatile food and energy prices, that the Fed more closely monitors, posted a slim 0.1 percent gain. That's the smallest increase since November 2020 and extends the gradually slowing trend underway since the spring.

Indeed, over the last three months, the core deflator has increased by an average annual rate of 2.15 percent, which is only a tad above the Fed's 2 percent inflation target. We expect that easing trend to continue as the economy downshifts to a slower growth rate and the pronounced slowing in market rents feeds through to shelter prices, which has been a major influence pushing up the core inflation rate. What's more, the Fed is getting its wish that the recent inflation cycle does not infiltrate household expectations. Usually, a headline-grabbing sustained increase in gasoline prices would have a major impact on consumer inflation expectations. If the latest survey by the University of Michigan is any indication, this time it is not. According to its release on Friday, household inflation expectations over the next year fell to 3.2 percent in September, the lowest since March 2021.

At its last policy meeting, the Fed indicated that it would be raising interest rates one more time this year. However, the latest tamer inflation reading argues for more patience. A prolonged data drought would be another reason to expect the Fed to refrain from further rate hikes. Fed Chair Powell last week stressed that policy decisions are being made on a meeting-by-meeting basis, based on the "totality" of the incoming data. The absence of key reports on the economy and employment would leave the Fed with a very murky picture of how the economy is evolving.

FINANCIAL INDICATORS

INTEREST RATES	Sep 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.46%	5.48%	5.44%	3.27%
6-month Treasury bill	5.55	5.53	5.50	3.95
2-year Treasury note	5.05	5.11	4.87	4.28
5-year Treasury note	4.62	4.58	4.30	4.07
10-year Treasury note	4.58	4.45	4.19	3.83
30-year Treasury bond	4.71	4.53	4.30	3.78
30-year fixed mortgage rate	7.31	7.19	7.18	6.70
15-year fixed mortgage rate	6.72	6.54	6.55	5.93
STOCK MARKET				
Dow Jones Industrial Index	33,507.50	33,963.84	34,837.71	28,725.51
S&P 500	4,288.05	4,320.06	4,515.77	3,585.62
NASDAQ	13,219.32	13,211.81	14,031.81	10,575.62
COMMODITIES				
Gold ($ per troy ounce)	1,864.60	1,945.20	1,966.20	1,668.30
Oil ($ per barrel) - Crude Futures (WTI)	90.88	90.34	86.05	79.74

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (August) - 000s	675	739	684	688
New Durable Goods Orders (August) - % change	0.2	-5.6	4.3	1.0
Consumer Confidence Index (September)	103.0	108.7	114.0	107.0

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