

Weekly Economic Update—October 30<sup>th</sup>, 2023

As advertised, the U.S. economy turned in a stellar performance in the third quarter, staging the strongest growth rate since the fourth quarter of 2021. While the monthly tracking data foreshadowed a powerful reading, the actual result still exceeded expectations. That said, no one is saying the economy is off to the races. In fact, just the opposite is the case. The consensus view is that the third quarter was juiced by forces that are poised to wane, even as growth-retarding headwinds are stiffening. But even as the growth engine is set to downshift, recession expectations that were so prevalent a few months ago are being pushed back into next year, with a groundswell of sentiment believing it can be avoided completely.

We agree with the more optimistic view of prospects, albeit we still believe the odds for a recession emerging next year are still greater than 50-50. But like most everyone else, the eye-popping growth rate turned in last quarter exceeded our expectation. The 4.9 percent increase in GDP topped the consensus forecast of a 4.5 percent advance and was the strongest outturn since the fourth quarter of 2021. The acceleration from the first half of the year was just as impressive, more than doubling the second quarter's 2.1 percent pace and the 2.2 percent in the first quarter. True, there are nitpickers that would note the caveats behind the acceleration, including major contributions from business inventory stockpiling as well as a big boost from government spending. Neither of these boosters is expected to lift GDP as much, if at all, in coming quarters.

Even removing the outsize contribution from government spending and inventory building, the economy still turned in an impressive performance. Real final sales to private domestic purchasers increased by an annual rate of 3.3 percent, about double the second quarter's advance. Indeed, private demand for these goods and services grew at a faster pace than was the case during the last two years of the pre-pandemic expansion. Within the private sector, businesses were virtually absent, as a small increase in spending on structures was offset by a decline in equipment outlays. Weakness here is expected to persist, reflecting higher borrowing costs, tighter credit conditions and reduced business expectations for capital spending reported in regional Fed surveys. The one business bright spot was provided by homebuilders, as residential outlays increased for the first time in nearly three years. New construction of single-family homes is getting a boost from the slim inventory of existing homes for sale, as homeowners are locked in with the low mortgage rates obtained years earlier.

Simply put, the muscle behind the private sector's torrid demand came from consumers, whose spending leaped by 4 percent, the strongest since the fourth quarter of 2021, and five times the 0.8 percent increase in the third quarter. The accelerated pace of consumer spending comes as no surprise, as the monthly tracking data underscored the trend, highlighted by the robust September retail sales report released last week. Friday's release of personal income and spending data rounded out that report by including spending on services. The result was more of the same; revenge spending on services, including travel and entertainment that was off-limits during the pandemic lockdown, is alive and well, rising by a sturdy 0.7 percent in current dollars, but a more modest inflation-adjusted 0.3 percent, as service prices jumped during the month. Importantly, spending on services would have been stronger if not for a pullback in outlays for financial services, most likely reflecting declining mortgage broker fees related to the slump in existing home sales.

Clearly, consumer spending, the economy's main growth driver, is benefiting from the still-hot job market, although we caution that the lofty increase in payrolls overstates the strength in worker earnings, as a shortening workweek is slowing the growth in weekly paychecks. That said, low unemployment and plentiful job opportunities give workers the confidence to spend, even among those in lower-paying jobs

who may be living paycheck to paycheck. It remains to be seen, however, if those living on the edge will retain their spending propensities as the strength in the job market ebbs, which we expect to happen relatively soon. Importantly, a key spending resource is running dry, most notably the pandemic savings built up in recent years. We estimate that there is still close to \$1 trillion of excess savings sitting on household balance sheets, but most of it is held by upper income individuals who tend to treat these assets as wealth rather than for spending purposes. Hence, while the overall personal savings rate has already fallen to 3.4 percent from a nearby peak of 5.3 percent in May, the rate for lower income households is most likely significantly below that.

Not only are savings lower, but borrowing costs are also eating into budgets, thanks to the rapid climb in interest rates. Personal interest payments on credit cards and other nonmortgage debt shot up to \$540 billion in September from under \$400 billion late last year, accounting for 2.8 percent of disposable income. The increase in debt servicing costs is accelerating as revolving loan balances are adjusting to the ever-higher rates induced by the Federal Reserve's tightening campaign over the past 19 months. The income share of these interest payments has exceeded 3 percent only once before, in October/November 2000, but the current trajectory will soon put it back above that threshold. Keep in mind that the sharp rise in outstanding debt will also be pushing up principal repayments. We expect that the depletion of savings among low-income households combined with the budgetary squeeze from higher debt-servicing burdens will pose a serious drag on consumption in the fourth quarter, leading to slower consumer spending later this year and into 2024.

The good news is that higher interest rates are also benefiting savers. Indeed, even as debt servicing is taking a bigger bite out of incomes, interest receipts on financial assets is having the opposite effect. In fact, interest receipts accounted for 7.8 percent of personal incomes in September, the highest share since April 2020. This too is destined to rise further as the rate on asset holdings adjusts to the higher levels now in effect. That said, the greater interest returns on assets could be a mixed blessing for the economy, as consumers have more of an incentive to save than to spend. What's more, with a host of uncertainties darkening the economic landscape, including wars in Gaza and Ukraine as well as the prospect of a government shutdown in two weeks, there may well be a greater urge of households to bolster precautionary savings.

These crosscurrents will be uppermost in the minds of Federal Reserve officials when they meet this week to decide whether to keep rates unchanged or raise them again for the 12th time since March of last year. Our view, as well as that of the consensus, is that the Fed will hit the pause button for the second consecutive meeting. No doubt, the torrid increase in GDP in the third quarter runs counter to the Fed's aggressive growth-dampening efforts aimed at wrestling inflation down to its 2 percent target. But there is a strong sentiment among policy makers to monitor the effects of past rate hikes to see if the lags are about to have a greater impact on economic activity. If they don't kick in more forcefully over the next month, a rate increase would clearly become a more likely option at the mid-December meeting.

And while growth came in stronger than expected in the third quarter, it didn't derail the steady improvement on the inflation front, something that provides some comfort for the Fed as well as the leeway to hold back on a rate hike. In fact, the Fed's preferred inflation gauge, the core personal consumption deflator, slipped to 2.43 percent in the third quarter, which is the closest to the Fed's target since the fourth quarter of 2020, just before the inflation cycle got underway. That said, the quarterly change masks an uptick in the final month, as the increase in the deflator kicked up to 0.3 percent in September from 0.1 percent in August. It is widely assumed that the last leg down to 2 percent will be the most difficult, and until a more tangible breakthrough occurs the Fed is not likely to take its finger off the rate-hiking trigger.

## FINANCIAL INDICATORS

INTEREST RATES	Oct 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.46	5.46	5.46	4.08
6-month Treasury bill	5.54	5.53	5.55	4.30
2-year Treasury note	5.03	5.11	5.05	4.41
5-year Treasury note	4.78	4.87	4.62	4.09
10-year Treasury note	4.84	4.93	4.58	4.02
30-year Treasury bond	5.02	5.09	4.71	4.15
30-year fixed mortgage rate	7.79	7.63	7.31	7.08
15-year fixed mortgage rate	7.03	6.92	6.72	6.36

STOCK MARKET					
Dow Jones Industrial Index	32,417.59	33,127.28	33,507.50	32,861.80	
S&P 500	4,117.37	4,224.16	4,288.05	3,901.06	
NASDAQ	12,643.01	12,983.81	13,219.32	11,102.45	

COMMODITIES					
Gold (\$ per troy ounce)	2,015.60	1,993.10	1,864.60	1,648.30	
Oil (\$ per barrel) - Crude Futures (WTI)	85.01	89.02	90.88	88.37	

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (September) - 000s	759	676	736	707
Real GDP (Q3) - % change, Saar	4.9	2.1	2.2	2.3
Personal Income (September) - % chg	0.3	0.4	0.2	0.3
Personal Consumption (September) - % chg	0.7	0.4	0.8	0.5
Personal Savings Rate (September) - Percent	3.4	4.0	4.1	4.5
Durable Goods Orders (September) - % chg	4.7	-0.1	-5.6	1.1

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