VIEWPOINT

Economic Commentary:

Continued Stability in the Labor Market May Elongate Timeline for Interest Rate Cuts

October 2023

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Declining inflation pressures this year have allowed the Federal Reserve to respond with a more gradual pace of interest rate increases since May as they assess the impact of their most aggressive monetary tightening of the last 40 years. The effects of monetary changes exhibit themselves with variable lags over a long period. The Fed's job to discern the appropriate amount of tightening to achieve their goal of 2.0 percent inflation is not only complicated by the variable lags, but also by current events such as the potential government shutdown in November. The resulting economic uncertainty is impacting business decisions, effectively slowing economic activity.

Headline inflation increased 0.6 percent during August – the most in more than a year according to the latest CPI report. The year-over-year reading rebounded to 3.7 percent, up from 3.2 percent, primarily due to the 10.6 percent month-over-month surge in gasoline prices. There was some evidence that higher energy prices have fed through to the core index (excludes food and energy), which rose by 0.3 percent month-over-month, although base effects helped push year-over-year core inflation down to 4.3 percent from 4.7 percent. However, the downward pressure on core inflation elsewhere still looks intact, as core goods prices fell again, by 0.1 percent month-over-month. Nevertheless, inflation is still running above the Fed's 2.0 percent target.

GDP & Consumer Spending

The final reading of second quarter 2023 real GDP was reported at a 2.1 percent annualized rate. Consumer spending in second quarter was revised down to a +0.8 percent annual rate from +3.8 percent in first quarter, reflecting a push back from consumers on higher prices. Real (inflation adjusted) retail sales are down 1.2 percent year-over-year through August and have been flat or negative in nine out of the last 10 months on a year-over-year basis, indicating that transaction volumes are declining as prices increase.

Real disposable incomes – the fuel for consumer spending – have been down for three consecutive months at a -1.7 percent annual rate, and consumers continue to tap their savings or credit cards for their spending. The personal savings rate is now at a year-to-date low of 3.9 percent. Credit card debt has grown at a 13.9 percent annual rate since mid-2021, compared to the 6.0 percent annual rate in the four years prior to the pandemic. At the same time, delinquency rates on credit card loans are at 11-year highs with the cost of credit card loans at 22.0 percent.

Tax Receipts, Manufacturing & Leading Economic Indicators

Federal tax receipts are declining, which is an indication of the slowing economy. Treasury receipts are down $437 billion this fiscal year through August compared to the same period in 2022, while outlays are up $142 billion – including $130 billion due to higher interest payments. The decline in tax receipts is mainly due to lower receipts from individual income taxes.

The ISM manufacturing index for September came in at 49.0 for the eleventh consecutive month below 50, indicating contraction in the manufacturing sector. Only five of 18 industries reported expansion. The New Orders index has been in contractionary mode for 13 consecutive months indicating weak demand.

The Leading Economic Indicators Index continues to trend lower – now for the seventeenth consecutive month through August. Since the inception of this index in 1958, such a string of declining readings has only happened when the economy is in or nearing a recession.

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The Labor Market

Employment gains in September were surprisingly strong with an increase of 336,000 in non-farm payrolls – nearly double market expectations – and the prior two months were revised upward by 119,000. Employment gains were broad-based. The unemployment rate remained at a 19-month high of 3.8 percent. Wages grew only 0.2 percent during September, bringing the year-over-year growth rate to a two-year low of 4.2 percent. The labor market remains the strongest pillar of the economy providing more income to more people. Although wage growth has been cooling, the resiliency of the labor market is one of the Fed's concerns as it tries to cool down the overall economy. Until the labor market shows weakness, it is unlikely that the Fed will consider lowering interest rates.

Interest Rates & The Fed

As expected, the Fed held the Federal Funds target range unchanged (5.25 percent to 5.50 percent) at their September 20 meeting, while leaving open the possibility of another rate increase before year end. The most surprising and hawkish element of the meeting was the median expectation for year-end 2024 moving from 100 basis points of rate cuts to only 50 basis points in the Fed Funds rate. Markets are pricing in a lengthy pause in interest rate actions and have pushed back the timing of the first rate cut from the spring of 2024 to late summer.

The real (inflation adjusted) Fed Funds rate is now at the highest and most restrictive level since 2009. Based on Fed projections given after the September meeting, the real Fed Funds rate is forecast to increase by another 100 basis points over the next year, bringing it to levels last seen in late 2007. Even if the Fed does not increase headline rates any further, declining inflation pressures will effectively cause the real Fed Funds rate to increase and further tighten monetary conditions. In addition to their interest rate policy, the Fed continues to reduce their balance sheet by about $95 billion per month – another policy tool that tightens liquidity.

With the Fed intent on keeping rates higher for longer, and commercial bank lending standards remaining tight, the increased cost of credit and its reduced availability are significant headwinds for refinancing existing debt as well as for ongoing economic growth, especially for smaller companies.

For more information please contact:

John Beuerlein | *Chief Economist, Pohlad Companies*

Lanie Beck | *Senior Director, Content and Marketing Research*
lbeck@northmarq.com | (918) 494-2690

Northmarq

3500 American Blvd W
Suite 500
Minneapolis, MN 55431
(952) 356-0100
www.northmarq.com

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