VIEWPOINT

Northmarq

SPECIAL MID-QUARTER EDITION

Economic Commentary:

Today's Contractionary Credit Cycle is Likely to Slow Economic Activity

November 2023

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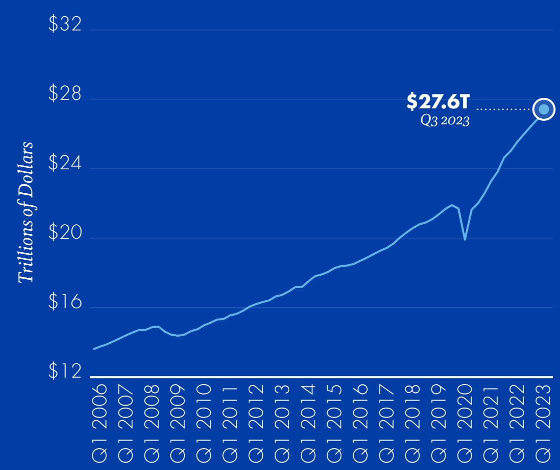
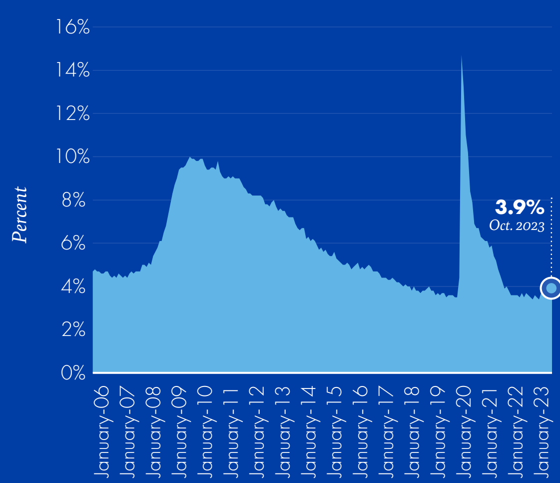
GROSS DOMESTIC PRODUCT (GDP)



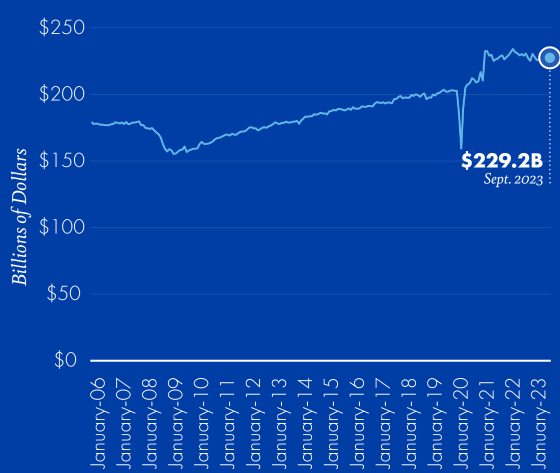
Source: Northmarq, U.S. Bureau of Economic Analysis

UNEMPLOYMENT RATE



Source: Northmarq, U.S. Bureau of Labor Statistics

RETAIL / FOOD SERVICE SALES



Source: Northmarq, U.S. Bureau of the Census

The initial reading of third quarter 2023 GDP showed that economic activity during the summer held up better than expected given the ongoing tightening of credit conditions. Nevertheless, the impact of the Fed's 19-month effort to slow inflation is becoming increasingly visible. More recent data indicate that the fourth quarter is starting off with little momentum, suggesting that a renewed slowdown is likely. The Fed is probably finished hiking interest rates, but the timing of the first cut in rates is an open question.

CPI, GDP & Consumer Spending

The September CPI report showed that headline inflation increased 0.4% during the month, with the year-over-year change remaining at 3.7%. Core inflation increased 0.3% – the same as the prior month – bringing the year-over-year figure to 4.1%. The largest component of the CPI is shelter (34% of CPI and 43% of core CPI). The methodology used for the shelter component calculation results in a lag of the impact of changes in shelter prices. When shelter prices are moving down in real time, as they are now, the shelter calculation is slow to reflect these changes and consequently provides an elevated component to the overall CPI calculations. Stripping out the shelter component from the core CPI results in a 1.9% year-over-year increase.

The initial reading of third quarter GDP was +4.9% (annualized rate) – much stronger than was expected. The primary driver of strength in third quarter was consumer spending, which grew at a 4.0% annualized rate compared to a 0.8% rate in second quarter.

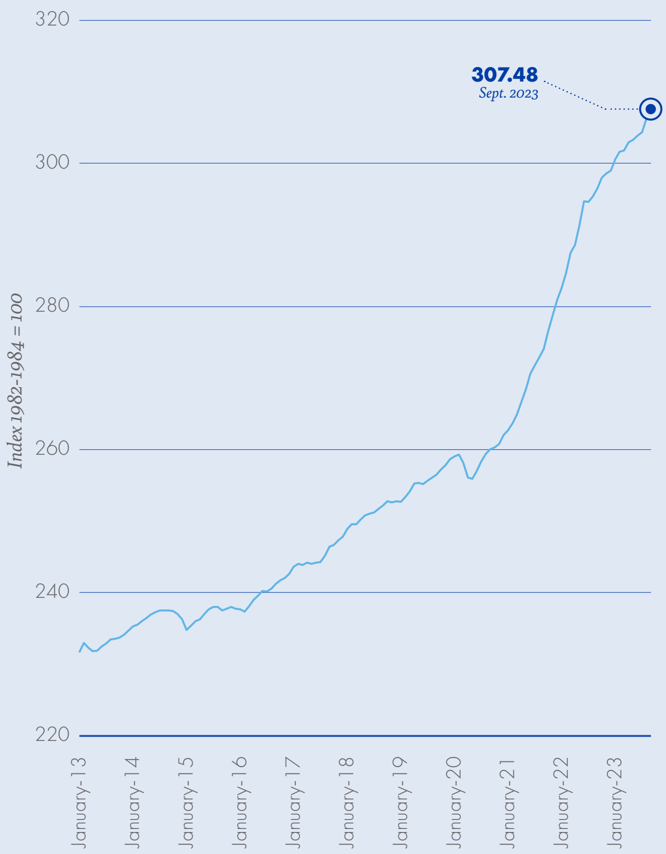
As has been the case for most of the past year, elevated consumer spending has come at the expense of a drawdown in savings and increased credit card debt. According to a Fed study, consumers outside of the wealthiest 20% have run out of extra savings and now have less cash on hand than when the pandemic began. The savings rate is now at a year-to-date low of 3.4%, compared to a long-term average savings rate of 8.0%. Credit card balances are at historic highs, having just passed the $1.0 trillion level.

For the government's fiscal year ending on September 30, treasury tax receipts were down $457 billion, causing the fiscal deficit to increase 23% from 2022 to $1.7 trillion. The decline in tax receipts is mainly due to lower receipts from individual income taxes. The resulting deficit is 6.3% of GDP – a level never seen in a fully employed economy.

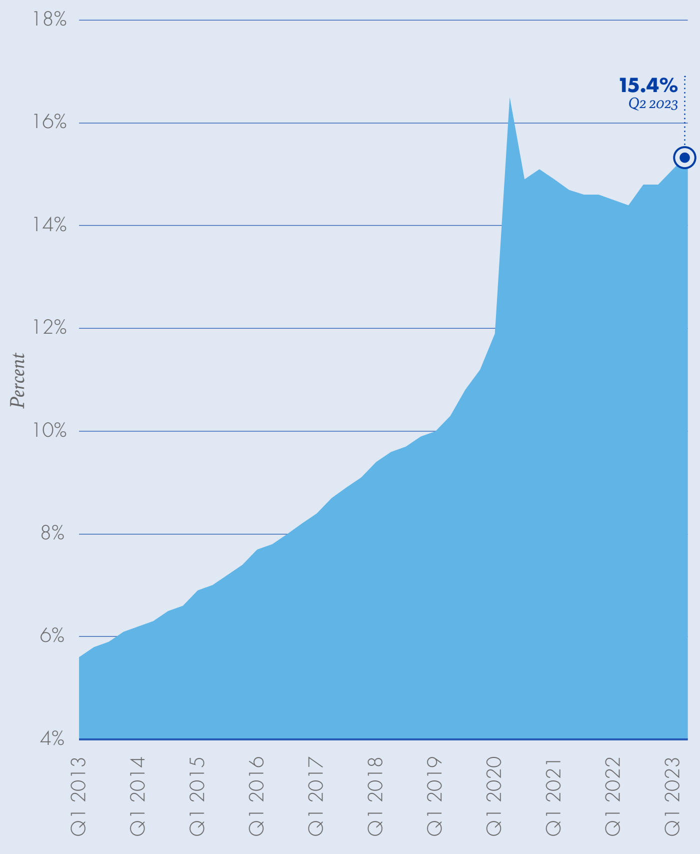
> *Markets are pricing in a lengthy pause in interest rate actions and now expect the timing of the first interest rate cut to occur in June 2024."*

John Beuerlein
Chief Economist, Pohlad Companies

CONSUMER PRICE INDEX (CPI)



E-COMMERCE RETAIL SALES (% OF TOTAL SALES)



Source: Northmarq, U.S. Bureau of Labor Statistics, U.S. Bureau of the Census

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Manufacturing & Leading Economic Indicators

The ISM manufacturing index for October showed contraction in manufacturing for the twelfth consecutive month. The composition of the report was weak, with declines in the production, new orders, and employment components. Only two out of 18 industries reported growth.

The Leading Economic Indicators index has been down for 18 consecutive months and is now at the lowest level since June 2020. For the month of September, the biggest drags came from consumer expectations, housing permits, and manufacturing new orders.

The Labor Market

Employment gains in October were weaker than expected, coming in at an increase of 150,000, and the prior two months were revised down by 101,000. Employment gains were narrowly based primarily in healthcare, government, and social assistance. 52% of 250 private industries added jobs in October – the lowest since April 2020 and down from 61.4% in September. Average weekly hours worked fell to 34.3, which was tied for the lowest reading this year.

The unemployment rate increased to 3.9% – the highest since January 2022 – as the household survey employment measure fell by 348,000. Wages grew only 0.2% during October, bringing the year-over-year growth rate to 4.1% – the slowest since June 2021. Additionally, the Challenger Job Cuts report showed that layoff announcements rose 8.0% year-over-year in October and have been increasing on an annual basis in each of the past three months.

Inflationary pressures from the labor market are easing with unit labor costs declining by 0.8% annualized in third quarter and rising only 1.9% year-over-year. The same report showed that non-farm productivity in third quarter was a strong 4.7% annualized, bringing year-over-year productivity to 2.2% – the strongest in two and a half years.

Interest Rates & Inflation

As expected, the Fed held the Federal Funds target range unchanged (5.25% to 5.50%) at their November 1 meeting, while leaving open the possibility of another rate increase before year end. There is little indication that the recent strength of economic growth has caused officials to revise their rate projections upwards. Powell stated that stronger growth "could" warrant further hikes, but that officials are "proceeding carefully." He also acknowledged that "tighter financial and credit conditions are likely to weigh on economic activity, hiring, and inflation."

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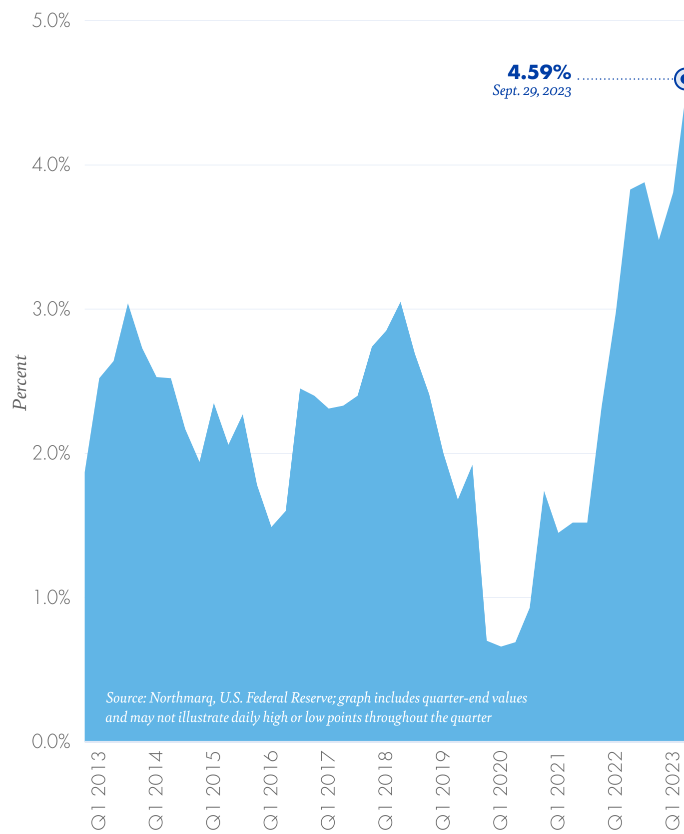
The real (inflation adjusted) Fed Funds rate is now at the highest and most restrictive level since 2009. Even if the Fed does not increase rates any further, declining inflation pressures will effectively cause the real Fed Funds rate to increase – a form of passive tightening. In addition to their interest rate policy, the Fed continues to reduce their balance sheet by about $95 billion per month – another policy tool that tightens liquidity.

Financial conditions are restrictive, and liquidity constraints are emerging across a broad front. The credit cycle is turning with negative implications for default rates, credit spreads, and corporate profitability. There is a decline in the supply of credit and a decline in the demand for credit at the same time, and this is causing a contractionary credit cycle that will slow economic activity.

10-YEAR TREASURY RATE



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