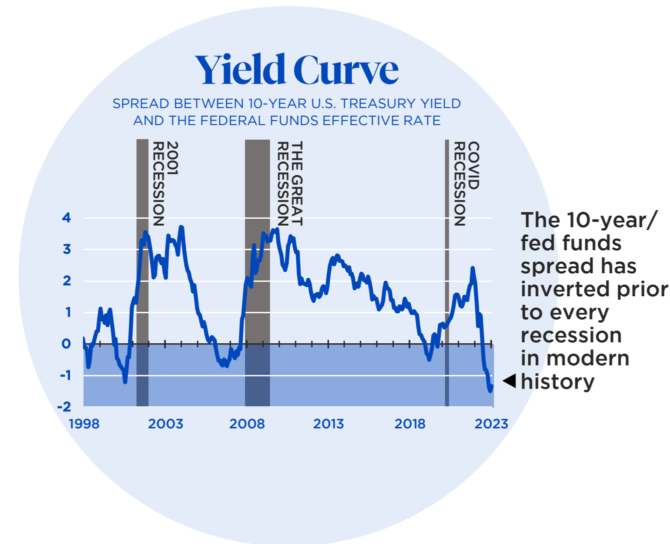
Economic & Financial Markets Monthly Review | July 2023

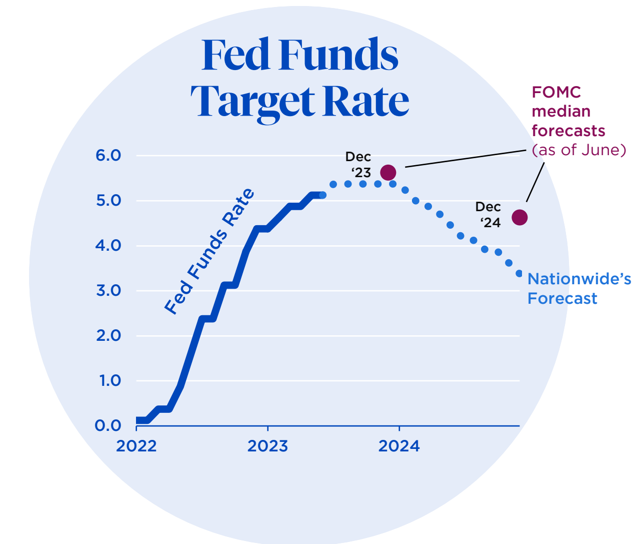
Summertime spending to keep growth going

Economic Overview

Where is the economy now?

Recent readings suggest that the expansion will carry into the second half of 2023 despite sharply higher financing rates for businesses and consumers in response to the Fed's rate tightening. But leading indicators for the economy still indicate that recession odds are high over the next year, which should result in an eventual, even if delayed, economic downturn.





Where we are this month

PRE-RECESSION PERIOD LINGERING

Solid hiring and services spending is extending growth despite many leading signals suggesting much weaker growth ahead.

YIELD CURVE INVERSION AGES

The 10-year to fed funds rate spread remains deeply inverted and the yield curve has shown a full inversion since November 2022.

MORE RATE HIKES, BUT HOW MANY?

The Fed's median rate estimates in June showed an additional two rate hikes over the second half of 2023, a surprisingly hawkish guidance.

What does this mean

- Our baseline forecast assumes that a moderate recession hits by the fourth quarter of 2023 in response to the cumulative Fed rate increases, tighter bank lending standards, and weaker corporate earnings
- But the timing of a downturn remains uncertain due to multiple crosscurrents including high labor demand and pandemic-related household savings.

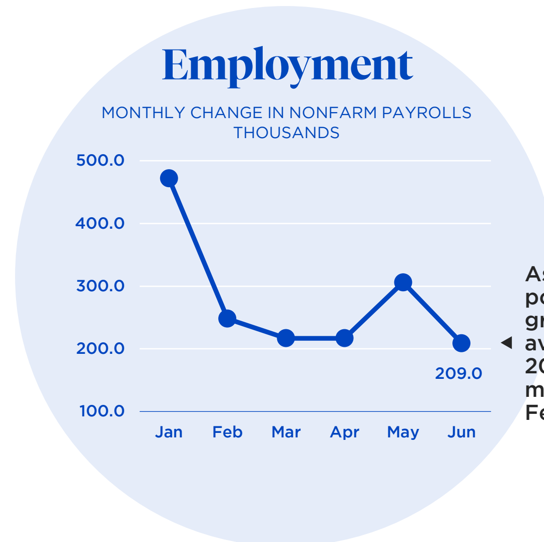
- The yield curve was fully inverted for at least 10 months before the start of the last seven recessions, also suggesting some room to run for the current expansion.
- The deep inversion shows the bond market's high expectation of a recession in the year ahead, as a downturn has always followed a sustained yield curve inversion since 1962.

- We project another 25bps rate hike in July but don't see further rate increases from there if hiring and inflation trends cool as expected in the lead up to a recession.
- Still, as signaled in June, Fed officials will be prepared to go more restrictive if the incoming data remain as resistant to higher interest rates as seen so far this year.

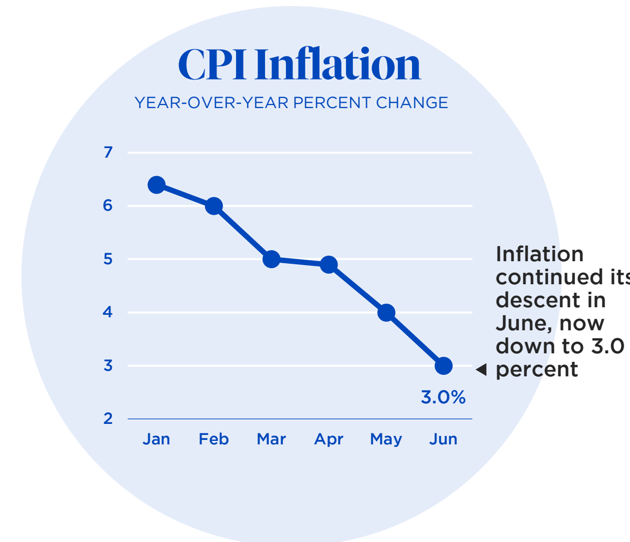
Economic Review

Hiring activity slows, but labor market is still tight

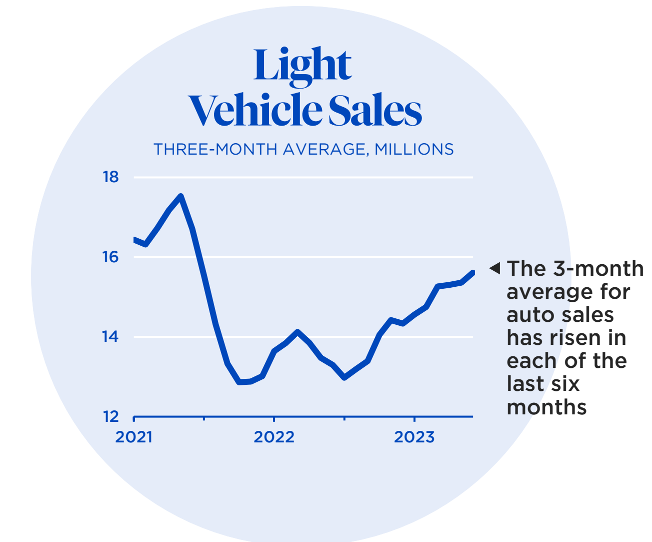
June saw weaker job growth and a downward trend for labor demand in many industries. But wages rose further due to continued tight labor conditions, breathing more life into incomes and consumer spending. With core inflation only cooling very gradually, the question for the Fed in coming months appears to be: how many more rate hikes will it take to finally slow inflation?



Aside from the pop in May, job growth has averaged near 200,000 per month since February



Inflation continued its descent in June, now down to 3.0 percent



The 3-month average for auto sales has risen in each of the last six months

Where we are this month

SLOWDOWN IN JOB GROWTH

Nonfarm payroll growth moderated to 209K in June with downward revisions to May and April totaling 110K jobs. Private payrolls slowed even further to a 149K gain.

CPI INFLATION DECLINES SHARPLY

Year-on-year consumer inflation dropped from 4.0 percent in May to 3.0 percent in June, the slowest reading since March 2021.

AUTO SALES CONTINUE TO CLIMB

The three-month moving average for light vehicle sales was 15.6 million in June — up more than two million units from last summer.

What does this mean

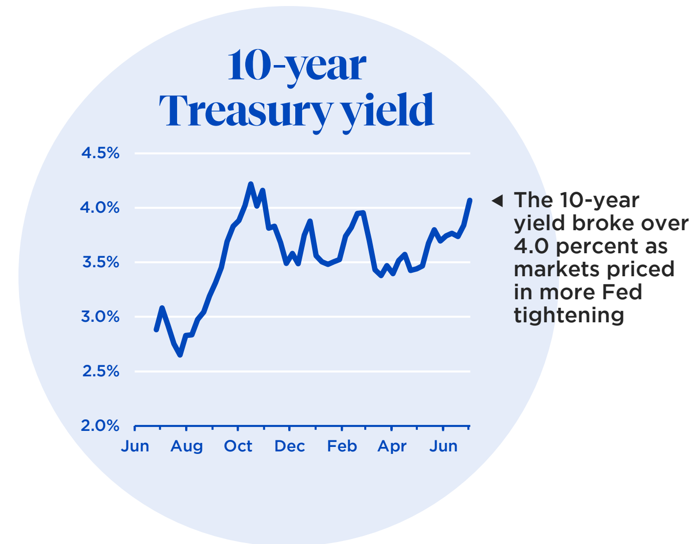
- Hiring has downshifted this year, but job gains remain solid and the unemployment rate was still very low at 3.6 percent in June – suggesting only a modest loosening of the labor market.
- Wage gains (still up 4.4 percent year-on-year) and a longer average work week in June should result in strong income gains and continued healthy consumer activity over the month.

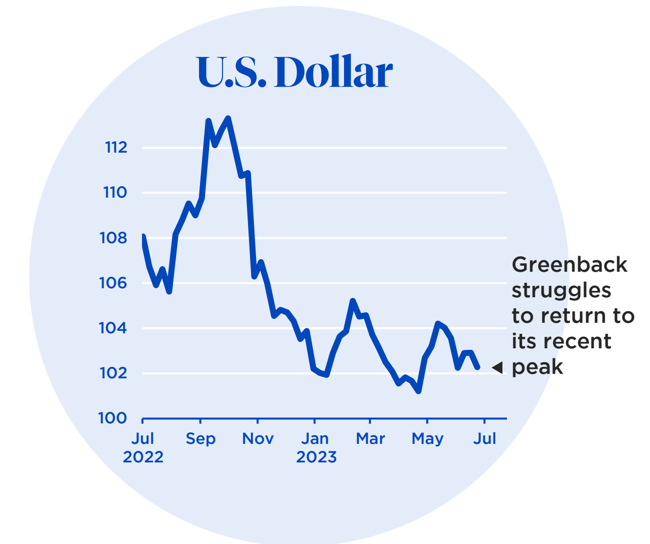
- Core CPI inflation also slowed in June falling to 4.8 percent. The three-month annualized pace of core inflation eased to 4.1 percent in June, improved from recent readings but still much higher than the Fed's inflation goal.
- Hot housing costs continue to lift core prices, up 7.8 percent over the past year. But shelter should cool over the second half of 2023 in response to lower home price appreciation and asking rents.

- Pent-up demand from the supply-limited pandemic period appears to be offsetting the drag from rising borrowing rates as consumers shrug off the higher costs of buying a vehicle.
- In addition to boosting sales, the improved availability of new vehicles is reversing some of the jump in costs for used cars — with the Manheim used vehicle value index down 16.5 percent from its pandemic peak as of June.

Equities in rally mode

The S&P 500 added more than six percent in June, leaving the index only eight percent under its all-time high. Second quarter 2023 results, however, are providing a challenge to optimistic investors, currently forecasting a drop of more than six percent. Fixed income investors also face issues with a looming Fed hike casting a long shadow.





Where we are this month

MARKET RALLY CONTINUES

The S&P 500 roared in June, ending the first half of 2023 with a 16 percent gain, but forward earnings estimates remain a challenge.

10-YEAR YIELD HITS 4.0% AGAIN

The 10-year Treasury note yield rose about 20 basis points over June and shot higher in early July, but the benign CPI report pushed rates lower

DOLLAR TURNS WEAKER

The post-pandemic dollar rally has ended with the greenback running lower in 2023, even as economic weakness persists outside the U.S.

What does this mean

MARKET RALLY CONTINUES

- Technology led the S&P 500 categories posting an impressive 42 percent gain in the first half. Other categories with gains over 30 percent were telecoms and consumer discretionary, favoring customer-centric companies.
- Not all stocks were in rally mode with five of the ten sectors failing to post gains in the first half of 2023. Energy, the winner in 2021 and 2022, finished last, subtracting seven percent.

10-YEAR YIELD HITS 4.0% AGAIN

- High yield led the fixed-income market in the first half of 2023, a meaningful reversal of 2022 struggles. Increased confidence in corporate performance boosted corporate bonds, bouncing off a nearly 16 percent drop in 2022.
- Short-term Treasuries continue to look to the Fed for guidance. An additional hike seems likely with the yield of the six-month Treasury above 5.40 percent in mid-July.

DOLLAR TURNS WEAKER

- The Yen held back the dollar in the first half of 2023, up more than 10 percent. This recovery comes after the back-to-back 10 percent declines relative to the dollar in 2021 and 2022.
- Despite the decline versus the highs from 2022, the U.S. dollar still is near its highest levels over the past 20 years compared to many major currencies, including the euro and U.K. pound.

Outlook

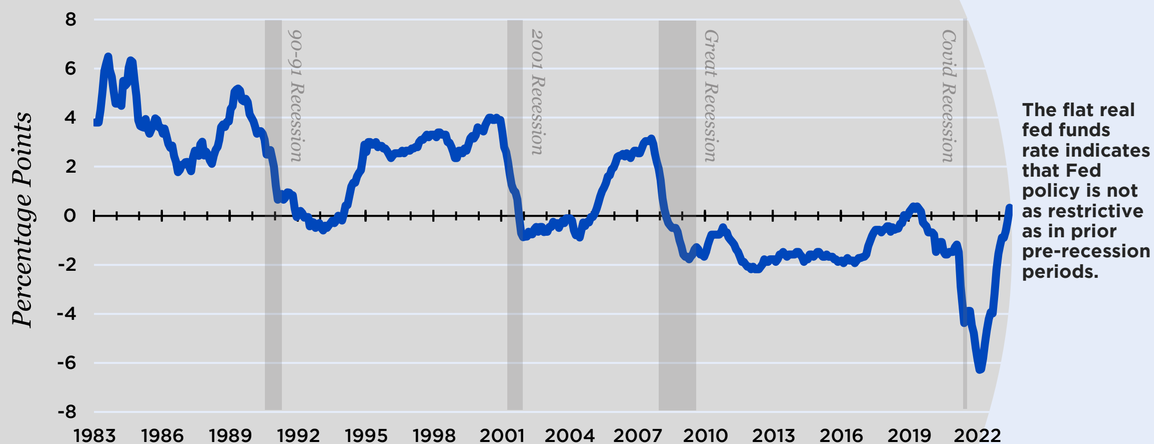
Is Fed policy restrictive yet?

Despite the fastest Fed tightening cycle in the past half century, labor market and inflation trends have remained buoyant into mid-year. One reason could be that the level of the fund funds rate given the rate of inflation is still not yet restrictive enough. The real fed funds rate (fed funds target rate adjusted for core CPI inflation) was still near zero in June. Historically, the real fed funds rate has been positive by several percent ahead of prior recessions. Current readings suggest that the Fed may have to raise rates even higher to bring inflation to heel. That said, a continued easing in the pace of inflation will also lift the real fed funds rate even once the Fed stops raising rates.

While rhetoric from Fed officials will continue to be hawkish in response to lingering services and housing inflation, we expect only one additional rate hike at the upcoming July FOMC meeting. But the Fed will be prepared to make more tightening moves later this year if labor and inflation data remain too hot.

Fed funds target rate less core CPI inflation

June 2023; Recessionary times represented by gray bars.



Podcast
Hear our mid-year health check on the economy
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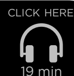
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Latest Forecast

Data as of July 2023

	2022	2023	2024	2025	2026
	ACTUAL	ESTIMATE	FORECAST		
REAL GDP	2.1%	1.8%	-0.3%	2.2%	1.7%
UNEMPLOYMENT RATE	3.6%	4.1%	5.3%	4.7%	4.3%
INFLATION [1] (CPI)	7.1%	**3.7%**	**3.0%**	2.4%	2.0%
TOTAL HOME SALES	5.67	4.91	5.00	5.50	6.00
S&P/CASE-SHILLER HOME PRICE INDEX	5.8%	2.5%	2.7%	3.3%	3.6%
LIGHT VEHICLE SALES	13.8	15.3	15.4	16.4	16.5
FEDERAL FUNDS RATE [2]	4.25%	**5.25%**	**3.25%**	2.00%	2.00%
5-YEAR TREASURY NOTE [2]	3.99%	4.00%	3.30%	2.70%	2.50%
10-YEAR TREASURY NOTE [2]	3.88%	3.70%	3.15%	2.90%	2.70%
30-YEAR FIXED-RATE MORTGAGE [2]	6.42%	6.60%	5.30%	4.65%	4.40%
MONEY MARKET FUNDS	2.27%	5.09%	4.03%	2.40%	2.03%

[1] Percent change Q4-to-Q4
[2] Year-end

More difficult to slow inflation over H2 2023

The year-on-year CPI rate should level off just below 4.0 percent over the second half of 2023, held up by still hot inflation for services and housing. The core CPI (ex-food and energy) is projected to be near 4.2 percent at year-end, well above where the Fed would like underlying inflation to run.

At least one more rate hike expected

Another 25bps rate hike is widely expected in July and the Fed is likely to provide hawkish guidance for future FOMC meetings. Despite the tightening bias, economic growth trends should slow enough by the fall to prevent further tightening — while rate cuts are not yet on the Fed's radar.

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