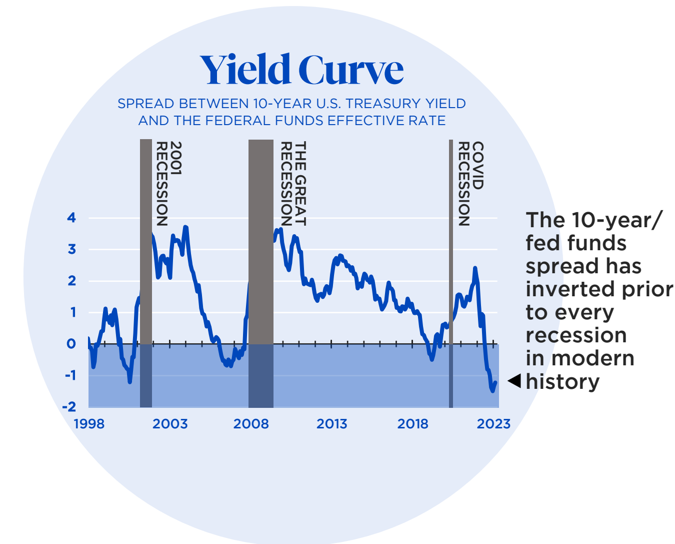
Economic & Financial Markets Monthly Review | August 2023

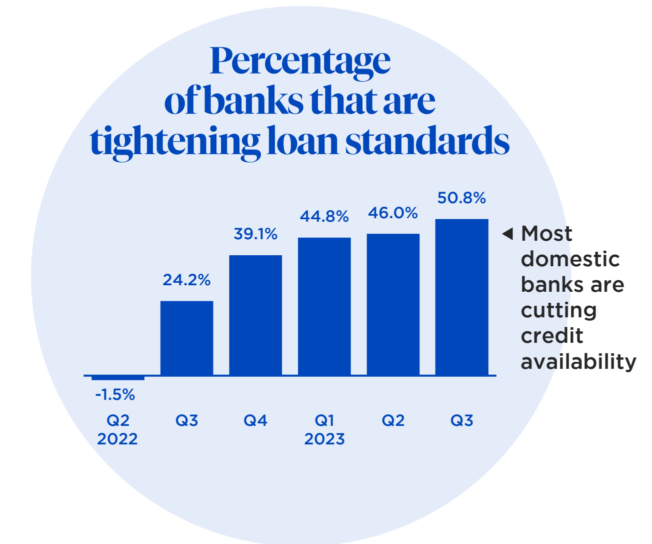
Is a soft or hard landing on the way?

Economic Overview

Where is the economy now?

Momentum within the consumer sector suggests that the expansion should continue in the near term despite tighter financial conditions for businesses and households in response to the Fed's rate increases. But leading indicators for the economy still indicate that a hard landing, or recession, will likely occur over the next year, even if it comes later than previously expected.





Where we are this month

GROWTH STILL SOLID

Low unemployment and solid wage growth is supporting consumer activity, with spending in the third quarter expected to remain buoyant.

YIELD CURVE STEEPENS A BIT

The 10-year to fed funds rate spread steepened moderately in early August; but the yield curve has been fully inverted since November 2022.

TIGHTER LENDING LIMITS GROWTH

More than half of domestic bank were tightening business loan standards in Q3, in line with levels ahead of prior recessions.

What does this mean

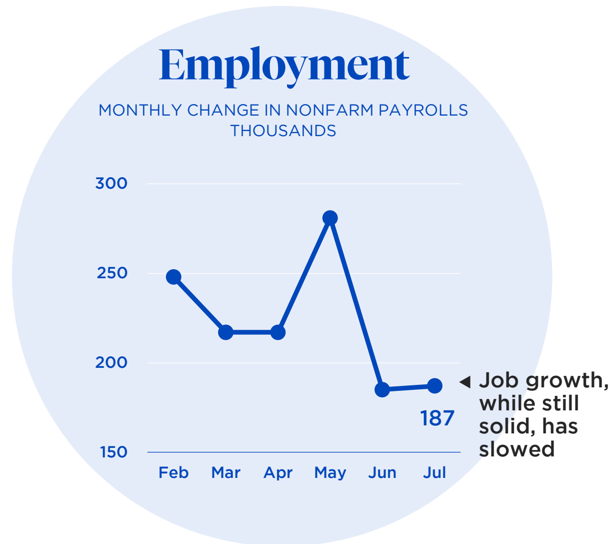
- Our recession call has not been cancelled but the start of one should be delayed until at least the end of 2023, and maybe into early 2024.
- Leading indicators still strongly point to an eventual recession, rather than a soft landing, in response to the cumulative Fed rate increases, tighter bank lending standards, and weaker corporate earnings.

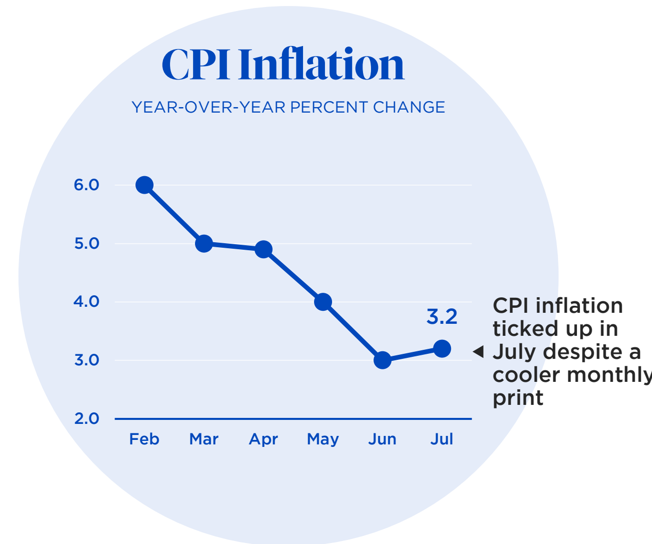
- While the bond market is pricing is slightly higher odds of a soft landing, the yield curve remains deeply inverted and the inversion has been sustained since late 2022 — historically, a reliable signal of a coming recession. .
- The yield curve should not steepen significantly until the Fed starts to lower the fed funds rate, which is not projected to occur until 2024.

- Higher lending standards for commercial loans increase the cost of doing business for many firms, reducing investment opportunities and forcing firms to look for areas to cut expenses.
- This will limit the ability of firms to expand and weigh on economic activity since it would include slower corporate hiring and business spending.

Consumer momentum carries into the third quarter

Job growth was under 200,000 for a second straight month in July as the downward trend for hiring continued. But wages were still strong due to tight labor conditions, and the resultant income gains continue to boost spending on services. On the inflation front, core prices continued to slow gradually while overall CPI inflation ticked higher in July.





Where we are this month

UNEMPLOYMENT STILL VERY LOW

Nonfarm payroll growth was slower again in July at 187,000 as employers in many sectors have reduced their hiring plans due to high labor costs, softer demand, and lack of available workers.

SMALL CLIMB IN CPI INFLATION

Year-on-year CPI inflation climbed in July to 3.2 percent, while the core rate fell for the fourth consecutive months to 4.7 percent.

FURTHER GROWTH FOR SERVICES

According to the ISM services index, the service sector continued to see solid growth in July, led by further demand from consumers.

What does this mean

Unemployment still very low

- The three-month average for job growth in July was the lowest since January 2021. Hiring activity is now more in line with prior late cycle periods but remains far from a recession signal.
- Still, the labor market remains very tight as the unemployment rate fell in July to 3.5 percent. Wage gains were up 4.4 percent from a year ago, far above the pre-pandemic average.

Small climb in CPI inflation

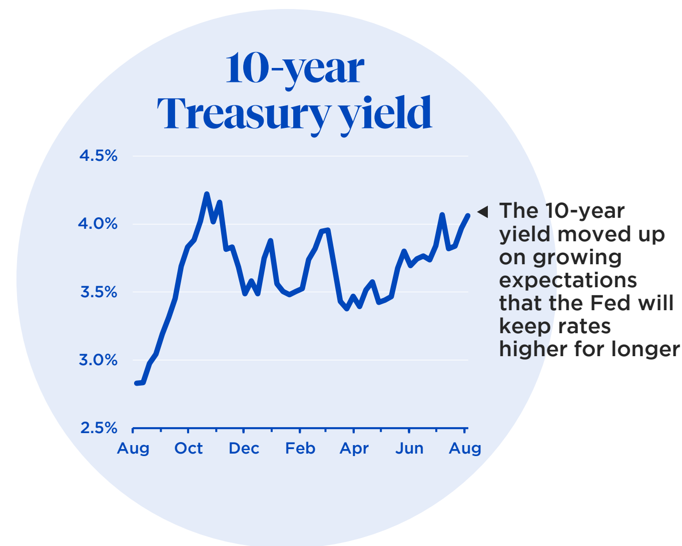
- The uptick in the CPI's 12-month trend rate was due to base effects from 2022. The 0.2 percent month-over-month rise was an encouraging sign that inflation continued to trend lower in July.
- Rents again drove faster services inflation in July and have prevented stronger disinflation for core prices. Although down from its recent peak, annual inflation for shelter was still 7.7 percent — although this is expected to cool further ahead.

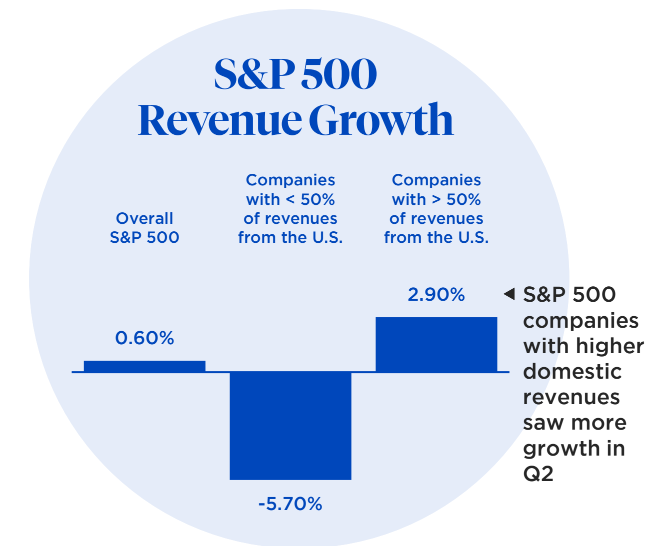
Further growth for services

- With the housing market struggling and manufacturing well into contraction, the service sector is currently the primary engine keeping U.S. economic growth going.
- Demand for services is being supported by very low unemployment and strong wage and income gains. Spending on services is unlikely to slow significantly until there is substantial easing of labor market conditions.

Earnings lift investor optimism

The S&P 500 rose for the fifth consecutive month adding roughly another three percent gain in July. Better-than-expected earnings lifted optimism, but the double-digit expected annual earnings gain for 2024 remains a high bar for the market. The U.S. Treasury 10-year yield moved above 4.0 percent and reached a ten-month high, while stable short-term rates suggest that Fed tightening might be near an end.





Where we are this month

What does this mean

ALL-TIME HIGH WITHIN REACH

The S&P 500 ended July up nearly 20 percent year-to-date. The five percent drop in Q2 earnings means the forward 12-month P/E ratio rests above 19, significantly above the long-term average.

- Consumer discretionary and technology led the upside earnings parade. Amazon's earnings beat represented 40 percent of the overall consumer discretionary upside surprise.
- Healthcare took it on the chin in the second quarter earnings scorecard, with profitability injured by higher labor costs for medical care.

10-YEAR ABOVE 4.0% AGAIN

After dipping mid-month, the 10-year Treasury yield shot above 4.0 percent in late July, briefly hitting a 4.20 percent high in early August — boosted by rising growth and inflation expectations.

- Short-term Treasuries continue to see little chance of rate cuts in the near term and remain locked into Fed guidance on the odds of further rate increases before year-end.
- The spread between the one-year nominal Treasury yield and the corresponding real yield showed volatile swings in July, with short-term inflation expectations falling and then snapping back on movements in oil prices.

U.S. REVENUES KEY FOR PROFITS

Healthy domestic sales are a key upside driver for earnings this year. But weak global revenues for U.S. firms suggest a building storm could make 2024 earnings a challenge.

- For firms with more than 50 percent of revenues from the U.S., revenue growth was up 2.9 percent, year-over-year, helping to boost stock performance through July.
- In contrast, businesses more dependent on international revenues recording a 5.7 percent drop, while the overall S&P revenue growth rate was 0.6 percent.

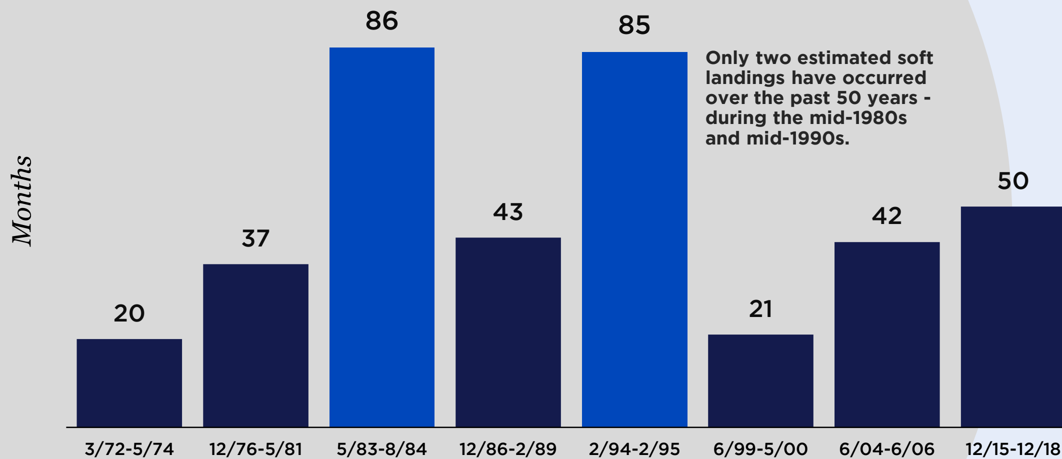
Outlook

Soft landings have been elusive

Slowing inflation back to trend without widespread job losses and negative real GDP growth (i.e., a soft landing) has proven difficult for the Fed in previous cycles. Only two of the Fed's tightening cycles since 1970 have not led to a recession within 50 months of starting. In the mid-1980s and mid-1990s, the Fed was able to rein in inflation and then lower interest rates before causing a recession. In each of the other periods, Fed rate increases drove a sharp pull back in spending and investment in response to the tighter financial conditions — a typical hard landing.

It has been only 17 months since the start of the current tightening cycle, perhaps another sign that the expansion has some room to run. However, the Fed has pushed through the sharpest pace of rate hikes over the past 50 years and could tighten more in coming months. And, most importantly, the Fed is not likely to consider rate cuts for some time, a key ingredient for a potential soft landing.

Time between the beginning of Federal Reserve rate hike cycles and the onset of recessions



Podcast
What's the likelihood of a soft landing now?

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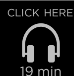
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Latest Forecast

Data as of August 2023

	2022 ACTUAL	2023 ESTIMATE	2024 FORECAST	2025 FORECAST	2026 FORECAST
REAL GDP	2.1%	2.0%	-0.2%	2.2%	1.7%
UNEMPLOYMENT RATE	3.6%	3.8%	5.3%	4.8%	4.3%
INFLATION [1] (CPI)	7.1%	3.5%	3.0%	2.4%	2.0%
TOTAL HOME SALES	5.67	4.89	5.00	5.50	6.00
S&P/CASE-SHILLER HOME PRICE INDEX	5.8%	3.9%	2.7%	3.3%	3.6%
LIGHT VEHICLE SALES	13.8	15.4	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%	3.80%	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

Job market projected to cool next year

Demand for labor should fade sharply around the expected recession late this year and in the first half of 2024. The unemployment rate is projected to peak around 5.5 percent later next year, although job losses should be considerably less than over the past two downturns, with moderately higher unemployment likely to linger through 2025.

Higher mortgage rates to limit home sales

30-year fixed mortgage rates could remain above 6.0 percent through mid-2024, restricting buyer activity and keeping the inventory of existing homes very low. A rebound in housing activity should occur later next year and into 2025 as financing rates drop in line with the Fed easing monetary policy.

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