

## Economic Summary – Q3 2023

Investors believing the long-anticipated economic slowdown would assert itself during the third quarter were wrong once again. Although the initial GDP reading will not be released until late October, it seems apparent that economic growth actually *accelerated* during the summer months. The Atlanta Fed’s most recent Q3 GDPNow measure is tracking at +4.9%, up from +2.1% in the second quarter. It’s expected to be whittled down as the September data is gathered, but the new quarter begins with a surprising amount of momentum. Although most economists are forecasting a sharp drop in demand over the final three months of 2023, this same expectation has lingered for more than a year and investors have grown increasingly skeptical.

The U.S. consumer shrugged off dwindling savings and record credit card balances and continued to frustrate policymakers, increasing consumption by +5.8% year-over-year in August. Retail sales climbed +0.6% in the final month of summer, well above the +0.1% median forecast. Persistent demand has fostered solid job gains and maintained pressure on wages, which continue to complicate Fed efforts to bring inflation down to its +2.0% annual target.

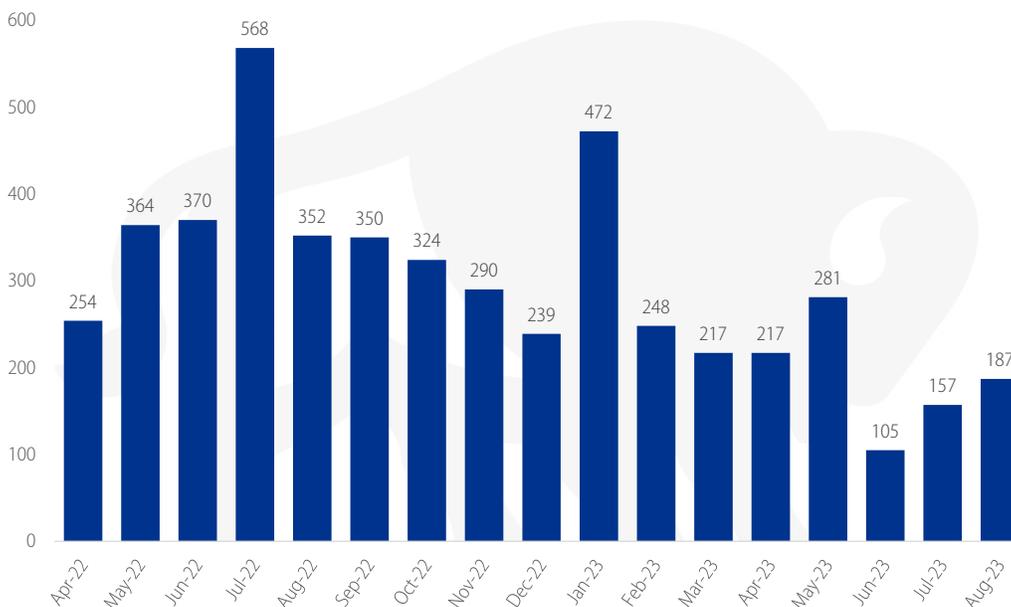
There was speculation throughout the quarter that FOMC members would consider raising the inflation target to +2.5% or even +3.0%, but Chairman Powell quickly dismissed that hope at the July meeting by affirming the committee’s “strong commitment” to achieving its established +2.0% goal.

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### Non-Farm Payrolls Total Change (in thousands)



Source: Bureau of Labor Statistics

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Despite increased summer demand for service jobs, the labor market did show signs of moderation from May through August. Nonfarm payrolls grew by an average of +150k per month, *one-third the pace from the same period a year earlier*. The unemployment rate slipped to 3.5% in July, within a fraction of the five-decade low, before climbing back to an 18-month high of 3.8% in August when +736k Americans entered (or reentered) the work force.

The unexpected rise in available workers boosted the participation rate to 62.6%, the highest since February 2020. Although overall labor participation remains below the 63.4% pre-pandemic mark, the rate for prime age workers (25-54) has now exceeded February 2020 and is within a percentage point of the all-time high, while the participation rate for prime-age women is currently the highest on record, dating back to 1948.

The recent JOLT survey showed 8.8 million job openings in July, the lowest count in more than two years and well below the peak of 11.5 million from May 2022. With the number of Americans actively seeking work estimated at 6.4 million in August, the gap between available jobs and jobseekers has narrowed in recent months, which should help temper wage pressure going forward. For now, rising wages continue to weigh heavily on consumer prices, which for better-or-worse is keeping the Fed entrenched in its tightening mode.

Headline inflation was widely expected to increase on an annual basis in both July and August due to the year-over-year base effect, *and it did*. What wasn't expected was a dramatic rise in oil and gas prices. OPEC+ production cuts combined with stubborn energy demand sent prices soaring. WTI crude was trading just under \$70 per barrel at the end of June but reached \$94 during the last week of September. Whereas U.S. producers might normally be expected to increase drilling to fill the global supply gap and bank record profits, this time seems to be different.

Domestic oil production is expected to reach a record high in 2023, according to the U.S. Energy Information Administration, but domestic producers, with no guarantee that the market price for crude will remain elevated, are choosing to pay down debt and distribute profits rather than incur additional drilling costs.

Higher energy prices will keep pressure on overall inflation in the near term, and if the price of oil doesn't mercifully recede in the coming months, it could bleed into core inflation, further complicating Fed policy decisions.

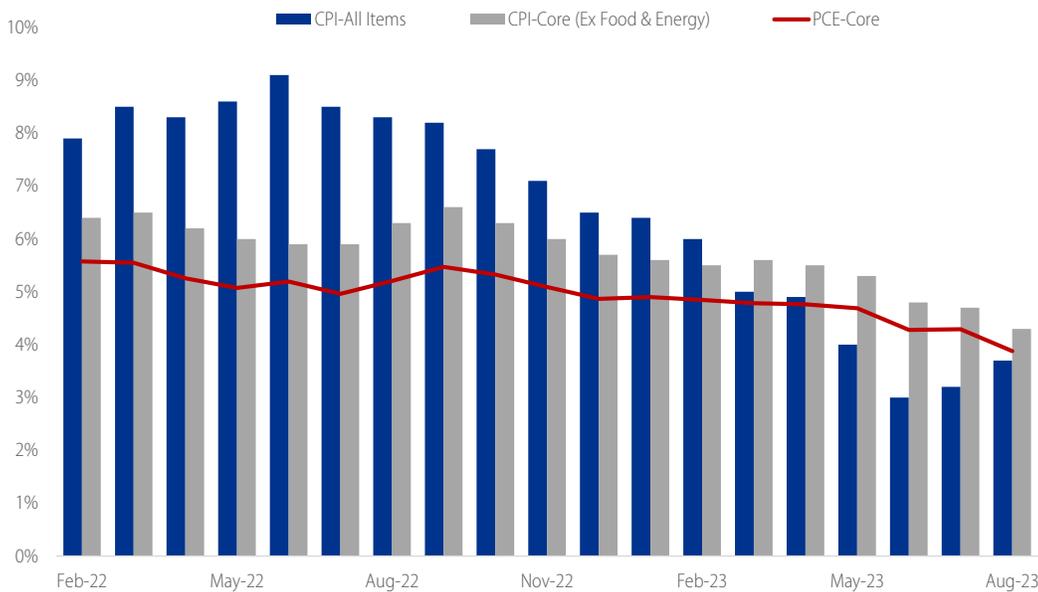
The headline consumer price index (CPI) rose by +0.2% in both June and July, before jumping +0.6% in August. It was the largest increase in 14 months, with over half of the gain attributed to a +10.6% rise in gasoline prices. Core CPI, excluding food and energy, rose +0.3%, the first uptick since February. The annual rate of consumer inflation climbed from +3.2% to +3.7% in August, the second straight rise after 12 months of steady decline, while core CPI retreated from a +4.7% annual pace to +4.3%.

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## Inflation Indicators (Year-over-Year Percent Change)



Source: Bureau of Labor Statistics, Bureau of Economic Analysis

Several price categories raised eyebrows in August, including the first rise in air travel costs since March. The +4.9% increase followed -8.1% declines in both June and July and suggests airlines will try to pass higher fuel costs and rising salaries on to passengers ... until they can't.

The cost of auto insurance climbed another +2.4% in August and is up +19.1% year-over-year, the biggest annual gain in five decades. Rising insurance rates can be attributed to higher repair costs, which are heavily influenced by the price of labor and parts. Unlike airline travel, insurance is mandatory.

But the consumer inflation picture isn't all bad. The Fed's preferred price measure, core personal consumption expenditures (PCE) has been on a steady 18-month decline, with the annual rate dipping under 4% in August for the first time in nearly two years. And there's ample reason to expect CPI moderation in the coming months. Food prices have eased. Goods prices are generally flat, and goods inventories are elevated which hints at holiday discounts. But, more importantly, the August increase in rent plus OER was the smallest in two and half years. Completion of new apartment units reached a 50-year high in 2022 and are expected to be even higher this year. With shelter costs being the most consistent driver of core inflation during the last two years, the rise in housing supply should help counterbalance some of the pressure in the near term.

Fed officials resumed their tightening campaign with a 25 basis point rate hike at the July FOMC meeting after a June pause. The 11th increase in the funds rate over an 18-month period brought the overnight target range to 5.25% to 5.50%, the highest since 2007. At the September FOMC meeting, committee members held the funds rate steady, but released an unexpectedly hawkish "dot plot" which indicated fewer rate cuts ahead in 2024 and 2025.

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The markets may have focused on bond supply, inflation, and the Fed policy early in the quarter, but the narrative shifted on August 1st when Fitch downgraded the U.S. sovereign debt rating from AAA to AA+. The announcement was a surprise, coming two months after President Biden had signed a bipartisan deal to push the debt ceiling reckoning out beyond next year. The downgrade itself wasn't a concern, but Fitch's explanation grabbed the attention of political leaders. Fitch cited *"alarm over the country's deteriorating finances and expressed major doubts about the government's ability to tackle the growing debt burden because of the sharp political divisions, exemplified by the brinkmanship over the debt ceiling that brought the government close to a disastrous default."*

Clear support for the downgrade was found a week later when the Congressional Budget Office (CBO) released its July Budget Review. According to the CBO report, the U.S. budget deficit for the first 10 months of the current fiscal year had swelled to \$1.6 trillion, \$200 billion above the May estimate, and *more than double the shortfall over the same period a year ago*. The widening deficit was the result of both lower revenue (-\$418 billion) and higher spending (+\$473 billion). By mid-September, the overall national debt had climbed above \$33 trillion, *effectively doubling in just 10 years*.

The U.S. paid an average interest rate of 1.56% on that debt in January 2022. By August 2023, the number had increased to 2.92% (Statista). When borrowing rates were at record lows, it didn't seem to matter. Suddenly, interest rates are at their highest in decades, and the crippling cost of debt is on center stage.

Bloomberg pointed out that annual interest payments on the \$33 trillion debt now exceed annual spending on national defense. According to the monthly treasury statement for August, the Treasury Department spent \$808 billion on interest payments while Department of Defense's outlays totaled \$695 billion in the same period.

Obviously, the current level of spending isn't sustainable. The sobering realization queued up a government shutdown that was averted by a last minute continuing resolution, which effectively punted the hard budget decisions out to mid-November. *Conversations leading up to the November 17 deadline are expected to be heated.*

Record Treasury issuance, QT balance sheet reduction, rising inflation expectations, and a lack of enthused buyers pushed yields higher for the second straight quarter. The 12-month Treasury-bill, which ended Q2 at its highest yield in 22 years, climbed a few more bps during the summer quarter to establish a new high going back to December 2000.

The 10-year Treasury yield reached a 16-year peak just days before quarter end and closed at 4.57%, more than 400 basis points above its pandemic low established in August 2020.

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### Q3 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
<b>Last</b>	6/30/23	5.00%-5.25%	5.28%	5.39%	4.90%	4.16%	3.84%
<b>High</b>			5.48%	5.48%	5.18%	4.69%	4.61%
<b>Low</b>			5.27%	5.24%	4.63%	3.95%	3.75%
<b>End</b>	9/30/23	5.25%-5.50%	5.45%	5.45%	5.04%	4.61%	4.57%

Source: U.S. Department of the Treasury

### Economic and Interest Rate Outlook

It seems self-defeating to speculate on where the economy will be in three months. Most of the expected hurdles in the path of growth are still firmly in place. Most notably, student loan payments, affecting roughly 27 million Americans, will come due in October after three years of deferment. Although it's impossible to know whether individual borrowers will be able to make payments without severely impacting discretionary spending, *Bloomberg News* reported that only 20% of the population is in better financial position than before the pandemic began. For the bottom 80%, holdings of cash and other liquid assets are now below pre-pandemic levels, according to Federal Reserve data.

The personal savings rate as a percentage of disposable income was +3.9% in August. Admittedly, this has been a volatile data series, especially over the past several years, but in the 10-year period before the pandemic, the average savings rate was +6.2%. With cash depleted for many, borrowings are on the rise.

The New York Fed reported that outstanding credit card debt topped \$1 trillion for the first time in the second quarter, and the average interest rate on this growing debt pile is just under 21%. The predictable cracks are already beginning to appear. Goldman Sachs reported that credit card losses are rising at the fastest pace in nearly 30 years, outside of the Great Recession. What makes this particular situation unique is that these losses are being incurred *during an expansion cycle* when individuals should be setting cash aside.

While consumption-fueled GDP in the world's largest economy continues to grow, other major economies are struggling. The European Union is in the midst of a mild recession, weighed down by the Russia/Ukraine war, an ongoing refugee crisis and rapidly rising energy prices. The European Central Bank (ECB) raised its overnight rate target in September by a quarter point, the 10th consecutive hike over a 15-month tightening cycle. After the meeting, ECB President Christine Lagarde indicated that interest rates were now high enough to make a "substantial contribution" to reducing inflation if "maintained for a sufficiently long duration." So, the ECB may be done tightening, but like the Fed, has signaled the start of the easing cycle will be delayed.

China's economy is still a long way from recession, but property values are plunging, growth is slowing along with foreign investment, and youth unemployment has gotten so high that the government no longer reports figures. The People's Bank of China

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(PBOC) has actually started *cutting* its key interest rates to support the economy and has been forced to reduce its holdings of Treasury debt to the lowest level since May 2009.

While China, the second largest foreign holder of treasuries has become a net seller, the Fed quietly continues to reduce its balance sheet. Over the past 12 months, quantitative tightening has allowed \$700 billion in maturing treasury supply to seep back into the general market. This might not be quite as big an issue if the Treasury had not borrowed over \$1 trillion during the quarter.

Market yields rise when supply exceeds demand. Supply has been massive in recent months and demand simply isn't keeping up. Fed mandates don't officially consider the detrimental effect higher rates have on the national debt, but that story has moved from the shadows to the spotlight. It might be time for Fed officials to pause balance sheet reduction, at least until rate hikes are complete.

At this point, the combined brake on economic growth is substantial. GDP will almost certainly weaken in the upcoming quarters. Bloomberg's September economist survey indicated an average GDP forecast of just +0.4% (QoQ% SAAR) over the next three quarters, with core PCE falling to 3.0% by Q1 2024.

The view of the nation's top economists is for significantly slower growth combined with moderating inflation. The surprisingly optimistic outlook resulted in a median forecast for *no additional rate hikes*, cuts to begin as soon as the second quarter, and a 2024 yearend funds target range of 4.00% to 4.25%. This is in sharp contrast to the Fed's September dot plot, which still indicated a final quarter point hike this year and just two rate cuts in 2024.

Chairman Powell emphasized repeatedly at the post FOMC press conference in September that the outlook was uncertain. *There's little doubt about that.* The U.S. economy may be entering the fourth quarter with apparent momentum, but the headwinds are strong. The Fed might not be done, but a case can be made that *they should be.*

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