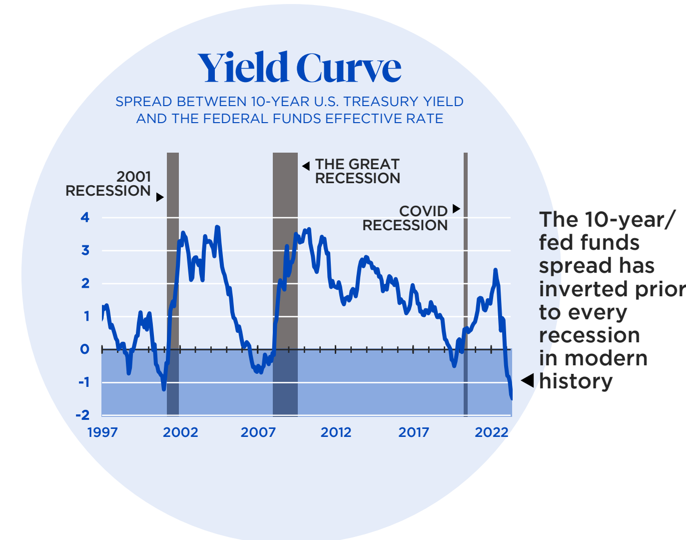
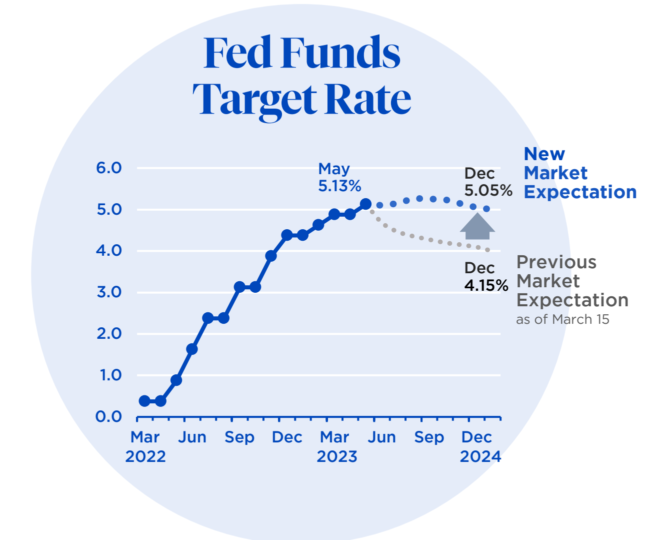
Economic & Financial Markets Monthly Review | June 2023

Resiliency of spending, hiring keeping a recession at bay

Where is the economy now?

Spreading contractionary readings across sectors in response to the Fed's tightening cycle suggest that the U.S. economy is moving towards a downturn. Key leading indicators also point to high recession risks over the next year. But this pre-recessionary period has been extended by continued strong job gains and spending on services.





Where we are this month

DELAYED RECESSION FOR NOW

Approaching mid-year, imminent recession concerns continue to be delayed by stronger-than-expected demand for workers.

DEEP YIELD CURVE INVERSION

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

RATE CUT ESTIMATES HAVE FADED

Financial markets are no longer pricing in high odds of rate cuts by the Fed for this year given lingering strength from job growth and inflation.

What does this mean

- Still, manufacturing has been contracting for months, and housing activity remains depressed, while the service sector expansion has slowed as consumers start to cut back.
- Our baseline forecast assumes that a moderate recession hits by the fourth quarter of 2023. But the timing of a downturn remains uncertain due to multiple crosscurrents including pandemic-related household savings.

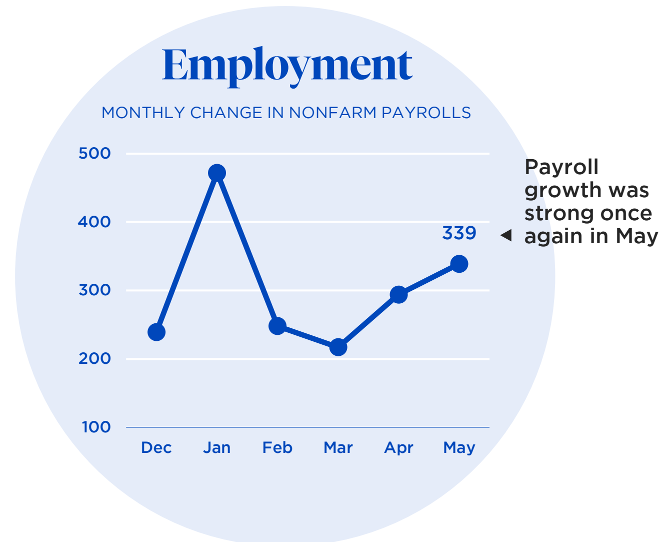
- This reflects the bond market's high expectation of a recession in the year ahead, as a downturn has always followed a sustained yield curve inversion since at least 1962.
- Over recent cycles, the Fed has typically cut rates ahead of a recession, causing the yield curve to steepen from its inversion — but this likely does not occur this time due to higher inflation.

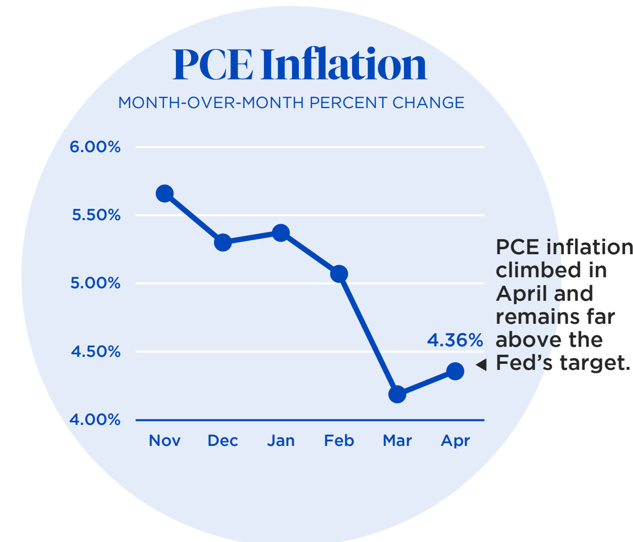
- Following the Silicon Valley Bank failure in March, fed funds futures showed a quick pivot to policy easing — in deference to commentary and forecasts from Fed officials.
- Markets now expect the fed funds rate to remain above 5.0 percent through year-end, including a possible rate hike at one of the next two FOMC meetings.

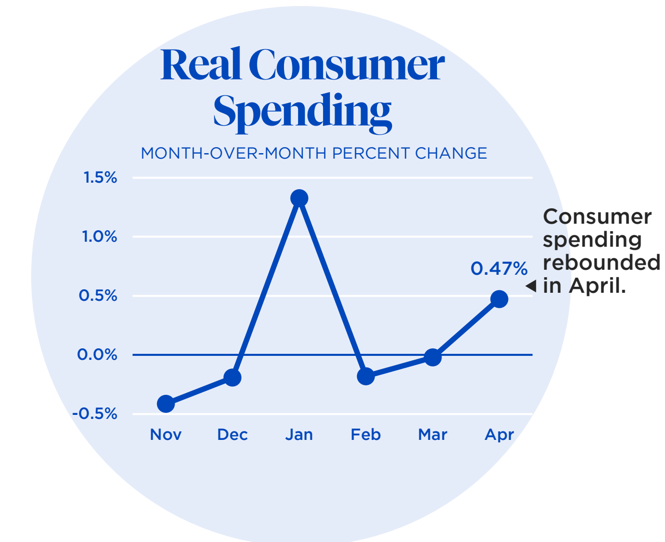
Economic Review

Labor demand has diminished very little

May's job growth was nearly equal to the average growth from the last 12 months, suggesting that there has been little cooling of labor demand. Additionally, wage gains were solid again, which should add to what was already a strong start to the second quarter for consumer activity. But the overheated labor market also increases concerns of persistent high services inflation.







Where we are this month

NO SLOWDOWN IN LABOR DEMAND

Nonfarm payrolls increased by a strong 339,000 in May as services firms continue to seek more workers to meet consumer demand.

PCE INFLATION CLIMBED IN APRIL

PCE inflation (the Fed's preferred measure of inflation) diverged with CPI in April as the 12-month trend rate climbed to 4.4 percent.

CONSUMER ACTIVITY STILL HUMMING

Real consumer spending climbed 0.5 percent in April, the fastest gain since January — hinting at a solid start for economic growth in the second quarter.

What does this mean

- A drop in reported employment within the household survey caused the unemployment rate to rise to 3.7 percent. But differences between the two surveys within the monthly job report are not unusual.
- Wage gains were slower in May than in April, but still strong enough to likely drive healthy consumer activity during the month.

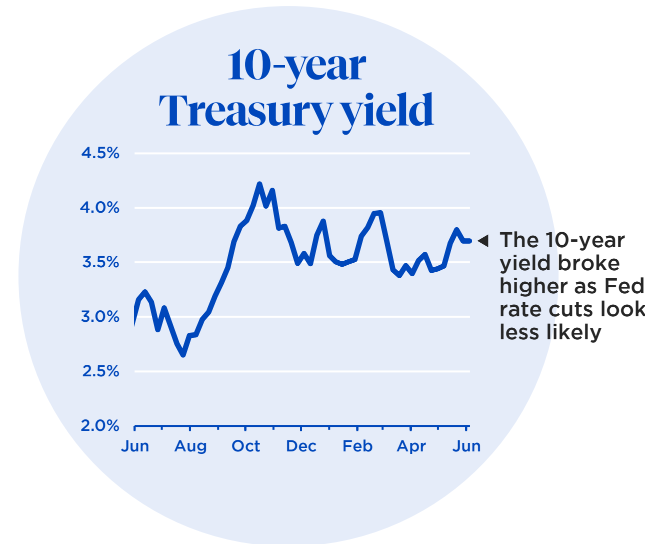
- Core PCE inflation also climbed, and Fed Chair Powell's favored core services ex housing inflation is only a little below its recent peak after rising to 4.4 percent in April.
- The core services reading will be an important data point influencing whether the Fed will hike the policy rate another 25 basis points in June or pause until the July meeting. The May CPI data released on the first day of the June FOMC meeting will also be closely watched given it will be the latest reading on inflation.

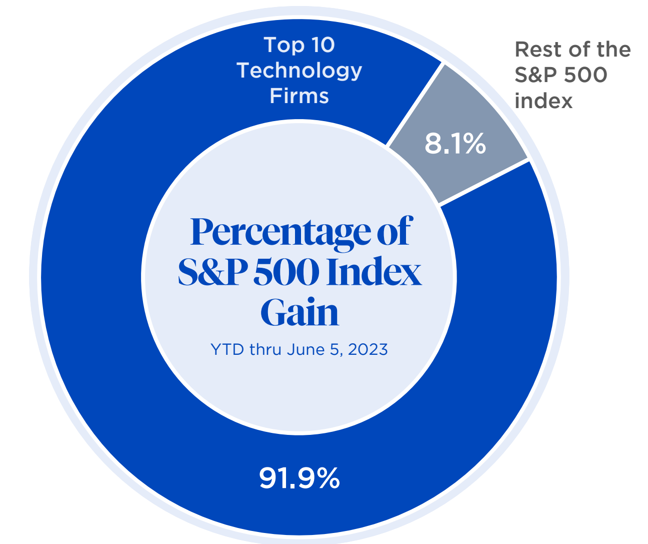
- Services spending was strong in April, as it has consistently been for more than a year now. However, there was also a rebound in goods spending led by a spike in auto purchases.
- Consumer activity is still being supported by strong job and wage gains, but consumers are also spending down their excess pandemic-related savings – which still amounted to roughly $500 billion according to a recent estimate from the San Francisco Fed.

Financial Market Review

Summer heats up for markets

Investors celebrated that the debt ceiling crisis was averted. The equity market looked ahead optimistically to potential double-digit earnings growth for 2024 and was buoyed by a surge in tech leaders, and the bond market focused on the Fed while a robust Treasury issuance awaits. The path forward for the equity market remains unclear with corporate earnings still under pressure from rising costs and a tight lending environment.





Where we are this month

EARLY SUMMER RALLY

As June starts, the 2023 gain for the S&P 500 was more than 11 percent despite bank failures and a close call for a government debt default.

DEBT CEILING CRISIS PASSES

The 10-year Treasury note yield moved modestly higher in May as expectations for higher policy rates extended to year-end 2023.

THE TECHNOLOGY INFLUENCE

Large tech firms (including Amazon, Google, and Tesla) have driven the market increase in 2023, accounting for 90+ percent of the S&P 500 gain.

What does this mean

- According to FactSet, the second quarter's earnings per share estimate shows a quarterly decline of two percent, notably higher than expected a month ago.
- The S&P 500 in early June was up nearly 20 percent from the low last September. While still down from the peak in January 2022, markets have shown remarkable resilience to threats.

- The debt ceiling extension removed some of the uncertainty plaguing the short-term Treasury market. A large wave of issuance will add new yield pressures that, but like the debt ceiling concern, should pass in due time.
- Mortgage and auto loan rates also moved higher over May, in part reflecting tighter lending standards by domestic banks.

- Market gains over May were more evenly distributed, with about 60 percent of the S&P 500 gain since May 1st generated from the top ten technology names.
- The lack of balance for equity market returns could be a risk factor in H2 2023, especially if recession fears come to fruition. Further lagging performance of non-tech leaders indicates rising concern about an economic slowdown.

Outlook

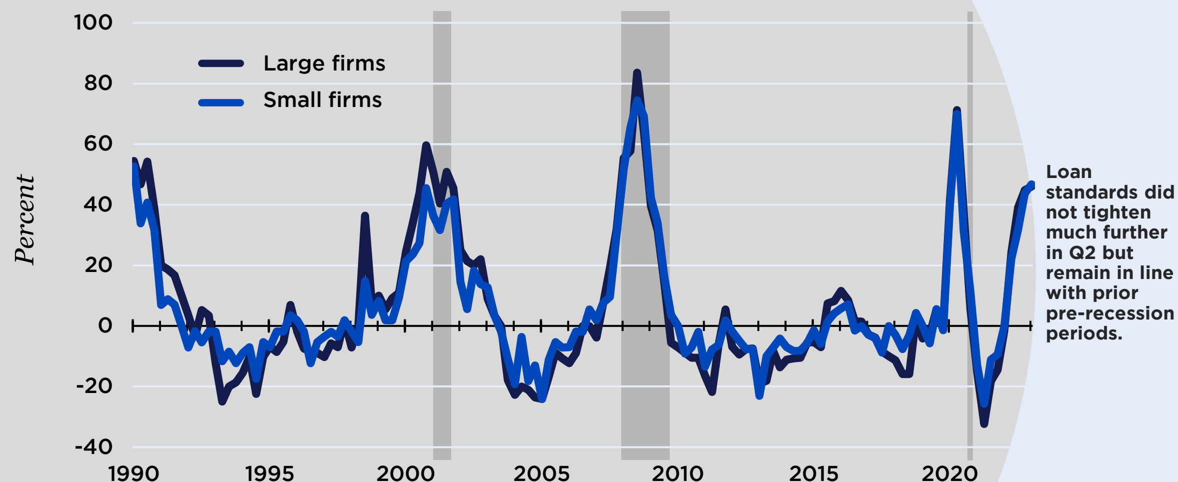
Tighter bank lending a key risk

The initial banking crisis that started in March has calmed as bank deposits have normalized and banks have broadly shored up their balance sheets. But the downside risk for the economy from a sharp tightening of bank lending may not have unfolded yet. Business loan standards tightened further in the second quarter, but not as much as worried given the disruptions for many regional banks since March. Still, the Fed's latest Beige Book findings noted much tighter credit conditions across most districts with increased concerns about liquidity for businesses. Mortgage credit availability in April was the tightest reported since the Great Recession as banks cut risk from their portfolios.

If the market for lending dries up in coming months, the negative impacts for consumer activity and business investment could be substantial — either clinching a recession or making a downturn even deeper/longer.

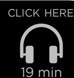
Percentage of banks that are tightening C&I loan standards

as of Q2 2023; Recessionary times represented by gray bars.



Loan standards did not tighten much further in Q2 but remain in line with prior pre-recession periods.

Podcast
How the strong labor market could influence the next rate hike decision?
CLICK HERE



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Latest Forecast

Data as of June 2023

	2022 ACTUAL	2023 ESTIMATE	2024 FORECAST	2025 FORECAST	2026 FORECAST
REAL GDP	2.1%	1.5%	-0.3%	2.3%	1.7%
UNEMPLOYMENT RATE	3.6%	4.1%	5.3%	4.7%	4.3%
INFLATION [1] (CPI)	7.1%	3.9%	3.0%	2.4%	2.0%
TOTAL HOME SALES	5.67	4.86	5.00	5.50	6.00
S&P/CASE-SHILLER HOME PRICE INDEX	5.8%	0.5%	1.4%	3.5%	4.0%
LIGHT VEHICLE SALES	13.8	15.2	15.3	16.2	16.5
FEDERAL FUNDS RATE [2]	4.25%	5.00%	3.00%	2.00%	2.00%
5-YEAR TREASURY NOTE [2]	3.99%	3.80%	3.10%	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%	6.40%	5.20%	4.65%	4.40%
MONEY MARKET FUNDS	2.27%	4.97%	3.78%	2.40%	2.03%

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

Recession not likely until the 4th quarter

The strong jobs market continues to buoy activity while pushing out the timing of a recession. Leading indicators still strongly point to an eventual hard landing, but household services spending is unlikely to taper off sharply until the fall. This sets the stage for a moderate recession that starts later and likely extends into 2024.

Fed tightening, not easing, still the focus

Whether the Fed pauses in June or institutes another rate hike, policy rates should remain restrictive for a while given the still hot inflation trends across the economy. Financial markets have pared back expectations of rate cuts as consensus builds that interest rates are more likely to remain 'higher for longer' across the yield curve.

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Sources

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