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Economic Commentary:

Signs Point to an Accelerating Economic Slowdown

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Data released in August showed that economic activity is holding up better than expected given the ongoing tightening of credit conditions. Nevertheless, the impact of the Fed's 18-month effort to slow inflation is becoming increasingly visible. It can be argued that the extraordinary stimulus measures provided by the government and the Federal Reserve during the pandemic have caused the full effect of the Fed's tightening cycle to be mitigated. However, fiscal spending is now slowing, and current estimates by the San Francisco Fed suggest that the excess savings that have powered consumer spending over the past two and a half years will likely be depleted in the current quarter of 2023, potentially setting the stage for a weakening of support from the primary driver of the economy – the consumer.

The CPI for July reported a 0.2 percent month-over-month increase, bringing the year-over-year CPI to 3.2 percent. Shelter is the biggest component of the CPI at 34 percent, and based on the ongoing easing in rent pricing, the overall CPI is expected to continue to slow. Stripping out the shelter component, the index is growing at 1.0 percent year-over-year, which is down from 9.9 percent a year ago. The core CPI (excluding food and energy) came in at 0.2 percent for the second month in a row. These are the weakest consecutive readings since the first two months of 2021. Core CPI year-over-year is 4.7 percent.

The second reading of second quarter 2023's real GDP was lowered to a 2.1 percent annualized rate from 2.4 percent. First quarter 2023 real GDP growth was 2.0 percent, and included in this report was the initial estimate of corporate profits in the second quarter. Adjusted pretax corporate profits fell 0.4 percent during the reporting period and were down 6.5 percent from a year earlier.

In the face of higher prices, consumer spending in second quarter 2023 slowed to a 1.7 percent annual rate from 4.2 percent in first quarter. After a strong start to the year in January, real retail sales have stalled and are down 0.1 percent year-over-year through July. Year-over-year real retail sales have been flat or negative in eight out of the last nine months. In July, real consumer spending increased 0.6 percent, but real disposable personal incomes declined 0.2 percent causing consumers to pull down their savings rate to an eight-month low of 3.5 percent from 4.3 percent in June. For comparison, the pre-COVID savings rate was 9 percent.

In addition to declines in sales growth, credit quality is also eroding. The New York Fed reported that credit card balances continue to increase, and that the delinquency rate for 30-days past due is at the highest level since second quarter 2020. The 60-days past due delinquency rate too has risen and is now at the highest level since fourth quarter 2019. The credit card non-payment rate hasn't been this high since third quarter 2012. Consequently, bankers set aside $21.5 billion of loan loss reserves during second quarter 2023, which is the third highest amount in the past decade.

In early August, Moody's cut the ratings on a number of U.S. regional banks due to pressures from rising funding costs and concerns about loan exposure in the commercial real estate market. Banks are seeing many depositors shift their funds into higher interest-bearing accounts, increasing banks' funding costs, while the decline in deposits and the decline in value of their securities is negatively impacting liquidity. As a result, bank credit, which is the amount of credit available to businesses or individuals for loans, is now contracting on a year-over-year basis – not a positive development for a credit-driven economy.

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The ISM manufacturing index for August came in at 47.6 for the tenth consecutive month below 50, indicating contraction in the manufacturing sector. Only five of 18 industries reported growth. The new orders index has been in contractionary mode for 12 consecutive months.

Through July, the Leading Economic Index (LEI) has been down for 16 consecutive months and is now at the lowest level since June of 2020. Historically, such a string of declining readings has only happened when the economy is in or nearing a recession.

The August employment report showed an increase of 187,000 in non-farm payrolls, and the prior month was revised down to 157,000. There have been downward revisions to every employment report this year, totaling 355,000. The three-month average of payroll gains is now at 150,000 – for comparison, it was 284,000 at the end of 2022. The unemployment rate increased to an 18-month high of 3.8 percent, up from 3.5 percent, driven by a 736,000 increase in the labor force and an increase of 514,000 unemployed. Full-time jobs declined by 85,000 and employment from temp agencies has been declining for seven months. Wages grew only 0.2 percent during August, which was the weakest monthly increase since February 2022, bringing the year-over-year growth rate to 4.3 percent. The Job Openings and Labor Turnover Survey (JOLTS) for July showed all four components of the survey deteriorating: job openings down, hirings down, voluntary quits down, and layoffs up. In short, the hot labor market is cooling, thus reducing wage growth pressures.

The Fed's Chair Powell delivered a speech at the Fed's Jackson Hole gathering in which he stated that although inflation has moved down over the past year, it remains too high. He reiterated that the Fed remains fully committed to its goal of 2 percent inflation and is prepared to raise rates further, if appropriate. The Fed intends to hold policy at a restrictive level until it is confident that inflation is moving sustainably down to the 2 percent goal.

The real Fed Funds rate (inflation adjusted) is now at the highest and most restrictive level since 2009. Even if the Fed elects not to increase rates further, the declining inflation pressures will effectively cause the real Fed Funds rate to increase.

Markets are now pricing in a lengthy pause in interest rate actions before the first interest rate cut possibly occurs in the spring of 2024.

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