ECONOMIC AND FINANCIAL DIGEST

Volume 31 August 2024

Mission Accomplished?

In the spring of 2022, the Federal Reserve embarked on a mission to wrestle inflation under control without cratering the economy. At the time, the Fed's preferred inflation measure, the core Personal Consumption Deflator, was increasing at a 5.5 percent rate and the unemployment rate stood at 3.6 percent. Over the next 12 months, the Fed stepped on the brakes harder and harder lifting its short-term policy rate from near zero to a range of 5.25%-5.50% in July of 2023. At that point, inflation had retreated to 4.3 percent, good but not close enough to the central bank's 2 percent target. With unemployment still at a historically low 3.5 percent, policymakers stayed the course, keeping rates unchanged at its peak levels until it saw more progress on the inflation front.

Fast forward to now, and inflation has receded 2.6 percent, putting the 2 percent target within sight. Meanwhile, the unemployment rate has crept up to 4.1 percent. That's still low by historical standards, but the half percent increase from its low point is rarely seen outside of a recession. The economy is still chugging along, but history shows that once the unemployment rate strings together several consecutive monthly increases, it is difficult to stop before a recession sets in. So, should the Fed declare "mission accomplished" and start unwinding its rate hikes before it's too late? Keep in mind that monetary policy affects the economy with a lag, and waiting too long could well put the Fed behind the curve.

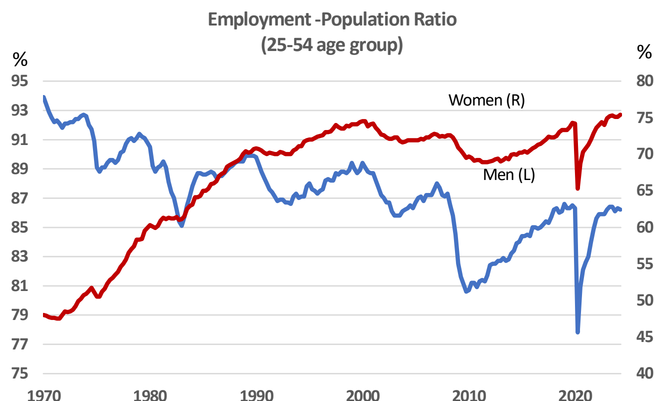
That is the debate currently running through the financial markets and keeping Fed officials up at night. The Fed professes to be data-driven; if it aligns policy with the latest batch of reports, it should start cutting rates now. But the numbers do not always tell the full story, and it's unclear how many months of data are needed to confirm a trend. When inflation more than doubled during the first year following the pandemic lockdown, the flareup was so rapid and occurred amid such unusual circumstances that the Fed thought it would be "transitory" and stayed on the sidelines. That was a blunder, of course, as inflation continued to rise for another year until the Fed finally stepped in. No doubt, that unfortunate episode is keeping the Fed far more cautious than otherwise now, fearing a premature easing before inflation is defeated. As it turns out, however, the forces driving up inflation in 2021-22 were indeed transitory; it just took longer for them to unwind than expected. Now they mostly have, and the Fed is risking another blunder – waiting too long to ease up on the brakes.

Thank You Ladies

Many catalysts lit the fire under inflation during the early years of the post-pandemic recovery. Topping the list were the trillions of dollars of demand fueled stimulus payments that collided with severely constrained supply chains. The ensuing supply shortfall was pronounced in both the product and labor markets. When lockdowns were lifted, the supply chains in the product markets were the first to heal, as production came back on stream, ports unclogged, global trade resumed and the shortage of parts eased, allowing factories to refill order backlogs.

However, the labor market was slower to recover and meet the intense demand for workers. Health concerns kept employees away from contact work, older workers whose 401k plans were stuffed with stimulus checks took early retirements, toughened immigration policy stifled the inflow of foreign job seekers and, importantly, family responsibilities kept parents home, particularly women who left the labor force in droves. The resulting labor shortage drove up wages and stoked the Fed's biggest fear of a wage-price spiral that continued until recently.

But the labor market eventually jumped on the recovery trail, as people returned to the labor force. The pandemic's grip on the nation eased, higher wages lured workers off the sidelines, people with lower incomes spent their stimulus checks and needed paychecks, and the intense competition for labor opened up job opportunities to a broader swath of marginal workers. An aging population continued to spur retirements, preventing the overall labor force participation from reaching pre-pandemic levels. But the prime-age (25-54) segment of the workforce fully recovered by early last year and climbed to a new high this year. Importantly, women led the charge. Indeed, more working-age women are working than ever before in U.S. history, leaving their male counterparts in the dust. The rise in flexible work arrangements,



including working remotely from home, clearly contributed to the increase, particularly for college-educated women with young children.

Rebalancing Almost Complete

Unsurprisingly, as the supply of labor expanded wage growth slowed, as the number of vacant jobs competing for workers declined. At the time of the first rate hike in March 2022, there were 2 job openings for every unemployed worker and the year-over-year increase in average hourly earnings soared to just under 6 percent. By May of this year, vacancies had dropped to 1.2 per worker, almost spot-on with the average for 2019, and earnings growth subsided to 3.9 percent.

The rebalancing of the labor market goes a long way towards explaining why the Fed is feeling more confident that inflation is on a sustainable path towards 2 percent. There is still a ways to go, as wage growth would need to slow to around 3.5 percent, which assuming 1.5 percent productivity growth, would be consistent with a 2 percent inflation rate. Keep in mind too that average hourly earnings in the monthly jobs report is not the only – or most relevant – measure of labor costs. Other yardsticks are showing a stronger increase, albeit they are not as current or as granular.

The good news is that the rebalancing in the labor market is unfolding just the way the Fed wants. Supply is up and hiring is slowing. But companies are not purging workers from payrolls in an effort to control labor costs. Simply put, workers are reentering the labor force, but not all of them are finding jobs right away, which is why the unemployment rate is creeping up – and wage growth is slowing. That may not be ideal for the job seekers, but if the unemployment rate were rising because companies were engaged in massive layoffs, the broader economy would be suffering far more damage than is currently the case.

Warning Signs

That said, it would be a mistake to be overly complacent about the resilience of the labor market. As noted earlier, when conditions start to weaken, it is difficult to stop. The half point climb in the unemployment rate so far is not particularly worrisome because it was historically low when the climb began and remains well below recessionary levels. Likewise, the number of workers filing for unemployment benefits is also well below that recessionary threshold. But the trend in both bears watching, as it could quickly gain traction before policy makers can get a handle around it.

As it is, other signs of deteriorating labor conditions are becoming more visible. While layoffs are still subdued, it is taking longer for workers on the unemployment lines to find a job. The percent of workers out of a job for more than 27 weeks has risen for five consecutive months and, at 22.2 percent, is the highest since early 2022. The job finding rate, the percent of unemployed workers last month who are employed this month has also been trending lower and small business hiring plans, which account for the bulk of new jobs, recently hit a four-year low.

So far, the cracks in the labor market have not had a significant effect on economic activity. Although the economy's first-half performance was underwhelming to say the least, it's key growth driver, consumer spending, has held up, thanks mainly to the muscle provided by upper income households who have benefited immensely from a strong stock market and surging housing wealth. There is no reason to think they will suddenly zip up their wallets, but those in the less wealthy cohort are tightening their belts and many are falling on hard times, as credit card delinquencies are rising and missed auto loan repayments are resulting in a wave of car repossessions.

Risk of Waiting

The financial struggles of lower-income households can be overcome if a resilient job market continues to provide them with paychecks. However, once hiring slows, they are the first to be left behind. Worse, when companies decide to downsize, they are usually the first to go. While this distressing cycle has yet to materialize, heightened job insecurity is already permeating the workforce. Fewer workers are voluntarily quitting and the wage premium for switching jobs has narrowed.

Should this feeling of job insecurity escalate, it is only a matter of time before households pull back spending and decide to build up precautionary savings. At that point, the path to a recession would become wider. With the job market still cranking out around 200 thousand payrolls a month, it does not seem that worries over employment opportunities are justified. However, recent job gains are coming from a narrowing group of sectors, with government and healthcare providing most of the increase. Signs of frugality are already appearing on a number of fronts, as the personal savings rate is creeping up and price-conscious consumers are trading down, something that is starkly revealed in recent earnings calls of high-profile retailers.

The Fed needs to stave off the prospect of an abrupt consumer pullback by relieving the financial burden on lower income households, cutting borrowing costs sooner rather than later. True, there is the risk that the inflation retreat could stall out. Indeed, further year- over- year progress will be harder to come by as incoming data will be compared to the low readings in the second half of last year, when inflation was falling sharply. What's more, shipping costs have recently spiked, which some commentators attribute to importers pulling forward deliveries to avoid possible higher tariffs next year that has become an election issue. But a renewed inflation flareup is unlikely to stick unless other conditions are in place, most notably a tight labor market driving up wages, which is no longer the case. And, if a repeat of the first-quarter's inflation flareup does occur, the Fed can always stop cutting rates temporarily to avoid undercutting its inflation-fighting mission.

KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	June	May	April	March	February	January	December	12-Month Range High	Low
Prime Rate	8.50	8.50	8.50	8.50	8.50	8.50	8.50	8.50	8.29
3-Month Treasury Bill Rate	5.24	5.25	5.24	5.24	5.24	5.22	5.24	5.34	5.22
5-Year Treasury Note Rate	4.32	4.50	4.56	4.20	4.19	3.98	4.00	4.77	3.98
10-Year Treasury Note Rate	4.31	4.48	4.54	4.21	4.21	4.06	4.02	4.80	3.90
30-Year Treasury Bond Rate	4.44	4.62	4.66	4.36	4.38	4.26	4.14	4.95	3.96
Tax-Exempt Bond Yield	3.94	4.00	3.87	3.54	3.53	3.36	3.36	4.13	3.36
Corporate Bond Yield (AAA)	5.13	5.25	5.28	5.01	5.03	4.87	4.74	5.61	4.66
Conventional 30-Year Mortgage Rate	6.92	7.06	6.99	6.82	6.78	6.64	6.82	7.62	6.64
Dow Jones Industrial average	38904	39129	38401	39106	38721	37764	36948	39129	33319
S&P 500 Index	5415	5235	5112	5171	5012	4804	4685	5415	4269
Dividend Yield (S&P)	1.33	1.36	1.39	1.37	1.42	1.47	1.48	1.63	1.33
P/E Ratio (S&P)	25.6	24.7	24.1	25.1	24.3	23.4	23.0	25.6	20.6
Dollar Exchange Rate (vs. Major Currencies)	124.0	122.2	122.5	121.0	121.4	120.6	120.2	124.0	118.6

* Monthly Averages

Economic Indicators

	June	May	April	March	February	January	December	12-Month Range High	Low
Housing Starts (Thousands of Units)	1353	1314	1377	1299	1546	1376	1568	1568	1299
New Home Sales (Thousands of Units)	617	621	730	683	643	664	654	730	611
New Home Prices (Thousands of Dollars)	417	407	414	436	421	430	418	440	407
Retail Sales (% Change Year Ago)	2.3	2.6	2.8	3.6	2.0	0.2	5	5.00	0.2
Industrial Production (% Change Year Ago)	1.6	0.3	-0.8	-0.4	-0.2	-1.2	0.8	1.6	-1.2
Operating Rate (% of Capacity)	78.7	78.3	77.7	77.7	78.0	77.2	78.2	79.0	77.2
Inventory Sales Ratio (Months)		1.37	1.37	1.37	1.37	1.38	1.37	1.39	1.36
Real Gross Domestic Product (Annual % Change)				1.4			3.4	4.9	1.4
Unemployment Rate (Percent)	4.1	4.0	3.9	3.8	3.9	3.7	3.7	4.1	3.5
Payroll Employment (Change in Thousands)	206	218	108	310	236	256	290	310	108
Hourly Earnings (% Change Year Ago)	3.9	4.1	3.9	4.1	4.2	4.3	4.3	4.7	3.9
Personal Income (% Change Year Ago)		4.6	4.4	4.3	4.3	4.6	4.5	4.9	4.3
Savings Rate (Percent of Disposable Income)		3.9	3.7	3.5	3.7	4.0	3.6	4.4	1.37
Consumer Credit (Change in Blns. Of Dollars)		11.4	6.5	-1.2	11.6	12.8	4.7	23.5	-16.3
Consumer Prices (% Change Year Ago)	3.0	3.3	3.4	3.5	3.2	3.1	3.4	3.7	3.0
CPI Less Food & Energy (% Change Year Ago)	3.1	3.4	3.6	3.8	3.8	3.9	3.9	4.7	3.1
Wholesale Prices (% Change Year Ago)	2.7	2.4	2.2	1.9	1.6	1.0	1.1	2.7	0.8