# Weekly Market Commentary

## *October 31, 2022*

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News that the economy resumed growth in the third quarter, following two quarterly contractions, landed with a loud thud this week. Investors and traders looked under the hood and found little to get excited about. For sure, nothing in the GDP report will sway the Fed to change its decision to raise interest rates at next week's FOMC meeting, when another outsized 0.75 percentage point increase is widely expected. Nor will it alter judgements as to whether the U.S. economy emerged from a first-half recession or whether it is moving closer towards one. Looking at the headline GDP, which met the common recession definition of two consecutive quarters of decline, the former perception would seem to be the case. Looking under the hood, however, the GDP report tracks the latter scenario to a tee.

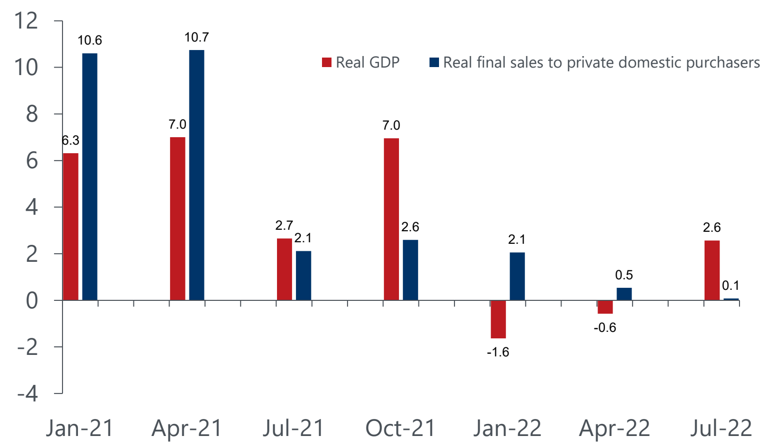
On the surface, the 2.6 percent annualized increase in real GDP, following a 0.6 percent decline in the second quarter and a 1.6 percent contraction in the first, reveals an economy firmly on the road to recovery. Indeed, the third quarter growth rate is spot on with the historical trend in the U.S., virtually a Goldilocks cruising pace that is neither too hot nor too cold. But only a die-hard idealist would cling to that view, as the headline growth rate masks a soft underbelly that more accurately describes the economy's performance. Indeed, rather than rebounding from a first-half slump, the details of the report reveal an economy that has turned considerably softer in the third quarter. What's more, the growth engine lost fuel during the period, suggesting little momentum heading into the final stretch of the year.

Importantly, the main thrust behind the growth pickup came from overseas rather than domestic sources. A positive turn in net trade contributed 2.8 percentage points of the 2.6 percent increase in GDP, fully offsetting the 1.4 percent drag from a slumping housing market and then some. Residential outlays, which account for less than five percent of GDP, plunged by an eye-opening 26.4 percent during the period and remains the heaviest weight on the economy going forward. The sagging real estate market is feeding through into the broader economy indirectly as well, pulling back spending linked to a home purchase, including appliances, furniture and moving expenses. While personal consumption did increase by an annual rate of 1.4 percent during the period, that was a slowdown from the 2.0 percent increase in the second quarter. What's more, the entire increase was for services; spending on durable goods fell for the second consecutive quarter.

Take out the boost from net trade – which is not likely to be sustained – as well as volatile inventory swings and government spending from the calculation, and the headline rebound in GDP is flipped 180 degrees by the slowdown in private demand. Inflation-adjusted sales to private domestic purchasers, which account for 80 percent of GDP, virtually stalled out in the third quarter, eking out a slim 0.1 percent advance following increases of 0.5 percent in the second quarter and 2.1 percent in the first. To be sure, the residential drag played a big part in the slowdown, but businesses and households, as noted above, took up only part of the slack. On a positive note, business stepped up capital spending in the third quarter, as outlays for equipment increased a robust 10.8 percent, reversing a 2.1 percent contraction in the second quarter.

Fred Eisel
Chief Investment Officer
Email: feisel@vfccu.org
Phone: 800-622-7494 ext. 1610

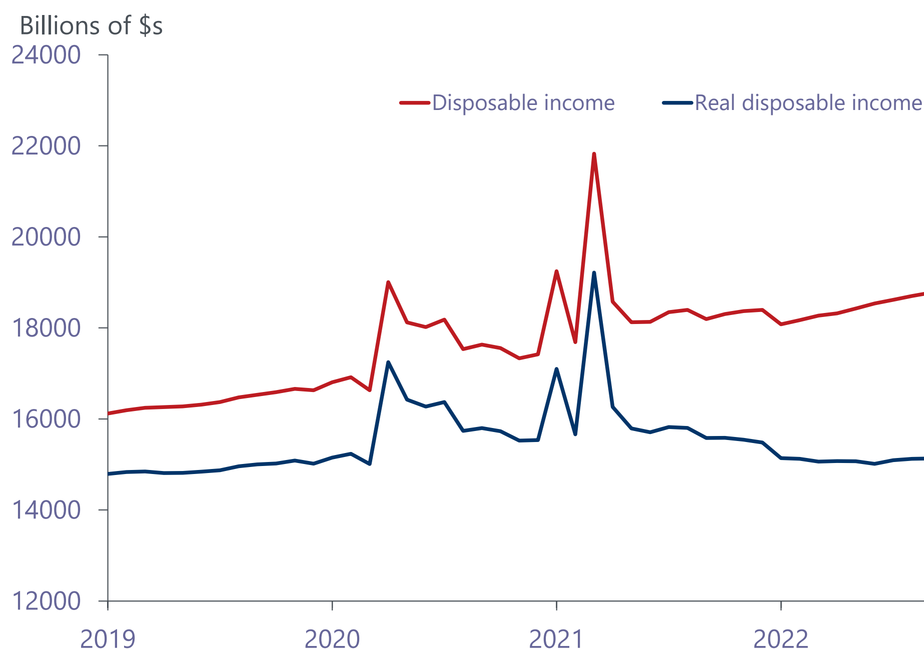
Scott Wood
Portfolio Strategist
Email: swood@vfccu.org
Phone: 800-622-7494 ext. 1631




But like the positive contribution from net exports, the boost from capital spending is not likely to be sustained going forward. The third quarter rebound may reflect the greater availability of components ordered months earlier when shipping logjams and other supply bottlenecks held back deliveries. In any event, the spending rebound has already lost steam. Shipments of capital goods, less aircraft – a proxy for business equipment spending in the GDP accounts – fell 0.7 percent in September, the first decline since February 2021. New orders for these same goods also contracted in the final month of the quarter, pointing to more weakness ahead. No doubt, there is a strong incentive to invest in productivity-enhancing equipment to offset rising labor costs and the shortage of workers. But business leaders have a very downbeat view of future sales prospects – with most expecting a recession next year – which undercuts that incentive.

Whether the economy stays afloat as the calendar heads towards 2023 depends largely on consumers, its main growth driver. The news on this front is mixed, at best. Thanks to a still sturdy job market, incomes are growing and encouraging households to keep their wallets open. And unlike business spending that faded at the end of the third quarter, consumer spending grew at a steady pace throughout most of the period, ending stronger than it began. In September, personal outlays increased by a solid 0.6 percent for the second consecutive month, lifting the level of outlays 8.2 percent above a year ago. Even after adjusting for inflation, real outlays increased by a respectable 0.3 percent, matching the advance in July.

The problem is spending outpaced the increase in income, which was entirely eviscerated by inflation and taxes. Real disposable incomes showed no gain in September and are down 2.9 percent from a year ago. Conversely, real spending, after its 0.3 percent September gain, is now almost two percent above its year-earlier level. To bridge that divide, households had to dip into savings and step up borrowing. The upshot: consumers are running out of fuel to sustain spending. The enormous savings cushion built up during the pandemic from copious government transfer payments and delayed spending due to lockdowns is vanishing as fast as the New York Yankees were ousted in the playoffs. In September, the personal savings rate stood at a depressed 3.1 percent; the last time it was that low you would have to go back to November 2007, a month before the economy descended into the Great Recession.

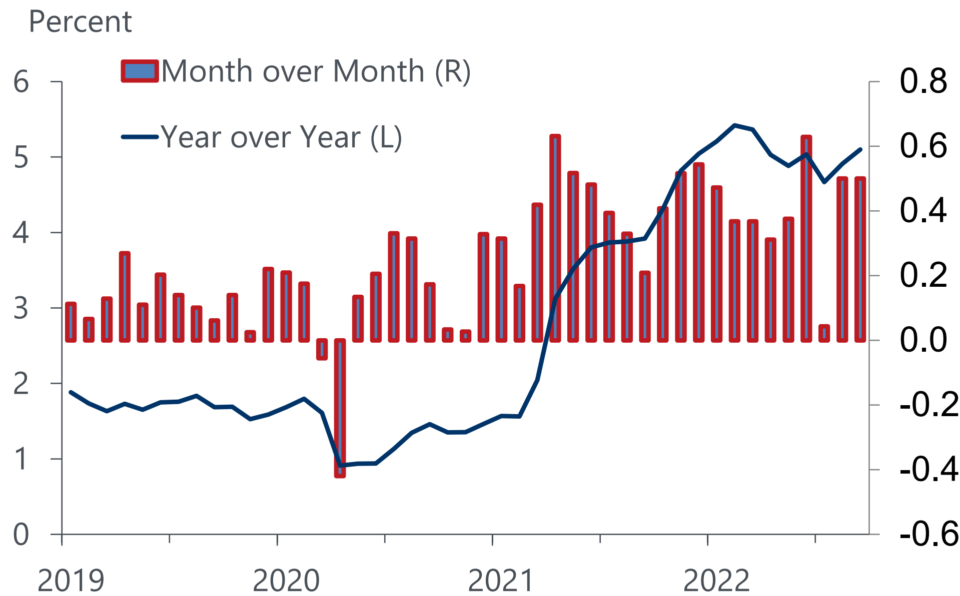



By itself, a low savings rate does not indicate that consumers are poised to go into hibernation, zipping up their wallets to rebuild finances. Household balance sheets are, collectively, still in good shape and while credit card balances are climbing, household debt burdens – and delinquencies – are still relatively low. But the headwinds against spending are gaining traction, most notably in the form of inflation and steeply higher borrowing costs. As noted, inflation wiped out all the income gain made last month and the lost purchasing power over the past year is taking its toll. Households in the aggregate may not yet be pulling back but they are altering spending habits in ways that echo distressing times, substituting cheaper for more expensive goods whenever possible and delaying discretionary purchases. The bite that inflation is taking on budgets of lower income households is particularly deep, reflecting the rapid rise in food, energy and housing costs which account for a larger fraction of their spending.

Hence, the pressure to curtail inflation remains the top priority of the Federal Reserve, notwithstanding signs that economic growth is downshifting. Any hope that fresh data on the price front would show some progress and encourage the Fed to ease up on its rate-hiking campaign was not forthcoming this week. First, the broadest measure of labor compensation, the Employment Cost Index, continued at an elevated rate, running five percent ahead of a year ago in the third quarter, virtually the same pace as the second quarter. The only welcome news is that wage gains slowed in the private sector, but there too, the 5.3 percent increase over the past year is far too strong for the Fed's comfort.

More important is that the primary inflation gauge the Fed monitors, the personal consumption deflator, continues to run stubbornly hot. Falling energy prices last month did hold the headline deflator to a 0.3 percent increase, the same as the previous month. But the increase in the core deflator, which strips out food and energy prices, posted a much larger 0.5 percent increase for the second consecutive month, lifting the increase over the past year to 5.1 percent from 4.9 percent.

Service price gains led the way up, paced by rising food and housing costs. Unfortunately for the Fed, service prices are stickier than goods prices, which is why the aggressive rate hikes so far have not had a more meaningful impact in curtailing inflation and why another 0.75 percentage point increase is almost certain to take place next week.




But they are not immune to higher interest rates, and there are signs that the Fed's moves are starting to take effect. Home prices have declined for two consecutive months, according the widely followed S&P/Case-Shiller index, and various industry sources point to softening rents in numerous markets. As the housing market continues to struggle in the face of skyrocketing mortgage rates, we suspect that cracks in housing costs will deepen in coming months. And it's not just higher borrowing costs deterring the demand for homes, eroding affordability and pushing an ever-larger swath of would-be borrowers to the sidelines. Keep in mind that more than 20 percent of homebuyers conduct their purchase entirely with cash. These cash buyers can now obtain yields of about four percent in the money market. On a median priced home of $481,000 in September, they would be forfeiting about $20,000 a year to purchase an asset that is declining in value. The housing market and its associated costs are being squeezed on both sides of the interest-rate pincers.