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September 2023 Economic Outlook: U.S. Economic Outlook: A cooling labor market and sticky inflation

Key takeaways:

- **The labor market is cooling with declining quits and job openings trending towards pre-pandemic levels.**
- **Inflationary pressures remain persistent, particularly in the service sector and rising food and gas prices challenging consumer spending and sentiment.**
- **The Fed Reserve is still battling ongoing inflationary pressures and likely will respond with an additional rate hike before year's end to quell the potential of future inflation reacceleration.**

Current economic hot topics

Three main topics impacting the U.S. economy today are the labor market, inflation, and interest rates. Throughout the report, we will explore these three key themes and how they are shaping up for the economy in 2024.

First, the U.S. labor market is normalizing. The labor market is showing signs of cooling with slowing new hires and declining job openings as well as decelerating wage growth.

Secondly, we'll take a bit of a deep dive into inflation, particularly some of the lesser talked about measures of inflation that the Fed keeps a very close eye on. While the labor market rebalancing is promising, the lagged effect of slowing wage growth on services inflation remains a significant challenge for the Fed.

Given the trends in the macroeconomy, the labor market, and inflation, we will end with interest rates and what we see happening with rates. We should expect at least one additional rate hike in the second half of this year to continue the ongoing battle with inflation.

Labor market showing clear signs of cooling

The labor market is demonstrating signs of normalizing. The labor flow metrics are balancing out. Labor flows consider the number of new hires, job openings, layoffs and discharges, and the voluntary quits rate. When we look at these four measures in a three-period year-over-year growth rate, they all tend to trend closely toward the zero line during periods where the labor market is balanced. Before the pandemic, labor flows demonstrated a more normal and balanced labor market.

In late 2021 and 2022, the labor flow metrics showed a significantly imbalanced labor market. During this time the

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economy had extremely high quit rates and job openings. Hire metrics were unable to keep up with the number of job openings. During this time, we were experiencing the most tight labor market and extremely low layoffs and discharges.

In September of 2023, we are seeing a flip in labor flows. Now, layoffs and discharges are higher than the same point in time last year. There are also declines in job openings. The number of hires and quits are declining year over year, so that's telling us that this labor market is softening. Overall, the loosening labor market trends are here to stay.

Finally, new hire trends also confirm signs of a settling labor market. The number of new hires on a three-month moving average is smoothing in the month-to-month volatility. The labor market is moving in the right direction, which is what the Fed has truly wanted to see.

The cooling labor market is important and good news. Quits are a great leading indicator of private wage and a six-month leading indicator of wage growth. According to these trends, wage growth will continue to decelerate as we head through the remainder of this year.

Underlying inflationary pressures remain stubborn

The cooling wage growth that we have seen so far has been relatively mild. Cooling wage growth is still not putting too much downward pressure on services inflation, which is definitely concerning to the Fed.

The Federal Reserve prefers the Personal Consumption Expenditures (PCE) Price Indices to gauge overall inflation rather than the CPI. This is not to say the Fed doesn't look at and pay attention to the CPI, but these PCE indexes are the more official measure of inflation for them.

The Total PCE Chain-Type Price Index represents headline inflation. It has been trending in the right direction, along with CPI, but there was a reacceleration in the inflation rate in July, according to the most recent data. This is not concerning and expected due to the base effect.

When looking at the Personal Consumption Expenditures Chain-Type Prices Indices, the Fed's primary focus, headline inflation is generally cooling. This excludes food and energy, which have seen little deceleration in headline inflation.

What concerns the Fed is the very minimal downward movement in core inflation and super core inflation measures. In July, total year-over-year price inflation reaccelerated from the base effect. But, more concerning than this reacceleration is the minimal downward movement in core and super core inflation. The deceleration in prices has been minimal, and inflation is still above 4%—services as a whole and services excluding energy above 5% year-over-year inflation.

Wage growth plays more heavily into the services inflation than overall total headline or goods inflation. The service sector inflation is stickier and not sensitive to falling commodity prices. Additionally, wage growth drives the service sector more than other sectors.

To date, wage growth has not slowed as much as needed to slow down this services inflation trend truly. But the good news is that the cooling labor market is a leading indicator that suggests wage inflation and thus service

sector inflation is likely to slow over the coming six months. Unfortunately, given that lag time, it's not likely fast enough for the Fed.

As a result, the Fed's going to be paying very close attention to these PCE services inflation rates, and that's going to be something that's definitely of concern for them as we head into the next FOMC meeting.

Continued inflation in volatile but essential categories to weigh on consumer wallets

While the economy made significant progress in the fight against headline inflation, we see some worrying signs in categories that impact consumers most.

Food prices have continued to increase yearly, with food inflation stuck above headline inflation. Fortunately, last month, the food-at-home prices inflation rate finally dipped below the headline inflation rate. But food away from home has continued with strong inflation. Overall, food inflation is well above that headline inflation.

High food and gas are among the most essential categories of consumer spending. Consumers respond quickly to gas prices, which are now rising again after falling from last summer's peak. So, unlike with more discretionary categories, consumers are primarily forced to absorb these price increases. Increased food and gas prices weigh more heavily on consumer wallets than price gains and tend to impact consumer confidence and consumer sentiment negatively.

High-frequency consumer data is already showing consumer confidence declines as gas prices rise. While the Fed doesn't usually respond strongly to flexible price pressures and is unlikely to react specifically to these prices, consumers will feel the impact of the rise. This will be a headwind for consumer spending, particularly on discretionary categories.

With increased gas prices and minimal downward movement in services inflation, there will likely be at least one additional rate hike by the Fed later this year. These trends will put extra downward pressure on consumer spending late in 2023.

At least one additional interest rate hike expected

While the labor market rebalancing is promising, the lagged effect of slowing wage growth on services inflation remains a significant challenge for the Fed during the next FOMC meeting. Couple that with still elevated food prices and reacceleration in oil prices, and we see a potential storm of inflation reacceleration.

It is unlikely the Fed is confident they have completely stamped inflation out. As a result, expect at least one additional rate hike in the second half of this year to continue the ongoing battle with inflation. Until the service sector inflation rate starts to trend lower, there will always be a chance for additional action from the Fed to curb inflation.

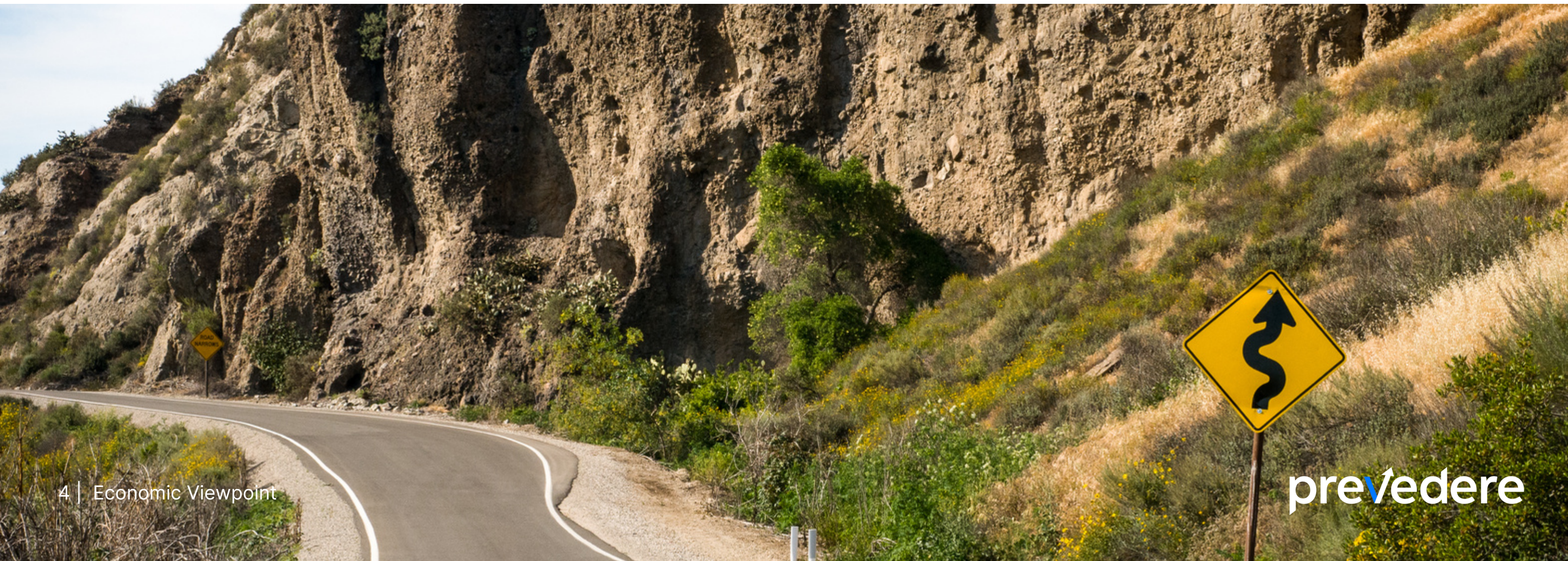
Conclusion

We are not entirely out of the woods yet. Things are likely to get a little rockier in the second half of this year as the higher borrowing cost persists and consumers face some significant spending challenges.

Sticky inflation remains elevated, particularly in the service sector. This ongoing concern for the Fed could call for one additional rate hike in 2023.

Continued high food price inflation and accelerating gasoline prices will put further downward pressure on consumer spending power in the second half of this year. The economy and consumer will see additional challenges due to the depletion of excess savings and the student loan repayments coming back into effect.

The labor market is showing signs of cooling nearly across the board. As a leading indicator of wage growth, a settling labor market suggests additional downward pressure during the coming quarters, which will be good news for service inflation early next year.



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