MACRO STRATEGY

Economic Monthly

Well, Do You Feel Lucky?

October 23, 2023

Monthly Themes

- The labor market has softened – at equilibrium or on a cliff's edge?
- Fiscal concerns remain in focus as the November 17 deadline looms.
- 10-year treasury yields rise sharply—a temporary high?

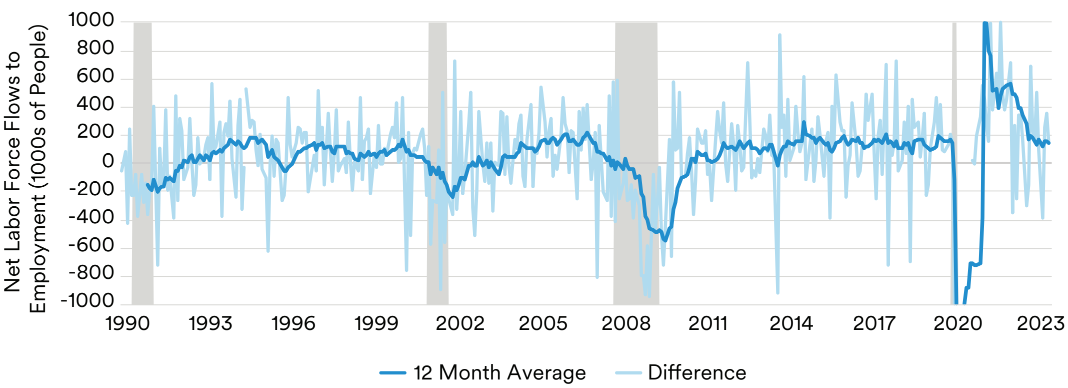
October data show us a decently-functioning economy, but one with numerous stressors that we expect will create further pressure on growth and could create an abrupt step down from the current decent conditions. A soft-landing scenario would require a great deal of luck to achieve.

The Labor Market: At Equilibrium or On a Cliff's Edge?

Despite the healthy establishment payrolls increase of 336,000 in September, we see a softening, rather than a signal for the Fed to hike.

First, the marginal number of people transitioning into or out of employment has reached pre-pandemic levels (Figure 1). These inflows have slowed over the last two years. The rate of people moving into employment is still healthy in absolute terms, but the metric is may be at a turning point as monetary policy remains tight and corporate profits weaken.

The Labor Market Has Softened but Still Remains Strong



Source: BLS, FRED, MIM

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Second, we are concerned about the sharp divergence between the payrolls number and the household survey's paltry 86,000 employment increase. That September reading was one of the weakest of the year, and a pronounced reversal from the prior three months' consistent 200,000+ increases. Accounting for statistical errors and methodology differences between the two surveys, the "truth" of employment growth is probably somewhere in the middle.

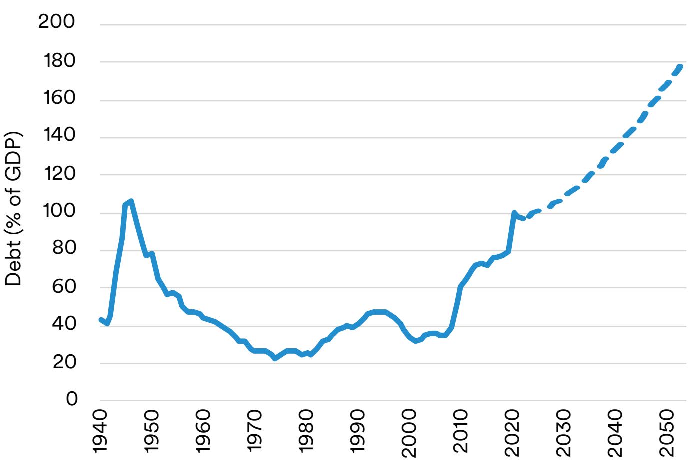
Getting Our House in Order

Fiscal concerns remain high, and we expect them to remain on a short list of worries beyond any government funding resolution that happens in November.

The current continuing resolution bill extends government funding to November 17. The lack of a House Speaker and the looming 2024 election year both add obstacles to the process and increase the risk of a shutdown in November.

Additionally, credit rating agencies have been more focused on the processes surrounding budget approvals rather than relying solely on financials. As such, a government shutdown or continued difficulty in passing a budget could put the U.S. credit rating under further scrutiny, especially given ballooning debt and net interest payments (see Figure 2 below).[1]

Debt to GDP Expected To Surpass 100% By 2024



Source: Congressional Budget Office, MIM

As we discussed in our previous monthly, a government shutdown should not by itself cause a recession. However, the delaying of spending or furloughing of workers may put marginal pressure on consumer spending and government spending in the near-term for the length of the shutdown, adding to the list of economic uncertainties.

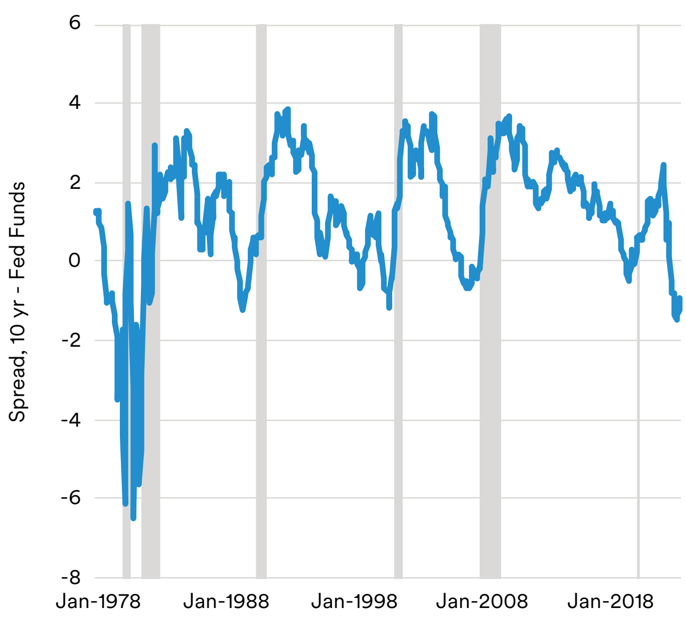
Rates ascendant

The 10-year treasury yield rose substantially in October, touching a high of 4.8% in the first week of the month.

The increase has come almost entirely from real rates, as inflation expectations as seen in the 5-year, 5-year forward inflation expectations have increased only marginally. This appears to be partly due to adjusted expectations about how long the FOMC will maintain current Fed Funds levels and about how long quantitative tightening will last. We expect some of these impulses to fade toward year end as anticipated economic weakness comes to the foreground and inflation falls further.

We also flag the changing structure of the yield curve. After a long period of inverted yield curves, we are seeing a steepening of the yield curve closer to positive. While inversions are commonly cited as leading indicators of a recession, in the last four recessions the yield curve normalized slightly before or coincident to the onset of the recession. If the pace of this shift continues as it has the last few months, the spread may be normalized by the first half of 2024, when we anticipate the recession will begin.

Yield Curve Normalization?



Source: Federal Reserve, Haver, NBER, and MIM

Risks to the Outlook

Our baseline outlook suggests a recession in the first quarter of 2024. Continued U.S. political disarray and the threat of turmoil in the Middle East with its potential effect on energy markets may provide further pressures on growth.

There are at least two potentially mitigating factors. First, consumers continue to spend, with monthly spending growth for June, July, and August all equal to or above personal income growth. Consumer spending in services remains solid, and continued strength in spending would soften the landing, so to speak. Second, large increases in construction spending and investment, fueled by the infrastructure bills, may also continue to buoy the economy, and soften a recession, even if consumer spending falters.

U.S. Outlook Summary

Our outlook remains the same as last month.

We expect that a recession will likely be avoided until 2024. The Fed has, in our view, completed its hiking cycle with its July rate hike. In 2024, we expect the Fed to begin a rate cut cycle, whether or not a recession takes place.

We foresee a downward shift of the 10-year U.S. Treasury yield toward 4.00% by year-end 2023. We believe the downgrade to U.S. debt is unlikely to lead to an enduring rise in rates, although they are approaching cycle highs.

We do not think credit markets have sufficiently priced in a hard landing scenario. Looking forward, we expect the credit cycle to turn in the coming quarters, with spreads widening further on continued recession risk. As a result, we prefer duration risks over credit risk.

MIM Forecast

U.S.	2023	2024
GDP	2.1	0.0
CPI	3.0	2.8
10 Year	4.00	3.50
Policy rates	5.50	3.00

Note: GDP is annual average growth rate, CPI is Q4 year/year, 10 year is year-end, policy rate is the upper bound year-end rate.
Source: Metlife Investment Management

Endnotes

1 Government shutdown: Could the U.S. implement austerity measures? (yahoo.com)

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