



The Fed Signals More Rate Increases Amid a Resilient Economy

Sticky inflation and further rate hikes reduce soft landing odds.

June 2023

KEY INSIGHTS

- The healthy employment picture has supported consumer spending, but it has also prompted the Fed to signal that more interest rate increases are coming this year.
- The labor market needs to loosen further for core inflation to meaningfully decrease toward the Fed's 2% target.
- My baseline scenario for the Fed is one or two more rate increases in 2023 as the central bank shifts to increasing rates at every other meeting.



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The U.S. economy continues to defy widespread expectations for a meaningful slowdown. The labor market remains strong, though demand for workers has started to moderate from its peak in 2022, as evidenced by lower vacancies and hiring intentions by small businesses. Strong employment growth and aggregate income have supported consumer spending, but this has made the Federal Reserve's job to bring

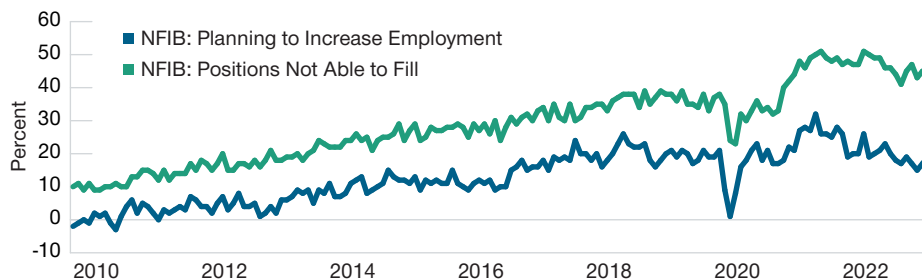
down inflation harder. As a result, the Fed seems set to hike interest rates further this year and keep them at a higher level for longer than markets anticipate. But how long can this economic resilience last?

Consumption Shifting to Services, but Consumer Balance Sheets Are Healthy

Consumer spending on goods—particularly vehicles—has been

Small Business Labor Market Still Tight

(Fig. 1) Sentiment based on surveys of small companies



As of May 31, 2023.

Source: National Federation of Independent Business (NFIB).

surprisingly strong. However, we expect vehicle sales to slow as the combination of higher interest rates and elevated average selling prices dampen demand.

Slowing vehicle sales will contribute to the ongoing shift in consumption from goods to services. Despite this trend, it's important to note that consumers are still spending. This contrasts sharply with the years after the global financial crisis of 2008–2009 and the “great recession,” when consumer balance sheets were heavily impaired and people needed to deleverage—which explains why that economic recovery was so shallow and slow.

No Major Cracks in the Employment Picture

The labor market appears to be slowly loosening. The unemployment rate crept up to 3.7% in May, although it is still near the lowest level since the late 1960s. Weekly claims for unemployment have also been on a gradual upward trend, average hours worked have declined, and wage inflation has slowed somewhat as demand for workers is not as strong as last year.

However, the number of job vacancies per unemployed person was still a historically high 1.8 as of April, so it would require many fewer vacancies and more unemployed workers to

return to the 2019 level of about 1.2.¹ In fact, I don't see any major cracks in the employment picture. These broad trends are consistent with a labor market that is normalizing, not an economy facing imminent recession. Overall, I anticipate only a small additional uptick in the historically low unemployment rate by the end of 2023.

The overarching question about the labor market is whether wage growth is decelerating fast enough to prevent a wage-price spiral from taking hold. The more time the economy spends in a high-inflation regime with a very tight labor market, the higher the risk that inflation expectations can become un-anchored and higher wage demands from workers reinforce the inflationary impulse.

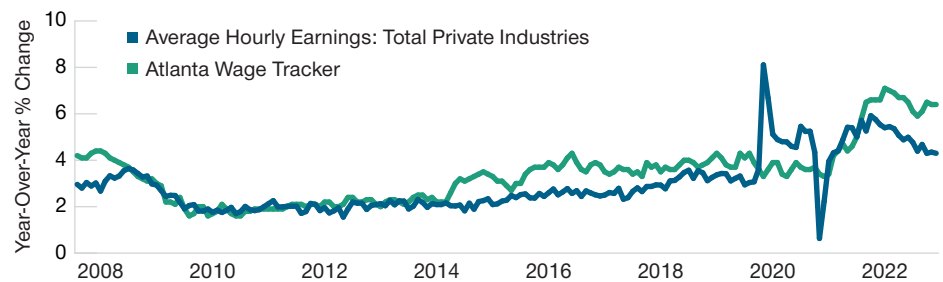
Some measures have shown signs of progress on this front, and wage inflation appears to have peaked across a range of measures, but progress still appears very slow. It is becoming increasingly clear that the economy needs more labor market slack for core inflation to meaningfully decrease toward the Fed's 2% target from over 5% as of May. The job on inflation is not yet done.

Interest Rates Are Set to Increase Further, but at a Slower Pace

Against this backdrop of core inflation that is still too high, the Fed needs

Very Slow Progress on Wage Inflation

(Fig. 2) Atlanta Fed's wage tracker recently reaccelerated



As of May 31, 2023.

Sources: Federal Reserve Bank of Atlanta, Bureau of Labor Statistics.

¹ Sources: Department of Labor's Job Openings and Labor Turnover Survey, Bloomberg Finance L.P.

to balance the risks of trying to slow the economy without pushing it into recession. My baseline scenario for the Fed is one or two more rate increases in 2023. However, the pace at which interest rates will increase is going to be much slower, with the most likely outcome a 25-basis-point increase at every other meeting.

As interest rates increase further, the question of whether the Fed will overtighten policy and cause a recession is going to loom over markets. While

a soft landing is possible, I think a recession is probably the more likely scenario. The stickiness of core inflation, coupled with the Fed's determination to bring inflation down, will lead the central bank to overtighten and tip the economy into recession, in my view. This has been the outcome of the majority of past Fed tightening cycles. On the question of timing, a downturn does not appear imminent, but I believe the economy will likely slide into a recession by the end of the year or in early 2024.



WHAT WE'RE WATCHING NEXT

We monitor employment of temporary and part-time workers as an indicator of overall labor market conditions, with a tight employment market leading to more demand for these categories of employees. Temporary employment has been on a downtrend in recent months, and there have been indications of falling demand for part-time workers, signaling that the jobs market may be loosening.

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