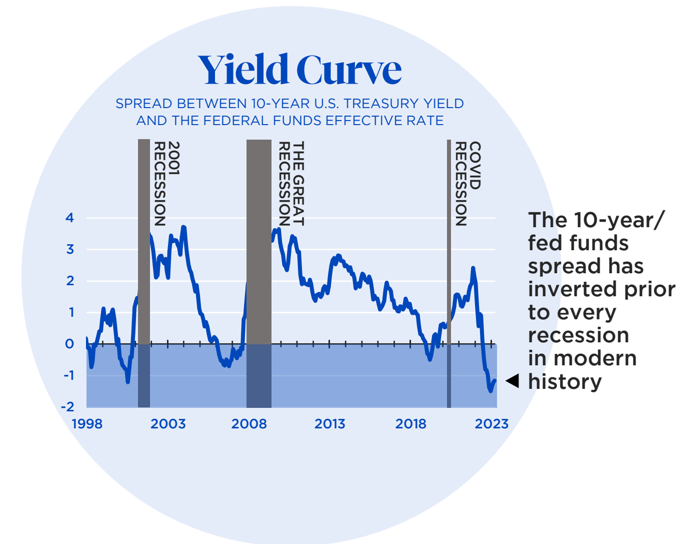
Economic & Financial Markets Monthly Review | September 2023

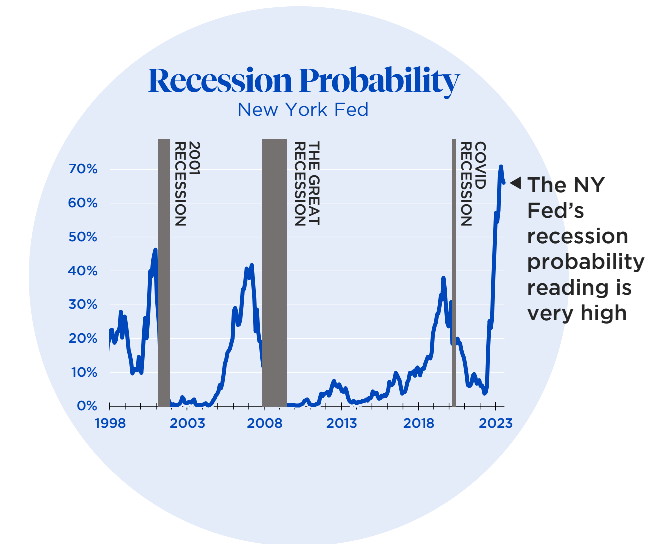
Cooler trends as summer turns to fall

Economic Overview

Where is the economy now?

Consumer and hiring activity remained solid in the third quarter, which should keep economic growth positive until year end. But a growing number of households are reaching their spending limits, while rising interest rates and tighter lending standards are weighing on investment decisions by businesses — typical signals that an eventual recession is on the way.





Where we are this month

RECESSION DELAYED FURTHER

Consumer spending has remained buoyant even as more households have been forced to dip into savings or take on additional credit card debt.

YIELD CURVE STILL INVERTED

The 10-year to fed funds rate spread has been inverted for 10 months, still short of the average length of inversion ahead of prior recessions.

INVERSION LIFTS RECESSION ODDS

The New York Fed's one-year forward recession probability was at 66.0 percent in July, only slightly down from May's peak.

What does this mean

- But leading indicators still broadly indicate a recession rather than a soft landing over the next year in response to the cumulative Fed rate increases, tighter bank lending standards, and weaker corporate earnings.
- A projected modest recession is unlikely to start until early 2024, pushed out by further momentum from the consumer sector and the labor market.

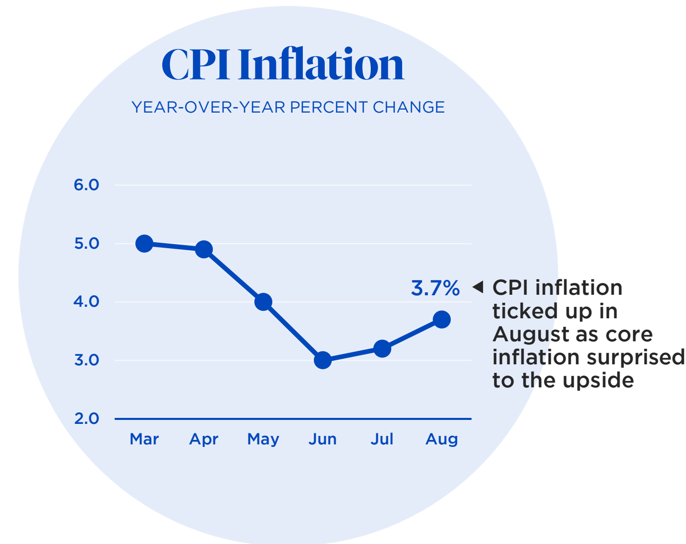
- A sustained yield curve inversion has historically been a reliable indicator of a recession. But the length of time from the inversion to the start of a downturn has ranged from 9 to 33 months.
- The current inversion suggests that the bond market is pricing in a recession over the next year, although the timing remains fluctuant.

- This measure, which tracks the slope of the yield curve, is higher than before the last three recessions — reflecting the depth and length of the current inversion.
- This aligns with the Conference Board's Index of Leading Economic Indicators, which has dropped to a level that historically signals a forthcoming recession.

Economic Review

Tailwinds for spending may be fading

Slower job growth and falling savings indicate that consumers may cut back on spending soon after a blowout summer. Still, the positive momentum for the consumer sector should carry into the fourth quarter, fed by elevated wage growth and service sector hiring. A renewed rise in energy prices pushed up inflation in August even as housing costs finally cooled.



Where we are this month

HIRING TREND SLOWS FURTHER

Nonfarm payroll growth climbed in August to 187,000. But this was the third straight month below 200,000 as the pace of hiring has cooled.

CORE INFLATION REMAINS STICKY

Year-on-year CPI inflation climbed in August to 3.7 percent, while the core rate fell for the fifth consecutive month to 4.3 percent.

PERSONAL SAVING RATE FALLS

The personal saving rate fell in July to 3.5 percent, an eight-month low and far below the 20-year median of 6.5 percent.

What does this mean

- Sharp downward revisions to previous months dropped the three-month average for job gains to its lowest level since the Covid disruptions in 2020 at 150,000.
- The labor market remains tight with annual wage growth still high at 4.3 percent. But slack is building with the unemployment rate up to 3.8 percent in August amid signs that more workers are re-entering the workforce.

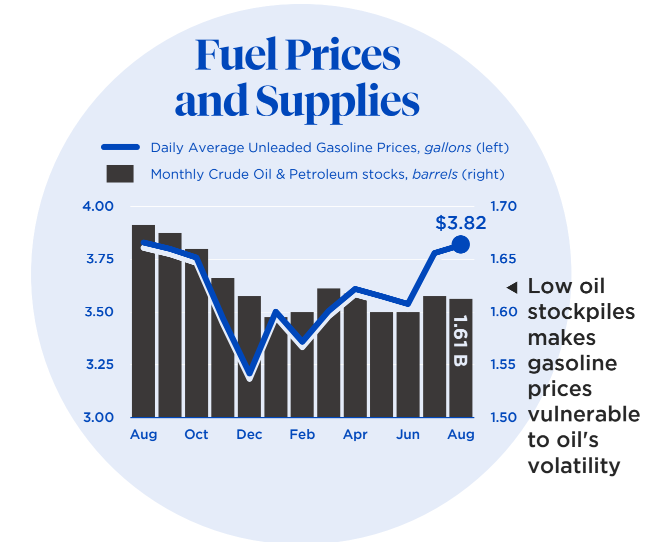
- Energy prices, which climbed 5.6 percent, were responsible for half of the advance in the CPI's 12-month trend rate. The 0.6 percent month-over-month gain was the largest since June 2022.
- At 0.3 percent, the monthly gain in core CPI was stronger than expected. It was led by price growth in rents and transportation, the latter of which climbed two percent on the month and 10.3 percent over the last 12 months.

- Strong consumer spending has been partially fueled by consumers dipping into savings while credit card debt climbed to a record high in the second quarter — both signs that many households are being spread thin by rising costs.
- Excess pandemic-related savings may also be exhausted soon. The San Francisco Fed estimates that only $190 billion remained in June and it is expected to be depleted over the third quarter.

Financial Market Review

Investors flee as the August heat blazes

The S&P 500 posted its first monthly decline since February, as worries build about third-quarter earnings where six in ten firms offered reduced forecasts. Adding to the investors' dilemma was the uptick in interest rates influenced by a widening in the budget deficit. Oil was another thorn, with the price breaking out above $85 per barrel and winter heating fuel needs just around the corner.



Where we are this month

What does this mean

RALLY TAKES A BREAK

Cyclical and smaller-cap names took the blunt of August's weakness, regular victims of prerecession jitters, as the S&P 500 retreated a modest 1.8 percent.

- The forward 12-month P/E ration for the S&P 500 is 18.6, significantly above the historical average, suggesting that any earnings misses could quickly deflate investors' outlooks.
- Lower inflation, while easing input and labor costs, poses another hurdle for earnings as companies will likely see pricing power dissipate going forward.

BACK TO LAST YEAR'S HIGH

The 10-year Treasury yield reversed gears again rising to near 4.30 percent. Real rates, nominal less inflation, pushed towards two percent, the highest levels since 2009.

- The yield on the 2-year Treasury remains near five percent, unmoved by the uptick in longer duration rates and suggesting little change in the immediate term outlook.
- Longer-term inflation expectations have traded within a narrow range, predicting an eventual success in the Fed's battle against cost pressures.

OIL RISES ON WINTER SUPPLY WORRIES

The price of oil moved above $85 per barrel, pushing gasoline prices to a 10-month high. Refinery outages and falling stockpiles have reduced the backup for the energy complex.

- Global energy markets worry about the coming winter and potential supply shortages by OPEC+ or from political complications.
- Higher prices at the pump are a reminder for consumers that the inflation fight is not over and may complicate the Fed's ability to shift away from restrictive monetary policy anytime soon.

Outlook

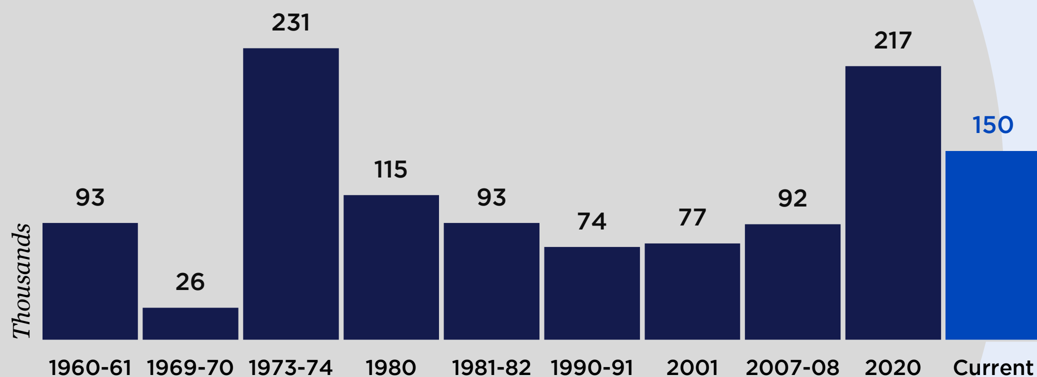
Job growth remains positive until the recession sets in

Stronger-than-expected job growth and the accompanying boost to consumer spending has been the primary driver of the extended expansion in 2023. While the hiring engine has slowed, the recent momentum for labor demand — with job openings still far surpassing unemployed workers and wages rising at a sturdy pace — should be enough to postpone a recession until early 2024.

The current pace of job gains is moderately above the average for the three months ahead of prior recessions and is poised to slow further in coming months, suggesting weaker spending trends ahead. There are other headwinds for consumer activity, as excess pandemic savings look to be exhausted and student loan payments have restarted. These factors and the potential for a federal government shutdown in early October suggest a downshift in the fourth quarter, a likely precursor to even weaker growth in 2024.

Average job growth in the three months ahead of recessions

Job losses typically occur in step with recessionary conditions, rather than acting as a leading indicator



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Data as of September 2023

	2022 ACTUAL	2023 ESTIMATE	2024 FORECAST	2025 FORECAST	2026 FORECAST
REAL GDP	2.1%	**2.3%**	**0.6%**	1.8%	1.6%
UNEMPLOYMENT RATE	3.6%	3.7%	4.5%	4.4%	4.0%
INFLATION [1] (CPI)	7.1%	3.5%	2.9%	2.4%	2.0%
TOTAL HOME SALES	5.67	4.86	4.80	5.50	6.00
S&P/CASE-SHILLER HOME PRICE INDEX	5.8%	4.8%	2.0%	3.7%	3.6%
LIGHT VEHICLE SALES	13.8	15.4	15.2	16.3	16.5
FEDERAL FUNDS RATE [2]	4.25%	**5.25%**	**3.50%**	2.00%	2.00%
5-YEAR TREASURY NOTE [2]	3.99%	4.40%	3.10%	2.70%	2.50%
10-YEAR TREASURY NOTE [2]	3.88%	4.20%	3.30%	2.90%	2.70%
30-YEAR FIXED-RATE MORTGAGE [2]	6.42%	6.90%	5.35%	4.65%	4.40%
MONEY MARKET FUNDS	2.27%	5.09%	4.28%	2.47%	2.03%

[1] **Percent change Q4-to-Q4**
[2] **Year-end**

Recession likely delayed into early 2024

Given the strong real GDP growth projected for the third quarter, positive momentum for the economy should carry through the end of 2023. But headwinds for growth are accumulating and still point to an eventual modest recession rather than a soft landing — focused now on the first half of 2024, with a recovery starting later next year.

Fed easing likely to be later and more modest

The fed funds rate should be steady (or move higher) at coming FOMC meetings, setting up an extended period of restrictive policy. We expect Fed easing to enter the discussion in early 2024, but elevated core inflation should prevent a sharp lowering of interest rates over 2024 — with an inverted yield curve likely through year end.

Contributors

Kathy Bostjancic
SVP & Chief Economist

Ben Ayers, MS
Senior Economist

Oren Klachkin
AVP, Financial Market Economist

Daniel Vielhaber, MA
Economist

Scott Murray
Financial Markets Economist

Ashleigh Leonard
Economics Specialist

Brian Kirk
Communications Consultant

Sources

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