3Q22 Economic Summary

Investor focus remained solidly on inflation and the Fed during the third quarter. Both stock and bond markets rallied in July as falling gasoline prices fostered hope that inflation had peaked and the Fed could begin taking its foot off the brake. However, these hopes were dashed in August after Chair Powell reaffirmed the Fed's singular focus on fighting inflation during his speech at the annual Jackson Hole Economic Symposium. Equities sold off and bond yields rose as markets reduced odds that the Fed could achieve a soft landing after Powell acknowledged that the inflation fight will likely cause "some pain" for households and businesses. The rout continued in September as markets played catchup to the Fed's more aggressive path. Investors had nowhere to hide with stocks solidly in bear market territory and bonds enduring the worst selloff in a generation.

After two quarters of negative growth, the U.S. economy rebounded in the third quarter. U.S. GDP grew at a 2.6% annualized rate as consumers and businesses remained resilient despite higher interest rates and rising inflation. Americans cut loose over the summer, spending their hard-earned cash on travel, entertainment and restaurants. The increased demand for services helped to offset a decline in goods consumption as consumers continued to spend less on things and more on experiences. Business fixed investment also contributed to the rise in GDP as companies sought to improve productivity through increased purchases of equipment and intellectual property. However, the biggest contributor to third quarter growth was a narrowing of the trade deficit as exports rose and imports fell. Easing of supply chain disruptions and record shipments of oil and natural gas to Europe drove the increase in exports, whereas the consumption shift away from goods was behind the decrease in imports.

Although the expansion in GDP was welcome and helped allay fears that the U.S. was currently in a recession, there is concern that the rebound is only temporary. Without the bump from trade, which is likely to reverse in coming quarters, GDP growth would have been relatively flat. Declining residential investment was the largest drag on growth. The housing market has borne the brunt of the Fed's tightening campaign with mortgage rates more than doubling since the start of the year. The rise in rates has caused existing home sales to plunge and new home construction to stall. Housing prices have started to decline but remain elevated due to limited inventory. With more rate hikes in the pipeline, the contraction in the housing market is expected to continue and will detract from growth in coming quarters.

While the housing market has reacted to the rise in rates, the labor market has not. Job growth remains strong as the U.S. added over 1 million new jobs during the quarter and the unemployment rate dropped to 3.5% in September, matching a 50-year low. Although there have been some signs of moderating labor demand, including layoffs in some industries that ramped up during the pandemic, employers continue to hire at a solid pace. Job openings remain high and quits rates remain elevated, forcing employers to increase wages to attract and retain qualified workers. This continued pressure on wages remains a key concern for the Fed.

Despite the FOMC's efforts to cool demand by raising rates, U.S. prices continued to rise during the quarter. Core CPI hit a 40-year high in September primarily due to a continued broad-based surge in services prices. Shelter and healthcare were the largest contributors to the increase, but even without these components, the cost of services still rose at a record annual pace. The breadth and depth of overall price pressures are particularly concerning to Committee members and underscore the need for swift policy action; therefore, the Fed continued its aggressive hiking campaign during the third quarter, raising rates by 75 basis points at both the July and September FOMC meetings. The moves brought the target range of the fed funds rate to 3.00%-3.25%. While markets were prepared for the outsized rate increases, the more aggressive path of policy depicted in the Fed's September dot plot forecast came as a surprise. Participants' median projection for the 2022 fed funds rate increased by 100 basis points, bringing the estimated target range to 4.25%-4.50% by year-end. At the post-meeting press conference Chair Powell acknowledged that the central bank had expected supply side healing to have a bigger impact on inflation, but thus far inflation has remained stubbornly high.

The Fed is expected to stay the course on its most aggressive tightening campaign since the 1980s even in the face of a weakening economic outlook. Chair Powell has made it clear that the Committee believes the pain from higher interest rates is preferable to the "far greater pain" from failing to restore price stability. Thus far, the solid labor market and hot inflation data continue to justify their hawkish policy stance. So, while markets continue to look for a policy pivot behind every soft data point, the Fed's campaign to crush inflation is likely to extend well into 2023.