2Q23 Economic Summary

The second quarter of 2023 started with fears that a recession was imminent and expectations that the Fed would soon begin cutting rates. However, as the quarter progressed, the US economy proved resilient, and the Fed remained vigilant in its commitment to tame still-too-high inflation. By quarter-end, investors began to come to terms with the fact that a policy ease was not likely in the cards for 2023, and the divergence between market expectations and the Fed's projected policy path narrowed. Yields rose across the board and the inversion in the yield curve steepened as short-term rates rose more than long-term rates.

Despite recession chatter, the bulk of U.S. economic data surprised to the upside in the second quarter as Americans continued to spend, undeterred by elevated prices and higher interest rates. While the goods side of the economy continued to weaken, demand for services remained strong with consumers spending more on travel, recreation and leisure. Though solid, consumption was a bit weaker than prior quarters as concerns over a possible U.S. debt default weighed on confidence and made consumers more cautious with their cash. Sentiment rebounded in June after the resolution of the debt ceiling crisis, which bodes well for consumption going forward. Business investment also increased during the quarter as companies aimed to improve efficiency and productivity in the wake of higher labor and materials costs. In addition, funding from the Infrastructure Investment and Jobs Act spurred the building of new chip and electric vehicle plants during the quarter.

Residential investment remained a drag on growth, but there were signs that the housing market may be bottoming. While elevated home prices and rising mortgage rates contributed to weakening demand, it appears that the main culprit for the continued decline in existing home sales was lack of supply, not affordability. Given that the majority of homeowners hold mortgages with rates well below the current level, there is little incentive to sell. With existing home inventories near record lows, prospective buyers shifted focus to new homes during the quarter, spurring a rebound in construction as builders worked to fill the void. If the rising trend in new home sales and starts continues, the housing market could become a contributor to growth in the second half of the year.

The labor market continued to be a source of strength for the economy. The U.S. added over 700 thousand jobs during the quarter, and the unemployment rate remained near a historic low at 3.6% in June. While labor market conditions remained healthy, signs of a modest cooling began to emerge. The pace of job creation slowed in June and job openings declined. Both were positive signs for the Fed that policy action may slowly be bringing labor supply and demand better into balance. However, wage gains remained brisk and quits rates elevated as employers continued to struggle to attract and retain qualified workers.

Although wage growth remained persistently strong, inflation data came in better than expected during the second quarter. June annual headline and core CPI prints were the lowest they've been since 2021. In addition, service prices excluding housing and energy, a measure closely watched by Chair Powell, increased at the slowest annual pace in the last 18 months. While the cooling in inflation data was a welcome relief, one good print does not a trend make. As Fed President Daily cautioned, "It's really too early to say that we've declared victory on inflation."

While most FOMC participants agree that the fight against inflation is not over, the Fed opted to take a pause in rate increases at the June FOMC meeting. After hiking 25 basis points in May, Fed officials left the target range of the fed funds rate unchanged at 5.00-5.25% in June in order to further assess the economic impact of the regional banking crisis on credit conditions for households and businesses. Although the Fed left rates unchanged, the updated dot plot showed that the majority of policymakers forecasted two more 25 basis point hikes this year, sending a very hawkish signal that this was indeed a skip and not a dovish pivot. Participants wanted markets to know that there is more work to be done and preempt any further easing in financial conditions in response to the pause. At the post meeting press conference, Chair Powell acknowledged that the three key components of inflation – goods, housing and the labor market – were heading in the right direction, but progress was slower than expected. As such, more hikes were forecasted and rate cuts were not expected until inflation comes down significantly, which Chair Powell said could be "a couple years out." Markets heeded the message, and bonds yields ended the quarter higher than where they began.

As inflation ebbs and the economy remains resilient, the odds that the Fed can achieve a soft landing have increased. Markets have baked in a 25 basis point hike at the July meeting but are betting the second hike in the dot plot forecast does not materialize. For this to happen, the Fed must be convinced that inflation has been meaningfully tamed, because if they back off too soon, inflation could come back stronger, requiring the Fed to do even more.

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