Economic Outlook:

Higher for Longer: Federal Reserve Strikes Hawkish Tone Despite a Second-Round Pause

October 2023

STIFEL

Lindsey M. Piegza, Ph.D.
Chief Economist

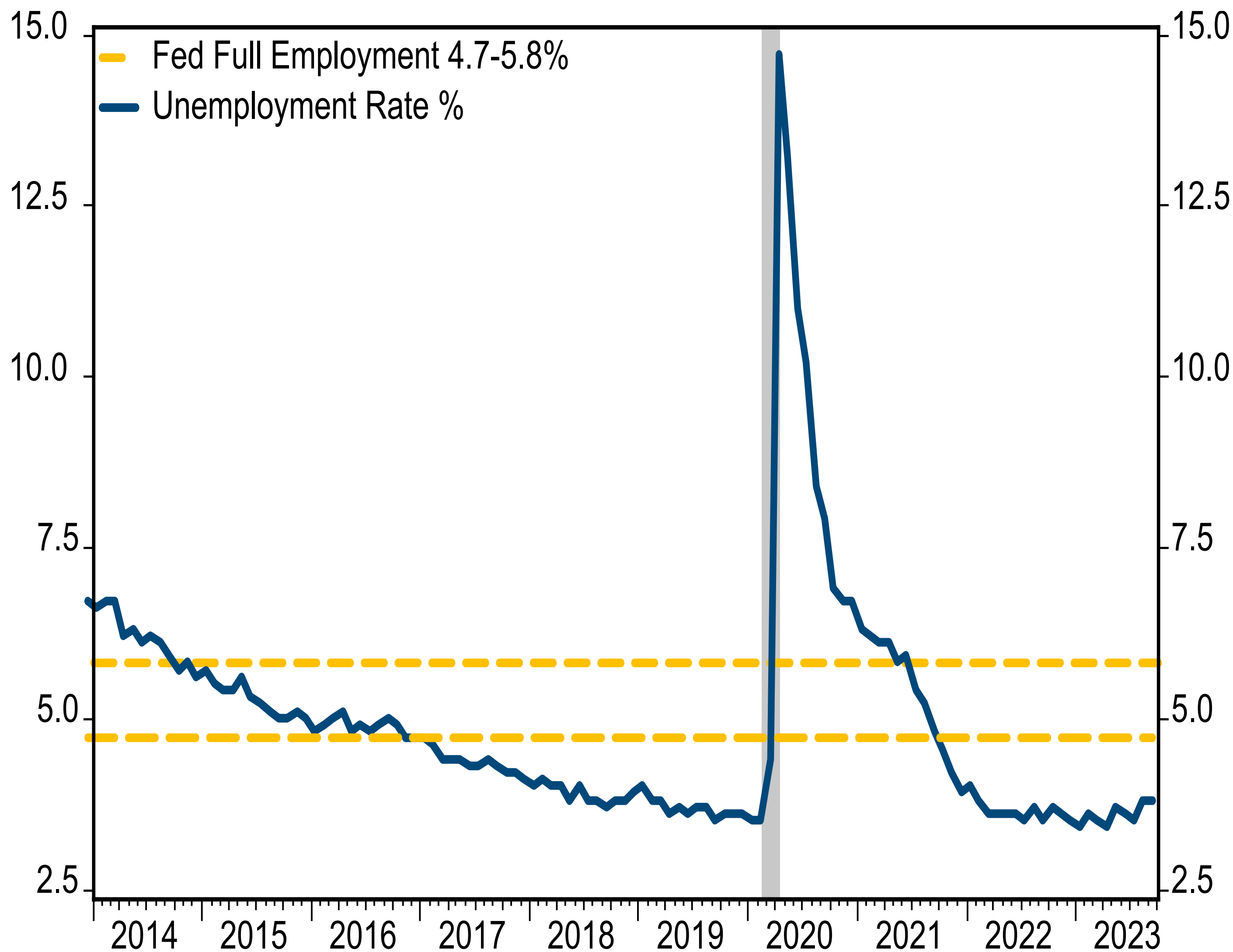
3.8% U.S. Unemployment Rate

The decline in the unemployment rate shows further improvement in labor market conditions

Household employment rose by **86,000** in September, and the labor force rose by **90,000**, resulting in an unemployment rate of **3.8%** in September for the second consecutive month, matching the highest rate since February 2022 but still near a five-decade low

The decline in the unemployment rate reflects more employment *and* sidelined workers

Returning workers will push unemployment rate higher



Source: Bureau of Labor Statistics/Haver Analytics

Average Hourly Earnings Lose Momentum in September

As businesses search for workers, compensation is elevated, although the trend appears to be moderating as businesses struggle to absorb costs

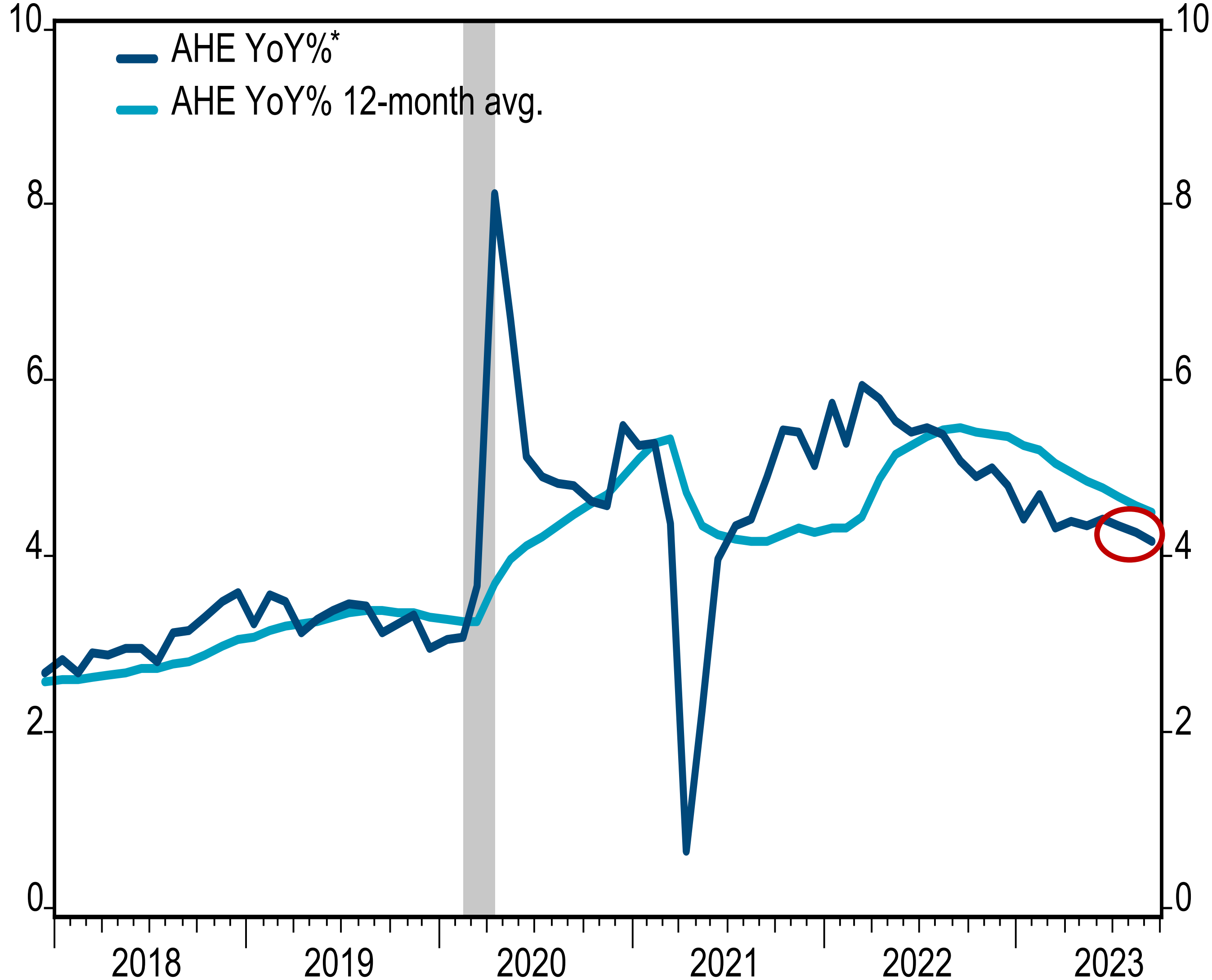
Average hourly earnings rose **0.2%** in September, following a similar rise in August

Year-over-year (YoY), wages rose **4.2%** in September, down from a 4.3% gain in August

Longer-term, businesses may turn to technology or close doors

For now, costs are likely to remain elevated as long as labor remains scarce

Average earnings increased early on during the pandemic as lower-wage workers dropped out of the workforce



Source: Bureau of Labor Statistics/Haver Analytics

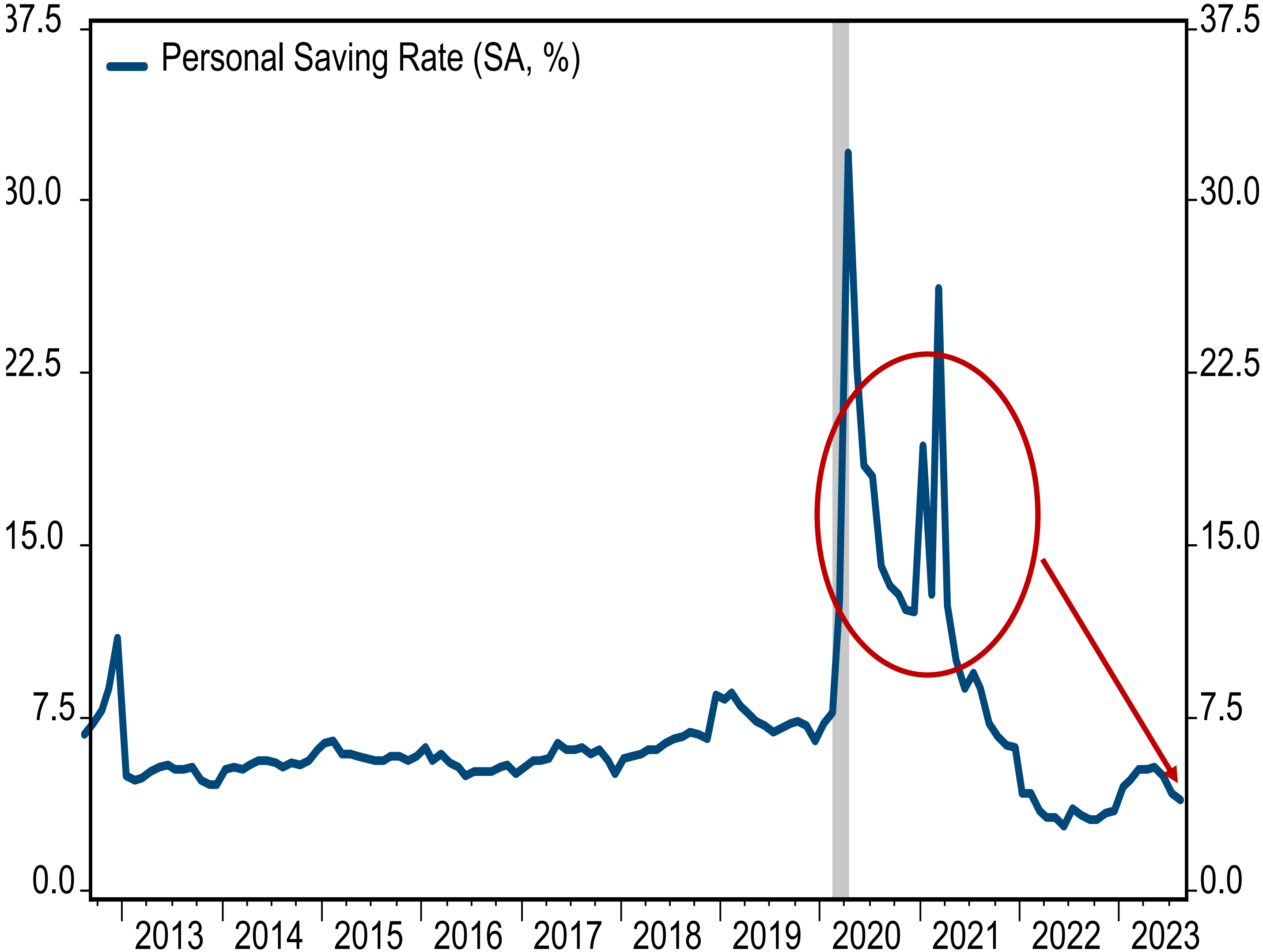
*Does not include government assistance

Trillions in Accumulated Savings Dwindle

The U.S. consumer remains solid with **$794 billion** in savings and a savings rate of **3.9%** as of August

Savings won't support potential workers indefinitely – already the savings rate has slowed, and that stockpile of savings has dwindled markedly as spending adjusts back to pre-pandemic patterns, fiscal support wanes and prices rise

Although higher rates are aiding the interest earnings on consumer behavior with trillions in money market funds and deposits earning 5.2% and 2%, respectively, totaling $630 billion on an annual basis vs. $37 billion before the pandemic



Source: Bureau of Economic Analysis/Haver Analytics

Debt as a Percent of Income Lowest Level on Record

At the same time, consumers are increasingly turning to credit cards and additional sources of debt to support spending habits

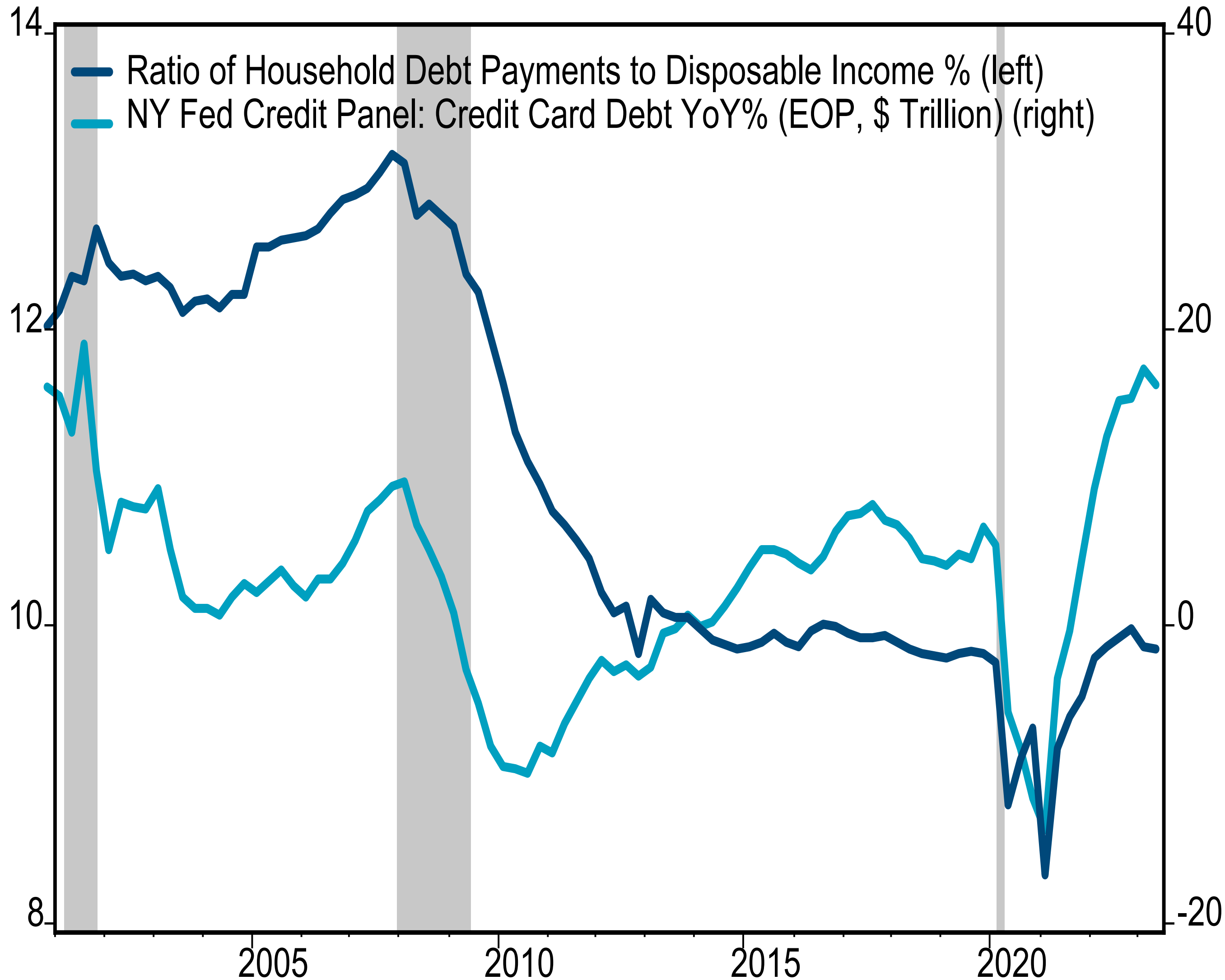
Credit card debt rose **16.2%** in Q2 from the year prior, following a 17.2% gain in Q1, the largest increase since Q3 2001

401(k) hardship withdrawals rose 36% in Q2 2023

Most households are better positioned to take on at least some additional debt burden

Debt as a percent of disposable income remained at **9.8%** in Q2, near the lowest on record

After 3 years of relief, student loan payments resumed in October for approximately 45 million



Sources: FRBNY/Haver Analytics

Retail Sales Volatile and Trending Lower

For some, the notion of a reduced or evaporated wealth cushion is causing an outright shift or reduction in spending habits

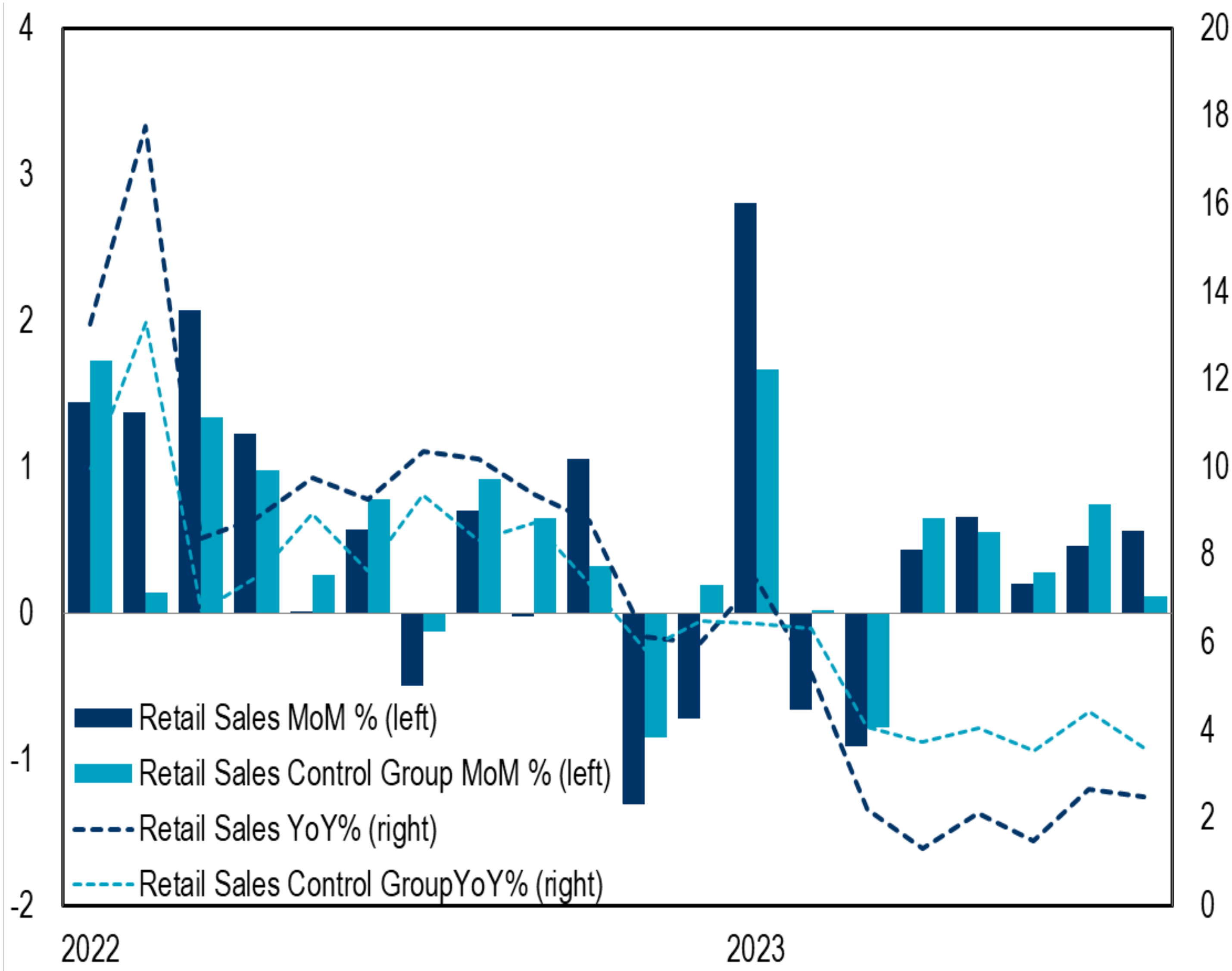
Trillions in savings and upward momentum in wages helped consumers to offset a loss of fiscal support, but inflation is complicating the picture

Large retailers report customers are cutting back as the balance sheet is becoming increasingly fragile amid rising costs and rates

Sales rose **0.6%** in August, following a 0.5% gain in July

Year-over-year, retail sales rose **2.6%** in August following a 2.5% gain in July

Control group sales rose **0.1%** in August and **3.6%** year-over-year



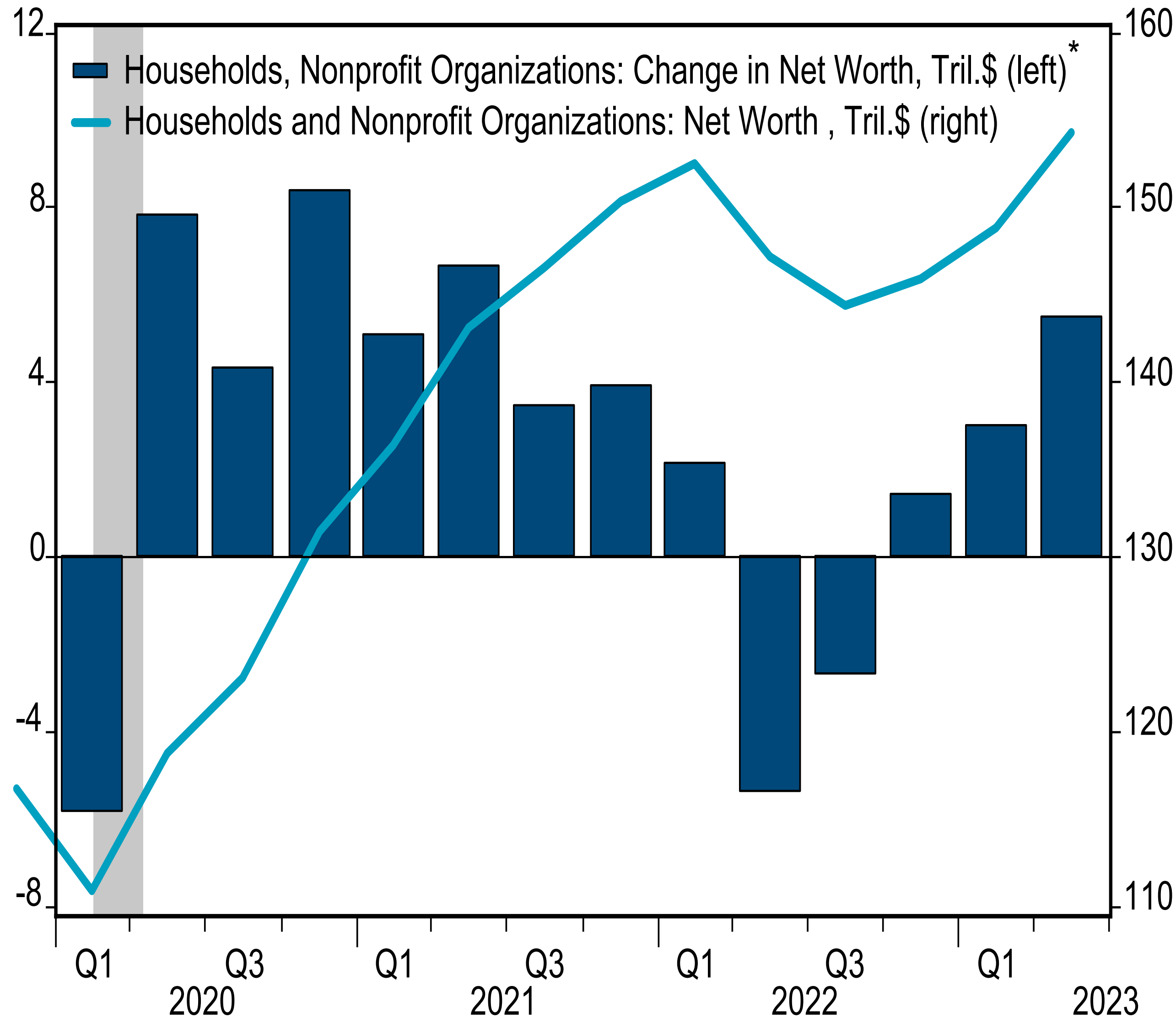
Source: Census Bureau/Haver Analytics

STIFEL | Fixed Income Capital Markets

Household Net Worth Jumps to a Record High

Household net worth has grown in the past few years, rising $3 trillion in the first quarter and $5.5 trillion in the second quarter to **$154.3 trillion**, a record high

This suggests there still is a significant amount of borrowing and spending power in the economy



Source: Federal Reserve Board/Haver Analytics

*Household net worth represents the total value of assets (financial as well as non-financial) minus the total value of outstanding liabilities.

Manufacturing Activity Slowing

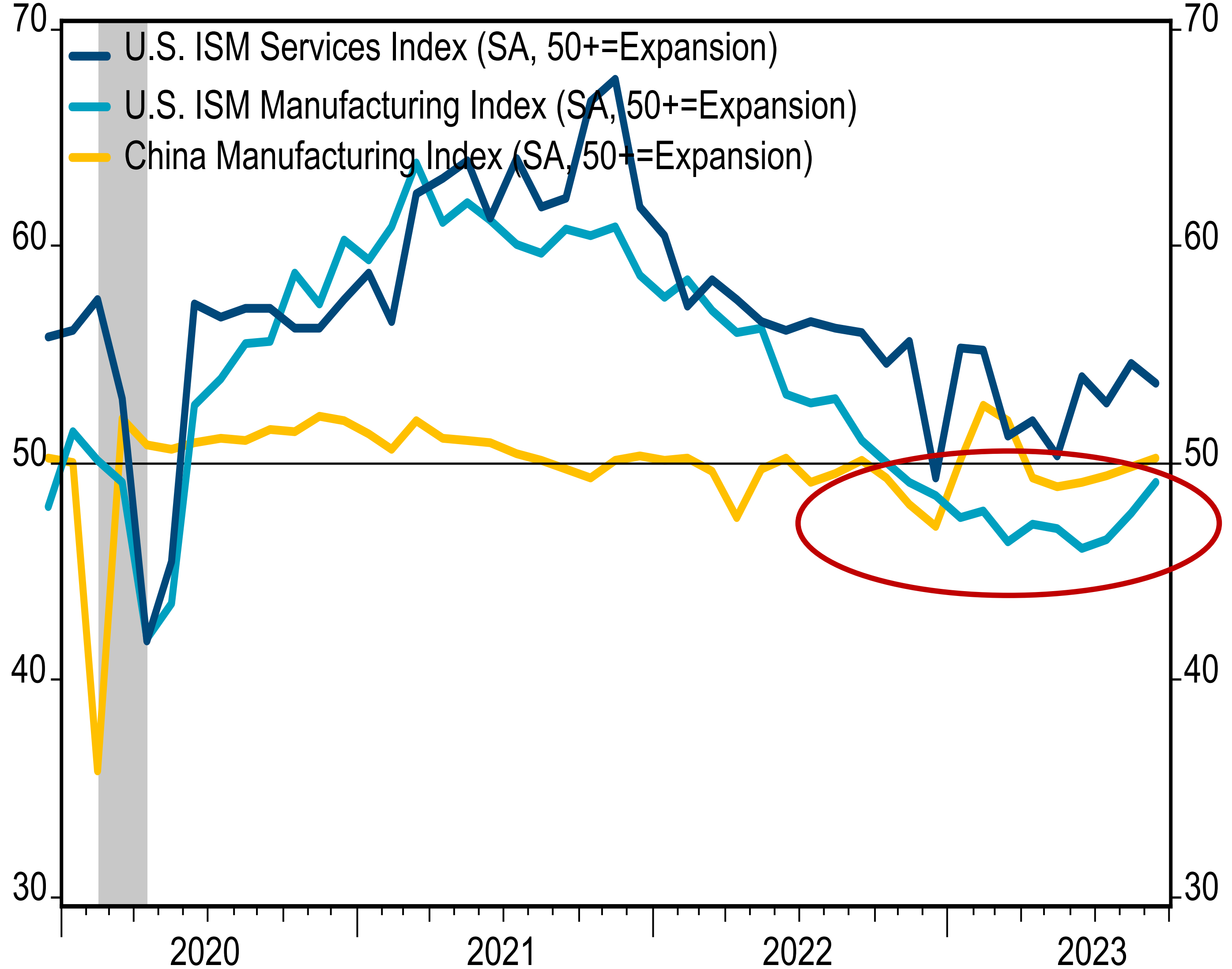
Even with a *relative* decline in spending, positive nominal spending is keeping pressure on producers

Consumers are shifting from goods to a pre-pandemic preference for services/experience

The Institute of Supply Management (ISM) declined from a near-term peak of 60.8 in October 2021 to **49.0** as of September, **falling below 50 as of November 2022**

The ISM Services Index, meanwhile, fell to **53.6** in September, a two-month low

The China Manufacturing Purchasing Managers Index rose slightly to **50.2** in September, bouncing along breakeven since June 2021



Sources: ISM, CFLP/NBS/Haver

STIFEL | Fixed Income Capital Markets

Home Sales Restrained by Record Low Affordability

Americans view their home as a workplace, school and refuge

Home sales surged during the pandemic and immediate aftermath

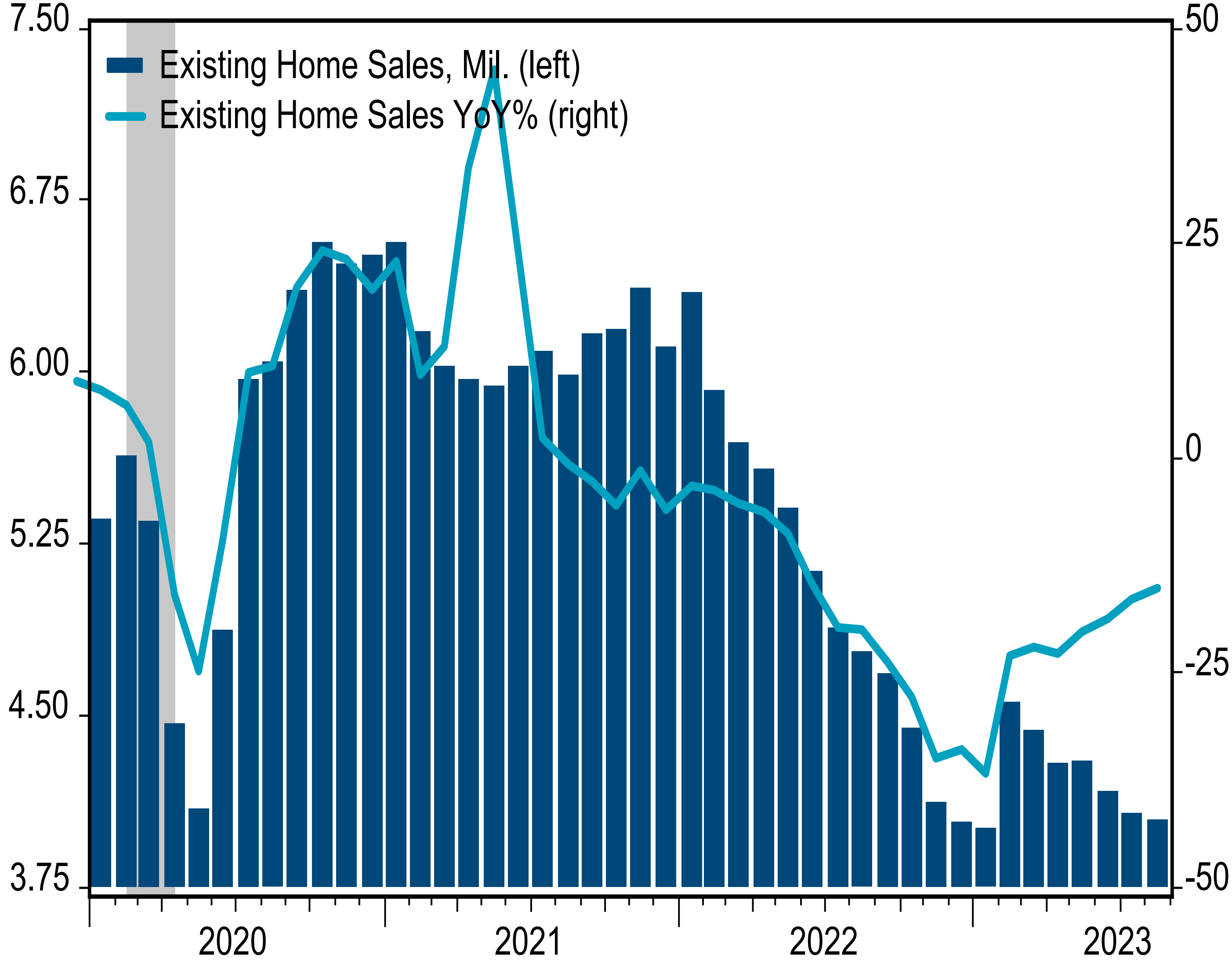
Sales rose 6.6% at the end of 2021, reaching a peak pace of 6.36 million units

Rising interest rates, rising costs of materials, and declining real income, coupled with a significant lock in effect from earlier low rates, has slowed transactions

Existing home sales fell 0.7% in August to a **4.04 million** unit pace

Off 36% from peak levels, sales are up 1% in the recent *"rebound"*

According to RedFin, more than 90% of homeowners have a mortgage rate below 6%, resulting in a lock-in-effect



Source: National Association of Realtors/Haver Analytics

STIFEL | Fixed Income Capital Markets

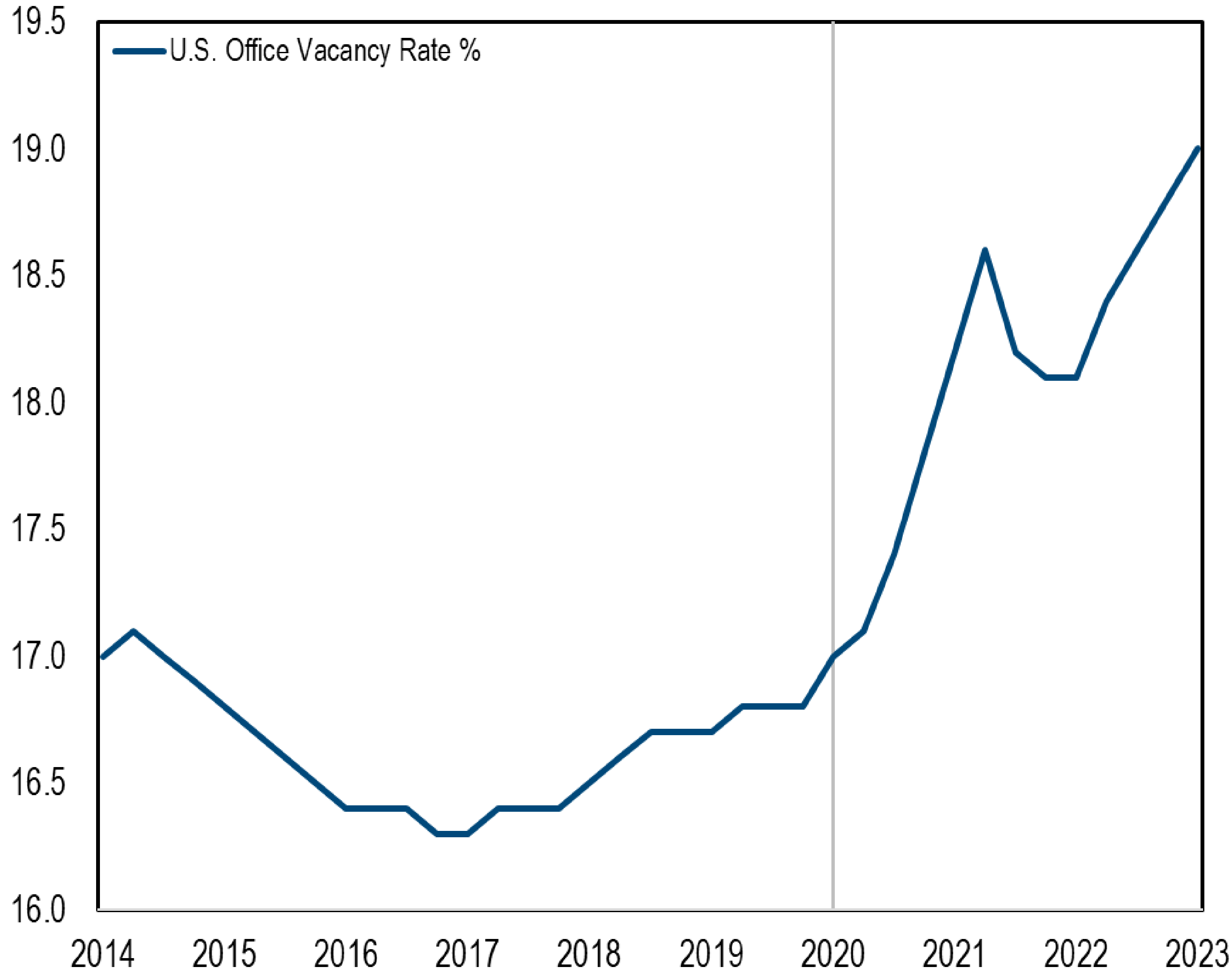
Office Vacancy Rate Hits New Peak

For the commercial market, as the work-from-anywhere environment has been wholly adopted, a change in structural preferences has resulted in a significant relocation of populations

For the downtown urban centers still experiencing at most a **40%-50%** return to office rate, the population support will be more difficult to recapture

According to real estate data firm Trepp, **4.02%** of office loans that make up mortgage-backed-securities are at least 30 days delinquent, the largest amount since 2018

Other areas, however, experiencing population booms will need further investment in commercial space to support the emerging growth and demand in everything from shopping centers to office spaces or alternative spaces for work, grocery stores, and everything in between



Source: Bloomberg, Reis Inc.

STIFEL | Fixed Income Capital Markets

U.S. Debt Rises to All-Time High: $33 Trillion vs. $25 Trillion Economy

In fiscal year 2022, the federal government ran a deficit of $1.38 trillion, or 6% of GDP

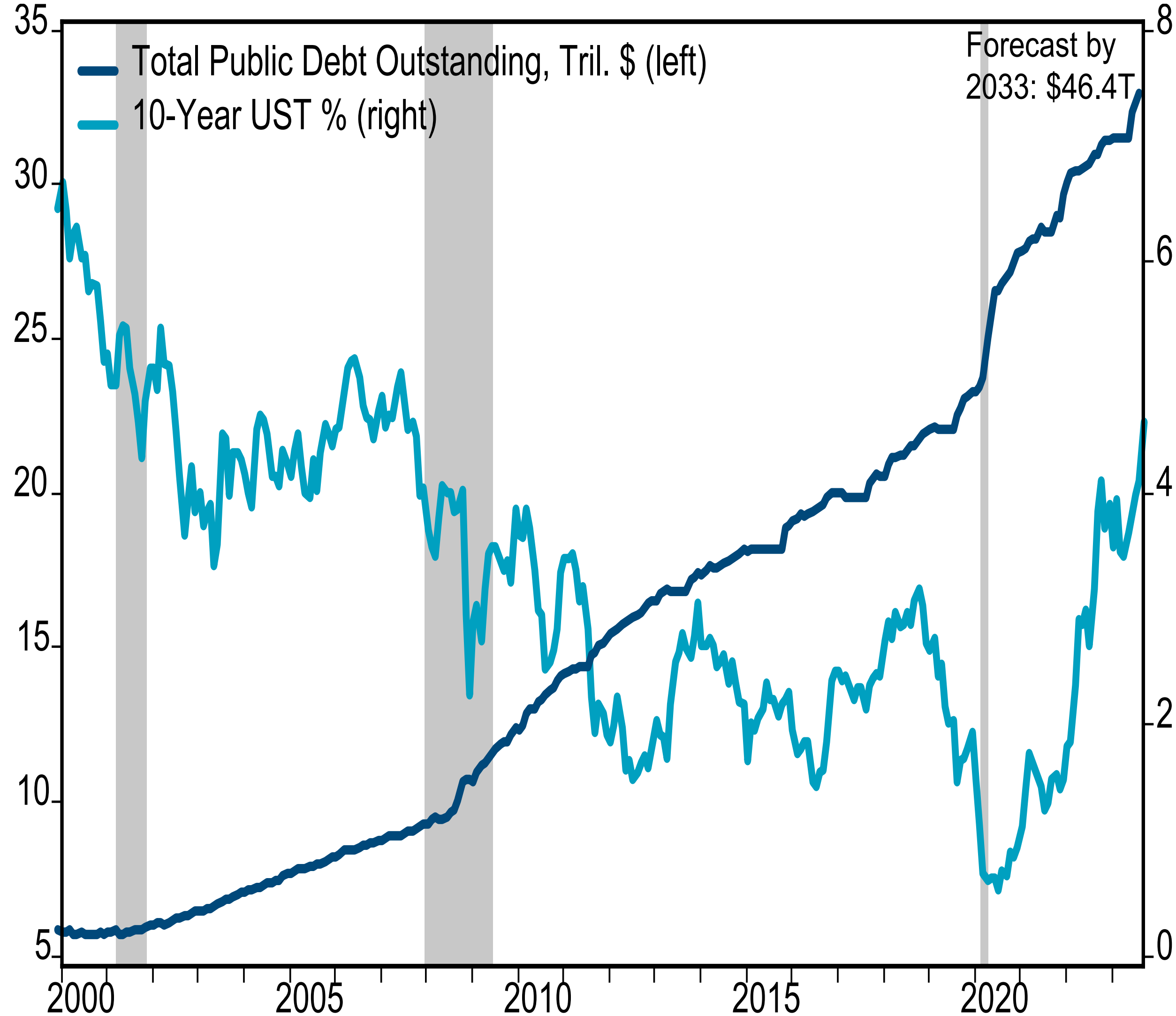
The deficit for fiscal year 2023, of course, will be markedly less than the year prior given the significant reduction in outlays from the waning federal response to the pandemic

The government balance sheet has grown 97% in the last 10 years to nearly **$33 trillion** as of late

Total public debt is forecasted to reach over $46 trillion by 2033

Officials in Washington were able to reach an agreement and avoid a government shutdown

The bipartisan measure will keep the U.S. government funded until November 17



Sources: U.S. Treasury, Federal Reserve Board/Haver Analytics

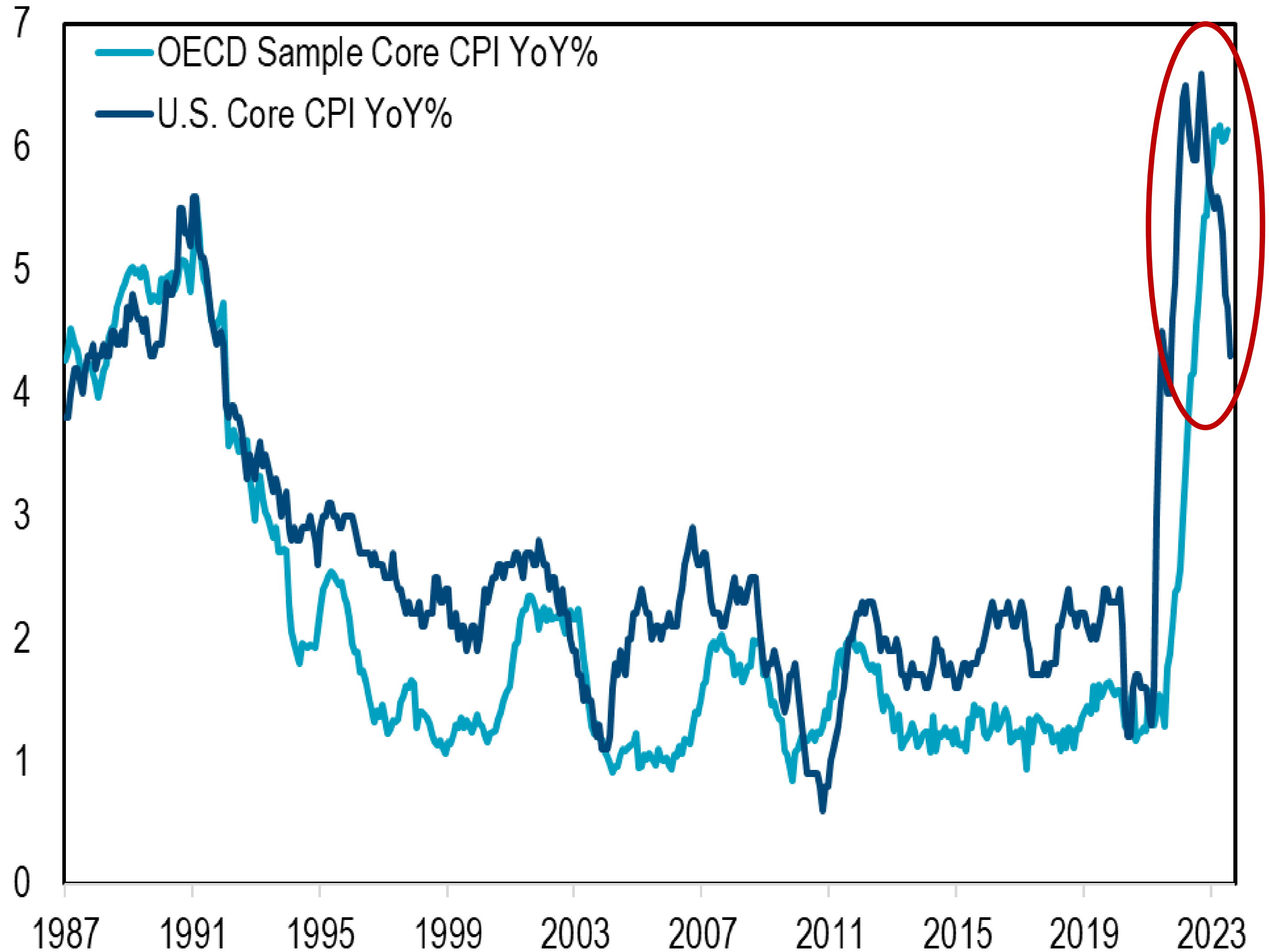
U.S. Inflation No Longer Higher than Abroad

Countries were reeling from supply-side constraints

U.S. inflation was exacerbated by fueling demand-side metrics and labor costs resulting from fiscal policy measures

U.S. inflation no longer continues to outpace other countries, rising **4.3%** as of August vs. **6.1%** elsewhere in the developed world

UK inflation: **6.7%**
Eurozone inflation: **5.2%**
Chinese inflation: **0.1%**
Japanese inflation: **3.2%**



*Sample includes: Canada, Denmark, Finland, France, Germany, Netherlands, Norway, Sweden, and the U.K.

Source: FRED

STIFEL | Fixed Income Capital Markets

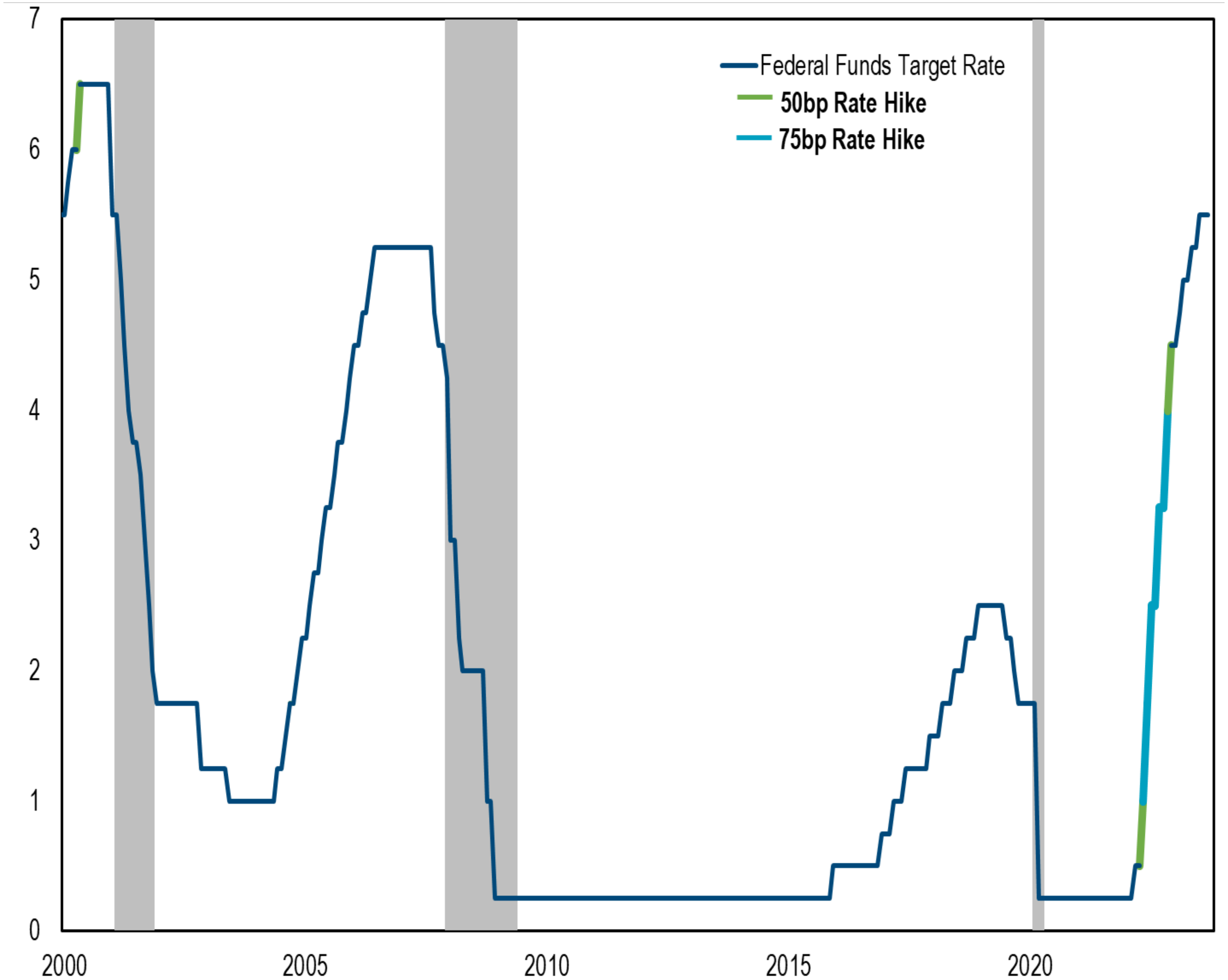
Federal Reserve Pauses in September

In March 2022 the Federal Reserve (Fed) took a decisively more hawkish position

The Fed has raised rates 525 basis points (bps) since March of last year: **25bps** in March, **50bps** in May, **75bps** in June, July, September & November, and **50bps** in December of last year. This year, the Fed has raised rates **25bps** in February, March, May and July reaching **5.25-5.50%**

The Fed's expected rate pathway has risen markedly above expectations with inflation still *"too-high"*

In September, the Summary of Economic Projections showed expectations for **5.6%** in 2023 with rates slowing to **5.1%** in 2024



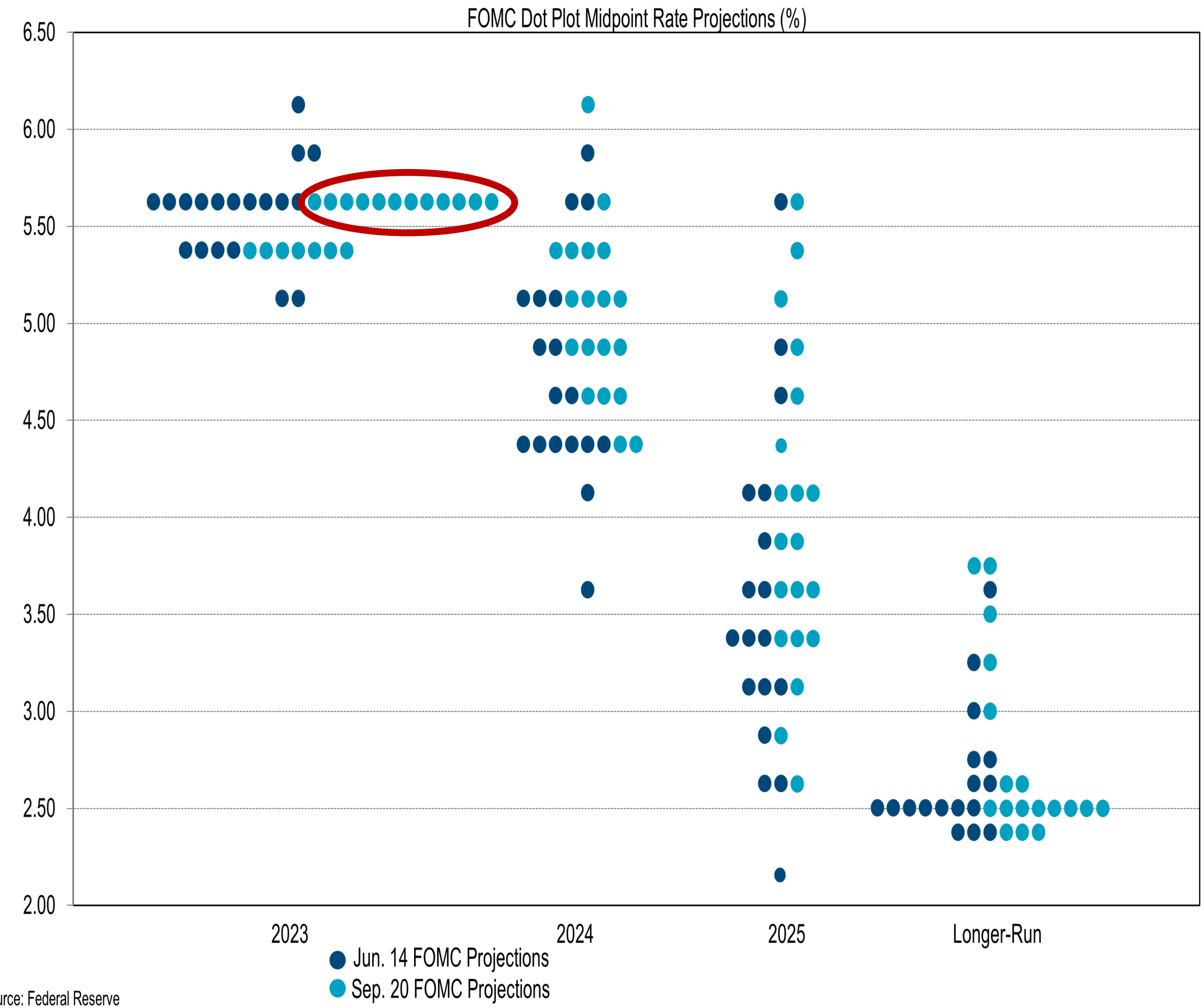
Source: Federal Reserve Board

Question 1: How High Will Rates Rise?

The majority of Fed officials anticipate a terminal rate still rising above 5.5% with **one** official forecasting a rate **between 6.00% and 6.25%** by next year

The median forecast for rates in 2024 rose 50bps from 4.6% to **5.1%**

Adjusting for inflation, the median expectation for real rates rose from 2.1% to **2.6%**



Source: Federal Reserve

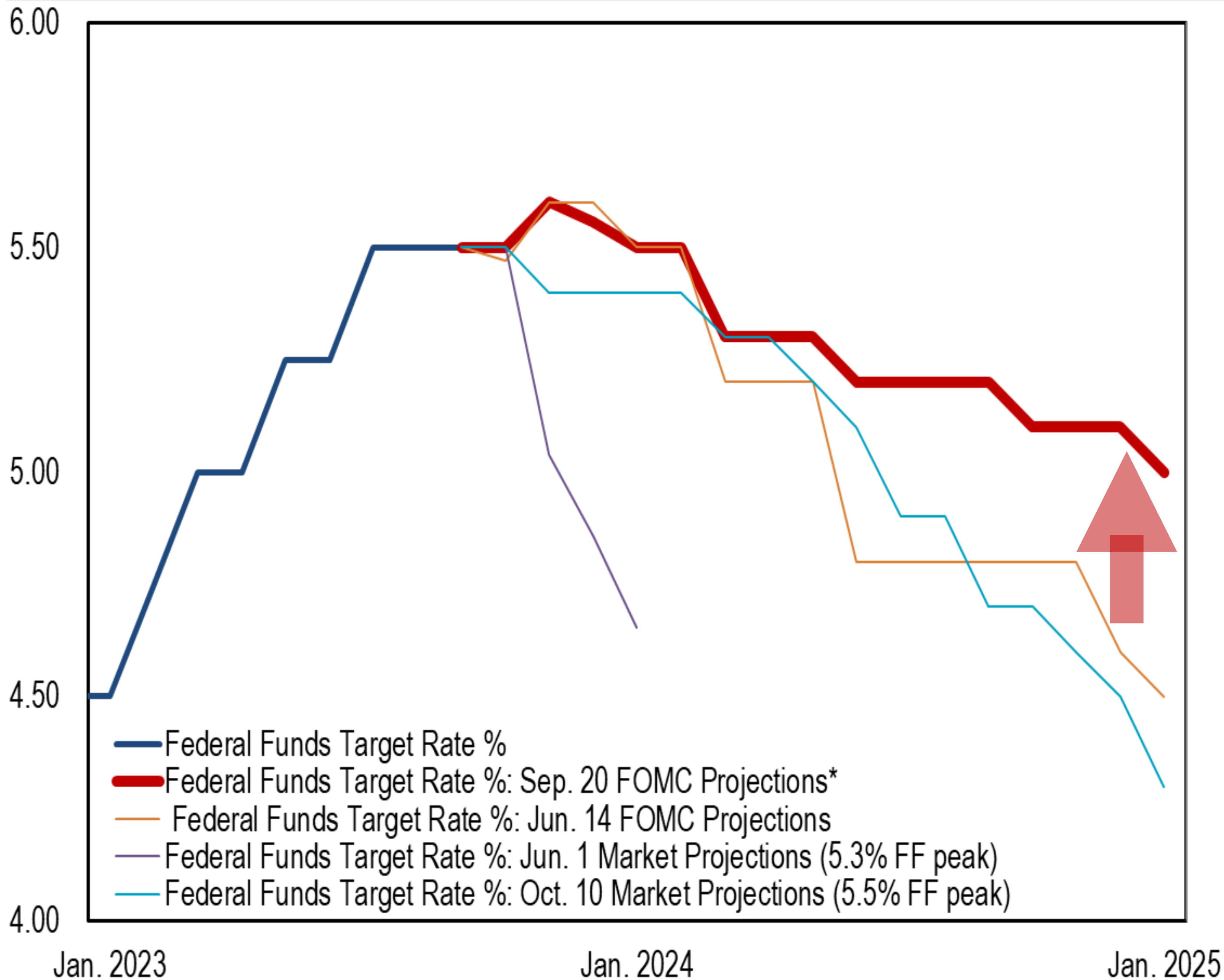
Question 2: How Long Will Rates Remain Elevated?

As of June, investors anticipated a peak fed funds rates of 5.3% and 60bps in cuts by the start of 2024

In the aftermath of a September pause, forward market projections now expect a 5.5% terminal rate with at least 10bps of cuts by the start of next year

In June, the median forecast anticipated 100bps of cuts in 2024 and another 120bps in 2025

September showed an expectation of **50bps** of cuts in 2024 and another 120bps in 2025, **with policy remaining above neutral until 2026**



Source: Federal Reserve Board/Bloomberg

*Projections assumed from the figures from FOMC SEP

STIFEL | Fixed Income Capital Markets

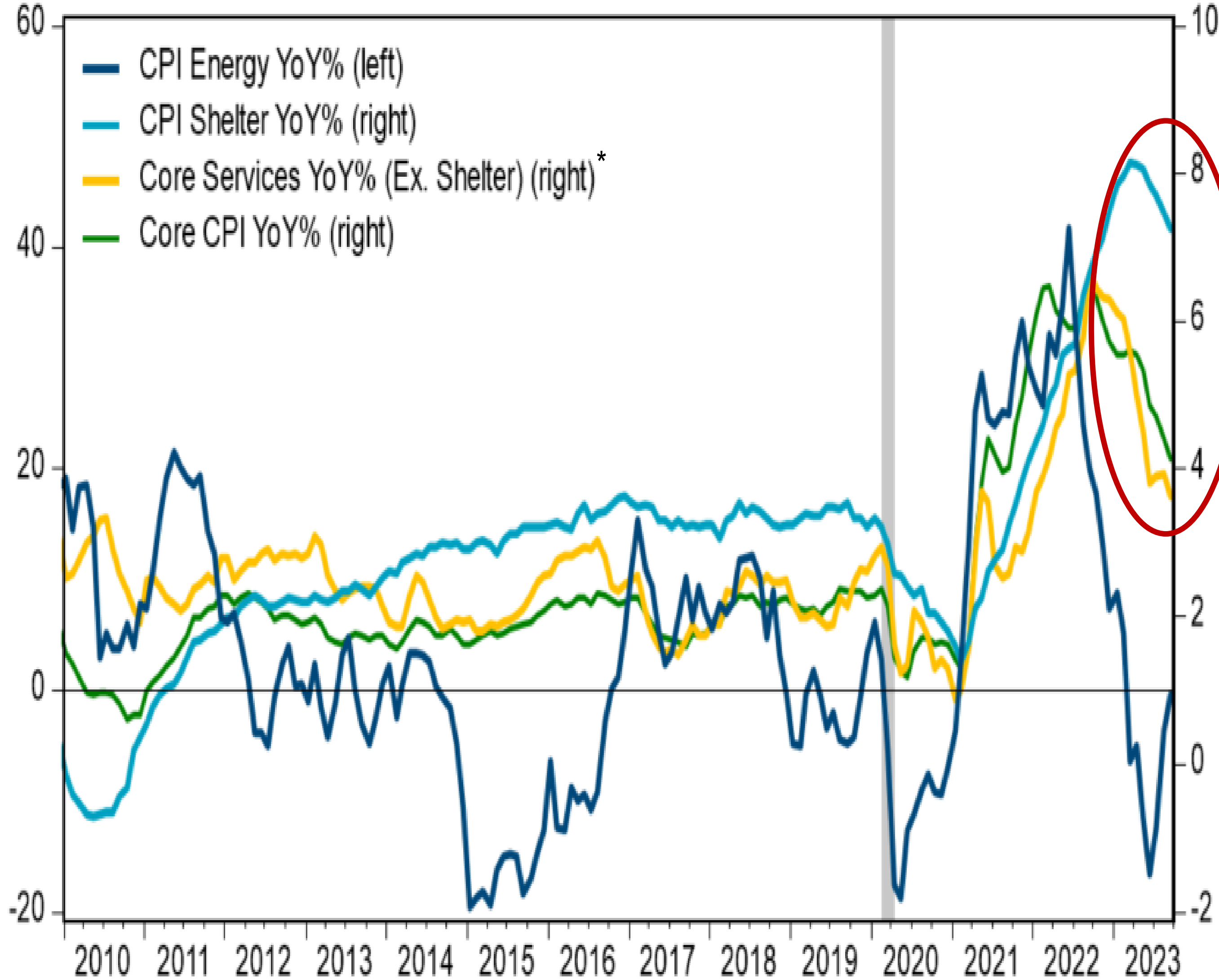
Inflation Remains Elevated with Core Services

The core Consumer Price Index (CPI) rose 0.3% in September and **4.1%** year-over-year, down from the 4.3% annual gain in August

Core services excluding shelter, meanwhile, rose **3.6%** year-over-year in September following a 3.9% annual gain in August

The Fed's headline Personal Consumption Expenditure (PCE) forecast was revised up a tenth of a percentage point to 3.3% for the current year

Inflation is expected to rise 2.5% next year and remain above 2% until at least 2026



Source: Bureau of Labor Statistics/Haver Analytics

*Core services inflation tracks healthcare, insurance, education, repairs, personal services, etc.

U.S. Economy Showing Signs of Weakness; Recession Looming?

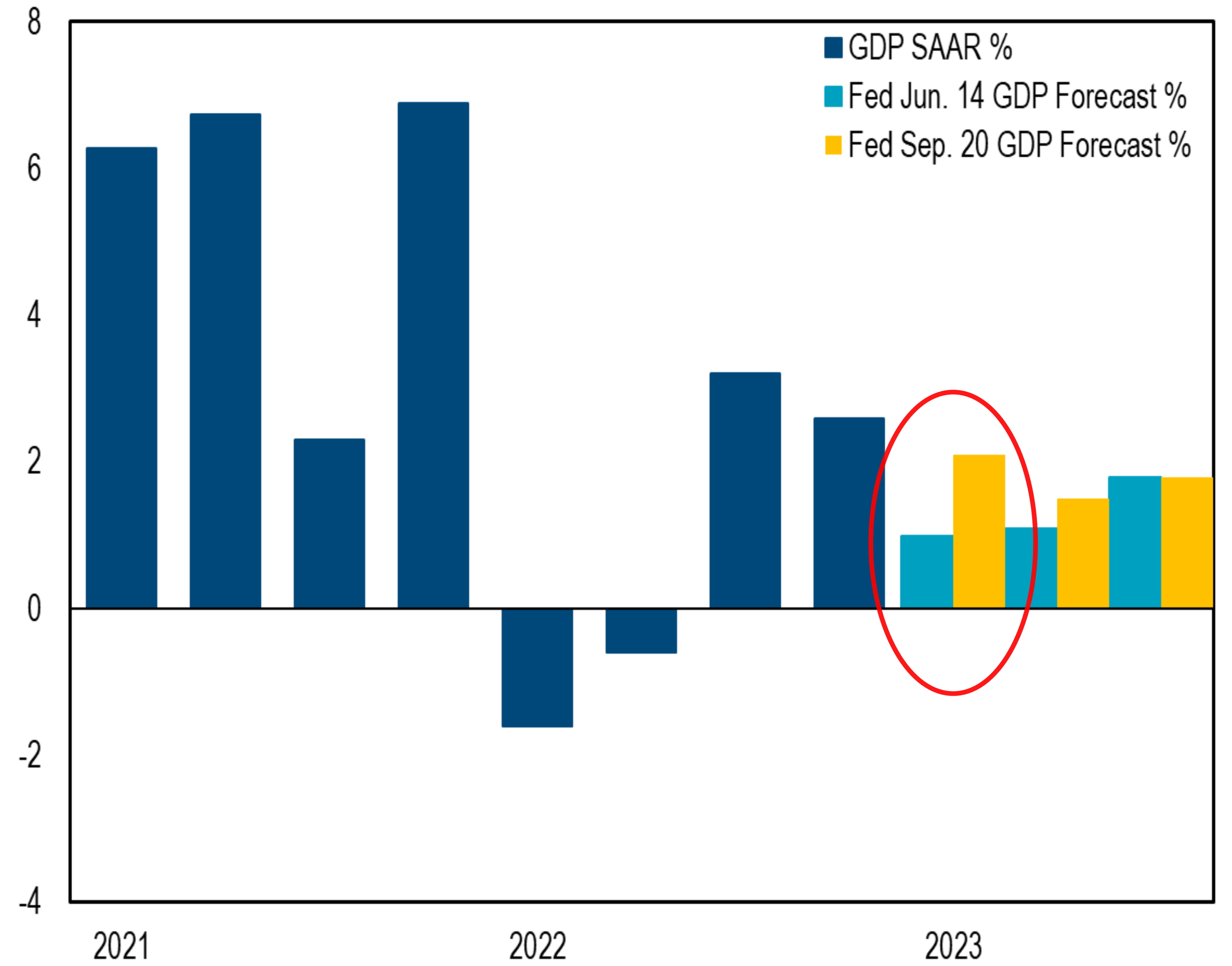
With an aggressive rate path, growth is likely to slow further with **the risk of recession at 50% for 2024**

GDP rose **2.1%** in Q2 2023, following a 2.2% rise in Q1

Excluding trade and inventories, final sales to domestic purchasers rose **0.4%**

The Fed more than doubled its GDP forecast from 1.0% to **2.1% in 2023** with growth expected to rise 1.5% next year, up from a 1.1% forecast in June

The unemployment rate forecast was revised down from 4.1% to **3.8%** for this year and revised lower from 4.5% to 4.1% in 2024



Source: Bloomberg/Stifel

Thank you

Q&A

Sources

- (1) https://economictimes.indiatimes.com/tech/technology/generative-ai-could-replace-300-million-jobs-goldman-sachs-report/articleshow/99085074.cms?from=mdr
- (2) https://www.theguardian.com/technology/2023/jul/11/ai-revolution-puts-skilled-jobs-at-highest-risk-oecd-says#:~:text=It%20added%20that%20highly%20skilled,indistinguishable%20from%20that%20of%20humans.
- (3) Stanford Institute for Economic Policy and Research study: https://drive.google.com/file/d/1kqbngD8pemqxAkZmWCOQ32Yk6PXK9eVA/view
- (4) https://www.waterworld.com/drinking-water/distribution/press-release/14297287/study-colorado-river-basin-lost-40-trillion-liters-to-climate-change
- (5) https://www.ers.usda.gov/data-products/food-price-outlook/summary-findings/
- (6) https://www.pgpf.org/blog/2022/11/how-much-does-the-united-states-spend-on-prescription-drugs-compared-to-other-countries#:~:text=According%20to%20a%202021%20study,Switzerland%20and%20the%20United%20Kingdom).

Disclosures and Disclaimers

The Fixed Income Capital Markets trading area of Stifel, Nicolaus & Company, Incorporated may own debt securities of the borrower or borrowers mentioned in this report and may make a market in the aforementioned securities as of the date of issuance of this research report. Please visit the Research Page at www.stifel.com for the current research disclosures applicable to the companies mentioned in this publication that are within Stifel's coverage universe.

The information contained herein has been prepared from sources believed reliable but is not guaranteed by Stifel and is not a complete summary or statement of all available data, nor is it to be construed as an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of investors. Employees of Stifel or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed within. No investments or services mentioned are available to "private customers" in the European Economic Area or to anyone in Canada other than a "Designated Institution". The employees involved in the preparation or the issuance of this communication may have positions in the securities or options of the issuer/s discussed or recommended herein.

Stifel is a multi-disciplined financial services firm that regularly seeks investment banking assignments and compensation from issuers for services including, but not limited to, acting as an underwriter in an offering or financial advisor in a merger or acquisition, or serving as a placement agent in private transactions. Moreover, Stifel and its affiliates and their respective shareholders, directors, officers and/or employees, may from time to time have long or short positions in such securities or in options or other derivative instruments based thereon.

Stifel Fixed Income Capital Markets research and strategy analysts ("FICM Analysts") are not compensated directly or indirectly based on specific investment banking services transactions with the borrower or borrowers mentioned in this report or on FICM Analyst specific recommendations or views (whether or not contained in this or any other Stifel report), nor are FICM Analysts supervised by Stifel investment banking personnel; FICM Analysts receive compensation, however, based on the profitability of both Stifel (which includes investment banking) and Stifel FICM. The views, if any, expressed by FICM Analysts herein accurately reflect their personal professional views about subject securities and borrowers. For additional information on investment risks (including, but not limited to, market risks, credit ratings and specific securities provisions), contact your Stifel financial advisor or salesperson.

Our investment rating system is three-tiered, defined as follows:
Outperform - For credit specific recommendations we expect the identified credit to outperform its sector specific peers over the next six months.
Market perform - For credit specific recommendations we expect the identified credit to perform approximately in line with its sector specific peers over the next six months.
Underperform - For credit specific recommendations we expect the identified credit to underperform its sector specific peers over the next six months.

Additional Information Is Available Upon Request

I, Lindsey Piegza, certify that the views expressed in this research report accurately reflect my personal views about the subject securities or issuers; and I certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this research report.

STIFEL | Fixed Income Capital Markets

STIFEL | Fixed Income Capital Markets