Weekly Market Commentary

October 23, 2023

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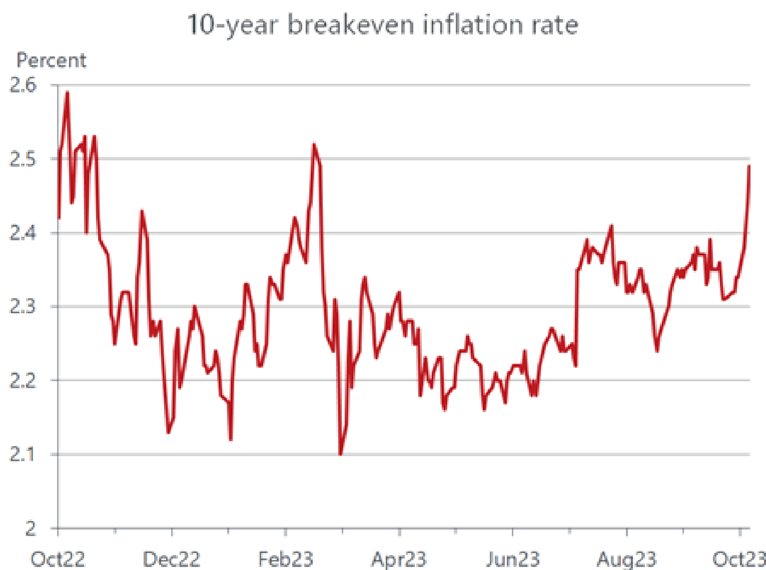
With the 10-year Treasury yield edging closer to five percent this week, the highest since 2007, the Fed's transmission mechanism is clearly working. As Fed Chair Powell reiterated at a speech before the Economic Club of New York on Thursday, monetary policy works through the financial markets. At times, the markets do not cooperate, as was the case between 2003 and 2005 when long-term yields refused to budge despite 150 basis points of Fed-induced rate increases that then-Fed chair Greenspan famously referred to as a "conundrum." Of course, times were much different then, as core inflation had been hovering around two percent for almost a decade and the unemployment rate ranged between five and six percent since coming out of the 2001 recession. Against that backdrop, investors felt little urgency to demand a higher yield premium to tie their funds up for a long period. Indeed, the 150 basis points of rate increases the Fed put into place was mainly designed to prevent inflation from rising, as the economy was growing at a brisk pace.

But the transmission mechanism is fully lubricated this time, as bond yields have surged in recent months against a much higher inflation and a stronger employment backdrop than prevailed in the 2003-05 tightening cycle. Whether the climb continues and overcomes a potential safe bid in the face of escalating geopolitical tensions remains to be seen. Yields slipped on Friday morning amid signs of a broadening of the Israel-Gaza war. It's also unclear what has been driving the yield upturn; Powell does not believe that rising inflation expectations are behind the move, as price and wage gains have receded markedly over the past year. He may be right, but the 10-year inflation breakeven rate spiked over the last week, reaching a seven-month high of 2.49 percent at the close of trading on Thursday.



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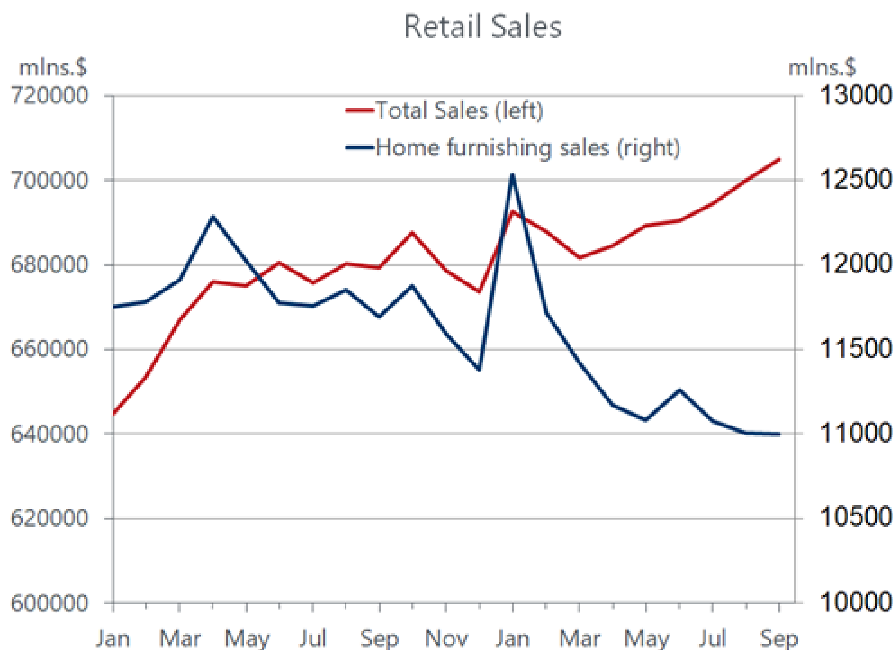
Whatever the reasons, Powell acknowledged that the sharp rise in long-term yields is contributing to the desired tightening of financial conditions that makes the Fed's job of curbing demand easier. Simply put, there is no conundrum for the central bank to ponder over now. At the margin, it lessens the need for the Fed to hike rates again at the next policy meeting that concludes on November 1, although it remains a live possibility at the December 13 meeting if there is no softening in economic and labor market conditions by then. That means incoming economic data would need to downshift considerably from the trends seen so far this month, which featured stronger jobs, inflation and retail sales reports than expected.

The one outlier, of course, is housing, which is one of the most interest-rate sensitive sectors of the economy. Not surprisingly, with mortgage rates surging to the highest level in more than 20 years, averaging 7.63 percent this week, the demand side of the housing ledger is feeling more pain than the supply side, where shortages are spurring builders to fill a void in the market for existing homes. But potential buyers need a median household income of $115,000 to afford a median priced home, which is well above the actual median household income of $74,500. That affordability gap pushes a broad swath of the adult population out of the housing market, which is strikingly revealed in the latest sales data.

In September, sales of existing homes fell for the fourth consecutive month, slipping to just under a four-million-unit annual pace, a level not seen since the tail-end of the housing collapse in 2010. The slide in home sales is far from over. Keep in mind that recorded sales of previously owned homes are based on contracts signed a month or two earlier. Since those contract signings, mortgage rates are up another half-percentage point and it's doubtful that the squeeze on affordability from higher rates has been offset by declines in home prices. According to the Mortgage Bankers Association, mortgage applications for home purchase have plunged to the lowest level since 1995 in mid-October.

While home sales do not directly impact GDP – they are basically a transfer of assets and do not contribute to new output – they do have indirect effects, most notably on ancillary purchases linked to a home sale. Hence, sales of home furnishings, appliances, building materials and moving services, among other home sales-related items, have languished in recent months. But the pullback in this group has hardly derailed overall spending, as consumers are binging out on other things that is more than offsetting the drag from weak home-related purchases. This is strikingly revealed in the latest retail sales report, which, like the key jobs report released earlier this month, staged a far stronger increase than expected.



Overall, retail sales leaped by 0.7 percent in September, following upward revisions to July and August, resulting in a blistering 8.4 percent annual increase over the last three months. Although the retail report mainly covers purchases of goods, it does include sales at restaurants and bars as well, where spending rose by a sturdy 0.9 percent, suggesting that revenge spending on services remained alive and well throughout the third quarter. Importantly, the control group of sales that feed directly into the GDP calculations rose by a solid 0.6 percent in September, lifting the growth rate for the third quarter to 6.4 percent from 2.4 percent in the second quarter. With consumer spending accounting for about 70 percent of GDP, it's clear that the economic engine revved up last quarter and headed into the fourth quarter with more momentum than thought.

The question is, will the momentum be sustained and prod the Fed into another rate hike to stave off a rebound in inflation? Powell noted in his New York comments on Thursday that he doesn't believe financial conditions are overly restrictive, given the ongoing strength of the economy. Some interpreted that as a signal another rate increase is more likely than not. However, the Fed chair also noted that there is still plenty of tightening in the pipeline that has yet to ripple through to the economy. He understandably refused to speculate when the "long and variable lags" from monetary tightening have their full effects on economic activity. But he clearly believes that they are steadily taking a toll, which justifies a more careful approach going forward.

We agree with that assessment and look for the growth engine to downshift in the fourth quarter, although the risk of it stalling out completely has diminished. Even as the tightening in the pipeline is winding its way through the system, the economy is facing headwinds that are poised to get stronger. The robust data for September is now in the rearview mirror and long-term interest rates have climbed by another 50-75 basis points since the beginning of that month. That will take a toll on consumer borrowing, particularly for big-ticket purchases like autos, as well as on corporate borrowing. Credit card delinquencies are starting to rise, banks are tightening credit, student debt repayments have restarted, the savings rate has declined below pre-pandemic levels, and wage growth is slowing. The last shoe to drop, a meaningful softening in the job market, has yet to occur. Whether or not it does before the December FOMC meeting may determine if another rate hike is taken before the end of the year. Even so, the prospect of the Fed keeping rates elevated for the foreseeable future aligns with other forces that should underpin a meaningful slowdown in job growth in coming months.