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AIM
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Prospects for a soft landing are looking better with each data release. However, the economy will be descending from a higher cliff than thought, so depending on the landing spot the trip down may also be steeper. Revised data this week reveal that the torrid growth rate in the third quarter was even hotter than the previously estimated 4.9 percent, with GDP staging an eye-opening 5.2 percent gain. Take out the aberrational quarterly gyrations over the first two years of the post-pandemic rebound, and you would have to go back nearly a decade, to the second quarter of 2014, to find a growth rate equally as large. To be fair, the third quarter was not entirely free of artificial influences, including leftover pandemic savings that fueled consumer spending.

Indeed, households tapped into their savings to finance more than 72 percent of the increase in personal consumption during the third quarter. That's in sharp contrast to their behavior in each of the previous three quarters when consumers eschewed some spending to pad savings, lowering the average increase in real consumption to 1.9 percent over the period. Still, consumers were not responsible for the upwardly adjusted growth rate last quarter; their spending was actually revised down a notch, from 4.0 percent to a still-sturdy 3.6 percent pace. Instead, business and government spending accounted for most of the revision. That's a positive development as more balanced growth suggests the economy is less vulnerable to an abrupt retreat in a particular sector, most notably consumers.

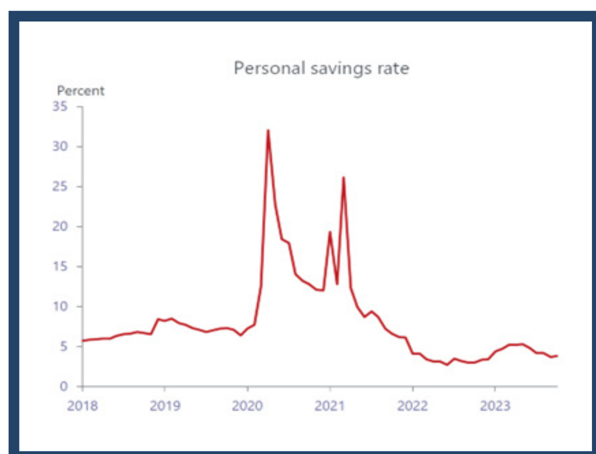
But consumers are by far the main growth driver, and they are the ones that will determine if the economy glides into a soft landing or comes crashing down. As expected, they have already begun to pull back, as spending in October downshifted from the third quarter's unsustainable pace. Also as expected, they relied less on savings to fund their purchases, most likely because there is less of it to tap into. Households are relying more on income, which fortunately is growing. It would be a mistake to write consumers off at this point, given the still vibrant job market, incomes that are finally outpacing inflation and solid balance sheets that received a big boost from rising stock and bond prices in November. Bonds turned in the strongest performance for a month since the 1980s, thanks to a steep decline in long term yields, and the S&P 500 posted its strongest monthly gain in more than a year.

Whether the slim 0.2 percent increase in personal consumption in November—half of the average monthly increase in the third quarter – is a sign that households are just taking a breather following   a spending binge in the third quarter remains to be seen. But the details of the October spending report suggests that there is a fundamental shift in consumer behavior that points to more frugal spending habits in coming months. Importantly, discretionary spending weakened considerably, as purchases of big-ticket items like autos, durable goods and furniture were the biggest drags on spending during the month. Clothing sales also declined and, while a breakdown by fashion categories is not available, retailers are reporting that customers are trading down to less expensive apparel.

This shift in spending behavior is consistent with anecdotal evidence that high prices and even higher borrowing costs are squeezing the budgets of a broadening swath of households, prompting them to devote more of their paychecks to necessities. The good news is that paychecks are still growing and purchasing power is getting a boost from declining inflation. The bad news is that the growth in paychecks is slowing, reflecting the slowdown in job growth and, importantly, in hours worked. Wages and salaries, which account for more than 50 percent of personal income, only rose by 0.1 percent in October, the smallest monthly increase this year.

Paradoxically, the main reason overall personal income increased by a faster 0.2 percent in October, which was still half the average

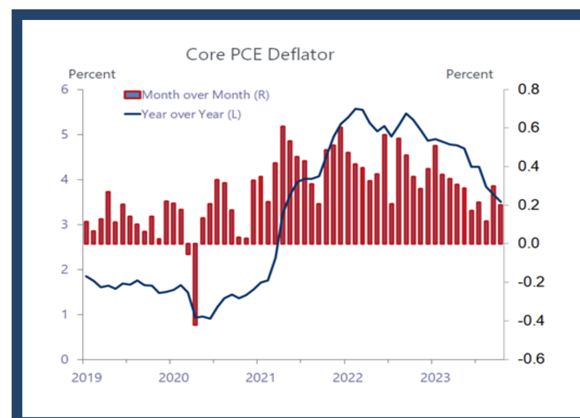
monthly advance over the previous nine months this year, is the boost provided by higher interest rates engineered by the Federal Reserve. While that has clearly driven up borrowing costs it has also lifted interest income for savers. Hence, interest receipts on financial assets are becoming a more important source of income, accounting for a 7.8 percent share in October. That's up from 7.2 percent when the Fed started raising rates in March of last year. True, the interest share was much higher in the years prior to the pandemic – averaging 8.8 percent in 2016 through 2019 – even though interest rates were much lower. But that's largely because income growth was much weaker then compared to the surge following the pandemic recession, thanks to massive government stimulus payments to households and the torrid post-pandemic rebound in job growth. Since April 2020, the annual growth rate in personal income averaged 6.2 percent compared to 4.4 percent from 2016 through 2019. Now income growth is slowing, with the 4.5 percent year-over-year gain in October virtually the same as the pre-pandemic pace. As current interest rates cover more financial assets, interest receipts will continue to make a greater contribution to income.



That said, while interest receipts are boosting personal income, they are not likely to bolster spending as most financial assets are held by wealthier households who have a lower propensity to spend than the general population. What's more, with activity slowing and households retaining a downbeat mood regarding the outlook, the incentive to build up savings as a precaution against adversity is strengthening. If anything, the high rates available on financial assets provide more of an encouragement to save than spend on nonessential items. We suspect that the personal savings rate, which stands at a historically low 3.8 percent in October, is poised to rise in the months ahead, putting a further damper on consumer spending.

We look for real spending by consumers to slow to 2 percent in the current quarter from the 3.6 percent third quarter pace. The slowdown would be welcome news for policy makers, as weaker demand also weakens the ability of companies to raise prices, helping the Fed in its inflation fight. On this score, the Fed also received good news this week as its preferred price gauge continued to recede, putting the 2 percent target within sighting distance. The personal consumption deflator was unchanged in October, lowering the increase over the past year to 3.0 percent from 3.4 percent in September and the lowest since March 2021. Slumping gas prices played a big role in the October retreat, but even excluding volatile gas and food prices, the disinflation trend is alive and well.

The core PCE increased 3.5 percent from a year ago, down from 3.7 percent in September and the smallest since April 2021. Importantly, the disinflationary trend is becoming more pronounced, as the core PCE has increased at an annual rate of only 2.5 percent over the past six months and 2.4 percent over the past three months. The steady inflation retreat has softened the position of Fed officials regarding future rate hikes, which have just about been taken off the table. However, they are still not considering rate cuts, which the financial markets are pricing in to start early next year, leading to four or five cuts over the course of 2024. We are looking for the first rate reduction to occur early in the second half of 2024, when inflation is expected to hover around 2.5 percent, and the downward trend is convincing enough for the Fed to move. The risk is that the Fed waits too long before easing – guided by lagging indicators for its



decisions – and the rise in real interest rates sends the economy into a hard landing. We will have more information on the Fed's plans when it releases a fresh set of economic and rate projections at its upcoming FOMC meeting on December 12-13.

KEY FINANCIAL INDICATORS

INTEREST RATES	December 1	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.38%	5.46%	5.43%	4.31%
6-month Treasury bill	5.36	5.47	5.49	4.67
2-year Treasury note	4.55	4.96	4.87	4.29
5-year Treasury note	4.13	4.49	4.48	3.66
10-year Treasury note	4.20	4.47	4.52	3.49
30-year Treasury bond	4.39	4.60	4.70	3.55
30-year fixed mortgage rate	7.22	7.29	7.76	6.49
15-year fixed mortgage rate	6.66	6.677.03	5.76	6.29
STOCK MARKET				
Dow Jones Industrial Index	36245.50	35390.15	34061.32	34429.88
S&P 500	4594.63	4559.34	4358.34	4071.70
NASDAQ	14305.43	14250.85	13478.28	11461.50
COMMODITIES				
Gold ($ per troy ounce)	2091.70	2003.70	2000.00	1811.40
Oil ($ per barrel) - Crude Futures (WTI)	74.78	75.18	80.84	80.34

KEY ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
New Home Sales (October) - 000s	679	719	662	697
Personal Income (October) - % change	0.2	0.4	0.5	0.3
Personal Consumption (October) - % change	0.2	0.7	0.4	0.4
Personal Savings Rate (October) - Percent	3.8	3.7	4.2	4.3

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