MACRO ENVIRONMENT

This summer saw a marked shift in sentiment among US investors and policymakers. Investors, fearing economic resilience would keep monetary policy tight, saw good news as bad in the third quarter. And by mid-October, the bond market rout that began in Q3 had pushed long-term interest rates to 15-year highs. But while markets became gloomy, the opposite was true for those monitoring economic developments. Hopes of a soft landing grew as the US economy outperformed and inflation held its summer gains.

Macro and market trends have not shifted significantly in October, despite geopolitical turmoil and disarray on Capitol Hill. The relative calm will only continue if the conflict in the Middle East stays contained, without spillover to energy markets or trade more generally. Washington political dysfunction also complicates international relations. Before the attack on Israel on October 7, President Biden was forced to reassure key counterparts of America's leadership role when aid to Ukraine was denied in the short-term funding bill passed on September 30. That came just before Congress essentially shut down, with the ousting of House Speaker Kevin McCarthy. Two Republican nominees for Speaker have since failed to win the necessary votes to win. One glimmer of hope is that the resistance to the second nominee, Jim Jordan, came from more traditional Republicans who rejected Jordan's previous scorched earth attitude to legislating and his willingness to see the government shut down or be unable to pay it.

Hopes of avoiding recession while restoring price stability were challenged late in the quarter by two new headwinds facing the economy. Rising energy costs, as Saudi Arabia and Russia joined in announcing production cuts, threatened to undercut progress on inflation and a strike by United Auto Workers (UAW) that extended into its second week by end-September risked economic recovery, with an estimated cost to the economy of some $100-$125 million every week it continues, according to estimates from Goldman Sachs. The strike has moved off the front page. But it continues, with attendant costs to the auto industry and the economy more broadly.

THREE THEMES TO WATCH IN Q4:

01 SLOWING GLOBAL ECONOMY
Have we seen the full impact of the global cycle of monetary tightening or is there more to come, for example, through a decline in bank lending in Europe and the US, real estate problems – notably in China – or weakening global trade?

02 US OUTLOOK
Unlike in Europe, where the economy has stagnated as the ECB fights inflation, the American economy has remained resilient. With headwinds from rising oil prices and the autoworkers' strike, as well as tight money, is a soft landing still in the cards?

03 HIGHER FOR LONGER
Will markets and the global economy adjust smoothly to a likely "new" new normal of "higher for longer" interest rates, held up in part by rising fiscal debt and deficits in the US and elsewhere? Developments in US bond markets in recent weeks may herald a regime change. As government deficits have grown, the demand for Treasuries is also slowing with QT replacing QE and traditional buyers such as Japan changing policies.

MARKETS VERSUS THE ECONOMISTS

The contrast between benign economic data and investor sentiment was striking in the third quarter. US equity markets, which had surprised on the upside during the first half the year , kept up the positive momentum in July before dropping sharply in August and September. The quarter ended 3.5% in the red. Bond markets began a sharp slide, with the 10-year Treasury yield reaching 4.6% towards the end of the month. At the same time, decelerating inflation during the quarter, alongside continued stronger than expected payroll expansion and healthy sales, saw hopes spreading that the US might succeed in bringing inflation down without a sharp rise in unemployment and a recession. The Federal Reserve itself revised growth forecasts up and unemployment down in its September Summary of Economic Projections (SEP).

Was the market reaction a case of good economic news being bad for investors? A stronger economy is good for American households and many companies. But it does mean higher interest rates for longer. In raising near-term growth projections, the Fed also pointed to higher

Figure 1a. Volatility remains elevated in equity markets

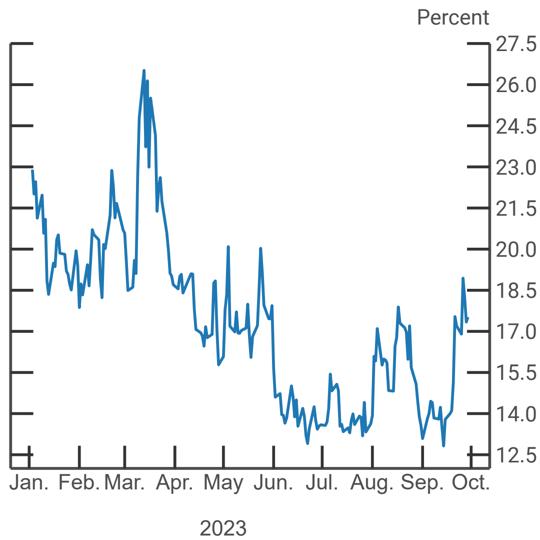
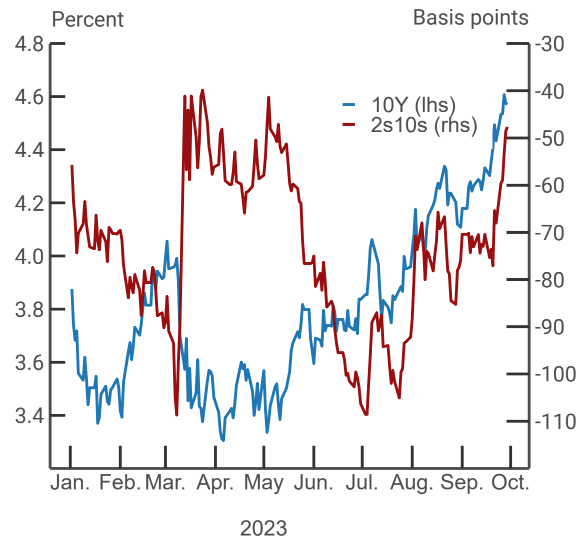


Figure 1b. The yield curve bear steepenes amid a surge in Treasury yields



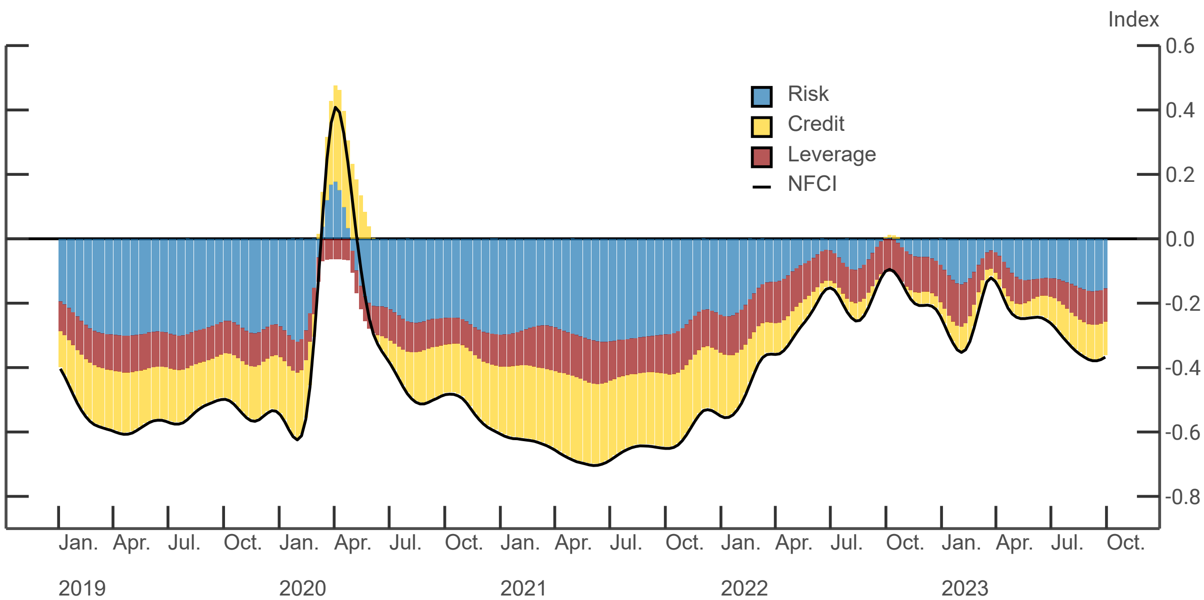
Source: RockCreek, Bloomberg.

interest rates during 2024 and perhaps beyond. That prospect weakens investor appetite for risk taking (Figure 1.a). In particular, the tech stocks that have powered the rise in equity markets look less attractive. And bond investors became wary, fearing that rates may have further to rise, thus pushing down prices (Figure 1.b).

That is one narrative to explain the disconnect last quarter. It leaves open the possibility of a soft landing, as inflation continues to slow towards the Fed's price stability goal of 2% and the economy outperforms expectations for jobs and growth.

Another view is that financial markets were correctly anticipating a stronger economy in the run-up in the first half of this year (Figure 2). In turn, the recent market slide reflects anticipation of a likely slowdown in the coming months. As RockCreek has said before, the economy is indeed set to slow as the impact of tight money gradually feeds through to consumption and business investment. Much of the economic strength so far, and the reduction in inflation, has reflected a rebalancing of supply as the impact of the pandemic has worn off. As an example, and contrary to earlier fears, men and women of prime working age have been returning to the labor force in

Figure 2. Financial conditions continue to ease despite tighter money



Source: RockCreek; National Financial Conditions Index, Federal Reserve Bank of Chicago.

recent months. Labor force participation for this group averaged 83.5% in Q3, compared to 82.5% in 2019, the last pre-pandemic year.

The next phase of the fight against inflation will be on the demand side. The Fed's squeeze on demand tightened over the quarter even as the pace of its rate hikes slowed. The policy rate was raised just once, in July, by 25 basis points. But market rates rose sharply and are now clearly restrictive. Monetary policy spread into higher borrowing costs and tighter financial conditions. The real interest rate implied by Treasury Inflation Protected Securities (TIPS) climbed from a low of 1.59% at the end of Q2 to 2.20% by the end of September. Mortgage rates also jumped back up, to 7.31% by end-September, compared to 6.61% three months earlier.

The labor market stayed robust in the quarter, although the extreme pressures that concerned Fed Chair Jerome Powell earlier in the Fed's fight against inflation were reduced. Vacancies remain high but are down from their peak. The Job Openings and Labor Turnover Survey, or JOLTS, was unexpectedly strong in September. But for Q3 as a whole, the survey showed signs that labor markets continued to ease over the summer. Though the number of jobs available for every American seeking work held at 1.5, the rate at which workers are deciding to leave jobs declined. Unemployment rose slightly, ending the quarter at 3.8%. Payrolls surprised on the upside in September, consistent with the narrative of a strong Q3 economy. But average earnings moderated, to a year-on-year increase of 4.2% in September. Recent data shows that some of the good cheer that has kept consumers spending – even as this has meant running up debts – may now be ebbing away.

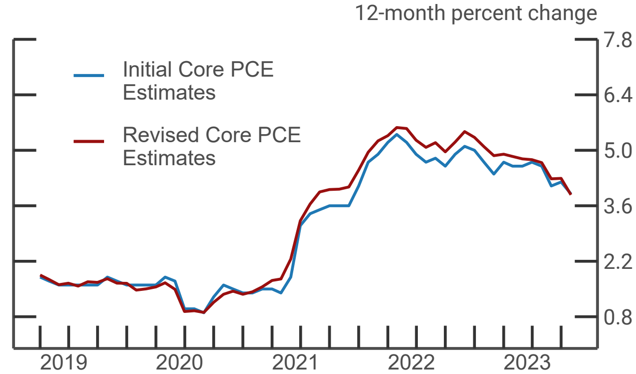
The path ahead for the economy depends largely on whether inflation continues to decline without further tightening, either directly by the Fed raising its policy rate or by financial market tightening as long rates rise. During the quarter, the balance of risks evened out between doing too much or too little further Fed tightening. But Chair Powell continued to emphasize the need for a credible and sustainable reduction in inflation. He and his colleagues do not want to take the risk of easing too soon. Their job is made harder by the difficulty of understanding what led to the inflationary surge of 2021-22 and why prices have decelerated with little economic pain so far.

THE INFLATION - JOBS PUZZLE PERSISTS

It is clear that the US economy has moved into better balance. Labor market pressures eased somewhat, and price inflation slowed. What is less clear is whether the squeeze on demand from higher borrowing costs will let the air out gently from the post-pandemic economy or whether tight money will eventually trigger a sharp pull back in spending and hiring that becomes self-fulfilling, as former New York Fed President William Dudley recently warned. The Fed appeared to move closer in Q3 to ending the tightening cycle that began in March 2022. But key decisions remain about how long to keep rates up at current levels.

History and theory are not helpful in answering the question. Nor have recent data offered a good guide. Covid lockdowns and accompanying policy responses in the US and elsewhere, together with the impact of Russia's attack on Ukraine, have blurred the economic picture to such an extent that sharply differing narratives can be supported by the evidence. GDP growth, driven by consumer spending, appeared to remain robust during Q3 after outperforming expectations in the first half of the year. Better price data in June and July encouraged the Fed to hold rates steady in September. In all of the third quarter, the policy rate was only increased by 25 bps, compared to the increase of 75 bps in the in the first three months of 2023. Initial August data for inflation and growth put pressure on the Fed to keep its options open on whether to raise rates later this year. Upward revisions to inflation over the last few years give them pause (Figure 3). But the sharp increase in market rates may be doing enough tightening of financial conditions.

Figure 3. Revisions to inflation data give central banks some pause



Source: RockCreek, Bureau of Economic Analysis, Bloomberg.

The most important economic phenomenon of the pandemic and post-pandemic period – the inflationary surge that characterized 2021 and 2022 – remains something of a puzzle and a matter of heated dispute among experts. Government policies around the world varied during this time. But the jump in inflation was widespread across the globe – with the exception of the two Asian giants, China and Japan.

The response to the inflation shock was similar among major central banks. All tightened policy in 2022 and 2023. Inflation has subsided around the world, but not simultaneously. And as the tightening cycle drew towards an end in Q3, economic developments diverged. In the US and Canada, economic resilience kept growth positive while inflation declined, to 3.7% and 4.0% year-over-year, respectively. Other major economies – with the unusual exception of Japan – did not fare so well. Europe continued to see sticky inflation, above target. Despite still negative real interest rates, economic output and sentiment dimmed over the summer, especially in Germany, which has complicated monetary policy. Some of the weakness reflected the challenges in China, the world's second largest economy, which continued to underperform in Q3 despite a series of measures– mostly monetary – aimed at boosting the economy.

If the price surge was fundamentally a result of supply shocks that are now easing, inflation could subside further without recessionary pain. In that case, the danger for the Fed and other major central banks is that they may tighten too much and for too long.

DEFICIT AND DEBT WORRIES RESURFACE

It has been more than three decades since James Carville, then political adviser to Bill Clinton, famously said he would like to return in another life as the apparently all-powerful bond market. Politicians feared a market thumbs down could scupper their spending and tax plans. The long period of low interest rates since then changed the calculus. It is now changing again. In a world of higher interest rates and more security dangers, concerns are growing about the burden of government borrowing and the growing share of government spending that must be devoted to servicing the debt. At the same time, there is little political consensus about how to cut the deficit. Generally, the argument is framed in terms of spending. Tax policy gets less attention. Given the relatively small proportion of federal spending that is truly discretionary – once defense, social security, Medicare and interest costs are put aside – it makes sense also to consider potential deficit savings on that side of the ledger. A deep dive into this issue at Brookings brought together experts to consider potential reforms that could garner political support and raise economic efficiency.

Deficits and debt raise the supply of government debt. There is a separate reason for recent volatility. The demand for Treasuries was buoyed since the Global Financial Crisis by the extraordinary Fed purchases under QE as well as by foreign purchases, e.g. from China. These trends are now changing. It seems that markets started to wake up to the implications of that, together with a strong economy that is holding up private investment and spending.

PRODUCTIVITY MATTERS

US GDP in Q3 likely grew by more than the 1-1.5% rate now widely thought to be the economy's potential growth rate – i.e., the rate of growth that is sustainable over the medium-term. The recent turn away from globalization, open markets and free trade in the US and other major economies will tend to dampen efficiency and productivity, according to research from three major international economic institutions – the World Bank, IMF and, most recently, the OECD. But there is better news for the US from research on the possibilities of Artificial Intelligence. American strengths in technology, flexibility and openness to innovation are likely to lead to US strength in capturing AI to make the economy more productive, according to McKinsey.