



Strong employment gains and a burst of consumer spending drive economic growth

November 6, 2023 | Economic Update

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Strong employment gains and a burst of consumer spending, which accounts for nearly 70% of real GDP, combined to power estimated third quarter economic growth to 4.9%, marking the most rapid quarterly advance since 2014, the fastest pace since late 2021, and more than twice the 2.1% rate of the prior three months. Real GDP has grown 2.9% over the past four quarters, well above its 2.0% trend. The economy's advance also gained momentum last quarter from a faster pace of inventory accumulation as well as an ongoing surge in government purchases. Closely watched "Core GDP," which includes consumer spending, business fixed investment and homebuilding, while excluding volatile government purchases, inventories, and international trade increased at a brisk 3.3% annual rate last quarter.

Consumer spending has been underpinned by the expanding net worth of US households. Between 2019 and 2022 household net worth grew by 37%, propelled by rising housing prices and investment portfolio gains. US median household net worth grew to \$192,000 by the end of 2022, up from \$141,000 three years earlier. This represents the greatest wealth accretion in the history of the Survey of Consumer Finances which has been published every three years since 1983. In retrospect, two factors contributed to this huge increase in wealth: vast federal stimulus payments and a slowdown in consumption during the pandemic lockdown allowing households to increase savings and pay down debt. Excess savings, which at one time amounted to over \$2 trillion, have supported steady spending and kept the labor market tight, forestalling the recession widely anticipated for this year. Now, there is evidence these cash balances are dwindling, causing a growing number of consumers, particularly those at the lower end of the wealth chain, to finance their spending or otherwise reduce their outlays. As excess savings diminish further and the wealth effect runs its course, its absence will represent a growing, longer-term headwind for the economy, tempering future economic growth.

Looking behind the last quarter's strong headline GDP growth, we find some warning signs in the economy's otherwise rosy picture. After picking up over the summer, activity in the housing sector, stung by high mortgage rates and lack of inventory, has flattened out, remaining below levels of a year ago. Housing represents 16.4% of real GDP. Higher interest rates also appear to be weighing on business fixed investment which declined slightly in the third quarter, as businesses seemed less willing to assume additional risk. Auto sales, particularly those of pricey EVs, have disappointed as rates have risen. In addition, Americans, eager to spend on such high-profile items as movies and concerts over the summer, saved less of their disposable personal income and their inflation-adjusted income declined last quarter elevating the possibility the pace of their spending will ease in the coming months. And millions of families will soon have to grapple with the resumption of federal student loan payments.

It's also worth noting that US credit delinquencies rose in September and are tracking above the long-term averages for the credit card and auto categories. Meanwhile, savings rates fell in the month,

pointing to weakening consumer credit health. Credit card 60+day delinquency rates rose to 2.65% in September from 2.56% in August, coming in above the long-term average of 2.41% since 2009. Meanwhile, auto 60+day delinquencies increased to 1.46% in September from 1.41% in August, well above the long-term average since 2009 of 0.92%. Household personal savings as a percent of disposable personal income fell to 3.4% in September from 4.0% in August, well below the long-term average of 6.5% since 1998.

So, there is the risk that elevated interest rates, diminishing excess savings, deteriorating consumer credit conditions, risk aversion on the part of business, wars in Ukraine and the Mid East and the possibility a partial government shutdown could cause new economic cracks to emerge, heightening the risk of a mild recession next year.

Payrolls

The Bureau of Labor Statistics (BLS) October jobs report lends further credence to the view the US economy has begun to slow from its torrid pace of this summer, and that the Fed has made considerable progress in taming inflation by tightening credit conditions. Nonfarm payrolls increased just 150,000 in October, lagging the consensus expected 180,000. Moreover, payroll gains for August and September were revised lower by a total of 101,000, bringing the net gain in jobs down to a weak 49,000. Private sector payrolls rose 99,000 in October but were revised down by 80,000 in prior months. The unemployment rate ticked up to 3.9% in October from 3.8% in September, the highest jobless rate since January 2022. Recall, the unemployment rate fell below 3.5% in April of this year. And civilian employment, an alternative measure of jobs that includes small business startups, dropped 348,000 in October. Perhaps the weakest data point in the BLS jobs report was that total hours worked in the private sector fell 0.3% in October, the equivalent of losing about 350,000 jobs. Meanwhile, average hourly wages rose a tepid 0.2% for the month, although this figure may have been distorted by the absence of higher paid auto workers. As inflation has slowed this year, so have increases in pay. For October, average hourly earnings were up 4.1% from a year ago, versus the year-over-year gain in wages of 4.9% last year.

Tightness in financial conditions, engineered by the Fed through the most rapid rise in its reference rate in 40 years, and Quantitative Tightening (QT) which is shrinking the Fed's balance sheet by \$90 billion a month, is reflected in the 3.2% decline from a year ago in the M2 measure of money supply, the inversion of the yield curve and in high real short-term interest rates which are impacting businesses as well as consumers. The growing risk aversion among business as reflected in curbing their investments and hiring, will contribute to the slowdown ahead. ***While job growth is likely to continue for the next few months, keep in mind the labor market is often a lagging indicator where employers continue to hire until after they see a decline in real output.***

While the labor market remains tight, supply and demand conditions continue to come into better balance. Over the past three months, payroll gains have declined from the pace seen earlier this year. Strong job creation has been accompanied by an increase in the supply of workers. The labor force participation rate has moved up since late last year, particularly for individuals aged 25 to 54 years, and immigration has rebounded to pre-pandemic levels increasing the pool of available workers. Nominal wage growth has shown some signs of easing and job vacancies have declined so far this year. Although the jobs-to-worker gap has narrowed, labor demand still exceeds the supply of available workers by a wide margin according to the latest Job Openings and Labor Turnover Survey (JOLTS). The so-called "quits rate," which measures voluntary job leavers as a share of total employment, held steady at 2.3%

for a third month, the lowest rate since the start of 2021. A more moderate level of quits implies workers are less confident in their ability to find another job in the current market.

The Fed

While inflation has cooled significantly this year, it remains well above the Fed's 2.0% target. The Personal Consumption Expenditure price index (PCE), the Fed's preferred measure of consumer inflation, rose 3.4% over the 12 months ending September. It rose 0.4% in September from the prior month, the same pace as in August. So-called "core" PCE prices, which excludes volatile food and energy categories, increased 0.3% in September, compared with a 0.1% rise in August. "Core" prices were up at a 2.8% annualized rate in April through September, down considerably from a 4.5% annualized rate in the prior six-month period.

The FOMC left rates unchanged at its meeting last week as was widely anticipated. While the accompanying statement talks about potential "additional policy firming," Chair Powell appeared pleased with the "significant progress" on bringing inflation down and overall, it appears the Committee will be on hold for a while despite the possibility of additional hikes should incoming data show a pickup in inflation.

Recent comments from several Fed speakers show they remain worried that some measures of underlying services prices, which showed more strength in September, might warrant keeping another rate increase on the table in the coming months despite other indications of a slowing economy. One favorable sign in the Fed's inflation battle: despite elevated prices, longer-term inflation expectations appear to be well anchored, as reflected in a broad range of surveys of households, businesses, and forecasters, as well as measures from the financial markets we observe.

Forward-Looking Economic Indicators

High-frequency, forward looking economic indicators we monitor are signaling a slowdown ahead. Below are the figures and their implications.

ISM Manufacturing Index declined to 46.7 in October. (Recall readings of this diffusion index below 50 signal contraction; readings above 50 signal expansion). Activity in the US factory sector, amounting to 12% of GDP, contracted in October at the fastest pace in three months as it has every month this year. The pullback likely reflected the impact of a strike at the nation's automakers that idled many vehicle plants and reverberated through suppliers of parts and components. Just two of eighteen major industries reported growth last month. Survey comments cited weakening demand, slowing activity and dwindling optimism for 2024. Weakening demand is evident in the new orders index which remained in contraction for fourteen consecutive months. Meanwhile the production index showed expansion for the second consecutive month. The combination of less demand from consumers and built-up inventories at retailers rules out a significant rebound in manufacturing output over the near term. However, fewer orders and faster production have allowed factories to catch up on their order backlogs. That measure fell to 42.2 in October and remains near the lowest reading since the 2008 financial crisis. Meanwhile, the employment index fell to 46.8 from 51.2 in September. Finally, the prices paid index rose to 45.1 in October remaining in contraction for the past six months, showing tight credit conditions are impacting inflation.

ISM Non-Manufacturing Index fell to 51.8 in October, lagging the consensus expected 53.0 (Recall readings of this diffusion index below 50 signal contraction; readings above 50 signal expansion). The major measures of non-manufacturing activity were mostly lower in October. The business activity index

dropped to 54.1 from 58.8, while the new orders index rose to 55.5 from 51.8. The employment index declined to 50.2 from 53.4, while the supplier deliveries index fell to 47.5 from 50.4. The service sector which accounts for nearly 80% of US business activity, continued to expand in October, but at a slower pace. Twelve of the eighteen major industries reported growth. When compared with the October ISM manufacturing survey report there is clearly a divergence in activity, where output has been shifting back to the services sector following the COVID-era when goods-related activity was artificially boosted. The two most forward-looking categories, new orders and business activity, were mixed in October, as the new orders index bounced back to 55.5 after a decline the prior month, while the business activity index slipped to 54.1 from 58.8 in September. Still, both show healthy expansion and have remained above 50 throughout the year.

Initial Jobless Claims measures the number of individuals who filed for unemployment insurance benefits for the first time during the past week. As such, it is the earliest, most forward-looking piece of US economic data. Higher than expected readings are taken as bearish for the US economy, while lower than expected readings are viewed as bullish for the economy. Weekly readings of initial jobless claims have been drifting higher, rising to 210,000 in the latest reporting period. The four-week moving average of claims, our preferred measure, rose to 207,500 confirming the slowing trend in hiring. Both readings came in above expectations.

University of Michigan Consumer Sentiment Survey for October was revised higher to 63.8, the lowest level in five months, from a preliminary reading of 63. The result marked a sharp retreat from 68.1, recorded in September. The gauge measuring consumer expectations fell by 9.9% to 59.3, largely due to deteriorating expectations over business conditions and worries over consumers' own personal finances. To a lesser degree, the decline was attributed to the implications of negative current events domestically and abroad.

Durable Goods Orders surged 4.7% in September easily exceeding the consensus expected +1.9%. Orders excluding transportation rose 0.5%. Orders are ahead 7.8% from a year ago, while orders excluding transportation have risen 1.7%. Unfilled orders rose 1.4% in September and are up 7.5% in the past year. A surge in commercial aircraft orders (+92.5% in September) was the major contributor to growth in new orders, following large declines in these aircraft orders in the prior two months. Without the typically volatile transportation category, orders for durable goods rose a healthy 0.5%, with gains across most major categories. The most important number in the September data is core shipments, a key input for business investment in the calculation of GDP, which was unchanged in September. These shipments rose at an annualized rate in Q3 versus the Q2 average. The growth of shipments has been slowing since the start of 2022 and this trend is likely to continue as the economy feels the lagged effects of Fed tightening.

Despite signs of slowing, the US economy has proven resilient, with forecasters' projections for a recession going unrealized. Many economists who had previously called for a downturn, now expect a cooling rather than a sharp pullback. Notably, our firm's proprietary Economic Model, designed to signal a change in the direction of the economy six to nine months in advance of an inflection point, has shown four consecutive monthly above-trend readings increasing the odds the US economy will narrowly skirt recession in 2024, achieving the Fed's desired "soft landing."

Financial Market Reactions

From their reaction to recent economic data, financial markets appear to have concluded the Fed is through raising interest rates for this cycle and that by the middle of next year, as inflation slows further, officials will begin to cut the benchmark rate to avoid pushing the economy into recession. Both bond and stock prices soared last week following reports of sharply slowing job growth and moderating wage gains, a sign the economy is cooling. Fed Chair Powell's comment during the presser following the Fed's announcement last week, "The question we're asking is should we hike more? Slowing down is giving us, I think, a better sense of how much more we need to do, if we need to do more," ignited the animal spirits among investors. Stock prices, as measured by the S&P500 index rose 5.9% for the week. The benchmark 10-year US Treasury bond price increased sharply as its yield posted its largest weekly decline since March, closing at 4.55% (after touching 5.02% on an intraday basis just a few days earlier) amid reports US Treasury bond issuance could be as much as \$100 billion less than previously forecast. And investors in interest rate futures markets reduced their bets the Fed would raise interest rates again, with the probability of one more increase falling to 10% on Friday from 26% the day before. Investors also began to anticipate the Fed would cut rates next May instead of June.

Investment Policy

From their recovery high in July, US equities, as measured by the S&P500 index, have corrected about 5%. The more volatile, tech heavy NASDAQ is 7% below its summer peak and the S&P500 equal-weighted index is 9% below its 2023 top. During the same time period, the S&P *growth* index has fallen 5% while its *value* counterpart has declined 6%. Despite this summer's pullback, the major equity indices, dominated by a handful of mega cap tech stocks, still show positive results for the year-to-date: the S&P500 is ahead 13.5% and the tech-dominated NASDAQ is up 28.7%. The All-Country World Index (ACWI) is 10.5% higher. Meanwhile the S&P500 equal-weighted index is flat.

Until last week's reversal, upward pressures on interest rates and dampened 2024 Fed easing expectations, coupled with higher energy prices, recession concerns, rising geopolitical tensions and underwhelming earnings had soured investor sentiment, outweighing the peak interest rate narrative, and improved Chinese macro data. Adding to the negative sentiment, by late October, the major US equity indices had fallen below their 200-day moving averages for the first time since last winter.

From a *valuation* perspective, the S&P500 index has gone from being undervalued at the start of this year to being fairly valued this summer at 17.6x next year's consensus earnings estimate of \$246. Currently, the S&P500 is selling at 17.7x next year's estimate. Markets routinely fluctuate between undervaluation and overvaluation reflecting shifts in sentiment. It's worth noting that the S&P500's multiple would be less than 15x 2024 earnings if the "magnificent seven" mega caps were excluded.

The reversal of last year's out-performance of *value* shares by *growth* continues in 2023 as investors have shown a strong preference for the relative safety of cash-rich, mega cap growth companies with strong secular growth prospects. Year-to-date, S&P *growth* is higher by 18.4% outpacing the S&P *value* index which is ahead 8.4%. The broadening-out of the market's leadership we have been expecting favoring *value*, has yet to play out and is unlikely to do so until investors see with greater clarity an end to "higher for longer" Fed policy and are willing to reallocate toward more economically sensitive investments.

As long-term investors, we prefer to look beyond near-term economic uncertainties and

short-term investor preferences to the coming business expansion, spurred by easing credit conditions and sound underlying business and consumer fundamentals, to the investment opportunities it will inevitably present.

The sharp rise in interest rates to more normal levels not seen in nearly a generation has made bonds investable once again. Accordingly, we have been extending durations in clients' bond portfolios toward a 2.5-year target. Maturing bonds are being replaced in clients' laddered portfolios by other high quality, marketable corporate obligations maturing in three to four years where yields of 5.50% - 6.00% have become available.

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Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. Definitions: **Personal Consumption Expenditures Index (PCE):** A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. **Conference Board's Confidence Index:** The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. **ISM Manufacturing Index:** The ISM manufacturing index or purchasing managers' index is considered a key indicator of the state of the U.S. economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. **ISM Non-Manufacturing Index:** The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. **S&P500 Index:** The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. **S&P500 Growth Index:** The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. **S&P500 Value**

Index: The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.

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