



US economy remains resilient

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Despite the tightest monetary policy regime in 40 years, the US economy remains resilient, expanding at an above-trend pace, and showing few signs of the widely forecast recession investors feared coming into this year. The aggressive business hiring, amounting to 3.1 million new jobs over the past year, and robust consumer spending, which accounts for over two-thirds of US economic output, have been driven largely by government's unprecedented fiscal and monetary stimulus policies, including a huge M2 money supply increase during the pandemic. The impact of these policies, while now diminishing, continues as does the lagged effect of earlier Fed tightening. Nevertheless, the same expansionary policies put in place to support the economy during the COVID era set the stage for a severe imbalance between the demand for goods and services and their supply, a "supply side shock," driving prices sharply higher. Following the reversal of Fed's accommodative policy early this year, headline consumer inflation, which peaked months ago at near 9%, has fallen to about 3%. The Fed's preferred inflation measure, the Personal Consumption Expenditures Index (PCE), has also declined, falling from 7% last summer to 3.3% last month, the slowest pace in more than two years. Despite these improving trends, inflation remains well above the Fed's 2% target.

Labor market conditions

The principal risk to the economy, as we see it, is that the Fed will keep credit conditions tighter for longer than necessary to bring inflation down, eventually triggering an economic downturn. Recently published labor market data showed the Fed's battle to curb prices has taken another positive turn as fresh figures show a further cooling trend. While the Labor Department's **Job Openings and Labor Turnover Survey (JOLTS)** for July released early last week signaled continued jobs strength, it also showed less extreme tightness than has been evident over the past couple of years. *Job openings* continued their recent downward trend, sliding 3.7% in July, while the 8.8 million job openings reported that month was at the lowest level since March 2021. Elsewhere in the JOLTS survey, the number of *quits* fell to 3.5 million in July, versus 3.8 million in June and 4.0 million a year earlier. July's quits were close to readings last seen in 2019 when there was less of an obvious imbalance between labor supply and demand. That brought the July quit rate to 2.3%, the lowest level since January 2021, matching the prepandemic 2019 average. The decline in quits may provide a better reading on job market tightness than do openings. In many cases workers quit their jobs because they have found a better position elsewhere, often at higher pay, adding to inflation. So, fewer high paying open jobs should eventually translate into reduced inflationary pressures.

Last Friday, the Bureau of Labor Statistics **Nonfarm Payrolls Report** jobs report for August showed the economy added 187,000 jobs, more jobs than expected. However, a jump in the unemployment rate from 3.5% in July to 3.8% last month, moderation in wage growth and downward revisions to jobs gains in prior months all pointed to an easing in labor market conditions which likely will provide the Federal Reserve with good reason to skip an additional rate hike this month. There are now 6.4 million people out

of work compared with 5.8 million in July. Civilian Employment, an alternative measure of jobs that includes small business startups, increased 222,000. Both measures showed the jobs market to be healthy, but downward revisions to June and July gains trimmed payrolls by 110,000, bringing the net gain to only 77,000. The strongest number in the August jobs report was total hours worked in the private sector, rising 0.4% in August, the largest increase for any month since January. The increase in the unemployment rate to 3.8% was due to a 736,000 increase in the labor force, good news for dovish FOMC members as it will make it easier for employers to find workers at any *real* wage rate. Average hourly earnings rose a tepid 0.2% in August adding to the picture of easing labor market conditions.

Sandwiched between the JOLTS and Nonfarm Payrolls reports, the Conference Board's **Confidence Index** fell more than anticipated in August, with the headline dropping 7.9 points to 106.1. This decline came following solid gains over the prior two months. Overall, there has not been a meaningful shift in consumer attitudes over the past few months. However, we have seen a notable change in the survey's labor market differential which reflects the gap between respondents saying jobs are plentiful and others saying jobs are hard-to-get. This differential has been trending lower lately falling 6.2 points to 26.2 last month. While this latest reading is still strong by historic standards, it is not as extreme as it has been, lower than all monthly Commerce Board reports in 2019. So, based upon this gauge of the labor market, readings of recent job market attitudes represent a return to pre-pandemic norms.

The extreme labor market tightness of the past year appears to be easing under the strain of one of the most intense interest rate-tightening cycles in decades, providing the Fed with justification to forgo a further rate increase this month, and possibly in November as well, as it digests incoming inflation and labor market data.

Downside risks

Looking ahead, despite the improving inflation outlook and sound fundamentals, it would be unwise to ignore the downside risks to the economy. Lower-income consumers are under growing pressure as they exhaust savings built up during COVID, and face higher borrowing costs. Jobs paying more are becoming harder to find. Credit card delinquencies at some retailers are higher than anticipated. As a result of changing office work practices, commercial real estate vacancies remain high and values in many downtown areas have plummeted, leaving lenders and landlords with large potential losses. There are shortages of housing away from crime-ridden central city locations. Further tightening of credit conditions could cause a recession by leading to a sharp pullback in lending and further declines in risk asset values. Following the failure of a handful of small and mid-sized US banks last winter, there are persistent rumors of further problems at other lenders. China, the world's second largest economy, is struggling to rekindle consumption amid weak consumer confidence, a housing downturn and shrinking exports. And oil prices have spiked once again.

Despite these concerns, many formerly pessimistic investment savants have scrapped their dour forecasts and now embrace the "soft landing" outlook. Our firm's proprietary [Economic Model](#), which earlier this year forecast a recession, has shown narrowly above trend readings for three consecutive months, usually a signal for a reversal in trend. While we are not ordinarily inclined to second guess the Model's message, data is so mixed and business conditions are so unique to this cycle (i.e., shuttering and then reopening the entire economy in a matter of a few months, ballooning and then shrinking the M2 money supply, and the impact of the war in Ukraine on commodity prices) that we await further above-trend confirming readings before definitively calling a turn. And, as a matter of interest, looking at hard data we have seen, we raised the odds last month to better than 50/50 the US will avoid a recession

in the foreseeable future.

While forward-looking economic indicators we monitor continue to paint a mixed picture, there is no hint in the data of an impending downturn in economic activity.

ISM Manufacturing Index increased to 47.6 in August (Levels higher than 50 signal expansion; levels below 50 signal contraction). The major measures of activity were mixed. New orders declined to 46.8 from 47.3 in July, while the production index rose to 50.0 from 48.3. The supplier deliveries index rose to 48.6 from 46.1 in July and the employment index increased to 48.5 from 44.4.

Activity in the US factory sector, which accounts for about 14% of US output, contracted for the tenth consecutive month in August, though at a slightly slower pace. Only five of the eighteen industries reported growth. Seven respondents noted slowing orders from customers across a wide range of industries and suggested higher interest rates are beginning to impact demand as well. Weakening demand was evident in the new orders index. Given the shift in spending from goods to services it's not surprising that this measure has remained in contraction for the past year. Meanwhile, the production index rebounded as fewer orders, unclogged supply chains and faster production have allowed factories to catch up on order backlogs. The slowdown in orders and reduction in backlogs has begun to affect the employment index, which remained in contraction for the third month in a row at 48.5 in August. Finally, the prices paid for materials index indicated less inflationary pressure from manufacturing.

ISM Non-Manufacturing Index declined in July to 52.1, below the consensus expected 53.1. (Levels higher than 50 signal expansion, levels below 50 signal contraction). The major measures of services activity were mostly lower in July. The business activity index declined to 57.1 from 59.2, while the new orders index fell to 55.5. The employment index dropped to 50.7 from 53.1, while the supplier deliveries index ticked up to 47.6.

There were no signs of a recession in the July services sector which accounts for 80% of output, but the survey shows this sector, while signaling expansion, is growing at a slower pace than earlier this year. Contrast this with the manufacturing index where activity contracted for the tenth consecutive month in August. Businesses and consumers have clearly been shifting their spending preferences toward services which were scarce during the pandemic.

Initial Jobless Claims declined to 228,000 in the week ended August 2 from 232,000 the previous week. The four-week moving average of claims, a better marker for the health of jobs market, was virtually unchanged at 237,250. A decrease in claims suggests a stronger labor market.

Second Quarter Real GDP was revised lower, as more moderate business investment than initially reported outweighed stronger consumer spending. Real GDP rose at a revised, above-trend 2.1% annualized rate last quarter, below the government's previous estimate. Household spending, the driver of the US economy, was revised higher to a 1.7% pace. Forecasters generally expect growth to accelerate in the third quarter on the back of a further pickup in consumer spending.

A gauge of income generated, and costs incurred from producing goods and services, *Gross Domestic Income (GDI)*, rose 0.5% after contracting in the prior two quarters. The average of GDP and GDI rose 1.3%, the largest advance in over a year. The National Bureau of Economic Research Recession Dating Committee, which officially determines the timing of business cycles, watches the average closely.

Equity investment policy

US stocks ended last month on a positive note, rising for the second straight week, recouping much of the ground they gave up earlier in the month. Year-to-date, the S&P500, a market cap weighted index, has gained over 18% as a handful of mega cap tech stocks have accounted for a large portion of that gain. By contrast, the equal weighted S&P500 has increased only about 6%. The tech heavy NASDAQ was 34% higher through last Friday. The bounce in equities was underpinned by a meaningful interest rate decline, a narrowing of the inverted yield curve which signals to some a recession can be avoided, anticipation the end of the interest rate tightening cycle is in sight, continued repositioning of investors as the “soft landing” narrative gains traction, renewed AI hype, and news of Chinese stimulus measures. Meanwhile, technical indicators are signaling the S&P500 is again close to being overbought and there are some concerns about the sustainability of the “bad news is good news” dynamic the stock market has fed on recently. The well-known fact that September is seasonally the worst month for stocks is not lost on traders. A mild 5% to 10% sentiment-driven pullback from current stock market levels, cooling investors’ animal spirits, would probably be a healthy development.

In a reversal of last year’s out-performance by *value* stocks, this year the S&P500 growth index has gained 23.6%, outpacing the S&P500 *value* index which is ahead only 12.1%. Initially driven by enthusiasm over Artificial Intelligence, investor participation in equities has broadened out over the past couple of months as the soft landing narrative took hold, encompassing market sectors that had previously languished, including economically sensitive areas such as energy, cyclicals, financials and consumer discretionary shares. Both *growth* and *value* equities are well represented in clients’ equity portfolios which have been fully invested within portfolio guidelines during the stock market’s recovery since last October.

From a valuation perspective, the stock market has gone from being undervalued at the start of this year to fairly valued now given the economic expansion and earnings surge we expect to unfold next year. Currently, the S&P500 is selling at 18.2x the consensus of 2024 estimated earnings per share of \$246 and 16.1x the consensus of 2025 estimated earnings per share of \$277.

As long-term investors, we prefer to look beyond the near-term uncertainties to the coming business expansion, spurred by easing credit conditions and sound underlying consumer and business fundamentals, to the investment opportunities it will inevitably present.

Fixed income investment policy

A sharp rise in interest rates this year to more normal levels has made bonds investable once again. Accordingly, we are extending bond portfolio durations in clients’ accounts toward a 2.5 year target. Lower yielding money market funds have been replaced by higher yielding US Treasuries maturing in less than a year. Maturing corporate obligations in clients’ laddered portfolios are being reinvested in bonds maturing in three to four years where yields of 5.25%-5.50% are available. Because we see longer-term interest rates rising further over the medium term, we have deferred adding further to portfolio duration.

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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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