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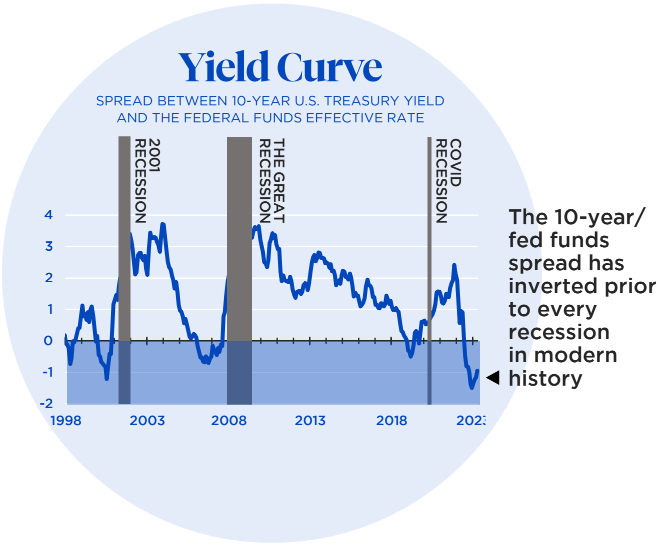
Economic & Financial Markets Monthly Review | October 2023

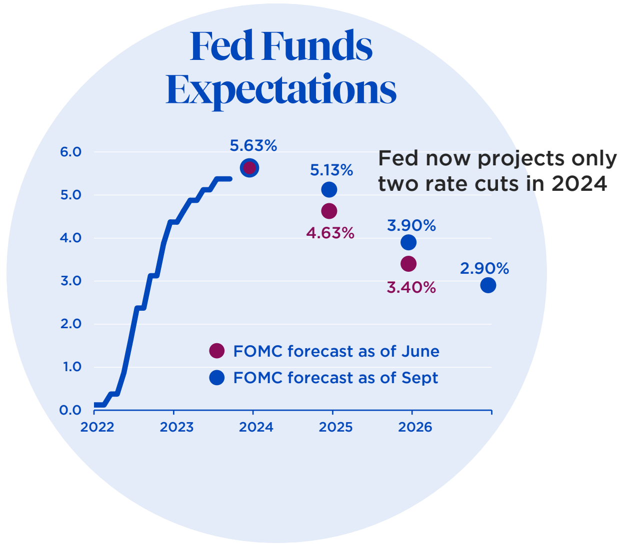
Rising interest rates dampen the outlook

Economic Overview

Where is the economy now?

The start of a recession has likely been pushed into 2024, but weaker trends are emerging across the economy as the end of 2023 approaches. Consumers are pulling the reins on spending while more businesses are prepping for falling sales ahead by cutting expenses and delaying capital investments — trends exacerbated by a further spike in interest rates.





Where we are this month

EXTENDED PRE-RECESSION PERIOD

The economy is on track for continued growth through year end, but the chances of a recession in 2024 are still elevated.

YIELD CURVE STEEPENS

The 10-year to fed funds rate spread remains deeply inverted but has steepened recently amid a spike in long-term Treasury rates.

HIGHER-FOR-LONGER FROM THE FED

The Fed's latest Summary of Economic Projections (SEP) emphasized a higher-for-longer rate path due to lingering inflation pressures.

What does this mean

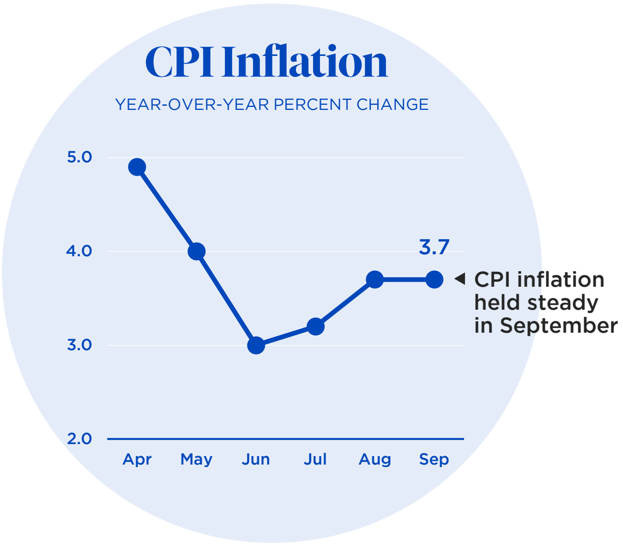
- Leading indicators broadly indicate a recession in the year ahead in response to the cumulative Fed rate increases, tighter bank lending standards, and weaker corporate earnings.
- A projected recession in the first half of 2024 should be modest with limited job losses and business closings — especially compared to the severe downturns over the past two cycles.

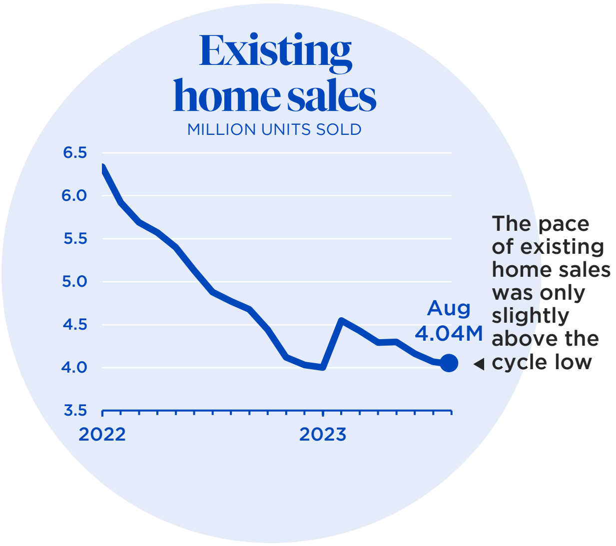
- The yield curve typically steepens ahead of recessions as the Fed eases policy in anticipation of weaker growth. This is less likely to occur in this cycle with the Fed projected to keep rates higher-for-longer over 2024.
- The sustained yield curve inversion is another warning sign for a recession, reflecting the bond market's high odds of a downturn over the next year.

- The majority of Fed officials still expect to hike once more in 2023. Moreover, the median estimates project two fewer rate cuts in both 2024 and 2025 compared to June — an extended period of restrictive policy.
- Even by the end of 2026, the SEP expected the fed funds rate to be slightly above the long-run neutral rate estimate of 2.5 percent.

Hiring still robust despite rate pressures

Job growth accelerated to an eight-month high in September and upward revisions to prior months suggest that hiring in recent months has not slowed as much as previously thought. The prospect of higher-for-longer rates into 2024 should keep rate-sensitive parts of the economy (most notably housing) stuck in neutral while also increasing the likelihood of a hard landing next year.





Where we are this month

JOB GROWTH NOW TRENDING UP

Nonfarm payroll growth jumped in September to 336,000. This hiring pace was an eight-month high and far surpassed expectations.

CORE SERVICES STILL CLIMBING FAST

Year-on-year CPI inflation remained steady in September at 3.7 percent, while the core rate fell for the sixth consecutive month to 4.1 percent.

HOME SALES DECLINE FURTHER

Existing home sales fell for a fifth time in six months in August as the pace of sales was only marginally above January's cycle low.

What does this mean

Job growth now trending up

- Upward revisions to August and July totaled 119,000 additional jobs. In combination with September's stronger-than-expected hiring, the labor market remained too hot in recent months to meaningfully slow services inflation.
- The labor market remains tight with annual wage growth above 4.0 percent and still more than 1.5 job openings for each unemployed worker.

Core services still climbing fast

- Despite core CPI prices climbing an expected 0.3 percent in September, the details show that it was held in check by falling core goods prices while core services still look buoyant.
- Core services less rents climbing 0.6 percent on the month (the fastest since December) will keep the Fed hawkish and open to another rate hike. It's possible, however, that the market could end up doing the tightening for them.

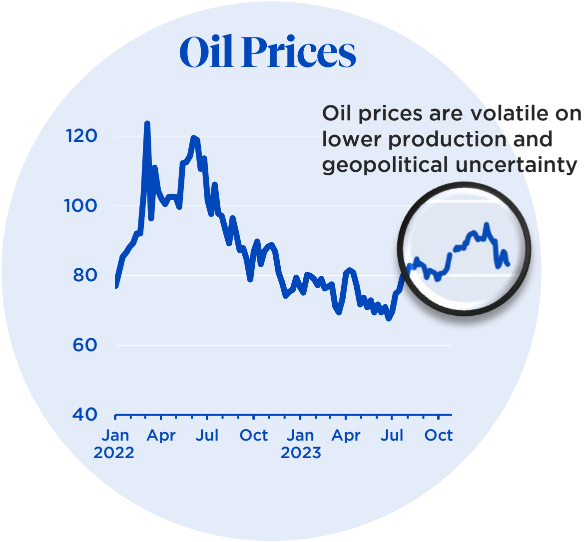
Home sales decline further

- High mortgage rates are hammering the housing market both in the form of reducing affordability for buyers as well as severely limiting supply due to the rate lock-in effect for current homeowners.
- Following the Fed's higher-for-longer rate path, mortgage rates should remain at or above current levels well into 2024, curtailing activity in the housing market over much of the next year.

Financial Market Review

Higher interest rates pull down stock prices

The S&P 500 fell in September as investors accepted that the Fed would likely keep monetary policy in restrictive territory to ensure that inflation returns to the central bank's 2.0 percent target. Tighter lending standards will restrict the flow of credit while higher long-term U.S. Treasury yields will make it more costly for households and businesses to borrow, increasing the likelihood that the U.S. economy will suffer a hard landing.



Where we are this month

What does this mean

LOWER EQUITY PRICES

The S&P 500 fell nearly 5 percent in September. Equities tied to interest rate-sensitive sectors such as real estate and information technology, lost the most ground.

- Investors pared back their equity bets as the Fed made it clear that a rate cut was not forthcoming, meaning the cost of capital would stay high. The pull back was widespread with energy the only sector to record an increase.
- Despite the drop, the equity market remained expensive. The P/E ratio for the S&P 500 averaged roughly 21.0, holding above its long-term historical average.

INTEREST RATES INCREASE

The 10-year Treasury yield increased and averaged 4.38 percent in September, its highest level in 16 years. Real interest rates, or nominal yields minus inflation, stayed in positive territory.

- The yield on the 2-year Treasury Note, which is sensitive to the Fed's interest rate policy, trended higher over the month and averaged just above 5 percent.
- Higher U.S. Treasury yields add another hurdle for the economy to overcome in addition to tightening lending standards. More restrictive credit conditions raise the likelihood of a recession.

GEOPOLITICAL UNCERTAINTY SPIKES

Geopolitical uncertainty spiked after Hamas launched an unprecedented attack on Israel. The conflict threatens to escalate into a regional crisis and could spur a negative shock to oil markets.

- The emerging crisis could curtail global oil production in an already tight market, putting upward pressure on oil prices and a renewed risk to inflation.
- This conflict comes at a time when the global economy is on a shaky footing. Economic growth in China and Europe is relatively weak and the U.S. economy may be headed for a recession.

Outlook

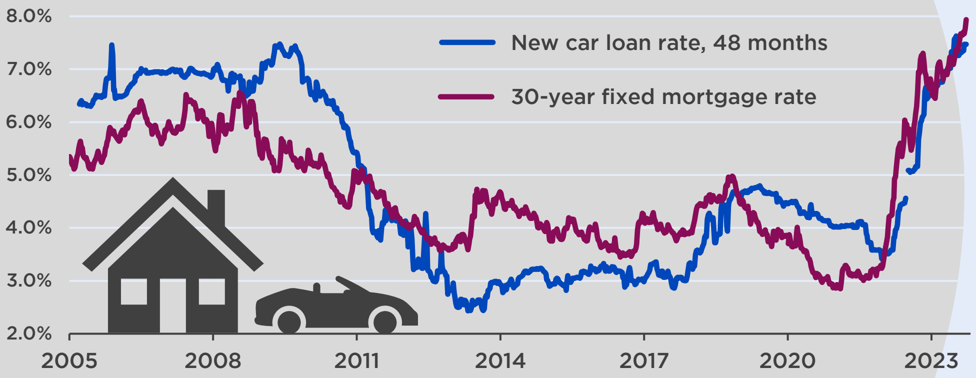
Renewed jump in interest rates a clear downside risk

Buoyant consumer activity has kept the expansion afloat even as rising interest rates battered the housing market and forced many businesses to cut back on investment. But a further surge in rates, with mortgage and auto rates now close to 8.0 percent and business loan costs at the highest levels in several decades, may finally begin to strongly restrict growth in coming months.

The headwinds for the fourth quarter are many, even with the government shutdown averted for the time being. The labor market, which has sustained consumer spending, is showing cracks while more households are being strained by the weight of rising costs. In response to high rates and a weaker job market, home and auto sales should fall off through mid-2024 — adding further downside ahead for the economy. We project a sluggish last quarter of 2023 with a modest recession following in the first half of 2024.

Consumer loan rates jump even higher

Q4 sales may be impacted by surging mortgage and auto rates, now approaching 8.0%



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Data as of October 2023

	2022 ACTUAL	2023 ESTIMATE	2024 FORECAST	2025 FORECAST	2026 FORECAST
REAL GDP	2.1%	2.4%	0.6%	1.7%	1.6%
UNEMPLOYMENT RATE	3.6%	3.7%	4.6%	4.4%	4.0%
INFLATION [1] (CPI)	7.1%	3.5%	2.9%	2.4%	2.0%
TOTAL HOME SALES	5.67	4.82	4.73	5.40	6.00
S&P/CASE-SHILLER HOME PRICE INDEX	5.8%	4.9%	2.0%	3.5%	3.2%
LIGHT VEHICLE SALES	13.8	15.4	15.1	16.3	16.5
FEDERAL FUNDS RATE [2]	4.25%	5.25%	4.00%	3.00%	2.00%
5-YEAR TREASURY NOTE [2]	3.99%	4.60%	3.75%	3.00%	2.50%
10-YEAR TREASURY NOTE [2]	3.88%	4.50%	4.00%	3.45%	2.75%
30-YEAR FIXED-RATE MORTGAGE [2]	6.42%	7.50%	6.30%	5.10%	4.40%
MONEY MARKET FUNDS	2.27%	5.09%	4.65%	3.40%	2.40%

[1] Percent change Q4-to-Q4
[2] Year-end

Modest recession should mean fewer layoffs

Job losses are not expected to be widespread over 2024 amid a modest recession. We expect the unemployment rate to peak around 5.0 percent later next year — much lower than seen over the previous two cycles. This should limit the income impacts for many households and help to prevent a more severe downturn.

Higher-for-longer interest rates into 2025

In line with a more restrictive path for Fed policy, longer-term Treasury rates should remain elevated in 2024. Yields are expected to recede later in 2024 as the Fed modestly lowers the fed funds rate. The yield curve would steepen but should remain inverted until year-end 2024.

Contributors

Kathy Bostjancic
SVP & Chief Economist

Ben Ayers, MS
Senior Economist

Oren Klachkin
AVP, Financial Market Economist

Daniel Vielhaber, MA
Economist

Ashleigh Leonard
Economics Specialist

Brian Kirk
Communications Consultant

Sources

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