The Fed has raised rates by 425 basis points this year and is signaling its intention to hike further in 2023. (UBS)

# Mixed signals as rate hikes continue

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**The UBS Chief Investment Office (CIO) believes that a period of subtrend growth is inevitable, and recession risks are high as the lagged effects of tighter monetary policy work their way through the economy.**

In US economic data for November, the Institute for Supply Management's manufacturing Purchasing Manager's Index (PMI) fell to 49, below the neutral reading of 50 and the lowest level since the start of the current expansion, which began in May 2020. The services PMI rebounded to 56.5, up from 54.4 in October.

Nonfarm payrolls increased by 263,000, the slowest job growth since April 2021, and the unemployment rate was unchanged at 3.7%. CPI inflation surprised to the downside for the second month in a row, rising 0.1% month-over-month. Core CPI rose 0.2% as core goods prices fell 0.5%, but service prices continued to rise.

The Federal Reserve raised rates by 50 basis points on 14 December, setting the federal funds target range to 4.25–4.5%. It also signaled its intention to continue raising rates. The “dot plot” showed 17 of the 19 dots above 5% at the end of 2023, with the median dot 50 basis points higher than in September.

### A narrow path to avoid a recession

The Fed is raising rates in an attempt to reestablish price stability. It therefore might seem a bit strange for it to announce more rate hikes in 2023 despite the lower-than-expected CPI readings in October and November. There are two main reasons for the Fed to continue raising rates.

First, some of the recent good news on inflation is transitory in nature. For example, used car prices have been falling rapidly from very elevated levels, including a 2.9% month-over-month drop in November, helping to bring down overall inflation. This trend may last a few more months at most, and it doesn't tell the Fed much about where inflation will be two or three years from now.

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Second, according to Fed Chair Jerome Powell, the labor market remains “extremely tight.” This is keeping upward pressure on wages. To the extent that wage growth exceeds productivity growth, it will put upward pressure on prices over time. Roughly speaking, if productivity improves by 1.5% per annum, then wage growth of 3.5% would be compatible with the Fed's 2% inflation target over the medium term.

So far, Fed rate hikes haven't done much to reduce wage growth. Job openings have declined from their peak, but there is still a big gap between openings and the number of unemployed workers to fill them. Until that gap narrows and wage growth slows to something closer to 3.5%, it will be difficult for the Fed to feel confident that inflation is on track to sustainably hit its target.

**Can consumers keep spending?**

One factor helping to sustain the economic recovery is the declining personal savings rate. Early in the pandemic, government support measures, including stimulus checks and enhanced unemployment benefits, allowed households to build up their savings and pay down their debts. The savings rate was unusually high until the middle of 2021. Since then, the combination of high inflation and less government support has weighed on real (inflation-adjusted) household income.

From January through October 2022, real personal income fell 6.6% compared with the same period in 2021. Despite this, real spending has continued to grow as households saved less. Consumer credit, especially credit card debt, has been increasing rapidly. In the latest reading, the savings rate for October was 2.3%, very close to the record low of 2.1% in July 2005.

We estimate that a bit more than USD 2tr in excess savings was built up through the middle of 2021, and since then, around half of that excess has been used up. It is possible that the savings rate will remain near current levels or drop even further in the months ahead. However, as more and more households exhaust their savings, we expect the savings rate to increase. If businesses detect that consumer spending is faltering, that would likely lead to a rapid reduction in the pace of hiring, which could push the US economy into recession.

The good news is that real disposable income has started growing again, helped by the lower monthly price increases and the strong labor market. The bad news is that Fed rate hikes will likely hurt the labor market and encourage the savings rate to rise. We believe that a period of subtrend growth is inevitable, and recession risks are high as the lagged effects of tighter monetary policy work their way through the economy.

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Read the original report, Mixed signals as rate hikes continue, 20 December 2022.

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