First Trust
Monday Morning OUTLOOK

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Where is the Economy?

What's going on with the markets and the economy? Long-term Treasury yields are up substantially since last Fall while the stock market, after a big rally, has stumbled so far this month. Meanwhile, the real economy appears to continue to chug along – even accelerating! – while inflation has dropped a great deal versus a year ago but will likely go up again soon due to rising oil prices. What do we make of all this and has this changed our fundamental outlook?

As recently as April this year the 10-year Treasury yield was 3.30%. This morning we awoke to 4.30%, a full percentage point higher. We think multiple factors have played a role. First, the real economy has remained stronger for longer than most expected. The economy grew at a moderate 2.4% annual rate in the second quarter and the early projection from the Atlanta Fed's GDP Now model is that real GDP will be up at a stunning 5.8% annual rate in the third quarter.

We think real GDP growth is more likely to clock in at a 4.0% annual rate in Q3, but even that would be unusually strong. With the exception of COVID re-opening in 2020-21, we haven't had a quarter at 4.0%-plus since 2017.

Meanwhile, inflation isn't going back to the Fed's 2.0% target anytime soon. Yes, inflation is down substantially from a year ago: the consumer price index was up 8.5% in the year ending in July 2022 but a much smaller 3.2% in the year ending in July 2023. But, given the recent spike in oil prices, look for the year-ago comparison to grow to about 3.6% in August. In turn, we are projecting that GDP prices will be up at a 3.6% annual rate in Q3.

If we are right about both real GDP and GDP prices in Q3, it is very hard to see the Federal Reserve standing pat at the current 5.375% level for short-term rates. The futures market is pricing in only a 11% chance of the Fed raising rates by 25 basis points in September as well as a 40% chance the Fed raising by a cumulative 25 bps through November. We think both these odds should be higher and if the market shifts toward our view, then long-term rates should also go up further in the next month or so.

The bottom line is that faster growth and persistent inflation are a recipe for the Fed to either move higher than the market now expects or stay at a higher level longer than the market expects, or possibly both.

In turn, we remain convinced that our call from the end of last year that the S&P 500 would finish this year at 3,900 remains a solid forecast. When we plug a 10-year Treasury note yield of 4.30% into our capitalized profits model, it spits out a "fair value" estimate for the S&P 500 of 3,126. We are not predicting a drop that low in stocks, but this method makes us comfortable keeping a target of 3,900.

In addition, we are not waving the white flag on our forecast of a recession and think the conventional wisdom has lurched too far and way too fast against the odds of a recession. Many investors think that with an unemployment rate of 3.5%, the economy is somehow invulnerable to a recession. But we think this theory is wrong; recessions almost always start when the jobless rate is at or near a low.

Recessions are ultimately about mistakes, about too much optimism given underlying economic conditions and the need for economic activity to adjust back downward. Consumers are soon going to be without the temporary extra purchasing power generated by COVID spending programs. Meanwhile, businesses are facing labor costs that continue to escalate faster than justified by productivity growth while business investment looks poised for a correction.

In addition, the government policies enacted in the last few years have not boosted long-term growth prospects and, although AI is a long-term positive, it is unlikely to generate enough extra growth in the short run to spare us a downturn.

A monetary policy that is tight enough to eventually wrestle inflation down to 2.0% doesn't make for a pleasant economic ride in the next year. The road is smooth today, but potholes are ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-22 / 9:00 am	Existing Home Sales – Jul	4.150 Mil	**4.100 Mil**		4.160 Mil
8-23 / 9:00 am	New Home Sales – Jul	0.704 Mil	**0.702 Mil**		0.697 Mil
8-24 / 7:30 am	Initial Claims – Aug 19	240K	**237K**		239K
7:30 am	Durable Goods – Jul	-4.0%	**-5.7%**		+4.6%
7:30 am	Durable Goods (Ex-Trans) – Jul	+0.2%	**+0.1%**		+0.5%
8-25 / 7:30 am	U. Mich Consumer Sentiment- Aug	71.2	**71.0**		71.2