

## Despite External Shocks, The Economy is in Good Shape

Once again, reports of the recovery's imminent demise are premature. Just as the seasons change, so do perceptions of the economy's health. In the waning days of the summer, things looked dire indeed. The job market was sputtering, consumers were pulling back, and public anxiety was ratcheting up, stoked by mounting geopolitical tensions in the Middle East and the onset of a highly divisive and bitter election campaign. Foreign conflicts and the election bombast are still highly disruptive forces, but the economic landscape has turned decidedly brighter. Job growth rebounded from a summer slumber and households reopened their wallets in September, setting the stage for a robust fall season.



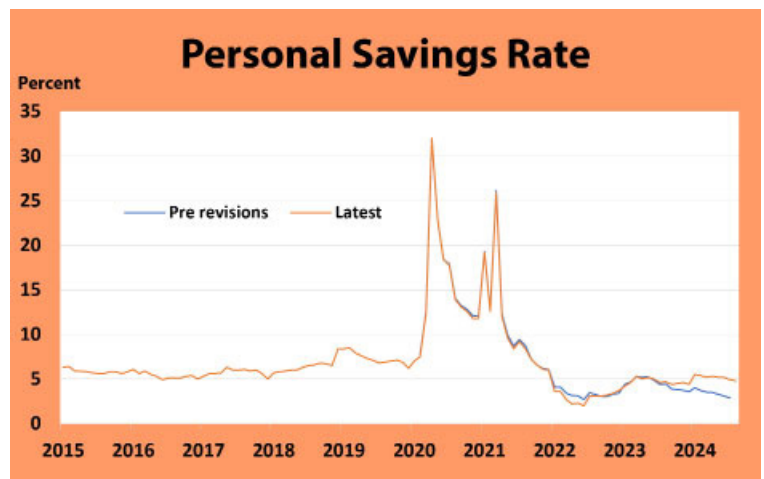
Sadly, the solid fundamentals will be obscured by foggy data over the next month or two, thanks to the disruptive impact of Mother Nature and an extended Boeing strike. Two monstrous hurricanes in late September and early October took a considerable toll on production, construction activity, and jobs in the South, not to mention the human toll on lives and property, that will distort incoming economic data. But the impact of these shocks will be temporary and rebuilding efforts will inject a burst of energy later in the year. Likewise, lost jobs and output will be recovered when the Boeing strike ends, imparting a jolt of energy into affected parts of the economy later in the year.

Odds are policymakers will keep their eyes on the bigger picture and not react to the depressed data at its upcoming rate-setting meetings. The next Federal reserve meeting takes place on November 5-6, just days after the October jobs report is released. That report is likely to be damaged by the aforementioned

shocks, which could resurrect concerns about the health of the job market. It's doubtful that the Fed will be swayed by a single month of weak data, knowing that special forces were to blame. Whether financial market perceptions remain unmoved, however, is another question. As we entered the fall season amid a burst of economic vigor and a sticky September inflation report, investors dialed back their expectations regarding Fed rate cuts. We still think lower inflation will allow policymakers to continue reducing rates through next year. However, the rate-cutting campaign should proceed at a slower pace than many expected, as the economy looks to be heading into 2025 with more momentum than thought during the summer.

## The Consumer is a Pillar of Strength

There were compelling reasons late this summer to believe the economy was running out of fuel, requiring quick and large rate cuts from the Fed to stave off a recession. With inflation trending sustainably lower towards the Fed's 2 percent target and job growth turning sluggish in July and August, policymakers responded even more aggressively than many expected, cutting rates by an outsize half-percent in mid-September, double the normal quarter point reductions. In hindsight, a case could be made for a less aggressive move.



For one, the government's annual revisions released after the Fed's mid-September meeting showed that the economy had considerably more firepower than thought. The revised data portrayed a faster growing economy than previously estimated and, importantly, that incomes were also much stronger, leaving

households with a bigger savings cushion. Since spending by households was driven mainly by income growth, they did not have to tap into savings, which economists had believed were severely depleted and would compromise spending going forward. Prior to revisions, the personal savings rate stood at 2.8 percent, much lower than pre-pandemic levels. After revisions, the saving rate now stands at a more elevated 4.8 percent, which is roughly in line with the past few years.

For another, while GDP and income were revised higher, job growth was not. In fact, revisions show that there were less jobs in recent years than earlier estimated. With fewer workers generating more output, that could only mean that worker productivity was stronger than thought. Stronger productivity, in turn, boosts the economy's growth potential. That goes a long way towards explaining why inflation was able to retreat even as growth accelerated. The combination of slowing inflation and stronger incomes translates into more purchasing power for households, which bodes well for sustained spending next year.

## More Wealth

To be sure, income gains are poised to slow in coming months, reflecting softer job growth and more determined efforts of employers to control labor costs. Even with the rebound in payrolls in September, the hiring trend is decelerating. Part of the slowdown reflects the ongoing business drive to boost productivity through investments in labor-saving equipment, and part reflects a slowdown in labor force growth due to tighter immigration policies. As job and income growth slows, so too will spending. But consumers – the economy's main growth driver – will not go into hibernation, which would throw the economy into a recession.



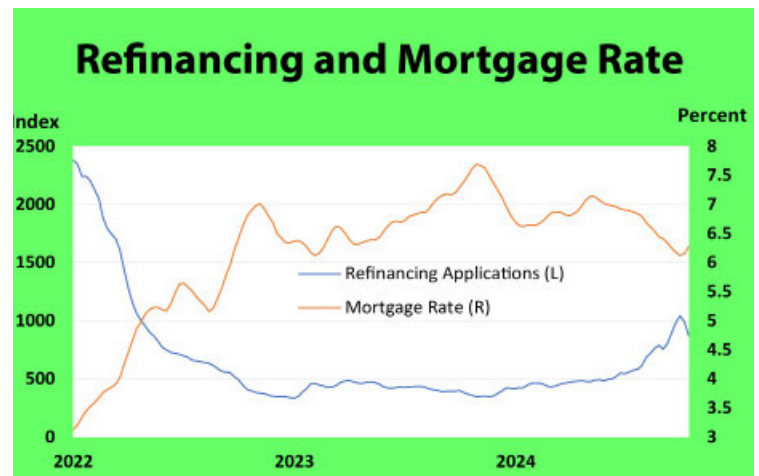
One reason consumers should continue to spend at a respectable pace is that they are ending the year in good financial shape. As noted, revised data show that households have more of a savings cushion than earlier

thought. That buffer could be tapped for spending purposes, but just as important is that there is less of a need to rebuild savings, which would result in less spending. True, most of the increased savings reside in the bank accounts of upper income households and will do little to ease the financial struggles of those further down the income ladder. That less wealthy cohort is falling behind on debt payments and pulling back on discretionary spending. Another headwind that has more of an impact on lower income households is the smaller inflation adjustments to entitlement programs next year. The cost-of-living adjustment to social security will be 2.5% in 2025, compared to 3.2% this year and 8.7% in 2023.

But mid-and-upper income individuals account for 80 percent of total consumer spending, and they are expected to keep their wallets open. Not only do they have more savings, they also own most financial assets that have greatly appreciated in recent years, thanks to the surge in equity prices and declining interest rates, which boosts bond prices. And while higher earners own most stocks and bonds, housing wealth is distributed more equitably. Since the beginning of 2020, housing equity has risen by \$15 trillion, with households in every income level sharing in the gains. If homeowners spend 1 cent of every dollar rise in housing wealth since the pandemic, that would boost consumption by \$150 billion.

## Housing Equity and a Potential Source of Funds

A key question for the consumer outlook therefore is whether homeowners will tap into their housing equity to fund spending. With the Fed cutting short-term rates by the outsized half-percent in September, mortgage rates also declined, from over 7 percent to under 6.5 percent by mid-October. That has already sparked an increase in refinancing activity, as mortgage refinancing applications more than doubled, albeit from a low base.



However, only 15 percent of homeowners with a mortgage have an interest rate above 6 percent. That means rates would need to decline much further for most households to benefit from refinancing. But mortgage rates follow the path of bond yields, particularly the 10-year Treasury issue. As reports of stronger economic activity and sticky inflation came into view following the Fed's rate cut, bond yields have backed up, with the 10-year recouping all of the declines surrounding the Fed's rate cut and then some. If mortgage rates follow in lockstep, they too will rescind all the recent decline.

That said, the surge in housing equity could still boost spending without having to be extracted through refinancing activity. If people feel wealthier because they own a house that is worth considerably more than they paid for it, they do not feel the need to save as much as before. Hence, homeowners would feel comfortable spending a higher fraction of incomes. This so-called wealth effect was on full display during the housing boom in the early 2000s, when the personal savings rate fell to an historic low of 1.4 percent in July 2005.

## Bond Vigilantes

One lesson to derive from the recent increase in bond yields is that the Fed only has control over short-term rates. Bond yields are determined by the markets, and if investors believe the Fed made an error, they will express that by moving yields in the opposite direction the Fed wants them to go. These traders are sometimes known as bond vigilantes, who tend to come out of the woodwork when they believe the Fed lowered rates prematurely – or by too much – threatening to reignite inflation.

Indeed, in the minutes of the Fed's mid-September meeting, it was revealed that several officials were more inclined to cut rates by a smaller quarter point rather than the jumbo half point that was ultimately put through. That sentiment has only increased since the meeting, thanks to the stronger than expected economic data released since then. It's unclear if the Fed will follow through with the additional quarter point cuts in November and December that it projected at the September meeting, given the surprising vigor in recent economic data. Even so, the bond market – and hence, mortgage rates – will go its own way depending on how traders view the near term economic and inflation outlook.

It's common to say that the next few economic reports will determine what the Fed does at its upcoming policy meetings. But as noted earlier, the Fed will be viewing foggy data, thanks to the hurricanes and strike-related external shocks that buffeted the economy in late September and October. Given the downside risks to the near-term data from these shocks, the odds are that the Fed will follow through with another quarter-point cut in early November, although bond traders seem to think it would be more prudent to skip any action at this meeting. But even with another cut, the level of rates would still be restrictive and retain a heavy burden on lower-income borrowers.

The good news is that the Fed is on a determined course to normalize policy, bringing rates down to a level that neither stimulates nor curtails activity. It's uncertain what that level is, but it is clearly lower. Importantly, inflation should continue to retreat and persuade both the bond vigilantes and policymakers that further cuts will be needed to keep the economy afloat.

---

## PCSB Bank Executive Management

### Michael P. Goldrick

President & CEO

michael.goldrick@mypcsb.com

### Kimberly DeMilia

Executive Vice President,

Division Head, Commercial Lending

kimberly.demilia@mypcsb.com

## KEY FINANCIAL AND ECONOMIC INDICATORS

### FINANCIAL INDICATORS\*

	<u>September</u>	<u>August</u>	<u>July</u>	<u>June</u>	<u>May</u>	<u>April</u>	<u>March</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
Prime Rate	8.30	8.50	8.50	8.50	8.50	8.50	8.50	8.50	8.30
3-Month Treasury Bill Rate	4.72	5.20	5.20	5.24	5.25	5.24	5.24	5.34	4.72
5-Year Treasury Note Rate	3.50	4.16	4.16	4.32	4.50	4.56	4.20	4.77	3.50
10-Year Treasury Note Rate	3.72	4.25	4.25	4.31	4.48	4.54	4.21	4.80	3.72
30-Year Treasury Bond Rate	4.04	4.46	4.46	4.44	4.62	4.66	4.36	4.95	4.04
Tax-Exempt Bond Yield	3.83	3.87	3.94	3.94	4.00	3.87	3.54	4.13	3.36
Corporate Bond Yield (AAA)	4.68	5.12	5.12	5.13	5.25	5.28	5.01	5.61	4.68
Conventional 30-Year Mortgage Rate	6.18	6.85	6.85	6.92	7.06	6.99	6.82	7.62	6.18
Dow Jones Industrial average	41491	40086	40086	38904	39129	38401	39106	41491	33319
S&P 500 Index	5621	5538	5538	5415	5235	5112	5171	5621	4269
Dividend Yield (S&P)	1.31	1.31	1.31	1.33	1.36	1.39	1.37	1.61	1.31
P/E Ratio (S&P)	26.3	25.7	25.8	25.6	24.7	24.1	25.1	26.3	20.6
Dollar Exchange Rate (vs. Major Currencies)	122.1	123.7	123.7	124.0	122.2	122.5	121.0	124.0	120.2

\* Monthly Averages

### ECONOMIC INDICATORS

	<u>September</u>	<u>August</u>	<u>July</u>	<u>June</u>	<u>May</u>	<u>April</u>	<u>March</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
Housing Starts (Thousands of Units)	1354	1361	1262	1329	1315	1377	1299	1568	1262
New Home Sales (Thousands of Units)		716	751	681	672	736	683	751	611
New Home Prices (Thousands of Dollars)		421	429	414	414	415	436	436	414
Retail Sales (% Change Year Ago)	1.7	2.2	2.9	2.0	2.6	2.8	3.6	5.00	0.2
Industrial Production (% Change Year Ago)	-0.6	-0.2	-0.5	0.8	0.1	-0.8	-0.3	0.8	-1.2
Operating Rate (% of Capacity)	77.5	77.8	77.6	78.2	78.1	77.7	77.7	78.4	77.2
Inventory Sales Ratio (Months)		1.38	1.37	1.38	1.38	1.37	1.37	1.38	1.36
Real Gross Domestic Product (Annual % Change)				3.0			1.4	4.9	1.4
Unemployment Rate (Percent)	4.1	4.2	4.3	4.1	4.0	3.9	3.8	4.3	3.7
Payroll Employment (Change in Thousands)	254	159	144	118	216	108	310	310	108
Hourly Earnings (% Change Year Ago)	4.0	3.9	3.6	3.8	4.0	3.9	4.1	4.3	3.6
Personal Income (% Change Year Ago)		5.6	5.9	5.8	5.9	5.9	5.9	6.0	5.0
Savings Rate (Percent of Disposable Income)		4.8	4.9	5.2	5.2	5.3	5.2	5.5	4.4
Consumer Credit (Change in Blns. Of Dollars)		8.9	26.6	3.2	9.6	1.5	-2.4	26.6	-2.4
Consumer Prices (% Change Year Ago)	2.4	2.5	2.9	3.0	3.3	3.4	3.5	3.5	2.4
CPI Less Food & Energy (% Change Year Ago)	3.3	3.2	3.2	3.3	3.4	3.6	3.8	4.0	3.2
Wholesale Prices (% Change Year Ago)	1.7	1.9	2.3	2.7	2.4	2.2	1.9	2.7	0.8