Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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# The Economy Exits the Fast Lane

The U.S. economy is going through a transition phase and is settling into a more sustainable pace of growth, with next year being decent but unspectacular. In our view, the probability we will enter a recession in 2025 is low, but not zero. Some of the naysayers' doubts about the economy's durability are rooted in unreliable surveys (particularly of household sentiment, which have a heavy political bias) and the recent rise in the unemployment rate, which triggered the so-called Sahm Rule that suggests a recession has already begun.

The most important reason pointing to continued expansion is that the job market is expected to hold up. We do not anticipate a much further rise in the unemployment rate because the growth in the labor force will be slowing in 2025. Hence fewer jobs will need to be created to absorb the supply of workers seeking to join the workforce. Layoffs of full-time workers should remain low, as employers remain stung by the labor shortages in recent years and profits are healthy enough to cover staffing costs. There is sufficient firepower in the economy to keep revenues flowing at a sturdy pace.

Of course, the proverbial elephant in the room is the outcome of the presidential election and the composition of Congress. Presidents inherit an economy and it often takes time before their policies begin to shape it. Our assumption is that there will be a divided Congress, which should deflect any major change in fiscal policy that would have a material impact on current trends. As for monetary policy, with the labor market and inflation close to their targets, 2025 should be a year of policy normalization. The Fed has started the rate-cutting cycle on September 18 and the direction of travel towards a neutral rate, one that neither retards nor stimulates activity, should continue. The eventual landing spot is uncertain, but a steady dose of rate cuts is expected throughout next year.

### *Migrants Pump Up the Labor Force*

The Fed's decision to start cutting rates reflects a shift in priorities from worrying about inflation to concerns over a weakening labor market. There has been much ado about the rise in the unemployment rate this year, from a 53 year low of 3.4 percent in 2023 to 4.2 percent in August of this year. A rise of that scale has never occurred outside of a recession, and many believe that history will repeat. The odds of that happening, of course, is not trivial. Historically, when the job market starts to buckle, it eventually breaks, sending millions of workers to the unemployment lines and shutting down spending, resulting in a dreaded recession.

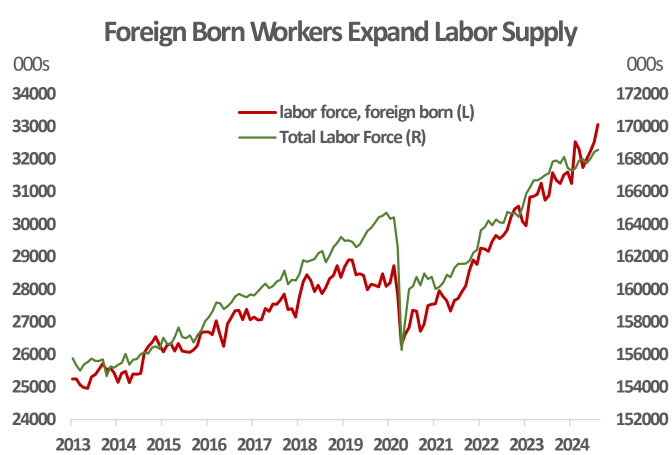
But this cycle has broken the rules in a number of ways, and past patterns may be avoided this time as well. At issue is what is causing the increase in the unemployment rate. If the climb occurred because companies were laying off workers, cutting staff in response to slumping sales and revenues, the consequences would be dire indeed as paychecks would vanish and decimate household purchasing power. Clearly, that is not the case now.

Rather, the climb in the unemployment rate is due mainly to the faster increase in supply than in the demand for workers. Simply put, growth in the labor force has accelerated, and workers entering the market are finding it harder to find a job, pushing up the unemployment rate. For the most part, the upsurge in migrants, both legal and undocumented, has been mainly responsible for the pickup in labor supply. Over the past several years, foreign-born workers have taken an ever-larger share of the labor force, accounting for almost 20 percent in August, up from a prepandemic share of 17 percent.

### *Tide is Turning*

During the first three years of the post-pandemic recovery, the surge in immigration was readily absorbed – even welcomed by businesses in desperate need of workers to meet burgeoning demand fueled by outsized pandemic stimulus funds. But with economic activity downshifting from the beakneck pace of 2021-2023, so too has hiring, resulting in the longer wait to land a position. While that has lifted the unemployment rate, it has not put a dent in the employment rate. Layoffs have remained low and the share of prime-age workers (age 25-54) gainfully employed has climbed above its prepandemic peak, sitting at only a tad under the record high set in 2000. Hence, workers have retained their paychecks as well as the purchasing power to support spending.

That said, with hiring slowing the risk is that the labor



supply overshoot will widen, driving up the unemployment rate to levels that threaten the job security of workers, leading to spending cutbacks, followed by more layoffs that would beget more spending cuts, setting in motion a vicious feedback loop that ends in a recession. This is a key reason why the start of a weakening job market is difficult to stop. Indeed, the slowdown in job growth in recent months is stark. Even with a modest pickup in August, job growth over the past three months has averaged 116 thousand, down from 267 in the first quarter of the year.

But a dramatic climb in the unemployment rate would occur only if the supply of labor continued to expand at its accelerated pace. That is not likely to happen if only because the main catalyst behind the recent upsurge – immigration – is poised to slow considerably. High frequency data from immigration court cases and border encounters suggest that immigration has slowed noticeably by midyear, and this will likely persist owing mainly to a tightening of immigration policy by the administration. This, in turn, will put downward pressure on growth in the labor supply and, by extension, lower the bar for the number of jobs the economy needs to add to keep the unemployment rate steady. By our calculation, this so-called breakeven pace of job growth declines from between 150,000 – 175,000 a month to around 100, 000 in 2025, which is almost spot-on with the recent pace of job growth.

### *Productivity Picking Up the Slack*

Still, with job growth slowing, so too would the economy other things equal, which in time lowers living standards. When fewer workers are manning factories, offices or are providing services to consumers, the nation's output of goods and services slows as well. But that relationship only holds if labor productivity remains static. Clearly, that has not been the case over the past year.

Indeed, despite the slowdown in job growth in recent months, growth in GDP has accelerated, rising from an annual rate of 1.4 percent in the first quarter to 3.0 percent in the second. True, quarterly data tends to be noisy, but even over the past year, GDP has increased by 3.1 percent, which is faster than the 2.5 percent average since 2000. And that faster growth has occurred amid slowing job growth.

Simply put, labor is producing more output than before. Nonfarm productivity leaped by 2.7 percent over the past year, more than double the pace of a year ago, and more than a full percentage point over its long-term trend. That torrid pace is not expected to continue but the good news is that the productivity trend may well have moved up a notch. There has been a sustained pickup in spending on software and research and development in recent years which, in the past, has led to stronger productivity growth. A similar burst of investment spending occurred in the 1990s that generated stronger productivity over the second half of the decade. We expect the recent pickup to sustain an above trend pace of productivity at least through 2025 as well.

### *Soft Landing Looks Promising*

Not long ago, several respected economists asserted that to get inflation down to normal levels would require a recession. While the unemployment rate will likely creep higher next year, there is a better than even chance the economy stays afloat. As noted, the increases so far have occurred for benign reasons, as layoffs remain low and companies are still hiring – although at a slower pace than the labor force is growing. The risk is that as the jobless rate moves higher, anxiety increases and causes a change in behavior. People can talk themselves into a recession if the threat seems real enough.

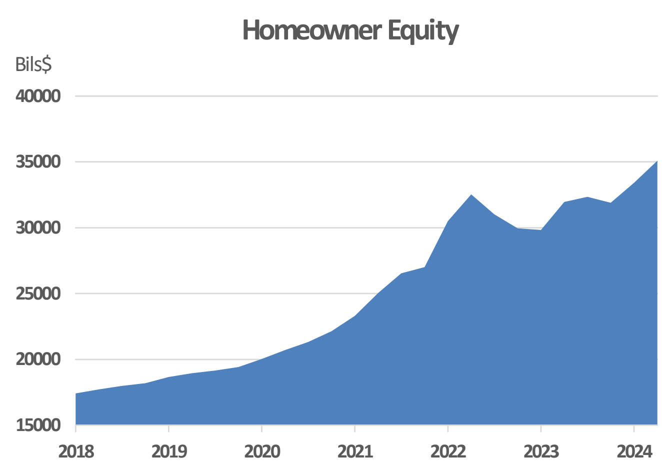
But we don't expect that to happen. One of the benefits of stronger productivity growth is that it enables employers to pay their workers more without damaging the bottom line. Hence, even with slower job growth, wages will continue to increase. Importantly, the gains in income will translate into more purchasing power because the productivity pickup allows companies to keep prices in check. Hence, labor costs will not be a source of inflation, nor would it impair profits, a win-win for both workers and businesses.

To be sure, lower income workers are usually the first victims of a softening job market, and this cohort is already struggling with mounting debt burdens, resulting in rising delinquencies and spending cutbacks. But about 90 percent of personal consumption in the U.S. comes from middle- and upper-income households, whose purchasing power is bolstered by appreciating portfolios of stocks and bonds as well as burgeoning housing equity. This so-called wealth effect should continue to underpin household spending over the coming year. Indeed, homeowners are sitting on $35 trillion of untapped housing equity, which could readily be extracted as interest rates decline to support spending.

### *The Fed Pivots*

Finally, just as the economy is transitioning from rapid growth stoked by an historically tight job market to a slower, more sustainable pace, so too is the Fed pivoting away from its restrictive policy. With inflation moving sustainably towards its 2 percent target, it is now laser focused on preventing a further deterioration in the job market. Following the half-point rate cut on September 18, the Fed expects to lower rates by an equal amount before the end of the year and another 1 percent in 2025.

Some believe the Fed waited too long to take its foot off the brake as it takes time for monetary policy to course through the economy. Time will tell; but taming inflation with minimal damage to the economy so far has been a major accomplishment that escaped policymakers in the past. That success makes it more likely the Fed will be just as effective in keeping the economy out of a recession.



# KEY ECONOMIC AND FINANCIAL INDICATORS

## Financial Indicators *

| | August | July | June | May | April | March | February | 12-Month Range High | 12-Month Range Low |
|---|---|---|---|---|---|---|---|---|---|
| Prime Rate | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 |
| 3-Month Treasury Bill Rate | 5.20 | 5.20 | 5.24 | 5.25 | 5.24 | 5.24 | 5.24 | 5.34 | 5.20 |
| 5-Year Treasury Note Rate | 4.16 | 4.16 | 4.32 | 4.50 | 4.56 | 4.20 | 4.19 | 4.77 | 3.98 |
| 10-Year Treasury Note Rate | 4.25 | 4.25 | 4.31 | 4.48 | 4.54 | 4.21 | 4.21 | 4.80 | 4.02 |
| 30-Year Treasury Bond Rate | 4.46 | 4.46 | 4.44 | 4.62 | 4.66 | 4.36 | 4.38 | 4.95 | 4.14 |
| Tax-Exempt Bond Yield | 3.87 | 3.94 | 3.94 | 4.00 | 3.87 | 3.54 | 3.53 | 4.13 | 3.36 |
| Corporate Bond Yield (AAA) | 5.12 | 5.12 | 5.13 | 5.25 | 5.28 | 5.01 | 5.03 | 5.61 | 4.74 |
| Conventional 30-Year Mortgage Rate | 6.85 | 6.85 | 6.92 | 7.06 | 6.99 | 6.82 | 6.78 | 7.62 | 6.64 |
| | | | | | | | | | |
| Dow Jones Industrial average | 40086 | 40086 | 38904 | 39129 | 38401 | 39106 | 38721 | 40086 | 33319 |
| S&P 500 Index | 5538 | 5538 | 5415 | 5235 | 5112 | 5171 | 5012 | 5538 | 4269 |
| Dividend Yield (S&P) | 1.31 | 1.31 | 1.33 | 1.36 | 1.39 | 1.37 | 1.42 | 1.63 | 1.31 |
| P/E Ratio (S&P) | 25.7 | 25.8 | 25.6 | 24.7 | 24.1 | 25.1 | 24.3 | 25.8 | 20.6 |
| | | | | | | | | | |
| Dollar Exchange Rate (vs. Major Currencies) | 123.7 | 123.7 | 124.0 | 122.2 | 122.5 | 121.0 | 121.4 | 124.0 | 120.2 |

* Monthly Averages

## Economic Indicators

| | August | July | June | May | April | March | February | 12-Month Range High | 12-Month Range Low |
|---|---|---|---|---|---|---|---|---|---|
| Housing Starts (Thousands of Units) | 1356 | 1237 | 1329 | 1315 | 1377 | 1299 | 1546 | 1568 | 1237 |
| New Home Sales (Thousands of Units) | | 739 | 668 | 666 | 736 | 683 | 643 | 739 | 611 |
| New Home Prices (Thousands of Dollars) | | 430 | 417 | 408 | 415 | 436 | 421 | 440 | 408 |
| | | | | | | | | | |
| Retail Sales (% Change Year Ago) | 2.1 | 2.9 | 2.0 | 2.6 | 2.8 | 3.6 | 2 | 5.00 | 0.2 |
| Industrial Production (% Change Year Ago) | 0.0 | -0.7 | 0.9 | 0.2 | -0.8 | -0.3 | -0.2 | 0.9 | -1.2 |
| Operating Rate (% of Capacity) | 78.0 | 77.4 | 78.2 | 78.3 | 77.7 | 77.7 | 78.0 | 78.4 | 77.2 |
| Inventory Sales Ratio (Months) | | 1.37 | 1.38 | 1.38 | 1.37 | 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) | 4.2 | 4.3 | 4.1 | 4.0 | 3.9 | 3.8 | 3.9 | 4.3 | 3.7 |
| Payroll Employment (Change in Thousands) | 142 | 89 | 118 | 216 | 108 | 310 | 236 | 310 | 89 |
| Hourly Earnings (% Change Year Ago) | 3.8 | 3.6 | 3.8 | 4.0 | 3.9 | 4.1 | 4.2 | 4.5 | 3.6 |
| Personal Income (% Change Year Ago) | | 4.5 | 4.4 | 4.4 | 4.4 | 4.4 | 4.3 | 4.9 | 4.3 |
| Savings Rate (Percent of Disposable Income) | | 2.9 | 3.1 | 3.3 | 3.5 | 3.5 | 3.7 | 3.9 | 1.37 |
| Consumer Credit (Change in Blns. Of Dollars) | | 25.5 | 5.2 | 11.7 | 3.7 | -1.0 | 11.9 | 25.5 | -16.3 |
| | | | | | | | | | |
| Consumer Prices (% Change Year Ago) | 2.9 | 2.9 | 3.0 | 3.3 | 3.4 | 3.5 | 3.2 | 3.7 | 2.9 |
| CPI Less Food & Energy (% Change Year Ago) | 3.3 | 3.2 | 3.3 | 3.4 | 3.6 | 3.8 | 3.8 | 4.1 | 3.2 |
| Wholesale Prices (% Change Year Ago) | 1.7 | 2.3 | 2.7 | 2.4 | 2.2 | 1.9 | 1.6 | 2.7 | 0.8 |

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