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**Economic  
Commentary:**  
Fed Funds Target Range Expected  
to Hold at June Meeting

*June 2023*

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## June 2023

The month of May was dominated by concerns over the extension of the debt ceiling. Fortunately, a rare exhibition of bipartisan negotiation and compromise carried the day. The resulting spending caps are not as severe as originally proposed, and tax increases were left off the table. The Fed can now prepare for their upcoming meeting on June 13-14 by concentrating on the incoming economic data to evaluate how their most aggressive monetary tightening over the last 40 years is impacting inflationary pressures and the overall economy.

### Inflation & Consumer Spending

The April CPI report showed inflation increasing by 0.4 percent month-to-month, dropping the headline year-over-year figure to 4.9 percent – the first sub-5 percent reading since May 2021. The core CPI (minus food and energy) also rose 0.4 percent, bringing its year-over-year reading to 5.5 percent – the same reading we had in January and an indication that core inflation is proving to be stickier than hoped. Dissecting the data further, Chair Powell's favorite CPI metric that looks at the services index without energy and rental measures increased only 0.1 percent in April, which is the weakest reading since last July. Inflation is cooling, however, overall prices are still rising at an elevated pace that, at the very least, will likely require the Fed to keep rates elevated for longer than markets had hoped.

Both retail sales and overall personal consumption expenditures in April rebounded from weak readings in the previous two months. On a year-over-year basis, however, retail sales are now growing at the slowest rate since May 2020. If we look at retail sales adjusted for inflation, we can see if volumes are increasing or decreasing. Currently, inflation-adjusted retail sales are declining by 3.2 percent year-over-year, which is an indication that the volume of transactions is down. Anecdotal reports from many major retailers assert that the macro environment is forcing a shift in consumption patterns from discretionary items to necessities.

### GDP vs. GDI

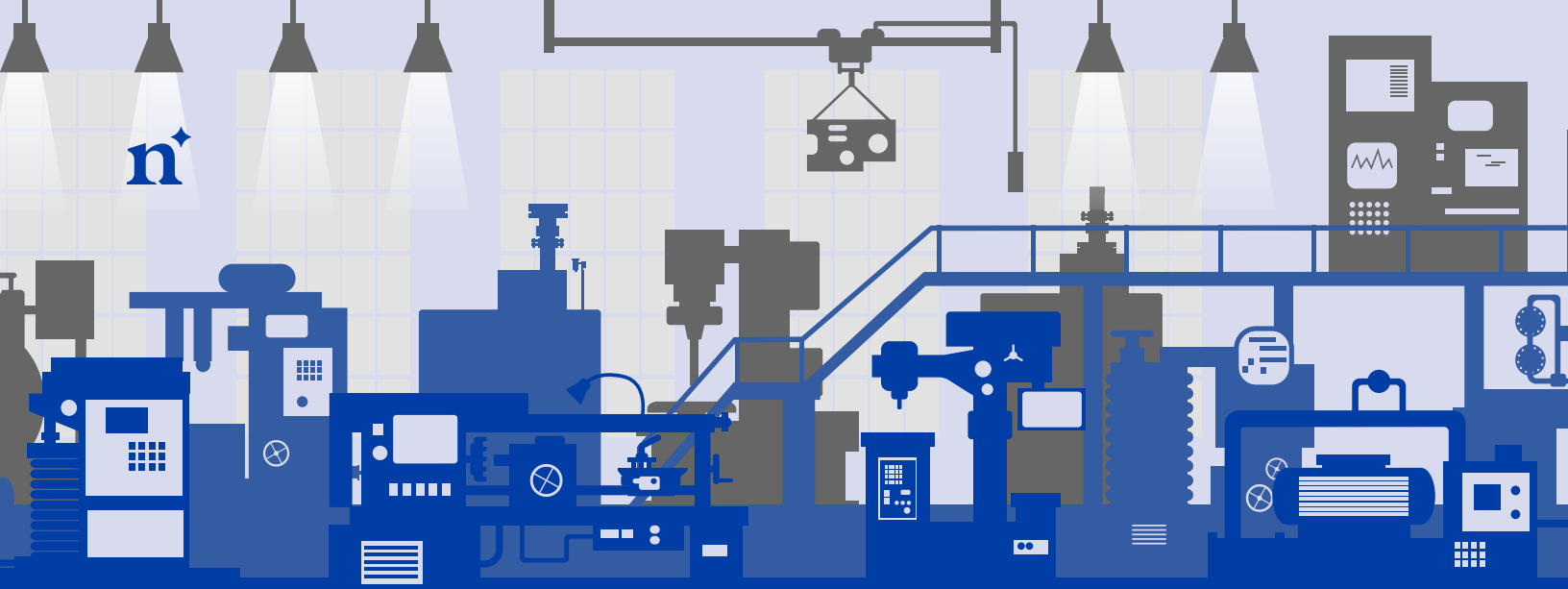
The Leading Economic Indicators declined for the thirteenth consecutive month and are now at the lowest level since September 2020. Historically, such a string of declining readings has only happened when the economy is in or nearing a recession.

We received the second estimate of first quarter 2023 real GDP, and it was revised up to 1.3 percent annualized from 1.1 percent. Of note, Gross Domestic Income (GDI) for first quarter 2023 was released at the same time. It showed a decline of 2.3 percent annualized, following a 3.3 percent decline in fourth quarter 2022. GDP is based on consumption and investment, whereas the GDI measures activity by aggregating income and profits. Over the long term, the two measures track each other, but often at turning points in the economy, the GDI will provide an early warning. At the very least, the two measures indicate that the economy is slowing. Confirming this was the associated report showing that overall corporate profits in first quarter 2023 declined 5.1 percent from fourth quarter 2022. These profits have fallen for three consecutive quarters and are now back to second quarter 2021 levels.

### Manufacturing & Employment

The May manufacturing ISM survey came in at 46.9, and sub-50 readings indicate contraction in the manufacturing sector. As such, only 22.2 percent of companies indicated they expanded in May, compared to 83.3 percent a year earlier. This weakness is likely to persist as the New Orders component of the survey fell to the second lowest reading since May 2020.

The May employment report grabbed headlines with a 339,000 increase in non-farm payroll employment – well above expectations of a 195,000 increase. Employment gains in the prior two months were also revised up by 93,000. There were several aspects of the report that belied the headline strength, however.



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The household survey, which is different from the establishment survey of employment, showed a 310,000 decline in employment during May. At the same time, the labor force grew by 110,000, resulting in the unemployment rate increasing from 3.4 percent to 3.7 percent, and reaching a seven-month high.

Another area of weakness is the continuing decline in the length of the average workweek. In May, average weekly hours worked declined from 34.4 to 34.3 and are now at the lowest level since April 2020. Employers have been slow to lay off workers, opting to reduce hours instead, but that may be changing. The Challenger Job Report for May showed that the number of layoff announcements have exceeded the number of hiring announcements each month in 2023 by a total of over 300,000.

### Fed Funds Outlook

Barring a surprisingly strong CPI report for May – to be released June 13 – the Fed is expected to hold the target range for Fed Funds at the current level (5.00 to 5.25 percent) and wait for the July meeting to determine if another rate hike is warranted. The expected pause in interest rate hikes comes after 10 consecutive Fed meetings in which the Fed Funds rate has been increased by a total of 500 basis points. The combined impacts of tighter lending standards at banks, an inverted yield curve, and the outflow of deposits from banks has turned the credit cycle so that the supply of credit and the demand for credit are both contracting. Implications of a contracting credit environment are higher default rates, wider corporate credit spreads, lower corporate profitability and overall slower economic growth.

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