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More questions than answers for the Fed

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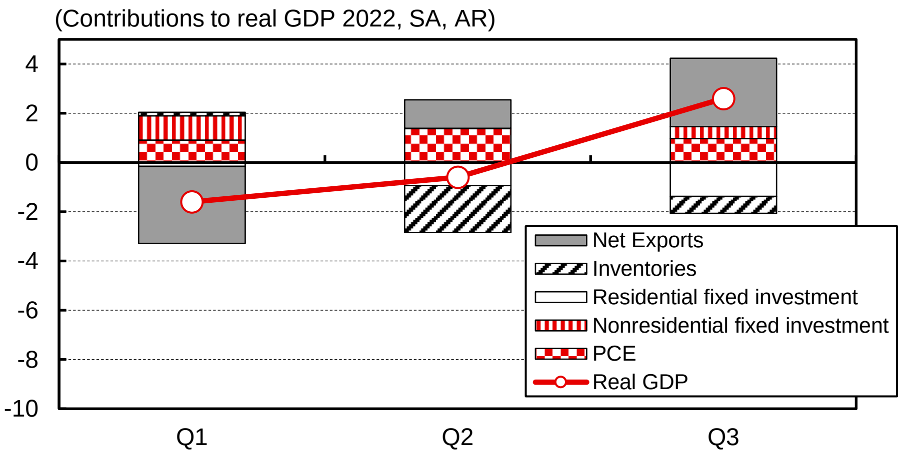
New data released the week before November's FOMC meeting didn't offer many surprises, but they also didn't provide conclusive evidence on the direction of the US economy. The Q3 GDP figures look positive on the surface, but underlying elements suggest that economic output is indeed slowing. The core PCE Price Index decelerated slightly month-over-month but accelerated slightly year-over-year. And the Q3 Employment Cost Index showed a deceleration in wages and salaries, but it may be too soon to call it a trend. The Fed will likely not alter its course in 2022.

Net exports drove GDP expansion in Q3

The first half of 2022 was filled with mixed signals on the economy. The third quarter offered some clarity on the past, but not much insight into the future. Real GDP increased at a 2.6 percent annual rate in Q3, following a 0.6 percent decline in Q2 and a 1.6 percent decline in Q1. Net exports for both goods and services were the largest positive contributing factor in Q3 (2.77 percentage points), led by increases in petroleum, nondurable goods, travel, and financial services.

Rising interest rates continue to have a clear impact on industries dependent on credit financing (i.e., housing). Residential fixed investments declined again in Q3, especially for single-family home construction. Personal consumption expenditures (PCE) decelerated in Q3, contributing 0.97 percentage points to real GDP, compared to 1.38 percentage points in Q2. This deceleration was driven by slower growth in services consumption, namely in food services and accommodations. Goods consumption continued to negatively impact real GDP in Q3, especially for motor vehicles and parts which contributed negative 0.36 percentage points.

GDP REBOUNDED IN Q3, DRIVEN BY NET EXPORTS



Source: BEA, MUFG Bank Economic Research

Heading into November's FOMC meeting, the latest GDP figures show some cooling in key areas such as personal consumption, but there is not a strong enough signal to warrant a change in course by the Fed.

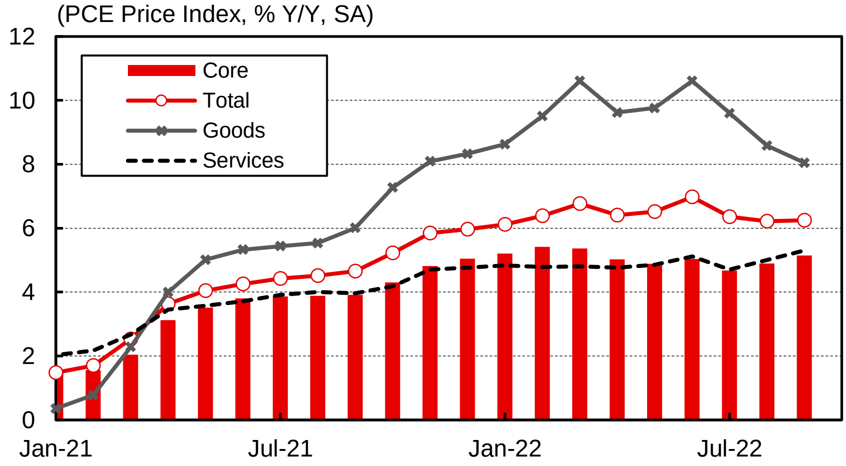
Price growth was steady in September

September's PCE Price Index shows mostly flat price growth. The headline PCE Price Index grew 0.33 percent month-over-month in September compared to 0.26 percent growth in August. Looking at year-over-year price growth, headline PCE growth was flat, growing 6.2 percent in September and August. Goods price growth continues to decelerate, but this was offset by accelerated growth in services. Overall, there was not a significant change in headline inflation.

Stripping out food and energy, core PCE showed a slightly more noticeable change, growing 0.45 percent in September compared to 0.54 percent in August. However, year-over-year growth showed slightly accelerated growth of 5.15 percent in September, compared to 4.89 percent in August, and 4.67 percent in July.

Whether you look at the PCE Price Index month-to-month or year-over-year, inflation was not significantly changed in September. While not overtly bad news, this likely means that price pressures are still prevalent in the economy that are preventing inflation from noticeably slowing down. Disinflation is the primary goal of the Fed, and the latest data do not show compelling evidence of that. Much like Q3 GDP, September's PCE will likely not alter the Fed's interest rate trajectory.

INFLATION WAS MOSTLY FLAT IN SEPTEMBER



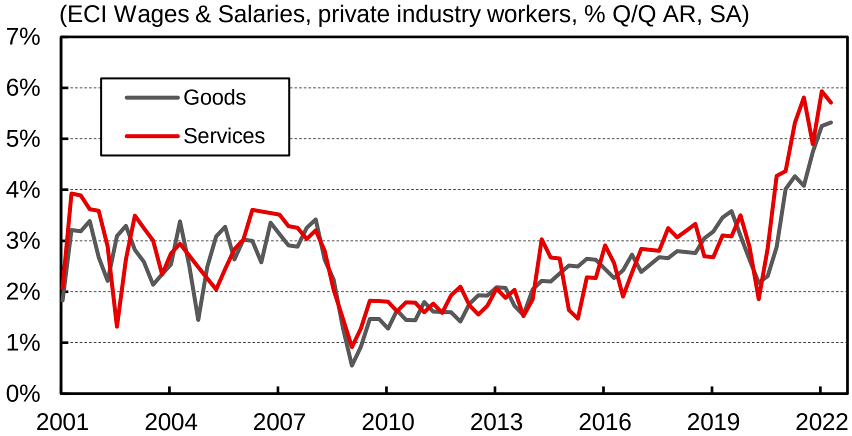
Source: BEA, MUFG Bank Economic Research

Wages decelerated in Q3, but it's too soon to celebrate

High employment costs continue to apply upward inflationary pressures, but there are some signs that they are weakening. The Employment Cost Index showed slowed growth quarterly, with wages and salaries for private industry workers growing 1.2 percent in Q3 compared to 1.6 percent in Q2. Wages and salaries decelerated for both goods-producing and service-providing industries.

At a surface level, this is good news for the Fed in their fight against inflation. However, wage growth remains very high and movement in one quarter doesn't necessarily constitute a trend. The annualized growth rate of the 2-quarter moving average in the ECI shows elevated wages and salaries for both goods and services industries, with no downward trend in sight. Labor costs are at the forefront of inflationary pressures, and this will likely be the case for the remainder of 2022.

WAGES AND SALARIES REMAIN HISTORICALLY HIGH



Note: 2-quarter moving average
Source: BLS, MUFG Bank Economic Research

Not enough evidence for the Fed to slow down

The Federal Reserve will likely raise interest rates by another 75 basis points in November’s FOMC meeting. While there exist some signs that the US economy is slowing down, the latest data on GDP, inflation (PCE), and wages (ECI) are not compelling enough to warrant a change in course by the Fed.

Raising the federal funds rate acts like a blunt instrument at cooling demand in the economy, but the effects are not always linear. Credit markets have taken a clear hit and are directly impacted by interest rates, but the rest of the economy has yet to feel the effects. Until the labor market shows strong signs of cooling, demand in the economy will likely remain relatively high, applying upward pressure on inflation.

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