Nationwide Economics

Weekly Economic Review & Outlook

February 6, 2023

Stunningly strong job gains are too hot for the Fed

The Fed reduced the size of its interest rate increase last week, while indicating that more rate hikes should be expected. The shockingly strong employment report for January provided evidence that labor demand has not slowed, making the Fed's job of significantly reducing inflation more complicated. Additionally, the January ISM surveys indicated that growth in the services sector jumped back into expansion, while manufacturing slid deeper into contraction.

Economy adds over half million jobs in January

Counter to the Fed's aims of cooling the robust demand for labor, employment gains surged to start 2023, which complicates efforts to substantially slow inflation. January's additional 517,000 jobs—a six-month high—was accompanied by large upward revisions to the prior months dating back to June. Job gains were broad-based across sectors, signaling widespread increased demand for workers. Consequently, the unemployment rate dropped to 3.4 percent, a new cycle low and the lowest reading in nearly 54 years as labor conditions tighten further across the economy. Wage gains were a tad slower but then annual growth of 4.4 percent is still much higher than average.

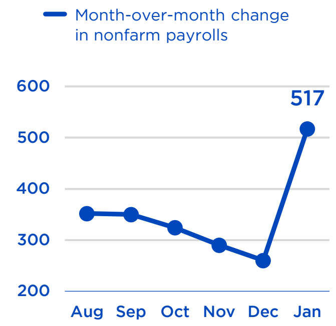
Usually, rising wages are a positive for the economy. However, amid the Fed's efforts to reduce inflation to its 2 percent target, the labor market remains too hot for the economy's own good. Last week, the FOMC announced a smaller 25 basis point rate increase while indicating that more hikes are likely in coming meetings. We previously forecast a terminal rate of 5.00-5.25 percent (which would mean another two 25bp hikes), but a higher terminal rate may be necessary if labor market conditions remain hot. At a minimum, the January jobs data should dampen expectations of rate cuts in the second half of the year; we expect the Fed to maintain restrictive monetary policy into 2024, especially with services inflation expected to remain high through year end. As a result, the shockingly strong start to 2023 for hiring ironically increases the odds of a hard landing later this year.

Manufacturing continues to decline while services activity rebounds

The manufacturing sector has slipped into a deeper contraction as the January ISM manufacturing index fell to its the lowest reading since 2009, outside of the brief Covid recession. As demand for manufactured goods continues to dry up, the new orders component pulled back further and is now at a level typically seen only during downturns. On inflationary pressures, input prices for manufacturing continued to decline, although the rate of decline was slower than in December. Manufacturing employment held up in January as firms are retaining workers even with production waning.

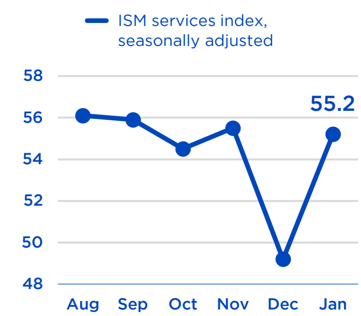
After a one-month drop below the 50-mark into contraction territory, the ISM services index soared back into expansion in January. It's likely not a coincidence that this surprise coincided with the robust job gains in January. The jump in net job creation along with an increase in the average number of hours workers worked and the rise in wages in January lead to buoyant gains in personal income that in turn supports spending activity especially in the services sector. The business activity component of the services index climbed to its second highest reading in the last 12 months, and new orders rebounded to a high level after falling in December. The prices paid component continued to recede very slowly and is still too high to signal rapid cooling in services inflation. Demand for services simply has not dissipated enough to drive any substantial downward pressure on prices.

Job growth much stronger than expected



January's blowout jobs number bucked the moderate downward trend in job growth from the second half of 2022.

Growth in the service sector resumes



After January's strong reading, the contractionary reading for the ISM services index in December appears to be an outlier amid solid growth for services.

Sources:
Bureau of Labor Statistics; Institute for Supply Management

Contributors: Daniel Vielhaber, Economist | Ashleigh Leonard, Economic Specialist

The Week Ahead

Here's our outlook for the days ahead. Subscribe to **Daily Insight** for updates throughout the week.

Trade Balance
Feb 7

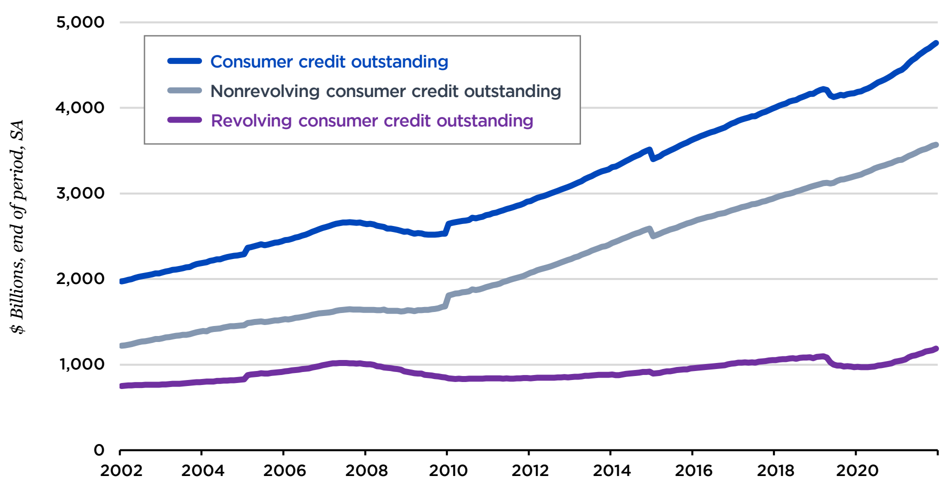
Trade deficit likely to widen

In November, the trade deficit shrank to $61.5 billion from the prior month's $77.8 billion, as imports fell over six percent, whereas exports only declined by two percent. The trade deficit for December should widen to $68.5 billion, led by an increase in the goods deficit. The advanced trade balance showed the deficit in the goods sector rising to $90.3 billion from $83.3 billion in November. Goods imports rose 1.9 percent, after the sharp decline in November, while goods exports fell another 1.2 percent—marking the sixth straight monthly decline due to slower global activity.

Consumer Credit
Feb 7

Inflation pushes consumers to borrow more

With inflation rates still high, consumers are relying more on credit to pay for rising expenses for non-discretionary items. Credit card usage has picked up markedly since the end of the Covid recession even amid rising financing rates. We expect a sizeable $22 billion expansion in consumer credit in December, down just moderately from the $28 billion increase in November.



Sources: Federal Reserve Board/Haver

University of Michigan Sentiment
Feb 10

Consumer sentiment to tick lower with recession fears looming

The University of Michigan consumer sentiment index for the first half of February is expected to edge down to 64.8 from 64.9 in January. The recent market rally should lift the current outlook while recession and inflation concerns reduce forward expectations. Significant uncertainty still looms regarding a moderate recession in 2023, and sentiment and expectations should remain volatile. Weakening sentiment is a downside risk for consumer spending in early 2023 as consumers prep for weaker economic conditions ahead.

Additional Economic Indicators

Previous Week's Indicators

	Period	Actual	Previous
Employment Cost Index	Q4	1.0%	1.2%
Conf. Board Consumer Confidence	January	107.1	109.0
Construction Spending MoM	December	-0.4%	0.5%
ISM Manufacturing	January	47.4	48.4
FOMC Rate Decision (Lower Bound)	Week ending Feb 1	4.50%	4.25%
Wards Total Vehicle Sales	January	15.74m	13.31m
Factory Orders	December	1.8%	-1.9%
Change in Nonfarm Payrolls	January	517k	260k
Unemployment Rate	January	3.4%	3.5%
Average Hourly Earnings MoM	January	0.3%	0.4%
Average Weekly Hours All Employees	January	34.7	34.4
ISM Services Index	January	55.2	49.6

This Week's Indicators

	Release Date	Period	Forecast*	Previous
Trade Balance	Tuesday	December	-$68.5	-61.5b
Consumer Credit	Tuesday	December	$22b	$27.962b
Initial Jobless Claims	Thursday	Week ending Feb 4	190,000	183,000
U. of Mich. Sentiment	Friday	February	64.8	64.9

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