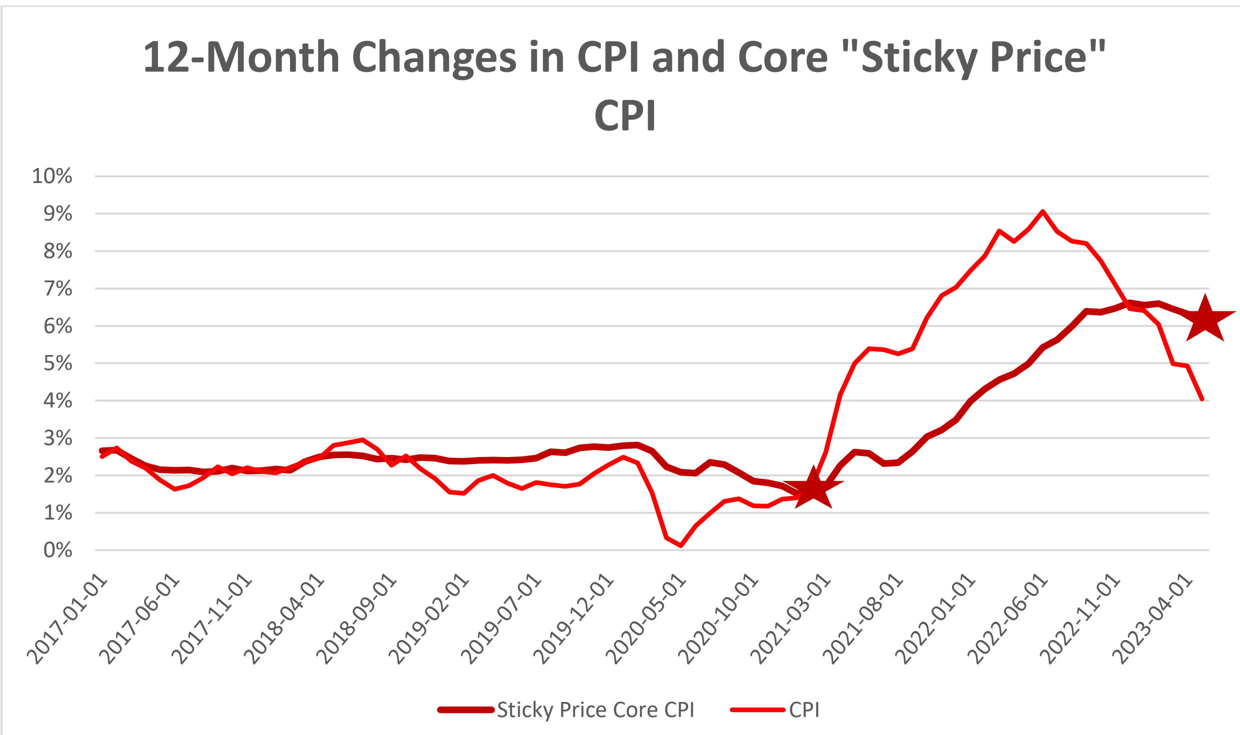
RPC Economic Digest

Inflation the Crux of Increasing Economic Weakness

- Inflation increased 4 percent in May from the same month last year, adding further pressure on household budgets. Core inflation rose 5.3 percent over the past 12-months, while "Sticky Price" core CPI, an alternate measure reflecting prices of goods and services that adjusts less frequently, has also remained persistently elevated.
- While inflation has slowed from a peak rate of 9.2 percent last June, inflation is still double the Federal Reserve target rate of 2 percent.
- Average real weekly wages ticked up slightly at 0.3 percent in May from the same time last year, yet had been declining for the prior 25 months through April. The BLS also revised down the 2022Q4 hourly earnings to negative 0.7% from the initial +4.9%, and real hourly earnings was revised to -4.7% from the initial +0.7% for 2022Q4.



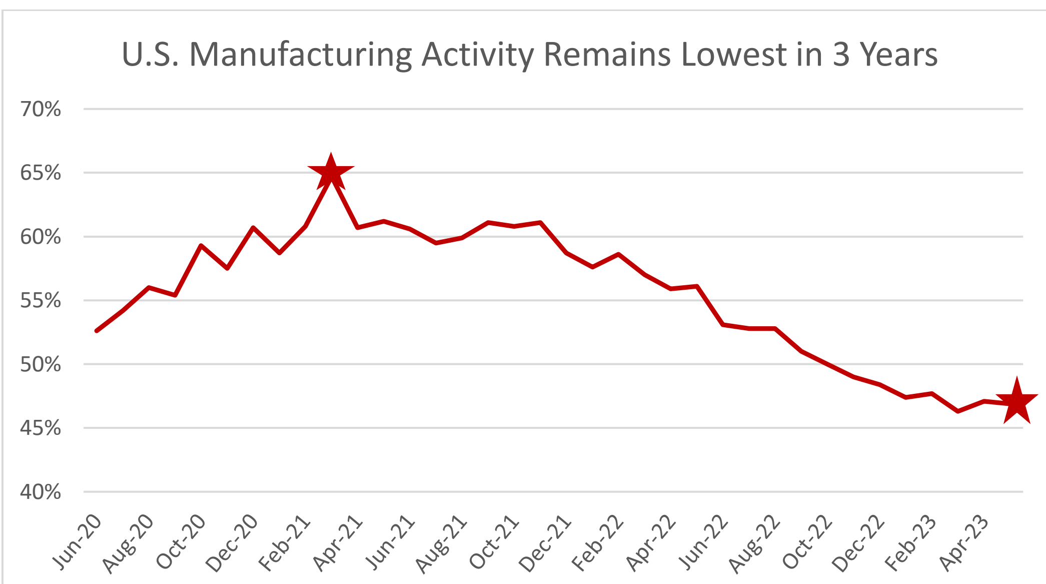
  - Businesses continue to list inflation as a major challenge. Where a majority of small businesses cited inflation as the *greatest* challenge a year ago, it is still a close second to labor quality and challenges with finding qualified workers to fill open positions.
  - Households have lost thousands of dollars in purchasing power over the past couple of years, which is a contributing factor to the $2.9 trillion increase in household debt that has accumulated since the end of 2019. In the first quarter of 2023, aggregate household debt increased by $148 billion, with the total now exceeding $17 trillion. The share of debt newly

transitioning into delinquency for most debt increased, with transition rates for credit cards and auto loans increasing, respectively, by 0.6 and 0.2 percentage points.

  - Real Gross Domestic Product slowed from 2.6% in the fourth quarter of 2022 to 1.3% in the first quarter of 2023, and real Gross Domestic Income was negative 3.3% in 2022Q4 and -2.3% in 2023Q1.

Longest Contraction in Manufacturing Activity Since the 2009 Great Recession

- U.S. manufacturing activity continued contracting for the seventh straight month, declining from April by 0.2 percentage points. This is the longest period of contraction in U.S. manufacturing since the 2007-2009 recession, with weakening economic conditions, in part, due to elevated borrowing costs for firms, dampening credit and tighter lending conditions.
- In June, the BLS reported that manufacturing productivity decreased 2.5 percent for the first quarter of 2023, instead of the initial estimated decrease of 1.3 percent. The revision accounts for a 1.5 percentage point downward change in output and a 0.2 percentage point downward revision in hours worked.
- Boosting manufacturing productivity is crucial for U.S. long-term economic growth potential given the "re-shoring" of production to the U.S. that has been taking place over the past decade due, in part, to elevated geopolitical risks, especially with the rising threat of China, that has exposed disruptions and national security risks of production supply chains. Boosting U.S. productivity to the long-term average of 2.2% achieved between 1948 and 2019 through pro-growth reforms could, according to one estimate, increase U.S. output upwards of $10 trillion, or $15,000 per household.



Mounting Risks Impacting the Financial System

- Risks continue to surface in the U.S. financial system. There has been rate inversion since last year, the longest stretch since the 1980s, suggesting an increasing probability the U.S. could slip into a technical recession.
- U.S. banks continued defending against headwinds and economic slowdown by increasing set-aside provisions for possible loan losses in the first quarter. There are numerous factors for the defensive posturing, including expectations of possible recession later in the year, as well as latent balance sheet risks in commercial real estate (CRE) loans held by banks. By one estimate, the value of CRE loans and securities held by banks is $2.2 trillion lower than the book value on their balance sheet.
- The CRE debt market will likely face enormous headwinds as loans mature without refinance options due to a growing reluctance for banks to hold these loans due to expectation of significant losses. Many banks have stopped issuing new CRE loans altogether, and other banks are shoring up their balance sheets by moving these loans from "held to maturity" to "available for sale" in the event they need to sell loans. Weakening macroeconomic conditions, higher borrowing costs from rising rates, and weak demand, particularly in the office sector, will likely cause commercial property valuations to fall.
- CRE debt could have a sizeable impact for many banks that hold the majority of CRE loans, with small- and mid-sized banks accounting for 70% of all CRE loans. Nearly $300 billion in bank-held CRE loans will mature this year, with upwards of $1.5 trillion maturing over the next few years.
- Adding to the CRE debt concerns, banks could face greater liquidity risks after the recent suspension of the federal debt limit, where the Treasury is expected to issue upwards of a trillion dollars in short-term debt in the next couple of quarters to replete the Treasury General Account (TGA).
- Banks have been a usual buyer of Treasury debt issuances, yet there could be pressures since banks have been bracing against balance sheet weakness due to the several recent bank failures and latent weakness in the CRE debt market. The Fed, already strained in its ability to unwind its balance sheet, could face pressure to step into the market to address bond market weakness as it has done in the past, but it would have to abandon its current objective to unwind its balance sheet in its effort to combat inflation. In any event, current demand for new Treasury issuances look stable as money market funds, which have been short in reverse repurchases, could move holdings into Treasuries.