Could be, who knows?
There’s something due any day
I will know it right away,
Soon as it shows.
Could it be? Yes, it could –
Something’s coming, something good,
If I can wait.

Can you feel the tension? The stock market has put together a two-month winning streak. Jobs growth remains moderate. Many retailers recently posted surprisingly healthy quarterly earnings. The Fed is (maybe) turning a little more dovish. All good signs, to be sure. But layoffs are rising, continuing unemployment claims are up, the housing market is in the dumps even as prices remain too high, and a few Fed officials are begging for higher-for-longer interest rates – none of which engender confidence. To top it off, consumers are spending more than they are earning, drawing down the savings they stockpiled during the pandemic; that’s surely not sustainable.

So which is it? Are the economy and the markets poised for liftoff, or about to sputter out after a false start as they did last summer? Consumer spending is the backbone of the U.S. economy, and it seems to be holding up very well – perhaps too well. Chart 1 shows U.S. retail sales over the past decade-plus. In the slow-growth economy from 2012 through the onset of the Covid pandemic, retail sales (both in-store and online) grew steadily at about 4% per year.

The red line on Chart 1 simply extends that 4% growth rate into a hypothetical world in which Covid didn’t exist. When the pandemic struck, sales plunged but quickly recovered, thanks to immense government support. Indeed, the green line (actual sales) dramatically outstripped the hypothetical steady-state red line, suggesting that consumer spending has been unsustainably high for the past two years or so.
These retail sales figures are not adjusted for inflation; most of the “excess” spending in 2021 can be traced to higher unit volumes, while most of the “excess” spending in 2022 was from price, not units. Thus, the “real” (inflation-adjusted) spending binge may already be on the decline. Further, the aggregate retail sales figures obscure differences among consumers. Anecdotal evidence suggests, for example, that wealthier consumers have maintained high spending levels while middle-income households have substantially cut back on their retail expenditures. We are also seeing evidence that consumers at all income levels are trading down, skipping brand names in favor of store labels or spending their money at off-price stores rather than premium shops. All of this suggests that the sunny picture shown in Chart 1 may have some serious clouds beginning to emerge.

Chart 2 looks at consumer behavior from a different angle. The personal savings rate shown is derived as the difference between income and spending. In the early months of the pandemic, savings skyrocketed as the CARES Act and other legislation sustained incomes while spending cratered. Since early last year, however, consumers have not-so-gradually been spending down that excess savings, i.e., they have been spending more than they have been earning. For as long as the savings rate remained above the historical 8% to 9% band, this was neither surprising nor concerning. What’s especially noteworthy about Chart 2, however, is that the spending binge has now taken the personal savings rate down to less than half of what it was before the pandemic; we’ve collectively overshot the mark, and it’s beginning to show up in consumer credit and debt statistics. This could be a sign of burgeoning confidence in a prolonged recovery, or it could be evidence that we’re headed for recession as unsustainable spending inexorably slows.

Consumers have good reason to be confident, of course. Despite high inflation rates and the Fed’s steep rate hikes, the labor market remains healthy. Job openings still outnumber unemployed workers by a wide margin – about 10.7 million jobs available, but only 6.0 million people looking for work. That makes for a tight labor market, so it’s not surprising that wage growth has persistently stayed above 5% annually.
The Federal Reserve thinks the labor market is actually too tight, contributing to overall inflation. By raising rates, the Fed explicitly hopes to dampen job growth, thereby (officials hope) also curbing inflation. Initial results look promising: The number of job openings and the annualized wage gains have both slipped for four straight months, although they still remain well above the Fed’s targets.

Chair Jerome Powell and his colleagues believe in the “soft landing” scenario, in which higher interest rates bring inflation down without causing a recession. The gradual decline in job openings and in the pace of wage inflation suggest they may be right. Monetary policy works with a substantial time lag, however, and it’s entirely possible that the erosion in job openings may ultimately extend farther than officials want.

Some yellow flags are already flying. Chart 3 shows that layoffs (red line) and continuing unemployment claims (blue line) have both started rising in recent weeks. The increases suggest that companies are no longer just freezing their hiring – now they are also beginning to reduce their workforces. Anecdotal data of mass layoffs is strongest in the technology and social media industries; as was the case in 2000, it’s possible that these layoffs may be limited to a single previously frothy sector, without adversely spreading to the rest of the economy.

Another yellow flag is the housing market. New home starts have been falling since last spring, while new home sales peaked in late 2020. Builders have reported needing to cut prices and offer financial incentives to move current inventory. The market for existing homes has also slowed, though not quite as dramatically. Further, after a brief surge in occupancy rates and construction, even the apartment rental markets in most cities have begun to cool. Potential first-time buyers have been frozen out, but they are opting to live with parents or roommates rather than rent their own apartments. Because housing is both a leading indicator of the broader economy and because new home purchases are correlated with spending in many other industries (furnishing, landscaping, automobiles, personal services, etc.), the slowdown in the housing market has convinced many investors that a recession is all but inevitable.
The sense of foreboding – clear warning signs despite resilient jobs and spending data – has become evident in the nation’s stock and bond markets. The yield curve on Treasury debt, for example, rose sharply earlier this year as the Fed hiked interest rates; more recently, it has also inverted, as shown in Chart 4.

In most normal economic circumstances, lenders require higher interest rates for longer-term debt, to compensate them for the higher risks that come with longer maturities. That was true in 2020 and 2021, as indicated by the positive slopes of the purple and yellow lines in Chart 4. But that’s clearly not the case today, as the 30-year Treasury bond rate is more than a full percentage point below the one-year bill rate.

Such inversions are often early indicators of recessions. The negative slope implies that investors expect slowing economic activity to force the Fed to cut short-term interest rates in the future. While it’s true that every recession in the past 80 years was preceded by an inverted yield curve, it’s also true that the curve inverted on many occasions that did not lead to recessions. In that light, it’s instructive to note that corporate credit spreads have remained remarkably stable as the economy has slowed: Perhaps Treasury debt investors expect recession, but corporate bond buyers are apparently more sanguine.

The stock market, too, is showing conflicting signs, as shown in Chart 5. The recent rally certainly reflects anticipation of something good just around the corner, but it’s important to keep the rally in context. This is the third time this year that stocks have staged a big comeback, following similar moves in March and July-August. Each of the two prior rallies ended badly, with stock prices initially rising back to their 200-day moving average (the orange line) but then falling to new lows. The result has been a pattern of lower highs and lower lows.
Will the third time be the charm? For the moment, the burden of proof lies with the bulls: The October-November pattern is, to date, no different from the March or July-April rallies; although stock prices are tantalizing close to their 200-day moving average ceiling again, Chart 5 shows no evidence that they can push past it this time, nor that they can overtake their summer highs. Emerging from Thanksgiving weekend with conflicting reports of consumer activity over the holiday – full stores but lower average dollar volumes, weak movie box office but full airplanes, etc. – the stock market seems poised either to burst through the old highs or to tumble to new lows. Could be, who knows? There’s something due any day, I will know it right away, soon as it shows.

The market’s tone lately is certainly hopeful, but it’s a hope clearly tinged with apprehension.\(^1\) Patience is essential: While this rally may not be the one that finally starts a new bull market, perhaps the next one may be it. American consumers are fundamentally sound, and sooner or later the stock market will embark on a new bull run. We can wait; but we are nonetheless actively debating whether and when to turn more bullish as we prepare our clients’ portfolios for 2023.

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\(^1\) Let’s not forget that *West Side Story*’s Tony – he of the optimistic “Something’s Coming” – was ultimately a doomed character. Something came, and it wasn’t good.