

Weekly Economic Update—May 23<sup>rd</sup>, 2022

It was another bad week for stocks, which tumbled for the seventh consecutive week and edged ever closer to bear-market territory. Since the end of last year, the S&P 500 is down 18 percent, which translates into about \$14 trillion of destroyed wealth. That's almost 60 percent of GDP. To paraphrase Senator Everett Dirksen, the prominent Republican leader of the 1960s, a trillion here a trillion there, and pretty soon you're talking about real money. The last time the market fell this much, in late 2018, the Fed came to the rescue, pivoting away from its three-year rate-hiking campaign. The question is, will the Fed at some point step in to stop the bleeding again?

Not if the incessant parade of comments by Fed officials, including chair Powell, is any indication. The four times over the last 30 years that the Fed abandoned a tightening policy the objective was to prevent inflation from breaking out of its relatively dormant state. This time, the inflation genie has already broken out, and the Fed faces the more difficult task of bringing it down. That requires far more patience and fortitude than in the recent past, which policy makers are determined to exhibit. It also requires help, and if the negative wealth effect from the market slump lends a hand in cooling the inflation embers, so much the better.

To be sure, the latest setback only makes a modest dent in the portfolio gains achieved over the past two years, as the S&P 500 is still more than 70 percent above its pandemic low of March 2020. However, compared to the prepandemic peak set a month earlier, in February 2020, the gain is a much slimmer 15 percent, a significant fall-off from the 41 percent gain built-in prior to the recent slump. That haircut to portfolios shaved the nest eggs of many early retirees who hoped that their swollen 401K plans would carry them through their golden years. Now not so much, and there is evidence that some are returning to work; the labor force participation rate for 55-64 year olds is much closer to prepandemic levels than other age cohorts.

Of course, that's precisely what the Fed is hoping for, as expanding the supply of labor would ease wage pressure, which is stoking the inflation upsurge. But the market slump also reflects growing recession fears that are linked to the Fed's tightening campaign. So far, there is sparse evidence that the two rate hikes, totaling 75 basis points, put in place are causing enough demand destruction to stifle activity. The main impact has been felt in the housing industry, the most interest rate-sensitive sector of the economy. Residential outlays, however, comprise a small fraction of GDP and would not by itself bring the economy to its knees. Despite slipping home sales in recent months, the housing market is underpinned by strong pent-up demand, an abundance of cash from investors and limited supply.

Importantly, there is no sign of demand destruction among consumers, the economy's main growth driver. True, household sentiment is tanking, with the University of Michigan Sentiment index plunging to the lowest point in more than a decade in early May. People are clearly fed up with surging inflation and deteriorating financial prospects. But as the saying goes, actions speak louder than words; either their low spirits have little relevance for the economy, or households are spending their way out of depression. In either event, retail sales staged another strong advance in April, climbing 0.9 percent following an upwardly revised 1.4 percent increase in March. What's more, the main drag on sales came from a decline at service stations, primarily reflecting a fall in gasoline prices that has since been reversed. Excluding gasoline, retail sales rose 1.3 percent, more than double the 0.6 increase in March.

Consumers spread their dollars broadly during the month, as 10 of the 14 major categories posted gains. That includes, encouragingly, auto sales, which was the second strongest sales category in April, suggesting the widespread shortage of parts is easing. Some support for this notion is coming from the

other side of the ledger, as industrial output got a big lift from the second strong monthly increase in auto production in April. Should this trend continue and fill up dealer lots, a big step towards normalizing the supply/demand imbalance in the auto sector would be taken. Price increases for used cars have already moderated considerably in recent months, although they are still up by more than 20 percent over the past year.

Simply put, inflation still trumps concerns over demand in guiding Fed decisions, which are set to deliver 50 basis point rate hikes in each of the next two policy meetings. No doubt, those moves would amplify growing recession fears that are becoming more prominent in the financial markets. From our lens, these fears are still unwarranted, at least over the immediate future. The typical recession indicators – rising unemployment, high real interest rates, overly leveraged household and business balances sheets – are far from present. If anything, these gauges signify more strength than weakness.

That said, it would be foolhardy to dismiss the growing recession risks amid a turbulent geopolitical environment that also features intractable supply-chain snarls, recurring Covid flare-ups and weakening economies overseas. Cracks are also appearing in an otherwise robust U.S. economy that is gaining notice in the markets. This week's downbeat earnings reports from Walmart and Target clearly spooked investors, although the disappointment reflected surging costs and shifting consumer buying preferences rather than weakening sales. Neither company announced any layoffs, which would be an early warning sign of looming adversity for the broader economy.

But the labor market has not emerged unscathed in recent weeks. Along with the shift in consumer buying preferences some high-profile firms that benefited immensely from pandemic era spending are reducing staff, including Netflix and Peloton, as well as a slew of technology companies. The number of unemployed workers receiving jobless benefits is still historically low. But new applications are moving up, as the 4-week moving average of initial unemployment claims has increased for six consecutive weeks, something that hasn't happened since the pandemic recession in early 2020. The latest 21 thousand increase for the week ending May 14 lifted total new claims to 218 thousand, the highest in four months.

By all accounts, the job market is not about to crumble. Given that there are 1.9 job openings for every unemployed worker, many of those laid-off workers will find positions, and the latest week's increase in new claims for jobless benefits could well be reversed next week. Odds are, however, the low for this cycle – 166 thousand hit in the week ending March 19 – is behind us. Over the last seven business cycles, recessions have lagged the low point in initial jobless claims by an average of 11 months, with a range of 3 months in 1981 to a high of 24 months in 2007. From our lens, the odds of a recession have risen to about 35 percent, but the peak risk for the onset of a downturn is early next year. Not coincidentally, that would be 11 months from the likely low point in new jobless claims set in March.

## FINANCIAL INDICATORS

INTEREST RATES	May 20	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.01	0.93	0.81	0.01
6-month Treasury bill	1.45	1.44	1.32	0.03
3-month LIBOR	1.50	1.41	1.18	0.15
2-year Treasury note	2.61	2.52	2.70	0.15
5-year Treasury note	2.82	2.86	2.93	0.82
10-year Treasury note	2.79	2.82	2.92	1.62
30-year Treasury bond	2.99	2.99	2.95	2.32
30-year fixed mortgage rate	5.25	5.30	5.11	3.00
15-year fixed mortgage rate	4.43	4.48	4.38	2.29
5/1-year adjustable rate	4.08	3.98	3.75	2.59

STOCK MARKET				
Dow Jones Industrial Index	31,262.90	32,196.66	33,811.40	34,207.84
S&P 500	3,901.36	4,023.89	4,271.78	4,155.86
NASDAQ	11,354.62	11,805.00	12,839.29	1,347.99

COMMODITIES				
Gold (\$ per troy ounce)	1,845.10	1,810.30	1,933.00	1,881.80
Oil (\$ per barrel) - Crude Futures (WTI)	112.70	110.18	101.07	63.88

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (April) - % change	0.9	1.4	1.7	0.9
Industrial Production (April) - % change	1.1	0.9	1.0	0.7
Capacity Utilization (April) - Percent	79.0	78.2	77.6	77.5
Existing Home Sales (April) - mlns	5.6	5.8	5.9	6.0

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