

Weekly Economic Update—July 18th, 2022

Fears of an imminent recession took a step back this week even as inflation alarms rang louder, prompting ramped-up expectations of a more aggressive response by the Federal Reserve. The latest data on consumer spending – the economy's main growth driver – highlights the importance of watching what households do, not how they feel. For sure, Americans are in a downbeat mood, with an outsized fraction believing the economy is heading in the wrong direction and sentiment overall sitting near record lows, according to the University of Michigan's latest polling. If actions aligned with feelings, consumers would have zipped up their wallets and sent the economy into a tailspin by now.

But that's not what's happening. Clearly, the frenzied shopping spree during the pandemic and its immediate aftermath is in the rear-view mirror. The enormous infusion of stimulus payments, low interest rates and wealth gains that fueled consumer spending last year are no longer propelling it forward. Indeed, all three have morphed into headwinds that together with raging inflation underpin the sinking mood of households. But contrary to expectations, American consumers have not gone into hibernation – at least, not yet. What is clear is that the stuff they are buying cost more – a lot more – but they are still purchasing them.

Both the steep price increases as well as their minimal impact on consumer spending were starkly revealed in the latest batch of data released this week. The first half of the period was marked by media hysteria over the latest consumer price report for June, which generated the headline reading of a 9.1 percent surge in inflation over the past year, the fastest since November 1981. There was a good deal of fodder in the CPI report to justify the hyped-up attention. The headline increase was not only steeper than expected, it was also more widespread, permeating just about every item in the basket of goods and services that consumers normally purchase. Worse, the biggest price increases were for the necessities – fuel, food and housing – that comprise a larger fraction of budgets of lower-income households.

Some drew comfort from the slight cooling in the annual increase in the core CPI, which excludes volatile food and energy prices, which eased from 6 percent to 5.9 percent in June. But that was mainly a function of easy comparisons with year-earlier levels, which were elevated by outsized monthly increases during the spring of 2021. On a month-to-month basis, the core CPI accelerated from 0.6 percent in May to 0.7 percent in June. Even so, the 5.9 percent annual increase in the core inflation rate is well above the Fed's comfort level and understandably stoked speculation that policy makers would step on the monetary brakes harder at its next meeting in two weeks. Following the report, the financial markets priced in greater odds that the Fed would hike rates by 1 percentage point at the meeting, up from the three-quarters of a percent previously expected.

Fed officials have conveyed mixed messages about their next move in recent days. Most who have made public comments appear receptive to the prospect, but are still leaning towards the smaller .75 percentage point increase taken in May. That became an even more likely outcome on Friday morning when the University of Michigan's sentiment survey revealed an unexpected retreat in household longer-term inflation expectations so far in July. Either way, the next rate hike would put the Fed on track for the most aggressive policy tightening on record. The front-loading of the increases reflects the Fed's attempt to compensate for the delayed response last when it stood pat in the face of accelerating inflation that was thought to be transitory. As well, it has been surprised by the steepness in the inflation upsurge so far this year. Importantly, as aggressive as the Fed's hawkish pivot is shaping up to be there is still some catching up to do. In real terms, the policy rate has never been as far behind inflation as it is now. From our lens, the Fed

is likely to raise the federal funds rate by .75 percentage points at each of next two policy meetings in July and September.

Not surprisingly, the latest Michigan survey revealing more favorable inflation expectations – which included a slight uptick in the sentiment index from June's record low – helped spur a powerful rally in the stock market on Friday. It also had a positive influence on the bond market, as the 10-year Treasury yield fell further below 3 percent, and well under the 3.25 percent reached in mid-June. Indeed, the bond market had been pricing in lower future inflation for several weeks, but for different reasons than the latest catalyst. Until this week, investors became increasingly convinced that the Fed's aggressive inflation-fighting campaign would go too far and throw the economy into a recession, once again failing to achieve the elusive soft landing. Hence, they believed the Fed would start cutting rates sooner rather than later in response to both weak demand as well as falling inflation.

But the markets responded to more sanguine influences this week. The retreat in inflation expectations suggests that the Fed may not have to pull the rate-hiking trigger as aggressively as thought, a prospect that undoubtedly stoked rallies in both the stock and bond markets on Friday. But stock investors also drew encouragement from the week's other major report on retail sales. As noted earlier, inflation may be dampening household spirits, but it is not stifling actual spending. In June, retail sales exceeded expectations, increasing by a sturdy 1 percent, with 10 of the 13 major sales categories posting gains. Unsurprisingly, the gains were paced by sales at service stations, where surging gas prices pumped up the cost of filling tanks. Following a hefty 5.6 percent increase in May, service station sales increased by 3.6 percent in June.

However, excluding gasoline sales retailers still posted a solid 0.7 percent increase in revenues last month, fully reversing the 0.7 percent drop in May. Importantly, the control group of sales that feeds into the GDP calculations rose by 0.8 percent, more than erasing the downwardly revised 0.3 percent decline in May. To be sure, all of the sales increase, and then some, reflected higher prices, as the 1.3 percent increase in the CPI last month exceeded the 1.0 percent nominal gain in sales. Simply put, consumers are paying more for the same, or fewer, volume of goods they are getting. But at least the higher prices are not yet deterring consumers from purchasing the goods. Keep in mind that the retail sales report does not include sales by service providers, where demand remains solid and its impact should be reflected in the more comprehensive report on personal consumption later this month.

That prospect along with the latest retail sales report likely mean the economy did not suffer a second consecutive quarterly contraction in GDP during the April-June period. Some had alluded to that possibility as confirmation the economy may already be in a recession. However, that alone would not necessarily portray such an outcome as the NBER, the official arbiter of when recessions begin and end, uses a broader array of indicators to make that determination. Those indicators, including the ones related to the all-important job market, are still flexing considerable muscle. The economy is generating nearly 400 thousand jobs a month, wages are rising and, as evidenced this week, households continue to spend at a healthy clip.

That said, the data now coming out describe past activity, even as the future holds many challenges. While we believe a recession has been avoided so far, the odds of the economy skirting one are getting slimmer with each rate hike and spike in inflation. The good news is that some of the bigger influences driving up inflation are reversing course, most notably gas prices which have been slipping steadily in recent weeks. Other commodity prices are also declining. The bad news is that service prices are rising faster, particularly for shelter, which will limit the slowdown in inflation and keep it elevated beyond the next few months. That, together with the resilience in consumer spending demonstrated this week, will keep the Fed's foot on the brakes until it sees clear signs of easing inflation.

The welcome retreat in inflation expectations – both among households and in the financial markets – probably moved the Fed away from hiking rates by a full percentage point at its upcoming meeting on July 27. But additional rate increases of .75 percentage points are on the way in each of the next two meetings.

And while monetary policy is garnering all the attention, fiscal policy is also becoming an under-the-radar drag on growth. Over the first nine months of the fiscal year, through June, the budget deficit shrank at the fastest pace on record. The combination of restrictive monetary and fiscal policies will take a toll on the economy over the second half of the year and push it ever closer to the cusp of a recession. We still believe a downturn can be avoided, but the margin of error is narrowing considerably.

FINANCIAL INDICATORS

INTEREST RATES	July 15	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.34	1.88	1.61	0.05
6-month Treasury bill	2.87	2.57	2.22	0.05
3-month LIBOR	2.74	2.43	2.06	0.13
2-year Treasury note	3.13	3.12	3.19	0.24
5-year Treasury note	3.05	3.13	3.35	0.78
10-year Treasury note	2.92	3.08	3.24	1.29
30-year Treasury bond	3.08	3.25	3.28	1.92
30-year fixed mortgage rate	5.51	5.30	5.78	2.88
15-year fixed mortgage rate	4.67	4.45	4.81	2.22
5/1-year adjustable rate	4.35	4.19	4.33	2.47

STOCK MARKET				
Dow Jones Industrial Index	31,288.26	31,338.15	29,858.78	34,687.85
S&P 500	3,863.16	3,899.38	3,674.84	4,327.16
NASDAQ	11,452.42	11,635.31	10,798.35	14,427.24

COMMODITIES				
Gold (\$ per troy ounce)	1,706.50	1,740.30	1,843.80	1,812.10
Oil (\$ per barrel) - Crude Futures (WTI)	97.57	104.36	109.91	71.42

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (June) - % chg (Y/Y)	1.3 (9.1)	1.0 (8.6)	0.3 (8.3)	0.9 (8.3)
Core CPI (June) - % change (Y/Y)	0.7 (5.9)	0.6 (6.0)	0.6 (6.2)	0.6 (6.2)
Producer Price Index (June) - % chg.(Y/Y)	1.1 (11.2)	0.9 (10.8)	0.4(11.0)	1.0 (10.9)
Retail Sales (June) - Percent Change	1.0	-0.1	0.7	0.9
Industrial Production (June) - % change	-0.2	0.0	0.8	0.4

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