

Weekly Economic Update—July 25<sup>th</sup>, 2022

The heat wave engulfing broad swaths of the nation – and even more so overseas – is in stark contrast to the distinct chill that infiltrated the economic data over the past week. If nothing else, the downbeat signals portrayed by the latest housing data and a softer labor market amplify erratic perceptions in financial markets regarding recession prospects. A week ago, investors were cheered by a stronger-than-expected retail sales report suggesting a still vibrant consumer that would keep the economy on a growth trajectory. The strength in consumer spending followed the eye-opening report of a 9.1 percent inflation rate that fueled expectations the Fed would hike rates by an aggressive 1 percent at its upcoming policy meeting next week instead of a more modest three-quarters of a percentage point.

All of those perceptions were upended this week. Two time-honored leading indicators of a recession flashed warning signals, inflation expectations retreated and financial markets priced in much greater odds that the Fed will throttle back its rate hike to 75 basis points at its policy confab. Meanwhile, expectations grew that next week's GDP report will show that the economy contracted for a second consecutive quarter in the April-June period, meeting the unofficial yardstick of a recession. From our lens, the economy's growth engine is still moving forward, although it is not running on all cylinders and the odds of it sputtering to a halt later this year or early in 2023 are clearly rising.

To be sure, the week's data calendar was exceptionally light, highlighted by home sales and construction that confirmed trends underway for several months. The housing sector gets particular attention in the recession debate because it typically leads the economy around cyclical turning points. That pattern, of course, reflects the industry's sensitivity to financial conditions, particularly to changes in interest rates. A home purchase is the most expensive undertaking a household will likely make in his or her lifetime, and the transaction more often than not requires a mortgage loan. Mortgage rates, in turn, increase and lifts the cost of a home purchase when the Fed strives to slow growth by tightening policy, an undertaking that typically leads to recession. Not surprisingly, home sales and construction fall before the broader economy sinks into a recession.

Importantly, the housing industry is battling powerful headwinds that are sending home sales into recession territory. With inflation surging and the Fed embarking on an aggressive tightening policy, mortgage rates have skyrocketed. In the latest week, the 30-year fixed rate stood at 5.54 percent. That's off from the 5.81 percent peak of a month ago, but more than double the 2.78 percent of a year ago. Unsurprisingly, sales of existing homes in June plunged for the fifth consecutive month in June, driving the total more than 14 percent lower than a year ago. The decline has been as widespread as it has been steep, falling in all regions except the Northeast.

Nor is it just climbing mortgage rates impairing sales. Throw in the nosebleed level of home prices, which have been on a tear since the onset of the pandemic, and prospective buyers need to take out a larger loan to finance the more expensive purchase. The increase in both home prices – which hit a record \$416 thousand for a median priced home in June—and the climb in mortgage rates since the end of 2021 has pushed the monthly mortgage payment on a median priced home up by nearly \$700 or 56 percent, pricing millions of buyers out of the market. Sales of new homes haven't been released for June yet, but the trend through May has echoed that of the much larger market for existing homes.

Needless to say, builders are not happy about the deteriorating sales picture, as reflected in the 12-point plunge in the NAHB homebuilder sentiment index in July. But unlike households, who keep spending despite plunging sentiment, homebuilders are aligning actions with their feelings. Housing starts fell for the

third consecutive month in June, but the 2 percent drop in the overall total masks a much weaker trend in the largest segment of the market – single-family homes. Single-family starts fell a sizeable 8.1 percent during the month and slipped below the 1million threshold for the first time since 2020. Given the headwinds facing homebuyers noted above, builders are not likely to rev up production of single-family homes anytime soon. Building permits – a forward looking indicator of future construction -- fell by 8 percent last month and, like starts, dropped below 1 million units for the first time since 2020.

We suspect that housing activity will be a drag on growth over the second half of the year as neither mortgage rates nor home prices will be reversing much, if any, of their climb, thus keeping affordability out of reach for much of the population. That said, residential construction plays a smaller role in the overall economy than it has in the past, and is unlikely to bring the overall economy to its knees. What's more, the softness that is unfolding is not poised to morph into a full-fledged collapse, similar to the housing crisis in 2008 that crippled the financial system in the process. There is still a shortage of homes on the market, which should put a floor under construction, and demand from younger households and investors should limit the decline in sales.

A more important influence that will determine recession prospects is the health of the job market. For sure, this continues to be a bright spot that underscores why most economists believe a downturn has not yet set in. No doubt, it is not unusual for job growth to continue early in recessions, as companies continue to fill staffing needs until they are sure that a fundamental shift towards weaker conditions has taken place. But the underlying strength of the job market is far greater than at the start of past recessions. Not only is the unemployment rate, at 3.6 percent, at historic lows and job vacancies near historic highs, payrolls are expanding at a rapid pace and generating income gains that should support growth-sustaining consumer spending, the economy's main growth driver, for the foreseeable future.

That said, even among an otherwise vibrant job market, cautionary signals are appearing. There is an abundance of anecdotal evidence pointing to companies placing a hold on new hiring, others rescinding job offers and some high-profile firms actually laying off workers. For the most part, these events are confined to certain industries, such as tech and construction, which are falling on hard times. With nearly two job openings for every unemployed worker, there is a good chance that those impacted can find jobs elsewhere. But signs that the job market is starting to soften more broadly are emerging, most notably in the government's data on claims for unemployment benefits.

In the latest reporting week, first-time claims for jobless benefits increased to 244 thousand, the highest level of the year and up from a low of 166 thousand in early March. The climb has been fairly steady and beginning to undermine feelings of job security. One signal: workers are quitting less frequently, a sign that they are not as confident in landing another better-paying position. But even with the recent climb, the level of unemployment claims remains low, far below the 300 thousand or so that typically occurs during the onset of recessions. It certainly will not discourage the Federal Reserve from raising rates at its policy meeting next week, which we believe will be three-quarters of a percent. Importantly, the nascent signs of weakness in the job market is precisely what the Fed is trying to bring about – slow hiring enough to curb wage gains, but not cause a massive increase in unemployment.

## FINANCIAL INDICATORS

INTEREST RATES	July 22	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.38	2.34	1.66	0.05
6-month Treasury bill	2.86	2.87	2.49	0.05
3-month LIBOR	2.78	2.74	2.20	0.13
2-year Treasury note	2.99	3.13	3.08	0.21
5-year Treasury note	2.85	3.05	3.19	0.72
10-year Treasury note	2.76	2.92	3.13	1.28
30-year Treasury bond	2.97	3.08	3.26	1.92
30-year fixed mortgage rate	5.54	5.51	5.81	2.78
15-year fixed mortgage rate	4.75	4.67	4.92	2.28
5/1-year adjustable rate	4.31	4.35	4.41	2.49

STOCK MARKET				
Dow Jones Industrial Index	31,899.29	31,288.26	31,500.68	35,061.55
S&P 500	3,961.63	3,863.16	3,911.74	4,411.79
NASDAQ	11,834.11	11,452.42	11,607.62	14,836.99

COMMODITIES				
Gold (\$ per troy ounce)	1,724.90	1,706.50	1,828.10	1,801.90
Oil (\$ per barrel) - Crude Futures (WTI)	94.94	97.57	107.08	72.95

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (June) - 000s	1,559	1,591	1,805	1,686
Building Permits (June) - 000s	1,685	1,695	1,823	1,797
Existing Home Sales (June) - mlns	5.1	5.4	5.6	5.7

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