

Weekly Economic Update—August 1st, 2022

If it looks like a duck and swims like a duck ... is it a recession? It might take months, or even years, for the National Bureau of Economic Research (NBER) to settle a question that is currently the central focus of debate among economists and pundits. From our lens, the economy is still swimming above water, but the tide appears to be running out and the Fed is making waves that could sink the boat. Despite the uncertainty over whether the economy will swim or sink, the financial markets are behaving like drunken sailors. The S&P 500 posted its biggest percentage gain for a month in July since November 2020, erasing about a third of the 24 percent plunge wrought by the bear market during the first half of the year. Bond investors also switched gears, replacing earlier fears that the Fed fell too far behind the inflation curve to the belief it has caught up and is poised to shift into reverse sooner rather than later. That pivot in thinking brought the 10-year Treasury yield down to under 2.70 percent this week, from an 11-year high of 3.50 percent in mid-June. It also brought about a steeper inversion of the yield curve that is a time-honored leading recession indicator.

Underscoring the recession debate was this week's report that the economy contracted for the second consecutive quarter in the April-June period, satisfying a common rule of thumb describing a recession. However, the NBER uses a broad range of metrics to determine the timing of a recession, which may or may not validate the two-quarter definition. Although they usually do align, a key metric – a still robust job market – strongly suggests that the economy is not yet mired in a slump. What's more, the slim 0.9 decline in GDP reported for the second quarter is based on incomplete data that may yet be revised higher as more information becomes available. Importantly, it is unclear how much of the GDP contraction reflects weak demand or supply shortages. Despite declining purchasing power and plunging household sentiment, consumer spending – the main driver of economic output – is well ahead of pre-covid levels and above where it would be had the trend prior to the pandemic continued. However, GDP – a measure of output – has fallen well below its potential this year. These conflicting trends suggest that supply constraints are more responsible for the GDP contraction than weak demand.

If so, it raises the question as to how much demand destruction the Fed should aim for in its quest to bring inflation under control. There may be some question as to whether or not the economy is in a recession, but there is little doubt that the inflation embers continue to run hot. With labor costs accelerating and consumers willing and, for the most part able, to accept higher prices on their purchases, the Federal Reserve remains firmly in a rate-hiking mode to curb demand. Following this week's .75-percentage point increase, the Fed has in the space of four months raised rates as much as it had over the entire 2010-2019 expansion. It also matched the peak 2.5 percent upper range hit during that period. Unlike then, however, the Fed is not likely to stop, which made this week's policy meeting more relevant for what the Fed said rather than what it did.

Simply put, the rate hike was fully anticipated, but the forward guidance was open to question. Would the Fed firmly commit to a similar rate increase at its next meeting in September as well as to the aggressive path of subsequent increases spelled out at previous meetings? If the policy statement and Chair Powell's comments at the press conference are any indication, the answer is ambiguous. Powell said that another 75 basis point increase in September is on the table, but the statement also acknowledged that "some softening" in certain sectors is unfolding. And while Powell confirmed that taming inflation is still the number one priority, he also said that he would monitor events closely and the next rate increase would depend on incoming data. Clearly, if the job market turns abruptly sour or other key indicators, such as consumer spending, falls off a cliff, a more cautious inflation-fighting approach would likely be taken.

Significantly, the next policy meeting is eight weeks away – longer than the more typical 6 week lag – so there will be ample data to parse through before a decision needs to be made. Indeed, the Fed will have two more jobs reports and two more CPI reports under its belt by the upcoming confab on September 20-21. We expect that both will retain enough firepower to justify another .75 percentage point increase before the Fed throttles back to 25 basis point increases in the subsequent three meetings. That said, the rate increases already on the books are taking an ever-bigger toll on some sectors, most notably housing, and the immediate increases in borrowing costs on credit cards and auto loans that will follow the latest Fed hike could well have a harsher – and broader – impact on consumer spending than expected.

It's important to remember that the flip side of the Fed's goal of curbing demand through rate increases is to encourage savings. The more households save, the less they spend. What is also relevant is that there are more savers than borrowers in the economy; so higher interest rates blunt their demand-stifling effect somewhat by providing savers with more interest income. At first blush, it may seem that the rate increases so far this year have had only a minimal impact on interest receipts, as personal interest income has advanced by a modest, albeit accelerating, pace in the second quarter. However, when you consider that households have drawn down their savings by \$650 billion since the end of 2021 and the savings rate fell to 5.1 percent in June, the lowest since August 2009, the modest boost to income from interest receipts in the second quarter looks quite impressive.

To be sure, lower-income households whose balances were inflated by pandemic-linked stimulus payments were more likely to have drawn down savings to finance purchases than middle and upper-income individuals, who are largely reaping the rewards of higher interest rates on their still-formidable savings cushion. But even those on a higher rung of the income ladder are being squeezed by inflation, which is no doubt starting to deflate that cushion. The robust job market is pumping up labor compensation and income, but inflation is eating into virtually all of the gains. In June, for example, income after taxes rose by a muscular 0.7 percent – the strongest in eight months – but adjusted for inflation, it fell by 0.3 percent.

This is where the rubber meets the road for policymakers, as consumer spending is the only sector keeping the economy out of recessionary waters. Business investment, government spending and residential outlays all turned negative in the second quarter, while personal consumption rose by 1 percent. If not for inventory destocking, which subtracted 2 percent from the growth rate, that increase would have been enough to sustain positive growth in GDP. Clearly, the Fed would not want to choke off the economy's main growth driver, particularly since the 1 percent increase in personal consumption was the weakest since the recession ended.

We believe that the strong job market, higher wages and savings cushion will keep consumers in a spending mood and spur a modest rebound in GDP over the second half of the year. The latest report on labor compensation – a stronger-than-expected increase in the Employment Cost Index in the second quarter – indicates that worker bargaining power remains intact amid acute labor shortages. True, cracks in the job market are emerging, as rising initial claims for unemployment benefits point to a pick up in layoffs. However, continuing claims for unemployment benefits have actually declined over the past month, which indicates that workers who lost jobs quickly found a new position.

Importantly, there are growing signs that consumers are resisting price increases, something that shows up in recent sales numbers as well as the earnings reports by an array of high-profile corporations. As this continues, companies would find it harder to pass on accelerating labor costs to customers, which would feed back into stiffer resistance to labor demands. This virtuous cycle of de-escalating price and wage pressure would, in turn, set the stage for the soft landing that the Fed is hoping to achieve. It also augurs for fewer rate hikes that is increasingly seeping into market expectations, underpinning the powerful stock market rally and yield declines in recent weeks.

FINANCIAL INDICATORS

INTEREST RATES	July 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.37	2.38	1.67	0.05
6-month Treasury bill	2.87	2.86	2.48	0.06
3-month LIBOR	2.78	2.78	2.29	0.13
2-year Treasury note	2.88	2.99	2.84	0.19
5-year Treasury note	2.68	2.85	2.89	0.70
10-year Treasury note	2.65	2.76	2.89	1.23
30-year Treasury bond	3.09	2.97	3.12	1.89
30-year fixed mortgage rate	5.30	5.54	5.70	2.80
15-year fixed mortgage rate	4.58	4.75	4.83	2.10
5/1-year adjustable rate	4.29	4.31	4.50	2.45

STOCK MARKET				
Dow Jones Industrial Index	32,845.13	31,899.29	31,097.26	34,935.47
S&P 500	4,130.29	3,961.63	3,825.33	4,395.26
NASDAQ	1,239.69	11,834.11	11,127.85	14,672.68

COMMODITIES				
Gold (\$ per troy ounce)	1,782.70	1,724.90	1,810.10	1,817.10
Oil (\$ per barrel) - Crude Futures (WTI)	98.30	94.94	108.40	73.70

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (June) - 000s of units	590	642	604	694
Durable Goods Orders (June) - % change	1.9	0.8	0.4	1.0
Real GDP (Q2) - % change, Saar	-0.9	-1.6	6.9	3.3
Personal Income (June) - % change	0.6	0.6	0.5	0.5
Personal Consumption (June) - % change	1.1	0.3	0.5	0.9
Savings Rate (June) - Percent	5.1	5.5	5.2	5.5

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