

Weekly Economic Update—August 22<sup>nd</sup>, 2022

It's more than likely that the economy is not in a recession, despite two consecutive quarterly contractions in GDP. But while the economy's growth engine is still powering forward, it is hardly running on all cylinders. The main driver, consumer spending, is providing much-needed fuel to keep the engine running, as evidenced by this week's retail report for July. But households are facing formidable headwinds as increasing borrowing costs and torrid inflation are squeezing budgets, even as the main offset to shrinking purchasing power – income-generating job growth – is poised to slow.

There is a worrisome bifurcation in economic activity that erodes confidence in the expansion's staying power. The Conference Board reported this week that its index of leading economic index fell for the fifth consecutive month in July, suggesting the risk of a recession later this year has increased notably. Of the ten components of the index, housing activity stands out as one of the biggest drags on growth going forward. The Index only captures the decline in building permits, which was significant in July. But the travails in the housing sector are much broader, with slumping trends visible on both the output and demand sides of the ledger. Data out this week highlight just how severe the deterioration is on both fronts.

With mortgage rates rising from under 3 percent last year to a peak of 5.81 percent in late June and home prices skyrocketing, housing affordability has deteriorated sharply across a broad swath of the population. The shrinking pool of potential homebuyers is taking a severe toll on sales, something that came under a harsh spotlight this week. Sales of existing homes fell by an eye-opening 5.9 percent in July, the sixth consecutive monthly decline, to 4.81 million units, which is 20.2 percent below a year ago. Excluding the two months in the wake of the pandemic shock in April and May 2020, this was the lowest pace of sales since 2014. New home sales for July will be released next week, but the trend there has been just as grim.

Although mortgage rates have slipped from their late-June peak to 5.13 this week, there is little confidence that it will continue to decline, as the 10-year Treasury yield to which it is linked has increased this week. As it is, mortgage applications for home purchases have been retreating for weeks on end and pending home sales, a leading indicator of existing home sales, slumped badly in July. Simply put, the outlook for home sales is downbeat, and that has broader implications for the economy. Fewer home sales mean that would-be buyers are not purchasing new furnishings, appliances or incurring moving expenses, depriving the growth engine of an important source of potential spending.

Unsurprisingly, builders are responding to the setback in sales as well as the continued squeeze on housing affordability that bodes poorly for transactions over the foreseeable future. Housing starts fell by an outsized 9.6 percent in July, weighed down by a 10.1 percent plunge in single-family starts where the slump in demand is concentrated. Plans for single-family construction point to more weakness ahead, as building permits – an indicator of future construction – fell for the fifth consecutive month, an enormous 24 percent contraction over that 5-month span.

The outlook for multi-family construction, however, is considerably brighter. As people are driven out of the single-family market by higher mortgage rates and unaffordable prices, the demand for apartments is increasing strongly – and driving up rents. And just as builders are responding to sagging home sales by scaling back single-family construction, they are stepping up multi-family construction to accommodate demand and take advantage of higher rents the finished apartments will bring. The silver lining of this pivot to multi-family building is that the increased supply of apartments will ease the upward pressure on rents, a major component of the consumer price index. What's more, the inflection point on rising rents may not be far off, as the number of apartments in the pipeline about to reach the market has surged to record highs.

But as grim as housing prospects are over the near term, it is not severe enough to bring the overall economy to its knees. For one, the housing sector's influence on the broader economy is relatively small. When it does lead to a wider catastrophe, it is usually when a housing slump creates fault lines in the banking system, as was the case with the housing collapse in 2007-08. But that's not the case now. The banking system is in no way threatened by the setback in housing activity, as mortgage lending has been responsibly distributed to credit-worthy borrowers and homeowners are not saddled with underwater debt that led to a tidal wave of defaults – and damaged bank balance sheets – during the housing collapse and financial crisis more than a decade ago.

Importantly, consumers are in much better shape to cushion the blow from a weak housing market in coming months. As noted earlier, consumer spending – the economy's main growth driver – is holding up better than expected in the face of powerful headwinds, such as higher borrowing costs and sharply elevated inflation. The latest retail sales report for July provided a stark reminder of consumer resilience. Total sales for the month came in unchanged from June, but mostly because a steep decline in gasoline prices suppressed the headline number. Excluding gasoline stations, sales were up a solid 0.6 percent. If the drag from volatile auto sales were also excluded, the gain for retailers is an even stronger 0.7 percent. The core group of sales, which enters the GDP calculations, staged a robust 0.8 percent increase.

It's important to remember that retail sales, which are mostly for goods, are expressed in current dollars, and goods prices declined by 0.5 percent last month. Hence, consumers got more for their dollars, as real sales increased by 0.6 percent. Aside from the surprising drop in auto sales – unit sales actually increased during the month – consumers spread their dollars over a wide range of goods. Nine of the thirteen retail categories notched gains in July, led by a sturdy 2.7 percent spike at nonstore retailers, primarily e-commerce sites. Internet shopping may have gotten a sizeable boost from Amazon's Prime Day, which fell in the middle of the month.

Most consumer spending is for services, which will be reported in the broader personal income and consumption report due next week. With consumers resuming more normal living patterns as easing pandemic restrictions encourage more outdoor activities, spending on services should continue to gain traction and give a lift to overall consumption this quarter. Indeed, with the upward revisions to previous estimates of the control group of retail sales, there is a good chance that the second quarter contraction in GDP will be revised to show a positive reading for the period. That would weaken the argument of those believe the economy is already in a recession based on two consecutive quarterly contractions in GDP. It would also strengthen the case for the Federal Reserve to remain on its aggressive rate-hiking campaign to curb inflation. It's still unclear if the next increase will be of the 50 or 75 basis point variety, as signs that inflation – and inflationary expectations – has peaked together with weak housing activity may prod the Fed to take the smaller increase. But there's another jobs and consumer price report scheduled for release before the next meeting on September 20-21, which may decide the issue.

## FINANCIAL INDICATORS

INTEREST RATES	Aug 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.37	2.56	2.38	0.05
6-month Treasury bill	3.11	2.95	2.86	0.05
3-month LIBOR	2.98	2.91	2.78	0.13
2-year Treasury note	3.23	3.26	2.99	0.23
5-year Treasury note	3.07	2.99	2.85	0.78
10-year Treasury note	2.97	2.84	2.76	1.26
30-year Treasury bond	3.01	3.17	2.97	1.87
30-year fixed mortgage rate	5.13	5.22	5.54	2.86
15-year fixed mortgage rate	4.55	4.59	4.75	2.16
5/1-year adjustable rate	4.39	4.43	4.31	2.43

STOCK MARKET				
Dow Jones Industrial Index	37,706.74	33,761.05	31,899.29	35,120.08
S&P 500	4,228.48	4,280.15	3,961.63	4,441.67
NASDAQ	12,705.22	13,047.19	11,834.11	14,714.66

COMMODITIES				
Gold (\$ per troy ounce)	1,760.30	1,818.90	1,724.90	1,782.90
Oil (\$ per barrel) - Crude Futures (WTI)	59.95	91.88	94.94	62.25

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (July) - 000s	1,446	1,599	1,562	1,650
Building Permits (July) - 000s	1,674	1,696	1,695	1,771
Existing Home Sales (July) - mlns	4,810	5,110	5,410	5,435
Retail Sales (July) - % change	0.0	0.8	0.4	0.8
Industrial Production (July) - % change	0.6	0.0	-0.1	0.4
Capacity Utilization (July) - Percent	80.3	79.9	80.1	80.0

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