

Weekly Economic Update—August 29<sup>th</sup>, 2022

Friday was Jackson Hole Day for the financial markets, as investors spent the past several weeks nervously anticipating what Fed Chair Powell would say at the annual central bank symposium held in Jackson Hole, Wyoming. Recall that at last year's confab, Powell famously asserted that the inflation acceleration, well underway at the time, would be transitory, a sentiment that contributed to the delay in raising interest rates until March of this year. That delay, of course, is now widely maligned as it gave the inflation embers more time to catch fire and resulted in a more aggressive rate-hiking campaign than would have been necessary had the Fed started sooner.

Still, better late than never, and the catch-up phase, which included outsized three-quarter point rate hikes in June and July, is nearly over. That's not to say the tightening phase is over; it's clearly not. Powell, for one, admitted some time ago that the Fed probably waited too long to start the inflation-fighting agenda and, importantly, discarded the notion that the forces driving inflation are transitory. At the time of his speech last year, the consumer price index had increased 5.5 percent over the previous twelve months. Now consumer price inflation is running at 8.5 percent, according to the latest reading for July. The fact that it slipped from a 9.1 percent peak a month earlier is encouraging but far from persuasive that a disinflationary trend has set in. Simply put, future rate increases may not be as hefty as the ones in June and July, but more hikes are on the way.

The big question is whether Fed officials believe that another three-quarter-point increase is necessary at the next policy meeting on September 20-21, or whether it's time to scale back to a still-heady, but more modest hike of half-percent. Powell's speech on Friday was eagerly anticipated for clues as to which option was more likely. Not surprisingly, the Fed chair did not specifically indicate whether the upcoming meeting would deliver a larger or smaller increase. But his remarks were clearly more hawkish than the financial markets were hoping for, and stocks turned decidedly lower on Friday. There was hope among market participants that the recent softness in some economic indicators would prompt the Fed to start cutting rates sooner than later, perhaps beginning next year.

But Powell vanquished those hopes. Instead, he doubled down on the urgent need to rein inflation in, indicating that rate hikes would continue well into next year, and held at elevated levels, until there's firm evidence that price increases have slowed enough to justify a pivot. The slowdown in most price gauges last month doesn't move the needle in that regard, particularly against the Fed's target of 2 percent inflation. As noted, the CPI is still running at a white-hot 8.5 percent pace and the Fed's preferred inflation measure, the personal consumption deflator, clocked in at 6.3 percent. In other words, there is still a ways to go before the inflation readings fall to the neighborhood of the Fed's target.

That said, it's important to not downplay the significance of the change in direction that occurred last month. On Friday, the day of Powell's speech, the Commerce Department released new data on the Fed's preferred gauge, with encouraging results. As noted, the 6.3 percent increase from a year ago in the headline PCE deflator is still way above the 2 percent target. But it is 0.5 percent below the inflation rate in June, echoing the improvement seen in the consumer price index released two weeks ago. True, sliding energy prices was a major influence in the slowdown. But excluding energy and food prices, the core PCE deflator also downshifted by 0.2 percent, coming in at 4.6 percent in July.

Just as encouraging is the momentum factor, looking at the month-to-month increases, which provide equally good news. Here we see that the headline PCE deflator fell 0.1 percent, the first drop since April 2020 and the core PCE deflator rose by a slim 0.1 percent, the smallest monthly gain since November 2020. While these readings are encouraging, there is little question that inflation will remain unacceptably high in coming months, prompting the Fed to keep its foot on the monetary brakes. From our lens, the odds

favor another three-quarter-point increase at the next meeting, followed by more modest quarter point hikes in November and December. That would bring the Fed's benchmark federal funds rate up to the 3.50-3.75 percent range by the end of the year. In the last rate-hiking cycle that ended in 2018, the fed funds rate peaked at 2.50 percent.

Importantly, the Fed has so far not changed the level of rates that it considers neutral, i.e., one that neither stimulates nor retards economic growth. That still remains at 2.50 percent, established at the June FOMC meeting. In effect, therefore, the Fed is saying that it is deliberately moving into restrictive territory, striving to weaken economic growth. That too was emphasized by Powell at Jackson Hole, as he asserted that the rate hikes in the offing would incur some pain to businesses and workers. While noting that bringing on a recession was not the Fed's objective – preferring a soft landing – he also made it clear that if it became a choice between recession or taming inflation, the former would be selected, as allowing inflation to run wild would lead to even more dire consequences.

To be sure, there are some who believe the economy has already slipped into a recession, since GDP contracted for two consecutive quarters over the first half of the year. This week's revised figures revealed that the second quarter contraction was milder than earlier estimated, coming in at -0.6 percent compared to -0.9 percent in the advance estimate, but still in contractionary territory. That said, the revision also bolstered the case against the recession notion, as it captured the income side of the ledger as well as the spending side. Theoretically, the two should equal each other, since one person's spending is another's income. But the two diverged sharply in the second quarter, with gross domestic income increasing 1.4 percent in the second quarter.

While the opposing trends can justify the case both for and against the economy being in a recession, the Commerce Department conveniently provides a number that combines the output and income sides, called Gross Domestic Output, which tilts the argument in favor of a still growing economy. The GDO increased 0.4 percent in the second quarter, following a slim 0.1 percent increase in the first. We agree with the growth camp, as the GDI advance reflects the still robust job market and sizeable wage increases for workers that underpin the ability of households to sustain spending, the economy's main growth driver.

But it's important to recognize the toll that the Fed's rate hikes combined with elevated inflation are taking on the broader economy as well as on households. The housing sector is clearly in recession territory, highlighted once again this week by the plunge in new home sales in July to the lowest level in more than five years. What's more, the sales data may underestimate the housing slump, as they reflect new contracts signed to purchase a home. But the real estate firm Redfin reported a 16.1 percent cancellation rate of contracts for July, which is the highest since the firm started collecting records. The housing market is usually the first shoe to drop before a recession sets in, making the outlook that much murkier.

The question then is how deep a recession would the Fed tolerate to restore price stability, or bring it down to the 2 percent target. Powell's hawkish tone sounded at Jackson Hole suggests that he would do "whatever it takes" to bring that about. No doubt, the prospect that the Fed would bludgeon the economy with a hammer is what sent the stock market reeling on Friday, as corporate profits is the nail that would feel the brunt of the hammer. We sense, however, that Powell is not too unhappy with the market's reaction, as tightening financial conditions would aid the Fed in slowing growth via the wealth effect. Importantly, we believe the Fed is trying to send a message to both employers and workers, signaling to the former that it would be prudent to slow hiring and for workers to accept smaller raises rather than risk losing a job. If the message gets through, a big step towards cooling inflation would be accomplished, as would the odds of incurring only a mild recession, if not a soft landing.

## FINANCIAL INDICATORS

INTEREST RATES	Aug 26	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.77%	2.37%	2.37%	0.05%
6-month Treasury bill	3.23	3.11	2.87	0.05
3-month LIBOR	3.04	2.98	2.78	0.12
2-year Treasury note	3.36	3.23	2.88	0.20
5-year Treasury note	3.19	3.07	2.68	0.80
10-year Treasury note	3.03	2.97	2.65	1.31
30-year Treasury bond	3.20	3.01	3.09	1.92
30-year fixed mortgage rate	5.55	5.13	5.30	2.87
15-year fixed mortgage rate	4.85	4.55	4.58	2.17
5/1-year adjustable rate	4.36	4.39	4.29	2.42

STOCK MARKET				
Dow Jones Industrial Index	32,283.40	37,706.74	32,845.13	35,455.80
S&P 500	4,057.66	4,228.48	4,130.29	4,509.37
NASDAQ	12,141.71	12,705.22	1,239.69	15,129.50

COMMODITIES				
Gold (\$ per troy ounce)	1,749.80	1,760.30	1,782.70	1,820.90
Oil (\$ per barrel) - Crude Futures (WTI)	92.85	89.95	98.30	68.68

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (July) - 000s	511	585	630	640
Durable Goods Orders (July) - % change	0.0	2.2	0.8	0.6
Personal Income (July) - % change	0.2	0.7	0.6	0.5
Personal Consumption (July) - % change	0.1	1.0	0.5	0.6
Savings Rate (July) - Percent	5.0	5.0	5.2	5.3

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