GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—October 17th, 2022

It was another eventful week on the financial and economic fronts; market yields and stock prices swung widely in both directions, and Washington's statistical mills generated more explosive data amid an already combustible landscape that is sure to keep policy makers on edge. There are still a myriad of questions about the health of the economy and how well it can navigate the headwinds and tailwinds that continue to nudge it in conflicting directions. But amid the fog of uncertainty, some themes are clearly coming into focus. Inflation continues to run hot, the Federal Reserve is primed to stick with its aggressive rate-hiking campaign, and the risk of a recession looms larger than it did a week ago.

The heightened prospect of a downturn gained more credibility following this week's release of the minutes of the last Federal Reserve meeting held on September 20-21. While the thrust of the message remained intact, i.e., the top priority is to bring inflation under control, the minutes highlighted the urgency with which policy makers view the challenge. Simply put, a key takeaway from the newly released minutes is that Fed officials are more concerned about under-reacting than over-reacting to an inflation cycle that is turning out to be far more persistent and entrenched than perceived in earlier meetings. It's hard not to interpret this sentiment as anything but a willingness to sacrifice economic growth for the sake of restoring price stability (and the Fed's inflation-fighting credibility).

Unsurprisingly, one widely followed market indicator – the spread between the 2 year/10-year Treasury yield – is solidly in recession-pointing territory, as it is currently more inverted than it was prior to the last four downturns. To be sure, the Fed is not openly confirming its acceptance of a recession to achieve its goal, as that would entail confidence-shattering risks to the financial markets as well as to the public, with unintended and potentially devasting consequences. Indeed, subsequent comments by the Fed's Vice Chair, Lael Brainard, toned down the Fed's message a bit, noting that it is important to pause at some point to assess the damage previous policy actions are having on economic activity.

Brainard's comments are a useful reminder that monetary policy affects the economy with long and variable lags. It's important to remember that the current tightening cycle began a relatively short time ago and has progressed at the most rapid and aggressive pace since the early 1980s. It's unlikely the economy has felt the full impact of the moves taken so far. The crumbling housing market is the first shoe to drop, but that was entirely expected given its sensitivity to financial conditions. With mortgage rates on the doorstep of 7 percent this week, a level not seen in more than 20 years, this sector is facing more hard times in coming months. But despite growing risk to the economy down the road, the Fed understandably needs to confront the clear and present danger of escalating inflation, which continued to take center stage amid this week's spate of economic reports.

Importantly, there was very little in the consumer price report that inspires optimism the Fed is making progress on the inflation front. The headline consumer price index did slow a tad, increasing 8.2 percent in the year through September compared to 8.3 percent the previous month. But the slowdown was less than expected and primarily reflected falling gasoline prices. That drag was not enough to offset rising food and other prices, so the overall CPI rose by 0.4 percent, the largest in four months. What's more, the relief from falling gas prices has since been arrested, as prices at the pump have crept up in recent weeks. More disconcerting is that the core CPI, which strips out volatile food and energy items and is a better gauge of the underlying trend, accelerated during the month. The annual rate of the core CPI leaped from 6.3 percent to 6.6 percent, the highest in 40 years.

Not all the details in the consumer price report were downbeat. Indeed, there were actually some hopeful signs. The annual increase was undeniably ugly, but momentum appears to have peaked. Over the past three months, for example, the annual rate of increase in the core CPI slipped to just under 6 percent from 6.5 percent in August and a peak of 7.9 percent in June. More than likely, the annual rate will also start declining as prices over the next three months will be measured against an elevated base a year ago, which was pumped up by robust price gains during the fall months. There's also some positive news on prices of goods, the prime inflation catalyst throughout the pandemic until recently. Commodity prices fell 0.3 percent last month, reflecting the aforementioned drop in energy prices. Even excluding food and energy, goods prices were unchanged last month, and more than a handful of products became cheaper, including used cars, apparel, and major appliances.

Indeed, for the first time since the onset of the pandemic core goods prices are increasing more slowly than services – 6.6 percent versus 6.7 percent over the past year. This trend shift is not surprising, as the reopening economy from pandemic lockdown has spurred consumers to spend more on services than physical goods. Odds are, goods producers will see their pricing power eroded further in coming months for a variety of reasons. For one, supply shortages are easing, and many high-profile retailers are stuck with excess inventories that they are marking down aggressively to clear shelves. For another, demand for big-ticket goods is vulnerable to the Fed's rate-hikes, as they are usually purchased on credit and can more readily be postponed when budgets are squeezed than essential purchases of nondurable goods, such as food and clothing. Many big-ticket items are also linked to a home purchase and, hence, are a victim of the sagging housing market.

To some extent, therefore, the Fed's policy moves in curbing goods inflation are bearing fruit. But the persistent increase in service prices is a more difficult hurdle to overcome, as they are stickier and account for a larger share of purchases that most households make. Most notably, housing costs, which comprise more than 40 percent of core consumer prices, are rising at the fastest clip in more than 30 years. Some relief should be forthcoming from sagging home sales and the slowdown in home price appreciation that is unfolding. But rents follow housing prices with a considerable lag, and an inflection point in rental costs may not be seen until well into 2023. Meanwhile, other service prices are coming under strong pressure from rising labor costs and still-solid demand from consumers.

Contrary to widespread reporting, the September consumer price report is not the last inflation reading the Fed will see before its next policy meeting on November 1-2. Later this month, the broader personal consumption deflator will be released as part of the personal income and consumption report. However, it's doubtful that it will deviate significantly from the trend portrayed in the CPI report, which further solidifies the likelihood the FOMC will push through another outsize 0.75 percentage point increase in the federal funds rate, lifting it to the 3.75-4.00 percent range, well above the 2.5 percent peak hit during the pre-pandemic expansion. While officials will no doubt discuss the risk of going too far and sending the economy into a recession, the bias to continue raising rates will be equally as strong.

The primary encouragement of course will be the ongoing strength in the job market, where extremely tight conditions are unwinding far too slowly for the Fed's liking. But officials will also be looking at how households are holding up under the weight of the rate hikes put in place. While recognizing the lags involved, they can only respond to what they see, and the latest retail sales report suggests that consumers are keeping their wallets open. On the surface, it looks like they are pulling back as retail sales were unchanged in September. But the retail report is mostly about goods and, as noted, commodity prices fell last month, so the volume of goods sold by retailers actually increased. The only glimpse of service spending in the report was for restaurant and bars, where spending rose by 0.5 percent. Importantly, the control group of sales, which excludes autos, building material, gasoline and food services, and feeds directly into the calculation of GDP, increased by a respectable 0.4 percent following an upwardly revised

0.2 percent gain in August. Households are clearly hurting from inflation and sharply higher borrowing costs but they apparently still have enough firepower to weather the headwinds coming from the Fed – at least for a while.

FINANCIAL INDICATORS

INTEREST RATES	Oct 14	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.71	3.37	3.14	0.05
6-month Treasury bill	4.32	4.09	3.81	0.06
3-month LIBOR	4.08	3.83	3.53	0.12
2-year Treasury note	4.51	4.31	3.87	0.40
5-year Treasury note	4.27	4.15	3.64	1.13
10-year Treasury note	4.02	3.89	3.45	1.57
30-year Treasury bond	4.00	3.85	3.52	2.04
30-year fixed mortgage rate	6.92	6.66	6.02	3.05
15-year fixed mortgage rate	6.09	5.90	5.21	2.30
5/1-year adjustable rate	5.81	5.36	4.93	2.55
STOCK MARKET				
Dow Jones Industrial Index	29,634.83	29,296.39	30,822.42	35,294.76
S&P 500	3,583.07	3,639.66	3,873.33	4,471.37
NASDAQ	10,321.39	10,652.40	11,448.40	14,897.34
COMMODITIES				
Gold ($ per troy ounce)	1,650.20	1,701.80	1,684.40	1,768.10
Oil ($ per barrel) - Crude Futures (WTI)	85.55	93.20	85.30	82.66

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Consumer Price Index (Sept) - % change	0.4	0.1	0.0	0.5
Core CPI (September) - % change	0.6	0.6	0.3	0.6
Producer Price index (Sept) - % change	0.4	-0.2	-0.4	0.4

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