GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—October 24th, 2022

This week's lean calendar of economic data focused mainly on the housing market. Since that's the most rate-sensitive sector of the economy, it should come as no surprise that the news was uniformly downbeat. As a time-honored leading indicator of recessions, the dismal readings on homebuilding activity and sales further solidified widespread perceptions that a downturn is just around the bend. Indeed, the consensus of economists expects a recession to occur at some point next year. We are on board with that outlook and believe it will unfold over the first half of 2023, albeit the peak to trough should be relatively mild barring a financial accident or some other shock that would dial up its severity.

That said, hard evidence of a looming recession is still hard to find – at least in the United States. No doubt, there's plenty of signs that Europe, China and a host of undeveloped nations are falling on hard times, and some of that adversity can be traced back to the strength of dollar. Not only is energy in short supply overseas thanks to the war in Ukraine, but transactions in the oil market are conducted in dollars and, hence, the greenback's strength makes purchases ever-more expensive. Ditto for dollar-denominated loan repayments by foreign entities that now find their debt burdens heavier, as the loans must be paid back in more expensive dollars. The prospect of debt defaults, particularly among emerging market countries, looms as an under the radar threat to the global economy with unpredictable consequences to the U.S. financial system.

The Federal Reserve – and the U.S. Treasury – is keenly aware of that threat and protective measures are no doubt being developed behind the scenes. Should an accident explode on the global financial markets, the long-discussed pivot away from the current aggressive rate-hiking campaign would most likely be taken. Many believe that only a severe financial accident would cause the Fed to abandon its current stance. That, or tangible evidence that the five rate increases since March is putting the inflation genie back in the bottle or sending the economy into a tailspin that would inevitably bring about the same result. While the markets are firmly on recession watch, they do not expect policy makers to do an about-face anytime soon. If anything, several Fed officials this week affirmed their commitment to stay the course until the inflation dragon is slayed.

The bottom line is that more rate increases are on the way, with another 0.75 percentage point increase in the federal funds rate likely at the upcoming policy meeting on November 1-2 and a high probability of a similar-size hike in December. The front-loading of monetary tightening reflects in good part the Fed's attempt to compensate for its belated response to the inflation outbreak that should have started at least several months earlier than it did. The risk is that it may be facing a mirror image of the mistake it made last year. By waiting too long to start its rate-hiking campaign, the Fed allowed inflation to gain traction and become more firmly entrenched in the economy, making it harder to control. But the aggressive front-loading of rate hikes and the commitment to stay on a restrictive path until there is clear evidence of a sustained inflation retreat runs the risk of sending the economy into a deeper nosedive than necessary, which would also become difficult to arrest and require drastic corrective measures. This prospect invokes the type of lurching policy swings that was so prevalent during the unsettled economic environment of the 1970s.

Unfortunately, the case for more monetary tightening in coming months is strong, which points to more pain for the beleaguered housing market. The rapid runup in mortgage rates and still-sky high home prices, notwithstanding recent setbacks, has severely eroded housing affordability and is undercutting home sales. The latest evidence of the sinking sales market highlighted the week's light slate of economic releases. Existing home sales – which account for more than 90 percent of total home sales – fell for the eighth

consecutive month in September, the longest stretch of consecutive declines since the housing collapse in 2007. Importantly, these sales figures reflect contracts signed a month or two earlier when mortgage rates still had a 5 handle. Since then, the 30-year rate has climbed to just a tad under 7 percent, standing at 6.94 percent in the latest week, according to Freddie Mac.

The further escalation of mortgage rates just about assures that home sales will continue to plummet in coming months. And while elevated borrowing costs is sending would-be buyers to the sidelines, it is also taking homes off the market, keeping inventories tight and sustaining upward pressure on prices. That's because millions of homeowners who might otherwise put their homes up for sale are locked in with mortgages taken years earlier when rates were much lower. Nor are homebuilders taking up the slack, as construction of new homes is also falling by the waysides. Housing starts fell another 8.1 percent in September, and the outlook, particularly for single-family homes, is looking grimmer by the day. Single-family permits – a leading indicator of construction activity – fell for the seventh consecutive month and stands 17 percent below year-ago levels. With sales and home-buying traffic falling off a cliff, construction costs high and labor in short supply, homebuilder sentiment is, unsurprisingly, also plunging. The National Association of Homebuilders reports that its sentiment index fell by a whopping 8 points in October, the tenth consecutive monthly decline. Except for two months in the spring of 2020, the onset of Covid, the index has not been this low in more than 10 years.

The Fed's latest Beige Book that summarizes regional economic conditions highlighted the unfolding weakness in the housing market. But that's not likely to deter the Fed from if its efforts to cool demand as slumping housing activity does not pose an existential threat to the economy. Residential outlays account for 4.6 percent GDP, considerably below the 6.7 percent share at the end of 2005 before the housing collapse and ensuing financial crisis it precipitated brought the economy to its knees. Housing's indirect threat via financial stress is even less concerning as there is no subprime catastrophe waiting in the wings and lending institutions maintain far stronger balance sheets than was the case in 2007. That said, the housing setback will take a toll on the broader economy as fewer home sales means that would-be buyers and sellers are spending less on home furnishings, moving services, appliances, and other big-ticket items than otherwise.

But the main cooling effect on demand – and, hence, inflation – would derive from more fundamental sources, most notably from a weaker job market that slows wage and income gains and saps consumer purchasing power. So far, the Fed's efforts have had minimal success on that front. By just about any measure, the job market remains historically tight and sturdy wage gains are allowing consumers to keep their wallets open. To be sure, households have used up a good deal of firepower this year, drawing on the excess savings accumulated during the pandemic to help sustain spending. Consumption growth slowed considerably in the third quarter, and we expect it to fade even more rapidly in the fourth as higher borrowing costs and inflation puts a further squeeze on household budgets.

But despite slower sales, businesses are holding on to workers and still hiring at a robust pace. The reluctance to lay off staff even in the face of weaker revenue growth is evidenced by the low level of claims for unemployment benefits, which at the latest reading for mid-October hovered just below the average level of 2019. With job openings almost two times greater than unemployed workers, labor shortages continue to be a pressing issue for businesses, prompting them to keep workers on their payroll even if sales are weakening. The difficulty of rehiring workers during the post-pandemic recovery is still fresh in minds, spurring many employers to risk being overstaffed during a mild slowdown to avoid being understaffed and ill-equipped to accommodate a rebound in demand later on.

We suspect that the Fed will not pivot from its rate-hiking campaign until there is clear evidence the job market is cooling and wage pressures are easing. But despite headlines of numerous major corporations cutting headcount and slashing hiring amid growing recession fears, the anecdotal reports are not yet showing up in the hard data. Still, there are faint signs of progress as job growth and new listings are slowing and beginning to curb wage increases. The Atlanta Federal Reserve's wage tracker slowed in September for the first time since last October, and the 0.4 percent slide from 6.7 percent to 6.3 percent was the largest

monthly drop since August 2009. It was also the first time in five months that this wage growth measure increased more slowly than the core consumer price index.

FINANCIAL INDICATORS

INTEREST RATES	Oct 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.99	3.71	3.19	0.06
6-month Treasury bill	4.44	4.32	3.90	0.07
3-month LIBOR	4.32	4.08	3.64	0.12
2-year Treasury note	4.50	4.51	4.21	0.46
5-year Treasury note	4.35	4.27	3.99	1.20
10-year Treasury note	4.23	4.02	3.69	1.64
30-year Treasury bond	4.34	4.00	3.61	2.08
30-year fixed mortgage rate	6.94	6.92	6.29	3.09
15-year fixed mortgage rate	6.23	6.09	5.44	2.33
5/1-year adjustable rate	5.71	5.81	4.97	2.54
STOCK MARKET				
Dow Jones Industrial Index	31,082.56	29,634.83	29,590.41	35,677.02
S&P 500	3,752.75	3,583.07	3,693.26	4,544.90
NASDAQ	10,859.72	10,321.39	10,867.93	15,090.20
COMMODITIES				
Gold ($ per troy ounce)	1,662.50	1,650.20	1,651.70	1,793.10
Oil ($ per barrel) - Crude Futures (WTI)	85.14	85.55	79.43	83.98

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two- Months/ Quarters Ago	Average- Past Six Months or Quarters
Housing Starts (September) - 000s	1,439	1,566	1,377	1,554
Building Permits (September) - 000s	1,564	1,542	1,685	1,668
Industrial Production (September) - % change	0.4	-0.1	0.7	0.3
Capacity Utilization (September) - % change	80.3	80.1	80.3	80.1
Existing Home Sales (September) - mlns	4.7	4.8	4.8	5.1

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