

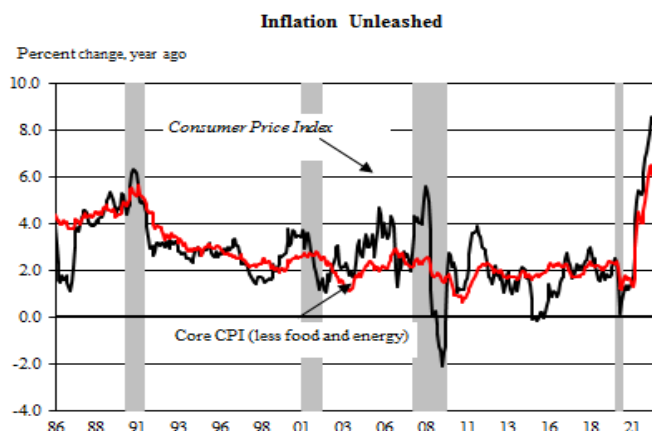
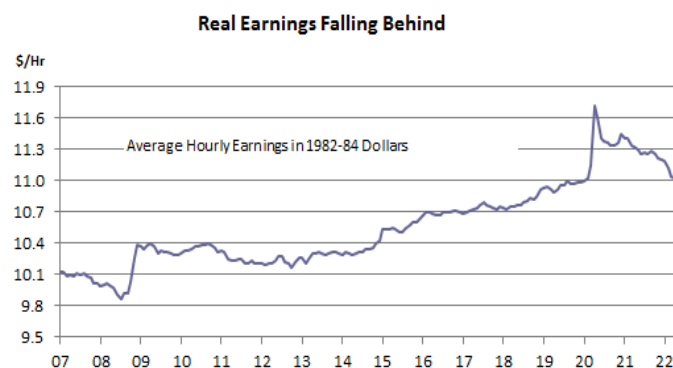
While consumers keep their wallets open, the fuel driving spending is starting to run out. True, the job-creating engine is still running on all cylinders, providing paychecks for 400 thousand new workers a month that will keep the spending spigot open for the foreseeable future. But those paychecks are getting less mileage in terms of what they can purchase, forcing households to tap into other financial resources to make up the difference. The good news is that they still have a formidable savings buffer to sustain shopping for a while longer. The bad news is that the financial cushion is rapidly deflating, thanks to accelerated drawdowns and adverse financial market conditions.

The diminished spending supports were starkly revealed in two key reports released this week. Taking center stage Friday was the government's data on consumer prices, which reaffirmed the drastic shrinkage in the dollar's purchasing power. The consumer price index surged by 1.0 percent in May, lifting the annual inflation rate to 8.6 percent – the highest since 1981 – from 8.3 percent in April. That's well ahead of the pay raises most workers are getting, which left them poorer in real terms. Adjusted for inflation, average hourly earnings fell 0.6 percent in May, the eighth consecutive monthly decline, leaving actual earnings no higher than they were in December 2018.

As expected given the headline-grabbing surge at the pump, gasoline prices were the primary inflation booster last month, spiking by nearly 50 percent over the past year. Overall, energy prices staged an eye-opening 34.6 percent increase, which translates into higher household electricity and fuel bills. The other primary culprit is food, which climbed 10.1 percent over the past year, the fastest since 1981, including a whopping 14.2 percent increase in the cost of meat, poultry, fish, and eggs. These skyrocketing prices on items that households frequently purchase are sure to inflame inflation concerns, particularly among lower-income consumers. It's doubtful they will be comforted by the notion that food and energy costs are being stoked largely by the war in Ukraine.

Importantly, core inflation, which excludes food and energy items, offers only slight comfort to policymakers and economists who view this gauge as a better measure of the underlying inflation trend. The core CPI increased 0.6 percent in May, matching the previous month's increase, unlike the headline index, which accelerated from 0.3 to 1.0 percent from month to month. That leveling off lowered the annual increase in the core CPI from 6.3 percent to 6.0 percent. But the slowdown, while welcome, was still less than the expected slide to 5.9 percent. What's more, some enduring influences are propping up the core CPI, which will make any retreat from the elevated inflation rate painfully slow.

Most notable is the sustained upward pressure on housing costs, which account for an outsized 41 percent weight in the core index. Shelter prices increased 0.6 percent last month, lifting the annual rate to 5.5 percent, the fastest since 1991. Rents are surging in most regions of the country, echoing the historic rise in home prices that is pushing vast swaths of



would-be homebuyers into apartments. With rising mortgage rates and surging home prices making a home purchase unaffordable for an ever-larger share of the population, the demand for rental units will not subside anytime soon – sustaining upward pressure on housing costs.

Unsurprisingly, the latest reading on consumer prices roiled the financial markets, sending stock prices into a nosedive and driving up interest rates. Any hope that the consumer price report would reveal a moderating trend and allow the Federal Reserve to move more slowly to contain inflation fell by the wayside on Friday. The Fed will almost certainly raise its policy rate by a half-percentage point at its meeting next week and most likely in July as well. Indeed, the 2-year Treasury yield leaped above 3

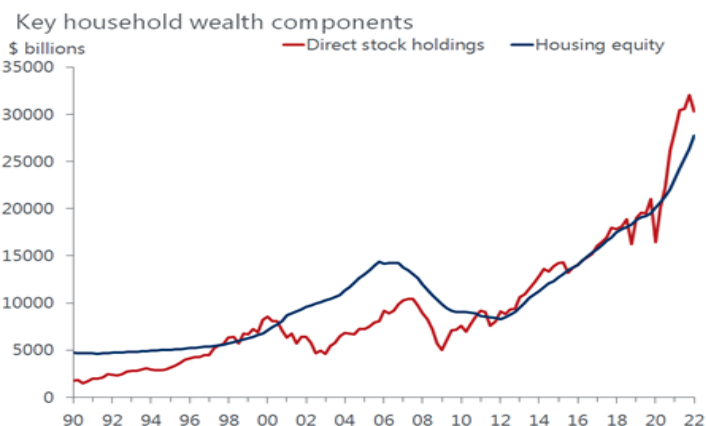
percent on Friday for the first time since late 2007, implying three 50 basis point increases over the next three meetings.

No doubt, expectations of an even more aggressive move will gain traction in the financial markets, a knee-jerk reaction to the dismal price report. Should the Fed follow through with bigger –and more frequent – rate hikes, the odds of achieving the elusive soft landing for the economy would diminish. The Fed has never accomplished that feat with an inflation rate running above 5 percent. As it is, most Americans already believe the nation has fallen into a recession, a perception highlighted by the plunge in the University of Michigan's sentiment index to the lowest level on record in early June.

The ongoing downdraft in stock prices is slicing more wealth from household balance sheets. According to this week's other major report released by the Federal Reserve, household net worth fell in the first quarter for the first time in two years. The fall in stock prices during the period wiped out \$1.7 trillion of equity holdings on household balance sheets, more than offsetting the gain in housing equity and resulting in a \$544 billion decline in net worth. Since the end of the first quarter, stock prices have continued to swoon, with the S&P 500 down more than 13 percent as of Friday afternoon. That translates into a hit of more than \$4 trillion in the portfolios of stocks directly held by households. However, it's important to note that the top 10 percent of wealthy households hold more than 90 percent of stocks and are unlikely to reduce spending meaningfully because of the market setback. Indeed, they may even jump in to buy more shares.

From a macro perspective, the negative wealth effect from tumbling stock prices is likely to be blunted by the ongoing rise in home values, which benefits a much broader spectrum of the population. In the first quarter, homeowners saw their housing equity increase by \$1.4 trillion, raising the equity stake in their properties to 69.9 percent, the highest share since 1986. Importantly, unlike stock prices, home values have continued to increase in the second quarter, providing more of a financial cushion for homeowners. According to most research, changes in home equity have a more considerable wealth effect on spending than changes in stock values. That said, Americans tend to view the stock market as a barometer of economic health, so the current market setback would only add to the downbeat mood of households.

We believe households still have enough firepower to keep the economy growing through the rest of the year, thanks mainly to the healthy job market and a formidable – although shrinking – savings buffer. But escalating inflation, especially on the goods and services, such as food, gas, and utilities, as well as housing costs that command an outsized share of budgets for low and middle-income households, is delivering a harsh blow to confidence. So far, spending has held up; but the Fed is determined to cool demand to rein in inflation, which involves injecting some softness into the labor market. The risk is that its efforts become too successful, prompting an increase in unemployment and a hard landing for the economy.



FINANCIAL INDICATORS				
INTEREST RATES	June 10	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.34%	1.18%	0.93%	0.03%
6-month Treasury bill	1.96	1.65	1.44	0.04
3-month LIBOR	1.72	1.63	1.41	0.12
2-year Treasury note	3.07	2.68	2.52	0.17
5-year Treasury note	3.27	2.93	2.86	0.74
10-year Treasury note	3.16	2.94	2.92	1.45
30-year Treasury bond	3.20	3.09	2.99	2.14
30-year fixed mortgage rate	5.23	5.09	5.30	2.96
15-year fixed mortgage rate	4.38	4.32	4.48	2.23
5/1-year adjustable rate	4.12	4.04	3.98	2.55
STOCK MARKET				
Dow Jones Industrial Index	31392.79	32899.70	32196.66	34479.6
S&P 500	3900.86	4108.54	4023.89	4247.44
NASDAQ	11340.02	12012.73	11805.00	14069.42
Commodities				
Gold (\$ per troy ounce)	1875.20	1853.90	1810.30	1879.5
Oil (\$ per barrel) - Crude Futures (WTI)	120.49	120.26	110.18	70.78
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Trade Deficit (April) - \$blns	87.1	107.7	88.1	87.9
Consumer Credit (April) - \$blns	38.1	47.3	34.1	31.6
Consumer Price Index (May) - % change	1.0	0.3	1.2	0.8
Core CPI(May) - % change	0.6	0.6	0.3	0.5

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