WEEKLY ECONOMIC COMMENTARY

The Federal Reserve is still hoping to wring inflation out of the system without causing too much damage to the economy – achieving the ever-elusive soft landing. But Chair Powell now admits this months-long goal may not be achieved as painlessly as hoped. In the wake of last week's eye-opening inflation report, the Fed hiked its prime lending rate by three-quarters of a percentage point, the steepest one-off increase since 1994, at its policy meeting this week. At his post-meeting press conference, Powell acknowledged that inflation has become even more persistent and virulent than expected, and wringing it out of the system is now the Fed's top priority, even if it means causing some increase in unemployment.

Hence, Fed officials made it abundantly clear that they have run out of patience waiting for transitory inflation-boosting forces to fade. They will do whatever it takes to bring demand back into alignment with supply. That means more rate hikes are in store, including the likely increase of another three-quarters of a point at the July policy meeting and continued increases at subsequent meetings that will land the federal funds rate above 3 percent by the end of the year from the current range of 1.50-1.75 percent. The Fed recognizes that this will inflict some collateral damage on the economy, as it lowered its growth forecast and expects the job-creating engine to cool down.

Indeed, in the summary of economic projections, Fed officials bumped up their unemployment rate forecast. It is now expected to rise to 4.1 percent at the end of 2024 from the current 3.5 percent. That's still a low rate historically, but a recession has always accompanied increases above half percent. Not surprisingly, recession fears have gained traction in the financial markets, sending stock prices reeling and putting the market on track to suffer its worst first-half performance since 1962. These fears overtook escalating market-based inflation expectations that sent bond yields surging heading into the Fed's latest meeting; in the two days since the meeting, yields have slipped by 15-25 basis points. The drumbeat of investor pessimism regarding the economy aligns with the ever-deepening downbeat mood among households and business leaders.

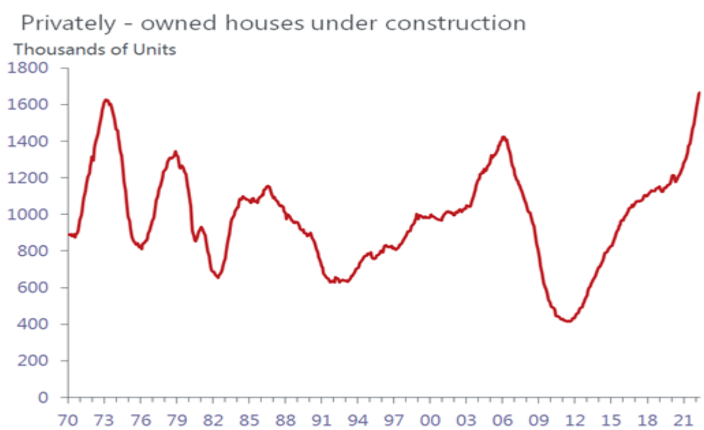
Clearly, the recent increase in household inflation expectations was a key factor prompting the Fed to take a more aggressive rate-hiking stance. The bolder moves are deemed necessary to short-circuit expectations before they become self-fulfilling. As households expect inflation to accelerate, they will demand more considerable wage increases, which companies would grant, expecting consumers to accept higher prices with their fatter paychecks, setting in motion a self-perpetuating cycle. The risk, however, is that the Fed, in demolishing inflation expectations, would replace that mindset with deepening recession expectations. That too, could become a self-fulfilling prophecy. Households would then cut back on spending amid rising job insecurity, prompting firms to lay off workers in response to weaker sales, ushering in a vicious downward cycle toward recession.

To be sure, the Fed does not intend to bring about a recession. But if a "softish" downturn involving a peak unemployment rate of 4.1 percent bottles up the inflation genie, it would likely consider that outcome a success. It may even draw some comfort from the last time it hiked rates by as much as 75 basis points at a policy meeting. That was in November 1994, which led to the rare soft landing in which the economy slowed but didn't break. The Fed followed that increase with one more hike, of a half percent, in March 1995, which set the stage for another five years of vibrant growth until the dot.com bust ushered in a mild recession in March 2001. However, at that time, the Fed aimed to keep inflation from rising above the 2-3 percent range and was not tightening into a confidence-shattering bear market in stocks and swooning business and consumer confidence.

The challenge facing the Fed now is considerably more daunting. Bringing inflation down from nosebleed levels involves a much greater risk of overkill (see 1981) than preventing inflation from rising. The task is rendered more difficult because the Fed is striving to calibrate demand with supply that is artificially constricted by the war in Ukraine, Covid-related lockdowns, and supply snarls that prevent goods from reaching retailer's shelves. The best-case scenario is to align demand with the economy's potential output and hope that the forces restricting supply are lifted sooner rather than later – or at least before a recession sends unemployment well above the Fed's 4.1 percent wishful target.

The critical unknown in guiding demand into that sweet spot is determining how hard to step on the brakes. Simply put, the Fed needs to be nimble and prepared to ease up when signs of a tipping point appear. Alternatively, if inflation remains stubbornly high despite signs of a slowdown, how much pain is the Fed willing to inflict on the economy to bring it down?

There is no easy answer to that question, but it's doubtful that the harsh growth-stifling rate hikes needed to break inflation in the late 1970s will be required this time. The economy is in a much different place than it was then, and the Fed's task is made easier by the considerable amount of inflation-fighting credibility it has accumulated over the past 30 years.

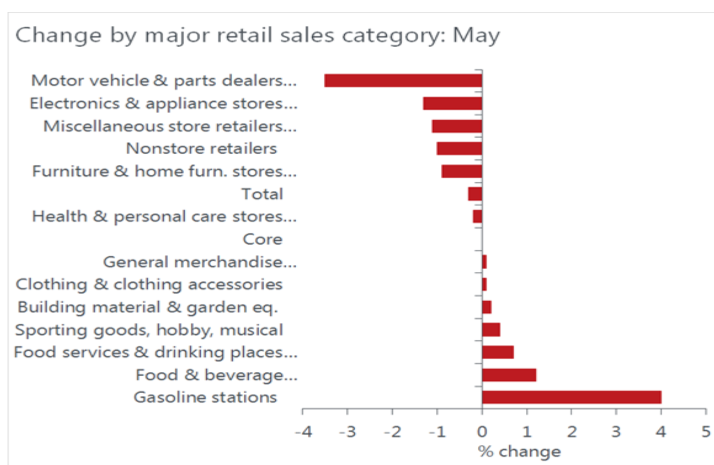


From our lens, the unexpected resilience of the inflation upsurge is spurring more aggressive rate hikes than expected a few months ago, which raises the odds that a mild recession will set in sometime next year. As it is, the swift and abrupt response in the financial markets to the Fed's expected moves has pulled forward the weakening trend that a more moderate policy would have produced later in the year. The half-point increase in mortgage rates this week – the steepest one-week increase since 1987 – punctuated a steep climb since the beginning of the year that has sent home sales tumbling and causing builders to rethink construction plans. Highlighting the latter, housing starts fell by a steep 14.4 percent in May to the lowest level in over a year.

Not too long ago, builders were scrambling to get more houses on the market to meet demand. Now, inventories in the new-home market are spiraling relative to sales, and the pipeline is bulging. Total houses under construction – apartments and single-family homes combined – are at an all-time high. So far, home prices continue to climb, thanks mainly to existing homeowners staying put and keeping their houses off the market. But when the burgeoning supply of new homes under construction hits the market, that should ease the upward pressure on prices. Meanwhile, housing construction is likely to be a drag on the economy over the foreseeable future.

Housing has a relatively minor influence on the economy, and its recent swoon would not, by itself, bring it to its knees. More important is the consumer, which drives 70 percent of the growth engine and is the lifeblood of the expansion. Therefore, signs of a pullback in consumer spending are the most tangible evidence yet that the economy is losing momentum. In May, retail sales fell for the first time this year, slipping by 0.3 percent. If not for the surge in gas prices, which siphoned off dollars that could have been spent elsewhere, sales would have fallen by 0.7 percent.

Even so, sales in current dollars for core goods (excluding price-driven gasoline, volatile autos, and building material items) that enter the GDP calculations were unchanged last month, the first time this category failed to increase this year. While this confirms the slowdown in spending, it is important not to exaggerate the consumer retrenchment, as the pullback in goods purchases last month was probably more than offset by an increase in spending for services. Households still have a formidable cash cushion to tap into, and wages are rising amid a robust job market. We still believe that consumers will keep the economy afloat, but they face stiffer headwinds from inflation and the Fed's rate-hiking campaign.



FINANCIAL INDICATORS				
INTEREST RATES	June 17	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.61%	1.34%	1.01%	0.05%
6-month Treasury bill	2.22	1.96	1.45	0.06
3-month LIBOR	2.06	1.72	1.50	0.13
2-year Treasury note	3.19	3.07	2.61	0.25
5-year Treasury note	3.35	3.27	2.82	0.87
10-year Treasury note	3.24	3.16	2.79	1.44
30-year Treasury bond	3.28	3.20	2.99	2.02
30-year fixed mortgage rate	5.78	5.23	5.25	2.93
15-year fixed mortgage rate	4.81	4.38	4.43	2.24
5/1-year adjustable rate	4.33	4.12	4.08	2.52
STOCK MARKET				
Dow Jones Industrial Index	29.858.78	31392.79	31262.90	33290.08
S&P 500	3674.84	3900.86	3901.36	4166.45
NASDAQ	10798.35	11340.02	11354.62	14030.38
Commodities				
Gold ($ per troy ounce)	1843.80	1875.20	1845.10	1763.9
Oil ($ per barrel) - Crude Futures (WTI)	109.91	120.49	112.70	71.50
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (May) - 000s	1549	1810	1716	1714
Building Permits (May) - 000s	1695	1823	1879	1832
Retail Sales (May) - % change	-0.3	0.7	1.2	1.2
Producer Price Index (May) - % change	0.8	0.4	1.6	0.9