WEEKLY ECONOMIC COMMENTARY

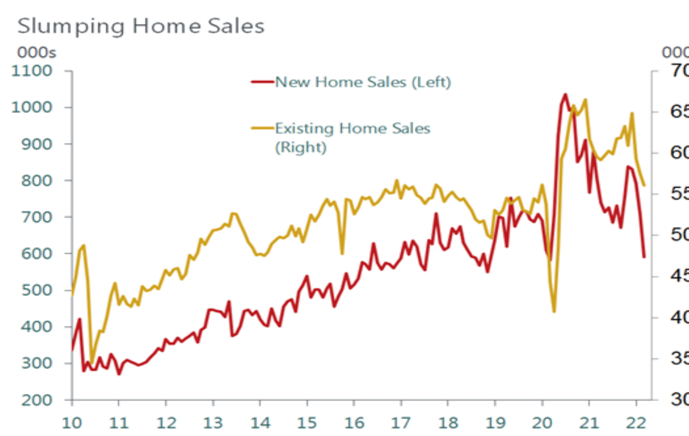
Following seven consecutive weekly declines, the stock market staged a robust advance this week, with the S&P 500 gaining 6.6 percent. Investors were apparently encouraged by the May 3-4 FOMC meeting minutes, as Fed officials did not sound as hawkish a note as feared. Still, there is no question that the Fed is continuing on its aggressive rate-hiking path, with taming inflation as the primary objective. The key takeaway from the minutes is that they confirmed expectations that the Fed was poised to raise its policy rate by 50 basis points in each of the next two meetings, following the similar half-point hike taken at the May meeting.

The Fed is moving rapidly to unwind its turbo-charged easy policy, hoping to get ahead of the inflation upsurge that has progressed much faster than expected. At the March FOMC meeting – the last one that contained a summary of economic projections – Fed officials expected to lift the federal funds rate to 1.9 percent by the end of the year. That target would be met by July if the two 50 basis point increases were taken by then, as expected. According to the minutes of the May meeting, "many participants judged that expediting the removal of policy accommodation would leave the committee well-positioned later this year to assess the effects of policy firming and the extent to which economic developments warranted policy adjustments."

The Fed may be front-loading its rate hikes because the next meeting after July is eight weeks away, on September 20-21, which is a longer interval than the usual six-week lag. Of course, a move between meetings could be taken, but that would be unusual and likely have a harsh, disruptive influence on the financial markets. By the third week of September, enough time would have passed to assess its aggressive rate hikes' impact on the economy and inflation. Interestingly, Fed officials in March expected to keep on raising rates next year, leaving the median funds rate at 2.8 percent at the end of 2023. That would exceed the peak 2.5 percent level reached at the end of the last tightening cycle in 2018, which has happened only once – in 2000 – over the previous six tightening campaigns since 1981. In the five other episodes, the funds rate peaked at a lower level than in the previous cycle.

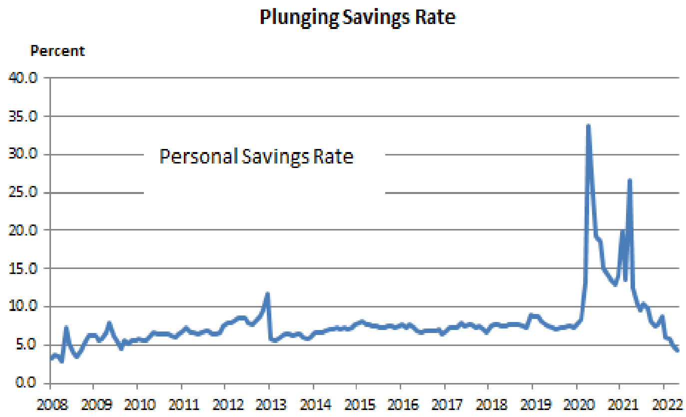
Given the more hawkish bias of Fed officials since the March meeting, the next set of projections presented at the June gathering will probably lift the year-end funds rate above the 1.9 percent projected in March. From our lens, there will be at least one more rate hike coming out of the three meetings left after July, although we expect future hikes this year to be scaled back to 25 basis points. The question is, will the Fed take its foot off the brakes before the end of the year? Until recently, the sentiment for continuing on the present course was strong. But the case for a pause is building, reflecting growing recession concerns that have recently emerged. While we believe fears of a downturn over the near term are overblown, the risk of a hard landing next year has increased, particularly if the Fed goes too far and chokes off demand even as supply disruptions – which are outside of the Fed's control – continue to stoke inflation.

So far, the main impact of the Fed's aggressive rate hikes has fallen on the housing market, where sharply rising mortgage rates and surging home prices have stifled sales. The setback in home sales has been pronounced in both the new and existing housing market, with this week's report revealing the fourth consecutive monthly drop in new home sales in April. The decline for existing homes has stretched out to three months but is poised to continue in the months ahead, as pending homes sales –contracts signed but not yet closed – fell for the sixth consecutive month in April. Housing activity will not be a plus for the economy as we advance, but its potential drag on activity should be more than offset by strength elsewhere.



Importantly, the ongoing sales slump is helping to correct the imbalance that has buffeted the industry over the past year. The supply of homes on the market is still historically lean, particularly in the existing sector, but is starting to pick up. Reports of homes taking longer to sell are increasing, and bidding wars are subsiding. The starkest evidence of easing supply shortages appears in the new home market, where inventories shot up to a 9-month supply, the highest since May 2010, based on the April selling rate. Unfortunately, less than 10 percent of those homes are completed, reflecting construction delays caused by shortages of parts and labor. However, as finished homes start to hit the market, some relief on the price front may be forthcoming, which should eventually help moderate the climb in rents, a significant component of the consumer price index.

As noted, the housing slump, unless accompanied by an unlikely financial crisis, would not constitute enough of a drag on overall growth to bring on a recession. The recent increase in recession fears is linked more to the potential damage that higher interest rates and inflation would have on consumers, the economy's main growth driver. Here, the latest data presents a mixed message. On the surface, consumers are far from ready to roll over. Thanks to a still robust job market

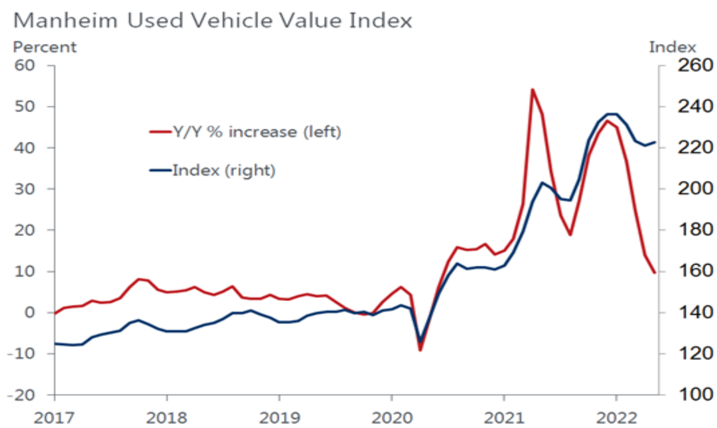


that is boosting incomes and healthy balance sheets, households are still keeping their wallets wide open. In April, spending on goods and services increased by a sturdy 0.9 percent, following a lofty 1.4 percent gain in March.

Unlike the March increase, which was driven primarily by higher prices, the April gain mainly consisted of real goods and services. Personal consumption adjusted for inflation increased by a buoyant 0.7 percent, more substantial than the 0.5 percent March gain and the largest since January. Simply put, the second quarter started off on a solid footing. Indeed, if spending showed no further increase in May and June, real consumption – which accounts for around 70 percent of GDP – would increase by more than a 4 percent annual rate during the quarter, up from 3.1 percent in the first quarter. However, the April strength comes with an important caveat, as it was financed primarily with household savings. In contrast to the spending side, inflation wiped out all income gain, leaving real disposable income unchanged. Hence, the personal savings rate plunged to 4.4 percent in April, the lowest since September 2008.

That said, the low savings rate last month overstates the drain on household balance sheets, as bank accounts are still inflated by the copious stimulus payments and foregone spending during the pandemic. The fact that households are putting aside a smaller fraction of their incomes reflects their willingness to draw down those accumulated savings – estimated at over $2 trillion at the start of the year – to satisfy pent-up demand. Still, that is not a bottomless well, and sustained income growth will be a critical driver of consumption in the coming months. Keep in mind that most of the savings are held by wealthier individuals who are less compelled to need those funds to finance purchases.

While the ongoing strength in consumer spending bolsters the case to keep hiking rates, there are signs that inflation is moderating, which may encourage the Fed to be less aggressive in the coming months than otherwise. The annual increase in the personal consumption deflator slowed to 6.3 percent in April from to 6.6 percent in March, the first slowdown since November 2020, while the core PCE also moderated to 4.9 percent from 5.2 percent. While the base effects are helping, the monthly increase in the headline PCE also cooled, as the 0.2 percent April increase was the slimmest since November 2020 as well. More specifically, some key markets where acute supply shortages have driven up prices are seeing less pressure. One that stands out is the auto sector, where parts are coming on stream and lifting production. According to a widely-followed gauge of used car prices – the Manheim Index – price increases have slowed to 9.4 percent in May, a steep fall off from the near 50 percent increases seen a year ago.



FINANCIAL INDICATORS				
INTEREST RATES	May 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.06%	1.01%	0.81%	0.01%
6-month Treasury bill	1.52	1.45	1.40	0.03
3-month LIBOR	2.08	1.50	1.28	0.13
2-year Treasury note	2.47	2.61	2.65	0.14
5-year Treasury note	2.72	2.82	2.96	0.79
10-year Treasury note	2.75	2.79	2.86	1.55
30-year Treasury bond	2.97	2.99	2.93	2.26
30-year fixed mortgage rate	5.10	5.25	5.10	2.95
15-year fixed mortgage rate	4.31	4.43	4.40	2.27
5/1-year adjustable rate	4.20	4.08	3.78	2.59
STOCK MARKET				
Dow Jones Industrial Index	33212.98	31262.90	32977.21	34529.45
S&P 500	4158.24	3901.36	4131.93	4204.11
NASDAQ	12131.13	11354.62	12334.64	13748.74
Commodities				
Gold ($ per troy ounce)	1850.60	1845.10	1896.90	1906.3
Oil ($ per barrel) - Crude Futures (WTI)	115.07	112.70	104.13	66.63
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (April) - 000s of units	591	709	792	753
Durable Goods Orders (April) - % change	0.4	0.6	-0.7	1.0
Personal Income (April) - % change	0.4	0.5	0.6	0.5
Personal Consumption (April) - % change	0.9	4.4	0.6	0.8
Personal Savings Rate (April) - Percent	4.4	5.0	5.9	6.3