WEEKLY ECONOMIC COMMENTARY

Amid extreme volatility buffeting financial markets, the "nowhere to hide" syndrome has rarely been as pronounced as has been the case in recent weeks. Virtually all asset classes have taken a hit in the just-concluded third quarter, and investors across the spectrum are feeling the pain. The one asset exception is the US dollar, which has gained about 18 percent against major currencies so far this year and shows no sign of weakening. Unfortunately, this emblem of US strength accentuates the pain overseas, making debt repayments more unbearable and adding to the inflationary pressures of US trading partners.

That said, even as the strong dollar helps the Fed curb inflation here via lower import prices, it also damages the earnings prospects of US corporations whose overseas revenues are now worth less when repatriated to the US. While that may be contributing to the weak performance of the stock market, other homegrown influences are clearly more impactful. Topping the list is the Fed's aggressive response to rampant inflation that stokes recession fears even as the economy generates mixed signals regarding its performance. Coming off of two consecutive quarterly declines in GDP, the third quarter looks to have staged a modest comeback – but the growth engine is clearly not running on all cylinders.

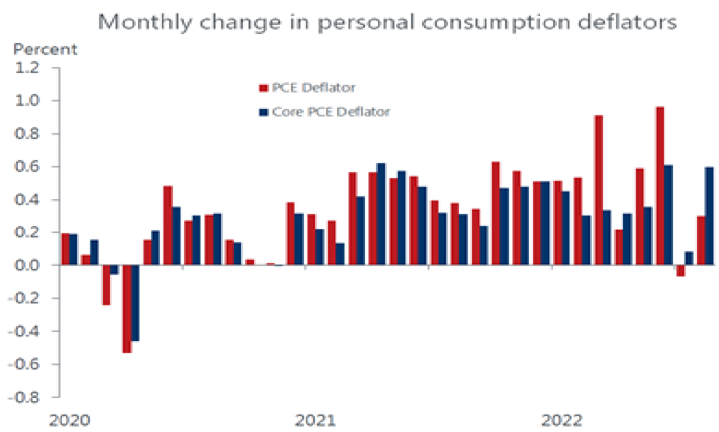
The weakest link, of course, is housing, the most interest-rate sensitive sector of the economy. The 30-year mortgage rate surged to 6.70 percent in the latest week, the highest since July 2007, making a home purchase unaffordable for a growing swath of the population. Sales are sagging, and the outlook is turning grimmer. Pending home sales – contract signings that lead existing home sales by a few months – fell to the lowest level since 2011 in August, excluding the brief plunge when the economy locked down in 2020. Since those signings, mortgage rates have jumped by another 1 ½ percent, suggesting more downside risks to already weakening sales prospects. With the sales outlook grimmer, builders are also pulling in their horns, applying for fewer building permits and breaking ground on fewer homes.

Despite the housing setback, few expect anything like the collapse that precipitated the 2007-09 Great Financial Crisis. The financial system is far stronger than it was then, homeowners have built up considerable equity in their property, lenders have been more diligent in providing mortgages to credit-worthy borrowers, and the housing market is not overbuilt. While sales are weakening, price increases are also slowing – and even reversing in some markets. With unfilled demand for housing strong, any further easing of prices could bring buyers back into the market, putting a floor under the sales decline. And while mortgage rates are prohibitively high for many would-be buyers, there are growing reports of lenders offering teaser rates and interest-only mortgages, an unwelcome reminder of earlier distress that could evolve if the trend accelerates.

To be sure, residential outlays play a relatively minor role in the economy, accounting for less than 5 percent of GDP. But housing punches above its weight. When people buy a home, they also buy a bunch of stuff that goes inside, including furnishings, appliances, and fixtures, and incur moving expenses. Not surprisingly, the slump in home sales is taking a toll on sellers of home-related goods and services. Sales fell 5.7 percent at appliance stores and 1.6 percent at furniture stores from a year ago in August, the only two retail categories where sales are trailing year-earlier levels. The latest personal income and outlay report released on Friday provides further details on how these cutbacks weigh on GDP. Adjusted for inflation, spending on home furnishings fell 0.9 percent in August, the second decline in the past three months.

Still, households are not about to zip up their wallets. While the housing cylinder is sputtering and weighing on home-related purchases, consumers are spending elsewhere. Real personal expenditures eked out a modest 0.1 percent increase in August, recovering the entire decline in July and then some. We expect real personal expenditures to advance by a soft 1 percent annual rate in the current quarter, which will propel GDP back into a positive growth trajectory. However, one that is less exuberant than thought before the Fed's rate-hiking campaign became as aggressive as it is turning out to be.

Indeed, despite growing investor fears that the Fed will over-correct and send the economy into a recession, policymakers are sticking to their guns, with several officials asserting this week that more rate hikes are on the way.

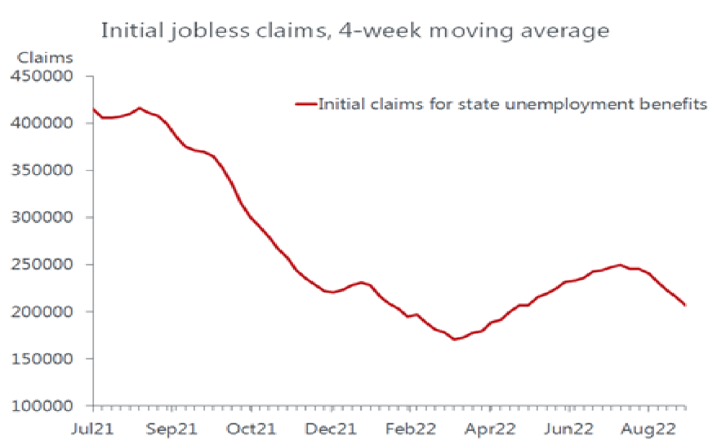


The income and spending report noted above gave further support to that prognosis. True, consumer spending advanced at a snail's pace in August, and third-quarter GDP is tracking a modest growth rate at best. But the inflation fires are still hot, as evidenced by the key price gauges the Fed closely monitors. Despite falling energy prices, the headline personal consumption deflator increased 0.3 percent in August, reversing July's slight 0.1 percent dip. Notably, the core personal consumption deflator that strips out volatile food and energy prices accelerated from 0.3 percent in July to 0.6 percent in August. The August advance in the core PCE deflator equaled the most robust monthly increase of the current inflationary cycle and lifted the annual inflation rate from 4.7 percent to 4.9 percent.

A key takeaway is that despite stubbornly high inflation, consumers are still spending, thanks to the sturdy job market and growing incomes. The Fed hopes that its rate hikes would, in time, curb hiring and slow wage gains, taking some steam out of labor cost pressures that are prompting employers to raise prices. So far, the results have been mixed. A growing number of high-profile companies are implementing hiring freezes, rescinding job offers, and some are reducing workforces. Odds are, these cutbacks will translate into slower job growth on a broader scale. However, there have been few reports of companies cutting worker salaries or scaling back wage increases.

One reason is that employers want to keep their workers happy, lest they jump ship. The number and rates of voluntary quits have come off the record peaks set a few months ago but remain well above pre-pandemic levels. Same for job openings, which still exceed the number of job seekers by a near historically wide margin. Simply put, companies slashed payrolls by more than was necessary during the height of the pandemic and are struggling to restore staffing levels to where they were before Covid-19 hit. Hence, they are eager to retain existing workers despite a soft economy and the increasing likelihood of slower growth in coming months and quarters. A proxy of layoffs, first-time claims for unemployment insurance, starkly illustrates that strategy. In the latest week, jobless claims fell below 200 thousand for the first time since early May and are well below the nearby peak of 261 thousand reached in mid-July. Even adjusting for weekly noise in the data, the four-week average of initial claims has been on a downward trend over the past two months.

Until the job market and wage growth show signs of easing, the Fed is not likely to change course, particularly in light of persistent rapid inflation and despite heightened volatility in the financial markets. Indeed, the slump in stock prices is not entirely unwelcome in the eyes of Fed officials, as the negative wealth effect aligns with the Fed's attempt to curb demand. Likewise, the growth-dampening surge in market yields is assisting the Fed's efforts. We expect policymakers to lift rates by another 125 basis points by the end of the year and, determined to break the back of inflation, keep them at that level throughout 2023. That steadfast approach in the face of slowing activity will likely bring a mild recession sometime in 2023. But that's a price the Fed is apparently willing to take to prevent inflation from gaining more traction and necessitating even harsher growth-killing rate hikes down the road.



FINANCIAL INDICATORS				
INTEREST RATES	September 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.27%	3.19%	2.88%	0.04%
6-month Treasury bill	3.95	3.90	3.35	0.05
3-month LIBOR	3.74	3.64	3.14	0.13
2-year Treasury note	4.28	4.21	3.53	0.27
5-year Treasury note	4.07	3.99	3.30	0.93
10-year Treasury note	3.83	3.69	3.27	1.46
30-year Treasury bond	3.78	3.61	3.37	2.03
30-year fixed mortgage rate	6.70	6.29	5.66	3.01
15-year fixed mortgage rate	5.93	5.44	4.98	2.28
5/1-year adjustable rate	5.30	4.97	4.51	2.48
STOCK MARKET				
Dow Jones Industrial Index	28725.51	29590.41	31318.34	34326.46
S&P 500	3585.62	3693.26	3924.26	4357.04
NASDAQ	10575.62	10867.93	11630.86	14566.70
Commodities				
Gold ($ per troy ounce)	1668.30	1651.70	1722.60	1761.3
Oil ($ per barrel) - Crude Futures (WTI)	79.74	79.43	87.25	75.75
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (August) - 000s	685	532	582	626
Consumer Confidence Index (September)	108.0	103.6	95.3	102.9
Personal Income (August)- % change	0.30	0.30	0.60	0.40
Personal Consumption (Augusst) - % change	0.4	-0.2	1.2	0.6