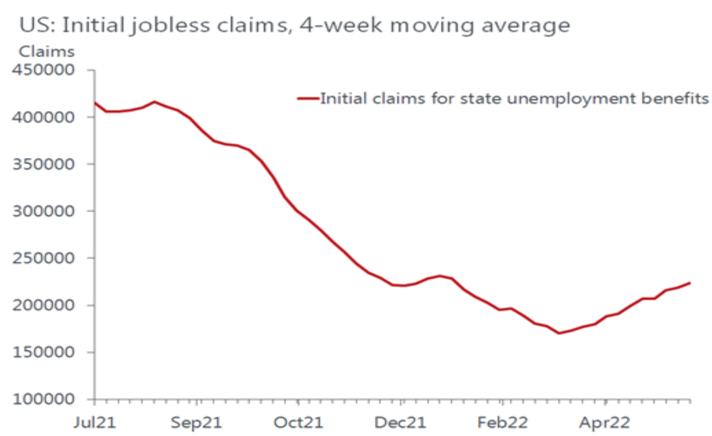
SMITH AFFILIATED CAPITAL

WEEKLY ECONOMIC COMMENTARY

WEEK OF JUNE 24, 2022

Barely two weeks after the May CPI report stoked inflation fears and sent the Fed's rate-hiking campaign into overdrive, the narrative appears to be changing – and impacting the financial markets in somewhat puzzling ways. For the most part, the hard data has yet to catch up with a raft of anecdotal evidence pointing to slowing growth and, yes, moderating inflation. But even among hard data, the downside surprises are more frequent than upside surprises. These include such key economic indicators as retail sales, industrial production, and, most prominently, housing activity, which mostly came in weaker than expected for May.

The major exception was the jobs report, which continued to portray a robust labor market and wage increases that are fueling the hawkish sentiment at the Fed. But employment is a lagging indicator, and the extreme labor shortages over the past year give companies a strong incentive to retain workers even amid signs of softening activity. That said, anecdotal and high-frequency data suggest that the job market is also starting to buckle. Layoffs are rising in some sectors, including tech and among home lenders, and reports of companies rescinding offers are proliferating. Initial claims for unemployment benefits remain low and even slipped a tad in the latest week. But an upward trend is becoming perceptible. Except for one week when it remained unchanged, the four-week average of new claims has increased for 12 consecutive weeks, the longest stretch of increases since the recession.



To be sure, claims for jobless benefits are still historically low, and job searchers have more than enough positions to choose from, with nearly two job openings for every unemployed worker at the end of April. But with recession prospects increasingly getting headlines amid reports of layoffs and canceled job offers, the strong bargaining position that workers have enjoyed over the past two years may be eroding. The first sign of growing job insecurity would be reflected in a reduced quits rate, which has been running at record levels. If workers turn less confident that a more lucrative job offer is waiting with open arms, they would be more inclined to stay put and prioritize security over higher pay. Importantly, wage gains among job switchers are much higher than for those who remain, so a slowdown in turnover would by itself restrain the increase in labor costs.

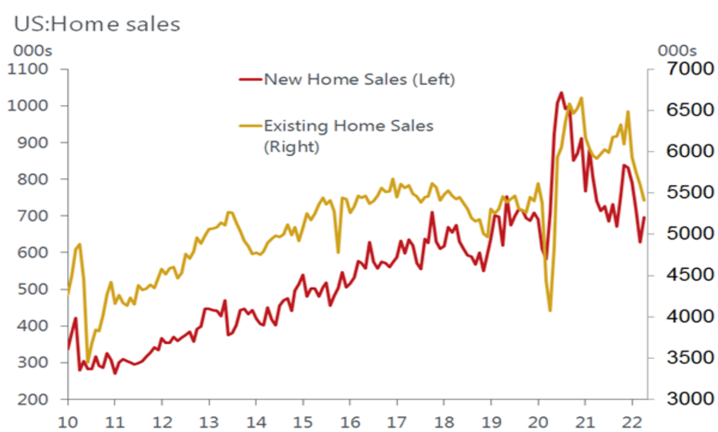
Undoubtedly, that would be a more appealing alternative to the Fed than suppressing wage gains by causing massive layoffs. Recent comments by Fed Chair Powell that reducing inflation is an "unconditional" priority confirm that the Fed is willing to accept an increase in unemployment to achieve that objective. With the unemployment rate at a historically low 3.6 percent, a rise to 4.1 percent, which the Fed predicts will be the endgame in its efforts, is not a terrible tradeoff. It probably aligns with a mild recession, although the Fed is still hopeful that it came tame inflation by steering the economy onto a soft landing. From our lens, the latter is still the most likely outcome, although the odds of a recession sometime next year have increased exponentially along with the prospect that the Fed will become overly aggressive in its inflation-fighting efforts.

Even as the Fed has pivoted vigorously to a hawkish stance, the financial markets have shifted in the other direction. The past week has seen a major dovish turn in the bond market, as yields have retreated perceptively from nearby peaks. In the days immediately following the June 10 CPI report, the 10-year Treasury yield climbed to just under 3.50 percent – the highest in over a decade – from around 2.75 percent at the start of the month. On Friday, about half of the increase had been erased, as the security traded at approximately 3.12 percent. The 2-year yield has followed a similar pattern, although the retreat from its nearby high has been less dramatic, resulting in a flatter yield curve. These movements clearly signal that market participants expect a slowing economy and receding inflation. Sharp declines in breakeven rates for 5 and 10-year securities confirm the lowered inflation expectations seeping into the fixed income markets.

The rally in stock prices this week – the first gain in four weeks – is somewhat puzzling, as heightened recession fears usually spur a risk-off trade. But here too, a dovish mindset appears to have stoked optimism, as recent signs of economic weakness and the prospect of tamer inflation encouraged investors to believe the Fed will stop its rate-hiking campaign before it sends the economy into a tailspin. Fed officials have not echoed that sentiment yet. However, in the press conference following the FOMC meeting, Chair Powell explicitly referred to the University of Michigan's reading on consumer longer-term inflation expectations. After mainly holding at 3 percent or less over the past 25 years, the survey revealed a leap to 3.3 percent in June, the highest since 1994. However, on Friday, the University released an updated reading for the month, which revised inflation expectations down to 3.1 percent.

No doubt, Fed officials welcomed that revision as well as nascent signs that price increases are moderating in a range of commodities. Most visibly, crude oil quotes declined from over $120 a barrel to about $107, and prices at the pump are easing a bit, with regular gas slipping to under $5 a gallon. Copper, steel, and lumber prices have weakened considerably over the past month, and the Bloomberg Commodity Index has been down more than 10 percent since early June. These commodities are traded globally, and their price action is more a reflection of more significant weakness unfolding overseas than in the U.S. Still, to the extent that weaker global demand for oil and other commodities contributes to slower price increases in the U.S., it relieves some of the inflation-fighting pressure off the Fed.

An axiom in economics says the best cure for high prices is high prices. That notion appears to be playing out in some sectors. The surge in gas prices, for example, has discouraged driving, reducing demand at the pump, even as it is bringing more production from oil rigs. Likewise, the astonishing surge in home prices and the rapid climb in mortgage rates has driven many would-be home buyers out of the housing market, resulting in falling sales and construction that contributed to the slide in lumber prices. The surprising increase in new home sales for May reported this week is an outlier that is not likely to be repeated in the coming months. This series is highly volatile and subject to larger revisions; even with the latest increase, new home sales for April and May are averaging 15 percent below the first-quarter average. What's more, the much larger market for existing homes is in a deeper slump, having fallen for four consecutive months. Not coincidentally, the median price for an existing home surged to an all-time high of $407 thousand in May.



Despite these nascent signs of economic softness and slowing price gains in some sectors, the overall inflation picture over the near term has not changed. We expect inflation to remain elevated through at least mid-year before tapering off in the fall, as the climb in service prices and housing costs is likely to be sustained even as goods prices ease. And with unemployment still historically low at 3.6 percent, the Fed will stay laser-focused on taming inflation until it shows clear signs of retreating on a sustained basis. Hence, we expect the Fed to hike its policy rate by another 75 basis points at its July policy meeting and again at the September confab before easing up later in the year when, we expect, the economy's growth engine will be downshifting.

FINANCIAL INDICATORS				
INTEREST RATES	June 24	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.66%	1.61%	1.06%	0.06%
6-month Treasury bill	2.49	2.22	1.52	0.06
3-month LIBOR	2.20	2.06	1.57	0.15
2-year Treasury note	3.08	3.19	2.47	0.28
5-year Treasury note	3.19	3.35	2.72	0.93
10-year Treasury note	3.13	3.24	2.75	1.53
30-year Treasury bond	3.26	3.28	2.97	2.15
30-year fixed mortgage rate	5.81	5.78	5.10	3.02
15-year fixed mortgage rate	4.92	4.81	4.31	2.34
5/1-year adjustable rate	4.41	4.33	4.20	2.52
STOCK MARKET				
Dow Jones Industrial Index	31500.68	29858.78	33212.98	34433.84
S&P 500	3911.74	3674.84	4158.24	4280.7
NASDAQ	11607.62	10798.35	12131.13	14360.39
Commodities				
Gold ($ per troy ounce)	1828.10	1843.80	1850.60	1781.8
Oil ($ per barrel) - Crude Futures (WTI)	107.08	109.91	115.07	74.00
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Existing Home Sales (May) - mlns of units	5.41	5.60	5.75	5.88
Median Sales Price (May) - $000s	407	396	379	377
New Home Sales (May) - 000s of units	696	629	715	750
Median Sales Price (May) - $000s	449	155	434	434