WEEK OF SEPTEMBER 23, 2022

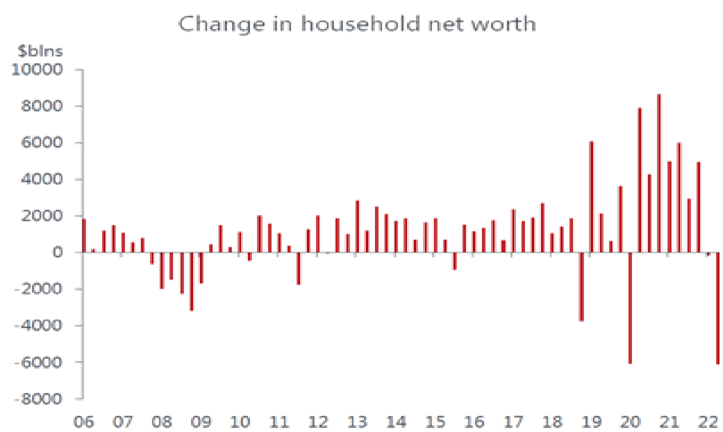
WEEKLY ECONOMIC COMMENTARY

The recession talk has ramped up considerably this week amid Fed chair Powell's not-so-veiled acceptance that it's a price he's willing to pay to curb inflation. Investors are taking heed, sending stock prices plummeting following the Fed's latest outsize rate hike this week and driving yields up to levels not seen since 2008, an acknowledgment that the Fed will follow through with more hikes in coming months. Powell is striving to keep inflationary expectations in check as an integral part of his anti-inflation fight. But the self-fulfilling nature of expectations can feed into the economy and inflation. If the public worries over a recession deepen, it can cause behavioral changes that increase the odds of it happening.

Most notably, households, fearful of job cuts and lost income, would turn more cautious in their spending habits, shoring up savings to build a cushion against adversity. So far this year, they have done the opposite, as the personal savings rate plunged from 8.7 percent last December to 5.0 percent in August, the lowest level in 13 years. In good part, households have been comfortable spending more of their incomes thanks to sturdy wealth gains during the pandemic stemming from surging asset values and generous government transfer payments that found their way into bloated savings accounts. But that dynamic is changing rapidly, and households would have to double down to recoup the wealth vaporized by slumping stock and bond portfolios this year.

In the second quarter alone, household net worth plunged by $6.1 trillion, the most prominent haircut on record and more than half the $11.1 trillion of vanished wealth spread over five quarters of the 2007-2009 financial crisis. Barring a remarkable turnaround in stock prices over the final week of September, household wealth should suffer another sizeable loss in the third quarter. And while slumping stock prices has been the biggest drag on portfolios this year, the spike in yields is also driving down the value of bond holdings. The one saving grace sustaining household wealth is the vigorous run-up in home values, which continues to bolster homeowner equity positions. But that boost is also starting to fade, as home price appreciation is slowing along with a tumble in home sales.

Indeed, the housing market once again demonstrated that it is the primary victim when Fed officials go on the warpath in its inflation battle. The slump in home sales firmly underway has numerous causes, not least of which is the skyrocketing price of new and existing homes that has put a purchase out of reach for a broadening swath of would-be homebuyers. But even as home price gains are slowing, affordability is being crushed by surging mortgage rates, which hit 6.29 percent this week on a 30-year fixed mortgage, a level not seen since 2008. The increase began earlier in the year but has accelerated since the Fed started tightening policy in March, reflecting a more entrenched inflation backdrop and firmer expectations of future rate increases.

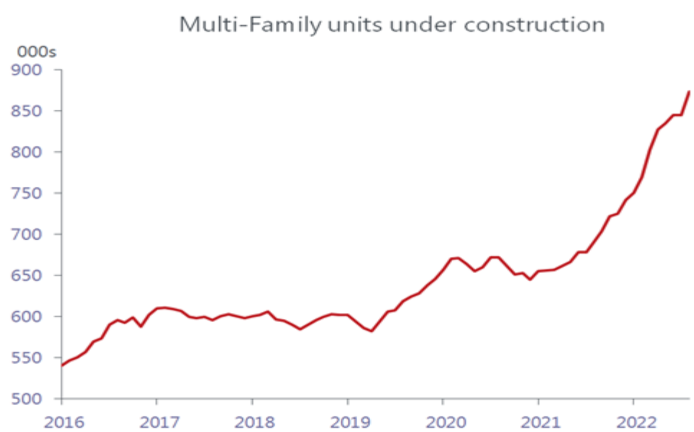


The toll that higher mortgage rates and elevated home prices are having on home sales was on full display again this week. Existing home sales fell for the seventh consecutive month in August, the longest stretch of declines since the housing collapse in 2007, driving the total 20 percent below the level of a year ago. Conditions have undoubtedly worsened in September, as mortgage rates have increased by more than a percentage point since early August and home prices remain elevated, although some regions are seeing declines. Adding to the sales weakness, many homeowners are taking their homes off the market, partly because they are locked in with the much lower mortgage rate obtained years ago. The supply of existing homes for sale declined in August for the first time this year.

Ironically, the factors discouraging home sales – elevated prices and mortgage rates – are prompting would-be buyers to rent instead, driving up rental costs, which are a significant component of the consumer price index. In a sense, the Fed's rate-hiking campaign is stoking a major source of inflation. However, that feedback loop should be broken over time as rising rents encourage a wave of apartment construction. Multi-family housing starts leapt by nearly 30 percent to a record annual rate of 640 thousand in August, sustaining the sharp upward trend of apartments in the pipeline. The accelerated pace of apartments under construction has been underway for over a year, and a bulge in completed units should start to reach the market in the coming months, curbing – if not reversing—the sharp rise in rents sometime in 2023.

Which raises the question asked by many skeptics of the Fed's aggressive policy stance: Is the central bank on the verge of going too far, inflicting more pain on the economy than is necessary? Given the lags with which monetary policy affects the economy, that risk should not be discounted. The critics argue that inflation underpinnings are already weakening, as commodity prices from lumber to oil have been declining for months, inflation expectations have stabilized and, by some measures, actually receding. Even within the service sector, the main driver of inflation, cracks are appearing; airline fares, car rental fees, and hotel rates have all been falling in recent months.

Fed chair Powell appears particularly worried that accelerating wages due to the tight job market is a key risk that inflation will become more entrenched and difficult to curb. But that would be more of a concern if wages were rising faster than inflation and employers were convinced they could pass on labor costs to consumers through higher prices. That, in turn, would make employers more receptive to granting ever larger wage increases knowing they have the pricing power to recoup the cost. But business pricing power is waning, as consumers are shunning more expensive items for cheaper ones. Corporations are taking a dimmer view of future sales prospects, with an expanding list of CEOs expecting a recession next year.



Notably, unlike the dreaded wage-price spiral of the 1970s, wages are trailing, not outpacing inflation. True, worker bargaining power has strengthened amid the tight labor market. Still, their efforts have been aimed at catching up to inflation rather than demanding raises to compensate for anticipated price increases. This was more prevalent in the 1970s when a significant fraction of the workforce benefited from COLA clauses that guaranteed they would not fall behind inflation. From our lens, the recent sturdy wage gains reflect a reset of wage levels to align with inflation rather than the onset of a sustained acceleration in wage growth.

That said, Fed officials are unanimous in their support for chair Powell's view that inflation is the overriding threat facing the economy. We expect they will follow through with their median expectation of another 1.25 percentage point increase in the benchmark federal funds rate by the end of this year. At this week's FOMC meeting, they significantly reduced their expectation for growth next year compared to projections made in June and increased the projected unemployment rate from 3.9 percent to 4.4 percent. That would be a 0.9 percent increase from the nearby low of 3.5 percent; an increase of that size has never failed to usher in a recession, solidifying our view that a recession is likely to occur sometime in 2023.

FINANCIAL INDICATORS				
INTEREST RATES	September 23	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.19%	3.14%	2.77%	0.04%
6-month Treasury bill	3.90	3.81	3.23	0.08
3-month LIBOR	3.64	3.53	3.04	0.13
2-year Treasury note	4.21	3.87	3.36	0.28
5-year Treasury note	3.99	3.64	3.19	0.95
10-year Treasury note	3.69	3.45	3.03	1.46
30-year Treasury bond	3.61	3.52	3.20	1.99
30-year fixed mortgage rate	6.29	6.02	5.55	2.88
15-year fixed mortgage rate	5.44	5.21	4.85	2.15
5/1-year adjustable rate	4.97	4.93	4.36	2.43
STOCK MARKET				
Dow Jones Industrial Index	29590.41	30822.42	32283.40	34798
S&P 500	3693.26	3873.33	4057.66	4455.48
NASDAQ	10867.93	11448.40	12141.71	15047.70
Commodities				
Gold ($ per troy ounce)	1651.70	1684.40	1749.80	1750.6
Oil ($ per barrel) - Crude Futures (WTI)	79.43	85.30	92.85	73.95
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (August) - 000s	1575	1404	1575	1606
Building Permits (August) - 000s	1517	1685	1696	1716
Existing Home Sales (August) - mlns of units	4.80	4.82	5.11	5.25