Economic Summary – Q3 2022

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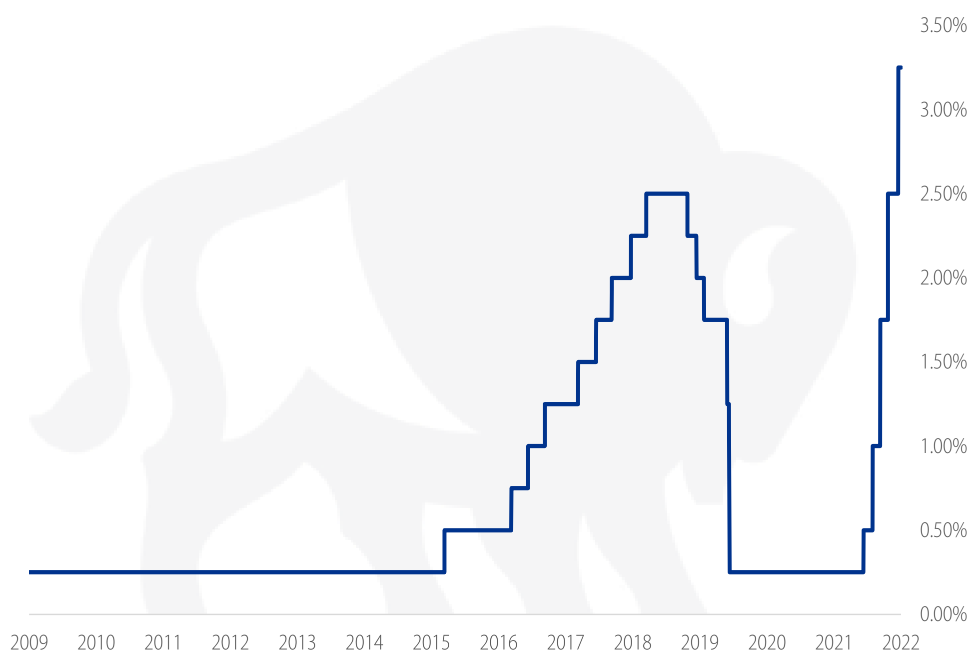
The focus of the third quarter remained squarely on inflation. The year-over-year headline consumer price index (CPI) appears to have peaked in June, but so far, the pace of cooling has been disappointingly slow. Frustrated Fed officials grew increasingly hawkish in their response throughout the quarter and signaled that the overnight funds target rate would need to be *higher for longer* in order to drive inflation down to the FOMC's 2.0% long-term goal. Seventy-five (75) basis point increases were announced at both the July and September FOMC meetings, bringing total rate hikes since March to three full percentage points, the most aggressive pace on record.

Federal Funds Target Rate (Upper Bound)



Source: Federal Reserve

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The Fed clearly held an overly-accommodative rate policy for too long, but other global central banks delayed even longer. *The result is the U.S. dollar has strengthened significantly relative to other currencies.* Although a strong dollar is generally a positive for the U.S. in lowering the price of imports, it also increases the cost of exported goods to foreign markets and has a profound negative effect on the profits of U.S. multinational companies. But the more severe damage is happening overseas. With the global commodities markets priced in dollars, nations that import oil and natural gas will lose exchange value and effectively pay more, further amplifying inflation overseas. In Europe, where the war in Ukraine had already created a severe natural gas shortage, this is a disaster.

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The inflation rate in August was +10.1% in the EU and +9.9% in the U.K., and as colder weather approaches, energy prices are only expected to build. In July, the ECB finally ended an eight-year negative rate experiment with a 50 basis point increase which pulled the benchmark deposit rate *up . . . to zero*. The ECB followed this with a 75 basis point hike in September, the biggest single increase in its history, and signaled another 75 bp move ahead for October. The September hike brought the ECB overnight rate from 0.00% to 0.75%. Clearly, there's still a long way to go, but they're walking a fine line.

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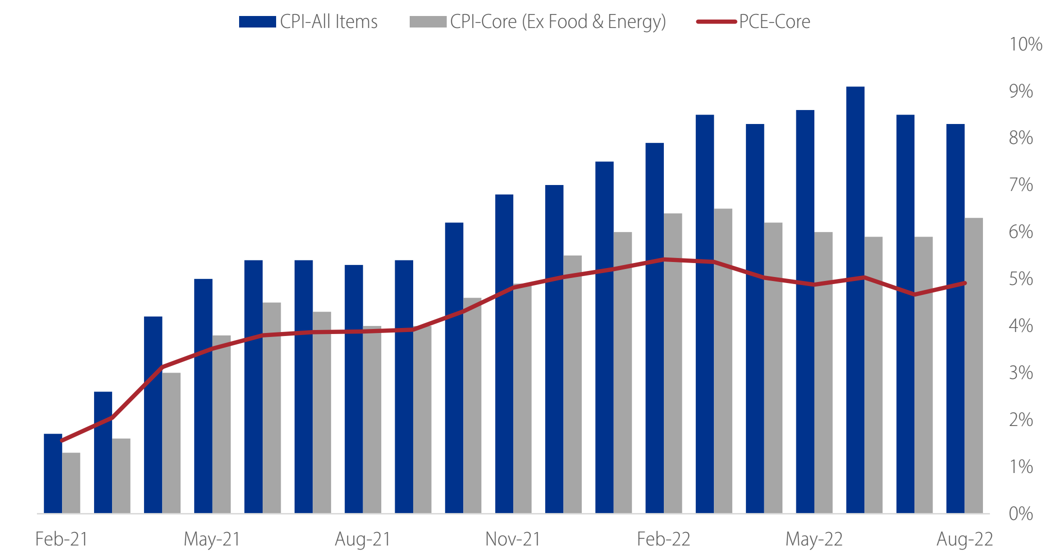
Rate increases are designed to slow demand, and in doing so will eventually bring down inflation; however, the EU is already very close to recession. It's in good company. The U.K and China may already be in recession, and the U.S. is generally expected to enter recession at some point next year. Foreign nations are hiking rates at an unprecedented pace, thereby ensuring a deeper downturn . . . but there's little choice. They'll have to prop-up their currency and try to lower inflation as best they can, or at least *appear to be trying*, until supply can catch up.

Here in the U.S., the headline consumer price index rose +0.1% in August, following an *unchanged* reading in July. On the surface, it wasn't a terrible number, but almost all of the moderation was the result of the decline in gas prices. The majority of prices continue to rise in the CPI basket of goods.

Consumer Price Index (Year-over-Year Percent Change)



Source: Bureau of Labor Statistics

On an annual basis, the rate of core consumer inflation actually rose from +5.9% to +6.3%. If there were a single report to blame for the September spike in yields and the corresponding resolve of Fed officials to drive inflation lower, this was it.

On a year-over-year basis, overall consumer prices rose at an +8.3% pace, down from +8.5%, but above the +8.0% forecast. Unfortunately, it was much worse when food and energy were excluded. Core CPI climbed +0.6% in August, doubling both the median forecast and the July increase. On an annual basis, the rate of core consumer inflation actually rose from +5.9% to +6.3%. If there were a single report to blame for the September spike in yields and the corresponding resolve of Fed officials to drive inflation lower, *this was it*.

The drop in crude oil prices mostly continued in September with WTI closing at $76 per barrel on September 26th, down from a summer high of $112 and the lowest since

January. A likely OPEC+ supply cut and the destruction from Hurricane Ian have since driven oil prices higher. Gas prices are also up from recent lows, but nowhere near the June peak.

Several home price indexes turned abruptly negative during the quarter as mortgage rates soared and sales weakened. The seasonally-adjusted annual pace of existing home sales dropped for the seventh straight month to 4.8 million in August, down from 6.5 million in January and -20% year-over-year.

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US Existing Home Sales (Seasonally adjusted annual rate, millions)

Source: National Association of Realtors

The median price for an existing home fell -1.7% for the month, the third straight decline of more than 1%. The S&P CoreLogic Case-Shiller home price index was negative in July for the first time since March 2012, and the Federal Housing Finance Agency home price index declined for only the second month in the last 10½ years.

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Affordability remains near record lows despite recent price declines. The average rate on a 30-year fixed rate mortgage (according to Freddie Mac) was 6.70% at quarter end, up from 3.11% at the beginning of the year and 2.88% at the low point last summer. Since the year began, the monthly payment on a 30-year fixed rate loan is up more than 50%, sidelining many buyers on the margin. The near-term sales outlook indicates more deterioration ahead. Mortgage applications have fallen to their lowest level since 1999, with new purchase applications down -37% and refi applications -82% lower since the year began.

On the employment front, the August labor report was still too strong for the Fed's taste. After averaging nearly +500k per month over the past year, nonfarm payrolls climbed by +315k in August, bringing total payrolls back above the pre-pandemic high point. Average hourly earnings rose +0.3% in August and +5.2% on an annual basis.

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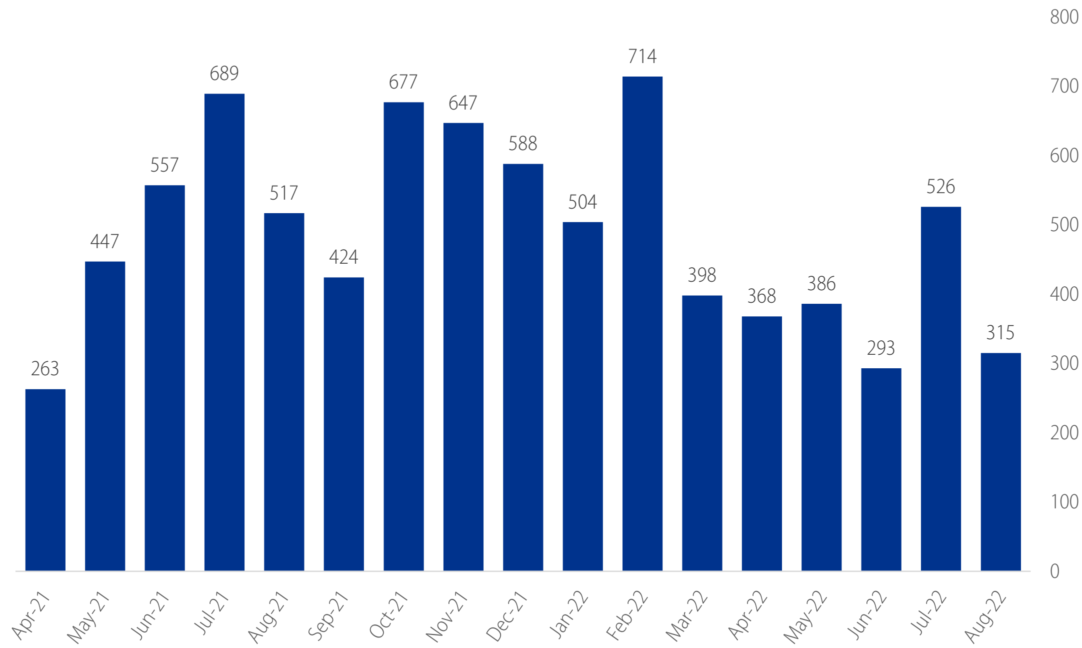
Non-Farm Payrolls Total Change (in thousands)



Source: Bureau of Labor Statistics

Although this is down from the cycle high of +5.6% in March, job openings still outnumber job seekers by almost a 2 to 1 margin. Fed officials have hinted they'd like to see some of these open positions disappear to further ease wage inflation. However, most companies have been reluctant to lay workers off in the midst of a labor shortage. Before they do, millions of open positions will be shelved, elevating the importance of the JOLT survey as a measure of job destruction.

By quarter end, as recession talk continued to seep into the national conversation, the question of *how much is too much* was gaining traction. Fed Chairman Powell signaled in late September that he'd like to see *positive real rates* across the entire yield curve (meaning interest rates are above the rate of inflation). *That's an extremely high bar.* Even when using core PCE as the inflation measure, the bond market is nowhere near this point …nor has it been for at least 15 years. With the national debt now above $31 trillion (double what it was ten years ago), higher interest rates are budget busters.

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Conventional thought is that Fed policy actions take effect with a lag of 6 to 12 months, so with the exception of the sputtering housing sector, the economy won't feel the majority of this year's tightening until next year. That being said, GDP was *negative* in both the first and second quarters, the S&P 500 has lost -25% of its value since early January, and consumer sentiment is teetering just above the record low established this summer. The FOMC left its 'longer run' median forecast at 2.50% in September, which means rate policy is already half a point above neutral. And yet, the FOMC's September dot plot reveals a median forecast that calls for another 150 basis points of tightening.

Although Powell has mostly sidestepped the question of increasingly restrictive policy ushering in a U.S. recession, San Francisco Fed President Mary Daly acknowledged that slowing demand enough to lower inflation without causing a recession will be "a struggle." And Chicago Fed President Charles Evans told CNBC's *Squawk Box Europe* he shares recent investor concerns that the FOMC may be acting too quickly to adequately assess the impact of rate increases.

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As the fourth quarter began, United Nations officials called on central banks to change course and avoid a willful, *policy-induced* global recession. This isn't likely to happen until inflation takes a meaningful dive, but the counterbalance conversation has begun. Every major inflation release going forward will take on extreme importance as investors weigh the effects of Fed policy and look for a turning point.

Q3 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
Last	6/30/22	1.50%-1.75%	1.64%	2.74%	2.95%	3.03%	3.01%
High			1.64%	4.11%	4.34%	4.19%	3.94%
Low			3.28%	2.66%	2.81%	2.63%	2.58%
End	9/30/22	3.00%-3.25%	3.25%	3.93%	4.28%	4.09%	3.83%

Source: U.S. Department of the Treasury

Economic and Interest Rate Outlook

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Economic and interest rate forecasts are all over the board as analysts try to guess what the Fed will do in response to outcomes that have proven impossible to predict. Fortunately, just weeks ago, the FOMC released its updated Summary of Economic Projections (SEP). In it, Fed officials lowered their 2022 GDP outlook from +1.7% to +0.2%, from +1.7% to +1.2% for 2023, and from +1.9% to +1.7% for 2024 with +1.8% growth expected in 2025. *Neither booming, nor recession-tinted.*

The median forecast for Core PCE (the Fed's preferred inflation measure) was increased from +4.3% to +4.5% for 2022 and from +2.7% to +3.1% for 2023, with +2.3% and +2.1% forecasted for 2024 and 2025. Although the SEP outlook has dimmed since June, it's still optimistic, reflecting the notion that current policy will ultimately prove successful.

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Fed officials also released a fresh "dot plot" at the conclusion of the September meeting, showing a median overnight target rate of 4.4% at the end of 2022, up from 3.4% at the June meeting. The median rate forecast increased from 3.8% to 4.6% for 2023, and 3.4% to 3.9% for 2024. This indicates another 125 basis points of hikes this year and a single quarter point hike in early 2023 before pausing for the remainder of the year to assess the impact, with rate cuts possible sometime in 2024.

Of course, since the September SEP doesn't forecast a deep economic downturn, a severe recession would alter the equation. The S&P 500 is now squarely in bear market territory, but with an estimated 30% of S&P 500 earnings originating overseas, ongoing dollar strength would suggest additional downside. Distress in equities would foster a "negative wealth effect" whereby investors and consumers grow cautious. As demand falters, price pressures could ease more quickly, allowing policy-makers to pause sooner. The hope is that while demand is subdued, supply will return.

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Assuming there's a recession next year, Americans will likely face the downturn without help from Congress or the Fed. *This would be a first*. The trick for Fed officials will be to maintain their policy stance as the drumbeat for market relief grows louder and louder. Powell has repeatedly warned the Fed's objective won't be met without pain. The question is: *how much pain is politically acceptable?*