

Economic Summary – Q2 2022

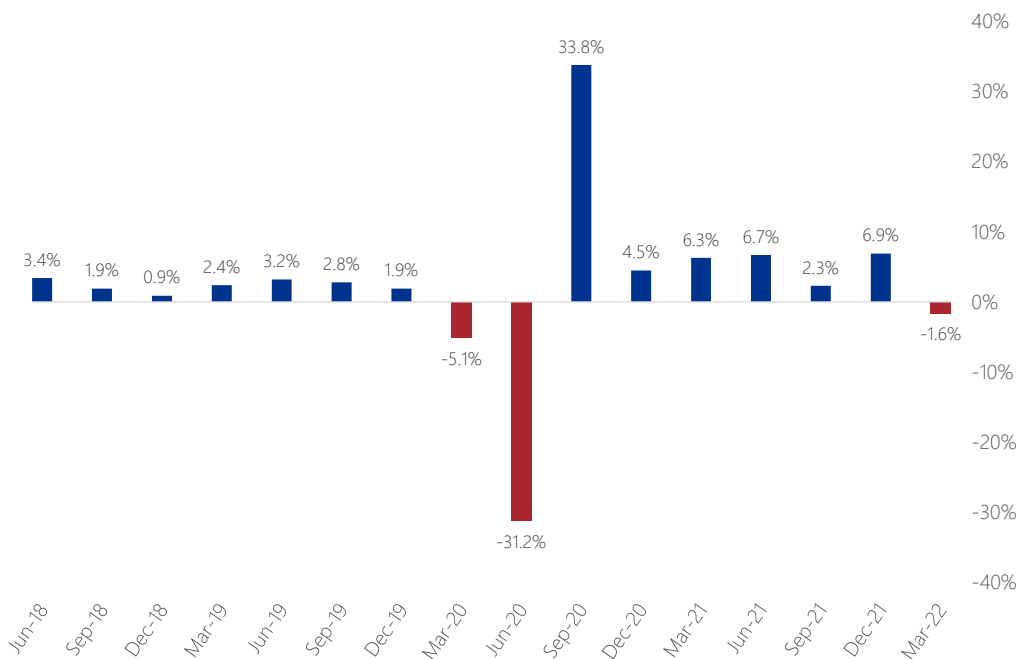
The second quarter of 2022 looked a lot like the first . . . *only worse*. The inflation rate continued to climb, and investors began to expect prices would rise even more. This expectation drove market yields higher and contributed to an increasingly aggressive policy response by the Fed.

What made the quarter so disappointing was that even the more positive notes were souring. The initial reading of first quarter GDP, released in late April, was -1.4%. At the time, the apparent contraction was both unexpected . . . and mostly ignored. Net trade and slower inventory buildup had subtracted a combined four percentage points from the headline. The counterbalance was solid improvement in personal consumption. Unfortunately, the second and final revision lowered Q1 GDP to -1.6% and chopped the consumption increase from +3.1% to +1.8%, implying U.S. consumers were already struggling when the second quarter began.

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U.S. GDP - Quarterly Annualized Percent Change



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Source: US Census Bureau

Rising prices continued to drain savings in the spring months, while consumer credit climbed to make up the shortfall. The personal saving rate slipped to a 13-year-low of 5.4% in April, roughly half of where it was just nine months earlier. At the same time, Federal Reserve data for April showed revolving credit up +19.6% year-over-year to a new record high of just over \$1.1 trillion. This isn't sustainable, especially as borrowing costs rise.

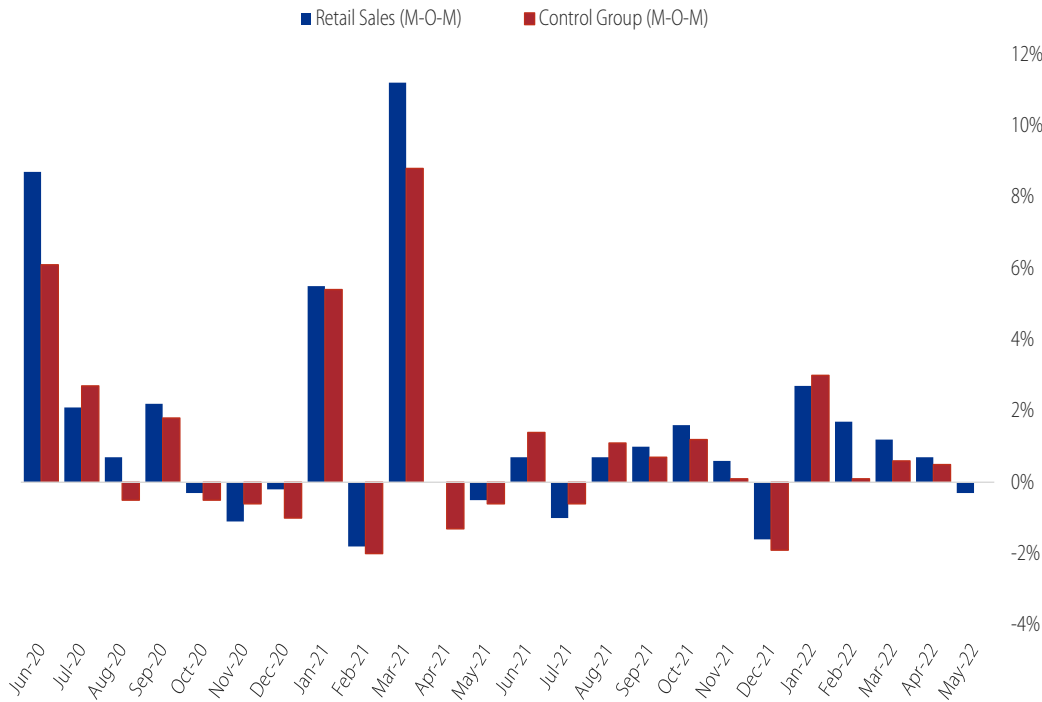
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Whereas stock markets bolstered confidence and spending in 2021, this too has abruptly turned. The S&P 500 experienced its worst first half performance in over 50 years, while the Nasdaq suffered through its worst six-month start ever.

The negative wealth effect of sagging stocks contributed to the first contraction in monthly retail sales this year. The -0.3% spending decline in May would have been considerably worse if not for large gains in grocery store and gas station receipts which were elevated by higher prices.

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Retail Sales (Month-over-Month Percent Change)



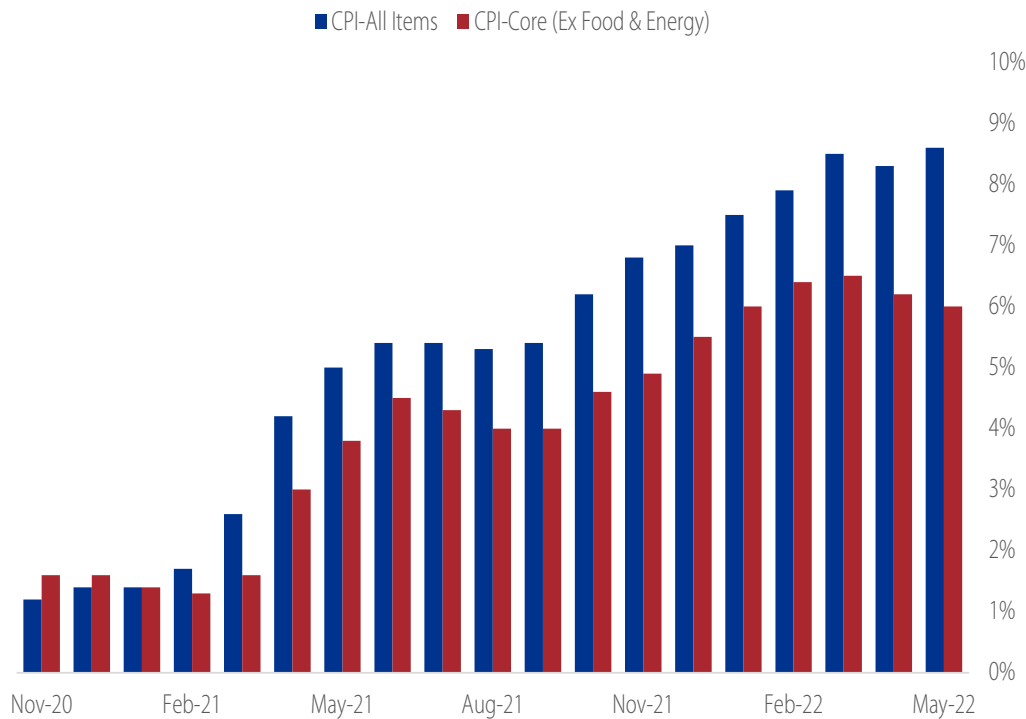
The primary contributors to the unexpectedly hot May report were food, energy, autos, shelter costs, and travel and leisure services, all major drains on the average consumer.

Source: US Census Bureau

One of the ugliest headlines during the quarter was the May consumer price index, which instead of retreating, actually climbed from +8.2% to a fresh 41-year high of +8.6%. The primary contributors to the unexpectedly hot May report were food, energy, autos, shelter costs, and travel and leisure services, *all major drains on the average consumer*. This troubling data was released during the Fed’s 10-day blackout period before the May FOMC meeting, which meant Fed officials were muzzled and unable to rein-in growing concerns. Inflation expectations soared along with bond yields.

At the June FOMC meeting, amid unchecked inflation expectations, committee members succumbed to market pressure with the first 75 basis point rate hike in 28 years.

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



Source: Bureau of Labor Statistics

Fed officials followed up what now feels like a ridiculously feeble 25 basis point rate hike in March with the first 50 basis point hike in two decades in May. At the June FOMC meeting, amid unchecked inflation expectations, committee members succumbed to market pressure with the first 75 basis point rate hike in 28 years. At the press conference that followed, Chairman Powell reiterated inflation was much too high, the Fed was committed to achieving price stability and would need to see compelling evidence that inflation was coming down before altering its course. The “course” at the time of the meeting was another 200 bps of rate increases before year end.

The positive response to Powell’s steadfast pledge to squelch inflation quickly evolved into concern that the Fed would overtighten and tip the economy into recession. Powell stoked this fear repeatedly during the month, asserting that inflation was the Fed’s top priority and implying that the economy could be sacrificed to achieve this objective. This tough talk was necessary to preserve remaining Fed credibility but damaging to consumer confidence.

The FOMC decided months ago that its employment mandate has been met, pointing to a +3.6% unemployment rate and overabundance of available jobs. The economic slowdown Powell is orchestrating will reduce the number of job openings over time, but fast dwindling savings and bear market destruction of retirement accounts could have a more immediate impact. According to a recent CNBC survey, 68% of workers who retired during the pandemic would now consider returning, along with 94% who simply left the workforce. As these worried workers reenter the labor market at the same time struggling industries announce layoffs, the unemployment rate is likely to climb.

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Existing home sales, which make up roughly 85% to 90% of all sales, have fallen every month since January, and are now at the slowest pace since June 2020. There are multiple reasons for the fading home sales, with affordability becoming an increasingly heavy weight. Freddie Mac reported monthly P&I payments on new mortgages had jumped an astonishing 35% over the past year, but lean supply continues to drive costs higher. Desperate buyers paid a record median price of \$407,000 for an existing home in May, with 88% of these homes on the market for less than a month. The number of active listings in May, according to Realtor.com, represented just 40% of the pre-pandemic count.

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



Source: National Association of Realtors

The average 30-year fixed mortgage rate was 5.70% at quarter end (Freddie Mac data), up more than 100 bps for the three-month period and 260 bps since the year began. According to the Mortgage Bankers Association, the volume of loan applications in early June was at the lowest level in 22 years. Not only has this rate increase squeezed out marginal buyers, but it's also dried up the refi market. Through the end of June, weekly mortgage applications were down -52% from the same period a year ago, with refinancing applications almost -80% lower.

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A recent report from Black Knight showed U.S. homeowners took out \$1.2 trillion in cash-out refinances in 2021 and tapped into \$275 billion in home equity. These actions quietly helped fuel consumer spending last year and boosted business for lenders, appraisers, and title companies. *This year is a completely different story.*

Just six months ago, most Wall Street firms were forecasting another bull market run in 2022, with both Credit Suisse and Oppenheimer calling for double digit gains for the S&P 500. COVID surge, inflation, war in Europe and a major shift in Fed policy combined to clobber stocks. During the first six months of 2022, the S&P 500 dropped -20.6%, while the DOW fell -15.3% and Nasdaq -29.5%.

Unfortunately, there has been no place for investors to hide. The 30-year treasury bond shed -26% of its value in first six months of the year, the 10-year note -13%, and the two-year note more than -3%. The 12-month bill began the year yielding 0.38% and closed the quarter at 2.75%, which translates into more than a 1% unrealized loss on a T-bill with just six months remaining to maturity.

Bitcoin, the leading cryptocurrency, thought to have low correlation with the more established financial markets, tumbled nearly -60% during the second quarter alone to slip below 19,000 for the first time in 18 months. Even *gold*, traditionally a hedge against inflation and a safe harbor in turbulent times, was down -1.2% for the year.

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Q2 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	3/31/22	0.25%-0.50%	0.48%	1.60%	2.33%	2.46%	2.34%
High			1.73%	2.97%	3.43%	3.58%	3.48%
Low			0.51%	1.66%	2.35%	2.55%	2.38%
End	6/30/22	1.50%-1.75%	1.64%	2.74%	2.95%	3.03%	3.01%

Source: U.S. Department of the Treasury

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News for much of the quarter was sobering, but if record inflation was the driver, recent signs of price improvement in raw materials suggest the peak may have passed. According to the Wall Street Journal, commodities futures are well below their previous highs with lumber (-31%), cotton (-27%), copper (-22%), corn (-17%), wheat (-12%), soybeans (-9.9%) and natural gas (-3.9%) all tumbling during the quarter. Even the price of WTI crude quietly fell nearly -12% from its 14-year high in early June, although oil remains under pressure.

M2 money supply growth, one of the primary factors driving domestic inflation to its four-decade high seems to be slowing rapidly. Between April 2020 and April 2021, the money supply increased more than +35%, but this April brought the first contraction in 12 years and after a tiny +0.1% increase in May, M2 was suddenly growing at a pedestrian +3.1% annualized rate in 2022. *A rapid slowdown in money supply growth is consistent with a weakening economy and lower consumer prices.*

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Uncertainty and market volatility aren't going away anytime soon, but if inflation continues to trend lower, investors and Fed officials should have an opportunity to breathe easier, and perhaps recalibrate the course.

Economic and Interest Rate Outlook

In late June, Fed Chairman Powell testified in front of both houses of congress. On the question of whether the Fed might inadvertently overtighten policy, Powell reiterated that inflation remains the bigger threat and said there were worse outcomes than a recession. Assuming prices continue to ease in the coming months and the Fed keeps on tightening, investors may not agree.

The past two years have been pretty miserable for most Americans and if the University of Michigan's consumer sentiment survey is any indication, it's only gotten worse. The June sentiment index plunged to its lowest level in the 45-year history of the series.

In the Fortune 500 annual CEO survey released in June, the biggest threat facing U.S. business leaders wasn't inflation or recession; it was the shortage of qualified workers. A remarkable 69% of companies represented were experiencing high attrition rates. To mitigate this problem, 93% are allowing more flexibility in the workplace. Of those surveyed, 50% reported employees are expected to come in two to three days a week, while just 10% require at least four days in the office. Fifteen percent of employers expect workers to come in on a weekly basis, and 25% have offered alternate arrangements. In theory, a shallow recession might rebalance the playing field between employers and workers, or it could make recovery an even greater challenge.

The June Bloomberg survey of the nation's leading economists showed a median yearend overnight funds target of 2.50% to 2.75% and a peak rate of 3.00% to 3.25% a year from now. This was presumably in line with the Fed's prevailing policy stance. However, following the uncomfortably hot May CPI report, Fed officials provided a fresh "dot plot," showing a median overnight target of 3.25% to 3.50% at the end of 2022, climbing to 3.75% at the end of 2023, before gradually moving lower over the next two years.

Inflationary pressure in the U.S. may be easing up a bit while recession alarms grow louder, but it's still a near certainty the FOMC will grind forward with another 75 basis point hike on July 27th, followed by another 50 on September 21st. After that, it gets a little fuzzy, especially when viewed through a wider global lens.

Eurozone inflation reached a record +8.6% year-over-year in June, driven largely by food and energy prices. Bloomberg Economics predicts global inflation will peak in the third quarter at +9.4% before ending the year at a still elevated +8.5%. The World Bank expects recession will be particularly hard to avoid for developing countries that have seen their currencies depreciate.

The next recession, whether it shows up in six months or two years, will be unique. On the fiscal side, another dose of stimulus checks or a tax cut of any significance would seem irresponsible with the national debt above \$31 trillion. On the monetary side, reinflating the Fed's balance sheet with yet another round of quantitative easing might cause more harm than good, leaving rate cuts as the primary tool in the Fed's tool kit.

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Inflationary pressure in the U.S. may be easing up a bit while recession alarms grow louder, but it's still a near certainty the FOMC will grind forward with another 50-75 basis point hike on July 27th, followed by another 50 on September 21st.

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