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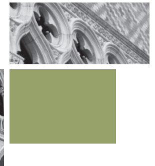
# ECONOMIC UPDATE

SECOND QUARTER 2022

July 7, 2022



### Quarterly Key Points

- The war between Russia and Ukraine is already entering its fifth month. Commodity prices remain elevated, and the inflationary effects continue to reverberate around the globe. In the U.S., headline CPI increased by 8.6% y/y and 1.0% m/m in May, while core CPI increased by 6.0% y/y and 0.6% m/m.
- 1Q GDP was weaker than anticipated, -1.6% q/q annualized, as a meaningful decline in net exports, reversal of inventories, withdrawal of fiscal support, and sharply downward revised personal consumption all played a part. Despite elevated inflation, aggressive monetary policy tightening, and frequent discussions about stagflation and recession, 2Q GDP is expected to be 1.5%-2.5% q/q annualized.
- The Fed increased the policy rate by 50 bps and 75 bps at its May and June meetings respectively, and initiated a quantitative tightening plan that started in June. The Summary of Economic Projections (SEP) now indicates that the Fed intends to raise rates at each remaining meeting in 2022 (four more meetings) by a cumulative amount equivalent to seven 25 bps hikes.
- The yield curve sold off during the quarter as the market re-priced inflation fundamentals and the increasingly hawkish Fed tone (again). The 2-year Treasury yield increased another 62 bps over the quarter while the 10-year Treasury yield rose 68 bps. Therefore, the 2s vs 10s curve steepened by 6 bps after starting the quarter completely flat.
- The labor market remains robust with the unemployment rate at just 3.6%. However, with gasoline prices hovering near $5.00 per gallon and an almost constant buzz about inflation, consumer sentiment has fallen. Mortgage rates have catapulted higher along with the broader selloff in interest rates, while businesses continue to fight through supply and labor shortages, inflation, and continued demand.

### Our View

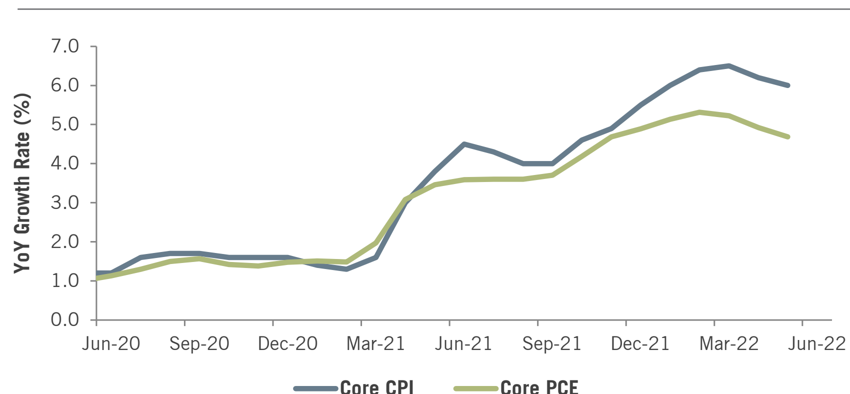
- Rampant inflation and the resulting Fed response are front-and-center for markets as the COVID pandemic fades into the background for the moment. Sustained inflationary pressure has resulted in a compressed timeline for monetary policy action.
- With the increasingly hawkish Fed posture and continued conflict in Eastern Europe, volatility in risk assets has persisted, providing attractive opportunities to add high quality spread across sectors in a measured way. We continue to be mindful of downside risks and remain cognizant of potential unintended consequences of large monetary policy and geopolitical shifts.

## 2Q2022 – UKRAINE AND INFLATION TOP-OF-MIND

The war between Russia and Ukraine is already entering its fifth month. Commodity prices remain elevated, and the inflationary effects continue to reverberate around the globe. Most notably here in the United States, gasoline is nearly $5.00 per gallon nationally. After climbing to nearly $120 per barrel during the month, crude oil prices declined to around $105 per barrel at the end of June, largely reflecting the expectation of slowing global consumption. More broadly, the Bloomberg Commodity Index has followed a similar pattern, reaching a high of 137 in early June before falling precipitously to 117 by the end of the quarter. We continue to believe that the consequences of this conflict, both intended and unintended, will be felt for years to come.

Headline CPI increased by 8.6% y/y and 1.0% m/m in May, while core CPI increased by 6.0% y/y and 0.6% m/m. Similarly, headline PCE increased by 6.3% y/y in May, while core PCE increased by 4.7% y/y (Figure 1). At this point, it goes without saying that these are the highest rates of inflation since the early 1980s. Notably though, PCE and core PCE are both holding steady at a lower rate than earlier this year on a rolling 3-month basis (and on a 3-month period over period basis).

**FIGURE 1: CORE CPI VS CORE PCE[1]**




Alternative Fed measures of core inflation like the Federal Reserve Bank of Cleveland Median CPI, the Federal Reserve Bank of Cleveland 16% Trimmed-Mean CPI, and the Atlanta Fed Sticky CPI 12-Month are also at series high points, measuring 5.5%, 6.5%, and 5.2% y/y respectively in May.

Headline producer price inflation (PPI) increased 10.9% y/y in April and 10.8% y/y in May. However, on a month-over-month basis, headline PPI has come down from a high of 1.6% m/m in March to 0.8% m/m in May. Similarly, core PPI has declined to 8.3% y/y in May after reaching an all-time high of 9.6% y/y in March. Last, but not by any means least, after reaching all-time highs earlier this spring, inflation expectations have fallen considerably commensurate with the Fed's increasingly hawkish policy stance. 5-year and 10-year breakeven rates are back down to ~2.7% and ~2.4% respectively. Meanwhile, the 5-year, 5-year forward breakeven has declined even further, to ~2.1%. Although some of this is due to the illiquidity of TIPS putting upward pressure on real yields, clearly the market believes the Fed can beat back inflation.

1Q GDP growth was weaker than anticipated, -1.6% q/q annualized, as a meaningful decline in net exports, reversal of inventories, withdrawal of fiscal support, and sharply downward revised personal consumption all played a part. Despite elevated inflation, aggressive monetary policy tightening, and frequent discussions about stagflation and recession, 2Q GDP is expected to be

[1]Source: Bloomberg

1.5%-2.5% q/q annualized with full year growth in the 2.3%-2.6% range. Notably, both 2Q and full year 2022 GDP growth estimates were revised downward during the quarter. At the end of 1Q, full year GDP growth was projected to be 3.0%-3.5% and the 2Q GDP growth estimate was centered around 3.0% as recently as early June. Furthermore, the Citi Economic Surprise Index turned sharply lower in mid-April and has been in negative territory since mid-May. In similar fashion, the Conference Board U.S. Leading Index also turned sharply lower shortly after 1Q, signaling slower economic output on the horizon.

## GOVERNMENT AND CENTRAL BANK UPDATE

In an effort to relieve pain at the pump, the Federal Government announced on March 31st that it would begin releasing 1 million barrels of oil per day for up to six months from the strategic petroleum reserve. Furthermore, President Biden has attempted to pressure OPEC members to increase production, including a planned visit to Saudi Arabia in July. On May 10th, the White House released the Biden-Harris Inflation Plan that focuses on investments in infrastructure and energy independence, among other things. More recently, Congress is considering a temporary federal gasoline tax holiday that could reduce the price of gas by ~$0.18 per gallon. So far, these efforts have provided little relief at the pump.

Against a backdrop of accelerating inflation, the Federal Reserve increased the policy rate by 50 bps at its May meeting. With the conclusion of the asset purchase taper, a "plan for reducing the size of the Federal Reserve's balance sheet" was also released in May. The quantitative tightening (QT) schedule started in June with initial caps of $30 billion per month for Treasury securities and $17.5 billion per month for Agency MBS. After three months (June, July, August), the caps will increase to $60 billion per month for Treasury securities and $35 billion per month for Agency MBS.

On virtually all accounts, inflation measures in May were higher than expectations, suggesting the Fed was falling further behind the curve. As a result, the Fed increased the policy rate by 75 bps at its June meeting, the largest single rate increase since 1994. There were no changes to the QT schedule; however, Fed Chair Powell indicated that another 75 bps hike is on the table for the meeting in July. Furthermore, the Summary of Economic Projections (SEP) median dot plot now indicates that the Fed intends to raise rates at each remaining meeting in 2022 (four more meetings) by a cumulative amount equivalent to seven 25 bps hikes. Market pricing indicates 75 bps in July, 50 bps in September, and 25bps each in November and December. If this path comes to fruition, the policy rate target would be 3.375% by the end of the year, and this will mark the most aggressive monetary policy tightening in the U.S. since 1994.

The yield curve sold off during the quarter as the market re-priced inflation fundamentals and the increasingly hawkish Fed tone (again). The 2-year Treasury yield increased another 62 bps over the quarter while the 10-year Treasury yield rose 68 bps. Therefore, the 2s vs 10s curve steepened by 6 bps after starting the quarter completely flat. Meanwhile, 10-year real rates increased by a whopping 112 bps, leaving 10-year breakevens at 2.35%. Year-to-date, 10-year real rates are 177 bps higher, reflecting aggressive Fed policy changes.

## RECOVERY SLOWS WITH ELEVATED INFLATION AND HIGHER INTEREST RATES

The labor market remains robust, with another 436k and 390k jobs added in April and May respectively, while the unemployment rate is holding steady at just 3.6%. Although initial unemployment claims have increased to ~230k, continuing claims have been consistent at 1.3 million. Nominal hourly earnings growth, while still elevated, turned slightly lower to 5.2% y/y in May after advancing by 5.6% y/y and 5.5% y/y in March and April respectively. The month-over-month number also slipped to 0.3% April and then held steady in May. Real hourly earnings, on the other hand, continue to suffer from the ill effects of elevated inflation, coming in at -2.6% y/y and -3.0% y/y in April and May respectively. The subtle changes in initial jobless claims and hourly earnings growth are being interpreted as a possible turning point in the labor market. Nevertheless, there continues to be ~11 million job openings and the quits rate continues to hover near 3.0%, suggesting that structural labor frictions may persist for some time. Following annual revisions earlier this year that resulted in a jump in the measured labor force, the labor force participation rate has basically been flat, in the 62.2%-62.4% range, signaling that potential workers are not hurrying back into the labor market despite 40-year high inflation.

With gasoline prices hovering near $5.00 per gallon and an almost constant buzz about inflation, the University of Michigan Consumer Sentiment Index dipped to 50 in June, the lowest measurement on record (Figure 2). Highlighting the taxing effect of inflation on real earnings, personal savings measured as a percentage of disposable income declined to 5.4% in May, marking one of the lowest savings rates since fall of 2008. Furthermore, consumer revolving credit grew at a 29% m/m annualized rate in March and 20% m/m annualized in April, marking the highest annualized monthly growth rates in over 20 years. Clearly, inflation is forcing consumers to dip into savings and borrow using credit cards in order to sustain current spending levels. Retail sales growth has come down every month since January, most recently measuring 1.2% m/m in March, 0.7% m/m in April, and -0.3% m/m in May. Personal consumption expenditures followed a similar pattern with 1.2% m/m, 0.6% m/m, and 0.2% m/m increases in March, April, and May respectively, while core PCE came in at 0.3% m/m, 0.3% m/m, and -0.4% m/m over the same time periods. Notably, these numbers are weaker than expected and previous months were revised lower in the May release.

**FIGURE 2: UNIVERSITY OF MICHIGAN CONSUMER SENTIMENT[2]**

Not surprisingly, mortgage rates have catapulted higher along with the broader selloff in interest rates this year. The Freddie Mac Weekly Survey rate ended June at ~5.7%, 260 bps higher than the beginning of the year. This also marks the highest 30-year mortgage rate since the fall of 2008. Nevertheless, home prices registered another 21.1% y/y increase in April. The combination of elevated home prices and expensive mortgage financing are weighing on housing activity. Leading indicators of housing activity like the U.S. Pending Home Sales Index have slipped well below pre-pandemic levels. Existing home sales have plummeted from a 6.5 million unit annualized pace in January to 5.4 million in May. New home sales have followed a similar pattern, dropping meaningfully from an 831k unit annualized pace in January to only 696k in May. Notably, this level of both existing and new home sales represents a more normal pre-pandemic pace. Existing homes months of supply remains low at ~3 months; however, new homes months of supply has increased to ~8 months. This is the highest months of supply of new houses since 2008. Compounding matters, building a new home has become extremely expensive as a result of cost of input inflation (building materials, labor, etc.).

Businesses activity remains elevated as manufacturers and service providers alike continue to fight through supply and labor shortages, inflation, and continued demand. Both manufacturing and services PMI measures have fallen from the historic highs realized in 2021; however, they remain strong and solidly in expansionary territory. The ISM Manufacturing PMI came in at 53 in June, while the ISM Services PMI measured 55.3. Both of these readings are in the middle of a normal range over the decade leading up to the pandemic. Industrial production and capacity utilization have moved well passed pre-pandemic levels. Industrial production at 105.1 in May is the highest in the series history, while capacity utilization at 80.8% is the highest since early 2008. Durable goods orders increased by 10.1% y/y and 12.2% y/y in April and May respectively. However, there was at least one sign of things slowing as the quarter wrapped up: the ISM Manufacturing Report on Business New Orders Index held steady at 55.1 in May but then dipped into contractionary territory at 49.2 in June.

## LOOKING AHEAD

Rampant inflation and the resulting Fed response are front-and-center for markets as the COVID pandemic fades into the background for the moment. Sustained inflationary pressure has resulted in a compressed timeline for monetary policy action and the expectation is for fairly aggressive rate hikes over the remainder of the year alongside a continuation of quantitative tightening. With the increasingly

[2]Source: Bloomberg

hawkish Fed posture and continued conflict in Eastern Europe, volatility in risk assets has persisted, reflecting fatter tails in the distribution of outcomes. There have been more frequent discussions about recessions and an eventual pause in monetary policy action, but not before the Fed feels confident that inflation is on a normalized path. In the meantime, market volatility has provided some attractive opportunities to add high quality spread across sectors in a measured way. We continue to be mindful of downside risks and remain cognizant of potential unintended consequences of large monetary policy and geopolitical shifts.

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