1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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Investors Show a Glimmer of Confidence

Financial Markets

As you will read in our analysis of economic indicators, the most recent data has given investors a bit of confidence that, when it comes to inflation, the worst may be over. Again, we remind readers that when analyzing economic statistics, it is important to avoid making decisions based on one or two observations.

This past week, equity markets had a strong performance. The Dow closed the week up 0.77%, the S&P 500 advanced 1.94%, while the NASDAQ led the group rising 4.56%. Investors were selective in their choice of sectors to favor. Technology outpaced the pack, gaining 5.12%, with Consumer Services, Consumer Goods, Health Care, and Industrials following in that order. Lagging the pack were Materials, Telecommunications, Energy, and Utilities.

This coming week has the possibility of heightened volatility as it is the start of earnings season.

Economics

It was a difficult week for England and Japan. Saddest, of course, was the assassination of former Japanese Prime Minister, Shinzo Abe. The former Prime Minister did much to bring Japan back into an important role in global affairs.

In Britain, the political world was shaken by Prime Minister Boris Johnson's resignation as Conservative party head and promise to step down as Prime Minister at a future date. Mr. Johnson has had a highly controversial stay at Downing Street. Many say his legacy will be as a great campaigner and less so as a prime minister. Mr. Johnson leaving office can't help but create political turmoil, particularly coming at very difficult domestic and international times. It is tempting to say that the situation in England can't get much worse. We will be watching carefully.

With all of the important economic releases and political activity, we still believe central banks will be the dominant market influencer. It is interesting that the Fed and the European Central Bank (ECB), although both in tightening modes, are at different levels of aggressiveness. The Fed appears far more aggressive in their hawkishness. It is important to remember that no central banker wants to create a recession. Just as inflation can get out of hand, so can monetary tightening.

As you read the economic indicators section, you will see some of the data appears to be slowly coming into balance. This in no way argues that inflation is defeated, but, if the numbers continue to improve, perhaps the Fed can be a bit less aggressive.

An interesting point on the EU and monetary policy. We have argued this point from the creation. The European Union is not one nation but a closely knit group of nations. They have both a common currency and a common monetary policy. This can and does create real economic dilemmas. An example might be that country A is a highly sophisticated manufacturing country, while country B is more rural, and, perhaps, agricultural. Let's suppose country B starts to fall into recession, but country A is still growing relatively fast. If each had its own currency, the problem could solve itself by country B's currency getting cheaper and country A's getting more expensive.

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The terms of trade start to reverse, and the imbalance can be redressed. In the absence of independent currencies and floating exchange rates, the adjustment is similar to 19th century rebalancing through a loss of employment and income declines in country B. This, of course, is a very simplified example, but hopefully it gives the reader an idea of the complications facing the EU and how much more difficult it is for the ECB to deal with several independent countries than it is for the Fed to deal with unified states.

Conclusion

There is no question that the jury is still out when it comes to the future of the U.S. economy. At the moment, it does not appear that the U.S. is headed toward a severe downturn, but a recession is clearly possible. We often don't know when a recession started or ended until after the fact, and we may find out at a later date that a technical recession started last quarter.

We haven't mentioned the Ukraine, but we have given our views in the past. The war will not be solved by economic policy. When it ends, there will obviously be a big boost to the global economy.

Since today's update was a bit longer than usual, we will give you a break next week and look forward to resuming on July 25th.

Economic Indicators

Given the wide-ranging impact inflation has on the economy, price statistics have been among the most closely watched economic indicators in recent months. This theme has only intensified, as Fed officials have continued to express their firm commitment to controlling inflation, even if it comes at the expense of economic growth. With so many underlying factors, inflation's path lower will not be immediate or easily recognizable; however, piecing together the available economic data provides some insight as to what may lie ahead.

When it comes to analyzing inflation statistics, the focus has been on identifying signs of "peak inflation" data. The most recent Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) Index readings offered little clarity on this front, with headline data showing a sequential acceleration in price increases, and the core readings holding steady.[1] Going forward, increased borrowing costs stemming from more restrictive Fed monetary policy should act to temper demand for core goods and services, thereby alleviating price pressures in these spending categories. The impact will not be immediate, but we are seeing some early indications of declining consumer demand with retail sales falling 0.3% over the course of the month and personal consumption expenditures decelerating to a modest 0.2% pace. While spending on gasoline and food sales remained strong, other spending areas saw pull backs, including car dealers, electronics, home furnishings, and online stores. Also, housing data like mortgage applications, inventories, housing starts, and existing home sales have started to weaken. This could be a positive dynamic for the peak inflation theme given shelter's significance in the CPI and PCE index measures. Statistics from the S&P CoreLogic Case-Shiller National Home Price Index suggest that housing prices are still rising, but the rate of growth appears to be slowing. Overall, the data continues to reflect a shift in spending from goods to services—a positive dynamic for future declines in goods prices.

Expectations of future inflation can be self-fulfilling, and, for this reason, are a crucial element in the overall inflation picture. One measure of inflation expectations, the five year breakeven rate[2], moved significantly lower in early July to 2.1%—over one percentage point lower than the late March peak. Another measure of inflation expectations from the Michigan Consumer Sentiment survey dropped significantly from the prior month as well, offering further support that expectations remain in check. Although monetary policy will have little to no

[1]The headline CPI and PCE index measures rose 1.0% and 0.6% month-over-month, while the core measures increased 0.6% and 0.3%, respectively.
[2]The five year breakeven rate is the difference between the five year Treasury rate and the five year Treasury inflation-indexed security rate. Market participants use this value as what they believe the expected inflation should be in the next five years, on average.

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impact on inflation pressures arising from supply constraints and higher commodities prices, they remain important elements in the overall inflation dynamic. Supply chains have continued to stabilize, with one indicator of supply chain pressure, the Logistics Manager's Index, falling nearly 15% from the all-time record in March. June's reading was also the lowest level in two years and slightly below the series average. While commodities prices are still elevated relative to historical averages, they have declined from recent peaks. Gasoline prices have fallen over 20%, wheat has declined 35%, and lumber has dropped more than 60% from highs seen earlier this year. If these trends continue, it will be an encouraging sign for more benign inflation readings in the future.

Looking at the U.S. labor market through the lens of its impact on inflation, there has been a shift towards the idea of "bad news is good news." In other words, weaker employment data may not necessarily be a bad thing, as increased labor market slack will reduce upward pressure on wages. Nonfarm payrolls increased by 372,000 in June, well above consensus estimates but below May's 384,000 pace, and the unemployment rate held steady at 3.6%. Encouragingly, the rise in average hourly earnings was unchanged from the prior month at 0.3%. While job openings have continued to move lower, it is important for this trend to continue in order to narrow the gap between labor supply and demand, especially with labor force participation failing to improve quickly. Taken together, these statistics add credence to the idea that the labor market can hold up despite slowing economic growth. However, further slack is needed, as a still-tight labor market could bring continued inflationary pressures through elevated wage growth.

With the Fed firmly committed to combatting inflation through more restrictive monetary policy, fears over slowing economic growth have understandably risen. Looking at this month's batch of data, indicators of economic activity like Industrial Production, Manufacturing Production, and PMIs all turned lower. These metrics remain in expansion and do not indicate that a severe contraction is imminent; however, successfully bringing down inflation without a significant decline in economic growth remains a tricky balancing act. With the latest Atlanta Fed GDPNow estimate for 2nd quarter growth coming in at -1.2%, the U.S. economy has likely entered into a "technical" recession.[3] While a historically tight labor market should provide support to consumers for the time being, a failure to temper inflation remains the paramount threat to continued economic growth.

[3]Technically, a recession is defined as two consecutive quarters of negative GDP growth. However, for this to be deemed an "official" recession by the National Bureau of Economic Research, broader economic weakness needs to prevail, impacting personal income and unemployment.

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