1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

August 8, 2022

Strong Job Growth Spurs Mild Investor Reaction

Financial Markets

Investors' reactions to this past week's strong employment release was reasonably tepid, even though it supports concerns over inflation and Fed tightening, considering the strong market performance the prior week. There could be many reasons for this. It may be that the market drawdown this year was overdone, and now we are in a reasonable trading range. Another possibility is that, even though the Fed has pushed rates up another 75 basis points, future rate hikes are already priced into the market. We will write more about the growth in jobs in the economics section.

Performance this past week was mixed. The Dow lost 0.13%, the S&P 500 gained 0.36% and the NASDAQ Composite gained 2.15%. The top performing S&P 500 sectors were Information Technology, Consumer Discretionary, and Communication Services.

Movement in financial markets are not always precipitated by financial events. Markets reflect people's fears and concerns beyond finance—they are an emotional thermometer. It will be interesting to see where the newest U.S./China tensions register with investors.

Economics

This week's economic report will be shorter than normal as we will be reviewing July's economic releases at the end of this update.

Clearly, the big shocker in the world of economics this past week was the employment report. It was far stronger than anyone anticipated and certainly gave the doves at the Fed something to think about. All things being equal, it would erase concerns about a recession looming around the corner. But, as always, all things are not equal. This has not been a textbook economic cycle. The upswing in the economy was interrupted not by economic imbalances, but by a pandemic. The severity of the pandemic and its effect on the economy produced a powerful government reaction of both monetary and fiscal stimulus. Both were successful in keeping the economy going during an unprecedented demand shock, but the unintended consequence has been a serious bout of inflation, which, of course, the Fed is trying to control as we write. The government's efforts at fiscal stimulus also had unintended consequences. As the impacts from the COVID-inspired recession lasted far longer than expected, government income subsidies expanded and became a work substitute. This led to an unusually large consumer savings base and many dropped out of the labor force. We may be seeing some segments of workers who opted out earlier are now returning to the workforce.

In previous weeks, we wrote how economic shocks can affect financial markets, and the most recent of them may be the nascent U.S./China tensions concerning the Speaker of the House's visit to Taiwan. It appears to have come at a dreadful time. As almost everyone is aware, saving face is vital to the Chinese psyche. The issue of Taiwan is not only a military/defense issue, but the loss of Taiwan is part of what the Chinese refer to as "the century of humiliation." Adding to the problem, China is about to have the Politburo vote President Xi to a third term. This all makes it impossible for China not to react strongly, but one must question the timing. This may weigh heavily on investor psyche.

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Conclusion

Although a lot of what we wrote reads as harrowing, we continue to believe that the Fed's policy efforts to control inflation will be successful. Employment statistics notwithstanding, the economy will continue to slow. Financial markets will likely remain volatile as investors continue to wrestle with confusing economic signals.

July Economic Indicator Update

The Federal Reserve has made its intentions clear—slow the economy just enough to bring inflation under control without triggering a recession. Economic indicators over the past month have generally supported the idea of a slowing, but not necessarily recessionary, economy, while inflation data has been mixed. With commodities prices showing signs of relief and goods prices trending lower, the emphasis is now on tempering inflation in the service sector to further the "peak inflation" dynamic that seems to have taken hold.

Economic releases this past month were supportive of what the Federal Reserve is trying to achieve—slower growth but not aggressively slower growth. Indicators of economic activity like Industrial Production, Manufacturing Production, and PMIs continued to trend lower. Generally, the PMI surveys suggested decreased demand but improved backlogs and softer price growth, which are all positive dynamics consistent with the Fed's goals. Second quarter GDP contracted at a 0.9% quarter-over-quarter annual rate, marking the second consecutive quarter of GDP decline. Inventories were a significant drag on growth, reflecting decreased inventory investment in reaction to overstocking, which was driven by last year's shortage-fueled build-up and the ongoing mix-shift from spending on goods to services. Encouragingly, personal consumption increased 1.0% over the quarter, with spending on services outpacing the decline in spending on goods. It is important to note that while two consecutive quarters of negative economic growth meets the "technical" definition of a recession, broader economic weakness seen in deteriorating personal income and unemployment needs to prevail in order to be deemed an "official" recession by the National Bureau of Economic Research (NBER)—two data points that have yet to significantly worsen.

The relationship between survey-based consumer sentiment data and consumer activity metrics remains contradictory. The Michigan Consumer Sentiment index rose slightly in July but sits just above the historic low reported in June. One year forward expectations continue to weigh on the overall index, with inflation and weakening labor market outlooks dominating consumers' attention. Conversely, retail sales data increased 1.0% and personal consumption expenditures rose 1.1% over the course of the month. While gasoline was a large contributor to the retail sales increase, there were also notable gains in discretionary spending categories like online stores, home furnishings, eating and drinking places, and sporting goods stores. Consumption makes up about two-thirds of economic output, so continued consumer resilience will be crucial for the U.S. economy to return to growth in future quarters.

We continue to watch for signs of peak inflation, but, with a multitude of inflation measures, the path lower will not be synchronized or immediate. There were surprises to the upside in both the CPI and PCE[1] inflation indices, with both measures accelerating month-over-month to 1.3% and 1.0%, respectively. The core measures also quickened in June. Food and energy prices were still the largest contributors to the rising headline indices, and it is worth noting that the decline in gas prices that began towards the end of June was largely excluded. Furthermore, we should see further improvements in food prices as Ukraine, a key exporter of agricultural commodities, restarts exports after reaching an agreement with Russia. When it comes to the core measures, accelerating services inflation outpaced the moderation in goods prices. Discounting resulting from overstocked inventories along with continued supply chain improvements should provide for continued declines in

[1]The Consumer Price Index and Personal Consumption Expenditures Index are popular inflation indices measured by the Bureau of Labor Statistics and Bureau of Economic Analysis

goods prices; however, shelter, a large component of core inflation, has accelerated over recent months. While housing market statistics like rising inventories, housing starts, home sales, and waning mortgage demand suggest a future slowdown in housing prices, it will not be immediate, and there will be a lag until price changes are ultimately reflected in inflation measures.

Narrowing the labor supply-demand gap in order to increase labor market slack will be crucial for easing wage pressures, controlling costs to businesses, and, ultimately, reducing the sticker components of services inflation. The most recent employment report did little to support this progression. Nonfarm payrolls came in significantly higher than consensus expectations, rising 528,000, and the unemployment rate fell to 3.5%, matching the pre-COVID level and tying the 50-year lows. Job gains were widespread, led by increases in the hospitality and healthcare industries, and the report officially marked a return to pre-pandemic employment levels. Conversely, labor force participation declined slightly to 62.1% and remains significantly below the February 2020 rate of 63.4%, while average hourly earnings accelerated 0.5% month-over-month and 5.2% year-over-year. In many ways, Friday's jobs report exemplifies the inflationary dynamic plaguing the U.S. economy, where outsized labor demand paired with insufficient labor supply leads to upward pressure on wages. However, not all employment data was inflationary. JOLTS job openings declined by over 600,000 and unemployment insurance claims have trended higher over recent weeks. Furthermore, according to the Michigan Consumer Sentiment surveys, fewer respondents are reporting that "jobs are plentiful" and a greater share are reporting "jobs are hard to get." Economic data seldom moves in unison, but we will look for more employment metrics to soften going forward, hopefully leading to reduced pressure on wages, and, ultimately, a moderation in services inflation.

More and more data is suggesting we are nearing or have reached peak inflation in the United States. However, peak inflation is not the end of the road. There are various elements contributing to the elevated inflation environment, and improvements will be gradual and sometimes inconsistent. Barring further exogenous shocks, inflation levels will likely trend lower over the coming weeks and months, but it will take time to bring inflation measures back to acceptable levels closer to the Fed's 2% target.

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