Weekly Market Insights

July 17, 2023

A Sigh of Relief!

Financial Markets

Equity investors breathed a sigh of relief this past week. The Dow rose 2.29%, the S&P 500 rose 2.42%, and the NASDAQ rose 3.32%. The relief rally was spurred by a softer than anticipated inflation report and an encouraging start to 2nd quarter earnings season by a handful of large banks. The positive inflation news gave investors a sense that a soft landing is not out of the realm of possibility. We will cover more about this later, but, clearly, this would be a dream for investors. Positive earnings reports are always welcome, but last week's announcements were particularly well received, since bank earnings and overall financial stability have been under scrutiny by market participants since the Silicon Valley Bank failure. This, of course, is just the beginning of earnings season, and there is still a long way to go on the inflation front, so a soft landing remains a very open question. Still, good news is always welcome.

The Economy

There has been an enormous amount of news about both the domestic and international economies, so it is hard to know where to start. This week, Ryan addresses many of the past month's U.S. economic indicators, so we will spend some time in the international arena. In his publications and interviews, Professor Branko Milanovic[1] makes a cogent argument that almost the entire world is capitalist in one form or another. To help readers better understand Professor Milanovic's point, we will provide a very short, incomplete definition of how capitalism organizes economic production. Labor is voluntary, capital is mostly private, and production is coordinated in a decentralized way, motivated by profit. Importantly, investors assume the risk. This brief definition is helpful to keep in mind as election campaigns pick up to analyze how candidates' proposals may affect each of these factors.

As we have written often, globalism in some form is here to stay. Therefore, it is becoming increasingly difficult to write about the United States economy as a standalone, unique economy. No matter what politicians and government representatives say or write, almost all recognize this. It shouldn't be a surprise that the current Administration is reaching out to China, most recently sending Treasury Secretary Janet Yellen to the world's second largest economy. She was received more warmly than expected. We, and many others, have been writing about the disappointing growth of the Chinese economy. We should expect to see the China-United States economic relations improve, as better ties will benefit both countries. Certainly, there will be changes but increased trade will happen.

We have spent a lot of time on China and the Chinese economy but the discussion has to broaden. China remains the dominant player in the region, but Vietnam, Indonesia, Malaysia and others are rapidly gaining importance. Then, there is India. India has already overtaken China as the most populous country in the world, and its population is well educated and hard working. India is the one country that can challenge or overtake China economically, and, it is a democratic nation with friendly U.S. relations.

[1]Senior Scholar at the Stone Center on Socio-Economic Inequality at the CUNY Graduate Center.

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Europe is an interesting case to analyze. There are two very important European organizations that regulate trade between the U.S. and Europe—the European Union and NATO. While both oversee trade, the EU focuses on civilian trade, and NATO, military. Each organization also has independent leadership, which can cause trade friction. An example is the purchase of military equipment, whether to buy U.S. or home grown. It seems better economic decisions could be made if the leadership could somehow be combined.

Conclusion

As we wrote in the introduction, last week's earnings and inflation reports were both positive. They show that the economy may be on the right path, but the race will be long and hard. We don't want to throw a damper on anything, but want to remind investors that caution and a bit of skepticism never hurts.

We also wrote about countries making economic advances, which is good news. A growing global economy should be a positive for all countries. It enforces economic discipline, keeps prices down, and expands markets for domestic producers.

Economic Indicator Update

Through June and the first two weeks of July, we have seen positive economic momentum paired with continued disinflation. With indicators related to the labor market, consumers, economic activity, and inflation all generally improving, or at least proving stable, recession expectations continue to be pushed out further. However, it's important to remember that monetary policy acts with long and variable lags, and interest rates have been in restrictive territory for a relatively short period of time. Given this delayed impact, along with the possibility for some additional tightening this year, we expect economic headwinds to materialize in the months ahead.

Inflation Indicators

Inflation indicators have continued to decline from their post-pandemic highs, but core measures, stripped of more volatile price components, have proven to be stickier. Despite year-over-year CPI inflation remaining above the Federal Reserve 2% target since March of 2021, inflation expectations still appear anchored. Furthermore, after months of providing upward pressure on inflation gauges, shelter prices exhibited more concrete evidence of decline in the most recent CPI report. Given housing's substantial weight in inflation indices, continued declines in this index component could fuel the next leg lower in the overall CPI and PCE Deflator indices.

- The Consumer Price Index (CPI) increased 0.2% month-over-month, lower than the 0.3% consensus estimate but higher than May's 0.1% rise.
- Core CPI also increased 0.2% month-over-month, below expectations for 0.3% and down from the prior month's 0.4% increase.
- The year-over-year rates were 3.0% and 4.8% for the headline and core measures, respectively.
- The shelter component of CPI decelerated 0.2 percentage points to 0.4% month-over-month and increased 7.8% year-over-year. Despite the decline, the shelter index still accounted for two-thirds of the total increase in the Core CPI measure.
- As evidenced by the Michigan Consumer Sentiment Survey, inflation expectations appear anchored. After declining 0.9 points from May to June, year-ahead inflation expectations were little changed in July at 3.3%. Long-run inflation expectations have proven stable, with the most recent reading of 3.1% remaining within the narrow range it has been in 23 of the last 24 months.

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Labor Market Indicators

Employment indicators showed signs of normalizing after May's surprising strength. However, despite gradual improvements, the labor market remains very tight by historical standards. Given the positive relationship between employment and consumer spending, achieving improved labor market balance remains paramount to the Federal Reserve in its goal to rein in inflation.

- Nonfarm payrolls increased 209,000 in June, lower than consensus estimates calling for 225,000 additions and May's downwardly revised 306,000 increase.
- June's payrolls number marks smallest gain since December 2020.
- The Unemployment Rate declined to 3.6% from 3.7% in the prior month but remains above the low of 3.4% achieved in April.
- The Labor Force Participation rate held steady at 62.6% for the third month in a row.
- JOLTS job openings fell to 9.8 million after the jump to 10.3 million in the prior report. Further reducing the gap between job openings and the 6 million unemployed will be a key factor in improving labor market balance.
- Initial jobless claims, a leading indicator for broader unemployment, fell to 237,000 and remain low relative to historical levels.

Consumer-Related Indicators

Consumer-oriented indicators continued to demonstrate strength after reaccelerating in May. While the impact of higher interest rates continues to trickle through the overall economy, the effects have yet to materialize in broader consumption data. Barring a significant spike in unemployment, continued consumer resilience dissipates recession concern in the near term.

- Retail Sales increased 0.3% in May, better than consensus estimates calling for a 0.2% decline but below April's 0.4% rise.
- Personal Consumption Expenditures increased 0.1% month-over-month but decelerated from the prior month's 0.6% gain. Real consumer spending (adjusted for inflation) was essentially flat compared to April.
- The Michigan Consumer Sentiment Index increased 13% in June, reaching its highest level since September 2021. Both the Current Economic Conditions and Consumer Expectations sub-indices improved, rising 6.3% and 11.0%, respectively. The improved sentiment was largely attributable to continued declines in inflation and stability in the labor market.
- The Conference Board Consumer Confidence Index improved 7.0% in June, driven by labor market optimism and continued economic expansion. While improved from the prior month, the Expectations Index remains below 80—the level associated with a recession within the next year.

Economic Growth Indicators

Economic activity continues to moderate, but recent indicators suggest overall growth remains positive. Under the surface, however, different sectors of the economy are not moving in sync. For example, manufacturing activity has been and remains weak, while the services sector has not yet shown significant signs of weakening. While growth rates have moderated from 2021's post-pandemic rebound, economists are not calling for a dramatic slowdown in the near term. As we alluded to earlier, the full impact of tighter monetary policy remains to be seen, but the current outlook does not appear worrisome.

- The final reading for 1st quarter GDP was revised significantly higher from 1.3% to 2.0%, fueled by a 4.2% increase in personal consumption—the fastest pace in 2 years.
- Industrial Production declined 0.2% month-over-month, below consensus estimates calling for a 0.1% increase and the prior month's 0.5% rise.

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- Durable Goods Orders increased 1.7%, marking another strong report after April's 1.2% increase. The reading was also significantly ahead of estimates calling for a 1.0% decline.
- The ISM Manufacturing PMI fell 0.9 points to 46.0. June's reading marks the 8th straight month with the index in contraction territory and is at its lowest levels since May of 2020.
- The ISM Services PMI increased 3.6 points to 53.9, marking the 6th straight month of expansion after briefly falling into contraction territory in December.
- The Leading Indicators Index (LEI) fell 0.7% in June, following a decline of 0.6% in April. The LEI has declined in each of the last 14 months, signaling weaker economic activity may be ahead.

To this point, U.S. economic indicators have not yet signaled that a recession is imminent. With the Federal Reserve of Atlanta's real-time estimate for 2nd quarter GDP calling for 2.3% growth, the U.S. economy looks poised for another quarter of tempered but still positive growth.

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