Financial Markets This Week

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JACKSON HOLE UPDATE

The job isn't done apparently. The stock market didn't like Powell's Jackson Hole speech at 10am ET Friday. Takes a while to read through his shorter, "more direct" remarks this year. Stocks fell hard for 6 minutes on the 10am news headlines, rallied back to unchanged for the next 5 minutes, and then collapsed to new lows by 1030am ET. Not sure what the problem was more than the Fed's inflation fight could take some time and there would be pain involved for everyone. Friday's 3.4% stock market loss was painful enough for us. Maybe that's what Powell wanted us to know with his final line of the speech: "We will keep at it until we are confident the job is done." And not a penny left in your retirement accounts.

<u>This is going to take some time.</u>
"Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses."

In looking over his remarks today, problem one for the market is Powell saying the anti-inflation fight would take some time. Heck, he said "softening of labor market conditions" was likely, which will obviously take some time if the unemployment rate just fell back to the lowest level ever recorded in July at 3.5%.

<u>No policy reversal anticipated.</u>
"July's increase in the target range was the second 75 basis point increase in as many meetings, and I said then that another unusually large increase could be appropriate at our next meeting. We are now about halfway through the intermeeting period. <u>Our decision at the September meeting will depend on the totality of the incoming data and the evolving outlook.</u> At some point, as the stance of monetary policy tightens further, it likely will become appropriate to slow the pace of increases.

Restoring price stability will likely require maintaining a restrictive policy stance for some time. <u>The historical record cautions strongly against prematurely loosening policy."</u>

Problem two for the market is Powell downplayed the soft inflation readings in July. They still need to push interest rates to 3.5% this year at a minimum. It was further unsettling perhaps that the jury is out on the need to go big for a third straight meeting and lift interest rates 75 bps to 3.25% on September 21, or whether to slow the pace to a rate hike of just 50 bps. More data are needed and the magnitude of the September hike "will depend on the totality of the incoming data" which probably includes the employment report on Friday, September 2 and the August CPI inflation report on Tuesday, September 13.

All of this is fine, but coming in today, we are somewhat surprised the market wasn't already sure that the Fed was still going to push 100 bps higher this year to 3.5%. Perhaps the second consecutive negative GDP report on July 28 had the market thinking recession and a Fed pause. On the other hand, we are surprised at Powell dismissing the drop in PCE headline inflation at 830am ET Friday. The core PCE increase of 0.1% was good news, and it is not just this month. Core PCE inflation has run steady at 0.3% on average starting in February this year, the July 0.1% offsetting the higher June 0.6%, which is markedly different than the story in 2021.

It almost makes it look like the Economic Impact Payments, the $600 and $1,400 checks in January and March 2021, respectively, had a lot to do with the inflation outbreak. The money's spent, maybe the inflation effect is too.

> July inflation good, labor market out of balance
> "The U.S. economy is clearly slowing from the historically high growth rates of 2021, which reflected the reopening of the economy following the pandemic recession. While the latest economic data have been mixed, in my view our economy continues to show strong underlying momentum. The labor market is particularly strong, but it is clearly out of balance, with demand for workers substantially exceeding the supply of available workers. Inflation is running well above 2 percent, and high inflation has continued to spread through the economy. While the lower inflation readings for July are welcome, a single month's improvement falls far short of what the Committee will need to see before we are confident that inflation is moving down."

We found the PCE inflation data today intriguing. It doesn't matter that Powell dismissed it as one month because Fed officials still want the Fed funds rate much higher than the current 2.5% "neutral" position due to the strong economy, unemployment at a record low and all that. Services prices ex-energy also slowed to 0.1% in July, the slowest one-month reading since 0.1% in January 2021. Services prices are stickier and there is some thought that this measure shows how entrenched inflation has become in the system. Services prices ex-energy are running 4.2% SAAR since December, which is close to where core PCE inflation is.

Core Consumer Inflation and stickier services prices ex-energy

Monthly	2022						2022	2021									2021
% Changes	Jul	Jun	May	Apr	Mar	Feb	Jan	Dec	Nov	Oct	Sep	Aug	Jul	Jun	May	Apr	Mar
Core CPI inflation	0.3	0.7	0.6	0.6	0.3	0.5	0.6	0.6	0.5	0.6	0.3	0.2	0.3	0.8	0.7	0.9	0.3
Services x-energy	0.4	0.7	0.6	0.7	0.6	0.5	0.4	0.3	0.4	0.4	0.2	0.1	0.3	0.4	0.4	0.5	0.3
Core PCE inflation	0.1	0.6	0.4	0.3	0.3	0.3	0.5	0.5	0.5	0.5	0.2	0.3	0.3	0.5	0.6	0.6	0.4
Services x-energy	0.1	0.6	0.4	0.4	0.4	0.3	0.3	0.4	0.5	0.3	0.2	0.3	0.4	0.4	0.4	0.4	0.5

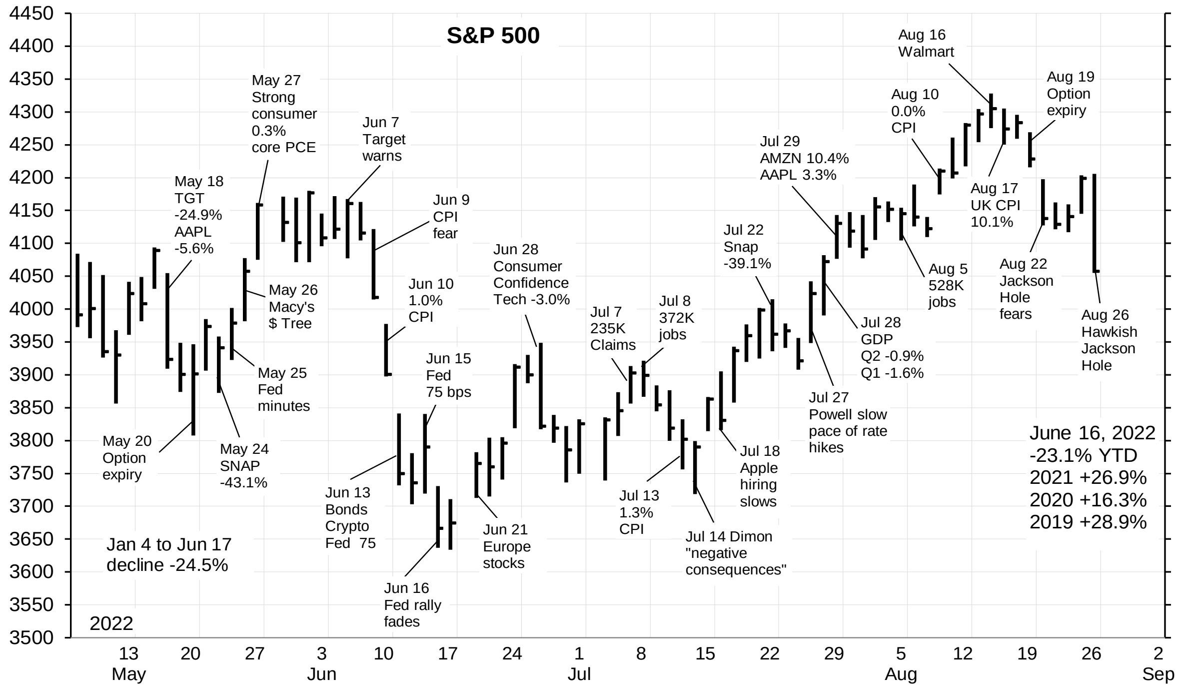
Dec 2021		Year-Year Inflation		
Weight		Dec 2020	Dec 2021	July 2022*
1.000	PCE inflation	1.3	5.8	6.5
0.077	Food at home	3.9	5.7	15.0
0.026	Energy goods	-15.0	46.4	50.2
0.016	Electricity/Gas	2.4	9.8	22.3
0.880	Core PCE	1.5	4.9	4.3
	Durable goods			
0.020	New vehicles	2.0	11.9	7.0
0.016	Used vehicles	9.3	48.4	-11.0
0.028	Furnishings	3.2	8.8	9.6
0.035	Recreational	-0.9	1.4	-0.3
	Nondurable goods			
0.028	Clothing	-4.6	5.0	5.7
0.031	Prescription drugs	-2.4	-0.2	3.0
0.010	Personal care	-0.3	0.3	9.3
0.644	Services ex-energy	2.0	4.2	4.2
0.036	Rents	2.3	3.3	7.5
0.114	Home prices	2.2	3.8	6.5
0.162	Health care	2.6	2.7	2.8
0.030	Transportation	-2.6	8.9	15.6
0.034	Recreation	1.8	4.5	6.1
0.059	Food services	3.8	4.5	7.0
0.010	Hotels/Motels	-7.5	21.6	-1.9
0.081	Financial/Insurance	1.5	3.5	-4.5
0.078	Other services	1.3	2.9	5.8
0.031	Nonprofits	4.0	11.3	2.4

* July 2022 is SAAR off Dec 2021

Fed officials talk about inflation expectations all the time, but the public sees CPI inflation most often where July CPI is 8.5% and core is 5.9% year-year versus July PCE of 6.3% and core is 4.6% year-year. PCE healthcare has an 16.2/88.0=18.4% weight in core PCE prices that is running 2.8% where medical services in core CPI has a 8.7% weight and is up 6.1% from December 2021 SAAR. Home prices have a bigger CPI weight of 22.3% to the total which also widens the difference in the two measures.

No one plans these things in advance, we hope, and not that it hasn't happened before, but it seems like a problem for public policy if the head of the central bank gives a speech and the S&P 500 collapses 3.4%. As for Powell's third lesson in Friday's speech, for the record, the pain of the Volcker rate hikes in the early 80s that brought 10.8% unemployment and recession, lowered core PCE inflation to only 3.2% in 1987… the best/lowest of any year in the 80s. A long time, lots of pain, and still shy of the Fed's inflation target today of 2.0%. To conclude, we are just hoping Powell wasn't trying to message the FOMC to up their Fed funds rate forecasts game with some 4 and 5 percent rates in 2023 and 2024. Stay tuned. September 21 2pm ET for new forecasts.

INTEREST RATES

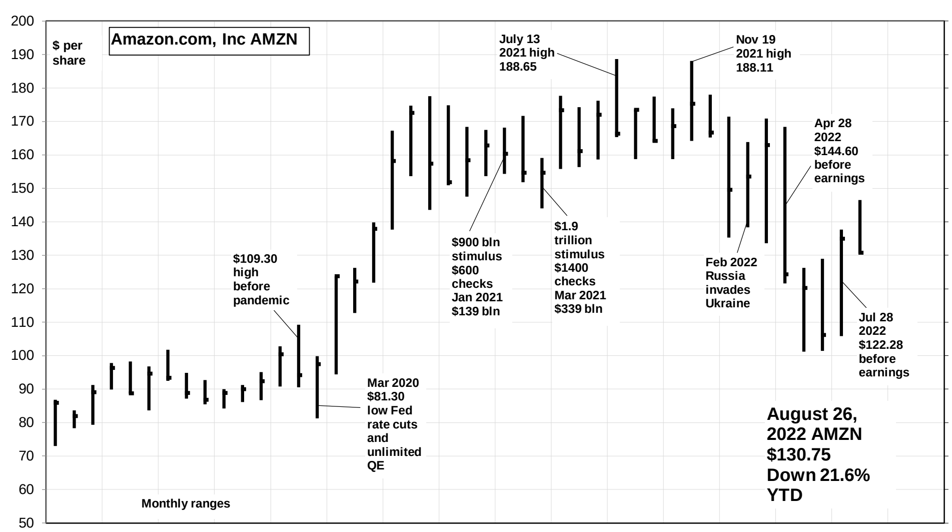


A shocking turn of events this week. On Friday, the S&P 500 fell back more than a third from its long rally from the June 17 low which puts the uptrend in jeopardy. Recession isn't here so the Fed is still pushing rates higher, is that what this is all about? We might have known that already, although Powell turned thumbs down on market recession talk, two consecutive quarters of negative GDP and all, saying today, "While the latest economic data have been mixed, in my view our economy continues to show strong underlying momentum." Okay. The yield curve flattened Friday thinking more rate hikes. At Friday's close 10-year yields were 3.04% and 2-year yields were 3.38%. Are more rate hikes coming? Latest Fed forecast is 3.5% this year, 3-7/8% in 2023. New update September 21. Beware. Powell waits for more data on whether to go 75 or 50 bps: October Fed funds adjusted is 3.155%

Amazon (AMZN) down 21.6% YTD, 20:1 stock split started June 6

Wall Street liked Amazon earnings this quarter with the stock closing 10.4% higher at $134.95 on Friday, July 29. Earnings were negative from its common stock investment in Rivian Automotive, but AWS operating income also fell, only the second quarter-quarter drop since 2018. Net sales were up 7.2% from last year and it expects Q3 sales $125-130 billion, up 12.8-17.3 percent year-year.

S&P 500 Weights	
Top 6: 24% of S&P	
7.39	AAPL
5.89	MSFT
3.39	AMZN
2.11	TSLA
1.52	Berkshire
1.98	GOOGL
1.83	GOOG
24.11	Top 6



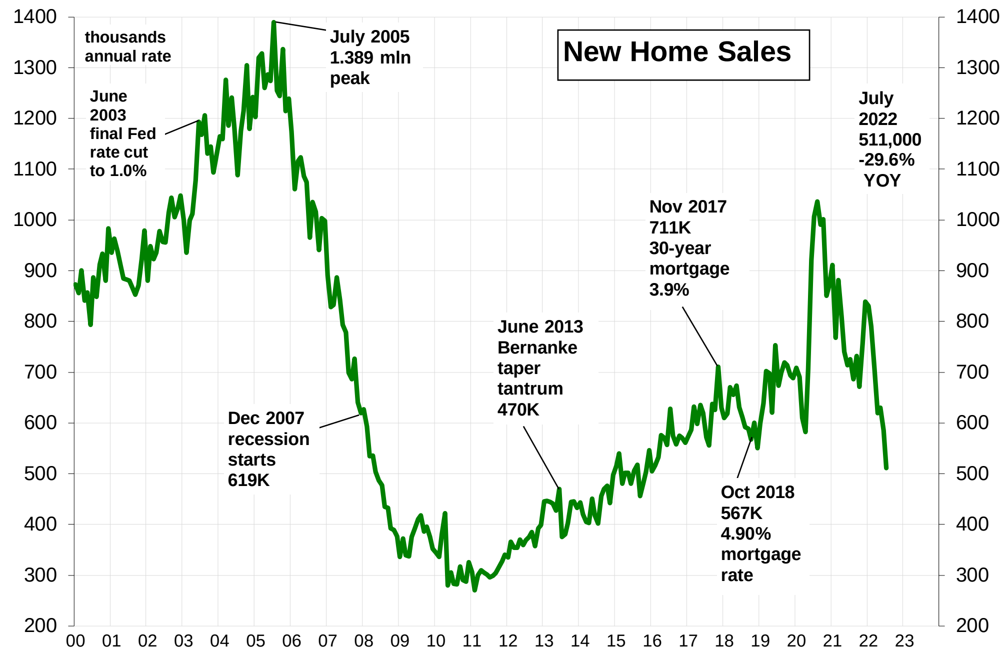
OTHER ECONOMIC NEWS

Market for new homes is in recession (Tuesday)

Breaking economy news. The most rates-sensitive sector of the economy has taken it on the chin as the Fed's aggressive tightening has taken the wind out of the housing market's sails. If the Fed was waiting on higher mortgage rates to slow the housing sector to a crawl, they got their wish with July new home sales, the only problem is that housing market weakness has not spread to the labor market and without job losses, the Fed's anti-inflation measures will fall short.

New home sales fell 12.6% in July to 511 thousand at an annual rate and are nearly 30% lower than a year ago. Sales activity was down this month by double-digits in the Midwest and the largest market down South. But new home sales in the West and the Northeast rose by 3.1 and 13.3 percent, respectively. Don't get too excited by the Northeast however as sales only moved up from 15 thousand in June to 17 thousand in July. July sales down South were massive at 342 thousand in comparison.

New home prices jumped 5.9% to 439,400 in July, well above the average of $397,100 in 2021 and $336,900 in 2020. The forecasts of some economists for home prices to plummet seem to be an exaggeration. For one thing, who would sell unless they lost their jobs and were unable to pay the mortgage. Right now job losses are quite modest based on the total number of jobless workers on the nation's unemployment rolls receiving benefits.



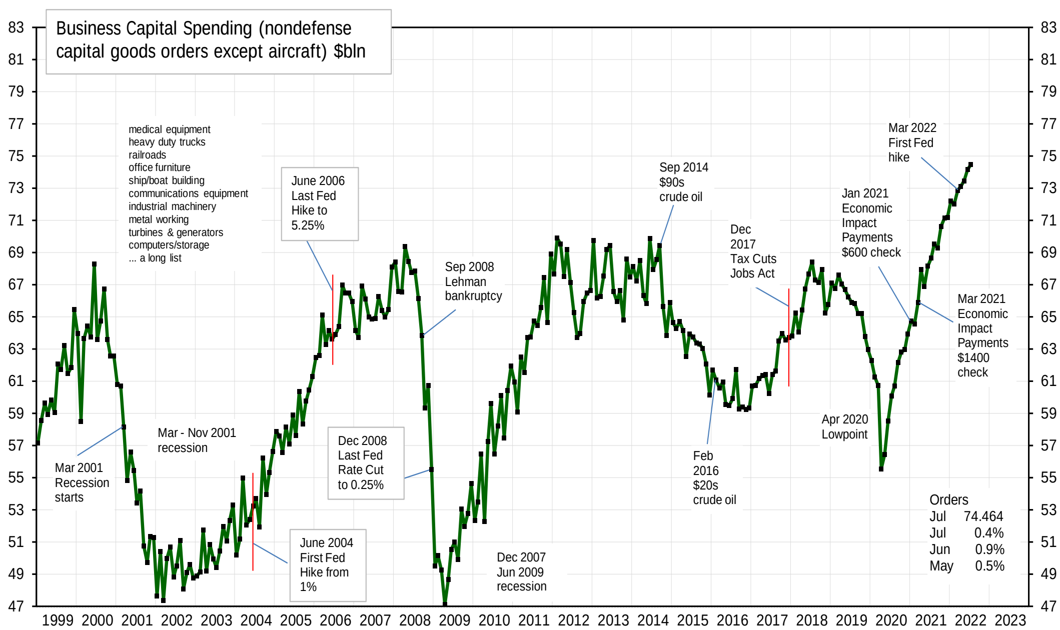
Net, net, the market for new homes is in recession-that's a fact. Prices on new homes look toppy, but there is no definitive downtrend yet even as new homes sales crater. Stay tuned. Story developing.

New Home Sales	Total	Northeast	Midwest	South	West	Median Price $
2019 Year	683	30	72	399	182	321,500
2020 Year	822	37	93	474	218	336,900
2021 Year	771	36	86	453	196	397,100
Feb 2022	790	47	89	455	199	427,400
Mar	707	51	80	399	177	435,900
Apr	619	44	64	371	140	458,200
May	630	18	52	389	171	441,100
Jun	585	15	68	389	113	414,900
Jul	511	17	54	342	98	439,400
	Thousands at Seasonally Adjusted Annual Rate					

Durable goods rise as the cost of new equipment inflated (Wednesday)

Breaking economy news. Companies continue to order up billions of new equipment even with surveys saying over half of the CEOs in the country see recession dead ahead and are taking steps to limit new hires if not actually lay off workers. The trend of business capital spending on long-lived equipment even fooled Bernanke back in the Great Recession as nondefense capital goods orders kept rising for the first seven months of the long 2007-09 recession.

We hardly know if we can get the words out. Nondefense capital goods orders ex-aircraft made another record high in July rising 0.4% to $74.464 billion: that's per month, not an annual rate. Machinery orders are the bulk of it, rising 0.4% to $38.585 billion. New orders for computers and related products have gotten a new life as maybe millennials tell their bosses what's what and won't return to the office. This computer orders category rose 4.0% in July on top of June's 8.2% leap.



Net, net, high inflation is literally sucking the life out of the economy, making consumers depressed and distorting the economic indicators in a way not seen in decades. Business capital goods orders keep moving higher, but in real terms adjusted for inflation, the demand for goods is not quite as robust. Durable goods orders are up, but the orders are in nominal terms and much of the equipment is highly inflated in terms of its cost. The bottom line is if economists are waiting for business capital equipment spending to turn down and cinch the case that a recession is coming, the worst inflation since the 1980s could make it a long wait. Business orders are no longer a leading indicator. Bet on it.

Companies actually ordered less equipment in Q2 2022

$BLN Nominal/Real GDP spending	Q2 21	SAAR	Q3 21	SAAR	Q4 21	SAAR	Q1 22	SAAR	Q2 22	SAAR
Core Durable goods orders *	202,995	17.0	207,488	9.2	212,966	11.0	217,112	8.0	220,743	6.9
GDP EQUIPMENT Nominal $	1270.4	8.6	1277.2	2.2	1307.7	9.9	1374.8	22.2	1393.5	5.6
EQUIPMENT Real $		12.1		-2.3		2.8		14.1		-2.7
"Inflation" Nominal - Real		-3.5		4.5		7.1		8.1		8.3

* Nondefense capital goods orders ex-aircraft $mln: total for quarter, monthly business capex proxy

Growth still negative, but job layoffs remain surprisingly low (Thursday)

Breaking economy news. The second revision to second quarter real GDP came in at -0.6% versus the -0.9% figure reported a month ago. It looks like a recession according to real GDP with two consecutive down quarters of -1.6% for Q1 and -0.6% for Q2. But investors and economists alike are scratching their heads seeing plenty of recession smoke but little fire. GDP was -0.9% and now it is only down 0.6% and the reason is stronger exports and Federal government spending did not fall as much.

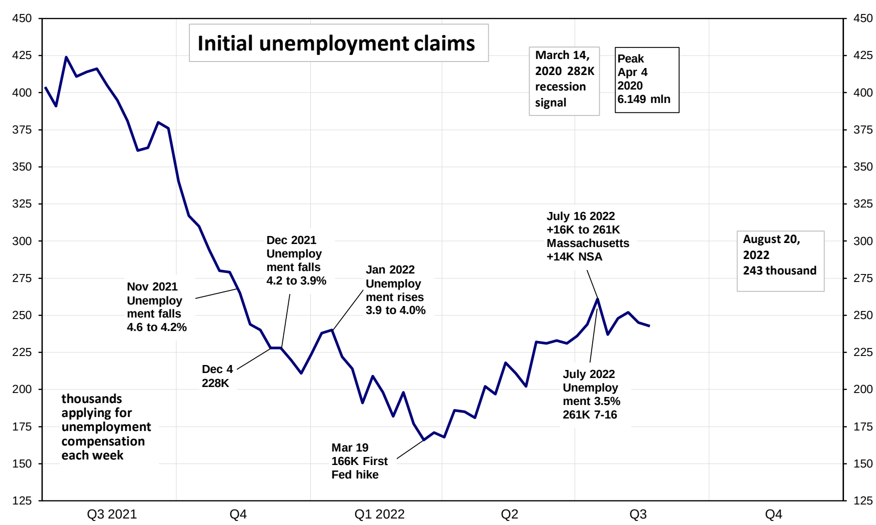
Meanwhile, the weekly jobless claims were underwhelming when it comes to showing mounting job layoffs that are necessary to make a recession a recession. Weekly jobless claims were 243K in the August 20 week, with another downward revision the week prior, where initial claims are 245K not 250K as originally reported for the August 13 week. The total number of jobless workers or so-called continuing claims, fell back 19K to 1.415 million in the August 13 week. The jobless pool of workers remains surprisingly steady. If recession is coming, it has a very long fuse.

	Q1 21	Q2 21	Q3 21	Q4 21	A1 22	Q2 22p	Q2 22r
REAL GDP	6.3	6.7	2.3	6.9	-1.6	-0.9	-0.6
REAL CONSUMPTION	11.4	12.0	2.0	2.5	1.8	1.0	1.5
CONSUMPTION	7.4	7.9	1.4	1.8	1.2	0.7	1.0
Durables	3.5	1.0	-2.5	0.2	0.5	-0.2	0.0
Nondurables	2.2	2.0	0.3	0.1	-0.6	-0.9	-0.6
Services	1.8	4.9	3.6	1.5	1.3	1.8	1.6
INVESTMENT	-0.4	-0.7	2.1	5.8	0.9	-2.7	-2.7
Business Plant	0.1	-0.1	-0.1	-0.2	0.0	-0.3	-0.4
& Equipment and	0.8	0.7	-0.1	0.2	0.7	-0.2	-0.2
Intellectual Property	0.8	0.6	0.5	0.5	0.6	0.5	0.5
Homes	0.6	-0.6	-0.4	0.1	0.0	-0.7	-0.8
Inventories	-2.6	-1.3	2.2	5.3	-0.4	-2.0	-1.8
EXPORTS	-0.3	0.8	-0.6	2.2	-0.6	1.9	1.9
IMPORTS	-1.3	-1.0	-0.7	-2.5	-2.7	-0.5	-0.5
GOVERNMENT	0.8	-0.4	0.2	-0.5	-0.5	-0.3	-0.3
Federal defense	-0.3	0.0	-0.1	-0.2	-0.4	0.1	0.0
Fed nondefense	1.0	-0.3	-0.3	-0.1	-0.1	-0.3	-0.3
State and local	0.0	0.0	0.5	-0.2	-0.1	-0.1	-0.1

Below line: Percentage point contributions to Q2 2022 -0.6% real GDP

Third estimate for Q2 and Annual Update is Thursday, September 29

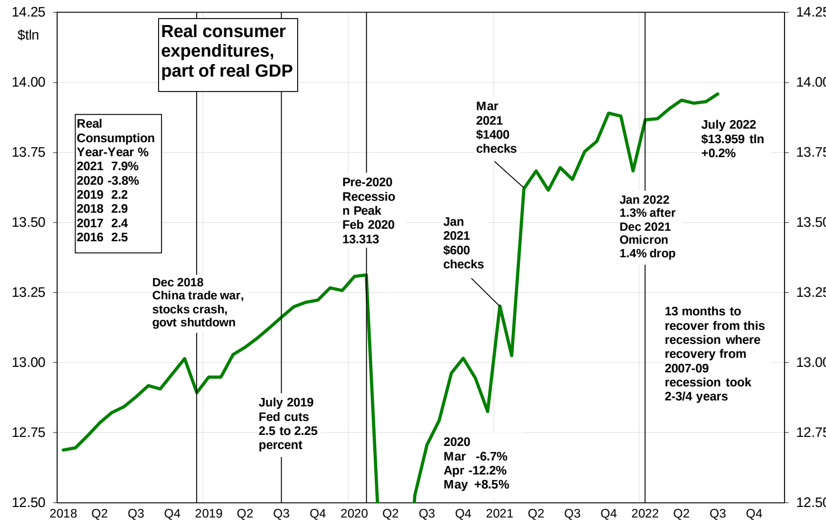
Net, net, the recession call remains mired in controversy with no clear winner yet on which way the economy is heading. We can't recall a time, certainly in the last thirty years, where real GDP fell for two consecutive quarters and the economy wasn't in recession. On the other hand, job layoffs are not growing despite all the anecdotal evidence to the contrary so weekly jobless claims don't indicate that unemployment is about to surge from the 3.5% best and lowest level in the nation's history. The economy remains a puzzle with economic growth still negative, but job layoffs remain surprisingly low. The recession everyone knows is coming isn't here yet.



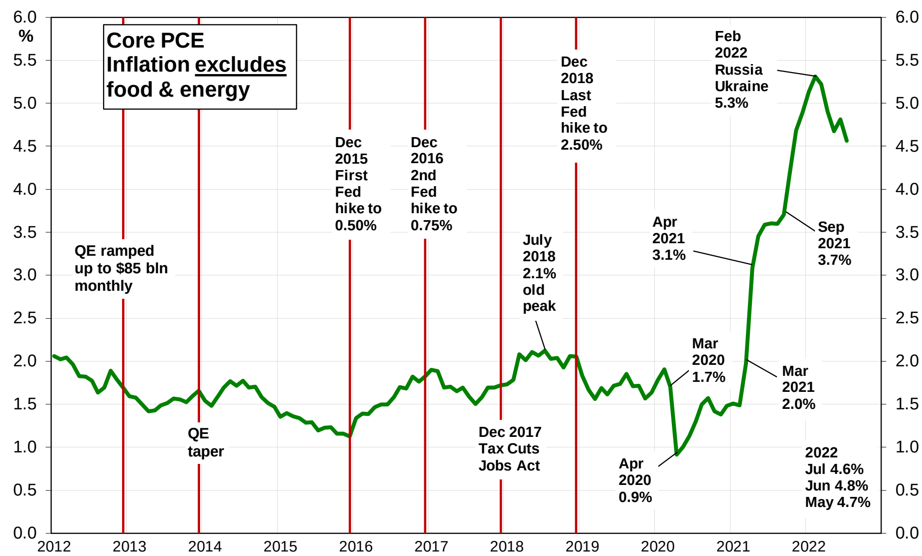
Powell probably doesn't have enough data to alter the script of future Fed policy moves when he gives his hotly-awaited speech at Jackson Hole Friday morning. Stocks have sunk nearly 5% from the recent highs trying to discount a hawkish turn by the Fed Chair as he raises the curtain perhaps on what the plan is for the September 20-21 meeting. At the press conference on July 27 Powell said the best outlook for interest rates was the Committee's own forecast made in June which suggests the pace of rate hikes will slow to just 50 bps in September, 25 bps in November, and 25 bps in December to end the year at 3.5%. This is the year-end level the Committee forecast when their last estimates were made in June. There isn't enough economic data to tear up the script and front-load rate hikes at a faster pace. Stay tuned.

Deflation this month, consumer spending steadies (Friday)

Breaking economy news. The July personal income report, including the Fed's targeted consumer inflation indicator. Everyone knows gasoline prices have plummeted by over 20% from the peak this year, still it is a shock to see deflation staring us in the face. PCE inflation actually fell 0.1% in July, and an even bigger surprise came from core PCE inflation that only rose 0.1%. Twenty minutes after the report October Fed funds futures rallied a few basis points and with an adjusted yield of 3.13%, the odds are split 50/50 between a 75 bps or a 50 bps rate hike on September 21.



Real consumer spending was better in July although much of the strength was in services, notably for housing (electiricty) and international travel (passenger fares). The consumer is alive and well despite telling surveys that they have rarely been so pessimistic about the outlook for the future. With consumer spending steadying in July, the third quarter may see an end to those two consecutive down quarters of real GDP in the first half of 2022. Don't forget an annual revision is coming for these data, which could see some of that negative growth airbrushed away. For the record, real consumption was down 0.3% in May and has been now revised to down just 0.1%. Real consumption rose 0.2% in July, which puts real growth around 2.5% for the third quarter. 2.5% growth is normal for consumer spending, probably not the slower growth Powell is expecting the rate hikes will produce.



Net, net, there is increasing evidence that consumer inflation has seen its peak rate for this cycle, while consumers don't like the higher prices, their spending at the shops and malls provides a solid start for third quarter economic growth. There is no need for Fed officials to alter the game plan for this year's rate hikes where the forecast calls for another 100 bps of monetary policy tightening to 3.5% over the final three meetings of the year. The ball's in the Fed's court, current inflation looks better than markets expected, but aggregate demand in the economy looks a little stronger now in the third quarter, so inflation may be harder to unwind and bring it back down to the Fed's 2.0% target. Stay tuned. Story developing at 10am ET this morning with Powell's address at Jackson Hole. The million dollar question is will deflation this month and steady as a rock consumer spending, make Powell do some last minute edits to his speech.

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