Courier Capital, LLC
Registered Investment Adviser
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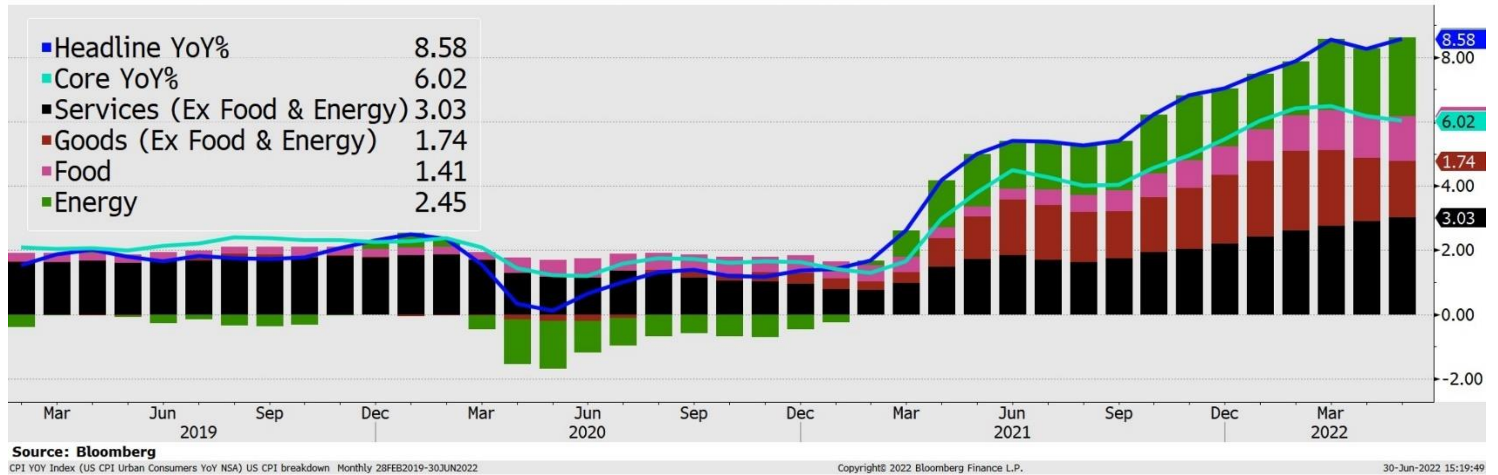
# Economic and Market Update – A VERY NARROW PATH (06/30/2022)

## Latest Developments and Economics

In the movie Top Gun: Maverick a critical part of one of the missions is a very narrow and difficult flight path fraught with dangers in order to achieve their objective. One could use almost the same description with the Federal Reserve trying to achieve their goal of taming inflation while not causing a significant recession – a 'soft landing' (Try to picture Jerome Powell in a cockpit with his aviator helmet). The markets are squarely focused on the following near-term economic items: progress on inflation; path of interest rate increases and economic growth/company earnings.

The inflation data is showing a continued rise in price levels. The latest Consumer Price Index (CPI) came in at 8.58% - the highest level since 1981. Core CPI, which excludes food and energy, came in at 6.02%.

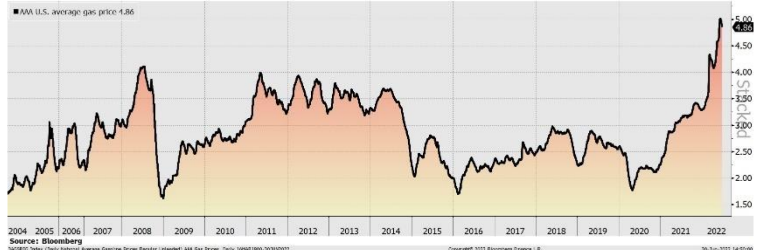
**US CPI Print in May**
**Substantial inflation pressure in energy, food, and housing costs**




The drivers continue to be housing, food, energy and wages. Housing, which makes up 1/3 of the CPI, is having a significant impact with a year-over-year increase of 14.8% (the highest since 1999) and leaves the current median price of a home in the United States at $407,600. Food prices also continue to increase based on the supply limitations from the war

**Soaring Food Prices**

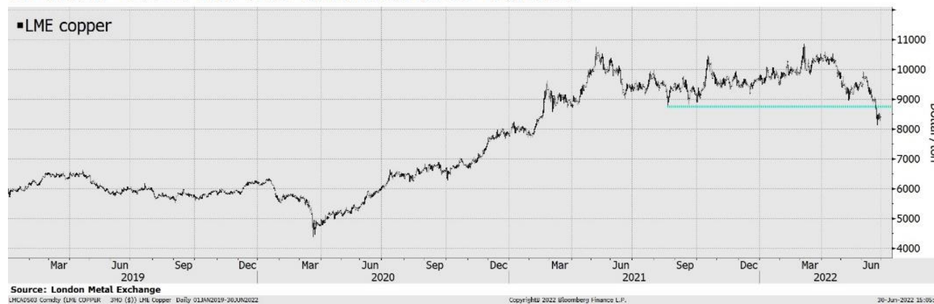
**Prices at the Pump**
**Average US gas price near record high**




in Ukraine, weather conditions in growing areas and the cost of transportation. Energy costs were led by the 4.1% increase in gasoline which results in a U.S. average price of over $5.00/gallon. This is due to strong demand and limitations in the refining capacity as well as the price of oil. In general, inflation is the result of a number of factors: surge in post-pandemic consumer demand, supply chain disruptions due to China's zero tolarance COVID policy as well as the war in the Ukraine and labor shortages driving up wage costs. Companies that have pricing power are also raising prices to offset the increase in costs that they are experiencing.

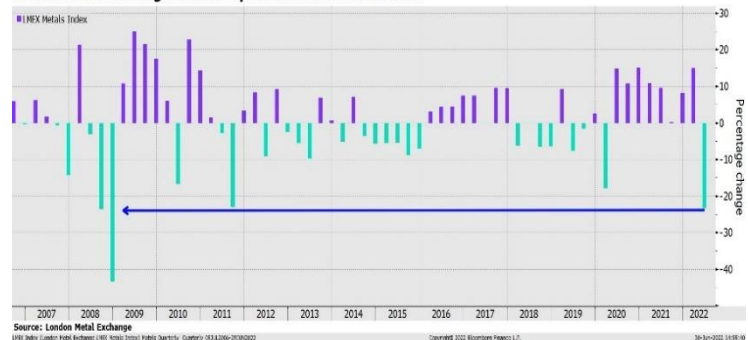
The United States isn't the only country impacted by 40-year high inflation. This is generally is a global phenomenon currently. Europe is also experiencing significant inflation at the country and regional level.

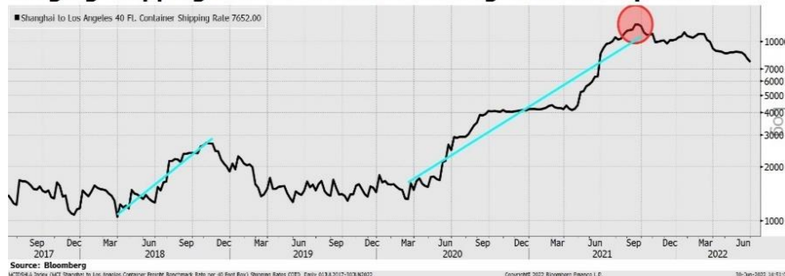
The good news on the inflation front is that some of the drivers of inflation are starting to level off or turnover.




Lumber is down from $1,410 per thousand board feet to $655. This occurred mainly during May and June. It is, however, still above the 2020 high of $400. Copper, a significant industrial metal, is down over 20% recently and steel has fallen from $1500/ton to $900.

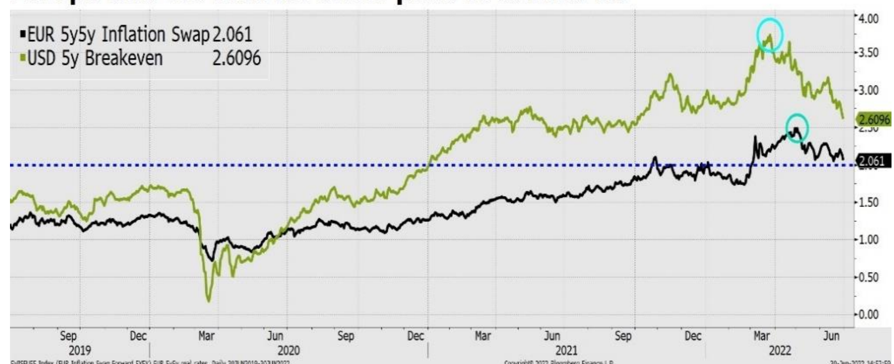
In fact, metals in general have come down during May and June experiencing their worst decline since 2008. Of course, this impacts the cost of industrial products and construction going forward.



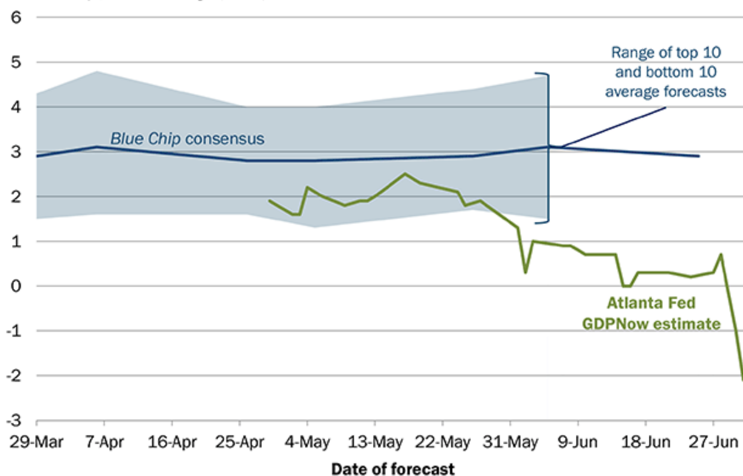

Even shipping rates are starting to retreat from what were historic highs – even though we are nowhere near normal.

This has provided hope that we will see inflation start to recede with evidence being a decline in inflation breakeven rates in Treasury inflation protected securities (TIPS). The five-year breakeven inflation rate is just about 2.61%. Of course, there is a difference between price levels and inflation. Inflation is the general growth of price levels. So, if gasoline is still $5.00/gallon next June theoretically inflation is at 0% but we would still be dealing with high price levels which would impact consumers. We need to see prices actually decline in critical components of CPI.



The inflation situation is what is driving the Fed's decisions on interest rates. After raising 0.25% in March and 0.50% in May the Fed took markets by surprise in June by raising 0.75% after guiding towards a raise of 0.50%. The 0.75% raise was the greatest since 1994. The hot inflation read of 8.58% most likely drove the Fed to this late decision. It was "leaked" to the Wall Street Journal only days before the decision. Moreover, the Fed guided towards another 1.75% increase by the end of the year. This would entail at least one more large rate increase – most likely in July – where Powell has indicated it will be either 0.75% again or 0.50%. Another 1.75%, if enacted, would mean the overnight interest rate would be around 3.50%. Powell has been strong in his wording and guidance in June in the hopes that the announcement causes behavior change and causes a softening in the economy. He indicated that inflation was the top priority and that "The committee is strongly committed to returning inflation to its 2% objective." It looks like he has been successful in communicating as CME Fedwatch indicates that markets estimate the chance of July 0.75% increase at 84.4%. The chart shows expected rate increases and cuts in 2022 (blue), 2023 (orange) and 2024 (purple).

Many are asking how the Fed missed the inflation read so poorly. Part of the explanation may be that the Fed was using the same tools they employed when they fought the last recession war (low growth, high unemployment and weak demand) in 2008. They followed the same plan of lowering rates in 2020 – problem was that 2020 was very different recession. In addition, this time the Federal government came in with massive amounts of stimulus directly to consumers. What was also different is that the COVID event constricted supply as well and, coupled with a massive rebound in demand with consumers who had cash in hand, very quickly created a significant imbalance of supply and demand. This may also be why they thought inflation was temporary until the initial surge in demand was over. What was also unforeseen was the war in Ukraine, which had a significant impact an energy and food supply, as well as worker shortages in the U.S. The result is that the Fed is under pressure to move quicker now to combat what they can in inflation – demand.




So, what else is impacting financial markets if longer term inflation expectations are starting to fall? The answer is near-term economic growth. The final 2022 Q1 GDP was revised down to -1.6% (from -1.4%). Furthermore, the Federal Reserve Bank of Atlanta estimates 2022 Q2 GDP at -2.1% which, if realized, would fit the common definition of the start of a recession – two negative GDP quarters. The IMF has estimated a drop in 2022 Global GDP to 3.6% (from 6.1% in 2021) and to 3.7% in the U.S. (from 5.7% in 2021). The World Bank projections are slightly more pessimistic with 2022 growth of 2.9% globally and 2.5% for the United States. The last 3 quarters of 2022 would have to be very strong in order to dig out of a 1.6% hole and finish positive. If Q2 does come in negative (or even zero) the last two quarters of the year have an even bigger hole from which to dig out in order to end the year positive.

**Pace of Existing Home Sales Down By 1 Million Units**

**May Data falls to 5.4M homes as rates soar**

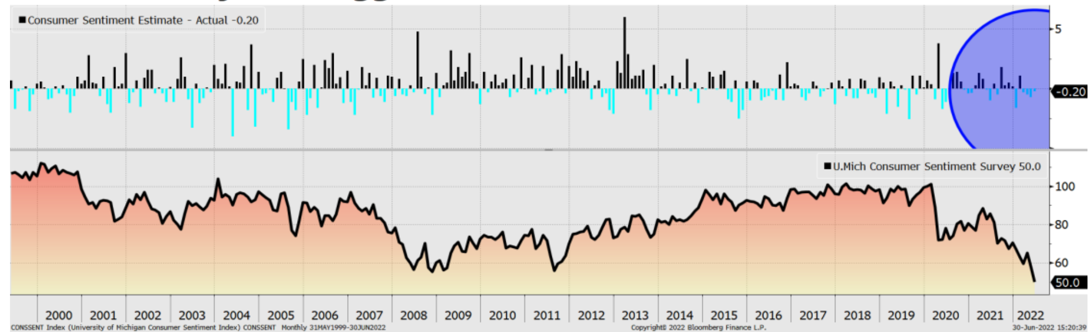
The signs of a slowing economy are certainly starting to show. Housing is the first industry that is exhibiting a significant drop in activity given its sensitivity to interest rates. Sales of existing homes fell for a fourth consecutive month declining about 3.4% in May (Black line). Much of this can be attributed to rising rates (Yellow line) – the average 30-year mortgage rate was 5.78% last week – up from about 3.45% in January and 2.93% a year ago.

Even though there are still over 11 million jobs outstanding (for about half that many currently seeking employment) some companies are starting to layoff workers while, anecdotally, some companies are starting to rescind job offers. Among the companies recently announcing significant job cuts are Carvana, Netflix, Compass, Redfin, Coinbase, Tesla, Robinhood, Wells Fargo and Warner Brothers. In addition, several other high-profile companies announced hiring freezes including: Uber, Meta (Facebook), JP Morgan, Nvidia, Lyft, Snap, Salesforce, Twitter and Intel.

All the grim news has put the consumer in a very foul mood, and it is starting to show in their spending. Inflation is beginning to change consumer behavior as they cut back on spending (and consumers are 2/3 of U.S. GDP). The Fed recently reported that more than half of the 12 Federal Reserve districts in the country reported a drop-in consumer spending in their beige book reports due to pushback on rising prices. Consumers are cutting back on large ticket items such as cars and houses and are foregoing discretionary purchases such as furniture, electronics and clothes. The consumer's mood is also reflected in the lowest consumer sentiment survey reading on record.

**Consumer Sentiment Drops**

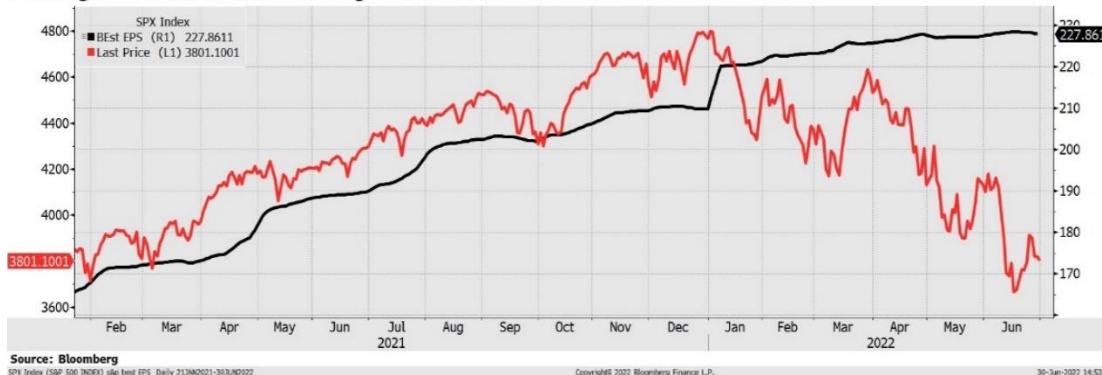
**U.Mich survey saw biggest miss below estimates**

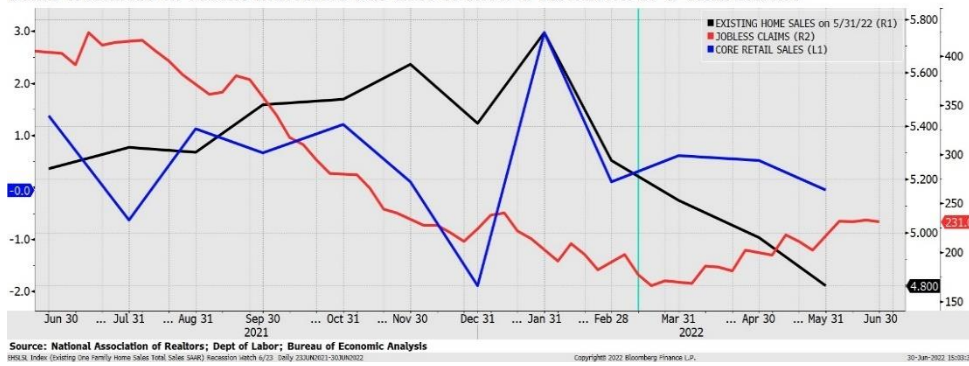



Another perspective on growth more closely tied to markets is company earnings. As consumers spend less and inflation continues to drive up costs, companies may start to see more pressure on profits. Companies that have pricing power can pass on some (or most) of the cost increases but others cannot and will see eroding profitability. In the coming weeks companies will report their 2022 Q2 results where we get a glimpse of how they are being affected. Currently earnings estimates for 2022 have not changed dramatically (Black line) while stock prices have fallen precipitously (Red line). If that holds then the P/E ratio is making stocks look less expensive but, if company earnings fall, then the P/E ratio starts to rise again even with stocks at their current level. In that case stocks will not be as cheap as they seem to be now because the 'E' in P/E is less.

**Earnings Backdrop**

**Analyst estimates stay firm amid S&P 500's rout**

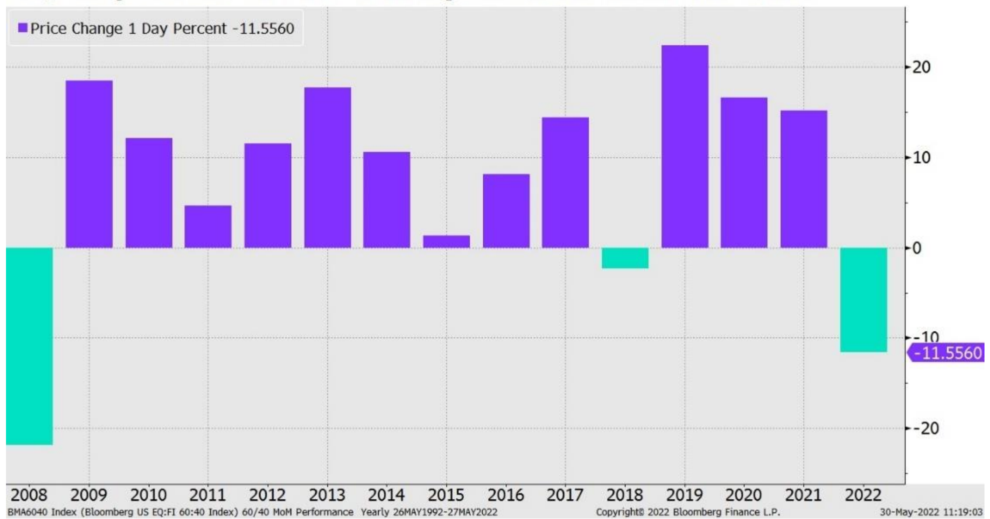


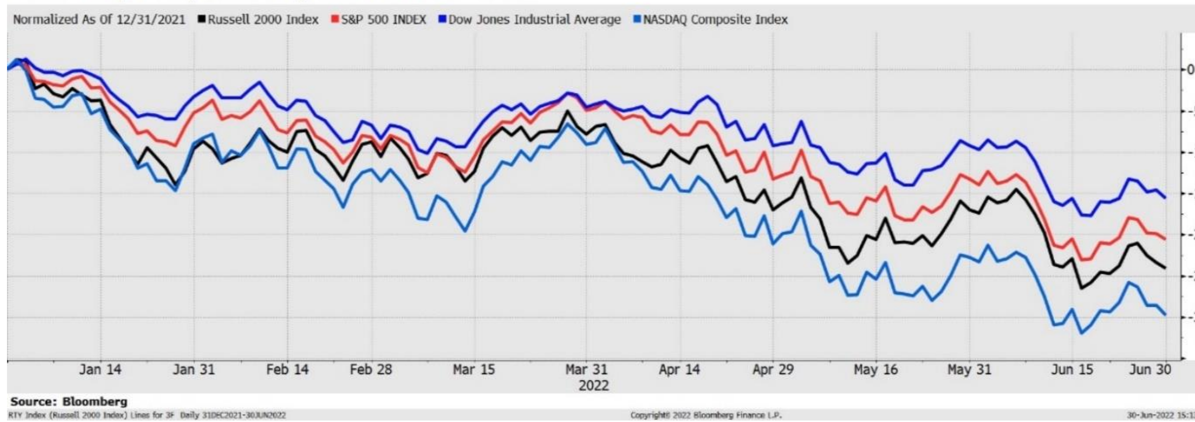



In sum, it seems we are already in a 'slowflation' environment and the path to a soft landing is now much narrower. The question then becomes does the economy move towards 'stagflation' or an outright recession. If it is a recession the current job situation and healthy consumer balance sheet puts the U.S. in strong position to help make the recession as shallow and short as possible.

## Financial Markets

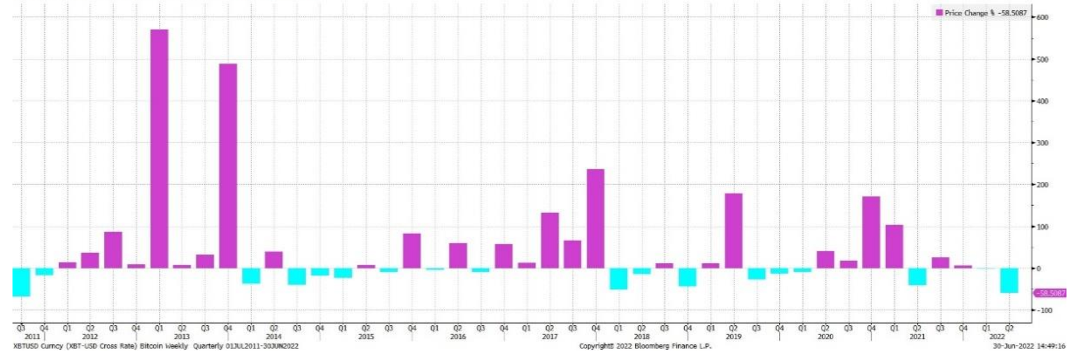
There is no sugar coating the first half of 2022 for financial markets. This is the worst first six months of the year for the S&P 500 since 1970 and, according to Barron's, the worst six months for 10-Year Treasury Notes since 1788 (yes, you read that correctly)! There were very few places to hide in 2022 so far except for cash – and even then, your purchasing power was eroding due to inflation. The benchmark 60% equities/40% fixed income portfolio is down well over 16% in the first six months of the year.

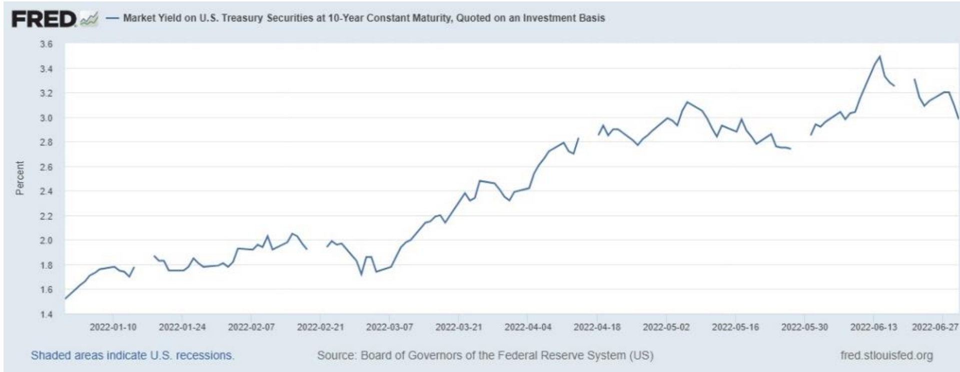



The S&P 500 is off 20% for the year, putting it right at the definition of a bear market. The disparity between the value and growth stocks is even more dramatic. The growth stocks, which have led the S&P 500 returns over the past few years, are down 27.6% while value stocks are down 11.4%. As the chart shows all U.S. stocks are down this year regardless of company size. Only the narrower Dow Jones has performed marginally better (Dark Blue) than the S&P 500 (Red). The small company stocks (Black) were worse and, with nearly a 30% decline, the NASDAQ (Light Blue) performance was lowest of all. In fact, the common theme this year is the more risky or speculative the investment the worse its performance. You could see this with the significant drop off in SPACS (Special Purpose Acquisition Companies), NFTs (Non-Fungible Tokens) and in Cryptocurrencies.

Bitcoin, the most well-known crypto, had its worst quarter since 2011. The value of a bitcoin struggled to stay about $20,000 and ended the month at $19,439 after reaching an all-time high of about $69,000. Bitcoin is down about 70% from that high and down about 52% since the beginning of 2022.




The safer asset class of fixed income has not performed much better. The 10-year Treasury note started the year at a yield of 1.52% and climbed to a high of 3.49% in the middle of June before settling back to 2.98% by the end of the month. There is currently a tug of war between the inflation impact, which pushes yields up and the threat of a significant slowdown or recession, which results in lower yields. This consequence is that the 10-year Treasury is down over 11% for the year while longer-dated U.S. Treasury bonds are experiencing a decline of over 20% so far. Even Treasury Notes less than 5 years are down over 4%. Corporate bond returns of similar maturities are worse than Treasuries. One silver lining for income investors is that buying fixed income now will actually generate some income with yields on short 2-year Treasuries near 3%.

**Should you have any questions please contact us.**

Image sources: Bloomberg and CNBC unless otherwise noted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