Courier Capital, LLC
Registered Investment Adviser
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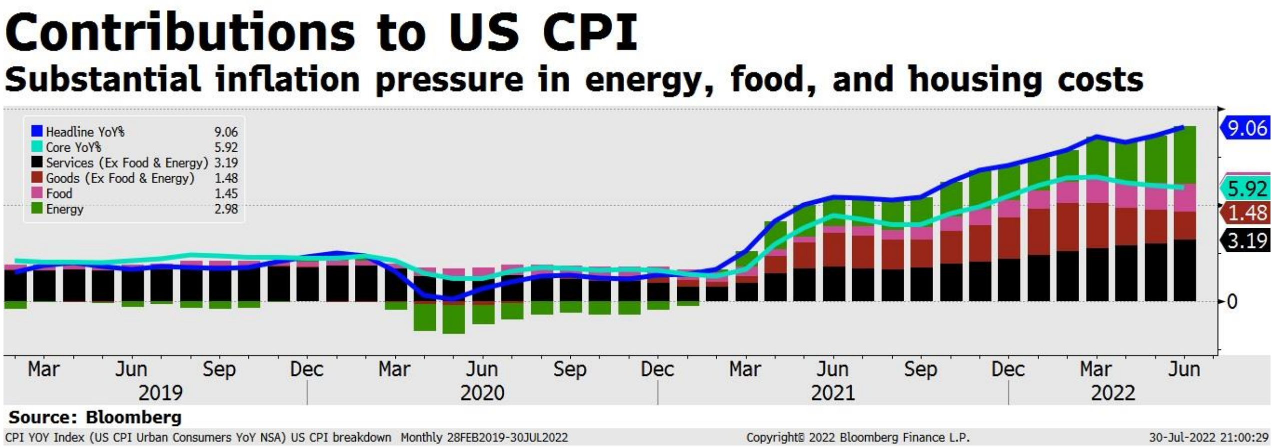
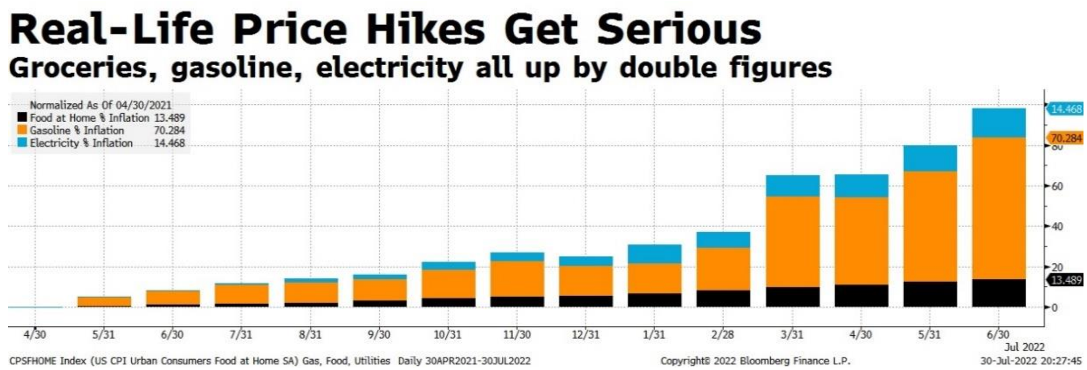
Economic and Market Update – FEELING THE HEAT (07/31/2022)

Latest Developments and Economics

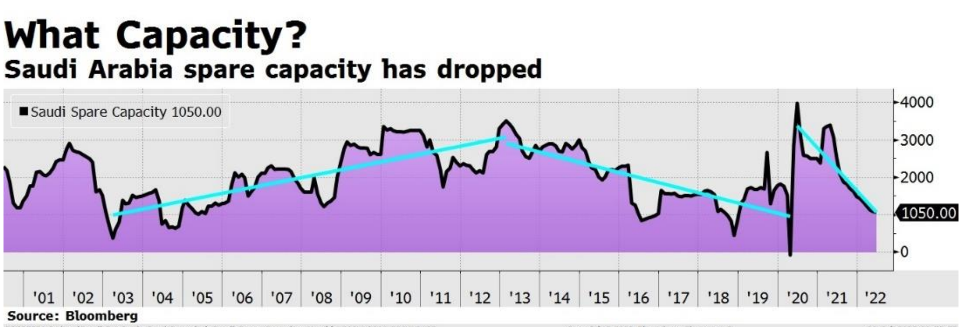
The United States and Europe are currently experiencing significant, and in some cases, record heat this summer. The heat is also being felt in other areas – though not metorogically. The U.S. consumer is feeling the heat of inflation as the latest Consumer Price Index (CPI) reading was over 9%, which signifies that the inflation riddle, while showing signs of abating, is still not solved.



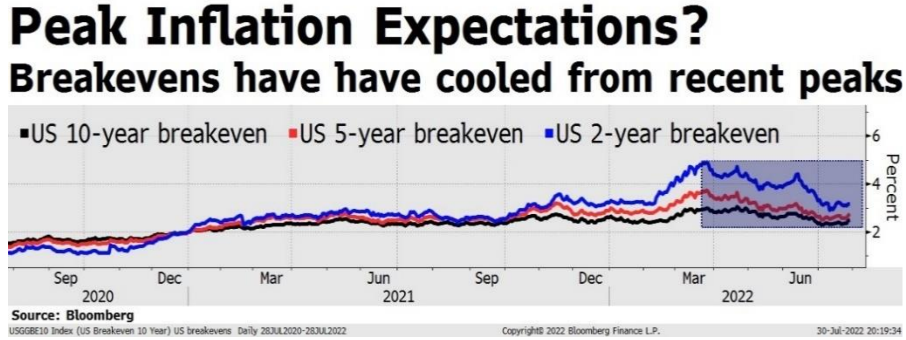
Furthermore, much of the inflation is concentrated in categories that impact consumers most directly. Food at home, gasoline and electricity are all up double digits since April of 2021. This is on top of housing costs – whether it be purchase or rent.



This strong inflation reading was reason for markets to believe that the Federal Reserve might raise interest rates as much as 1.00% at their July meeting. The Fed did settle on another 0.75% raise, their second in as many months, to bring the upper end of short-term rates to 2.50%. Part of the reason for not moving higher was that some sources of inflation are starting to peak and recede – commodities, such as gasoline, are an example. The average retail price of a gallon in the U.S. was $4.44 at the end of July, down from a high of just over $5.00 in June. Some of the decrease is due to lower expected demand should the U.S. enter a recession.

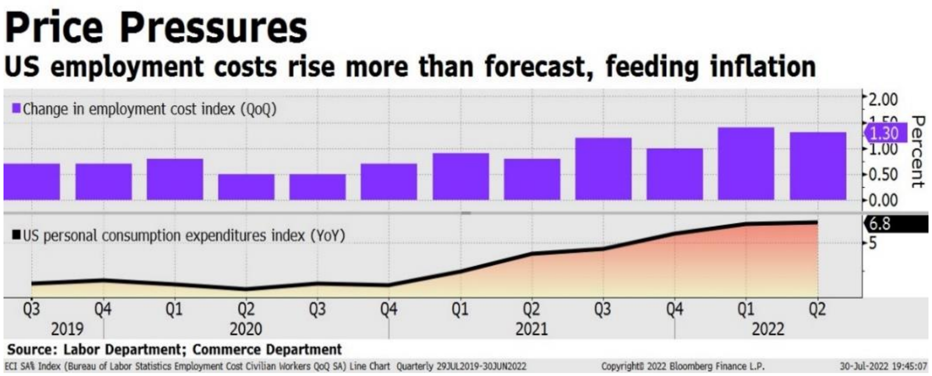


Beyond that, the chance of oil and gasoline moving significantly lower is low. The U.S. has no excess oil capacity – only Saudi Arabia and United Arab Emirates do but even that is slim. President Biden's recent trip to Saudi Arabia is not likely to result in increased supply, beyond what was already promised, not only due to little excess capacity but there is also no motivation for Saudi Arabia to increase production while oil prices are high. OPEC has a meeting scheduled for early August where we may see the result of any new production goal discussions.

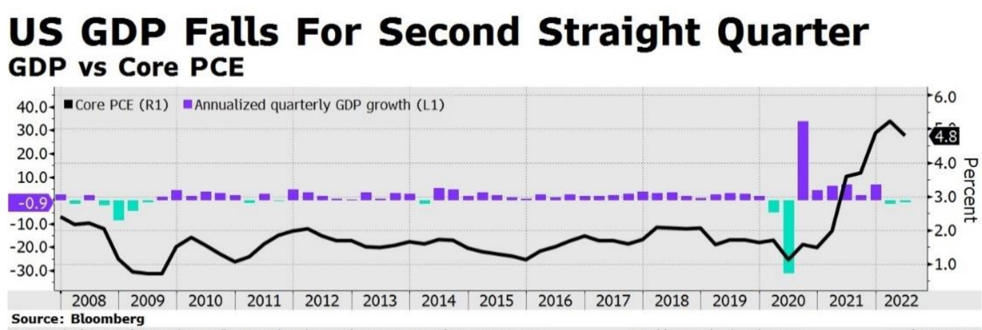


Moreover, long-term inflation expectations are starting to come down. Expectations in bond markets are measured by the yield difference between regular treasury bonds and an equivelant maturity inflation-protected bond. The 10-year implied inflation breakeven dropped from 3.0% to 2.3% in July.

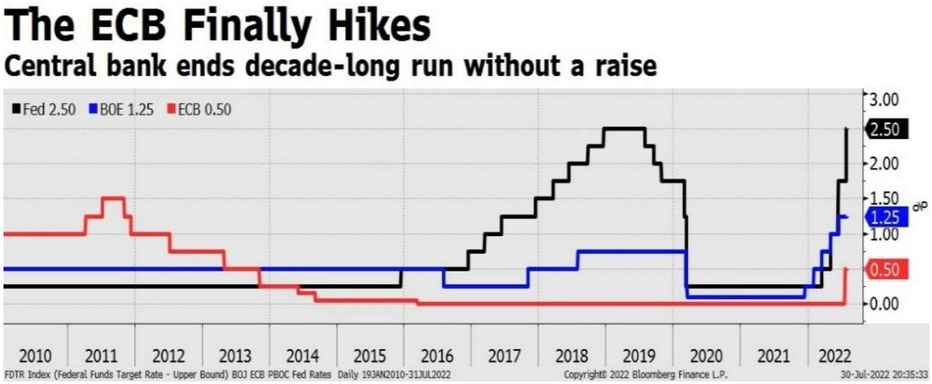
Despite the good news there remain elements of inflation which are not moving down or are continuing to rise. One of the most important is labor costs. Wages, which are sticky and a significant source of fueling more inflation, continue to rise. The Employment Cost Index (ECI) is a broad measure of labor costs and it rose by 1.3% in Q2 - more than expected. The tight labor market, with 11.3 million open jobs and about half that many looking for work contributed to labor costs rising over 5% over the last year. Futhermore, the U.S. consumer, while not happy, is still spending. Generally, consumers are spending more money but getting less goods and services due to inflation. Estimates are that inflation is costing the average household about $500/month. Evidence suggests that this additional spending is now coming from credit cards as consumers, especially those with less resources, have used up all of the savings from COVID shutdowns.



Despite the inflation problem the U.S. economy had a Q2 GDP first read of -0.90%. The expectation was for a slight positive reading but, the U.S. economy recorded its second straight quarter of negative GDP growth (the revised Q1 was -1.6%). The heat is also on Fed Chairman Powell as he has been adamant about bringing down inflation but is also dealing with a struggling economy.

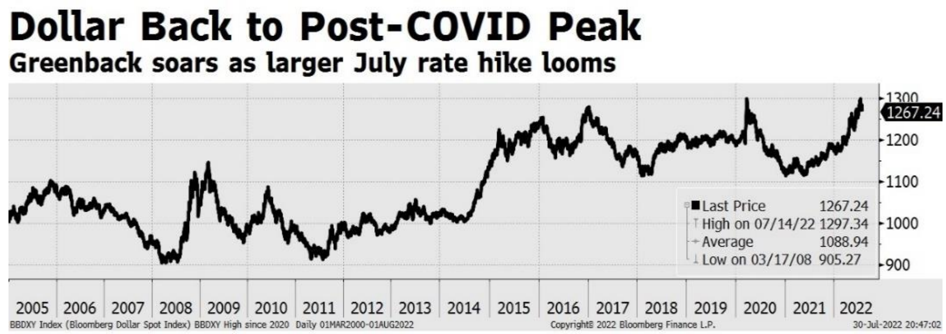


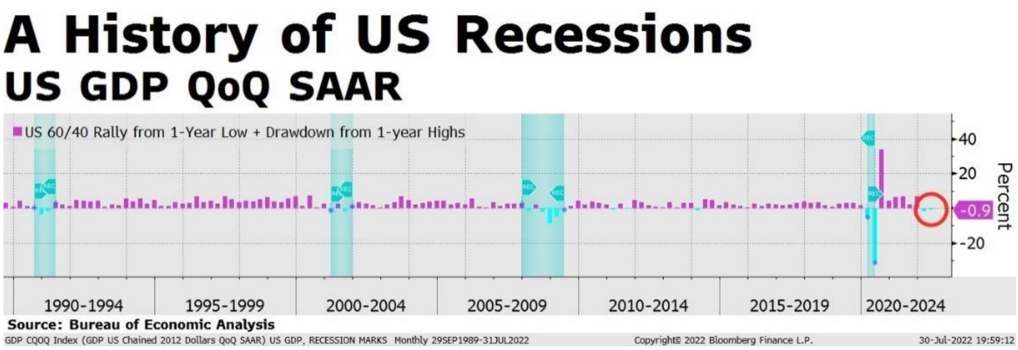
This puts the Fed in a very precarious position. Their main tool in attacking inflation is interest rates, which they must continue to raise but, raising interest rates also slows the economy further. The most dangerous situation would be if the Fed raised interest rates enough to slow the economy but not enough to bring down inflation. This would most likely result in the 'stagflation' situation that has been discussed in previous letters. The wage cost inflation and strong consumer spending just mentioned makes the Fed's job harder as a stubborn labor market generally means the Fed may have to raise rates higher than they wish in order to affect inflation. The higher rates go the more likely that a recession develops as well. This is why many believe that we do not get out of this situation without some sort of recession – how severe cannot be known. The Fed will not meet again until September and Chairman Powell indicated that clear guideance on rates is not possible. He had already been taking heat for not dealing with inflation earlier and now there is criticism that he is raising rates too quickly. Senator Elizabeth Warren called him out last week for two significant rate increases in two months. These are the times when being Fed Chair is especially hard.



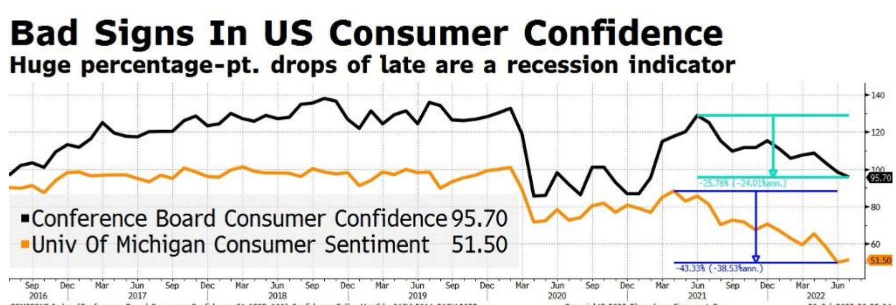
Most developed economies around the world are dealing with inflation and their central banks are also responding with rate increases (though not as aggressive as the U.S.). Conversely, Asian economies (especially China) are reducing rates in order to spur economic activity. There seems to be a bi-polar world alignment when it comes to interest rate direction that is very divergent.

The interest rate differential has also contributed to a strong U.S. Dollar. The greenback is currently at a 20-year high relative to other currencies. The Euro even reached parity with the U.S. dollar. This puts profit pressure on U.S. Multinational corporations and means that, through U.S. dollar-denominated assets, the U.S. is exporting inflation to other countries.



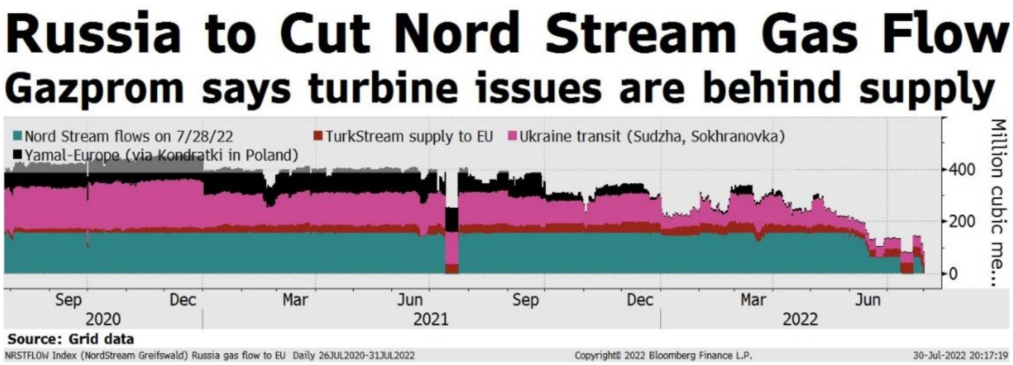


The two sequential quarters of negative growth in GDP in the U.S. has raised the question again as to whether we have already entered a recession. The Biden adminstration and Jerome Powell recently both argued fervently that we are not in a recession. The common definition of the two negative quarters is a non-technical, cliff notes version of recession. Also, this wrangling over a term has no real significance. The U.S. economy is slowing it is just a matter of degrees and whether it has crossed a line to put the label 'recesssion' on it. If it is a recession it would be historically very unusual (which is following another unique recession when we shut down the economy due to COVID in March, 2020). The National Bureau of Economic Research (NBER) is the official agency that defines the beginning and ending of recessions (often after a delay) and they characterize a recession as "<u>a significant decline in economic activity that is spread across the economy and lasts more than a few months</u>". GDP is just one of the indicators they take collectively to call a recession. One of the other major indicators is employment. Recessions usually exhibit a fairly significant rise in unemployment. As of today, we are still at 3.6% (historically low) with the 11.3 million open jobs mentioned above. Others include personal income and consumer behavior. Wages continue to rise and the consumer is still spending, but becoming miserable. Consumer confidence is dropping which is a red flag for a potential recession forthcoming. Part of what drives people to spend is how they feel, and they do not need to be in a recession to feel bad. This has the potential for a self-fulfilling prophecy.

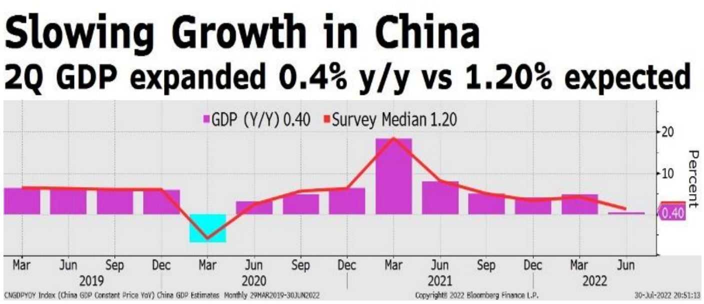


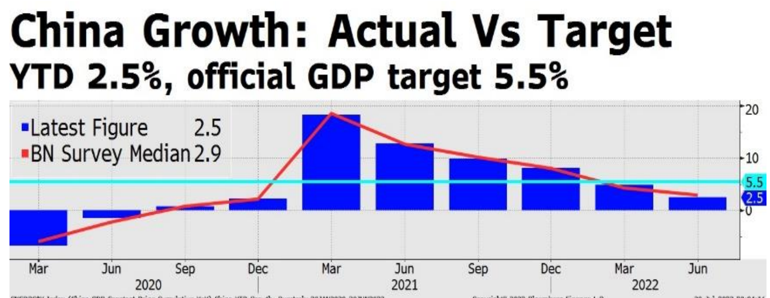
Recessions are also preceded by a prolonged inverted yield curve, which we do have that right now with the yield on 2-year treasuries definitively higher than 10-year treasuries. Many feel the chance of recession has increased, especially if the Fed continues this path of rate increases.

As we turn to international affairs heat takes on different meanings there as well. Russia continues to be coy about their plans to supply Europe with the natural gas that they will need to heat their homes this winter.



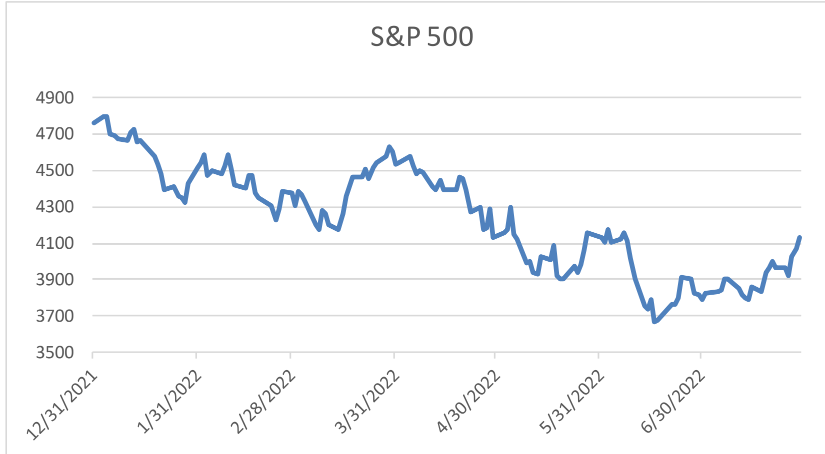
Russia claims that the pipeline which supplies the gas needs to be shut down for equipment repair - repeatedly. The European Union has accused Russia of economic warfare using natural gas as a 'weapon'. The EU has called on member countries to accept a voluntary 15% gas usage reduction which could lead to mandatory rationing should there be a supply emergency. Gas prices in Europe doubled in a month after Russia cut supply but remain 30% below the March post-invasion price. With a significant energy problem, continued inflation issues and rising interest rates the prospects of a recession on the European continent look higher than that of the United States. This is in conjunction with significant political issues in some countries. In the U.K. Prime Minister Boris Johnson resigned after pressure from his party and in Italy Prime Minister Mario Draghi resigned after only 18 months as his unity government failed.





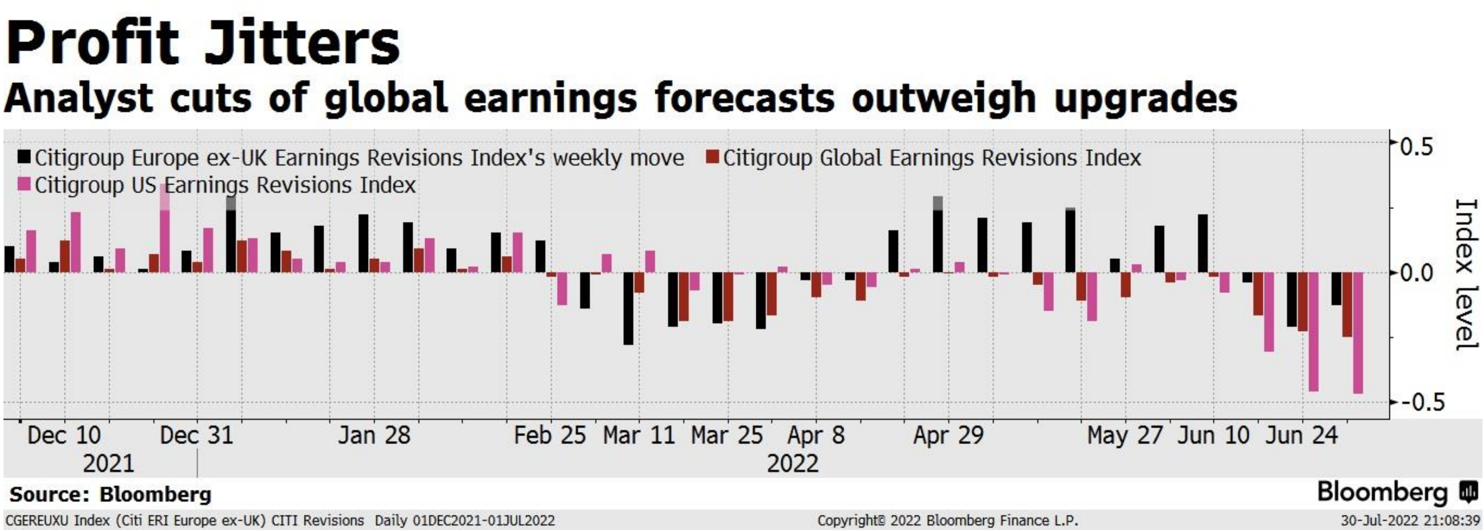
China is feeling some economic heat as growth is slipping quickly. Their Q2 GDP came in at 0.4% year over year – far less than the 1.20% that was expected. The economy continues to be slowed by the zero-COVID policy and that is also causing global growth to slow through continued supply chain slowdowns and disruptions. Current economic growth is far below official targets of 5.5%, coming in at 2.5% annualized rate for the year so far. The country also is being significantly affected by the real estate sector. July sales at China's top 100 real estate developer fell 39.7% from the same period last year. There has even been homeowner revolt with homebuyers threatening to renege on their mortgages due to concerns that the developers will not be able to complete pre-sold apartments. In addition, the manufacturing sector continues to fall. Together, real estate and manufacturing are estimated to be responsible for about one third of the Chinese economy (second largest globally). This contributed to China cutting key borrowing rates recently. One more headache are geopolitical tensions with the West. There has been much attention paid to Taiwan, which China considers an island in Chinese territory (by history). The island of 23 million people have been ruled by a democratic system independent from China since 1949. The planned visit by Senator Nancy Pelosi in early August has heightened tensions further and China responded to the U.S. with a very stern warning not to "play with fire".

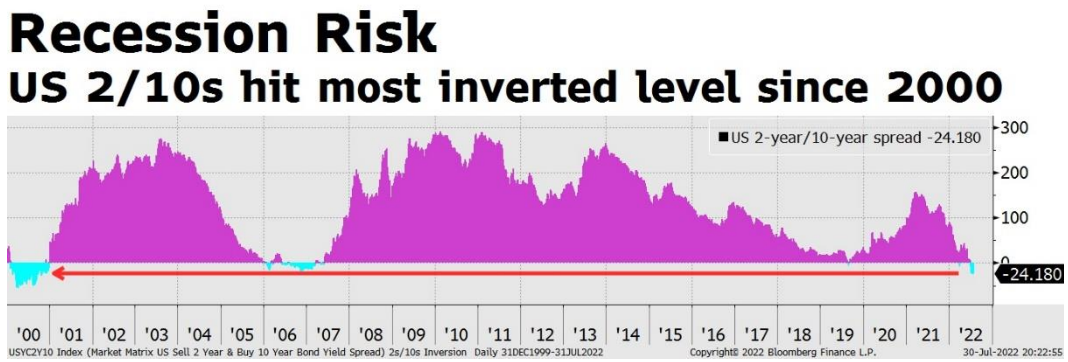
Financial Markets



The S&P 500 had its best month since November 2020 when the index rose almost 11% after the announcement of a successful COVID vaccine. The S&P 500 rose 9.22% in July recovering some of the losses from 2022 and leaving the benchmark at -12.58% for the year. U.S. mid-sized and small companies performed marginally better – most likely due to lesser impact from a strong dollar as those companies are more domestically orientated.

The relief rally was driven primarily by two events during the month. The first was the comments by the Federal Reserve Chairman in his press conference. Despite raising interest rates by 0.75% and clearly stating that taming inflation was of utmost priority some of the comments made were interpreted as dovish. Chairman Powell indicated that, in his opinion, we were reaching the neutral interest rate (the rate at which the policy is neither restricting the economy nor expanding it) and that he expected rates to end the year near 3.50%. If true, this would mean a potential increase in rates of only 1.00% for the rest of the year – a slowing of rate increases. In addition, he even mentioned that the committee could “adjust the stance of monetary policy” rates should risks emerge. Second, the market has been satisfied with the corporate earnings reports for Q2 so far. Companies have performed better than feared this quarter. Of the 278 companies in the S&P 500 that have reported 75% of them have beaten earnings expectations. This is especially true of big tech which has taken the brunt of the decline in equities this year. Apple, Amazon, Microsoft and Alphabet all reported results that were not as bad as expected and all were up. In fact, Information Technology and Consumer Discretionary stocks led the July performance. Despite the positive Q2 many companies indicated that they are feeling the impact of building headwinds. They see a retracting consumer that is reducing sales and are feeling the impact of inflation on costs, interest rates on financing and declining profitability due to a strong U.S. dollar. This is causing a reassessment of corporate earnings globally for 2022 and estimates are being revised down.





Fixed income also enjoyed positive performance in July. This is despite a yield curve that remains inverted (near-term rates are higher than long-term rates). The difference between the yields on these two securities are a key indicator of an economic rough patch. Inverted yield curves have preceded each recession since 1969. Yields in the near future will also be impacted by other technical factors. The Federal Reserve has been reducing its holdings of almost $9 trillion in bonds by $47.5 billion per month and will increase that to $95 billion per month starting in September. In addition, China's direct holdings of U.S. Treasury bonds fell below $1 trillion for the first time since 2010. China has reduced treasury holdings by 9% and Japan, the number one external holder of treasury debt, dropped by 4%. With the Fed a net seller (rather than buyer) and less external buyers of U.S. debt participating, there could be future upward pressure on treasury yields due to liquidity.

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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