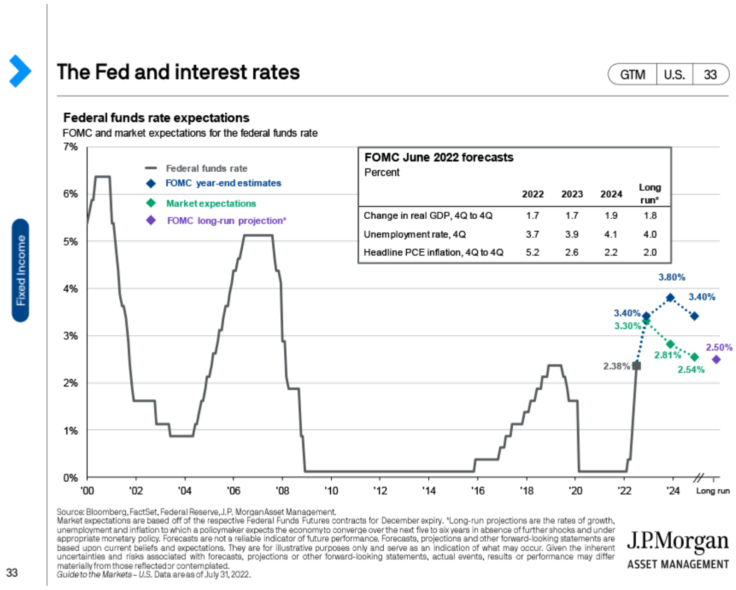
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

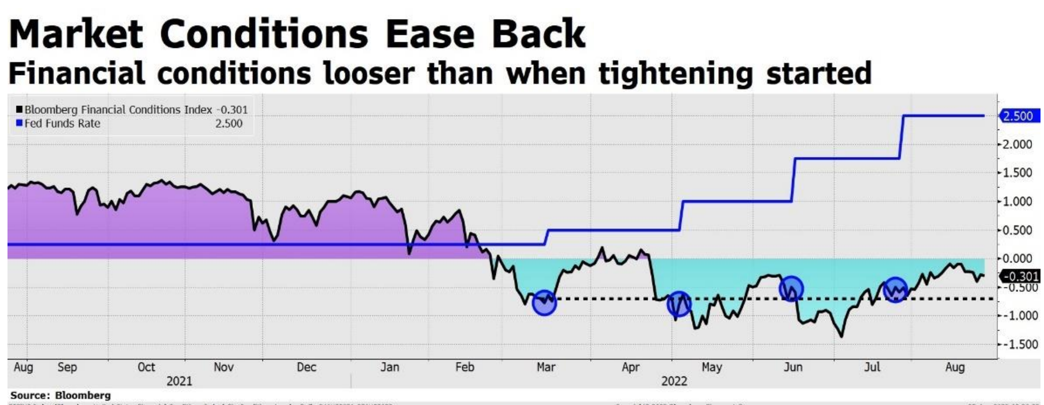
Economic and Market Update – GAME OF CHICKEN (08/31/2022)

Latest Developments and Economics

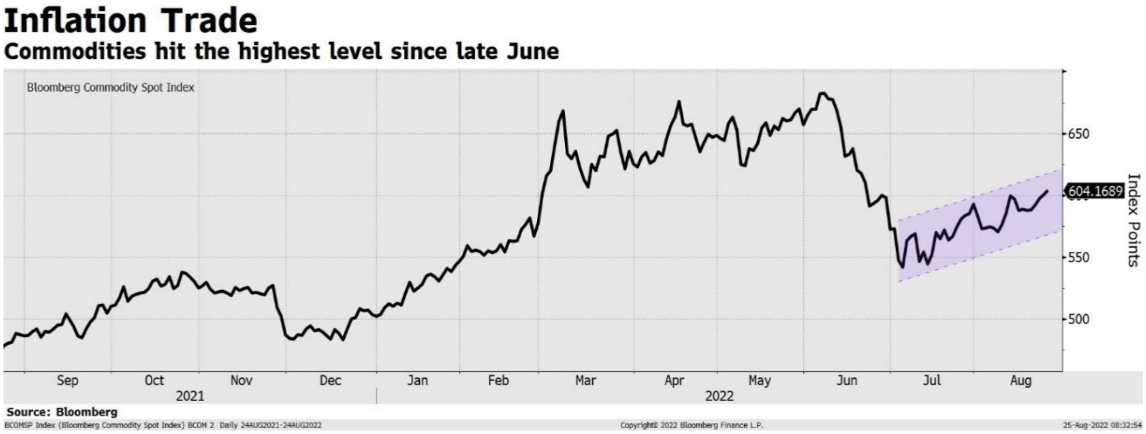
In the traditional game of chicken two cars drive towards each other head on until one of them loses their nerve and veers off to avoid a collision. Since the middle of June, it can be said that the Federal Reserve and the financial markets seem to be engaged in the same game of chicken economically. The Federal Reserve has been consistent in their message that interest rates will continue to increase until they receive reliable information that inflation is heading back down towards their 2% target. The financial markets instead interpreted the last inflation reading of 8.5% (vs. last month's 9.1%) as if the inflation war was being won already. Also, certain parts of Chairman Powell's last press conference before Jackson Hole were parsed and the focus was on statements about being at the neutral rate and anticipating a slowing of rate increases. All of this contributed to the rally in financial markets and fueled this game of chicken.

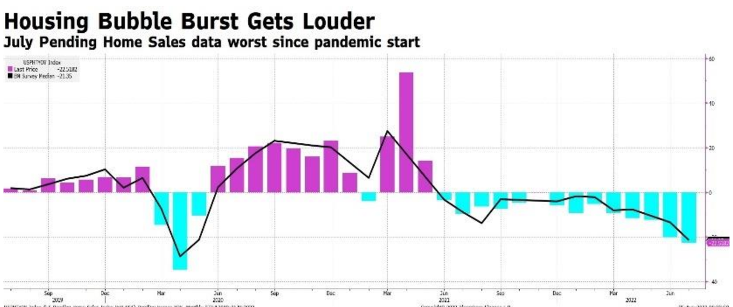


The graph above illustrates this game with the Fed's projected course of interest rate increases (blue dotted) while the markets response with a "we don't think so" projection of future interest rates (green dotted). The very short comments that Powell made last week after Jackson Hole seemed to set the record straight. Powell said that there "will be pain" as the Fed continues to address inflation as their paramount priority, even if it means the economy slows, further increasing the chance of recession. In other words, Powell hit the gas pedal in his car and the 1,000 point drop in the Dow Jones Industrial Average after his comments may mean that the markets did blink in this game of chicken.



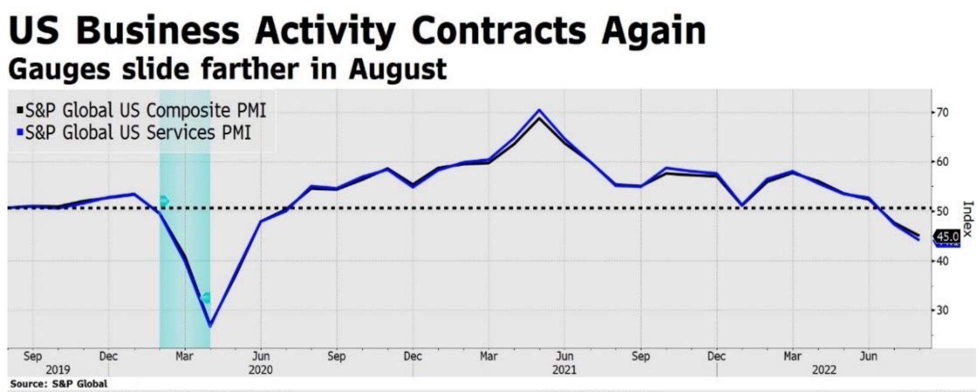
Even if inflation is trending in the right direction there still could be a long way to go to get from 8.5% to the Federal Reserve target of 2.0%. Lately financial conditions have become looser even while the Fed is trying to tighten. Two of the key indicators to watch that will determine the course of inflation as well as potential recession are jobs and unemployment. The latest non-farm payroll showed 528,000 jobs were added during the month – blowing the estimates of the 200,000 range out of the water. This also brought the unemployment rate down towards historic lows at 3.5%. This tight job market is a significant input to future inflation as companies are paying more to attract and retain workers. The labor shortage also contributes to the supply shortage as less workers means goods and services are not produced at a level that is balanced with demand (think of airline travel and pilot/crew shortage as an example). This shortage also keeps prices high due to scarcity. Recessions are also characterized by job losses and high unemployment. There are still 10.7 million jobs open, even though it is less than 11.3 million the month prior. Plus, we are starting to see companies cut back. Among the companies announcing job cuts as of late are: Ford, Walmart, Coinbase, Robinhood and Bed, Bath and Beyond. Inflation signals have become more mixed as well. Commodities seem to be rising again even though gasoline prices have retreated. Yet, OPEC in their latest meeting announced that they would increase production by 100,000 barrels per day or about 0.10% of global demand, even after Biden's visit last month requesting more.

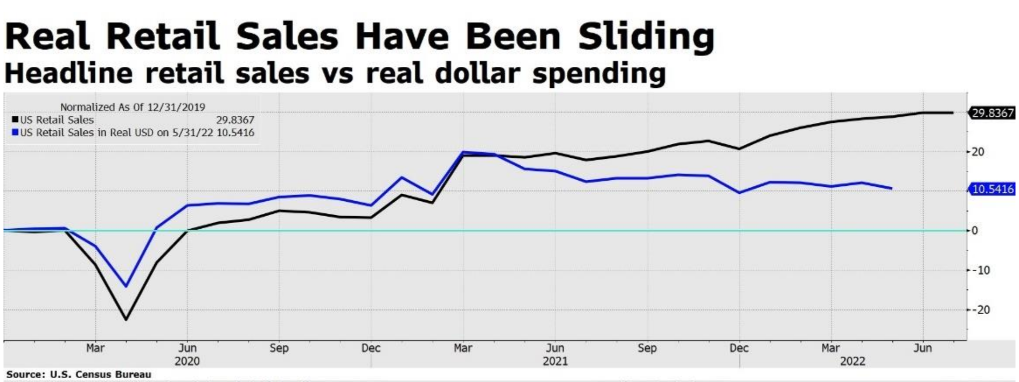




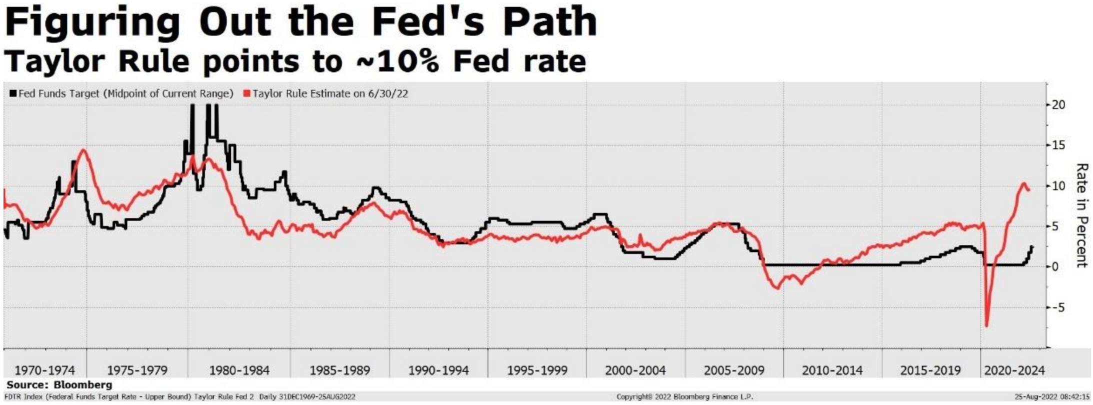
Housing has continued its slide with both existing and new home sales falling dramatically as interest rates (and mortgages) rose. Home prices actually fell 0.77% last month – the first decline in three years and the largest drop in monthly prices since January 2011. Shelter costs are heavily weighted in the Consumer Price Index (CPI) making up about 23% of the total and, due to the lag in calculation, it will take a little while for this leveling off to find its way into inflation data.

We are also seeing signs of a slowing economy in business activity. Purchasing Manager Index (PMI) readings are showing a continued trend down below the growth line of 50. This decline means businesses expect to produce less in coming months.

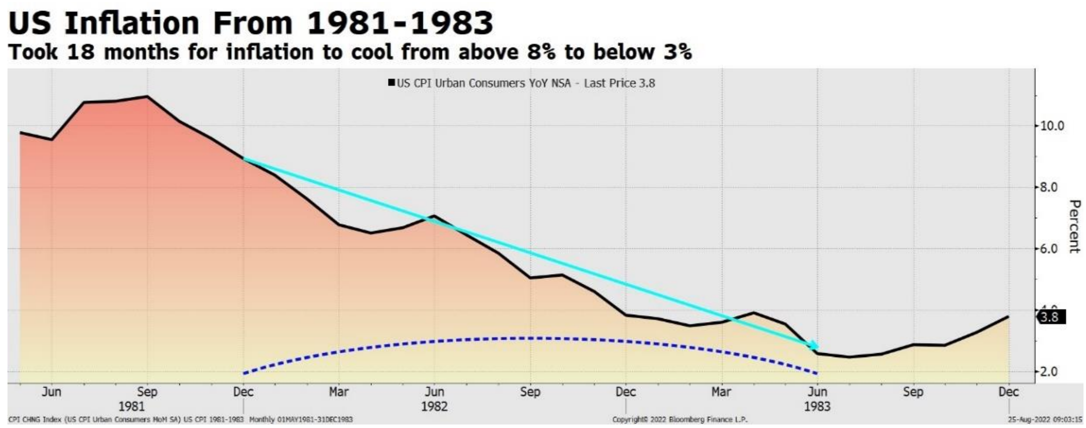




Even with current challenges we still see the consumer spending in retail. The black line shows dollars spent on retail sales but, after adjusting for inflation we see that they are actually spending less on a "real" basis (blue line) and that inflation-adjusted spending is in decline.



So, estimating the rate of disinflation as well as how high/long the Fed needs to go with rates to move towards a 2% inflation target is problematic currently. A 30-year-old economic formula that relates the suggested interest rate level to the current state of the economy and inflation is called the Taylor Rule. Its use was in guiding where interest rates should be currently. According to the Taylor Rule our interest rates should be near 10.0% rather than the present 2.5%. Now, there are no projections that result in a 10% interest rate at all but, if history and Chairman Powell are reliable guides, it does mean that we should expect the higher interest rates we are seeing may be around for longer than currently expected in order to bring down inflation towards target.



This brings us to the next Fed meeting in September. The projection is at least another 1.25% increase in interest rates for the rest of 2022 bringing us to 3.75% or even 4.00%. The question is what the path will be – most are now forecasting 0.75% in September followed by 2 more 0.25% increases before year end while others have the path as 0.50% in September followed by another 0.50% and then a 0.25% by the end of the year. Economic data between now and September will determine the degree and path of remaining interest rate increases.

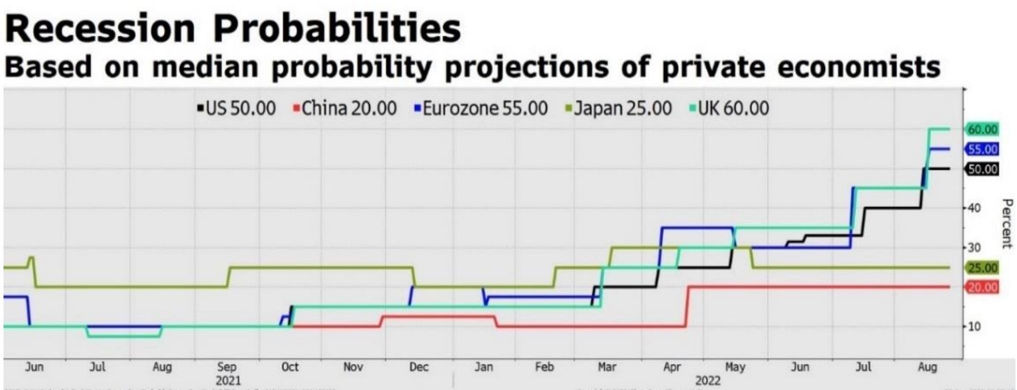
There were also three legislative items that moved forward during the month of August which will have economic impact. In an effort to onshore more critical supply chain issues the "chips" act was passed. The CHIPS and Science Act provides $52.7 billion for American semiconductor research, development, manufacturing, and workforce development. This includes $39 billion in manufacturing incentives, including $2 billion for the legacy chips used in automobiles and defense systems, $13.2 billion in R&D and workforce development, and $500 million to provide for international information communications technology security and semiconductor supply chain activities. It also provides a 25 percent investment tax credit for capital expenses for manufacturing of semiconductors and related equipment. Second was the "Inflation Reduction Act" which primarily addressed climate change issues. The bill includes around $369B in grants and tax credits related to climate change with the goal of lowering energy costs and reducing carbon emissions by roughly 40% by 2030. This includes credits and incentives for electric vehicles and solar roof panels. It introduced a minimum 15% tax on corporations' reported income, a 1% tax on company share buybacks and puts $80 billion in additional resources into the IRS to ramp up enforcement of tax code on individuals. It is also projected to eventually lower the cost of prescription drugs by allowing Medicare to negotiate prices and put a cap on annual prescription out of pocket costs. The current projection is that the bill would reduce the annual budget by $300 billion over 10 years.

The detailed projection is as follows:

REVENUE – 15% Corporate Tax ($222 Billion); Prescription Drugs ($265 Billion) IRS Tax Enforcement ($124 Billion) 1% Stock Buyback Fee ($74 Billion) and Loss limitation extension ($52 Billion) for a total of $737 Billion.

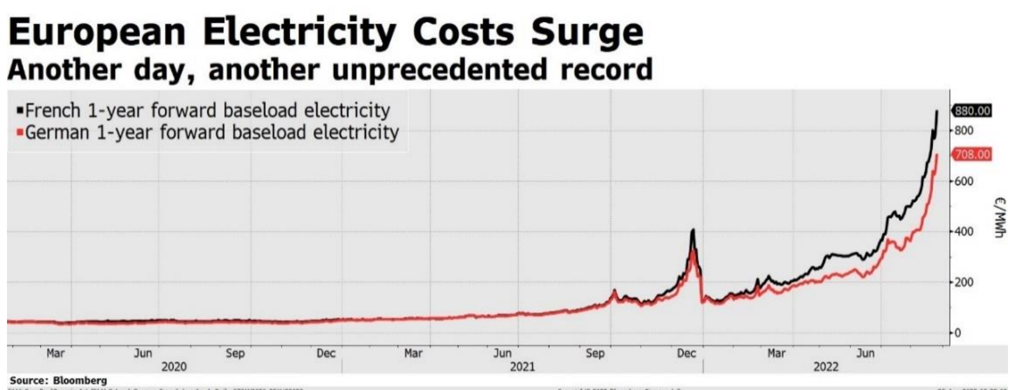
SPENDING – Energy Security and Climate Change ($369 Billion) Affordable Care Act Extension ($64 Billion) and Western Drought Resiliency ($4 Billion) for a total of $437 Billion resulting in $300 billion net benefit.

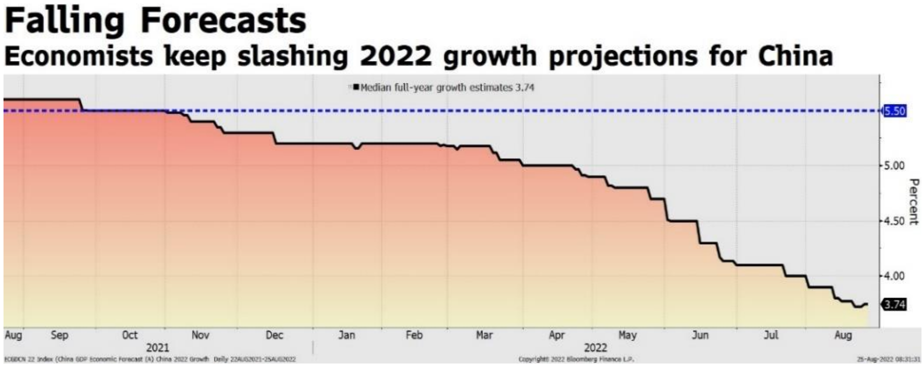
Finally, President Biden proposed executive action on cancelling student loan debt of up to $10,000 ($20,000 if the student received a Pell Grant) for individuals making less than $125,000 and couples making $250,000 per year. He also extended the pause in repayment that started in March 2020 to December 2022; reduced the maximum repayment to 5% of income above $30,000 and accelerated student debt forgiveness to 10 years rather than 20 years. There is question whether he has authority to execute this as fiscal matters are the prevue of Congress so there is potential for it to be challenged. At its core it is additional stimulus which is counter to the Fed trying to fight inflation. However, it may not be so stimulative as borrowers have not had to make payments since March of 2020. Finally, the University of Wharton and Goldman Sachs estimate that the cost of the program could be between $400 Billion and up to $1 Trillion over the next decade. The majority of this comes from the maximum payment being lowered to 5% as well as the additional forgiveness terms (ex: a person making $70,000 would have a maximum payment of $2,000 annually – [$70,000 - $30,000] * .05).

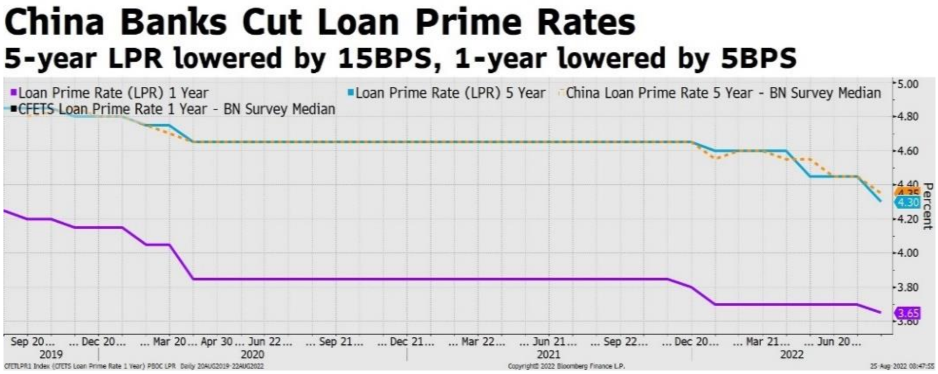


The quick pace of interest rate increases coupled with an economy that seems to be slowing has caused the risk of a recession in the U.S. to increase significantly. Economists estimate the near-term probability to be about 50%. This is below the risk currently assessed to the United Kingdom and the Eurozone.

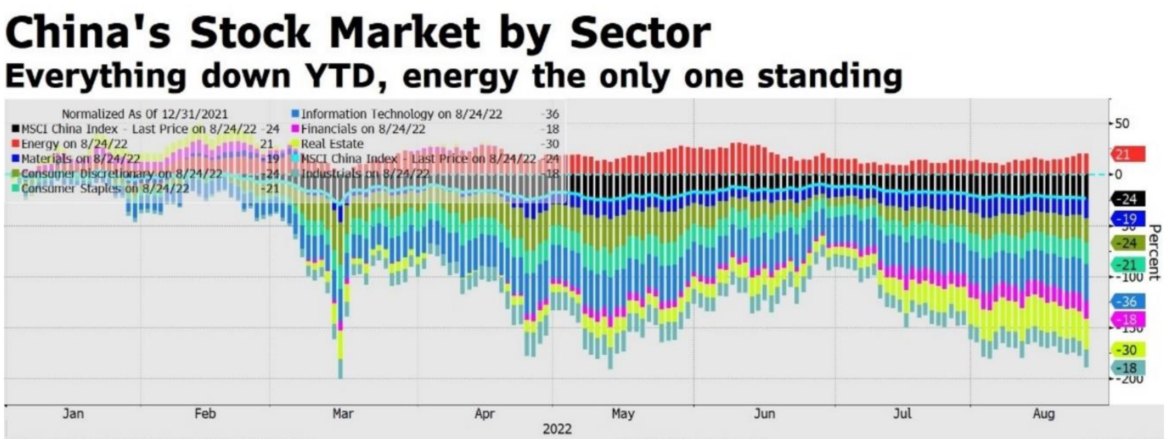
The European and U.K. economies look more vulnerable currently. The risk of recession has caused their central banks to react much slower to rising inflation data. The U.K. just raised its rates by 0.50% to 1.75% despite inflation hitting 10.1% in the latest reading. The European Central Bank raised rates by 0.50% (0.25% was expected) bringing rates to 0.0% while inflation in the Eurozone continued to rise reaching 9.1%. Half of the inflation was caused by energy prices. Natural gas, electricity and gasoline continue their rise unabated. The main reason is the war in Ukraine and Russian sanctions as the Euro area gets 40% of its natural gas from Russia. There are few alternatives in the short-term and winter is coming. Natural gas prices are nearly 12 times higher than they were at the beginning of 2021 and the worry is that Russia cuts supplies altogether. The countries are talking about a cap on gas prices and expect the gas situation to last the next several winters. Energy could be the tripwire that tips the U.K. and the Eurozone into a recession that could be rather deep. Food isn't helping either. The combination of COVID, climate and conflict are causing shortages and rising prices. Grain finally being shipped out of Ukraine should help to partially alleviate the situation though 20 million metric tons still sit in Ukrainian silos.





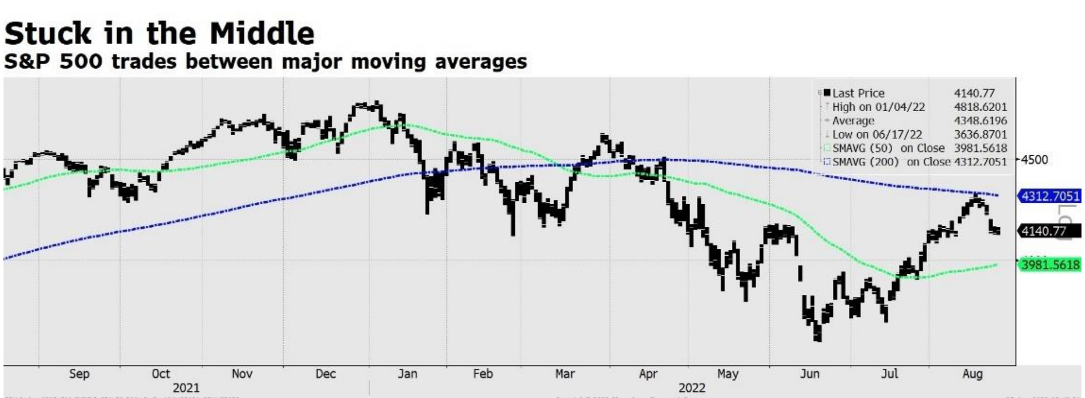


Although China is not projected to fall into recession the slowing economic growth is significant. The targeted annual growth of 5.50% has fallen to 2.74% for 2022. China's industrial production was up only 3.8% in July vs. 4.5% consensus expectations. Real Estate was up only 5.7% through 2022 while it was up 10.3% in 2021. The consumer is not helping as retail sales were up 2.7% - about half of what was expected. The Chinese government has responded with a lowering of interest rates (vs. developed economies raising rates) and more government infrastructure spending. Neither the government spending levels nor the rate cuts were of the magnitude of prior action. It seems that the Chinese government is accepting the fact that economic growth will not be as robust as in the past.



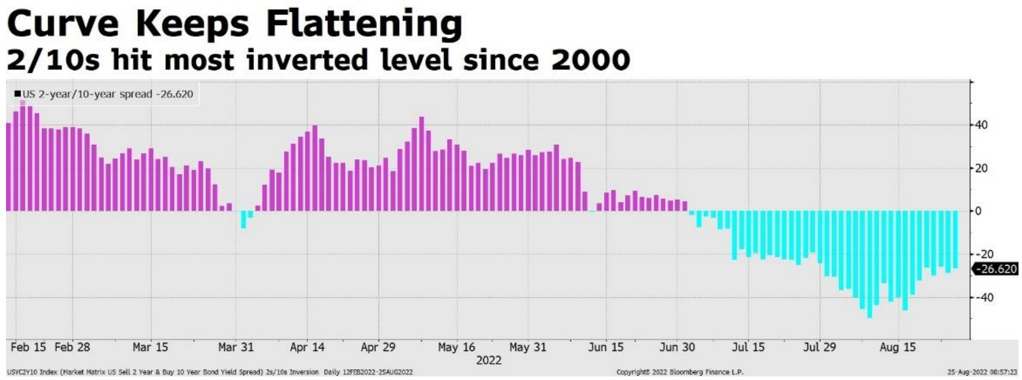
The economic implication is slower global growth as the second largest economy slows its pace of expansion. The economic data has been reflected in China's equity returns. The MSCI China Index is down over 20% YTD and close to 30% for the last 12 months. All sectors except energy are down for the year.

Financial Markets



The uncertainty regarding inflation, interest rates and recession has caused the equity markets to lack conviction in a direction. This is why we see the S&P 500 recently stay in a trading range between 3900 and 4300. The Fed talk last Friday certainly ended the game of chicken and the markets lost - once again proving that you generally don't win when fighting the Fed.

The S&P 500 was down over 4.00% in August making it the worst August in seven years. This also puts the S&P 500 right at the bottom of the trading range and down just over 16% eight months in to 2022. It is possible that we continue to test the low of this range as the market seems to have more headwinds than tailwinds at this point. Some of these include: continuing higher rates; higher costs due to inflation; marginally higher taxes, a strong dollar, supply/labor shortages and a retrenching consumer. We will see more over the next two months with the Federal Reserve action in September and company third quarter earnings in October. This quarter may reveal a cumulative and more pronounced effect on corporate profitability.



In a rarity fixed income has provided no relief to a decline in equities. The Bloomberg Aggregate Bond Index fell another 2.8% in August bringing the 2022 YTD return to -10.75%. If you are holding long-dated U.S. Treasury Bonds you are staring at a loss approaching 25% for the year.

As a result, the moderate 60/40 portfolio is down close to 14% for the year. In addition, the bond market continues to flash a recession signal as the yield curve remains inverted. The yield on the 10-year treasury bond is about a quarter percent less than the yield on a 2-year treasury. With the Federal Reserve continuing to raise rates in the near term they may push up yields on near-term maturities tipping the inversion even further. Even if the Fed does slow down it seems that it is their intention to keep the higher rates at least through 2023 as well.

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

Buffalo Office

1114 Delaware Ave.

Buffalo, New York 14209

PHONE: 716-883-9595

Jamestown Office

214 West Fifth Street

Jamestown, New York 14701

PHONE: 716-484-2402