



WEEKLY

Economic Commentary

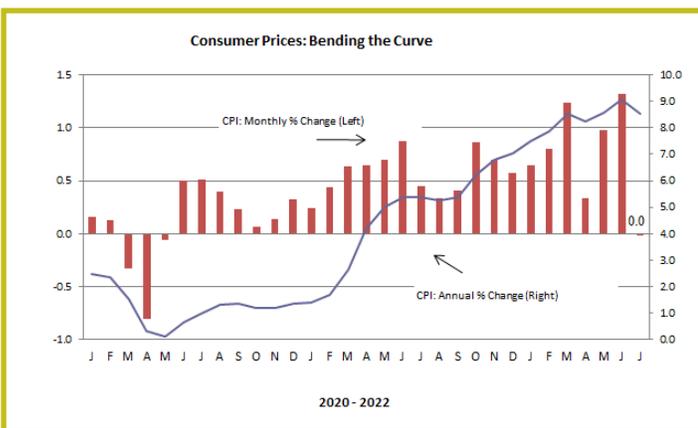
August 12, 2022



Millennium
CORPORATE CREDIT UNION

After suffering through a yearlong battering of unrelenting bad news, inflation doves finally had a week to celebrate. For sure, it's still unclear if we are seeing the beginning of the end of accelerating inflation, or the beginning of false positive readings that obscure the true inflation trend. That unanswered question looms large and the fog of uncertainty won't clear up for at least several more months. Nor does it move the needle on the policy front, which remains steadfast in the inflation fight and instills concerns about a mishap. That said, baby steps should be rewarded, and the financial markets are eagerly embracing the positive signals that shone brightly over the past week.

The headline-grabbing consumer price report for July took center stage, as it was the first month since May 2020 that consumer prices did not increase; indeed, without rounding out the data the CPI actually slipped 0.02 percent from June. The inflation downshift last month bent the longer-term trend, as the increase in consumer prices over the past year slipped from 9.1 percent to 8.5 percent. Not surprisingly, plunging gasoline prices was the biggest drag on the index, falling 7.8 percent during the month. Filling up at the pump is becoming cheaper this month as well, as average prices for regular gas fell below \$4 a gallon this week, according to AAA, from over \$5 at its peak in June.

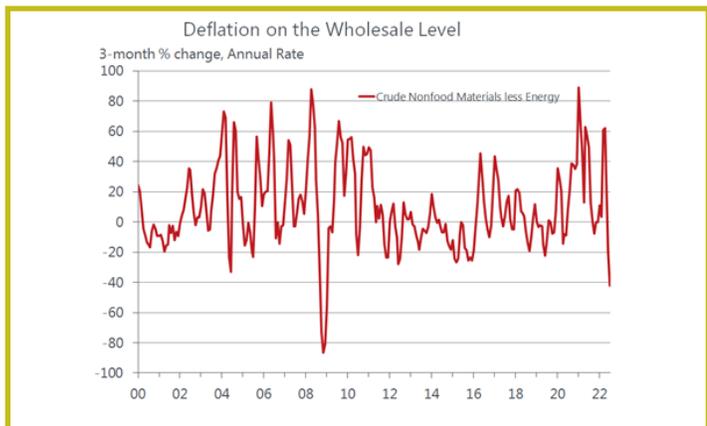


Importantly, the benign consumer price report was not just a gasoline story. Excluding volatile food and energy items, core prices also came in much tamer than expected. The 0.3 percent increase in the core CPI last month matched the slowest increase in eleven months, although it was not enough to lower

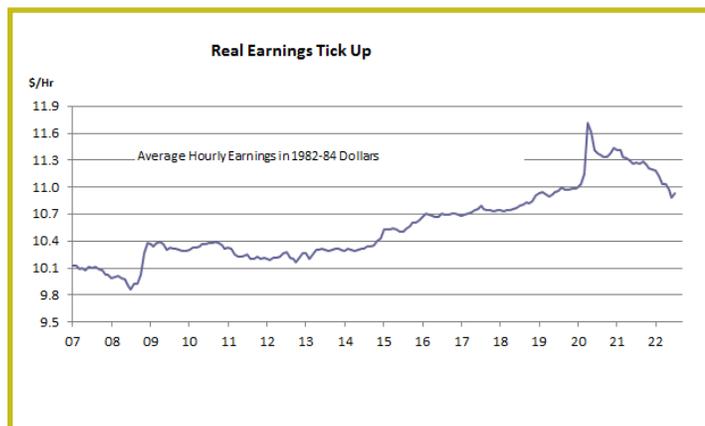
the annual increase from the 5.9 percent in June. What's more, lower-income consumers who spend a large fraction of their budgets on food and housing found little relief from the broader slowdown in prices. Food prices rose by another hefty 1.1 percent in July and are up 10.9 percent over the year. Likewise, housing costs continue to increase at a rapid rate, led by increasing rents. Rents on primary residences leaped 0.7 percent in July, lifting the annual gain to 6.3 percent – the fastest since 1986.

Rents are not likely to come down anytime soon, as record housing prices together with rising mortgage rates are throwing more would-be homebuyers into the rental market, driving up demand for apartments. With housing costs remaining sticky and comprising 40 percent of the core CPI, wrestling inflation down to levels seen before the pandemic will be difficult. But the process should begin shortly as plunging demand for homes will filter through to lower prices and eventually ease congestion in the apartment market, reining in rental costs. Meanwhile, easing price pressures on a broader scale should continue over the coming months, as supply snarls are untangling; delivery times are shortening, freight charges are dropping like a stone and price spikes caused by pent-up demand for services, particularly for vacationers, are retreating; hotels, air fares and rental car prices all fell significantly in July.

Indeed, the pipeline on the wholesale level is outright deflationary. This week also saw the producer price index – a measure that mostly captures the supply side of the economy – fall by 0.5 percent in July, the first monthly decline since April 2020. As was the case for consumer prices, the decline was heavily influenced by plunging gasoline prices, which fell by 16.7 percent and accounted for 80 percent of the decline in goods prices. The core index, excluding energy, food and trade, moved up by a slim 0.2 percent. However, the headline readings cover prices of finished goods, just before they reach retail shelves. Further down the pipeline, price pressures virtually disappear. Over the past three months, crude prices for nonfood materials less energy plummeted by a 30 percent annual rate, a deflationary pace not seen since the Great Recession in 2008.



Importantly, the inflation moderation last month should take some sting out of the main complaint of households, namely that surging prices are robbing them of their purchasing power. For the first time since last September, workers actually saw their earnings increase faster than prices. Real average hourly earnings increased by 0.5 percent in July, the strongest monthly gain since the final month of 2020. To be sure, paychecks are still not going as far as they did a year ago, as real earnings are down 3 percent since then. But that gap has narrowed a bit from the 3.3 percent shortfall in June and while food, housing and other necessities are still taking a growing bite out of budgets, the plunge in gasoline prices should offset some of that squeeze. In July, consumers spent \$70 billion at service stations, so the 20 percent drop at the pump frees up about \$15 billion that can be spent on other things.



The bidding war for workers is still going strong and driving up wages, even as sagging gasoline and other commodity prices are slowing inflation, a combination that should sustain the recent

improvement in real earnings. Against that backdrop, consumers should remain in a buying mood and keep the economy out of a recession over the foreseeable future. That backdrop also points to unsettled market conditions. As noted, the recent improvement in the inflation picture reflects mainly the decline in volatile prices – gasoline, commodities and services related to fading pent-up demand. But an adverse turn in geopolitical events, i.e., the Ukraine war that shuts off gasoline supplies from Russia, or another Covid flare-up that causes lockdowns and more supply disruptions, could easily drive volatile prices upward again. That, in turn, would keep pressure on workers to demand bigger raises and upend sentiment in the financial markets, which have recently priced in much lower inflation expectations over the short and medium term.

It would also shift the narrative regarding monetary policy. The tame consumer and producer price reports prompted many to believe the Fed would ease up on its rate-hiking campaign, as they provide some breathing room for it to tread more lightly while assessing unfolding developments. Prior to the latest inflation readings, the consensus among forecasters was that the Fed would put through its third-consecutive outsized rate hike of 75 basis points at its upcoming meeting on September 21. Following the CPI and PPI reports that perception has wavered, with the futures market pricing in less than a 50 percent chance of a 75 basis point increase as of Friday.

Unsurprisingly, that shift in perceptions is giving the stock market a big lift, as it offers hope that a less aggressive rate-hiking campaign increases the odds of avoiding a recession. The stock market logged its fourth consecutive weekly gain this week, with the S&P 500 retracing about 50 percent of the bear market losses incurred over the first six months of the year. No doubt, with another soft reading on consumer prices expected in August, the odds are tilting towards a smaller 50 basis point increase at the upcoming policy meeting. However, recent public statements by Fed officials, including some of the more dovish members, strongly indicates that another 75 basis point increase will be pushed through at the upcoming meeting.

From our lens, one or two months of tame inflation readings will not be enough to satisfy the Fed that the back of inflation has been broken, particularly if consumer demand remains strong and labor costs are accelerating. While another month of soft inflation is likely in August, that would not move the needle for the Fed if the month also saw another vigorous jobs report, with worker pay rising briskly. We expect a 75 basis point rate hike in September followed by more subdued 25 basis point increases at the remaining three meetings this year as both the economy and inflation show visible signs of cooling.

KEY FINANCIAL INDICATORS

	August 12	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	2.56%	2.50%	2.34%	0.06%
6-month Treasury bill	2.95	2.87	2.87	0.05
3-month LIBOR	2.91	2.86	2.74	0.12
2-year Treasury note	3.26	3.22	3.13	0.21
5-year Treasury note	2.99	2.77	3.05	0.78
10-year Treasury note	2.84	2.84	2.92	1.29
30-year Treasury bond	3.07	3.07	3.08	1.93
30-year fixed mortgage rate	5.22	4.99	5.51	2.87
15-year fixed mortgage rate	4.59	4.26	4.67	2.15
5/1-year adjustable rate	4.43	4.25	4.35	2.44
STOCK MARKET				
Dow Jones Industrial Index	33761.05	32803.47	31288.26	35515.38
S&P 500	4280.15	4145.19	3863.16	4468.00
NASDAQ	13047.19	12657.55	11452.42	14822.90
COMMODITIES				
Gold (\$ per troy ounce)	1818.90	1792.40	1706.50	1779.80
Oil (\$ per barrel) - Crude Futures (WTI)	91.88	88.53	97.57	68.88

KEY ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Consumer Price Index (July) - % change	0.0	1.3	1.0	0.3
Core CPI (July) - % change	0.3	0.7	0.6	0.5
Producer Price Index (July) - % change	-0.5	1.0	0.8	0.8
Small Business Optimism Index (July) - Index	89.9	89.5	93.1	92.4

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