

## Economic Outlook:

### The Fed Makes a Move: Inflation vs. Recession

*August 2022*



# STIFEL

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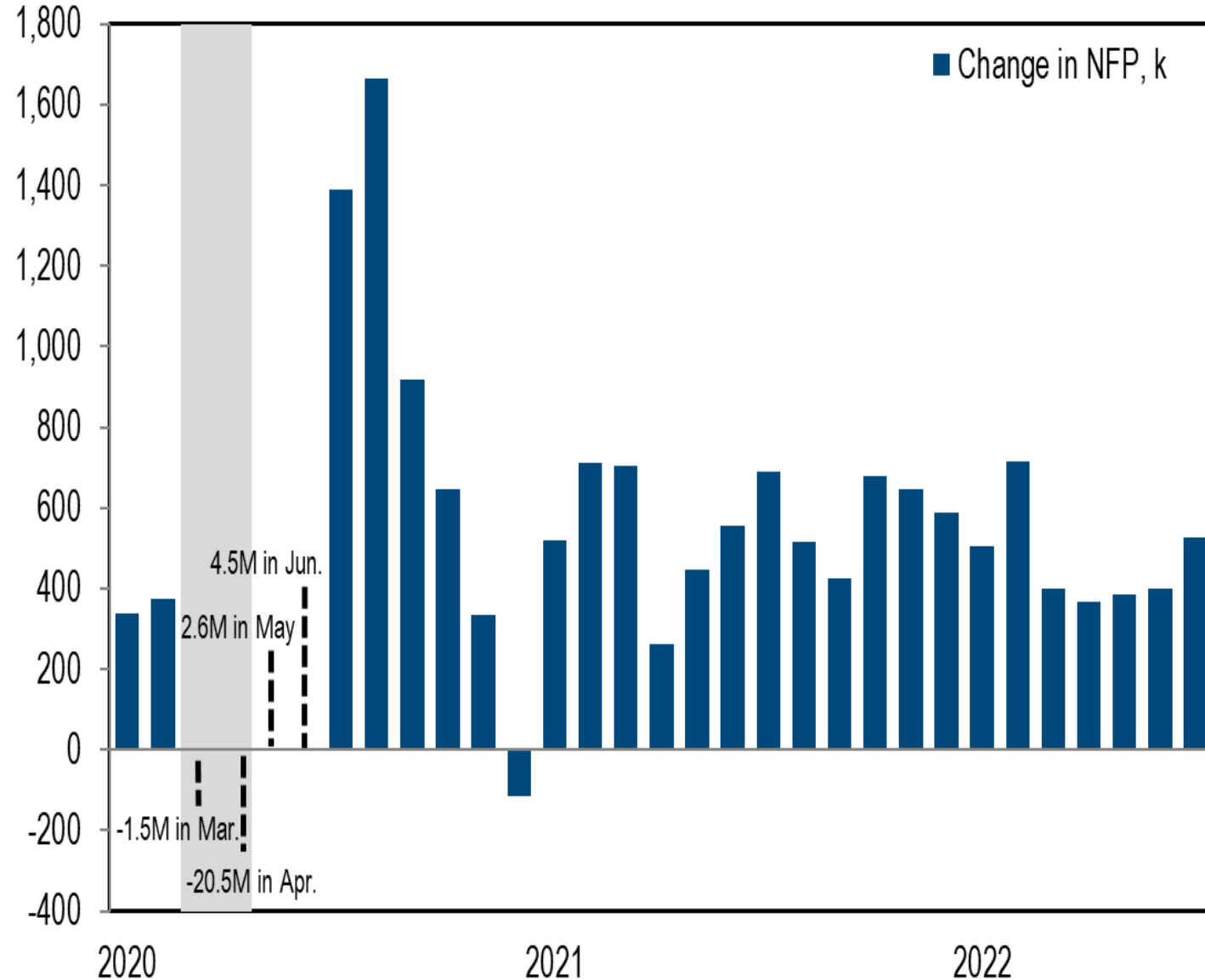
## 528k Payrolls Added in July

The labor market is a key representation of the unevenness in the recovery

Nonfarm payrolls rose **528k** in July 2022, the most in five months

Nonfarm payrolls fell 1.5M in March and 20.5M in April of 2020, the largest monthly decline on record

For the full year of 2021, payrolls rose 6.7M, a record high, but following a 9.3M drop in 2020, the largest decline on record, and more than the combined decline in 2008 and 2009



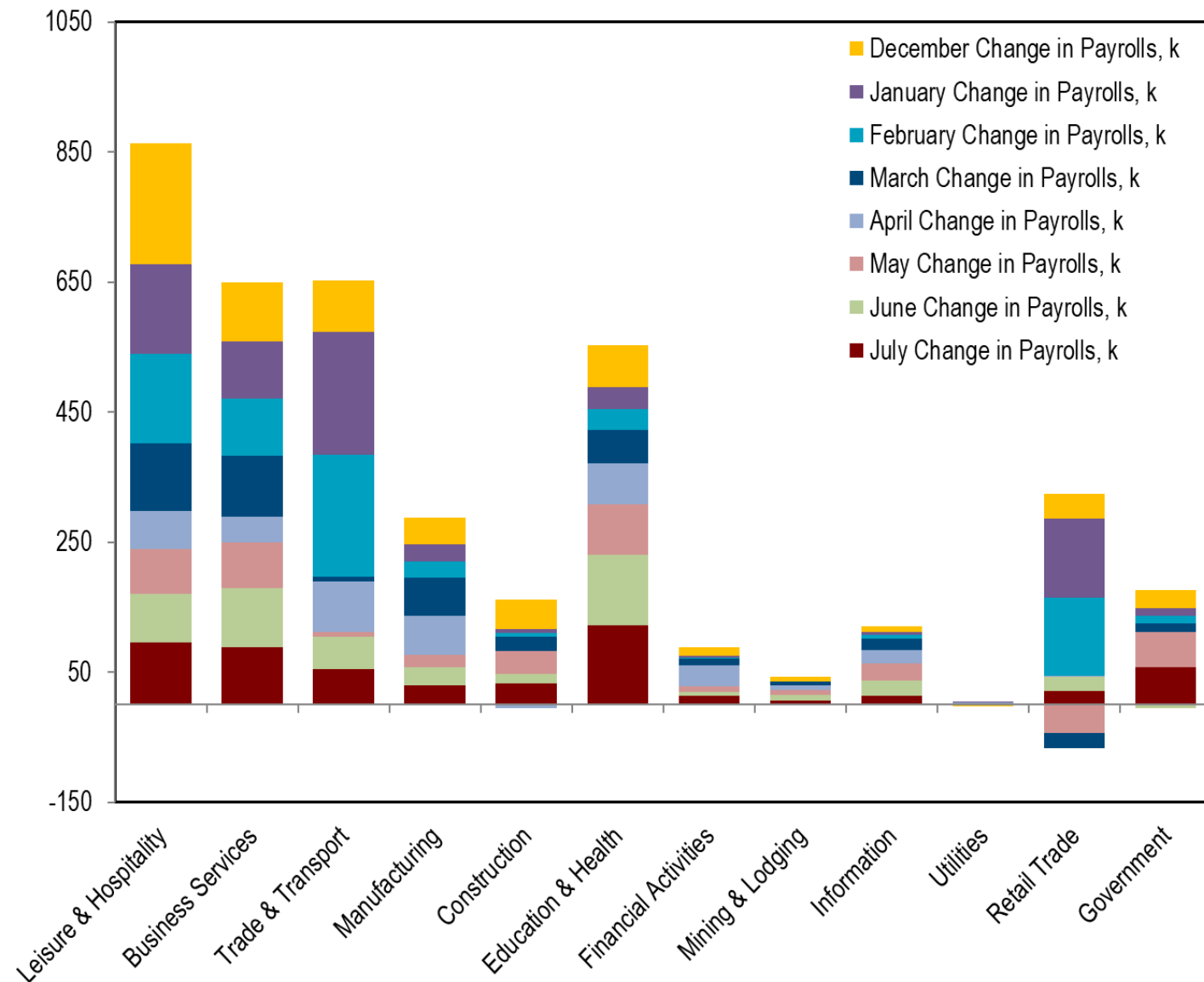
Source: Bureau of Labor Statistics/Haver Analytics

## Payrolls by Category

Education & health payrolls led the gain in payrolls in July with payrolls rising **122k**

Leisure & hospitality payrolls rose **96k**, business services payrolls increased **89k**, trade & transport payrolls rose **54k**, and retail trade payrolls rose **22k**

Additionally, information payrolls rose **13k** in July



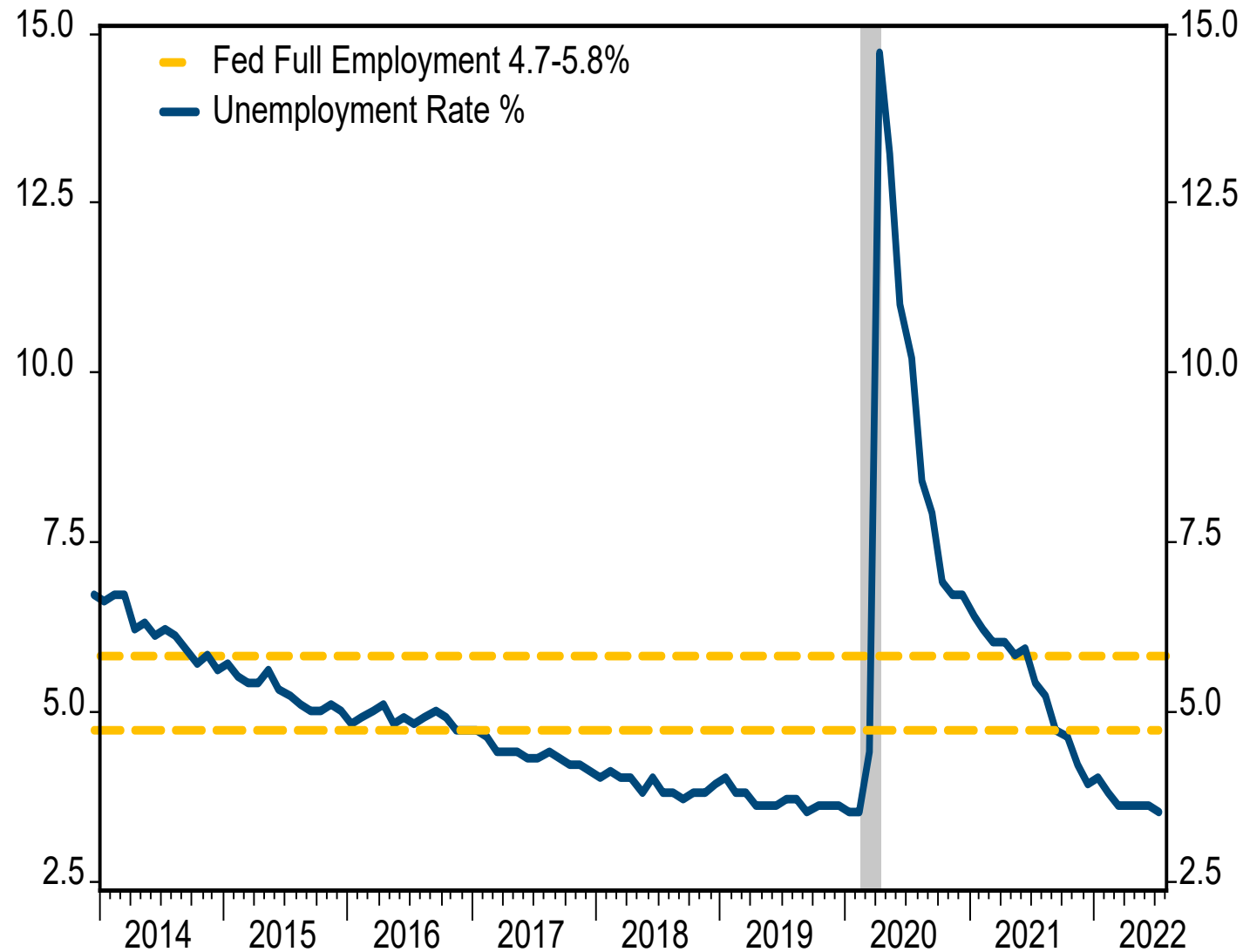
Source: Haver Analytics/Bloomberg

## 3.5% U.S. Unemployment Rate

Household employment fell by **179k** in July although the labor force declined by **63k**, resulting in an unemployment rate of **3.5%** in July, the lowest since February 2020

The decline in the unemployment rate reflects more employment *and* sidelined workers (**623K**)

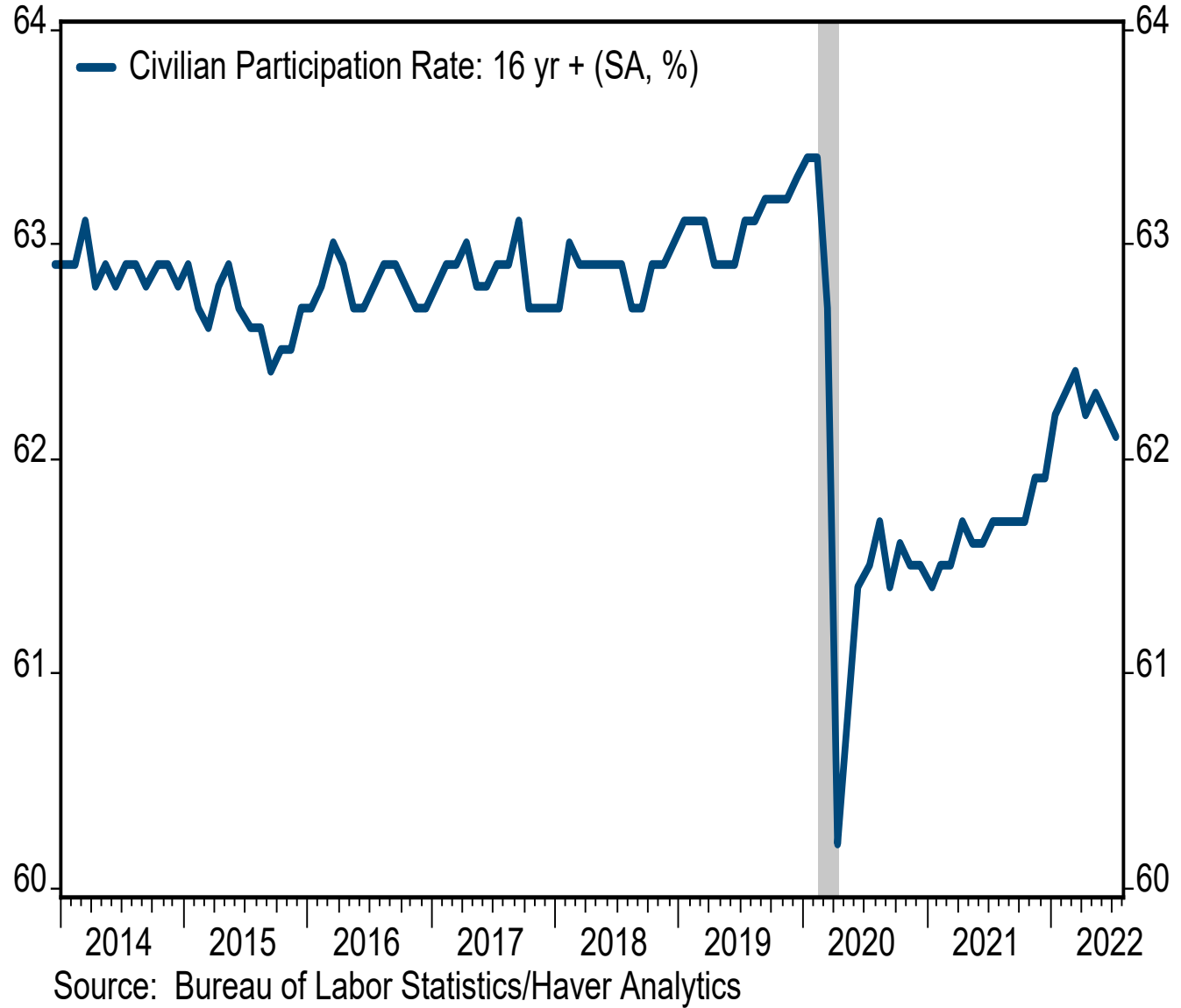
Returning workers will push unemployment rate higher



Source: Bureau of Labor Statistics/Haver Analytics

## Participation Rate Stubbornly Low

The labor force participation rate fell from 62.2% to **62.1%** in July, a seven-month low and well-below the pre-crisis peak of 63.4%



## Average Hourly Earnings Remain Solid

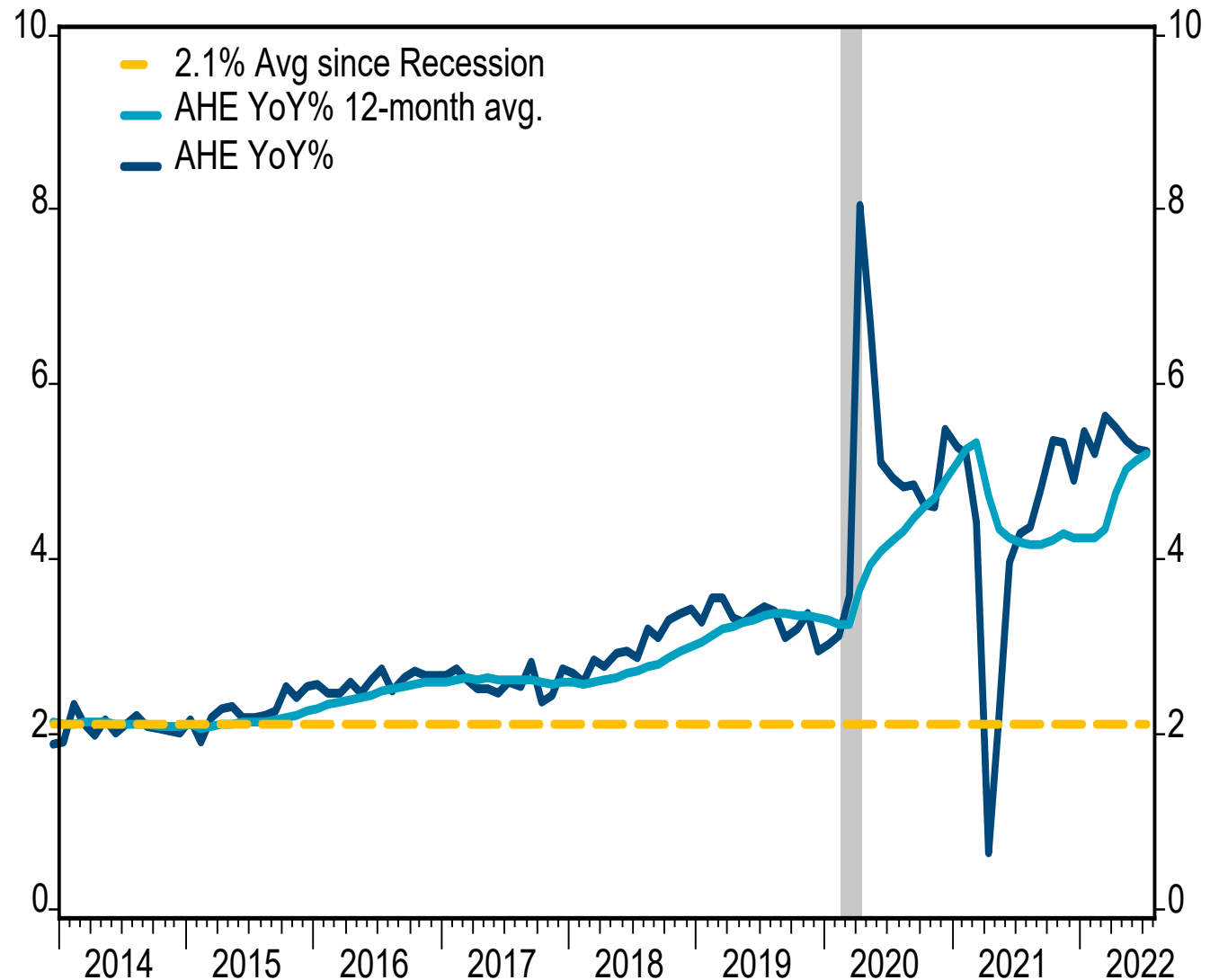
As businesses search for workers, compensation is on the rise

Longer-term businesses may turn to technology or close doors

Average hourly earnings rose 0.5% in July, following a 0.4% increase in June

Year-over-year, wages rose **5.2%** in July, below a recent peak of 8.2% in April 2020

Average earnings increased early on during the pandemic as lower-wage workers dropped out of the workforce

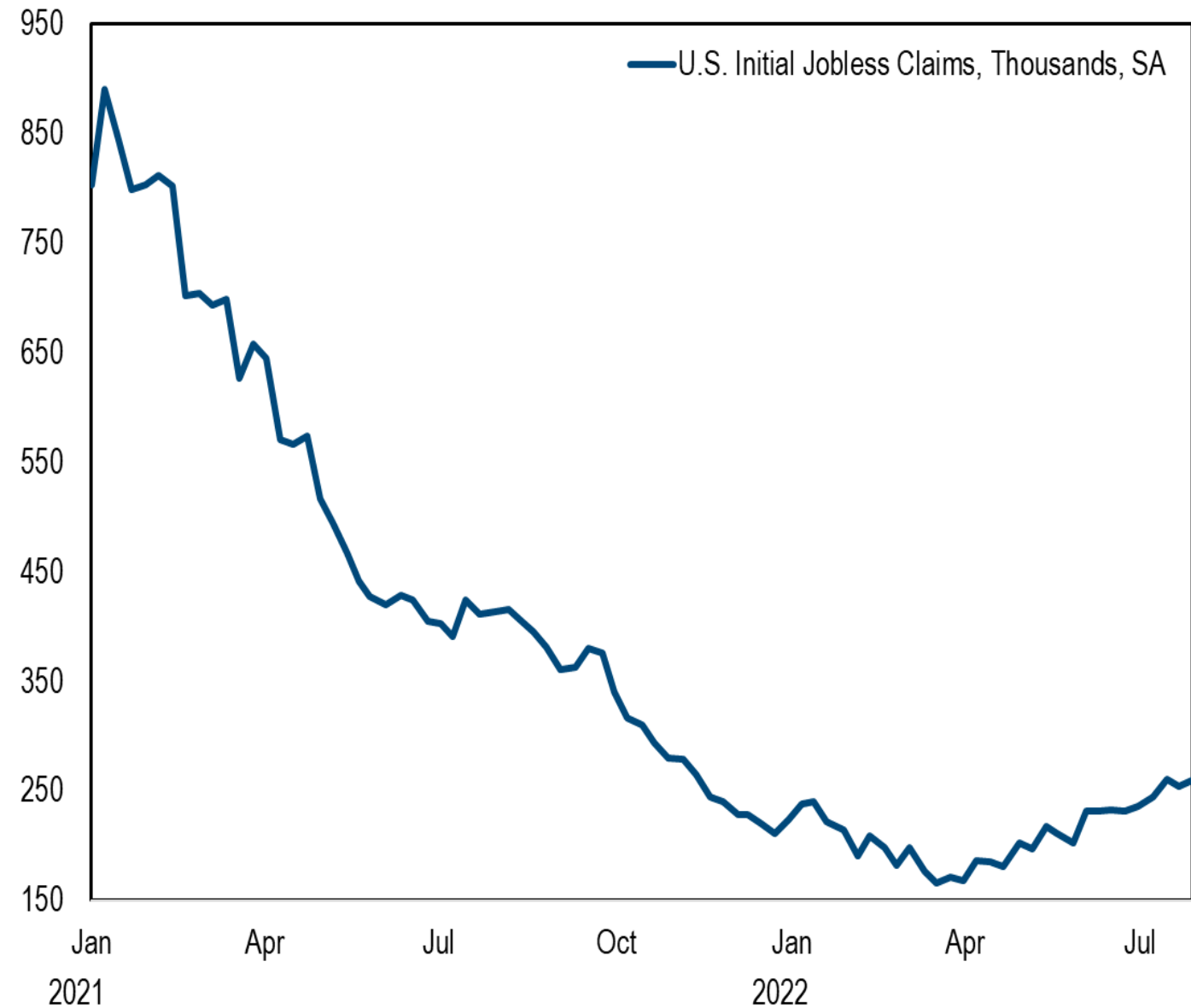


Source: Bureau of Labor Statistics/Haver Analytics

\*Does not include government assistance

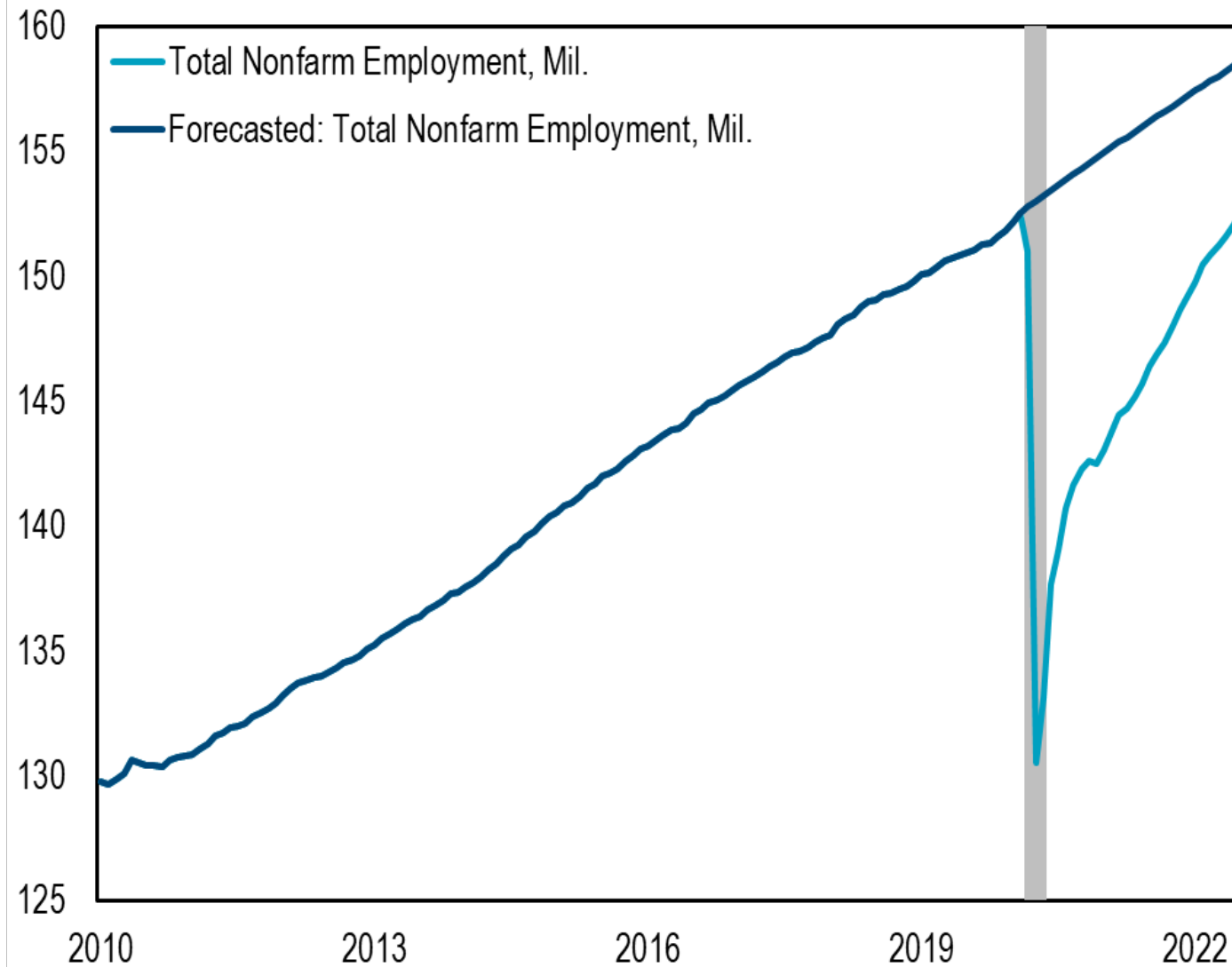
## Jobless Claims on the Rise

Initial jobless claims rose to **260k**, an eight-month high and jumping 30k in the past six weeks



## Total Employment Still Behind Pre-Covid Levels

Total nonfarm employment remains around 6.4M jobs short at 152.5M of July



Source: Bureau of Labor Statistics/Haver Analytics

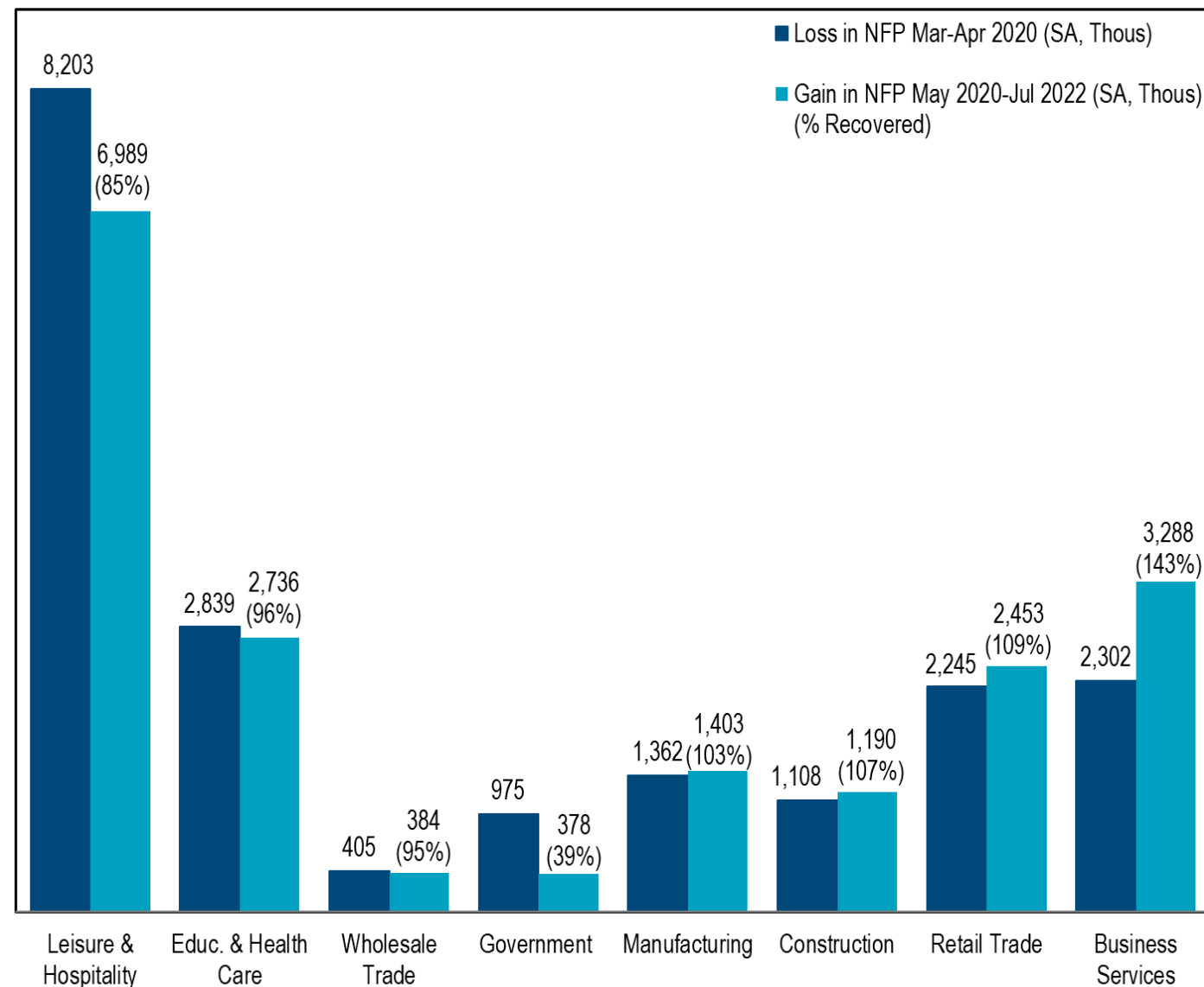
## Hardest Hit Industries Still Struggle to Recapture Jobs

As of July, the labor market has finally recaptured all of the jobs lost at the onset of the Covid-19 pandemic

However, some of the hardest-hit sectors are still struggling to reconnect with customers, employees and supply chains

The leisure and hospitality industry lost over **8M** jobs during the pandemic but has since recaptured nearly **7M** or **85%**

The hardest hit sectors have recaptured roughly 90% of lost jobs

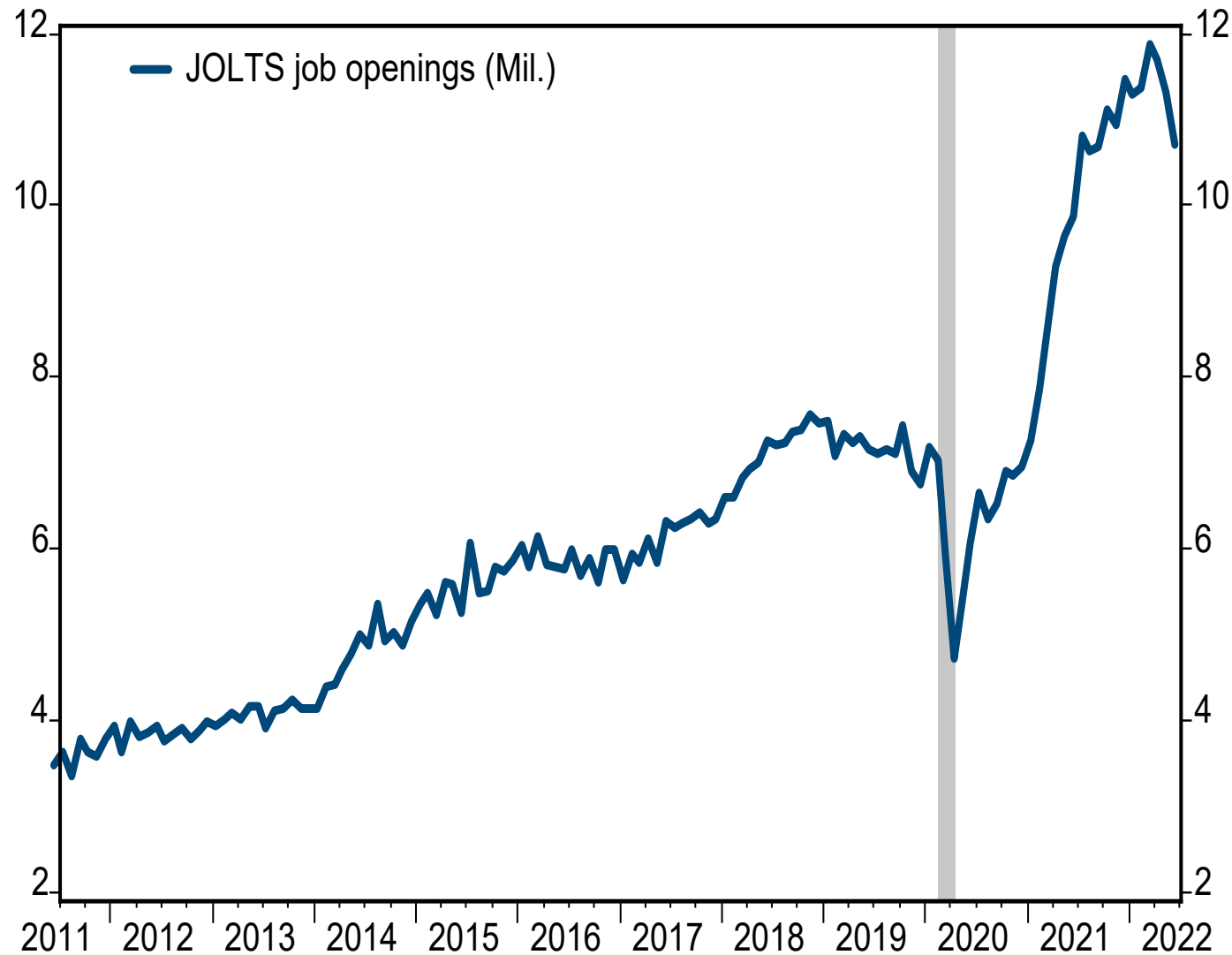


Source: Bureau of Labor Statistics

## Labor Demand Outpaces Labor Supply

Hiring limited by supply, with demand far outpacing available workers

The number of job openings, according to JOLTS – the Job Openings and Labor Turnover Survey – fell from 11.3M to **10.7M** in June, albeit the twelfth straight month above 10M, suggesting producers remain desperate for workers to increase output and meet a still-heightened level of demand for goods and services



Source: Bureau of Labor Statistics/Haver Analytics

## Where Have All the Workers Gone?

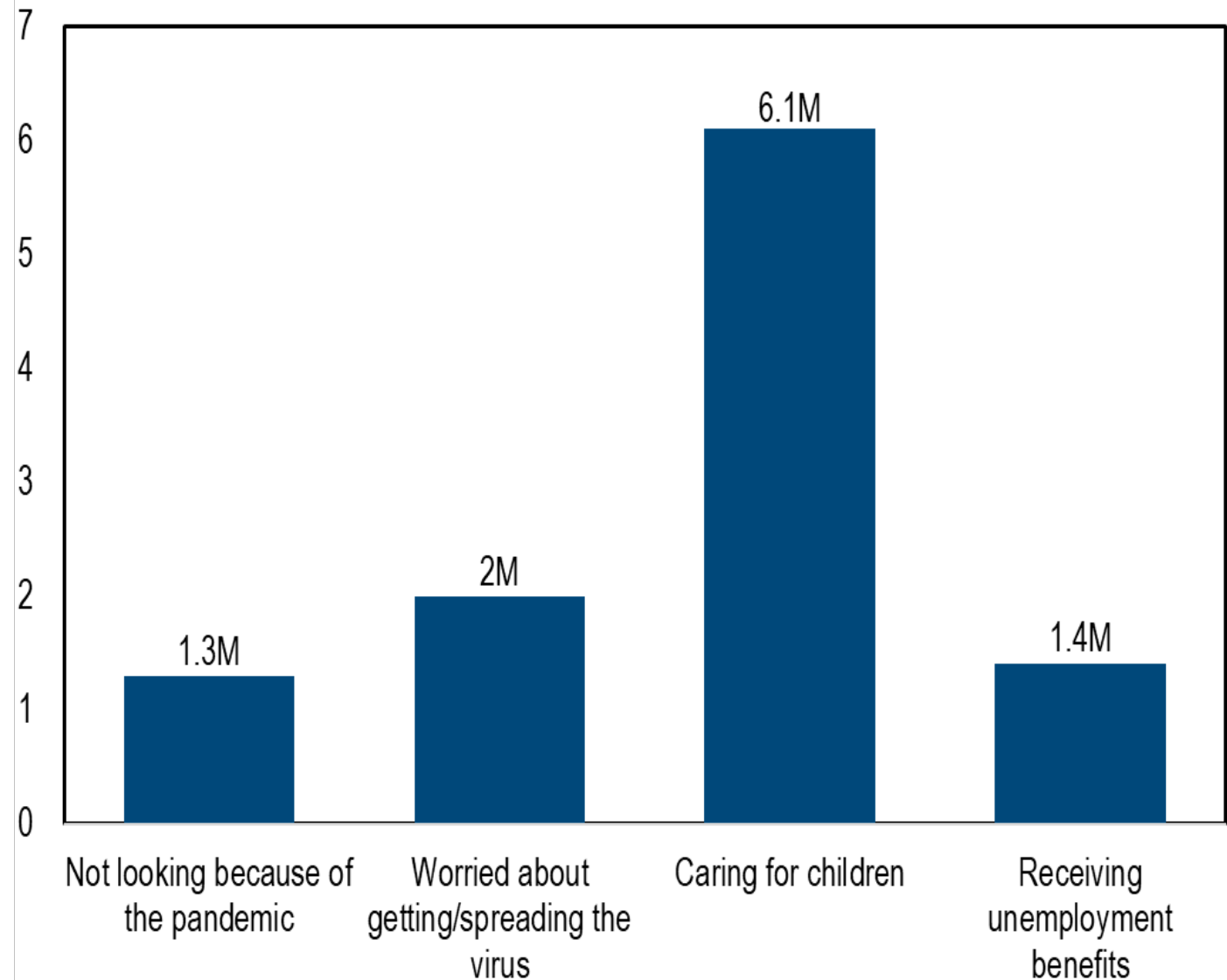
Some workers have lingering health concerns or ongoing health impacts resulting from the virus

Some face lingering childcare or elder care issues

Labor supply gap will be improved with school reopen, higher vaccination rates and an end to federal benefits but It will take time to entice workers back into the labor market

According to the Bureau of Labor Statistics, as of July, **2M** American report they remained sidelined due to *“worries about getting or spreading the virus”*

The Census Bureau reports that **6.1M** people are out of work because they were *“caring for children not in school or daycare”*



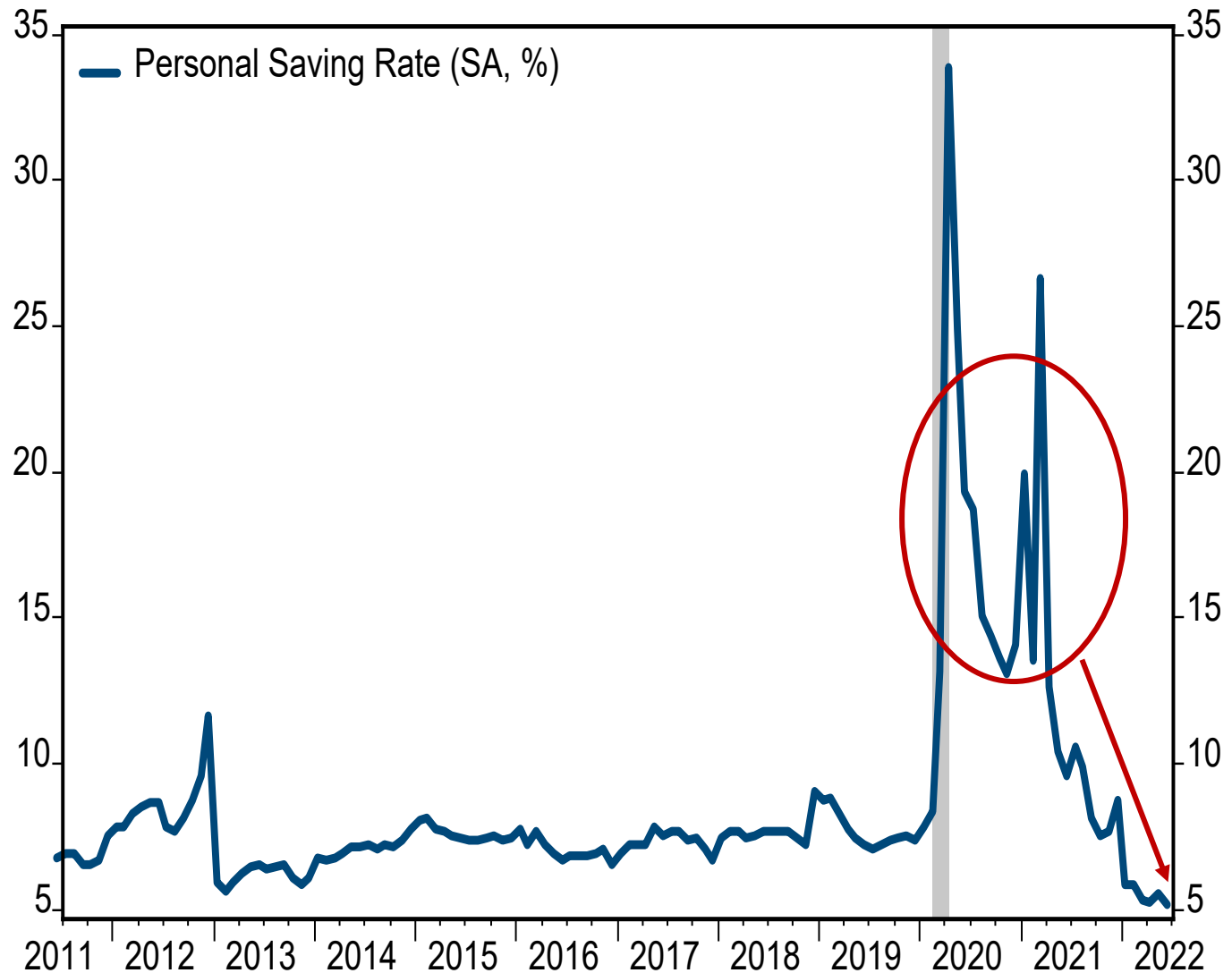
Source: Bureau of Labor Statistics

## Trillions in Accumulated Savings Dwindle

The U.S. consumer remains solid with **\$944B** in savings and a savings rate of **5.1%** as of June

Additional savings, higher wages and additional federal spending will help supplement the consumer and mitigate the fiscal cliff resulting from an end of pandemic stimulus

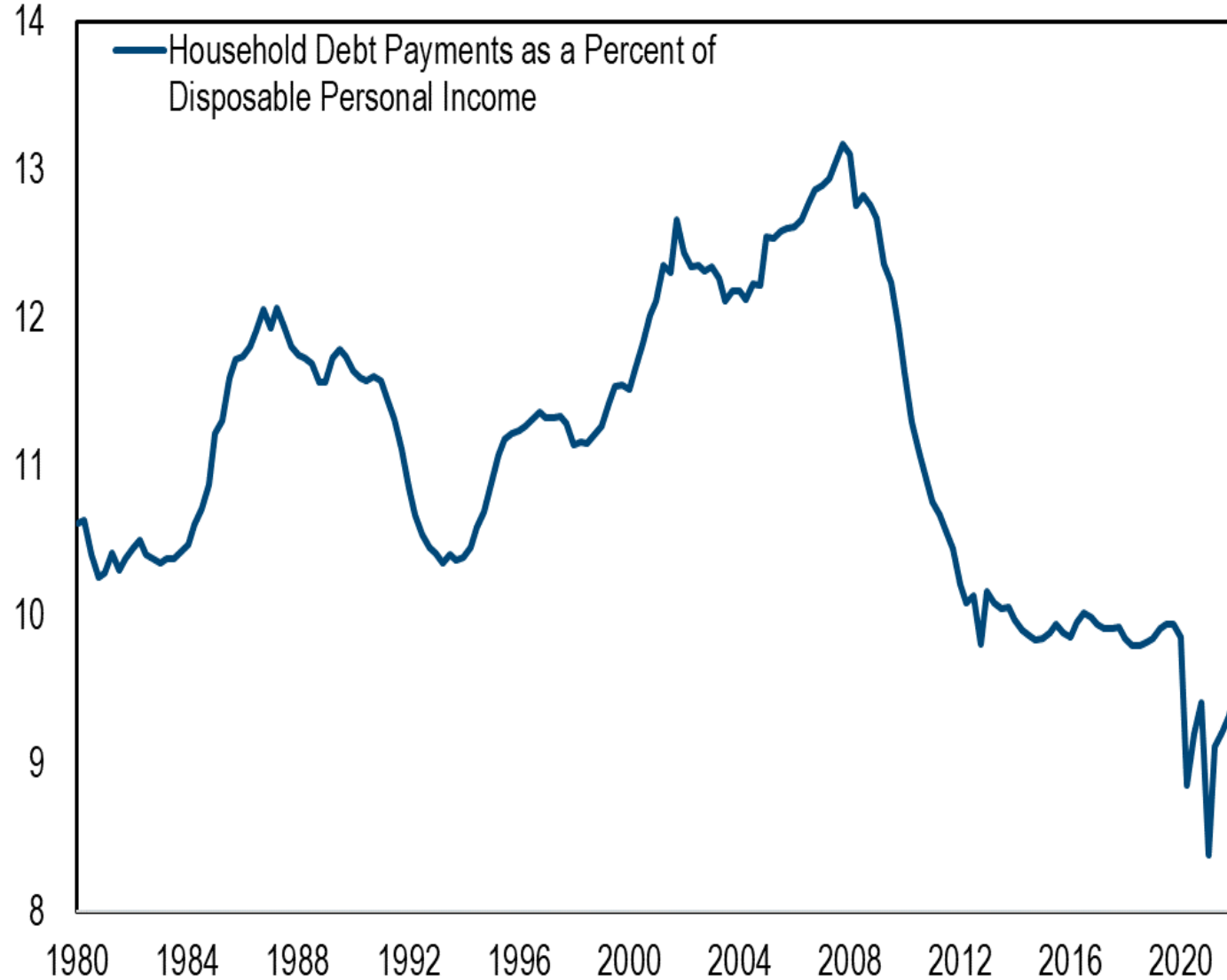
Savings won't support potential workers indefinitely – already the savings rate has slowed, and that stockpile of savings has dwindled markedly as spending adjusts back to pre-pandemic patterns, fiscal support wanes and prices rise



Source: Bureau of Economic Analysis/Haver Analytics

## Debt as a Percent of Income Lowest Level on Record

Debt as a percent of disposable income rose from 9.3% to **9.5%** in Q1, still near the lowest on record



Source: FRED

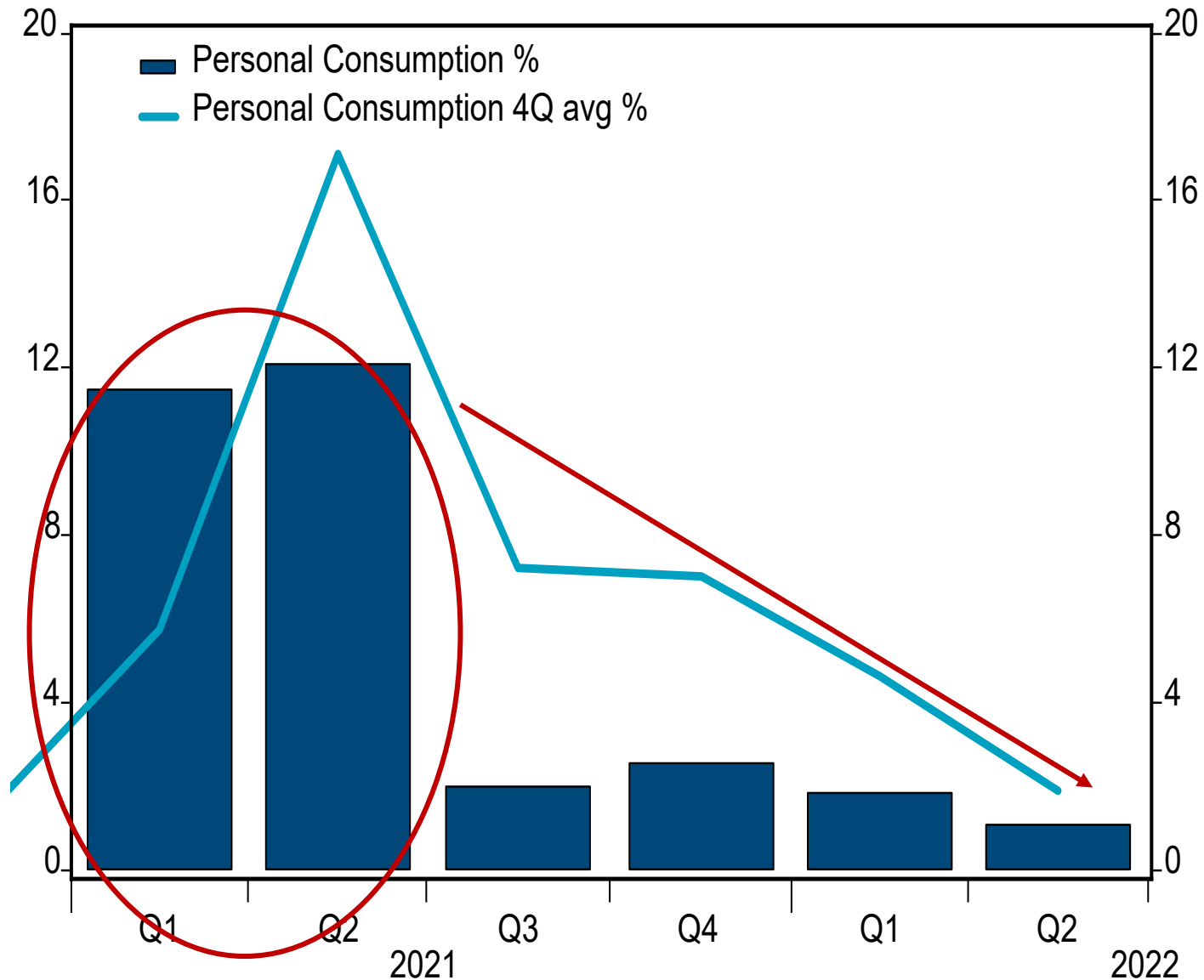
## Stimulus Support to Consumption Wanes

With the worst of Covid-19 behind us, safety protocols are greatly reduced, and life is returning to “normal”

The consumer is also returning to normal, reengaging in marketplace with a minimal impact from Omicron

Personal consumption expenditures rose **1.0%** in Q2 2022, down from the 1.8% pace the quarter prior, and further below the 12% pace in Q2 2021

On a four-quarter average basis, consumption fell from 4.6% to 1.8%, further below the record 17.1% pace in Q2 2021



Source: Bureau of Economic Analysis/Haver Analytics

## Retail Sales Trending Lower

Early signs of weakness amid Delta variant

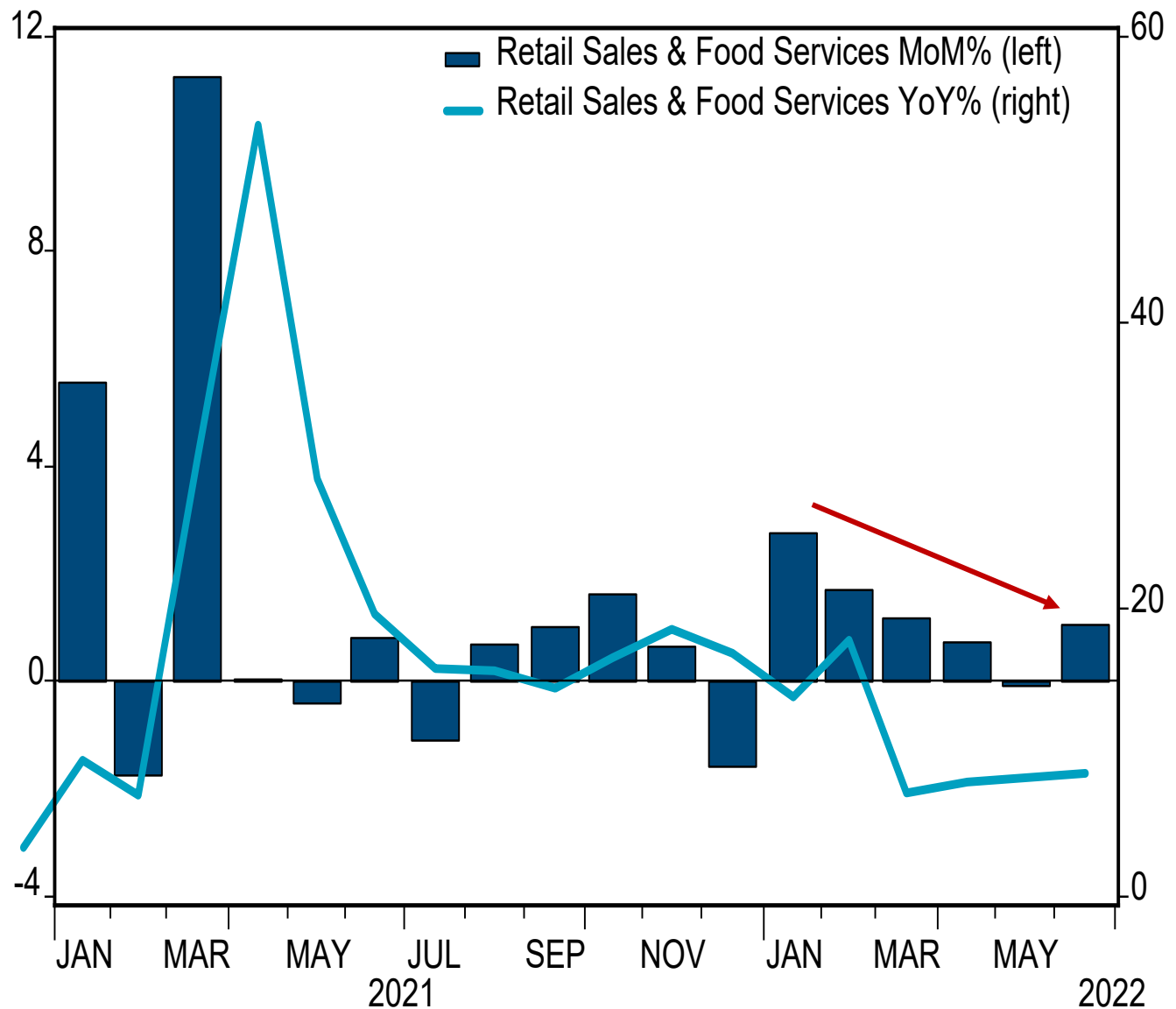
Trillions in savings and upward momentum in wages has helped consumers to weather different variants and to offset a loss of fiscal support, inflation is complicating the picture

Consumption to remain positive, however, several factors pulled forward end-of-the-year spending

Large retailers report customers are cutting back as the balance sheet is becoming increasingly fragile amid rising costs and rates

Sales rose **1.0%** in June, following a 0.1% decline in May and a 0.7% increase in April

Year-over-year, retail sales rose **8.4%** in June, following an 8.2% gain in May



Source: Census Bureau/Haver Analytics

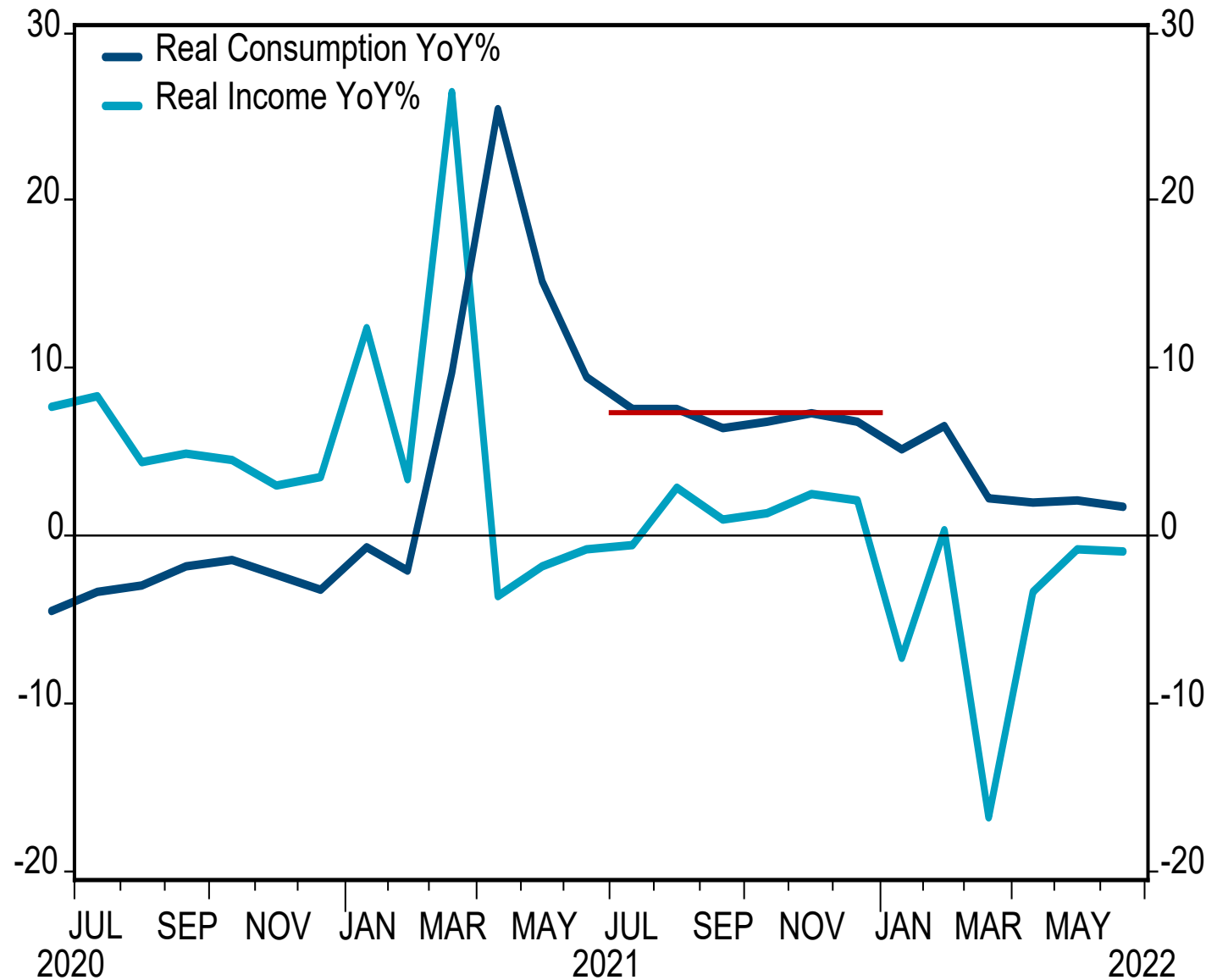
## Real Consumption and Income Weak

Taking inflation into account, real consumption rose **1.6%** over the past 12 months, the weakest pace since February 2021

Real income fell **1.0%** over the past 12 months, following a 0.9% decline in May and a 3.4% drop in April

Real income has remained in the red since March

Consumption remains positive – for now – but real spending is already trending lower, falling from an average pace of 7.3% July to December of 2021 down to 3.2% from January to May 2022



Sources: BEA, BEA/H/Haver

## Manufacturing Activity Slowing

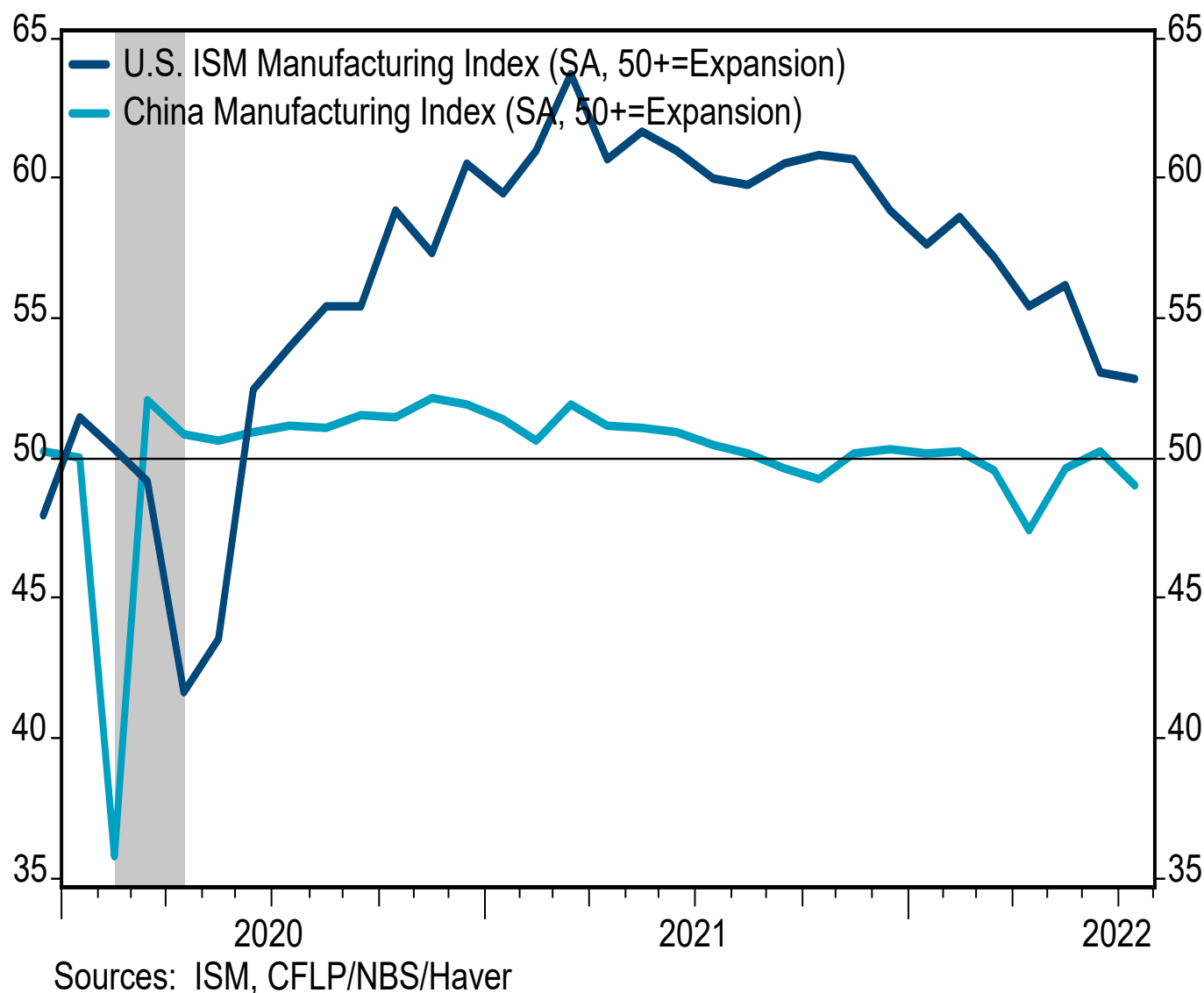
Producers face labor shortages and lingering supply chain disruptions as bad as 2020

Shortages reported for lumber, tires, wire, etc.

The ISM manufacturing Index dropped from 50.3 in February 2020 to a low of 41.7 in April 2020, but has since rebounded to **52.8** as of July, albeit a two-year low

The China Manufacturing PMI rose from 50.2 to **49.0** in July, down from a near-term peak of 52.0 in March 2020

Solution to supply chain disruptions will depend on global response to the virus – even domestic producers are impacted resulting in price pressures



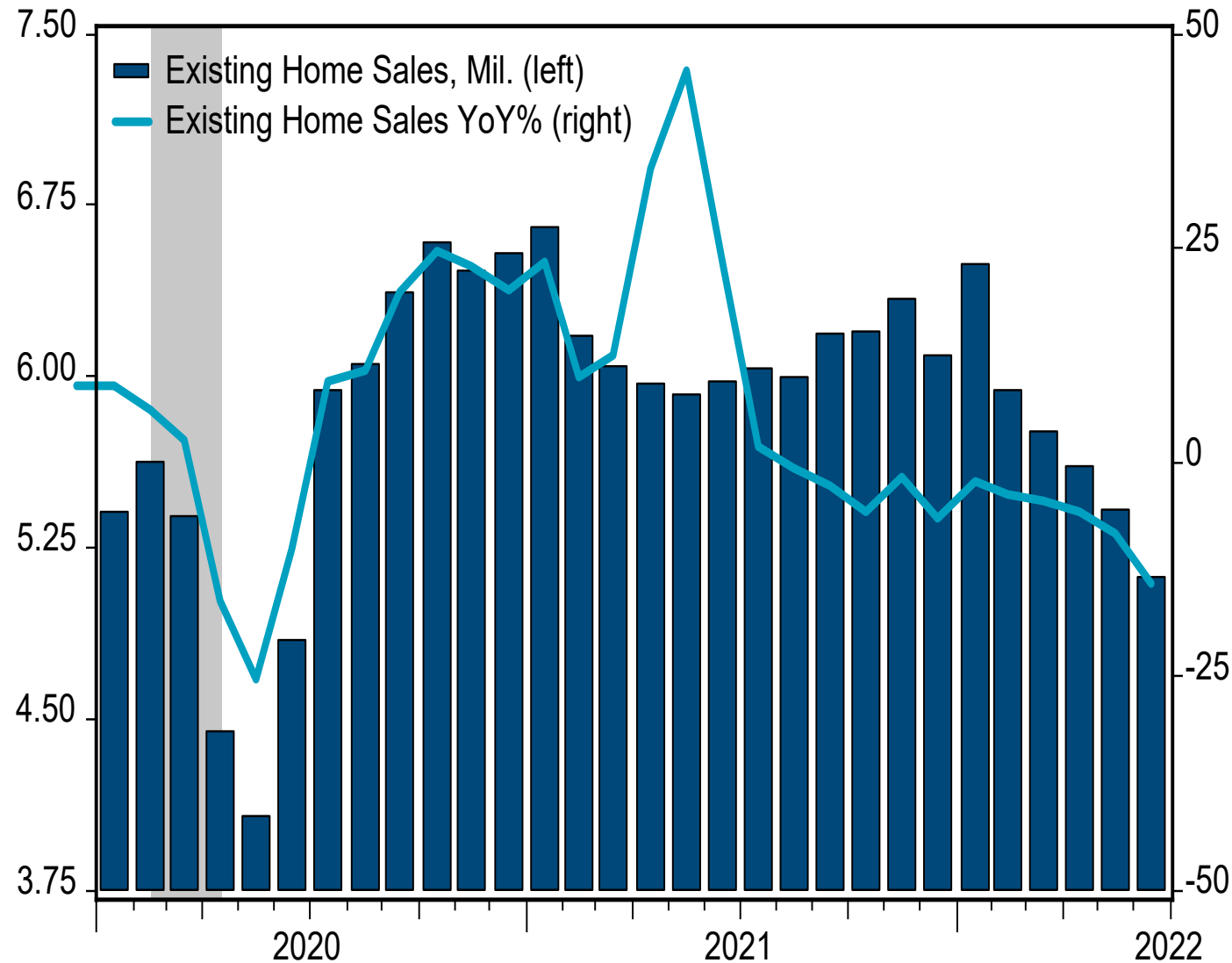


## Wanning Demand for Housing

Americans view their home as a workplace, school and refuge

Existing home sales dropped 5.4% in June to a **5.12m** unit pace, however, up more than 26% since the May 2020 low

Rising interest rates, rising costs of materials and declining real income is already taking a toll on some would-be buyers and prompting many more potential sellers anxious to offload in a still-hot market



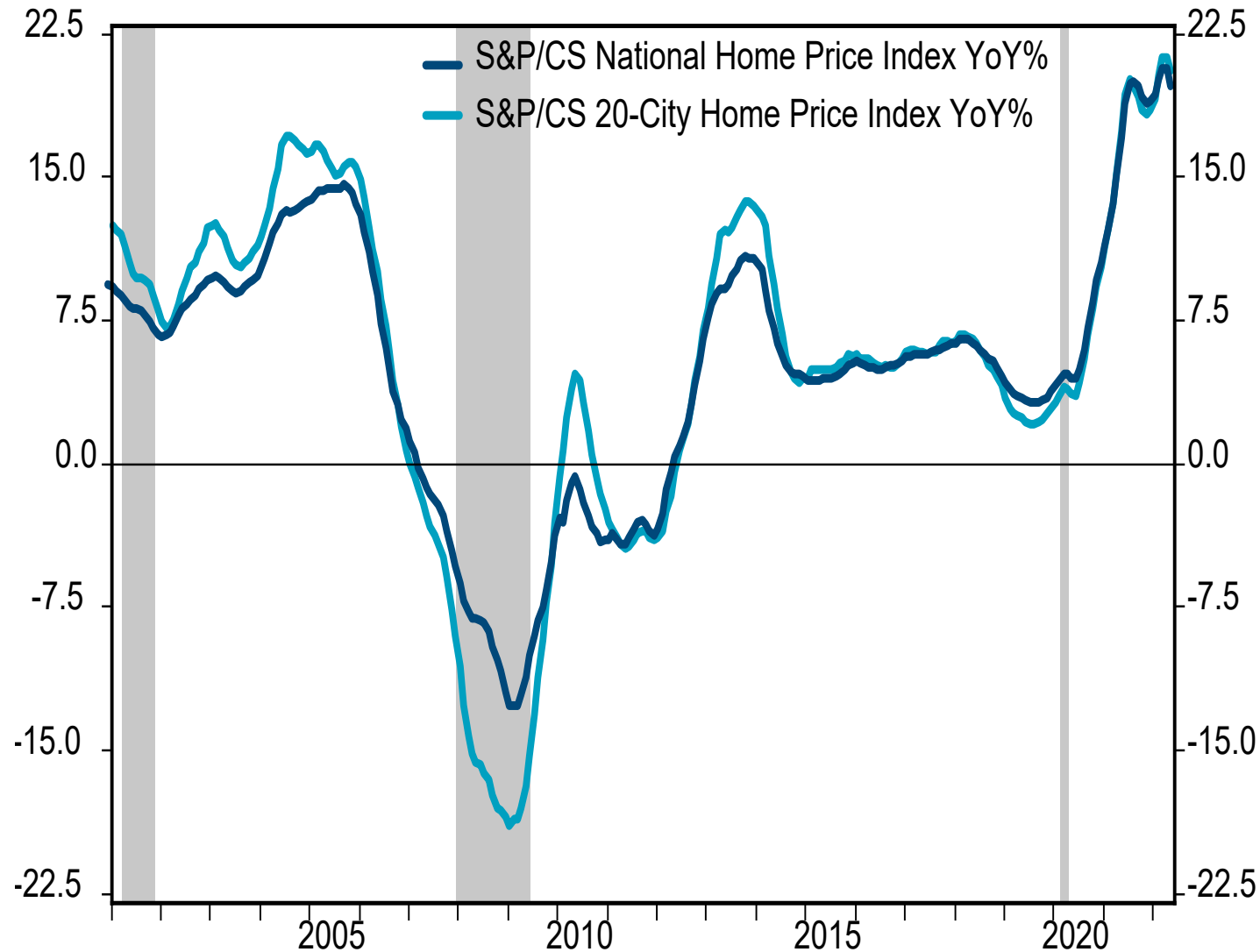
Source: National Association of Realtors/Haver Analytics

## Home Prices Still Elevated

Year-over-year, the 20-city home price index rose **20.5%** in May, near the largest gain on record

Nationally, home prices rose **19.8%**, following a 20.6% rise the month prior, the largest gain in the history of the index dating back to 1987

Price growth not limited to downtown, urban markets



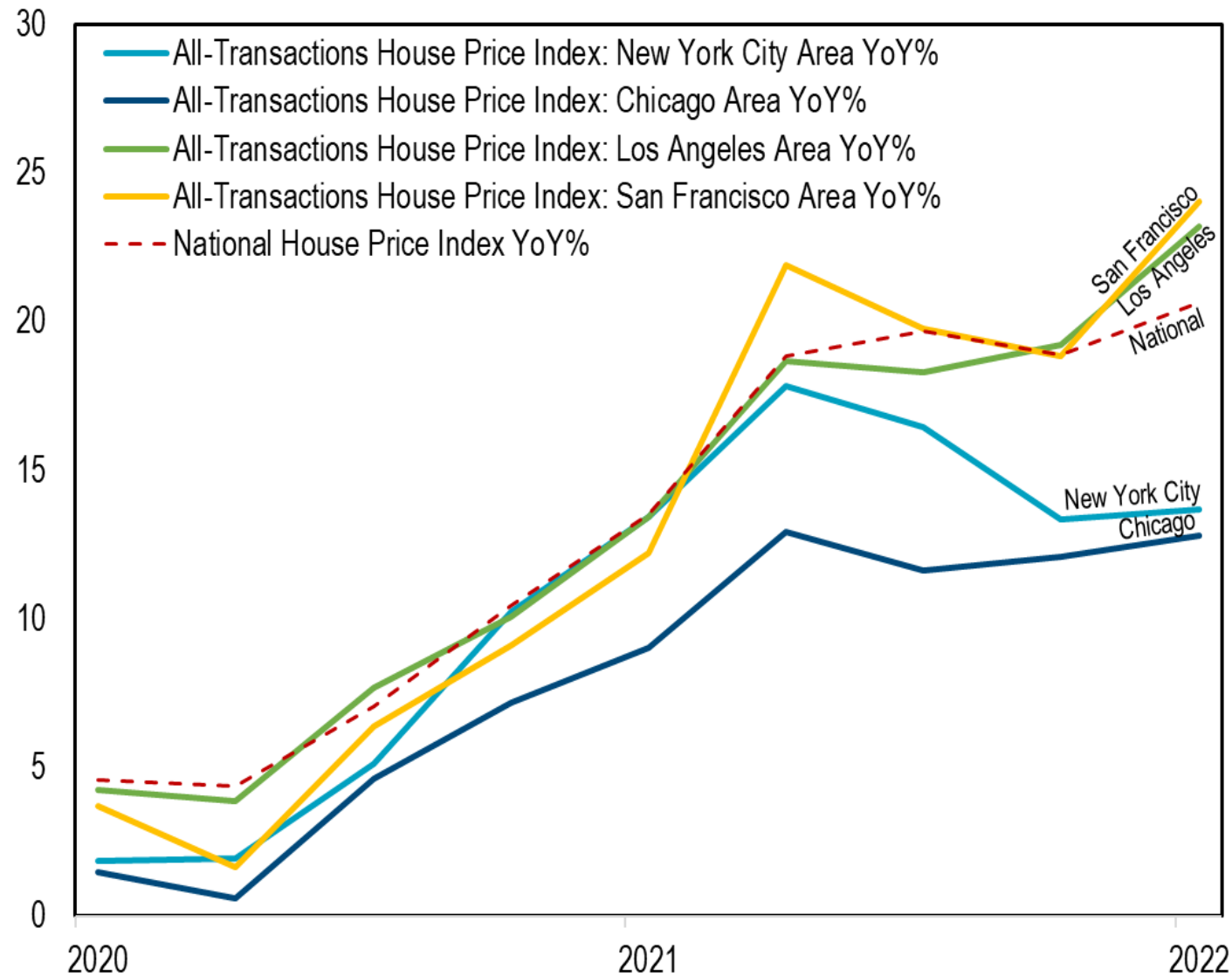
Source: Standard & Poor's/Haver Analytics

## Home Prices Still Elevated... But Slowing

House prices in Chicago are up 12.8% in Q1 2022, up from 12.1% in Q4, down however from a near-term peak of 12.9% in Q2 2021

In New York City, house prices are up 13.7% as of Q1 2022, while house prices in the Los Angeles area are 23.2% more expensive

Home prices in San Francisco, meanwhile, have also started to rise slightly, up 24% in Q1 2022



Source: FRED



## \$1.2T Infrastructure Plan

After months of negotiations and a standoff between progressive and moderate Democrats, the **\$1.2T** package of road, broadband, and other "*hard*" infrastructure improvements passed in November

Key items include:

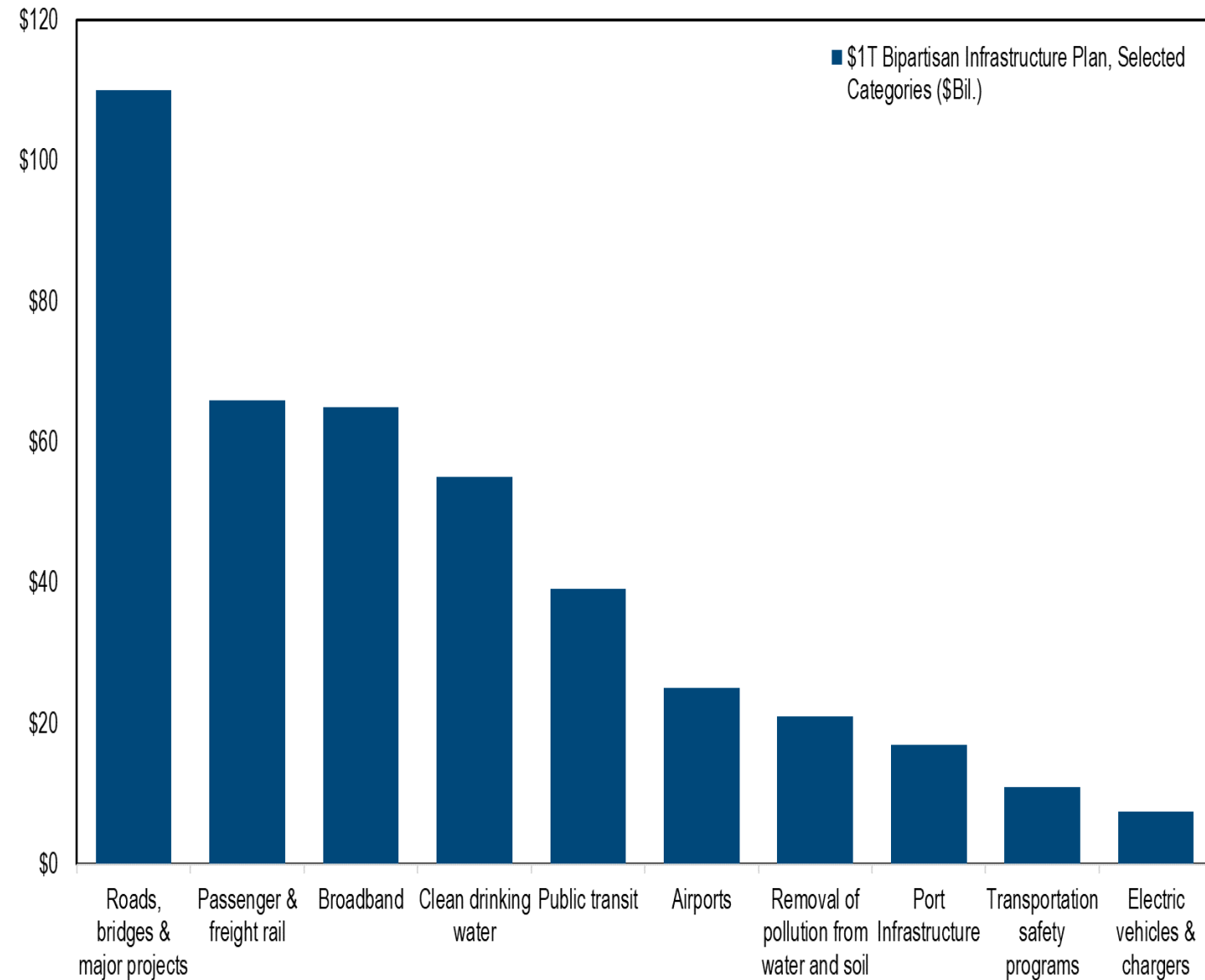
\$110B for roads & bridges

\$66B for passenger & freight rail

\$55B for clean drinking water

The five-year spending initiative will have a limited impact on growth in near-term

In the SOTU, President Biden continued to push for BBB at \$1.75T



Source: Reuters/NPR

### Advocates argue

- The package will serve to reduce the deficit by limiting tax fraud and increasing tax revenues from corporate America
- Increase spending to combat climate change
- Allow the government to negotiate certain drug prices

### Opposition suggests

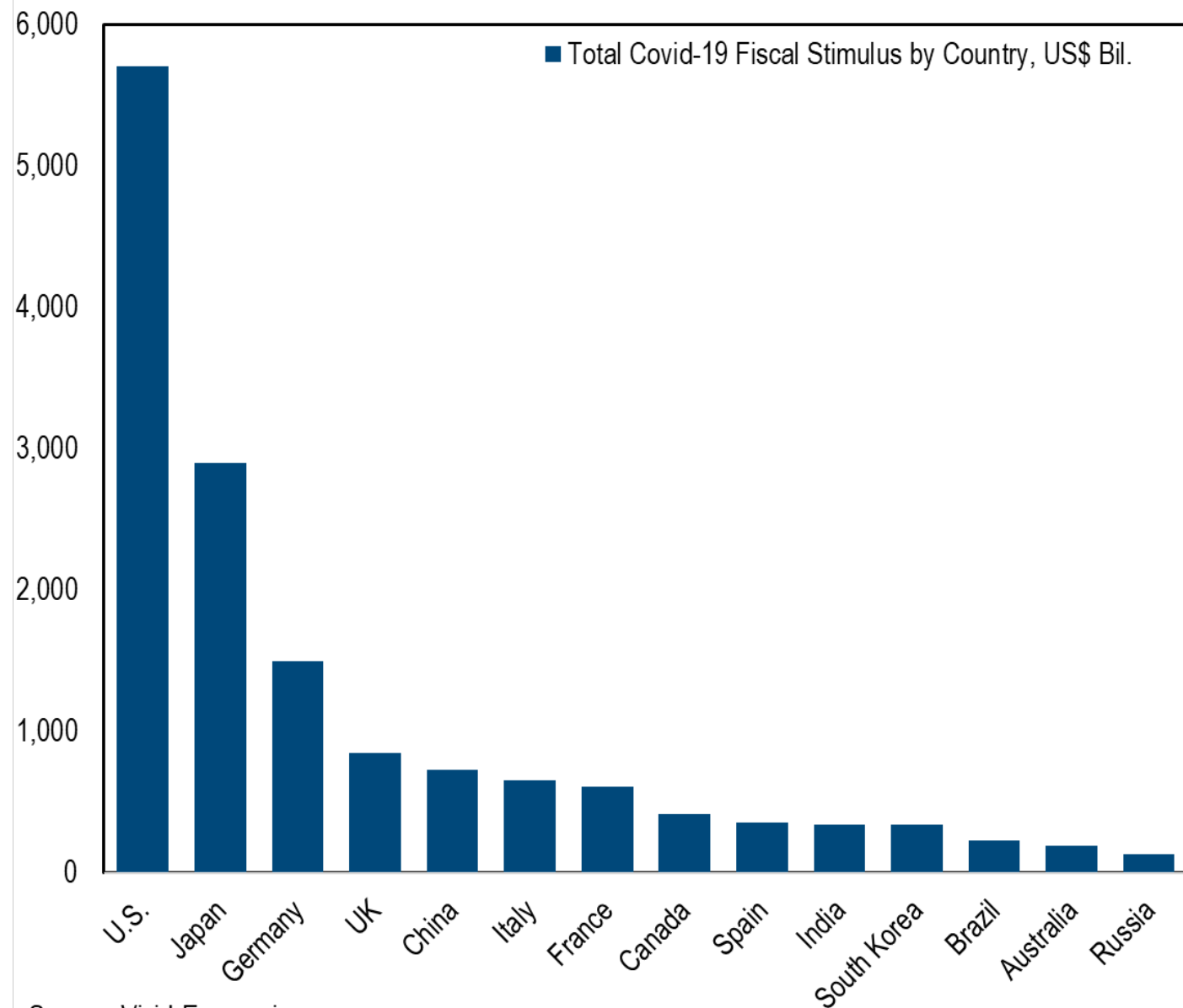
- The legislation will simply result in tax increases on most households
- The legislation would fail to bring down inflation with some arguing the legislation may exacerbate inflation pressures by handing out more federal dollars to American households resulting from elevated tax collection from the private sector
- According to initial estimates, the measure could reduce the deficit by about \$102B over the next 10 years
- Although, other analysis suggests the act would slightly increase inflation until 2024
- The bill passed in the Senate on August 7 and is likely to pass in the House on Friday, August 12

## Global Covid-19 Spending

Even without BBB, the U.S. has spent nearly **\$6T** in Covid relief grossly contributing to the nation's inflationary concerns

Developed nations in total spent \$17T on the pandemic with government spending becoming a greater share of GDP in every major advanced economy, a relentless expansion of government

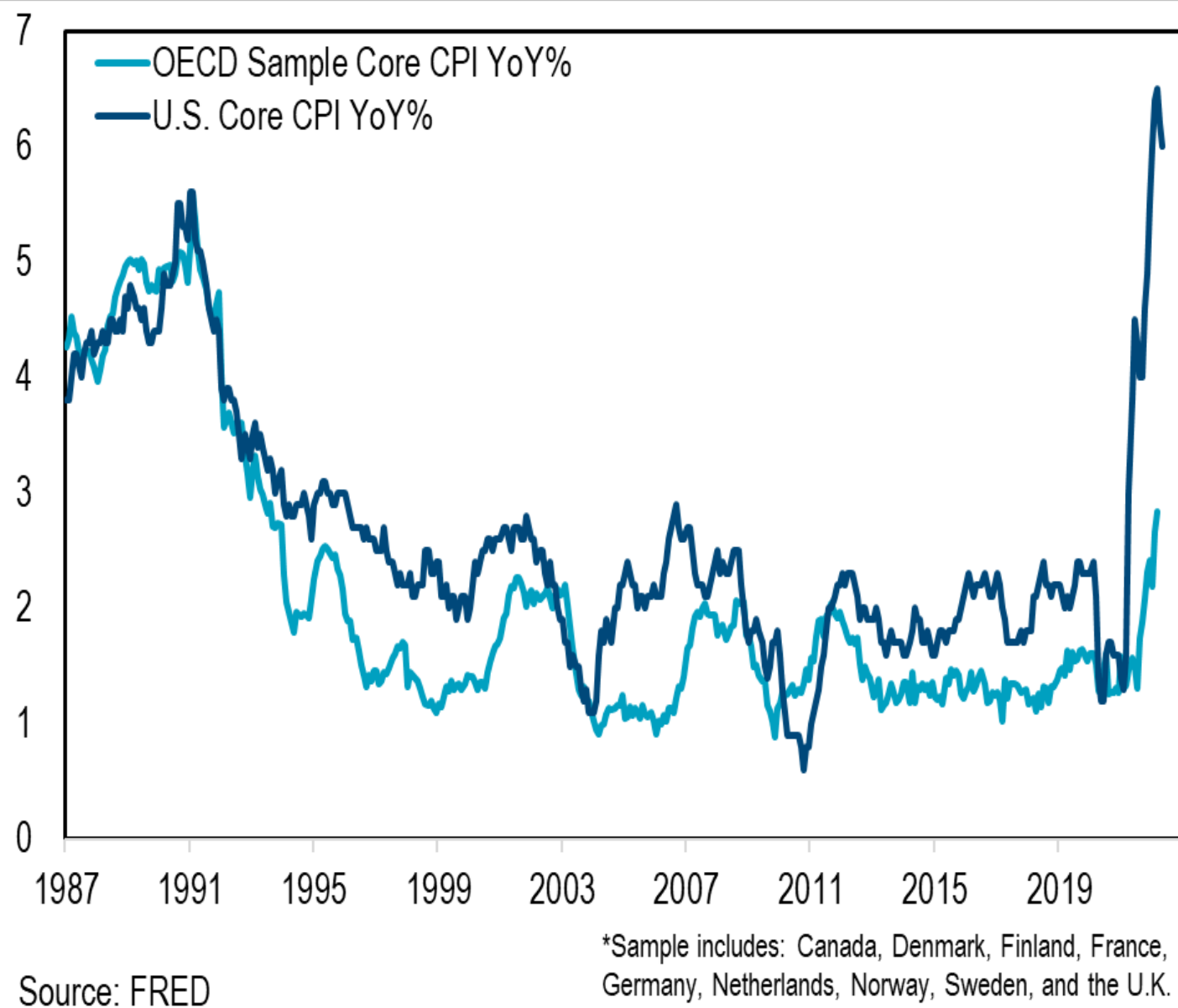
The U.S., however, spent more than double the next highest spender with much in the way of direct payments, leading to higher inflation rates than almost anywhere else in the world



Source: Vivid Economics

## U.S. Inflation Higher than Abroad

U.S. inflation continues to outpace other countries, rising 5.9% as of July vs. 2.8%



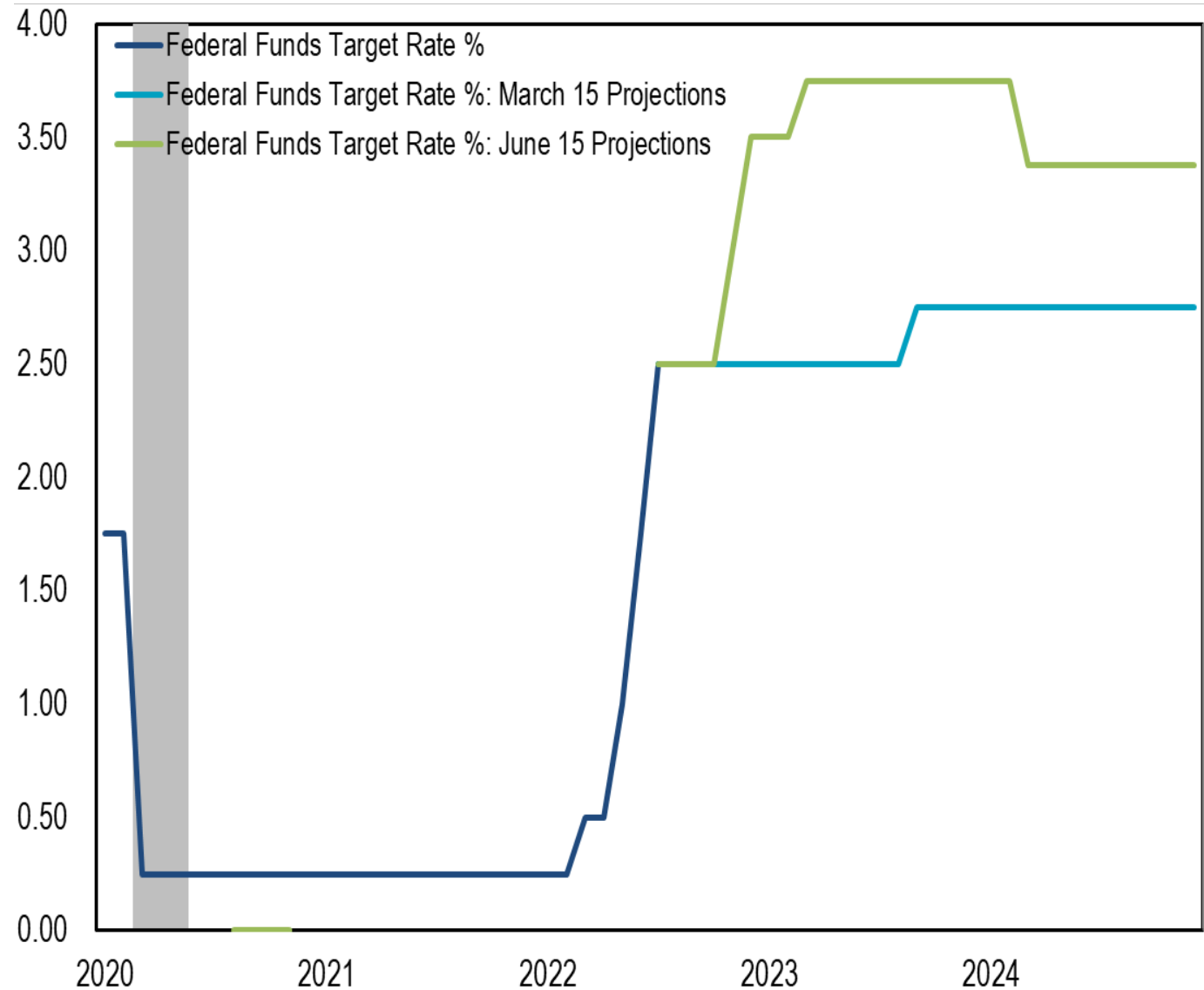
## Rate Expectations Materially Increased

The Fed raised rates 75bps in July to 2.25-2.50%

Rate hike full priced into the market

*“...the Committee anticipates that **ongoing increases in the target range** will be appropriate.”*  
- July 27 FOMC Statement

According to the June 2022 FOMC dot plot, members expect the target rate to reach near 3.50% this year and around 3.75% next year

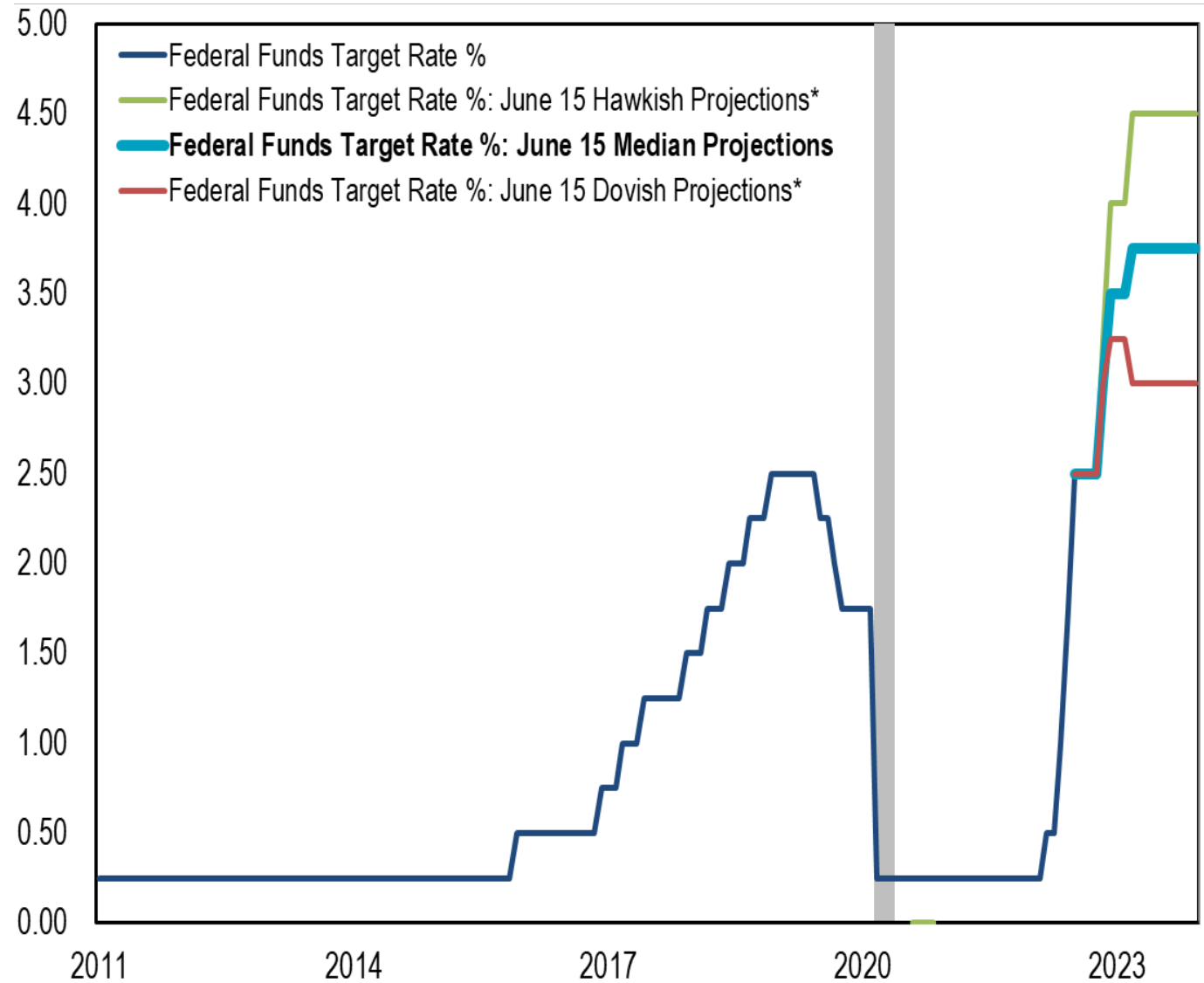


Source: Federal Reserve Board/Bloomberg

## An Array of Policy Opinions Among Fed Members

The array of opinions among policy makers is still quite large

The more dovish members are forecasting a federal funds rate of closer to 3.25% by year-end while hawkish members are forecasting around 4.0% by year-end



Source: Federal Reserve Board/Bloomberg

\*Median projections based on June Dot

## “Too High” Inflation Motivation for Hawkish Fed

“Too high” inflation motivation for Fed policy directive

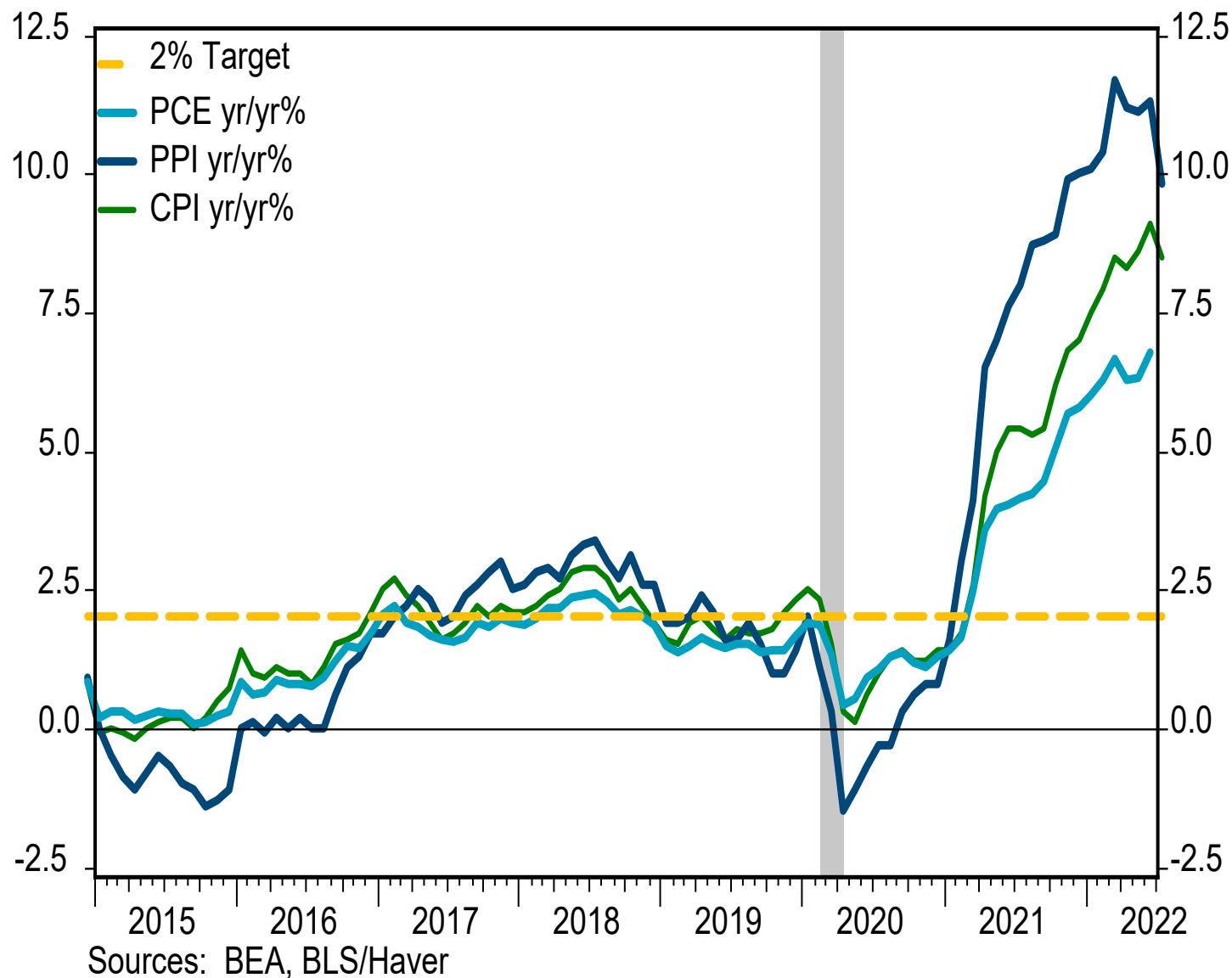
Labor and wage gains “solid,” however inflation has become more “broad-based”

The PCE rose **1.0%** in June and rose **6.8%** YoY, up from the 6.3% pace in May, and the largest gain since January 1982. The core PCE rose **0.3%** in June and rose **4.8%** YoY, up from the 4.8% pace in May

Inflation had fallen short of the Fed’s 2% target for nearly a decade

Inflation averaged 1.3% from 2015-2020, allowing a potential for inflation to run near 3% for the next five without exceeding a longer-term average of 2%

However, in 2021 alone, inflation averaged 3.7%



## Inflation by Category

	MoM%	YoY%
<b>CPI</b>	0.0%	8.5%
<b>Core CPI</b>	0.3%	5.9%
<b>PPI</b>	-0.5%	9.8%
<b>Core PPI</b>	0.2%	7.6%

The cost of gasoline continues to rise, up **44%** over the past 12 months, with other housing materials such as lumber and heating equipment up **5%** and **17%** over the past 12 months, respectively

The cost of animal feed and certain foods has also increased with animal feeds up **13%**, eggs up **38%**, and pork prices up **8%** from a year ago in July



Gasoline: **44.0% YoY**



Used Cars & Trucks: **6.6% YoY**



Asphalt: **73.8% YoY**



Prepared Paint: **25.8% YoY**



Lumber: **5.3% YoY**



Heating Equip.: **17.3% YoY**



Animal Feeds: **12.8% YoY**



Pork: **7.6% YoY**



Eggs: **38% YoY**



Mixed Fertilizer: **18.2% YoY**



Cereal: **16.8% YoY**



Corn: **9.3% YoY**

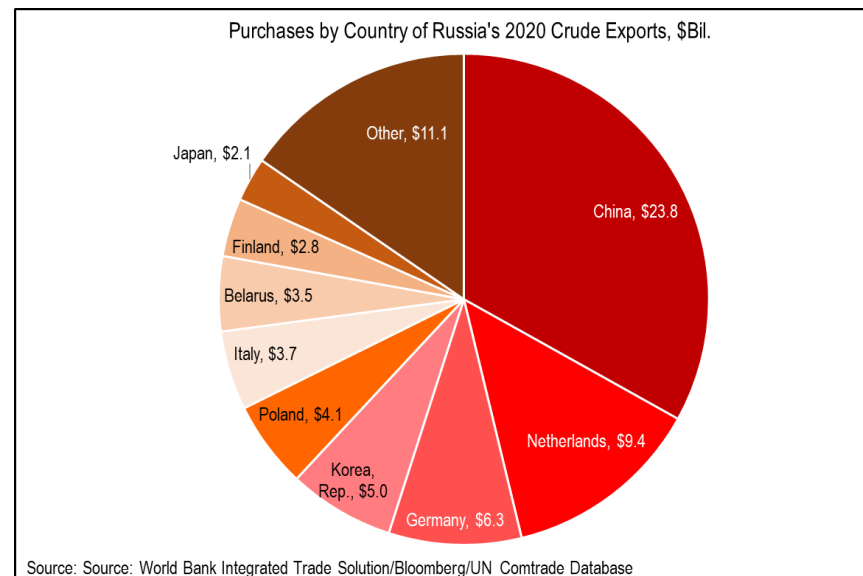
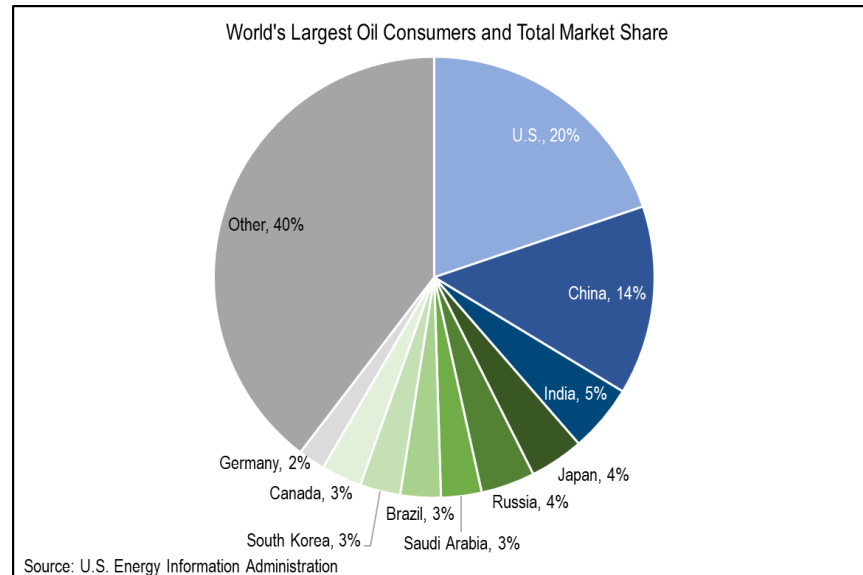
Source: Haver Analytics

## Oil Prices Impacted by International Factors

Russia is the world's **third largest oil producer** behind only the U.S. and Saudi Arabia

While Russia accounts for 3% of U.S. crude oil imports and roughly 1% of total crude oil processed by U.S. refineries, **Russian exports account for nearly 25% of the European Union's crude, 40% of its natural gas, and 46% of its coal imports**

Oil prices are at \$89.71 a barrel as of August 8, down from a near-term high of \$123.70 on March 8



## Agricultural Impact of Russia-Ukraine War

Ukraine is considered the breadbasket of Europe with 70% of land agricultural

Ukraine is the **fourth-largest exporter of maize** globally – behind only the U.S., Argentina and Brazil – accounting for 13% of the world's total maize exports

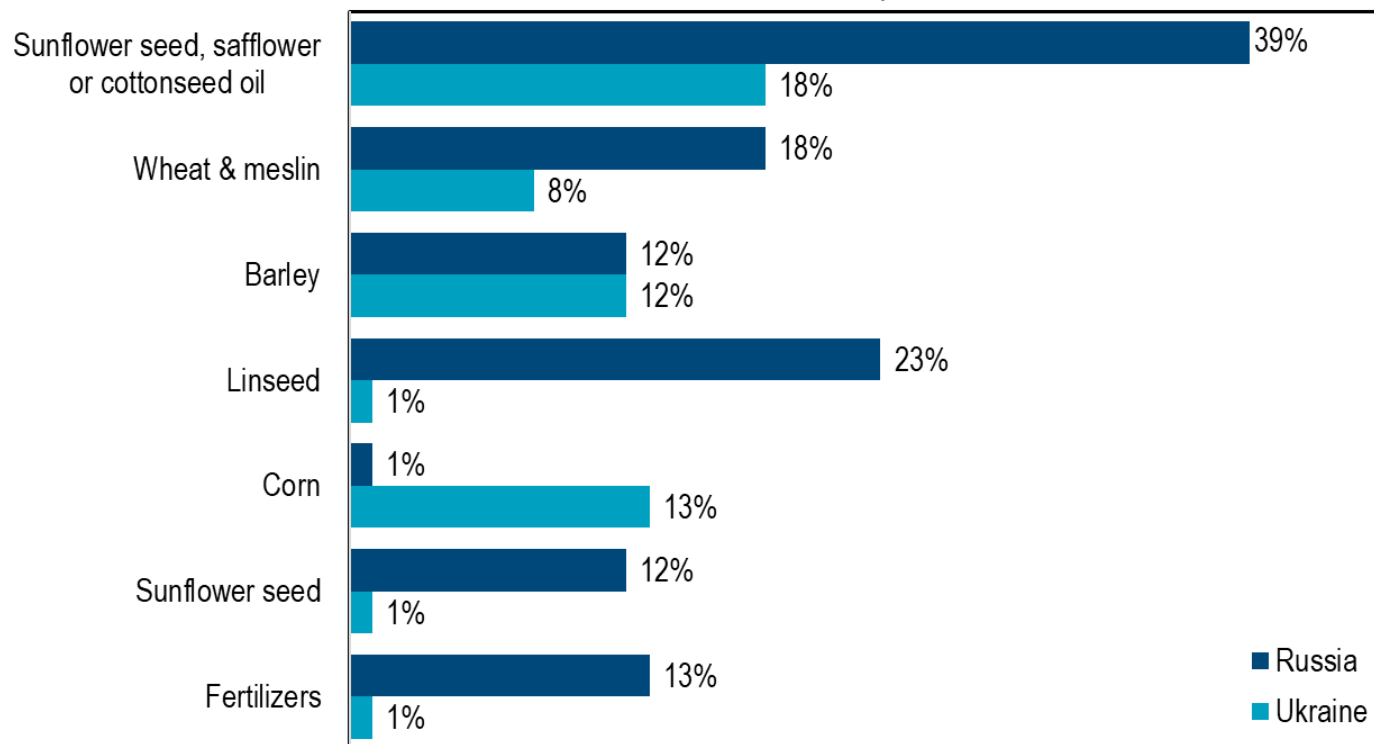
Ukraine is the **fourth-largest exporter of barley**, accounting for 12% of total world exports, and the **fifth-largest exporter of wheat and meslin**

Ukraine is the **largest exporter globally of sunflower seeds and sunflower oil**, which is the fourth most-consumed vegetable oil in the world

Russia is a **leading exporter of wheat and meslin**, exporting \$7.9 billion worth in 2020, or roughly 18% of global exports

Russia is the **sixth-largest producer of corn**, accounting for 2.3% of the world's exports

Russia & Ukraine Share of Total Global Exports in 2020, %\*



Source: International Trade Centre

\*Exports shown are those with a combined share over 10% of 2020 export

## Cost of Staples Elevated

Prices were already on the rise after Covid-19, international conflict is now adding pressure

The cost of staples – bread, pasta, and flour – are rising with wheat prices up over **\$7** a bushel as the world faces uncertain grain stockpiles

Gas prices are on the rise across the country with the national average at **\$4.03** a gallon as of August 8, up 27% from this time last year and up more than 100% from a recent low of \$1.98 in March 2020

Average household spending \$100s more on gasoline

The fastest way to derail consumer is heightened energy prices, but there is no alternative for food supply

Oil prices are at \$89.71 a barrel as of August 8



Source: Bloomberg

## U.S. Economy Showing Signs of Weakness

Typically, the Fed raises rates when the economy is overheating versus struggling to gain legs post-pandemic

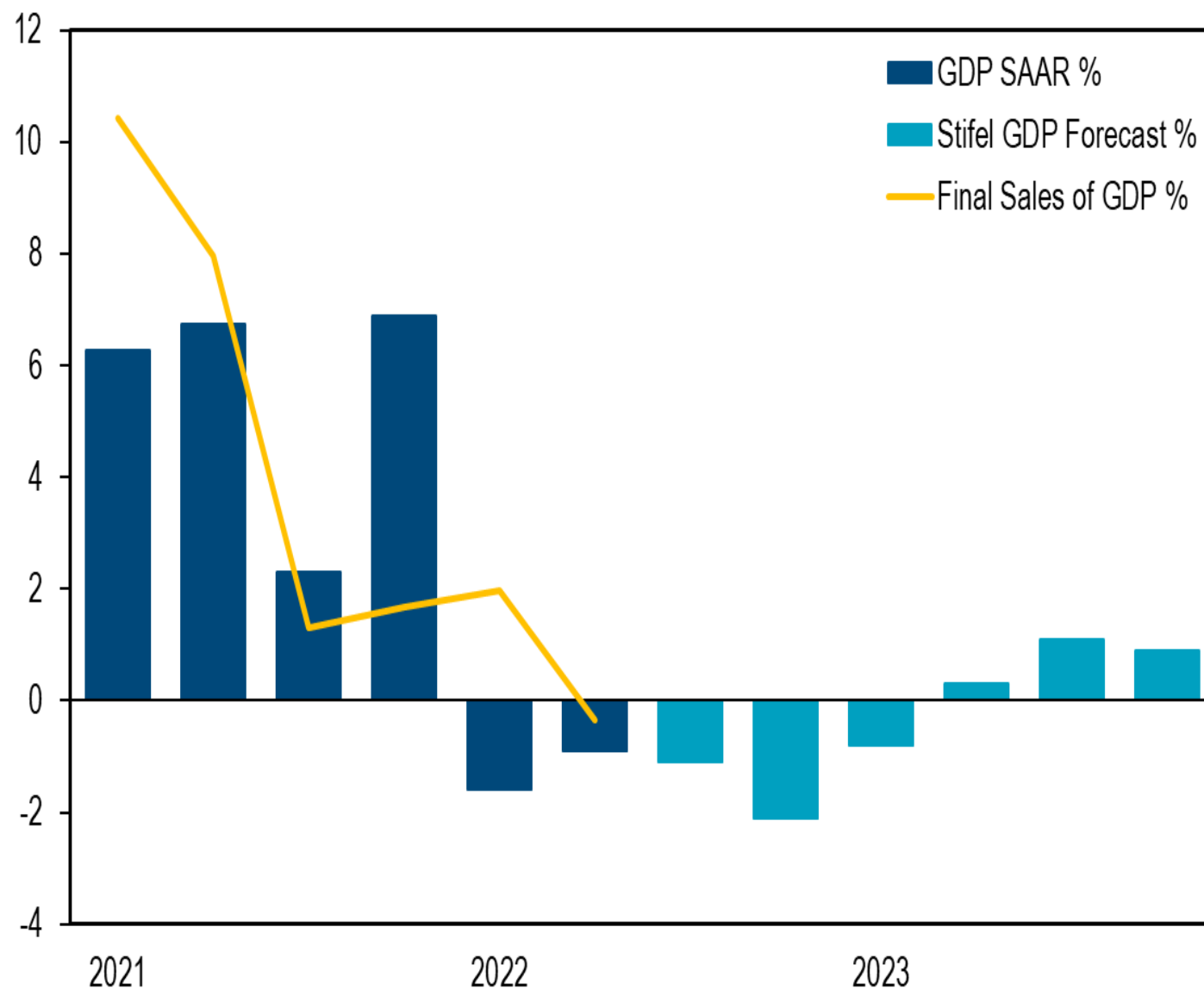
The majority of price pressures stem from supply side constraints, limiting impact of Fed rate hikes

With an aggressive rate path, growth is likely to slow

After a record 31.2% drop in Q2 2020, growth rebounded a record 33.8% in Q3 and rose 4.5% in Q4 2020

GDP fell **0.9%** in Q2 2022, the second consecutive quarter of decline

Excluding trade and inventories, final sales to domestic purchasers fell **0.3%**



Source: Bloomberg/Stifel

- National Bureau of Economic Research (NBER) Business Cycle Dating Committee *officially* determines recession
- Eight committee members accepted as experts in macroeconomics and business cycle research
- An official recession involves a significant decline in economic activity that is spread across the economy
- Weakness typically lasts for a modest period of time
- The Committee emphasizes “*economy-wide*” measures of economic activity

- Topline growth has slowed markedly; Q2 GDP fell 0.9% following a 1.6% decline at the start of the year.
- *Real* consumption has declined; *real* retail sales declined 0.5% in June.
- Manufacturing is slowing; the ISM fell from 53 to a reading of 52.8 in July
- *Real* income growth is negative; *real* income fell 1.0% in June.



*“We’re going to do everything we can to avoid a recession, but we are committed to bringing inflation down, and we are going to do what we need to do.”*

-Minneapolis Fed President Neel Kashkari, CBS’s Face the Nation,  
July 31, 2022



*“If you really thought things weren’t improving...50 (basis points) is a reasonable assessment but 75 could also be okay. I doubt that more would be called for.”*

-San Francisco Fed President Mary Daly, LinkedIn Interview,  
August 2, 2022

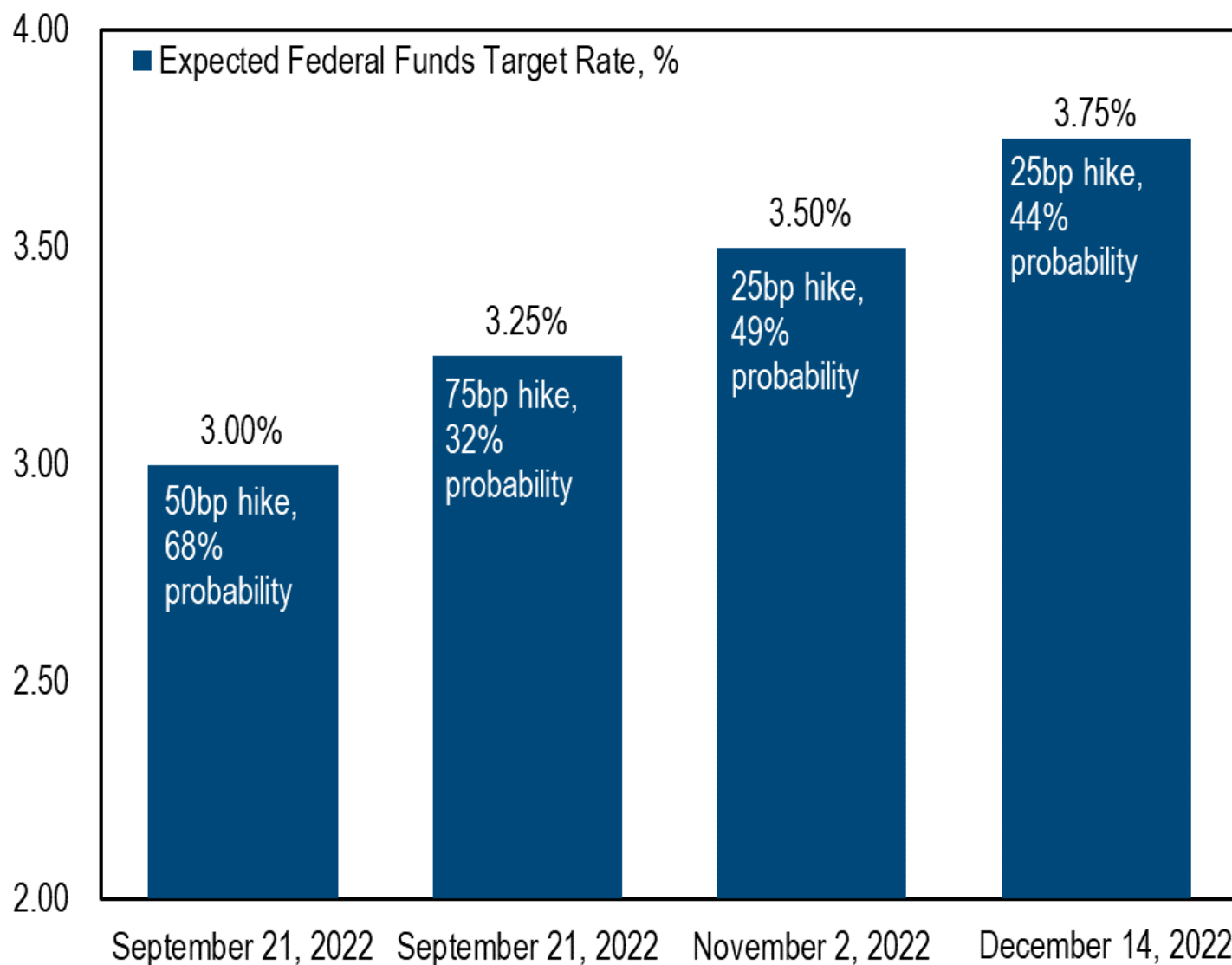


*“We have more work to do because we have not seen that turn in inflation. It's got to be a sustained, several months of evidence that inflation has first peaked – we haven't even seen that yet – and that it's moving down.”*

-Cleveland Fed President Loretta Mester, Washington Post Interview,  
August 2, 2022

## Expectations for Rate Hikes Diminish into Year-End










Market participants continue to ping pong between a 50bp and 75bp hike come September 21 with the expectation for at least two more 25bp hikes into year-end



Source: Bloomberg/CME FedWatch

## What Does This Mean for Rates?

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Inflation	FF Pathway	GDP Expectations	10-Year UST Yield Near Term	10-Year UST Yield Medium Term
	Dovish	Minimal Contraction/Modest Recovery		
	Dovish	Modest Contraction/Minimal Recovery		
	Hawkish	Deeper Contraction/Robust Recovery		

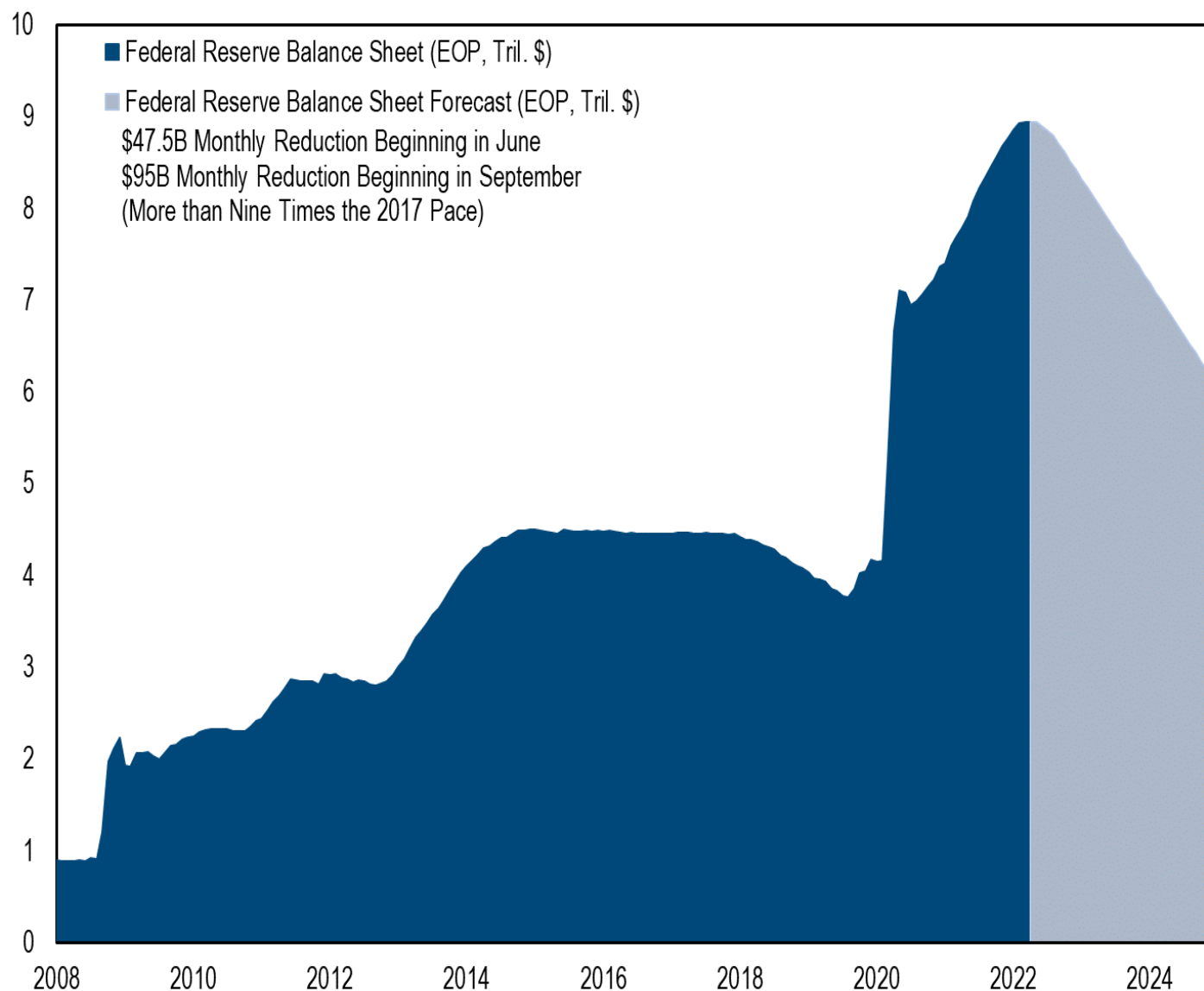
## Balance Sheet Provides Alternative to Rate Hikes and Floor for Rates

The Fed should back off quickly after initiating a series of rate hikes to avoid recession

Aside from raising rates, the May statement also signaled that the Fed would begin a drawdown of the balance sheet which has ballooned to near **\$9T**

Ramping up to **\$95** billion a month by September including a **\$60** billion reduction of UST and a **\$35** billion reduction MBS. The first three months however will begin at a slower pace of **\$47.5** billion comprised of **\$30** billion UST and **\$17.5** billion MBS to allow the fed to assess the market's reaction

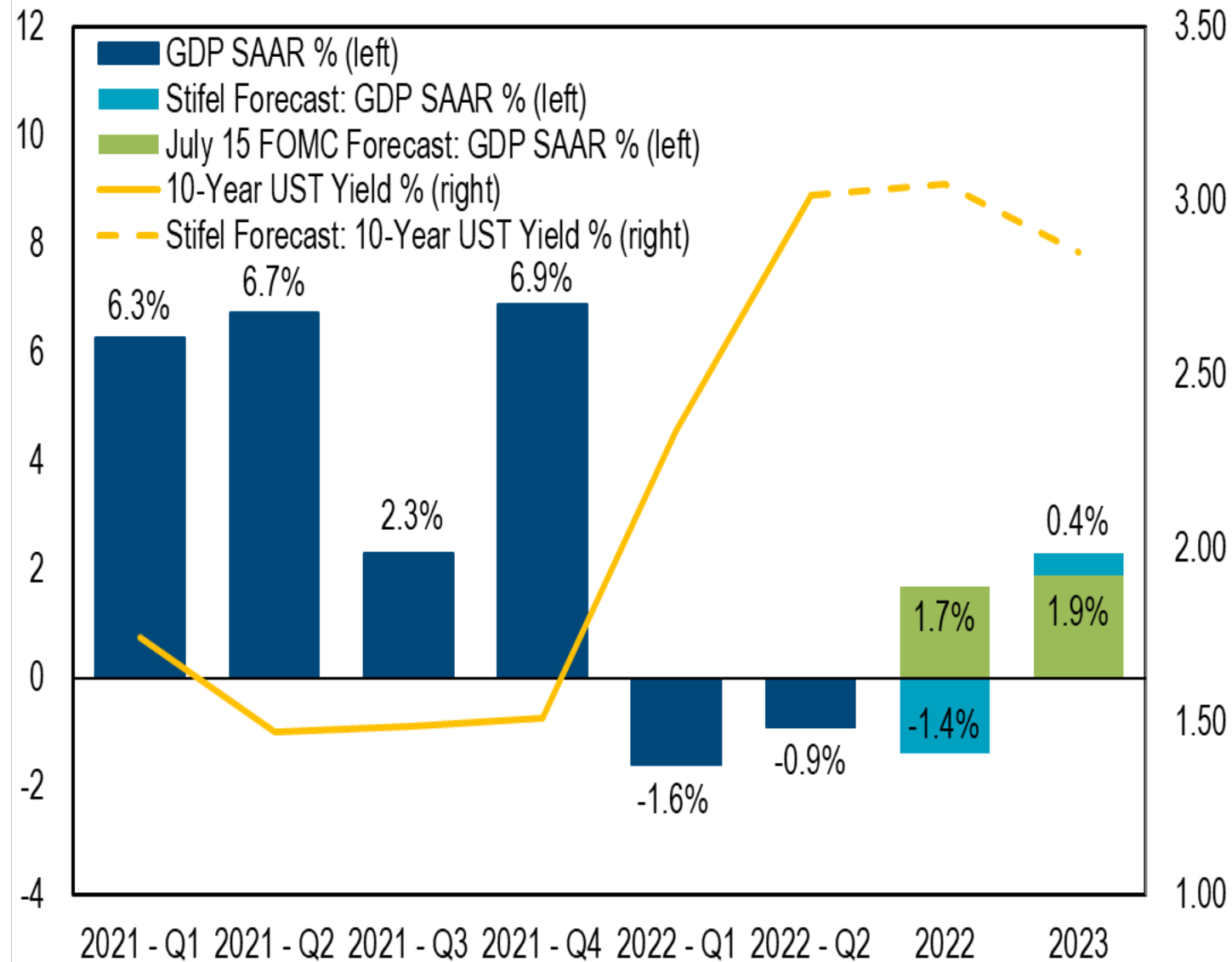
Recall, by contrast, after the taper in 2014, the Fed kept its balance sheet steady for roughly three years before allowing the portfolio to shrink



Source: Federal Reserve Board/Haver Analytics/Stifel

## Fed Optimistic Regarding Growth

Amid increased economic uncertainty and volatility in the market, the economy is likely to slow into the second half of the year with growth dropping further into negative territory



Source: Census Bureau/Federal Reserve/Stifel/Bloomberg

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# Thank you

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