THOUGHTS OF THE WEEK

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Are Markets Overreacting?

This is a question that economists are asked every time there is market turbulence. My instinctive answer is that the stock market is not the economy, which is also an easy answer to give, considering that markets are more forward looking than economists' data points. But it is also true that markets have been wrong before and are prone to overreact to news that may or may not have consequences for economic activity.

There are three primary scenarios that could unfold:

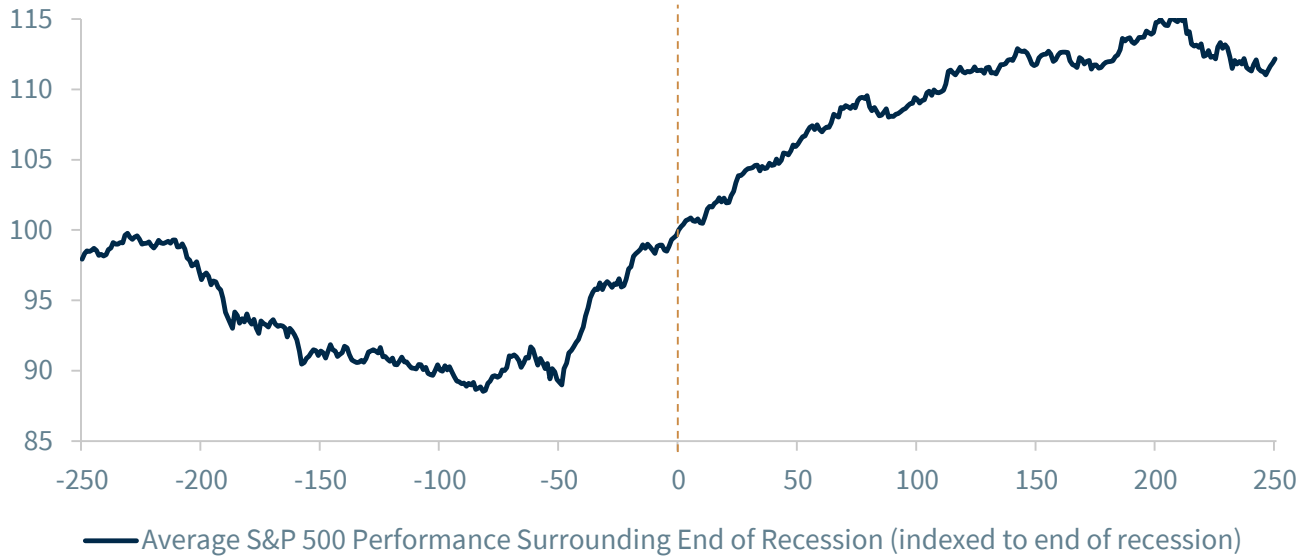
The Fed engineers a soft landing (35%): while this is very challenging, the Federal Reserve (Fed) could potentially still be able to bring down inflation without sending the economy into a recession. This scenario assumes that inflation will come down over the next few months and the Fed won't be forced to continue to hike as fast and as much as they have suggested.

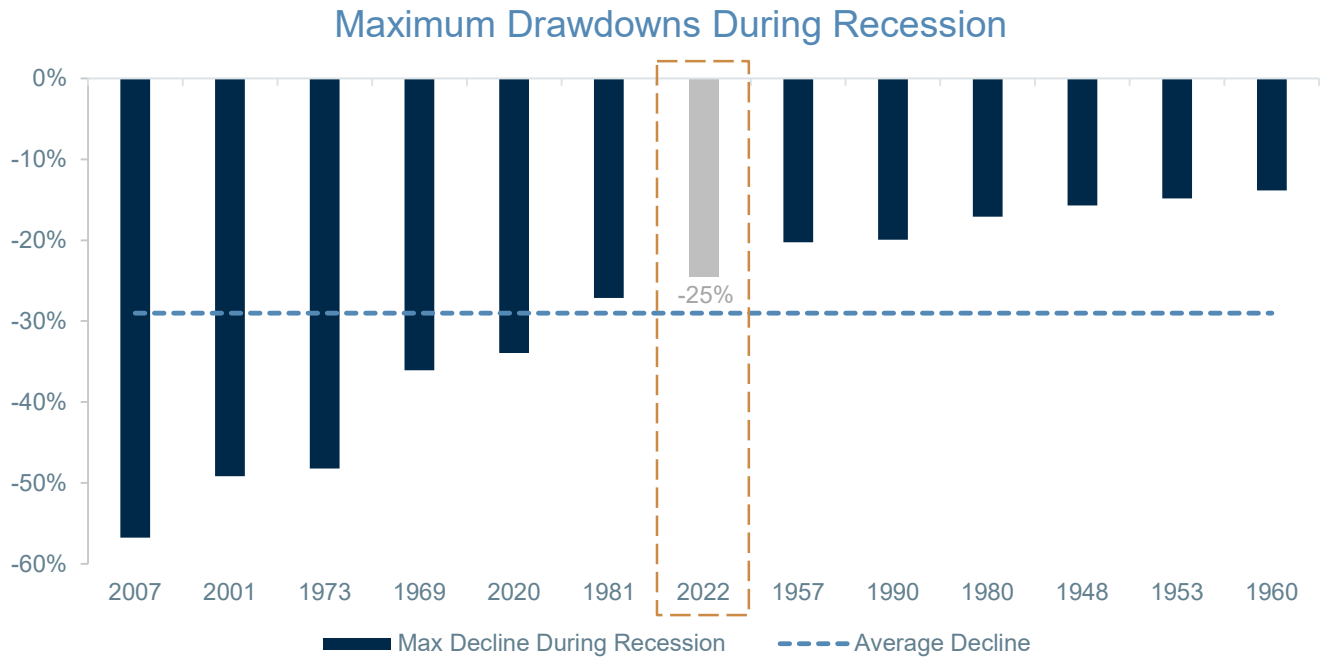
The Fed does not engineer a soft landing, and we experience a mild recession (60%): the average recession since 1948 has brought down the S&P 500 by ~29%, and down ~25% in a mild recession (where the economic loss is not greater than 2.5%). With the June 17 low, the S&P 500 market recorded a ~25% decline since its peak in January and therefore has fully priced in what a mild recession would be. Therefore, if even a mild recession were to unfold, the market shouldn't experience significantly greater losses.

The Fed does not engineer a soft landing, and we experience a severe recession (5%): while we don't expect this will be the case, there are a lot of variables that are out of the Fed's control such as the Russia/Ukraine war, consumer sentiment, etc. Therefore, if a more severe recession were to occur the S&P 500 could experience deeper losses.

However, the key remains that the stock market is not the economy. In fact, the equity market is a forward-looking mechanism, and equities have historically bottomed ~four months prior to the end of a recession. Therefore, equities historically have not 'waited' until the economy recovered to recoup their losses.

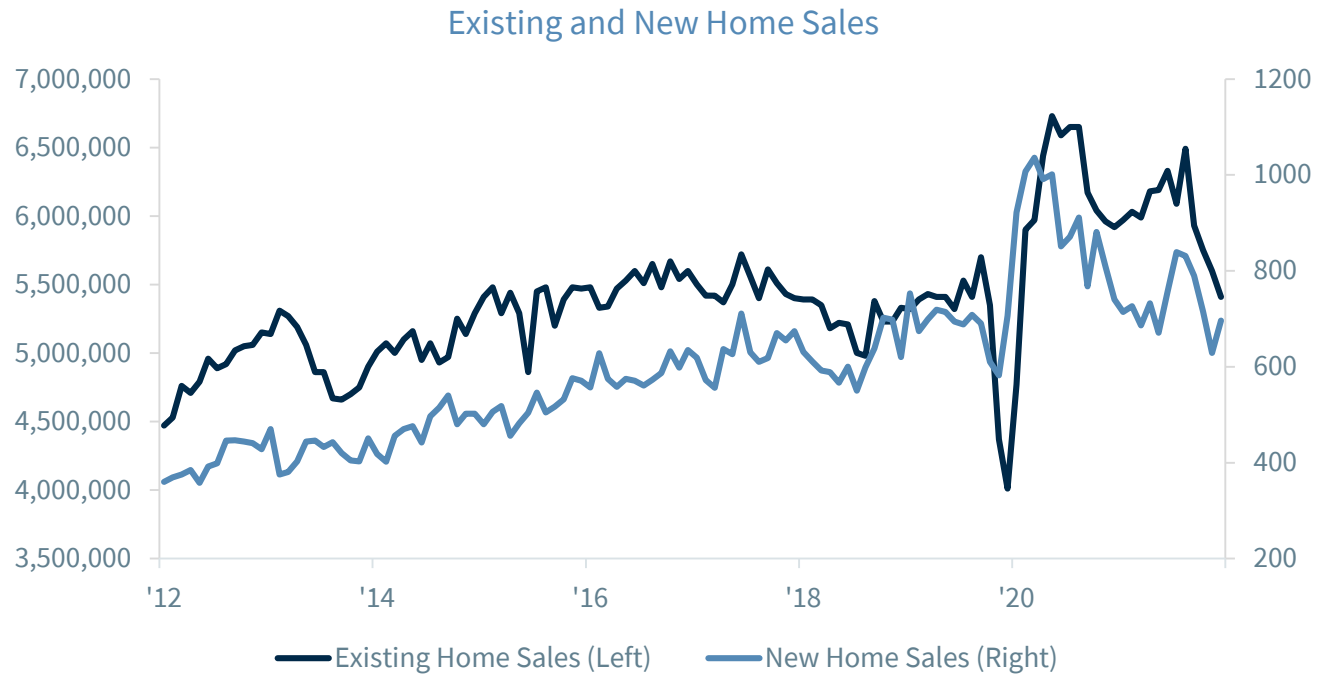
Average S&P 500 Performance Surrounding End of Recession





We think that the Fed 's recent change in tone regarding the seriousness of inflation and the assertiveness of its message changing the path for the "appropriate path for monetary policy" was major news for the 'real' economy. The reason for this is that the previous path was relatively benign for economic activity while the new one, if followed, will probably do more damage to the economy than the previous path.

Let's look at the sector that was already affected before this change took place, the housing market. The first 25 basis point increase to the federal funds rate early this year had an outsize effect on mortgage interest rates. Mortgage rates increased a full percentage point between mid-January of 2022 and mid-March 2022. After that, mortgage rates have continued to increase as the yield on the 10-year Treasury has continued to move higher.



Thus, the housing slowdown is well on its way, and it will contribute to put downward pressure on house price inflation during the next several quarters. So far, signs of housing weakness have appeared in the market for homes $250,000 in price and lower, while some cracks are also appearing in regional markets for homes priced $250,000 to $500,000.

Existing Home Sales

Region	$0-100K	$100-250K	$250-500K	$500-750K	$750K-1M	$1M+
Northeast	-18.4%	-20.1%	-7.0%	10.3%	16.4%	24.3%
Midwest	-18.3%	-15.6%	6.0%	31.1%	31.6%	18.2%
South	-28.9%	-34.1%	5.3%	39.4%	43.6%	32.7%
West	-29.5%	-53.9%	-27.5%	10.8%	17.7%	17.3%
US	-22.3%	-26.8%	-2.6%	22.8%	26.0%	22.1%

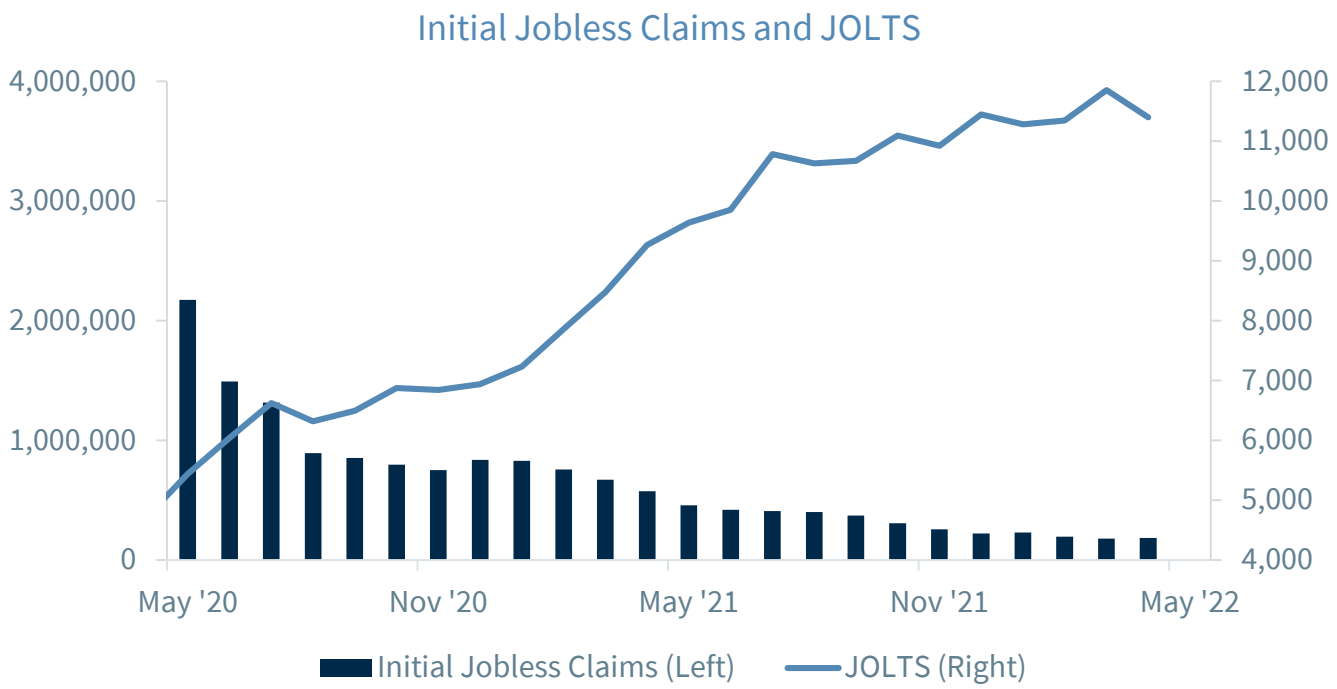
However, we want to be clear that we are not looking at a collapse of the housing market as we saw back in 2008 during the Great Recession when the housing bubble imploded and triggered a financial crisis that spanned across the globe. What we are expecting is a slowdown in the housing market as segments of the population are priced out of the market due to the increase in home prices as well as the increase in mortgage rates.

What About Employment?

Remember what the NBER, the official source for calling recessions, says about a recession: “The NBER's traditional definition of a recession is that it is a significant decline in economic activity that is spread across the economy and that lasts more than a few months. The committee's view is that while each of the three criteria—depth, diffusion, and duration—needs to be met individually to some degree, extreme conditions revealed by one criterion may partially offset weaker indications from another.”

That is, for a recession to be called we need to see weakness across the overall economy. In the case of employment, it needs to weaken considerably across the overall economy. From the employment side, however, anecdotal evidence is not a good indicator of how the overall employment sector is doing. If we hear this and that company is laying off workers it is very difficult to infer that, on net, US firms are laying off workers. We saw in May that the retail sector shed 60,700 jobs but other sectors of the economy more than offset that monthly decline. That is, the retail sector was weak, but the rest of the sectors were not.

Furthermore, one of the most coincident indicators of the health of the labor market is the initial jobless claims number, which comes in every week. This number has remained close to all time lows and although it has trended higher over the last several months, it is not signaling any problems for the US labor market yet. At the same time, the JOLTS, that is, the Job Openings and Labor Turnover Survey number, is still very strong, pointing to the existence of almost two jobs available for every worker looking for a job.


Initial Jobless Claims and JOLTS
4,000,000
3,000,000
2,000,000
1,000,000
0
12,000
11,000
10,000
9,000
8,000
7,000
6,000
5,000
4,000
May '20
Nov '20
May '21
Nov '21
May '22
Initial Jobless Claims (Left)
JOLTS (Right)

Summary of the week:

Initial Jobless Claims: This week's initial jobless claims number declined compared to the previous week on a seasonally adjusted basis. Although the 4-week moving average increased slightly, this increase does not pose any threat to the US employment picture. Initial jobless claims for the week ending June 18 were 229,000, declining 2,000 from the previous week's revised level of 231,000, according to the Bureau of Labor Statistics. The 4-week moving average was 223,500, an increase of 4,500 from the previous week's average, which was 219,000. The advance seasonally adjusted insured unemployment rate was 0.9% for the week ending June 11, unchanged from the previous week.

Consumer Sentiment: A lower 5-year ahead inflation expectations number from the University of Michigan consumer sentiment report is a good sign for the Federal Reserve (Fed) and for the path of rate increases. The Fed chairman commented that the original increase to 3.3% was concerning for the Fed. However, the downward revision to 3.1% seems to indicate that longer-term inflation expectations remain 'relatively' well anchored. Of course, one number does not make a trend, but it is a step in the right direction. Still, this may not be enough to change the current expected change in the Fed funds rate in July. The final read for the University of Michigan Consumer Sentiment for June number came in at 50.0, slightly lower than the preliminary number of 50.2. Meanwhile, 12-month inflation expectations remained at 5.3%, unchanged from the May reading while the 5-year ahead inflation expectations number, which was originally reported at 3.3% was revised down to 3.1%. All the components of the Consumer Sentiment Index were lower in June than in May but the all-important 5-year inflation expectations number, which had been reported at 3.3% was revised down to 3.1%. The originally reported increase to 3.3% was used as one of the reasons for the Fed to have increased the federal funds rate by 0.75 bps during its last FOMC meeting.

New Home Sales: New home sales in May were more than 100,000 units above consensus expectations. They still were lower on a year-over-year basis. This shows that the housing market is down but not out, and it is consistent with our view of a slowdown in the housing market. Sales of new single-family homes were 696,000 in May according to the US Census Bureau and the Department of Housing and Urban Development. This was up 10.7% from the revised April rate of 629,000 but down 5.9% from a year earlier. The median sales price for a new home sold in May was $449,000 while the average price was $511,400. Meanwhile, the seasonally adjusted level of inventories for new home sales at the end of May was 444,000, or 7.7 months at the current sales pace. New home sales were very strong in the South and in the West in May while weak in the Northeast and Midwest. Sales of new homes in the Northeast were 42.5% lower in May compared to a year earlier while they were 37% lower in the Midwest. However, new home sales in the South were up 1.5% in the West sales were up 0.5%, all compared to a year earlier.

Economic Forecasts:

	Quarterly Historical					Quarterly Forecast							Annual	Annual Forecast	
	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	2021	2022	2023
GDP (annual rate)	**6.3**	**6.7**	**2.3**	**6.9**	**-1.4**	**2.0**	**1.0**	**0.7**	**0.5**	**-0.1**	**-0.2**	**0.9**	**5.7**	**2.1**	**0.5**
Year-over-year	0.5	12.2	4.9	5.5	3.6	2.4	2.1	0.6	1.1	0.5	0.2	0.3			
Private Domestic Final Purchases	**11.8**	**10.1**	**1.4**	**2.6**	**3.7**	**2.3**	**1.2**	**0.7**	**-0.6**	**-0.7**	**-0.8**	**0.4**	**7.9**	**2.8**	**0.1**
Year-over-year	2.5	16.0	7.3	6.4	4.4	2.5	2.4	2.0	0.9	0.2	-0.3	-0.4			
CPI (y/y)	**1.9**	**4.8**	**5.3**	**6.7**	**8.0**	**8.3**	**8.4**	**7.9**	**6.9**	**5.7**	**4.8**	**3.9**	**4.7**	**8.2**	**5.3**
Ex-food & energy	1.4	3.7	4.1	5.0	6.3	5.9	6.2	6.0	5.3	4.5	3.6	2.7	3.6	6.1	4.0
PCE Price Index (y/y)	**1.8**	**3.9**	**4.3**	**5.5**	**6.3**	**6.4**	**6.4**	**6.1**	**5.3**	**4.4**	**3.5**	**2.7**	**3.9**	**6.3**	**4.0**
Ex-food & energy	1.7	3.4	3.6	4.6	5.2	4.9	4.8	4.5	4.1	3.6	2.9	2.3	3.3	4.9	3.2
Unemployment Rate	**6.2**	**5.9**	**5.1**	**4.2**	**3.8**	**3.6**	**3.6**	**3.5**	**3.6**	**4.1**	**4.7**	**5.0**	**5.4**	**3.6**	**4.3**

Fed Funds Target Rate:

Fed Meeting	Fed Funds Target Rate
Current	1.50-1.75
July 26-27	2.25-2.50
September 20-21	2.75-3.00
November 1-2	2.75-3.00
December 13-14	3.25-3.50

DISCLOSURES

Economic and market conditions are subject to change.

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Consumer Price Index is a measure of inflation compiled by the US Bureau of Labor Studies. Currencies investing are generally considered speculative because of the significant potential for investment loss. Their markets are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Consumer Sentiment is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.

Personal Consumption Expenditures Price Index (PCE): The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

Consumer confidence index is an economic indicator published by various organizations in several countries. In simple terms, increased consumer confidence indicates economic growth in which consumers are spending money, indicating higher consumption.

The S&P 500 Total Return Index: The index is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 7.8 trillion benchmarked to the index, with index assets comprising approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance.
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Source: FactSet, data as of 6/24/2022

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