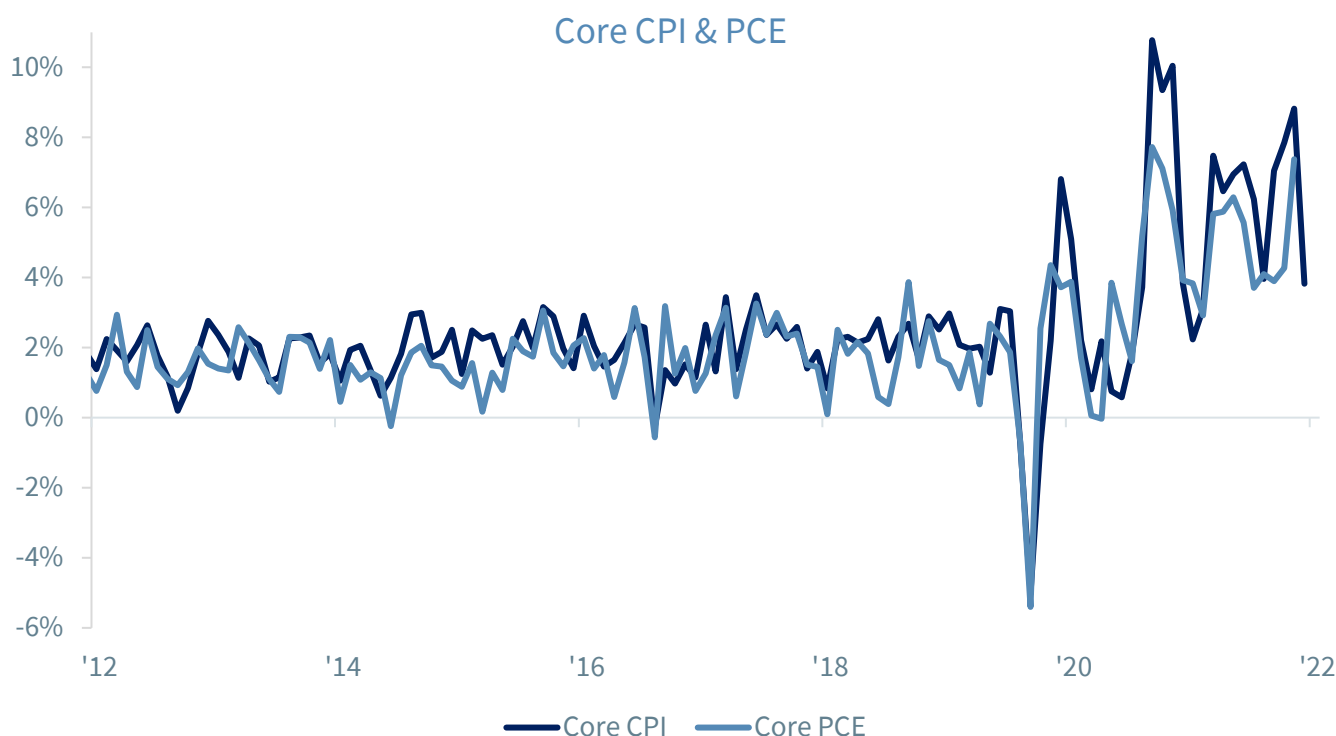


THOUGHTS OF THE WEEK

Eugenio J. Alemán, PhD, *Chief Economist*Giampiero Fuentes, CFP®, *Economist***WEEKLY
ECONOMICS****One Month Doesn't Make a Trend... But it Helps!**

July's inflation numbers were the best news the US economy has had for a long time. Both the Consumer Price Index (CPI) and the Producer Price Index (PPI) showed better than expected prints, with 0% for the CPI month-over-month and 8.5% year-over-year and -0.5% for the PPI month-over-month and 9.8% on a year-earlier basis. Of course, these numbers are just one month after a grueling half year but could be pointing to a better start for the second half of the year.

However, it is also true that much lower energy prices (e.g., lower gasoline prices) were the biggest reason for the better-than-expected number in July for both indices. I know that there are plenty of economists/analysts out there that always like to look at the glass half empty, so we normally place ourselves on the 'not-so-followed path' of trying to look at the glass half full.



Thus, the most important number from the CPI report wasn't the overall number, which includes energy prices; the most important number in July was the core CPI, which does not include energy or food prices, and increased by only 0.3%, the lowest monthly increase since March of this year when it was also 0.3%. This number is crucial for the Federal Reserve (Fed) and if we continue to see low numbers for the core CPI, it will reduce the pressure on the institution to increase the federal funds too much and too fast.

The Fed needs to see clear indications that even if energy and food prices go up, this increase in energy and food prices is not seeping through to the core numbers. If this is the case in the next several months, then the Fed may rethink its interest rate increases going forward.

However, this path is full of risks for Fed officials because there is nothing they can do to prevent potentially higher energy and food prices in the future, so they may have to ‘play it safe’ and go ahead with a higher increase in interest rates than we expect, which is 50 basis points during the September meeting. Thus, the PCE price index, but especially the PCE price index excluding food and energy, released later this month, will be a very important indicator of inflation, even better than the CPI number released this week.

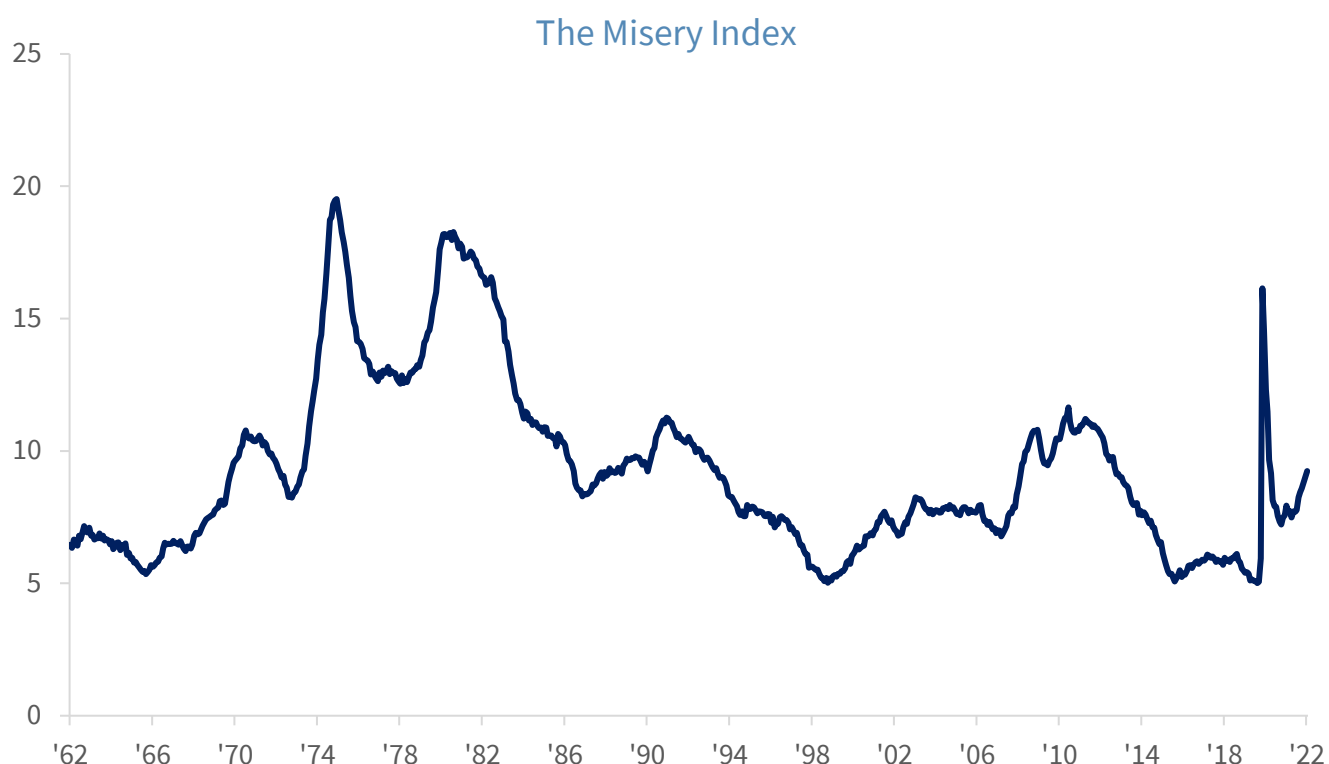
Why is Inflation So Damaging?

Inflation has not been this high for about 40 years or so. Thus, for many Americans, this is the first time they are facing such high inflation and younger generations are probably struggling with what to do about it. Furthermore, while older generations have more experience with high inflation many of them are on fixed incomes because they are retired, and they are suffering the most from higher prices. Thus, it is obvious that inflation would be front and center in today’s political discourse.

Furthermore, higher inflation is very trying for all Americans but particularly for those in the lower income levels who, in normal times, struggle to get by from month to month and higher prices are putting an added burden on their ability to get to the end of the month.

For the Fed, keeping inflation low and stable is one of the institution’s two mandates. The other mandate is keeping the rate of unemployment low. The later mandate is not at issue today. The US unemployment rate declined to 3.5% in July, matching the rate recorded just before the start of the COVID-19 pandemic and the lowest rate in more than 50 years. During the 1970s and 1980s, the rate of unemployment and the rate of inflation was so high that economists coined a term called the ‘misery index,’ which is calculated by summing the rate of inflation and the rate of unemployment.

Today, the misery index has been going up because of the increase in inflation but the very low rate of unemployment is keeping it from surging past previous periods, especially the periods of the 1970s and 1980s, which were called the years of ‘Stagflation’ (See the June 10, 2022, *Weekly Economics* for more on Stagflation).



However, this could change very quickly if firms decide to start massively laying off workers because they fear the US economy is heading towards a recession. So far, this hasn't happened, as demonstrated by the blockbuster July nonfarm employment number, up 528,000 new jobs during the month.

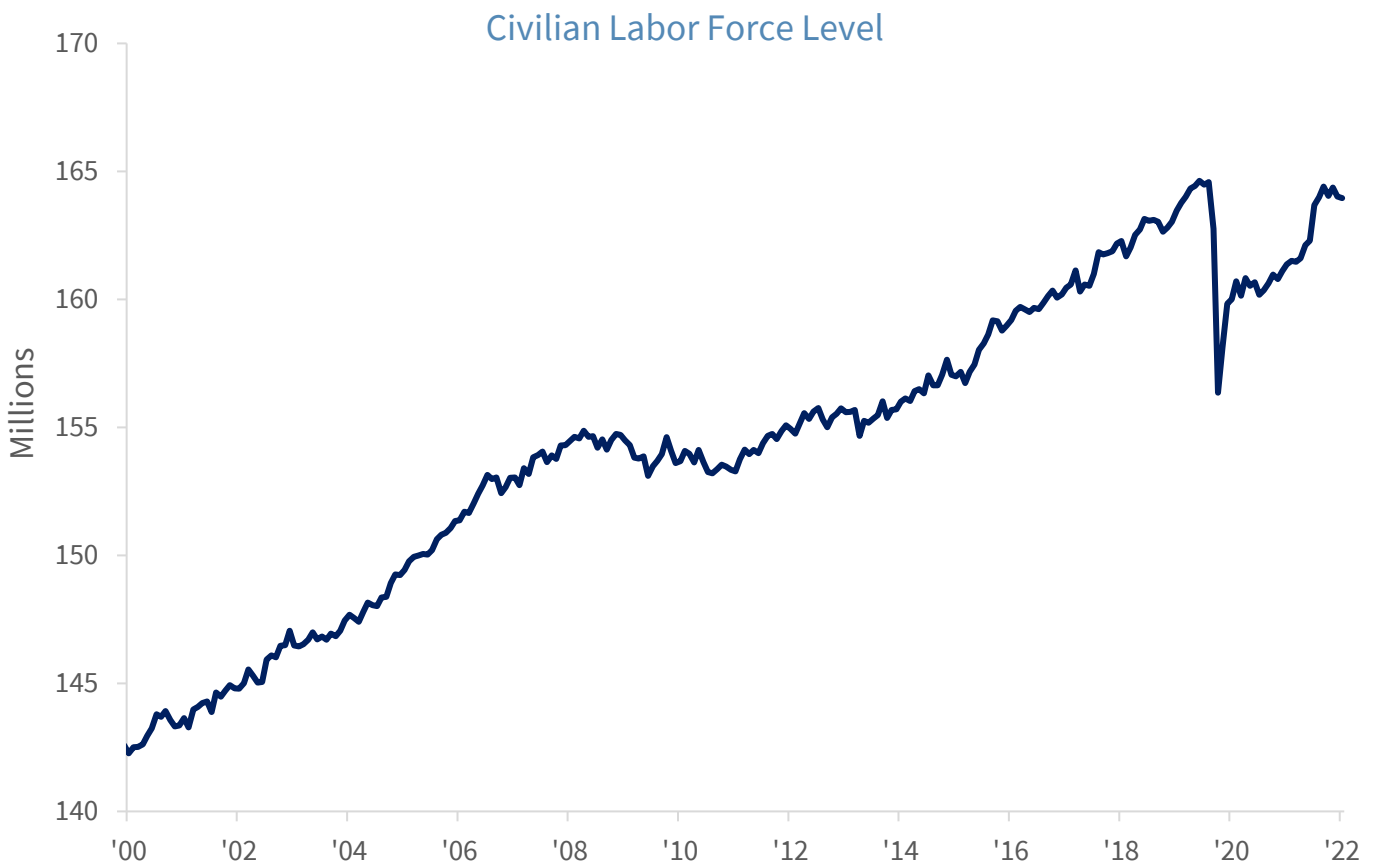
But the biggest issue for the Fed is deciding what is its primary objective and currently, that objective is, clearly, to bring inflation down. However, the dual mandate for the Fed is very tricky because in normal times, the rate of unemployment and the rate of inflation go in opposite directions. That is, if the rate of unemployment is too low, the rate of inflation is normally pushed higher.

Having said this, the US economy has enjoyed very low rates of inflation over the last 30 years alongside very low rates of unemployment. So, today, the question for the Fed is, will the US economy go back to pre-COVID times during which we had a very low rate of unemployment alongside a very low rate of inflation or have times changed again and are we going back to the 1970s and 1980s?

There is no simple answer to this question. However, according to the press conference given by Fed Chair, Jerome Powell, after the Federal Open Market Committee (FOMC) meeting in July, it seems that Fed officials are starting to believe that the 'Non-Accelerating Inflation Rate of Unemployment' (NAIRU) is higher today than it was prior to the COVID-19 pandemic outbreak in 2020 (see the *Weekly Economics* for August 5, 2022).

If this is the case, then it spells trouble for the US economy, the rate of unemployment, and thus for the misery index, as the Fed is probably going to increase interest rates until they bring the rate of unemployment high enough to contain inflation according to this NAIRU explanation of inflation.

Looking at the graph below, after the COVID-19 pandemic many Americans have been reluctant to return or reengage in the labor force and firms have had to increase wages to bring back workers.



However, the effort seems to have stalled early this year as the labor force level has started to come back down again. Thus, the unemployment rate in January and February of 2020, just before the pandemic, was at 3.5%, just like today. However, the level of the labor force was at ~164.6 million while today's labor force level is at ~164M or ~570,000 fewer people today than when we had a similar rate of unemployment.

Furthermore, more than one million Americans have died since the pandemic started and although many of them were older, and probably retired, many of them were younger and probably still engaged in the US labor force. Thus, this recovery from the pandemic has caught firms with a reduced supply of labor and that has contributed to the increase in wages, which tends to push prices higher in what economists call a process of 'cost-pull inflation.'

But inflation is not only going up due to 'cost-pull' factors but also due to what is called 'demand-push' factors, as Americans have reengaged in the economy after an almost two-year hiatus and used their savings over that period to catch up in buying goods and services. That was also a large contributor to inflation since early 2021. However, this 'demand-push' inflation has been winding down as real disposable incomes have come down and demand is adjusting back to what it looked like pre-COVID recession, that is, more service oriented than goods oriented.

Thus, the Fed need not worry too much about 'demand-push' factors driving inflation and should concentrate on 'cost-pull' factors. This is the reason why it is so concerned about the potential existence of a higher NAIRU rate of unemployment and has focused its efforts on slowing down the economy to bring down these 'cost-pull' factors, which are basically driven by higher labor costs.

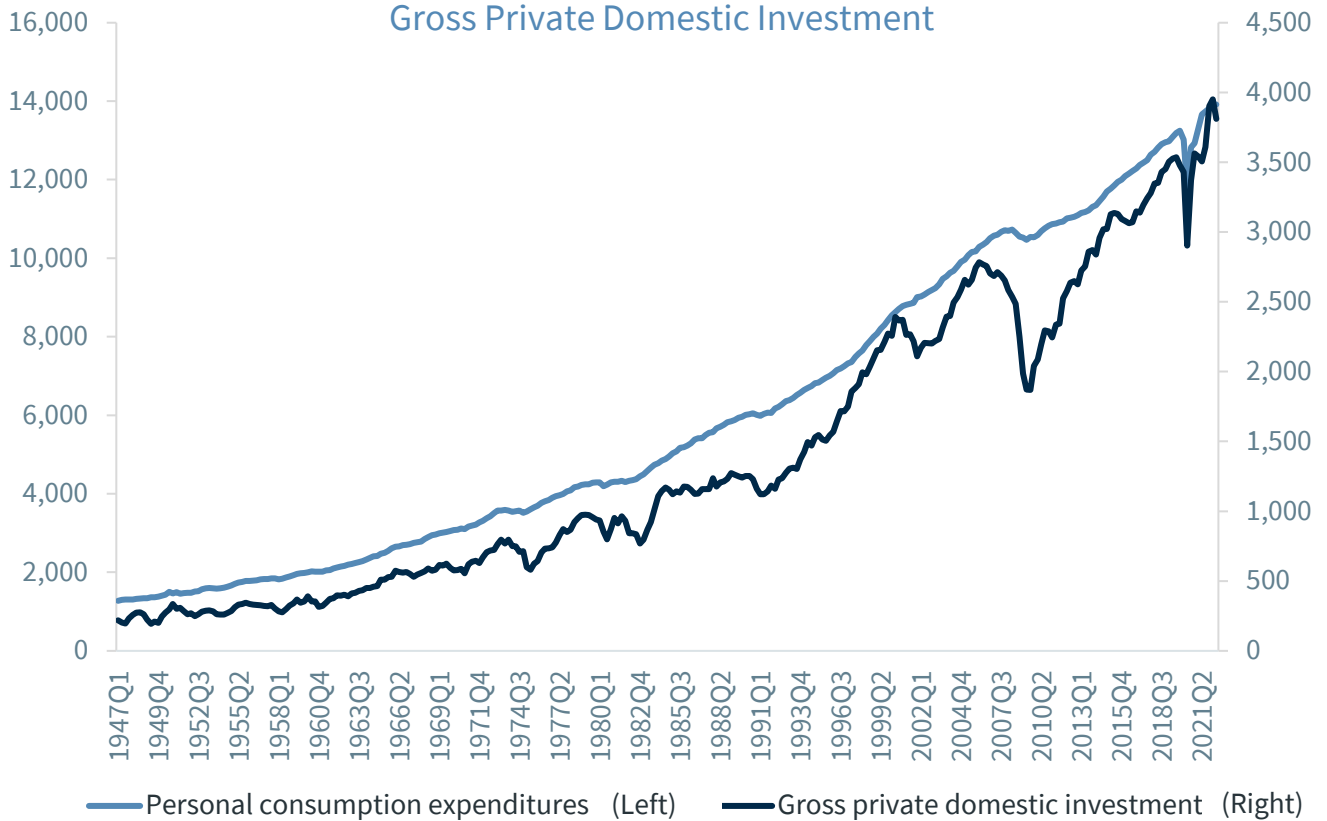
This means that we will be tracking what is happening with wage and salary pressures as this will determine the path for Fed interest rate increases during the next several months.

Economic Growth is Slowing Down in an Orderly Fashion

Economic data released during the last month continues to point to a further slowdown in economic activity. Perhaps the only exception to this trend has been exports, which contributed to economic growth, especially during the second quarter of the year despite the strength in the US dollar. The good news on the economy, if this could be depicted as good news, is that this slowdown has been an orderly one, triggered by higher inflation, higher interest rates, lower real disposable personal income, and lower real personal consumption expenditures.

However, as it has always been the case, 'orderly' has a very different meaning for the most volatile sector in the economy, that is, for investment, or gross private domestic investment. Investment turned the corner during the second quarter of the year, bringing down GDP growth to negative territory during the quarter. Investment is, normally, not only the most volatile sector of GDP but also one of the most revised components of GDP. As an example, investment was originally reported up by only 0.1% during the first quarter of the year but was revised up to 5.0% during the third estimate of Q1 GDP. Thus, estimating investment is also a very difficult task. The graph below clearly shows the difference in behavior over history of two components of GDP, personal consumption expenditures (PCE) and gross private domestic investment (GPDI). It is clear that consumption (PCE) is the more stable of these two components of GDP.

Personal Consumption Expenditures vs. Gross Private Domestic Investment



Having said this, even if investment has the potential for being revised during the second estimate of Q2 GDP, the direction of that revision is also not known. That is, the revision could be upwards or downwards. If it is revised downwards then it will mean that, all other things constant, Q2 GDP would be revised further into negative territory.

In principle, everybody was expecting investment lower in the second quarter because investment is the most interest rate sensitive sector of GDP. And since higher interest rates have been affecting business decisions since early in the year, lower investment expenditures were already included in the Q2 GDP expectations. However, the only uncertainty today is whether the 13.5% decline in gross private domestic investment (GDI) reported in Q2 was correct, higher, or lower. This will determine whether GDP for the second quarter remains as is, is revised up, or down, respectively.

Summary of the week:

CPI: This week's CPI report was expected to show inflation cooled in July thanks to falling gas prices, and it did so as the headline number eased from 9.1% in June to 8.5% year-over-year vs 8.7% expected. More importantly, the month-over-month CPI was unchanged in July, the lowest reading since May of 2020, following the strongest month-over-month increase since 2005 of 1.3% in June. Lastly, core inflation (ex-food and energy), increased 0.3%, less than the expected 0.5% consensus, after increasing 0.7% in June. Overall, this week's better-than-expected report is likely to further reinforce our original forecast of the Fed's decision to hike rates by 50 basis points at its next meeting on September 21-22. Strengthening this view, Fed expectations went from 65% odds of a 75bps in September before the CPI release, to 67% odds of a 50bps hike immediately after. The consumer price index (CPI) was unchanged in July, with the 7.7% decline in the gasoline index offsetting increases in food and shelter prices, according to the Bureau of Labor Statistics. On a year-over-year basis, the index increased by 8.5%, less than the expected 8.7%, not seasonally adjusted. While the index for gasoline and natural gas declined, the electricity index increased. Food at home and food away from home increased by 1.3% and 0.7%, respectively. The all items less food and energy index increased 0.3%, down from an increase of 0.7% in June, and less than the consensus of 0.5%. In contrast with last month's strong 2.1% increase, transportation services declined by 0.5% in July. New vehicles continued to increase by 0.6%, and used cars and trucks declined slightly by 0.4%. Despite the housing market recent cooling down, shelter continued to increase.

PPI: The Producer Price Index (PPI) for final demand declined 0.5% in July, with goods falling 1.8% and services increasing 0.1%. On a year-over-year basis, final demand prices increased 9.8%. The lower-than-expected CPI report yesterday, along with this week's confirmation from the PPI release is very good news for the Federal Reserve (Fed), and they further reinforce our view of a 50 basis point (bp) increase in September. However, 80% of the decline in final demand goods is due to a 16.7% decline in gasoline prices, as other items within the index have not yet turned the corner. After two large increases of 1.0% and 0.8% over the last two months, the Producer Price Index fell by 0.5% in July, a much better number than the expected 0.3% increase. Final demand prices came in lower than expected at 9.8% year-over-year compared to the 10.4% consensus, and 11.3% last month. Final demand goods experienced the largest decline since the COVID-19 outbreak in April of 2020, declining by 1.8% in July. While the headline number seems reassuring, it is mostly driven by falling gasoline prices (-16.7%).

Jobless Claims: The initial jobless claims number is revised on a weekly basis and tends to be very volatile. Therefore, we normally look at the four-week moving average, which helps smooth out the weekly volatility. Having said this, the four-week moving average is approaching levels that suggest weakness in the US labor market so we will keep a close eye on this number during the next several months. Initial jobless claims continued to increase during the week ending August 6, according to the Department of Labor. Initial jobless claims were 262,000 or 14,000 more than during the previous week on a seasonally adjusted basis. The previous week's reported level was revised downwards by 12,000, from 260,000 to 248,000. However, the four-week moving average increased by 4,500, to 252,000. Meanwhile, the advance seasonally adjusted insured unemployment rate remained at 1.0% for the week ending on July 30. Although the initial jobless claims number continued to increase, the detailed segmentation by state did not show concerning trends in the labor market for now. Only CT had an increase of more than 1,000 in initial jobless claims. CT had an increase of 4,790 but the state did not provide the sectors where these claims came from. However, KY, OH, MI, and IL reported a decrease of more than 1,000 claims during the week with only OH providing details on the sectors. In OH, there were fewer layoffs in the manufacturing industry. Thus, while the initial jobless claim number continued to increase, there are no signs that this increase is widespread and encompassing the majority of states as well as economic sectors.

Summary of the week:

Import/Exports: US Import and Export prices both declined in July, which combined with the PPI and CPI reports earlier this week, all suggest the possibility that inflation might have peaked. While the declines across all three reports were mostly driven by lower energy prices, other underlying concerns remain. Overall, the import and export prices report is another good news for the Federal Reserve as we head towards their next meeting in September. US import prices fell in July by 1.4%, the first decline since December 2021, and the largest since April of 2020. As expected, the decrease in fuel and nonfuel prices were the largest drivers of the decline. Among energy, natural gas, which experienced a 54.3% increase in the second quarter, fell the most in July by 20.6%. Foods, feeds, and beverages declined as well in July for the third consecutive month, the most since November of 2020. On the other hand, most finished goods increased in July, with automotive vehicles leading the pack with an increase of 0.6%. US exports declined the most in July since April of 2020, falling 3.3%. Agricultural exports decreased the most at 3.0% due to lower prices for soybeans, wheat and cotton, according to the Bureau of Labor Statistics. Nonagricultural industrial supplies and material prices experienced the largest decline since April of 2020, falling by 7.0%. Similarly to US imports, most finished goods increased due to increases in prices, and mostly due to automotive vehicles. On a positive note, consumer goods prices declined slightly for the second consecutive month. Import and export prices were lower than what economists estimated, which ultimately bodes well for the Federal Reserve's goal of bringing inflation lower. Another good news is that excluding energy and food, import prices still declined by 0.5%.

Consumer Sentiment: Consumer sentiment increased for the third consecutive month, likely due to the decline in energy prices. Year-ahead inflation expectations declined slightly from 5.2% to 5.0%, but five-year inflation expectations climbed slightly from 2.9% to 3.0%. Meanwhile, the current economic conditions index fell, after experiencing some relief in July, suggesting that while employment remains strong and inflation seems to have peaked, the consumer is expecting the economy to slow down. Consumer sentiment increased by 7% month-over-month, printing a higher-than-expected 55.1 vs. 52.3 consensus, and 51.5 in July. The main driver behind the increase in sentiment was once again falling energy prices, which prompted the median expected year-ahead inflation rate to fall to 5.0%, the lowest level since February. Long-term (next five years) inflation increased slightly from 2.9% to 3.0%, remaining in the 2.9-3.1% range experienced over the last 12 months. The improvement in consumer sentiment in August goes along with everything we have seen this week in terms of economic releases. However, while the improvement in the year-ahead inflationary expectations should be reassuring for the Fed, the slight uptick in the 5-year inflationary expectation doesn't help the argument for the Fed to not go for a 75 basis point increase during the upcoming FOMC meeting. We remain in the 50 basis point camp as this is just one data point, and every other economic release this week strengthened our view.

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	-1.6	-0.9	0.9	0.4	-0.3	-0.5	-0.2	0.9	5.7	1.6	0.0
Year-over-year	0.5	12.2	4.9	5.5	3.5	1.6	1.3	-0.3	0.0	0.1	-0.2	-0.1			
Private Domestic Final Purchases	11.8	10.1	1.4	2.6	3.0	0.0	0.1	-0.1	-1.0	-1.1	-0.8	0.4	7.9	2.2	-0.5
Year-over-year	2.5	16.0	7.3	6.4	4.4	1.9	1.6	0.9	-0.2	-0.5	-0.7	-0.6			
CPI (y/y)	1.9	4.8	5.3	6.7	8.0	8.6	8.8	7.8	6.5	4.8	3.9	3.5	4.7	8.3	4.6
Ex-food & energy	1.4	3.7	4.1	5.0	6.3	6.0	6.2	5.8	5.1	4.3	3.3	2.6	3.6	6.1	3.8
PCE Price Index (y/y)	1.8	3.9	4.3	5.5	6.3	6.5	6.6	5.7	4.8	3.8	2.8	2.4	3.9	6.3	3.4
Ex-food & energy	1.7	3.4	3.6	4.6	5.2	4.8	4.8	4.1	3.4	2.9	2.2	1.9	3.3	4.7	2.6
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
2022	July 26-27	2.25-2.50
	September 20-21	2.75-3.00
	November 1-2	3.00-3.25
	December 13-14	3.25-3.50
2023	January 31-February 1	3.25-3.50
	March 21-22	3.25-3.50
	May 2-3	3.00-3.25
	June 13-14	2.75-3.00
	July 25-26	2.50-2.75
	September 19-20	2.25-2.50
	October 31-November 1	2.25-2.50
	December 12-13	2.25-2.50

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 Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation.

Leading Economic Indicators: The Conference Board Leading Economic Index is an American economic leading indicator intended to forecast future economic activity. It is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of ten key variables.

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Source: FactSet, data as of 8/12/2022

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