***Summary***

Economic data for the week included consumer price inflation coming in little changed on the headline side, while producer price inflation declined on a headline level. Consumer sentiment improved more than expected.

Global equity markets rose sharply last week, as slowed inflation results led to positive sentiment. Bonds fared positively, with little change in rates, but tighter credit spreads. Commodities gained across the board, helped by a weaker dollar.

***Economic Notes***

(0/+) The **producer price index** (PPI) fell by -0.5% in July, versus an expected 0.2% gain, representing a sharp reversal from the 1.0% rise in June. Energy input prices falling -9% was a significant contributor to the monthly change, although food prices rose 1%. Removing food and energy, core PPI instead rose by 0.2%, although that was only half the gain expected. While trade service margins rose for the month, intermediate goods prices fell back sharply—again, affected by energy to some degree. Year-over-year, PPI decelerated to an increase of 9.8% on a headline level and 7.6% for core. These remain quite elevated, and at multi-decade highs, but the fact that they haven't become worse was celebrated.

(0) **Import prices** fell back by -1.4% in July, just below the median forecast of -1.0%. Removing petroleum trimmed the decline to -0.7%, with food and industrial supplies prices falling, while autos and capital goods saw minor increases. On a year-over-year basis, import prices remain up 8.8% (4.6% ex-petroleum), which is in line with other key inflation measures. Imported inflation is even more of the negative kind, as there is no economic growth benefit as a side effect coupled with it.

(0/+) The **consumer price index** (CPI) for July was unchanged at a headline level for the month (on a rounded basis, as it actually declined slightly when taken out to two decimal points), while the ex-energy and food core measure rose 0.3%. This was lower than expectations, and significantly lower than the June results. Energy prices declining over -4% (notably gasoline down -8%) helped ease the headline, while food prices offset that a bit, up over 1%. On the core side, gains for new cars offset declines in used cars. Gains of over 0.5% remained in shelter and medical care, while airfares fell by -8%. Across the board, the monthly picture showed far less upward momentum in prices than in prior recent months.

Over the trailing one year most oft-quoted, headline and core CPI rose 8.5% and 5.9%, respectively. Energy commodities being up 45% over the year remains a key driver, along with food (+10%), cars (+5-10%), and housing (+6%) having contributed significantly as well. The 'food at home' category (i.e. groceries) up 13% has pressured lower income budgets especially.

Inflation remains the concern of the year, and it's been analyzed and written about ad nauseam. Aside from monthly changes, the trailing 12-mo. number is the one most commonly quoted. Per its construction, the 1 mo. change from a year ago falls off, while the most recent month is tacked on—which lays out the math for price change calculations. Supply hang-ups from last year have now been falling off, with volatile energy prices playing an outsized role when strong/weak months are added/removed. Auto prices remain elevated due to still-low inventory, with stories of almost-completed vehicles waiting on factory lots, only needing a few final computer chips to allow their transport to dealer lots. Attention has now drifted to higher shelter costs, which are a direct outcome of higher rents and home prices, the latter of which take some time to ease into CPI. These are also a reason why core inflation may not fall back quite as quickly as many would hope. In fact, seeing a bit of a reacceleration into late 2022 wouldn't be entirely surprising, based on the calculation, before a move lower toward normalization in 2023. At this point, financial markets are just looking for progress, or at least a sustainable sign price hikes have peaked.

(+) The preliminary **Univ. of Michigan index of consumer sentiment** report for August saw a rise of 3.6 points to 55.1, beating expectations calling for 52.5. While assessments of the current environment saw a decline of nearly -3 points, expectations for the future improved by almost 8 points. Inflation expectations for the coming year fell by -0.2% to 5.0%, while those for the next 5-10 years rose by a tenth to 3.0%. The report saw broad improvement in a variety of areas, with pessimism about the future fading, while current inflation conditions continued to weigh on today's mood.

(-) **Nonfarm productivity** declined by an annualized -4.6% in Q2, meeting consensus expectations, but was an improvement on the prior quarter's -7.4%. The year-over-year rate decelerated by nearly -2% to -2.5%. **Unit labor costs** rose 10.8% in Q2 at an annualized rate, ahead of consensus expectations of 9.6%. Year-over-year, the rate rose by 1.3% to 9.5%. Hourly compensation rose at the greatest 12-month pace since 1982, in keeping with inflation data matching similar records for that timeframe. Labor costs have been elevated by inflation, as well as tight labor demand; fewer job openings and rising jobless claims could signify slowing in this pace.

(0) **Initial jobless claims** for the Aug. 6 ending week rose by 14k to 262k, just below the median forecast calling for 265k. **Continuing claims** for the Jul. 30 week rose by 8k to 1.428 mil., above the 1.420 mil. expected. The initial claims numbers rose the most in MA and CA, while CT led in declines. These certainly have been picking up, from very low levels. However, there has been debate about seasonality adjustments made by the Department of Labor this year, which may have understated claims earlier in the year and could overstate them a bit now. It also appears that some claim results in the Northeastern U.S. could have included fraudulent claim numbers that elevated the results, but details remain a bit murky.

## ***Question of the Week***

### ***Are we already in recession? How much does that matter?***

This is a key question of the past few weeks and months, with a variety of data pointing to economic slowing. But the answer is far from conclusive.

A common assumption is that recessions are based on two consecutive negative quarters of GDP growth (which, based on Q1 and Q2, the U.S. now qualifies). If it could only be that simple. Officially, the National Bureau of Economic Research (NBER) makes a qualitative committee decision as to whether or not the U.S. is in recession. The inputs used coincide to some degree with The Conference Board's index of coincident economic indicators, among some others. Also, recessions tend to be labeled after the fact, as the committee assigns a starting and ending month. How 'official' or not the recession is labeled may matter less to financial markets, which look at the probability of recession as much as the actual event, through impacts on earnings, interest rates, and the yield curve, for example. However, it can be a make-or-break definition politically, especially in an important mid-term election year. Having the economy defined under a recessionary cloud can cast incumbent leaders as failures, rightly or wrongly, which has tended to negatively impact parties in power. (The reluctance of leaders to acknowledge the rising chances of 'recession' this year is a case in point.)

In looking at the various recession-related components, we see a mixed story. Inflation has played a larger role this time, requiring a deeper look at after-inflation 'real' data more than usual.

- Negative. Manufacturing growth has decelerated, which has been hampered by the inability to get needed supplies and in some cases, enough workers. Regardless of the cause, it's still weaker.
- Mixed. Housing has been a blend of strength in multi-family building (as developers are taking advantage of higher rents), and continued below-pace single-family construction. The latter has been the case for several years, exacerbating the shortages and higher housing prices. Nevertheless, a recession could cause a further fall back in construction, potentially worsening the current home inventory problem. (Higher interest rates have helped slow sales, but vacillating interest rates this cycle another issue.)
- Positive. Job markets remain strong, with payrolls and openings high and claims low. In fact, it's uncommon to have a recession without labor weakness and layoffs. That these haven't happened mean that it may not be a recession, or it just hasn't happened yet. There are a variety of Covid disruptions still present that have affected participation rates. Personal income, industrial production, and retail sales also remain positive, especially on a nominal basis, while the after-inflation 'real' data a bit less so.

When we say, 'it may not matter' tongue-in-cheek, it's worth noting that a quarter of positive 0.1% GDP growth is not that different from flat 0.0% growth, or even a slight decline of -0.1%. In that environment, differences by industry become more important. Cyclical sectors such as manufacturing and consumer goods/services tend to always fare worse when the economy slows. On the other hand, a more severe recession, with growth of negative -2%, for example, could tend to spread further throughout the economy beyond marginal spending, and take longer to bounce back from. The 'artificially-generated' Covid recession was a notable exception.

Stock markets have experienced drawdowns of up to -20% when a recession hasn't happened, but -25% to -30% before actual recessions. So, the 2022 bear market low (-23.6% from Jan. 3 to Jun. 16 for the S&P 500) has been inconclusive, but not out of character for either case. So far, it's been a price multiple adjustment. Bear market rallies (like July's +9% rebound) can be seductive times to invest due to the chance of the bear being over and investors fear of missing out. While not a prediction of any kind, if stock earnings reflect their typical tendency to fall by -15% to -20% in recessions, that could be a catalyst for a second stage lower for the bear market before experiencing an actual bottom. But, again, after already falling -25% this year, a further move down doesn't necessarily have to be dramatic. If all of this isn't confusing enough, the good news is that returns 12 and 24 months after bear markets have been quite strong historically.

Interest rates are playing a unique role in this cycle also. The Fed is firmly committed to fighting inflation by raising rates significantly, even if a recession follows (and has essentially said as much). However, if inflation continues to peak and economic slowing persists, their 'data dependent' path may change. Usually, recessions feature policy easing and a lowering of interest rates. This is related to why inverted treasury yield curves can be predictive of recessions.

As is mentioned many times, whether or not we're in a recession at this moment is most impactful on job prospects and corporate expectations. In this last quarter's earnings calls, a variety of S&P 500 companies noted a paring back of hiring or capex in anticipation of a possible recession. Of course, such behavior can be self-reinforcing; lower spending out of 'fear' can spread more widely and enhance economic slowing already happening. Financial markets look to the future, though, which explains why stock market results during recessions have been mixed to even positive, as investors are already aware of the immediate problem and are looking ahead to the next cycle. Trying to time investments around the timing of a recession can be very difficult to impossible—one will always be a step behind.

***Market Notes***

| Period ending 8/12/2022 | 1 Week (%) | YTD (%) |
|---|---|---|
| DJIA | 2.99 | -5.98 |
| S&P 500 | 3.31 | -9.34 |
| NASDAQ | 3.10 | -16.21 |
| Russell 2000 | 4.97 | -9.48 |
| MSCI-EAFE | 2.16 | -14.29 |
| MSCI-EM | 1.65 | -15.67 |
| Bloomberg U.S. Aggregate | 0.24 | -8.89 |

| U.S. Treasury Yields | 3 Mo. | 2 Yr. | 5 Yr. | 10 Yr. | 30 Yr. |
|---|---|---|---|---|---|
| 12/31/2021 | 0.06 | 0.73 | 1.26 | 1.52 | 1.90 |
| 8/5/2022 | 2.58 | 3.24 | 2.97 | 2.83 | 3.06 |
| 8/12/2022 | 2.63 | 3.25 | 2.97 | 2.84 | 3.12 |

After a lackluster start to the week, U.S. stocks were up sharply on Wed. onward after the monthly CPI report showed a flattening in headline prices, and core CPI not getting significantly worse. The search by markets for an inflation peak translates directly to the path the Fed may take in upcoming meetings, such as whether the Sept. FOMC rate hike will be 0.75%, 0.50% (consensus base case), or 0.25%. From a technical standpoint, markets have upwardly retraced almost 50% of the early 2022 decline, which has generated more bullish sentiment. For the chartists out there, a key question has been whether an upward 'breakout' continues to take hold from this point. Every sector gained ground last week, led by energy, materials, and financials, all gaining over 5%. Defensive sectors consumer staples and health care lagged with gains under 2%. Real estate rose over 4% on the week as well.

The Inflation Reduction Act, a slimmed-down version of the earlier Build Back Better, has made its way through Congress, with little market reaction. This is despite the 15% minimum tax on company profits (although some important exemptions persist, resulting in lowered revenue estimates), a 1% excise tax on stock buybacks, and an increase in IRS tax enforcement efforts. These were far less severe than earlier proposals, so perhaps the magnitude was a bit of a relief. Of course, questions from tax and revenue experts surface which question the viability of those particular focal points. For instance, buybacks have been seen for years as a 'negative', since they represent cash that could be used for dividends or capex spending. However, on net they've added value to shareholders (through raising of EPS) as opposed to other potentially more wasteful uses of corporate cash (bad acquisitions).

Foreign stocks fared similar to U.S. equities in both developed and emerging markets, with relief over U.S. inflation results. European nations noted that tax and emergency relief would be made available in efforts to combat inflation and gas price pressures, while industrial production continued to grow. EM results were led by commodity-oriented Brazil, Mexico, and South Africa, while Chinese stocks were little changed.

U.S. bonds were mixed to higher, with minimal change in treasury yields but tighter credit spreads, which led to gains in corporates. Foreign bonds fared positively, due to a weekly decline in the dollar.

Commodities gained ground across the board last week, with energy and agriculture leading. The price of crude oil rose by over 3% to $92/barrel, while natural gas futures prices rose by another 9% (up over 130% year-to-date). Gasoline prices rose as well, although they're down -10% over the last month, correcting further than other petroleum products. This appeared to improve the mood, via consumer sentiment and in other asset classes.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.



Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.