Economic Update

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This weekly update provides a snapshot of changes in the economy and markets and their implications for investors.

Growth

2Q22 Real GDP showed the economy contracted at a 0.9% annual rate in 2Q22, following a decline of 1.6% in 1Q22. Weakness was widespread with declines in both residential and non-residential construction, capital spending on equipment, inventory rebuilding and government spending at both the federal and state and local levels. This was only partly offset by modest gains in consumer spending and an improvement in trade. With massive fiscal drag, a higher dollar and higher mortgage rates, GDP growth is likely to continue to be very soft for the rest of the year. So far in 3Q22, July manufacturing and services PMIs have confirmed continued weakening in the economy, with both indicators decreasing relative to June.

Jobs

July nonfarm payrolls rose by a boomy 523K despite expectations for a moderate 250K, bringing total nonfarm employment above pre-pandemic highs. The unemployment rate dipped to 3.5%, the lowest since 1969, while the labor force participation rate ticked down to 62.1% from 62.2% and wage growth bounced to 0.5%. There are signs elsewhere that the huge excess demand for labor is easing and initial jobless claims are ticking higher. However, at a time when talk of recession dominates most investment conversations, the continued strength in the labor market provides an important buffer for the economy and suggests that any recession will likely be mild for workers.

Profits

The 2Q22 earnings season is coming to a close with 476 companies having reported (95.3% of market cap). Our current estimate for 2Q22 is $47.22. 70% of companies have beaten on earnings expectations and 63% have beaten on revenue expectations. Revenue beats are tracking above their long-run average, while earnings beats are tracking below. In a similar vein, revenue surprises have been larger than average, while earnings surprises have been below average. Record inflation, continued supply constraints and a stronger dollar were among the key headwinds for profitability in 2Q22.

Inflation

Hot inflation is still running well above the FOMC's 2% target, with the headline PCE price index rising +1.0% m/m and +6.8% y/y in June. The core PCE deflator also rose +0.6% m/m and +4.8% y/y. The July CPI report was cooler than expected. Headline CPI remained unchanged m/m while core CPI rose 0.3% m/m. With this report, headline CPI inflation fell from 9.1% y/y in June to 8.5% in July. Core CPI rose 5.9% y/y, registering the same y/y increase as in June. While a fall in energy prices drove the monthly decline in inflation, other areas of inflation, such as food prices and owners' equivalent rent, still remain hot.

Rates

Persistent inflationary pressures have pushed the Fed to accelerate its rate hiking trajectory. At its July meeting, the FOMC announced a 0.75% increase in the federal funds target range, bringing the federal funds rate to a range of 2.25%-2.50%. The Fed kept the door open for another 0.75% increase at its September meeting but emphasized that policy decisions will be made on a meeting-by-meeting basis and be highly data dependent, acknowledging the risk of economic data further deteriorating. The committee still appears on track to raise rates to a range of 3.25%-3.50% by the end of the year, but there is scope for the Fed to be less aggressive with rate increases.

Risks

- The Fed could push the economy into recession if it overtightens policy in response to supply-driven inflation.
- Heightened geopolitical tensions with Russia could result in continued energy shortages, low consumer confidence and dampened growth.
- Markets may remain depressed and volatile until investors receive clarity on inflation and the Fed.

Investment Themes

- After this year's sell-off, fixed income now offers more protection against a market correction or economic downturn.
- U.S. equity investors may use profits as a guide in a rising rate environment.
- Long-term growth prospects, a falling dollar and wide valuation discounts support international equities.

● Denotes updated information

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Data are as of August 22, 2022

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