Weekly Market Commentary

August 21, 2023

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It was a rough week for investors, as stock prices tumbled for the third consecutive week and bond yields surged to the highest level in more than a decade, sending bond prices significantly lower. These sharp moves were influenced more by changing perceptions than actual events, although economic reports out this week continued to surprise on the upside. At the heart of things, traders and investors are becoming ever more convinced that the economy's resilience is not a passing mirage but is poised to remain a feature of the landscape for the foreseeable future. That means the Fed will stay alert to the continued build-up of inflationary pressures, keeping future rate hikes squarely on the table. Indeed, the release of the minutes from the July 26 policy setting meeting confirmed that several Fed officials still believe another rate increase is warranted this year.

Despite taking a breather on Friday, the bond market will continue to come under pressure as long as the economy continues to display more strength than expected. And with market yields on treasury securities, the safest of assets, becoming an ever more attractive alternative to risky assets, the competitive pull away from stocks should remain strong. Although the jury is still out regarding the Federal Reserve's next move – the prevailing bet is that it will not hike rates at its upcoming policy meeting in September – there is a growing expectation that the central bank will keep rates higher for longer. That perception is the primary influence behind the recent run-up in bond yields, which essentially reflects market expectations of where short-term rates will be over the longer term.

There is an old saying that the cure for high prices is high prices, because it eventually reduces demand and undercuts the pricing power of sellers. The same can be said for interest rates; at some point, higher interest rates take a toll on economic activity, bringing on a recession, which prompts the Fed to lower rates. Ironically, the more investors are convinced the Fed will keep rates higher for longer – sustaining upward pressure on interest rates – the greater the odds it will produce the very recessionary outcome they are betting against. To be sure, it is not just the economy and Fed policy expectations that are driving up bond yields. Thanks to the burgeoning budget deficit, the Treasury is having to sell more bonds in the third quarter than expected, increasing the supply that needs to be absorbed by an already-skittish market. Keep in mind also that the Fed is striving to shrink its bloated portfolio, selling bonds every month as it unwinds the massive buildup under the quantitative easing policy used to combat the pandemic recession.

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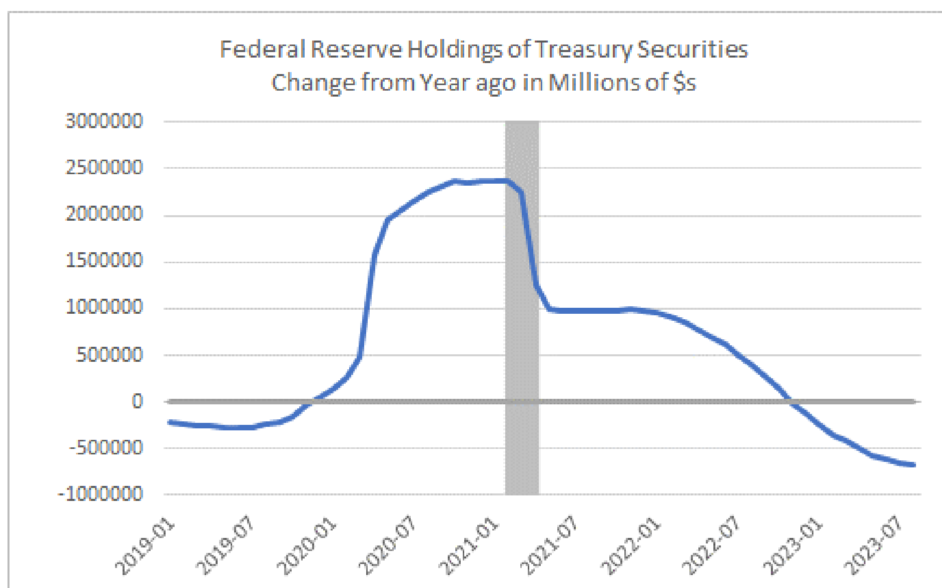
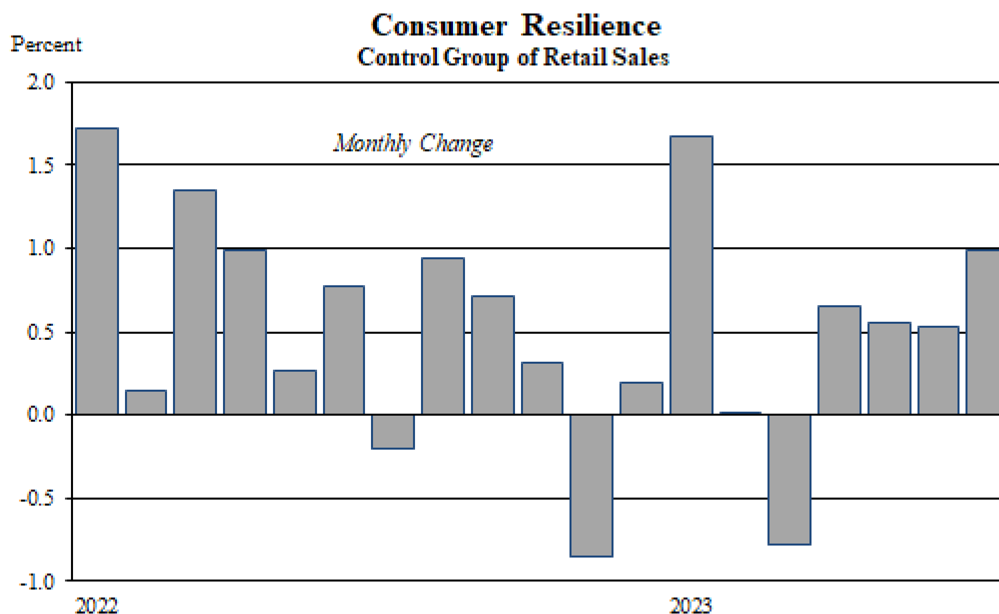


But so far, the bet that the economy can withstand higher interest rates is paying off. Indeed, the Atlanta Federal Reserve's GDP tracker is forecasting an astonishing 5.8 percent growth rate in the third quarter, a dramatic step-up from the 2.2 percent pace over the first half of the year. That tracker, of course, is based on a narrow set of economic indicators available for July, and no one believes the strength they depict will be sustained over the rest of the period. Still, forecasters are falling over themselves raising their outlook for the period, and the recession that many thought would have begun by now has been shunted to the waste bin. One reason: the economy's main growth driver, consumers, is running on all cylinders as they shifted into a higher gear in July.

Of the heavy calendar of economic reports this week, the one for retail sales took center stage. The consensus expectation was that sales would increase 0.4 percent in July, a sturdy gain and up from the 0.2 percent increase in June. Instead, sales crushed expectations, surging 0.7 following an upward revised increase of 0.3 percent in June. What's more, the increase was broadly based, with nine of the 13 major retail categories notching gains. Leading the way, online sales jumped 1.9 percent, the strongest in seven months that was boosted by another of Amazon's Prime Day events. Other sectors posting strong advances were sporting goods (1.5 percent), restaurants and bars (1.4 percent), clothing (1.1 percent) and grocery stores (0.8 percent). Gasoline sales also rose 0.4 percent, the first monthly gain since last October, but this was mostly price-driven, as the long retreat in fuel prices reversed in mid-July and has since moved up significantly. Barring an abrupt reversal again, this will boost service station sales – and gasoline prices – in August as well.

Sales at restaurants and bars are the only retail sales category that consist of services rather than goods in the report. Hence, it suggests that consumers are also spending freely on services, which will be more fully revealed in the personal income and consumption report later this month. Simply put, personal consumption, which accounts for about 70 percent of GDP, started the third quarter with a bang. Indeed, the so-called control group of retail sales – total sales excluding autos, building materials and gasoline – that feeds directly into the GDP accounts notched a robust 1.0 percent increase in July, the strongest since January. And while inflation accounted for some of the increase, the consumer price index only rose by 0.2 percent during the month, so most of the spending gain was for real goods.



Again, just as the Atlanta Fed's GDP tracker will eventually downshift as data for August and September come in, we don't expect consumer spending to remain as torrid as the July reading indicates. Indeed, there are signs in the otherwise strong retail sales report that suggest consumers are becoming more selective in their purchases, as spending on expensive interest-rate sensitive products, such as autos and furniture, weakened. That said, even if consumer spending remains flat in August and September, a strong start to the quarter would leave the average for the period well above the average for the second quarter. Hence, a formidable growth rate for the period is already baked in – not as eye-opening as the Fed's 5.8 percent tracker but comparable to the 2.3 percent second-quarter pace.

That alone would up the odds of another interest-rate hike by the Fed, if not at the next meeting in September, then at the November or December meeting. But things are not that simple. Keep in mind that the central bank's goal is not to slow growth just for the sake of slowing growth. The objective is to wrestle down inflation, and if they can do this while the economy continues to expand and sustain job growth, all the better. Until recently, even the Fed's own staff of economists felt it could not be done, as they predicted the economy would fall into a recession before the end of the year. Now they have second thoughts. At his post-meeting press conference last month, Fed Chair Powell noted that the staff has abandoned its recession forecast in recognition of the strong forward momentum the economy possessed at the time of the meeting.

That momentum has only gotten stronger since the meeting, which is most notably captured by the retail sales report this week. Importantly, even as the economy is chugging along amid a historically low unemployment rate, inflation has retreated considerably. As discussed last week, the consumer price index stands just 3.2 percent higher than a year ago, down from a peak of over nine percent last summer. From our lens, the progress made on the inflation front will continue, although more slowly going forward, but the Fed's aggressive rate-hiking campaign over the past 17 months will be taking an ever-bigger toll on the economy. Consumers cannot tolerate high borrowing rates forever, and they are already starting to feel the pinch.

In fact, delinquency rates on credit cards and auto loans are rising, credit is becoming tighter and debt repayments are taking growing bite out of incomes. This week, mortgage rates surged to over seven percent, the highest in more than 20 years. Thus far, the housing market has held up well in the face of previous rate increases; but the latest backup in mortgage rates is boosting monthly mortgage payments sharply higher and pricing many households out of the homebuying markets. Housing activity is historically the first to succumb to higher rates leading into a recession. We believe that the stage is set for the economy to slow markedly over the second half of the year, as the lagged effects of the Fed's rate hikes kick in and usher in a mild recession early next year. As the aforementioned saying goes, the cure for high rates is high rates; by the spring of 2024, it is highly likely that the Fed will start to cut rates.