Weekly Market Commentary

August 28, 2023

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Investors had a lot to process this week, highlighted by the widely anticipated remarks by Fed Chair Powell at the annual Jackson Hole Symposium. Unlike a year ago, when Powell shook up the markets with his warning that the Fed would inflict pain on the economy through higher interest rates aimed at taming raging inflation, there was nothing earth-shattering in his remarks this time. That's not to say the markets were calm, as stock prices swung widely during the week and yields continued to move higher. But late August is vacation time for traders when market moves tend to be amplified by noise more than substance. A better sense of market trends will have to wait until after Labor Day.

That said, all eyes and ears were laser focused on Powell, hoping for clues as to whether more interest rate hikes were in store this year. As expected, Powell's comments were nuanced, leaving open the door for further monetary tightening but not shutting down the possibility it is done. Overall, the tone of his speech was somewhat more hawkish than anticipated, a takeaway that resonated in the markets as well. After his comments on Friday morning, the 2-year Treasury yield – which reflects Fed rate expectations – leaped above five percent, up about 10 basis points from the start of the day. From our lens, Powell appeared to be more concerned that inflation was receding too slowly for comfort, indicating that more needs to be done to finish the job. Importantly, he insisted that the two percent inflation target was binding, dashing hopes by some that the Fed would be more flexible and not try to squeeze the last one percent out of the CPI while the economy was poised to slow.

But from Powell's lens, that's not necessarily in the cards, noting that… "Additional evidence of persistently above-trend growth could warrant further tightening of monetary policy." Clearly, recent data on the economy is not particularly comforting, as most indicators have surprised on the upside. The Fed chair is particularly concerned about the ongoing imbalance in the labor market, which is putting upward pressure on wages. While recognizing that some cooling has taken place – job openings are declining, fewer workers are switching jobs voluntarily and labor force participation is rising, easing worker shortages – labor conditions overall remain very tight. Hence, more rebalancing needs to take place to restore an equilibrium between the demand and supply for workers.

The question is, can this be accomplished without further rate hikes? This is where the rubber meets the road for the Fed. Powell recognized the risks of going too far in his comments and inflicting more pain than is necessary to bring inflation under control. But he also acknowledged the risk of not doing enough and allowing inflation to fester and eventually reignite, like what happened when the Fed eased prematurely during the 1970s. Simply put, balancing out those risks will be a major challenge going forward, and the totality of incoming data will determine the next moves. Clearly, the jobs reports will play a central role; at this point, there are few signs that labor conditions are easing enough to satisfy policymakers. While many high-profile companies are announcing layoffs and staff reductions, that's not showing up on the unemployment lines.

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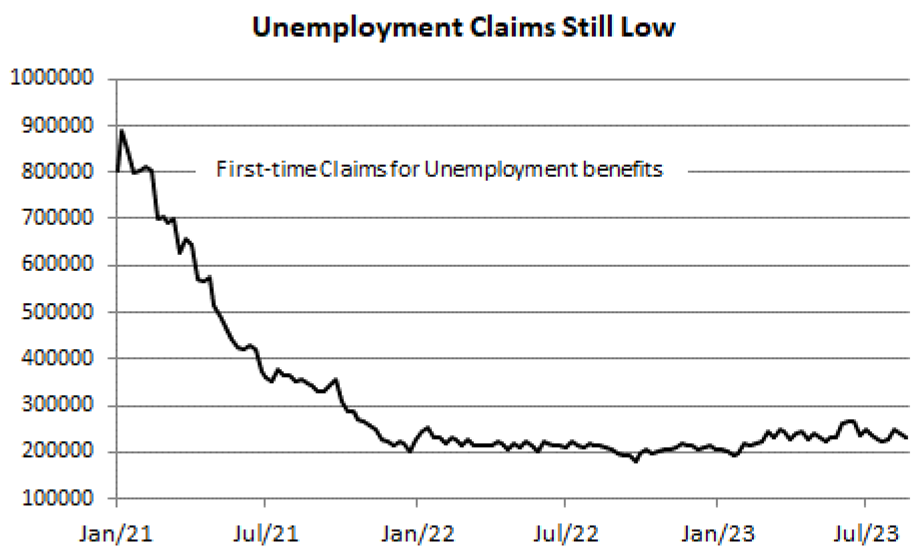
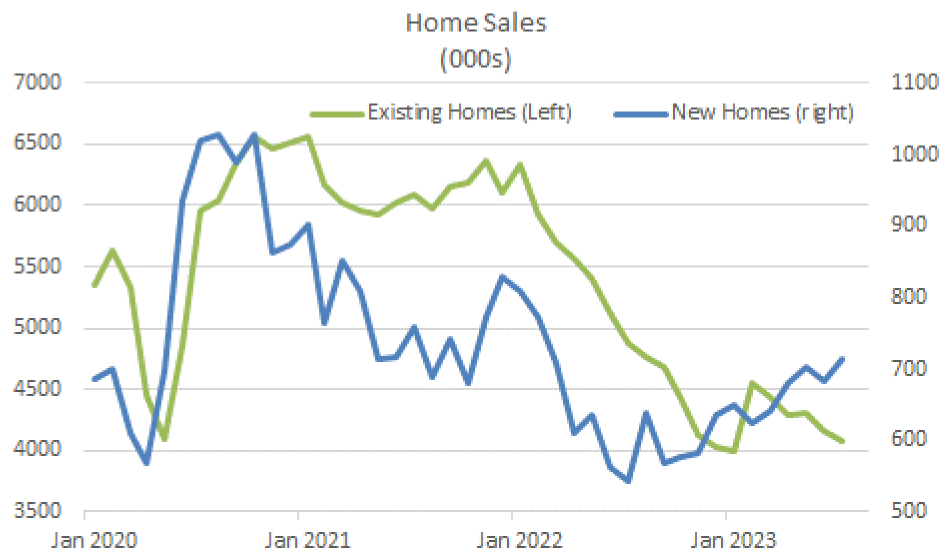
Indeed, despite the recent upsurge in strikes and the shutdown of the Yellow trucking company that laid off 30,000 workers, first-time claims for unemployment insurance have hardly budged and remain below pre-pandemic levels. That may change as members of the UAW union authorized a strike if a settlement is not reached before their contract expires in mid-September. That's 150,000 potential striking autoworkers that would not only bloat unemployment claims, but would also play havoc with the jobs data, which the Fed will be closely monitoring in coming months. The increase in strikes reflects both the still-strong bargaining position of workers amid a tight labor market as well as the attempt by workers to obtain hefty wage gains to catch up with the inflation spike over the past two years.



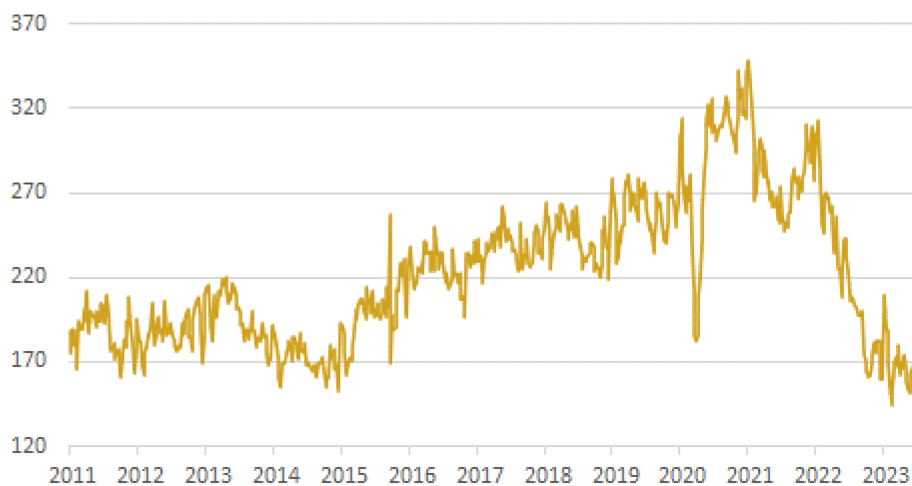
However, there's an important distinction between wage increases aimed at catching up with past inflation versus increases to compensate for anticipated inflation. The latter would constitute the dreaded wage-price spiral, reminiscent of the 1970s, that spurred the Fed into a growth-stifling rate-hiking campaign that resulted in two deep recessions in the early 1980s. While we are far from that point now – inflation expectations have been well contained for the past two years – the Fed is clearly concerned that wage pressures could be a source of stubborn inflation. Powell noted in his prepared comments on Friday that inflation has become more directly linked to the tight labor market in recent years, reflecting an economy that is more dependent on the labor-intensive service sector than in past years.

Again, wage increases are far from a flashpoint at this juncture; in fact, they are showing signs of easing, as indicated in recent jobs reports. But until the job market provides clearer evidence of cooling, the Fed can be expected to retain a hawkish bias. At the very least, Powell strongly indicated that rate cuts are not on the radar screen, cementing the perception that it intends to keep rates "higher for longer." That's bad news for at least one sector – housing – which is the most rate-sensitive sector of the economy. The disruption in the housing industry caused by higher interest rates is starkly evident in this week's home sales reports, which were the highlights amid a relatively light calendar of economic data.

With mortgage rates creeping above seven percent for the first time in more than 20 years, existing home sales continued to slump in July, wiping out virtually all of the gains made over the first half of the year. Sales of existing homes, moreover, are recorded at the time of closing, so it takes a few months for changes in mortgage rates to feed through to the data. Hence, it is highly likely that these sales will continue to fall in coming months. One reason resales are slumping is simply that buyers have scant supply to choose from. That, in turn, is largely because homeowners are staying put, not putting their homes on the market and giving up the low three to five percent mortgage rate they obtained when they either purchased their homes or refinanced their mortgages.



Ironically, the slump in the resale market is boosting the fortunes of builders, who are filling the inventory void by creating new homes and offering concessions to buyers, contributing to rising sales. However, that's not a sustainable model as construction costs, particularly labor costs, are increasing, and builders, too, must borrow funds at high rates. Importantly, with mortgage rates surging above seven percent, buyers across the board are fleeing the market. Mortgage applications for home purchases plunged to the lowest level since 1995 in the latest week, according to the Mortgage Bankers Association. The direct impact of home sales and residential construction on overall economic activity is relatively small, accounting for less than five percent of GDP. But the indirect impact is exponentially larger, as a home purchase generates a wide swath of ancillary purchases, including furniture, home appliances and moving services, among others.



Not surprisingly, the housing industry has historically been the first to lead the economy into a recession. Just as the lagged impact of the Fed's rate hikes is now taking a bigger toll on the sector, its effects should proliferate and filter through to the broader economy in coming months. Hence, our view is still that growth will weaken from here and bring down wage and price inflation, ushering in a mild recession in 2024. While Powell delivered a somewhat hawkish message at the Jackson Hole event, incoming data over the second half of the year should be weak enough to make the July rate hike the last of the tightening cycle. That said, if the jobs and inflation reports scheduled before the next policy meeting surprise on the upside, the odds of another rate hike in September would certainly increase – as would the odds of a recession next year.