Economic & Financial Markets

Monthly Review

May 2022

Can the Fed slow inflation without a recession?

Don't be misled by negative first quarter economic growth – core spending and the job markets are solid

Another bad month for both equities and fixed-income

Is the stock market flagging a recession?

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In this issue

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Economic Update

Business Cycle

As of May 2022

The current economic expansion is more than two years old, with the Covid-19 recession having ending in April 2020. Since then, the economy has seen rapid economic growth on average with rising inflation — and the Federal Reserve finally responding by tightening monetary policy. Moreover, the Russian invasion of Ukraine and further lockdowns in China have imparted new negative supply shocks.

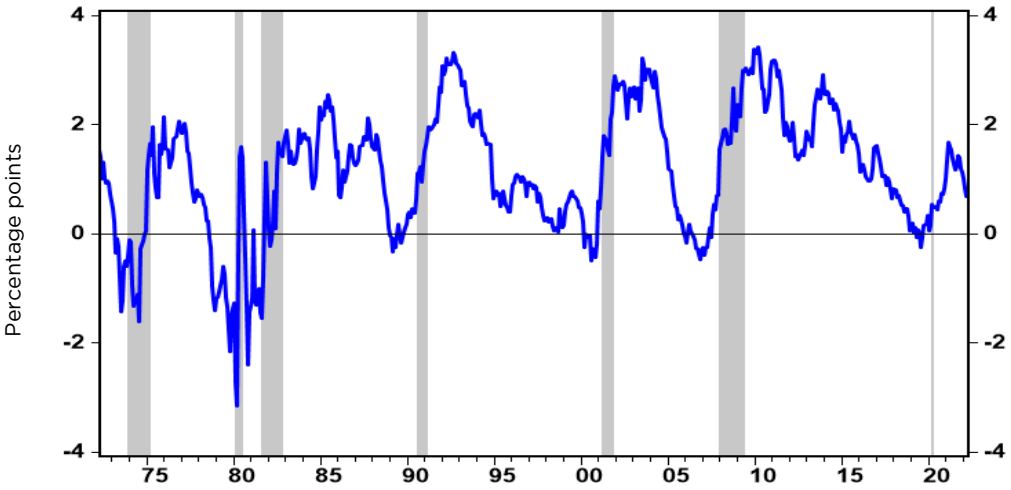
Sharply rising inflation and interest rates, along with Fed tightening, are usually later-cycle phenomena. While we do not expect this expansion to end soon, the odds of a downturn within the next few years have clearly risen.

Yield Curve

Spread between 10-year and 1-year U.S. Treasury yields

One of the best predictors of an economic downturn is a fully inverted yield curve, when short-term interest rates are above long-term rates for a sustained period.

The spread between 10-year and 1-year Treasury note yields moved irregularly higher over April (and early May) as long-term rates rose sharply with inflation high and quantitative tightening looming. While the spread is not low enough to be considered a recession warning today, significant Fed tightening this year could flatten the yield curve, raising recession concerns. Moreover, this spread could shrink further if financial markets expect a significant slowing of the economy, with long-term rates falling.



Sources: Bureau of Labor Statistics; Haver Analytics
Shaded areas depict recessionary periods

Don't be misled by negative first quarter economic growth – core spending and the job market are solid

Economic growth was negative in the first quarter, but there appears to be less cause for alarm than the headline number suggests, with consumer and business investment spending solid. Rising mortgage rates and prices have begun to hurt home sales, but excess demand remains, and job growth is still strong thanks to record-high labor demand. Although the possibility of inflation persisting at a high level poses a threat, above-trend growth is still expected for the remainder of the year.

Real GDP contracts in the first quarter

Real GDP contracted at an annualized rate of 1.4 percent in the first quarter, the first decline since the record-breaking drop in the second quarter of 2020. But just as growth was overstated in the fourth quarter 2021 as a result of a surge in inventories, a sharp decline in net exports (and reduced inventory buildup) was entirely responsible for the headline contraction. Core GDP growth (final sales to private domestic purchasers — essentially personal consumption expenditures and business fixed investment spending) was stronger to begin this year than it was to close last year. Other signals that the sign in front of the first-quarter real GDP number isn't representative of how the economy performed include the 1.65 million jobs added over the quarter and the solid growth seen in the ISM manufacturing and services sector surveys for January-March (which continued into April).

With core growth still strong and slower growth in much of the rest of the world, imports surged as the U.S. economy plays the role of the world's locomotive of growth. Covid impacts on inventories and trade have caused significant volatility in recent quarters, but the details of the first quarter show a more positive outlook than the negative headline real GDP estimate.

Job growth was solid again for April

Nonfarm payrolls grew by 428,000 for April, slightly above consensus estimates even with March's slight downwardly-revised figure. The gains were broad-based, with no major industry group reporting a decline and manufacturing showing a particularly large gain relative to its recent history. On the negative side, the labor force participation rate dropped for the first time in nearly a year. Despite this, the unemployment rate remained unchanged because of a fall in household employment (a negative that will probably not persist).

This report seems to indicate that labor demand remains as strong as ever (job openings heading into April were at a record high). Labor supply, however, remains the primary constraint for further job gains, although it's unlikely that participation levels will continue to drop. Without further growth in the labor force going forward, wages could rise even more rapidly and lead to accelerated wage-price inflation for the economy.

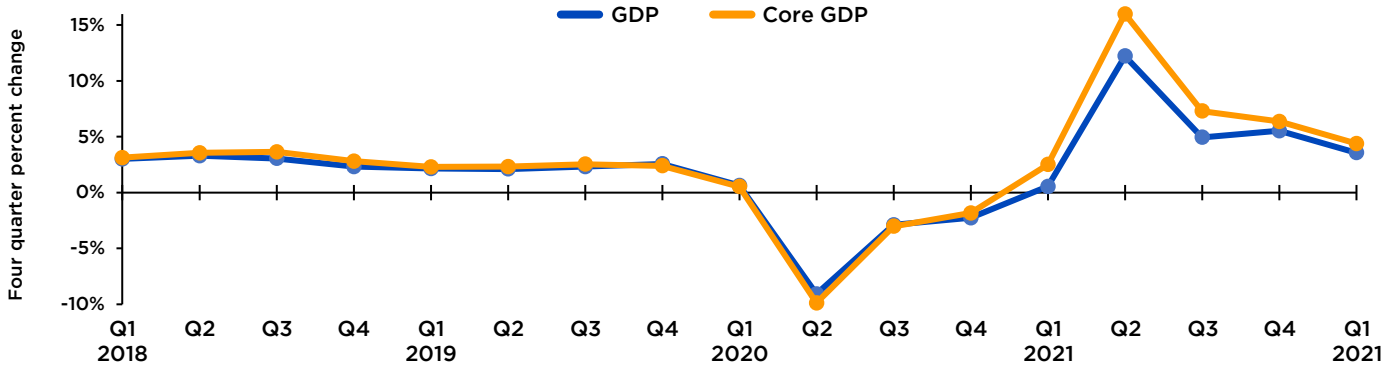
The labor market remains 1.2 million jobs below its pre-Covid peak, but that gap should close soon with further solid hiring in the months ahead. Job gains should slow going forward, however, considering that the market is essentially at full employment and especially if employer demand starts to fade towards the end of the year as tighter monetary policy starts to bite.

Affordability beginning to slow home sales

Total home sales (new plus existing) in March fell to their slowest pace since June 2020, when they were still recovering from the collapse caused by Covid. While homebuyer demand has remained solid so far, it is expected that sales activity will continue to fall as sharply rising mortgage rates (currently around 5.30 percent for a 30-year fixed mortgage) and high house prices reduce affordability. The Wells Fargo housing market index suggests the traffic of prospective buyers was at an eight-month low in April. Still, with house price appreciation approaching 20 percent over the past year, the housing market is still facing excess demand despite falling affordability as the inventory of homes for sale remains near all-time lows.

Elsewhere, supply chains are healing in some areas, and the eventual lifting of Covid restrictions in China will help further. While there are some signs that shutdowns in reaction to rising Covid infections are on the cusp of being eased, China's zero-Covid policy remains a risk to the elongated supply chain problems and high inflation persisting beyond what is currently forecasted.

Core GDP growth remains solid and above overall GDP growth



Sources: Bureau of Economic Analysis

Another bad month for both equities and fixed-income

The S&P 500 index sank by almost nine percent in April, eliminating the rally from mid-March's year-to-date low. Negative second-quarter earnings guidance, fears over a worsening of the war in Ukraine, and inflation anxiety caused the worst monthly setback for the market since March 2020. The U.S. Treasury 10-year note yield rose by almost 70 basis points last month and surpassed 3.0 percent early in May, while shorter term yields (such as those on the 2-year note) rose by significantly less — opening a 40-basis point gap to the 10-year yield. Commodity prices continue to reflect supply disruptions as the war and lockdowns push most commodity prices higher.

Free fall

The stock market declined severely in April, returning the S&P 500 index to its year-earlier level. The retreat from the record high on January 3 is approaching 20 percent, at which point the market would be in bear market territory. Still, the market sits almost 20 percent above the February 2020 level, achieving a healthy performance over a turbulent period.

Weak earnings guidance for the second quarter has dampened investors' optimism. Twice the number of companies issued negative outlooks for the second quarter than positive. This reversed a trend of more positive forecasts during the previous quarterly earnings seasons. As a result, expected annual earnings growth for the second quarter is now under five percent, a sizable step back from the first quarter's nearly 10 percent pace. Profit margins are feeling the brunt of the spike in costs for inputs and labor. At this point, expectations for the third and fourth quarter earnings remain healthy at above 10 percent.

Investors should feel some solace as the current price-earnings multiple is 17.6, below the five-year average. At the end of March 2022, this measure was above 19. Among sectors, the spread of price-earnings multiples is wide, with consumer discretionary at 25 and energy at 10. Even the Shiller cyclically adjusted S&P PE ratio has fallen sharply, although the level remains historically high.

Bond prices retreat

Inflation fears and Fed comments roiled fixed-income markets. Gasoline prices significantly added to March's inflation measure, released last month, and soared to record highs in May. Expectations for a quick deceleration in inflation are fading. At the same time, forecasts for significant Fed rate hikes and an anticipated reduction in the Fed's balance sheet hurt investors' confidence in holding fixed-income securities.

Over the past two months, the yield of the 10-year U.S. Treasury note rose by more than 110 basis points to surpass 3.0 percent for the first time since 2018. Since 1960, this is the ninth largest increase. The other eight occurred in the early 1980s when the yield was in double digits — suggesting a much larger percentage impact in the current period. Long-term Treasury investors surrendered almost nine percent in April. That decline is the second worst since 1973, barely above the drop from June 2003.

The early April inversion in the two-ten Treasury note spread was short-lived as long-term rates jumped over the month. The spread had widened to more than 40 bps by early May, easing markets concerns about a near-term downturn. (Note that we think that a better predictor of economic growth and recession uses a shorter-term rate, such as the federal funds rate, compared with the 10-year note yield). With Fed Chair Jay Powell pulling market expectations back from a potential 75 basis point rate hike over upcoming meetings, the 2-year yield has leveled off — although still expecting sharp Fed rate increases ahead.

Commodities still expensive

The benchmark WTI crude oil price traded above $100 per barrel for most of April as OPEC+ rejected a significant output increase despite rising worldwide demand and the worsening supply shortfall after the Russian invasion of Ukraine. In addition, natural gas futures remained elevated as suppliers struggled to replenish inventory. The forecast for La Niña this summer suggests a higher-than-normal demand for electricity which could hit the consumer as producers pass along the cost for natural gas, a key input.

Agricultural prices also rallied on concerns over harvests and the global supply and demand situation (yet another victim of the Russian invasion of Ukraine). Corn, hogs, wheat, and soybeans are up by more than 35 percent over the last six months. This is another source of inflation, in addition to the recent avian flu outbreak.

The U.S. dollar has benefited from the rally in crude oil prices, higher U.S. rates (and expectations of even higher rates), and the perception that the U.S. is a safe haven for investments. This could continue to be a drag on exports, already hurt by weak global growth although it may help to pull inflation down some. Financial markets are already looking ahead to the FOMC meeting in June, when the next survey of economic projections will be released. This will give an update on the Fed's thinking about inflation, growth, and how quickly the Fed itself expects to tighten monetary policy.

Asset Class Performance

Total returns represented as of April 30, 2022

	1-month	6-months	12-months
S&P Composite 500 Index	-8.72%	-9.65%	0.21%
S&P Midcap 400 Index	-7.11%	-9.88%	-7.03%
S&P Smallcap 600 Index	-7.81%	-11.13%	-8.54%
EAFE[1]	-6.78%	-12.92%	-10.35%
U.S. Dollar Index[2]	2.89%	5.04%	6.06%
CRB Commodity Index[3]	1.40%	12.62%	20.90%
Intermediate Treasuries[4]	-1.60%	-5.75%	-6.06%
Long Treasuries[5]	-8.89%	-17.56%	-12.23%
Investment-grade Corporate Bonds[6]	-5.47%	-12.75%	-10.43%

[1] Index measuring equity performance of developed markets outside of the U.S. and Canada

[2] Federal Reserve trade-weighted broad currency index

[3] Commodity Research Bureau; CRB spot index

[4] Index of 1-year to 10-year Treasury notes

[5] Index of 10-year and longer Treasury notes and bonds

[6] Index of U.S. investment-grade corporate bonds

Sources: Bloomberg; Haver Analytics

Is the stock market flagging a recession?

The S&P 500 fell into its first correction of this cycle in January and has continued to slide in the early spring, down to a near-bear market decline of 18 percent in mid-May. The stock market is a leading indicator and a barometer of financial conditions more generally, so the recent trend does at least hint at heightened risks for the real economy.

Stocks fall prior to recessions

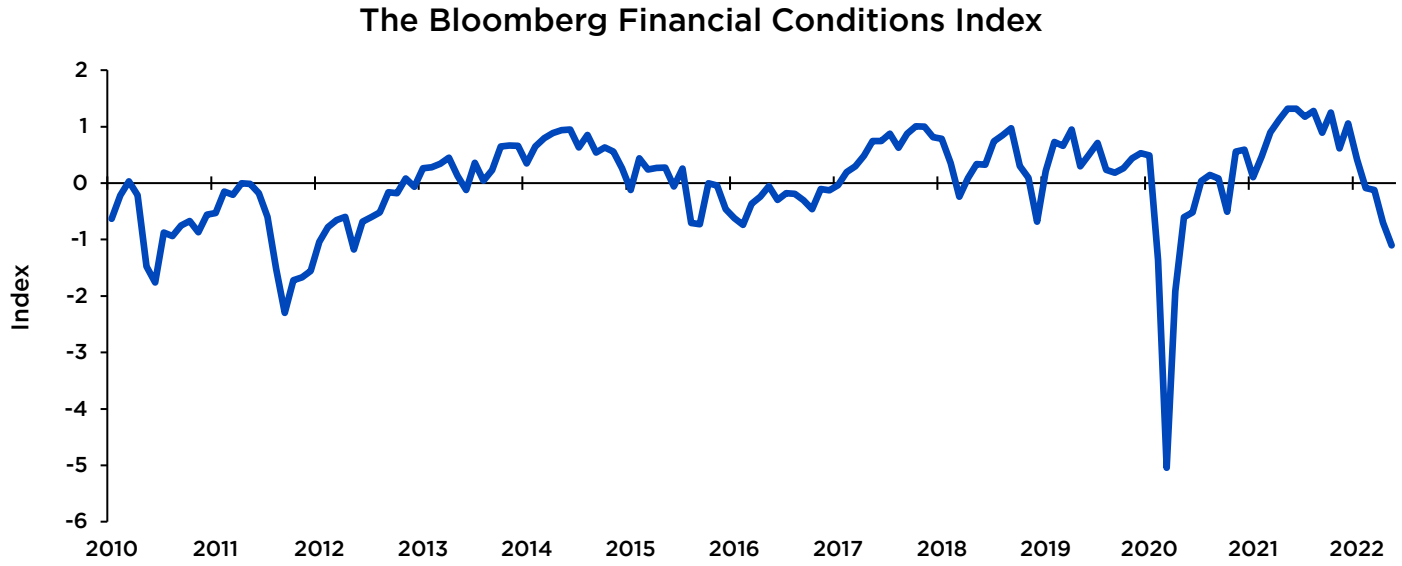
Falling equity prices are a characteristic trait of pre-recession periods. The S&P 500 index, in fact, slipped into either a correction or bear market in advance of ten out of the last 11 economic contractions, with the only exception coming when both an expansion and bull market ended in February 2020. On average, the economic downturn in these cases came 7.5 months after the stock market downturn began.

Financial conditions tightening

A decline in the equity market is not only a potential signal of looming macroeconomic weakness, but it also has real consequences through its impact on financial conditions. It is no coincidence that the market's slide has been accompanied by a growing slowdown in venture capital funding, for example, that has in turn weighed on startup employment. With credit spreads widening and the dollar climbing alongside the pullback in stocks, aggregate measures of financial conditions have reached their most restrictive levels since the recession in 2020.

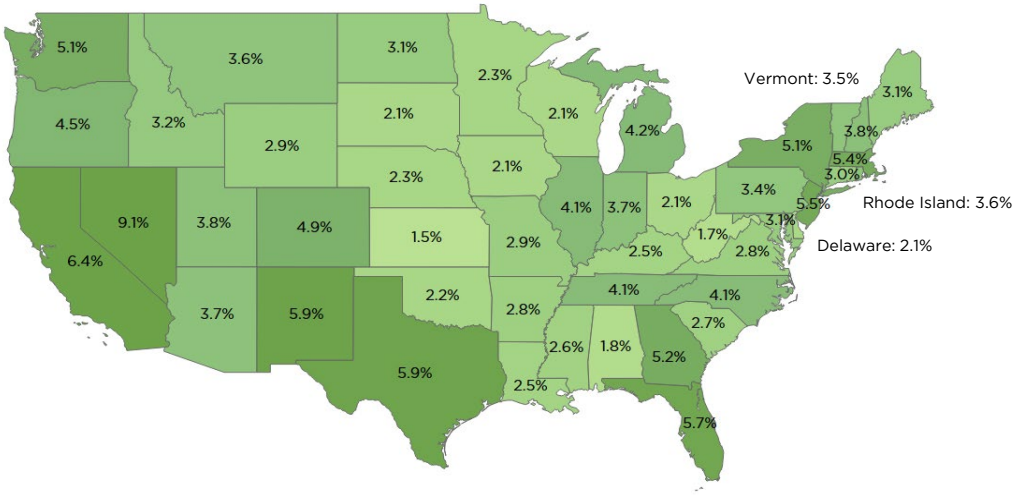
Risks still not overwhelming

Still, it is important not to overstate these developments. Stock market retrenchments may be necessary conditions of recessions, but they are not sufficient. Of the 26 corrections in the S&P 500 prior to this year, only six gave way to an economic contraction within a year. There have even been three bear markets on record in which the economy continued to grow for years after the market peak (nearly three years after the 1987 bear market; eight years and close to four years, respectively, after the first two bear markets of the 1960s). And while financial conditions have undeniably tightened this year, they remain much more accommodative than is typical during recessions and are even more supportive than in the early stages of the last two expansions. Most importantly, the economic fundamentals remain solid, marked by booming job growth, solid manufacturing activity, and healthy levels of business fixed investment. The imbalances that typically take hold in the latter stages of cycles, such as elevated consumer indebtedness and tight lending standards, have yet to develop while leading indicators in aggregate are still pointed upward. The most prescient of the leading indicators, the spread between the Fed's benchmark policy rate and longer-term Treasury yields, currently suggests little risk of a near-term downturn even after the hikes of recent months. Moreover, the Conference Board's index of leading economic indicators continues to show solid 12-month gains, rather than the declines seen shortly before recessions ensue. The stock market's decline is a signpost that the risks are climbing, but a sustained expansion for the foreseeable future remains the best bet given the broader fundamentals.



Source: Bloomberg

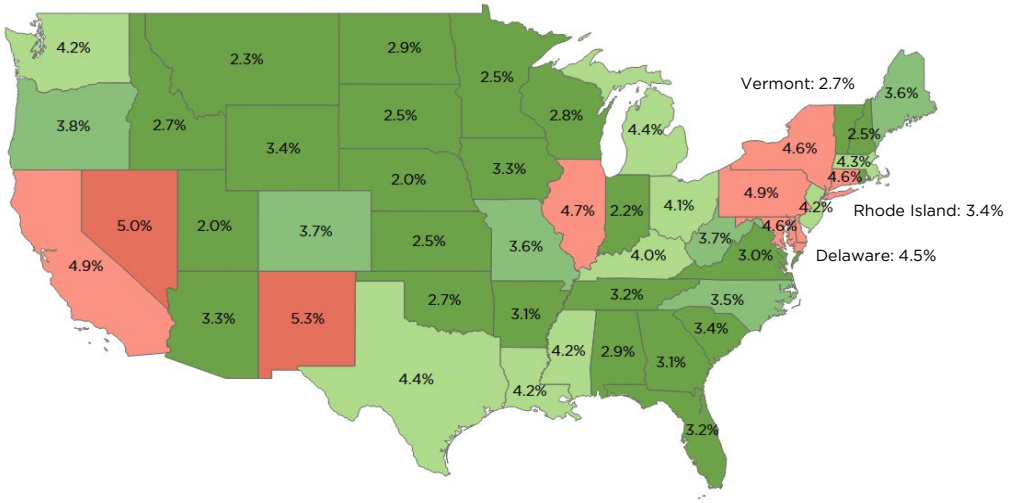
Strong job gains in many states as hiring demand persists



Sources: Bureau of Labor Statistics; Haver Analytics
Twelve-month growth rate in nonfarm payroll employment, March 2022

- Job gains were strongest in the Pacific Region plus Nevada and parts of the Southwest and Northeast — including several states where the pandemic recovery was delayed due to governmental restrictions or sectoral concentrations.
- Hiring over the past year was slower across much of the middle of the country where tight labor markets have limited the availability of workers.

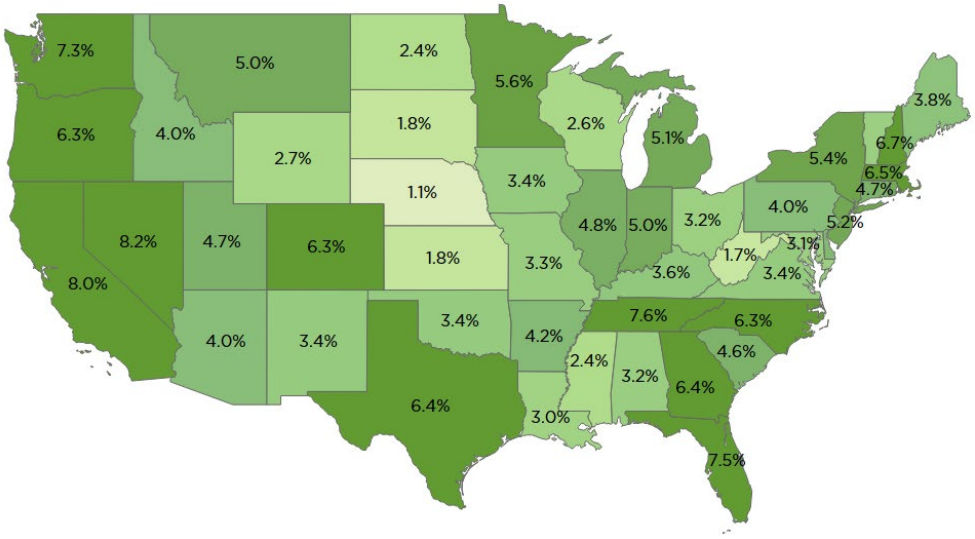
Ultra-low unemployment rates in many parts of the country



Sources: Bureau of Labor Statistics; Haver Analytics
Civilian unemployment rate, March 2022

- The unemployment rates in 15 states were at-or-below 3.0 percent as of March — a very low level which is placing strong upward pressure on wages in many areas as employers vie for workers.
- Only three states still have unemployment rates at or above 5.0 percent —New Mexico, Nevada, and Alaska (not shown) — as labor markets tighten across the country.

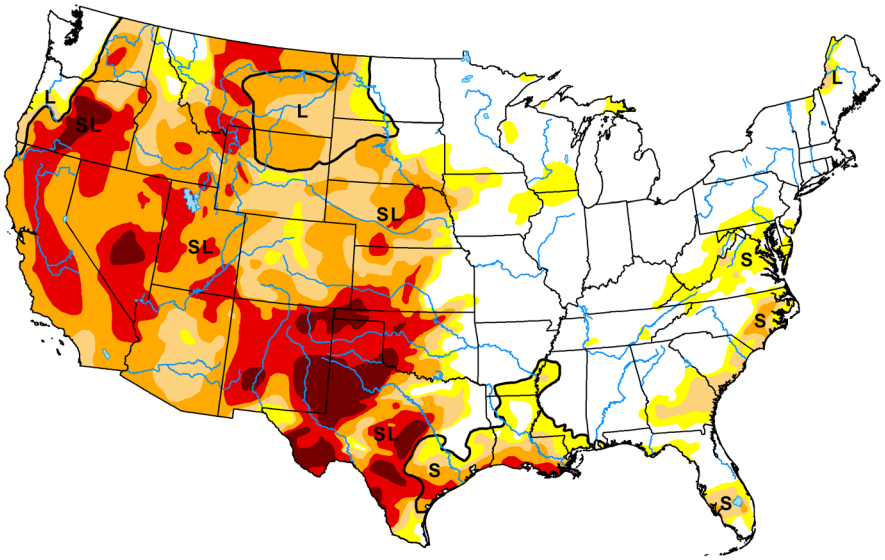
Most states had above-trend real GDP growth last year



Sources: Bureau of Economic Analysis; Haver Analytics
Four-quarter change in real gross domestic product by state, 2021Q4

- States in the Pacific Region and parts of the Southeast and Northeast (plus Texas, Colorado, and Minnesota) surpassed the national four-quarter real GDP growth rate of 5.5 percent as of 2021Q4.
- Many states in the middle of the country lagged the national growth pace, weighed down in part by higher costs and supply chains disruptions across the agriculture sector.

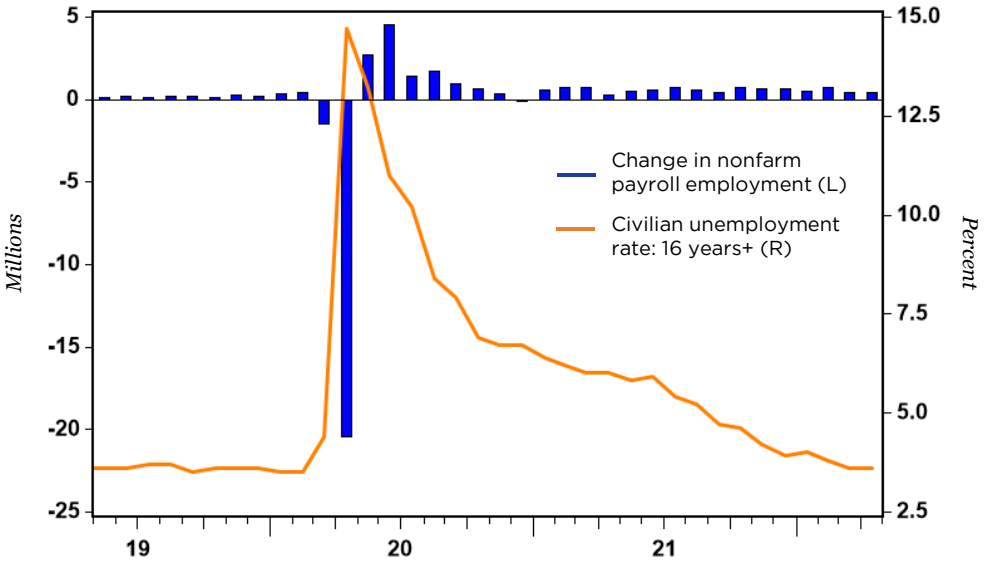
Much of the western U.S. (especially the Southwest) has severe drought conditions



Sources: National Drought Mitigation Center
U.S. Drought Monitor; May 5, 2022

- The megadrought in the West continues to disrupt the supply of water for residential and agricultural uses in many key crop production states, extending into the Upper Great Plains where the wheat crop has struggled this year.
- La Niña conditions in the Pacific Ocean could persist into 2023 and maybe beyond — estimated to drive further dry and hot weather across the western half of the country.

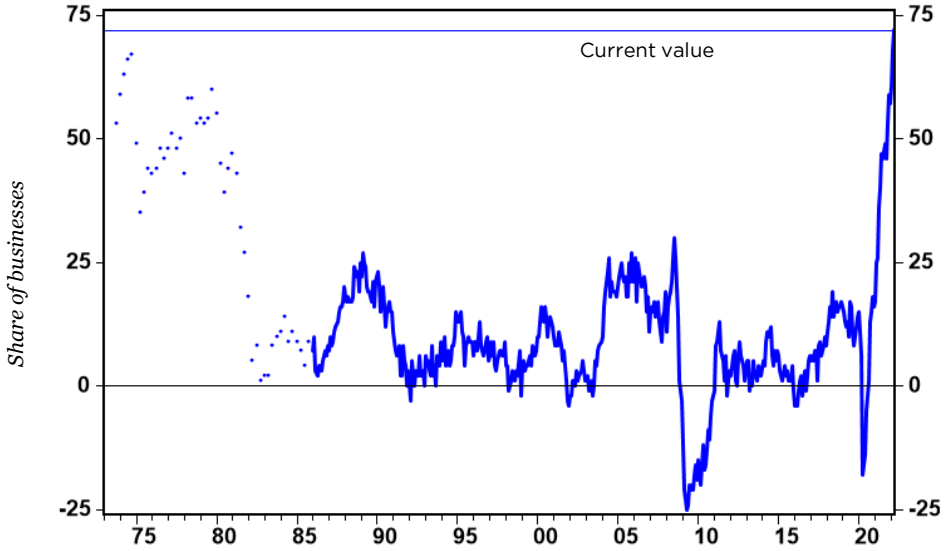
Another month of solid job gains for April



Sources: Bureau of Labor Statistics; Haver Analytics
Monthly change in nonfarm payroll employment; level of the civilian U-3 unemployment rate, April 2022

- Nonfarm payrolls rose by 428,000 for April as demand for workers remained strong across most sectors. Over the past six months, the economy has added more than 3.3 million jobs and is closing in on pre-Covid peak employment levels.
- The U-3 unemployment rate was steady at 3.6 percent for April, just above the pre-pandemic level (and 50-year low) of 3.5 percent. The labor force participation rate slipped for April, however, although this is probably a one-time drop after several months of improvement.

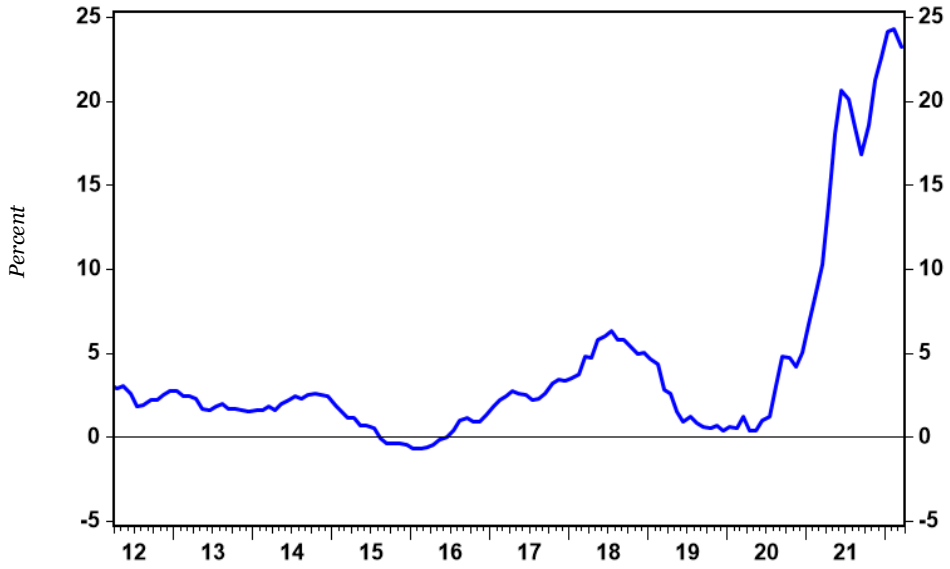
Small business passing through rising costs to consumers



Sources: National Federation for Independent Business; Haver Analytics.
Percent of firms raising average selling prices, March 2022

- In response to sharply higher costs for inputs and labor, a record 72 percent of small businesses reported raising selling prices in March — even above the estimates from the early 1970s.
- Half of small businesses were planning to raise prices further in coming months as rising costs continue to squeeze profit margins for many firms.

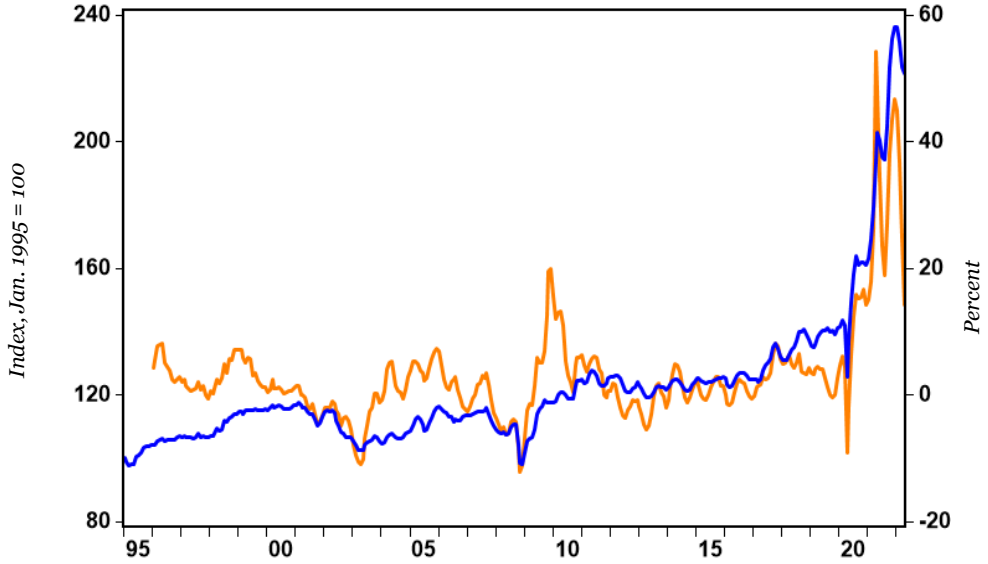
Construction input costs rising at a record pace



Sources: BLS; Haver Analytics
12-month changes in PPI: materials and components for construction; March 2022

- Driven by sharply higher prices for lumber, metals, and asphalt (among others), materials for construction as measured by the Producer Price Index were up by more than 24 percent annually for January and February.
- While price increases for some construction inputs may have reached their peak, insurance claims costs for property coverage could continue to be highly elevated for some time.

Used cars prices are starting to pull back



Sources: Manheim; Haver Analytics
Manheim used vehicle value index; April 2022

- The Manheim used vehicle value index has declined for three consecutive months as prices, although still elevated, fall from their Covid-induced peaks.
- The 12-month change in the Manheim index dropped to 14.1 percent for April and is likely to decline further in coming months as the auto market normalizes.

Index value, left axis

12-month change, right axis

Forecast from Nationwide Economics

As of May 2022	Actual		Estimate	Forecast			
	2020	2021	2022	2023	2024	2025	2026
Real GDP [1]	-3.4%	5.7%	2.8%	2.0%	1.8%	1.7%	1.6%
Unemployment Rate [2,7]	8.1%	5.4%	3.6%	3.6%	3.7%	3.8%	4.0%
Inflation (CPI) [5]	1.2%	6.7%	5.6%	2.4%	2.5%	2.6%	2.5%
Total Home Sales [3,7]	6.47	6.89	6.65	6.45	6.15	5.90	5.70
S&P/Case-Shiller Home Price Index [9]	10.3%	18.8%	9.8%	4.4%	3.0%	2.5%	2.0%
Light Vehicle Sales [3,7]	14.5	14.9	15.2	16.5	16.1	15.7	15.5
Federal Funds Rate [2,4,6]	0.00%	0.00%	2.50%	3.25%	3.00%	2.75%	2.50%
1-Year Treasury Note [2,4]	0.10%	0.39%	2.70%	3.30%	3.15%	2.95%	2.75%
5-Year Treasury Note [2,4]	0.36%	1.26%	3.20%	3.35%	3.25%	3.15%	3.00%
10-Year Treasury Note [2,4]	0.93%	1.52%	3.30%	3.40%	3.35%	3.30%	3.20%
30-Year Fixed-Rate Mortgage [2,4]	2.67%	3.11%	5.55%	5.65%	5.60%	5.00%	4.90%
Money Market Funds [2,8]	0.47%	0.14%	1.53%	3.03%	3.22%	2.97%	2.72%

Major forecast changes from last month

- After announcing a 50 basis point (bps) rate hike in May, Chair Powell signaled that further 50 bps moves could happen in June and July as the Fed focuses on reducing inflation. We now expect the lower bound of the federal funds rate to climb to 2.50 percent at year-end 2022, followed by further rate increases over 2023. Long-term interest rates have jumped sharply over the past month and should continue to edge higher as the Fed tightens aggressively and inflation expectations remain elevated — with the 10-year Treasury note yield projected to end 2022 at around 3.30 percent.
- The combination of negative first quarter real GDP growth, sharp Fed tightening, and continued supply chain disruptions (both geopolitical and Covid-based) should result in slower growth for the year than we had previously expected — with real GDP growth projected to dip below 3.0 percent over 2022. Beyond this year, growth should slow further in response to tighter monetary and fiscal policy, as well as additional pullbacks from globalization of economic production.
- Inflation estimates continue to move higher as the war in Ukraine and Covid lockdowns in China have delayed the healing of supply conditions across the globe. We have raised our projection for the 12-month gain in the consumer price index to 5.6 percent for the end of 2022.

[1] Percent change year-to-year
[2] Percent
[3] Million units
[4] Year end
[5] Percent change Q4-to-Q4
[6] Target rate, lower limit
[7] Year average
[8] Annual return
[9] Percent change Dec-to-Dec

Sources: Haver Analytics (actuals); Nationwide Economics (estimates and forecasts); except Money Market Funds (all data from Nationwide Economics)

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