WEEKLY WISDOM

Supporting the Consumer, Taking Down Inflation

June 8, 2022

The Consumer Represents 70% of the U.S. Economy

Remember Fed Chair Powell using the word "transitory" to describe inflation last year? Fast forward to today – inflation and consumer demand have both proven persistent. We receive May CPI data later this week, and even if the data is cooler than expected, inflation will remain elevated for quite some time. Supply chains remain clogged, commodity prices are at highs and wages and rents are well ahead of where the Fed is comfortable with. We are focused on the long-term impact that persistent inflation is having on consumers. For now, we're seeing the continuation of resilient underlying demand – noted globally by the recent re-opening in China and here at home by the shift from goods to services. In addition, capex will support productivity and will also help GDP. We believe this underlying demand will continue to support economic growth through the next couple of quarters, but we continue to monitor the pace of the Fed rate hikes. We expect the Fed will be more hawkish than most believe given their dual mandate of employment and inflation targets, the latter not being transitory.

We're seeing initial indications of normalizing demand from retailers and housing market data. Retailers have reported excess inventories because of overordering and shifting consumer preferences. In summary, goods that were popular and hard to get when the consumer was stuck at home are now available and in less demand as consumers have shifted their wallet toward services (see last week's Weekly Wisdom: Slowing Down and Trading Down). New home sales dropped 16.6% in April, back to pre-pandemic levels – an effect of fast-rising mortgage rates and very high home prices. That said, the housing industry has under-produced for the last 13 years, land is scarce and pent-up demand remains strong.

Leading Indicators and Trade Balances Support Q2 Economic Growth

ISM Services and ISM Manufacturing, both leading indicators, reported the 24th consecutive month of expansion in May. Exports and imports remain historically high according to this week's trade balance report, which reflects April data. Travel exports – spending by visitors to the U.S. – was the highest since February 2020, while travel imports – Americans traveling abroad – also climbed to the highest level since the pandemic onset. The trade deficit narrowed in April as exports jumped to a record high – a net positive contribution toward Q2 GDP. Exports of both goods and services were led by industrial supplies and materials, and travel exports – while a slowdown in imports can be attributed to shifting demand, normalizing inventory levels and China lockdowns.[1]

Consumer Demand Remains Robust, Companies Need to Capture It

Easing supply chain challenges and excess inventories will reduce inflationary pressures as retailers offer goods at discounted prices to make room for higher demand items. Target (TGT) announced that

[1] Source: Reuters

it will mark down unwanted items and optimize its inventory for the second half, taking a short-term hit to profits but positioning itself to better capture the "very resilient customer" going forward. Walmart (WMT) and Macy's (M) announced similar excess inventory problems – citing a consumer shift from bulky electronics, furniture and appliances to luggage and household essentials, and from casual clothing to dressier clothing and makeup. Restoration Hardware (RH) is feeling the full brunt of the consumer shift as well, lowering their full-year forecast and guiding a Q2 revenue decline of 1-3% compared to estimates for a 5% increase. Lululemon (LULU) reported strong earnings that exceeded expectations and reported that inventory levels rose 74% y/y.

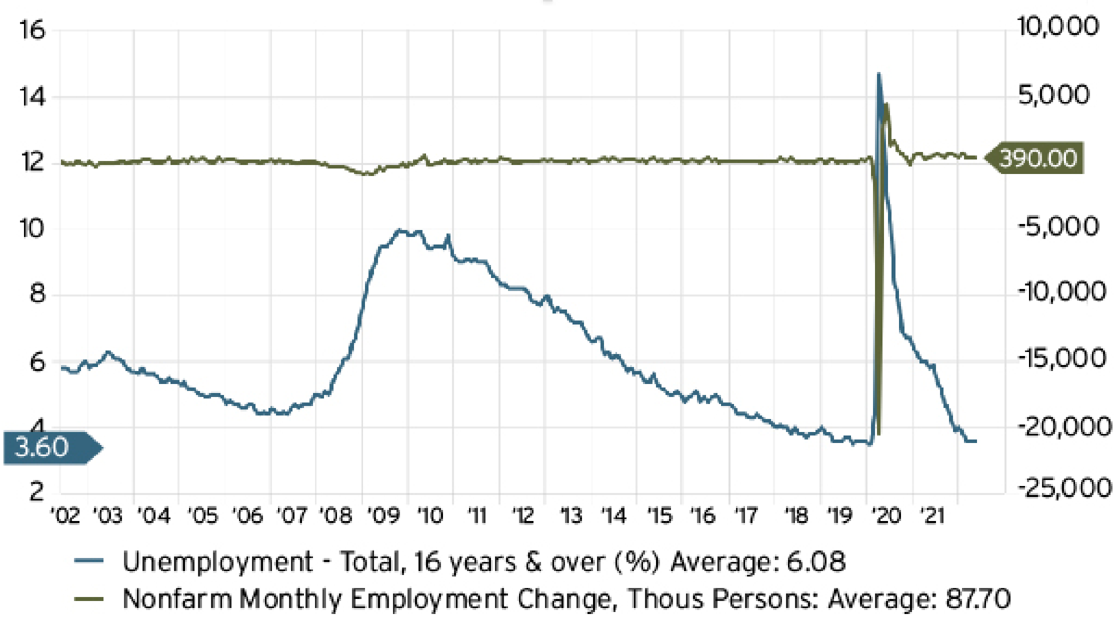
While efficient supply chains and excess inventories will offer some relief on prices of certain goods, elevated demand remains widespread, and higher prices are likely to continue – particularly in services (e.g., rents, leisure and hospitality), reopening themes (e.g., travel and beauty products) and energy goods (e.g., gasoline).

Broad Underlying Momentum Gives Us Confidence in the Consumer

We remain confident in the consumer's ability to absorb inflationary pressures because of economic buffers in place. These buffers include momentum from healthy consumer balance sheets, widespread job availability and rising wages. According to Bank of America, total card spending was up 9% y/y in May. Checking and savings accounts are still higher than pre-pandemic, and the share of credit card spending vs. total card spending remains around 2019 levels – households are not relying on credit to meet rising bills, and delinquencies remain low. Low-income households have almost double the level of checking and savings compared to 2019, and wage growth is outpacing headline PCE inflation for lower-income workers.[2]

Job openings remained near peak levels in April, while data revealed elevated hiring and still low unemployment in May.

Chart 1: Historically Low Unemployment and Elevated Hiring[3]



There are some segments of the labor market that are slowing. This is particularly true in technology, where much of the slowdown is attributed to shifting demand and Apple's iOS privacy update – resulting in lower ad revenue through the popular app platform. Additionally, app store revenue growth decelerated in May – further confirmation of consumer demand shifting away from pandemic-

[2] Source: Bank of America
[3] Source: FactSet (chart)

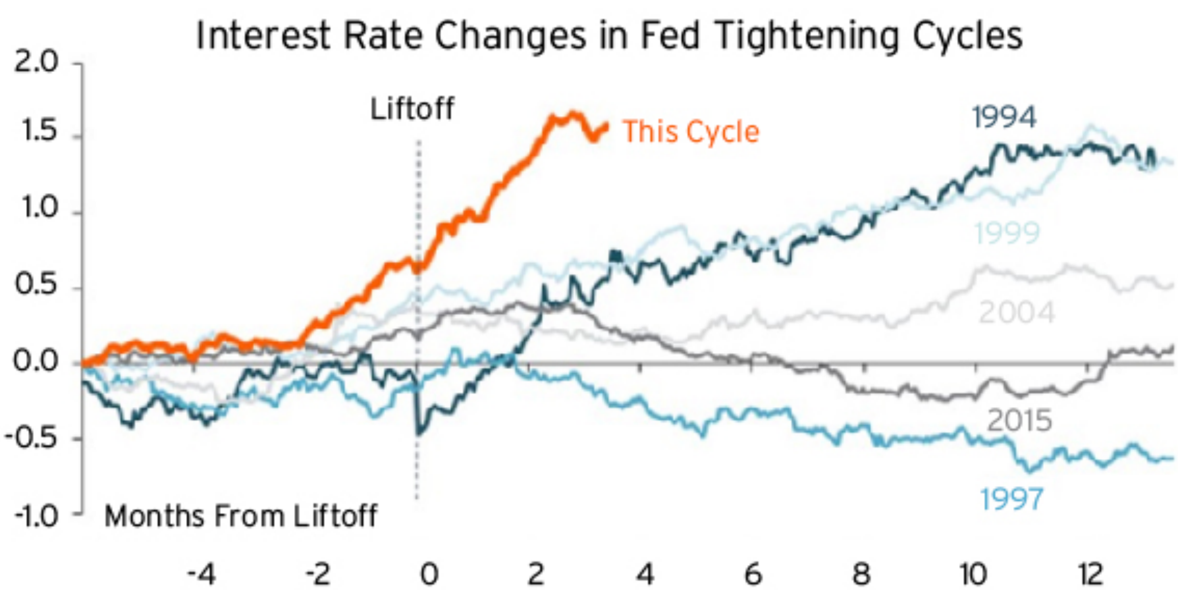
beneficiaries. Also, much of the technology industry was the beneficiary of the stay-at-home trend, and that is now reversing.

As a result, many companies in the technology sector have indicated hiring freezes and layoffs. Elon Musk, CEO of Tesla (TSLA), shared his high-profile "super bad feeling" about the economy and announced a hiring freeze, while Jamie Dimon, CEO of JP Morgan (JPM), predicted an impending economic "hurricane". Although consumer and corporate confidence levels are near lows, our perspective is that the economy is experiencing a period of normalization and while certain pockets may be slowing, jobs, wages, demand and inflation are all elevated. We don't see a recession in 2022 given strong underlying momentum from the consumer and a recovery in productivity, while 2023 is more uncertain and depends on the Fed's actions and the inflation/interest rate environment.

Current State of the Tightening Cycle – How Fast and How far Should the Fed go?

The Fed has only risen the Fed Funds target rate by 75 bps this year, and balance sheet shrinking began this month – yet aggregate interest rate change is currently reflecting the fastest tightening cycle compared to the past five cycles going back to 1994. This tightening pace is due to the Fed's strong media narrative that includes Chair Powell saying that "no one should doubt our resolve [...] what we need to see is inflation coming down in a clear and convincing way."[4]

Chart 2: Indices Reflect Aggregate Government, Corporate and Consumer Interest Rates[5]



This broad acceleration in interest rates is likely to curb demand at some point, and some economists are questioning how far the Fed will need to actually raise rates to curb demand, given the fast headstart markets have already made. IPO and private equity activity have also stalled with rising rates and price volatility. With our expectation that inflation remains elevated despite these rising rates – driven by rents, wages, commodities and reopening themes – we're staying laser-focused on the consumer's resilience.

Stephanie Link: CNBC TV Schedule

DATE	SHOW	TIME
Thursday, June 9	Closing Bell: Overtime	4:00 PM ET

[4] Source: CNN
[5] Source: Piper Sandler

Disclosures

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