MARKET COMMENTARY

US Economic Review

- Despite a meaningful slowdown in the housing market, the US economy remains overheated. Labor markets are tight, aggregate incomes continue to grow at an unsustainable pace, and consumption remains high.
    1. New home sales have decreased sharply, and record months of unsold new inventory are under construction. Home price appreciation has stalled in many regions.
    2. Unemployment remains quite low at 3.7%.
    3. Aggregate incomes (Fig. 1), our favorite indicator of demand-side inflation, continue to grow at 10% (double the pre-COVID trend).
    4. Consumers are unusually resilient to higher interest rates due to low revolving debt, fixed-rate mortgages, and accumulated excess savings.
- Continued strength in the US economy isn't unilaterally positive. At Jackson Hole Fed Chair Powell said, "Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also **bring some pain** to households and businesses."
- In an encouraging sign, the unemployment rate increased from 3.5% to 3.7% in August despite adding 315k jobs to the economy. This outcome, where labor markets soften due to increases in labor force participation instead of job loss, indicates that a soft landing remains possible.

Fig. 1: Aggregate income growth
Wage and salary disbursements, year-over-year

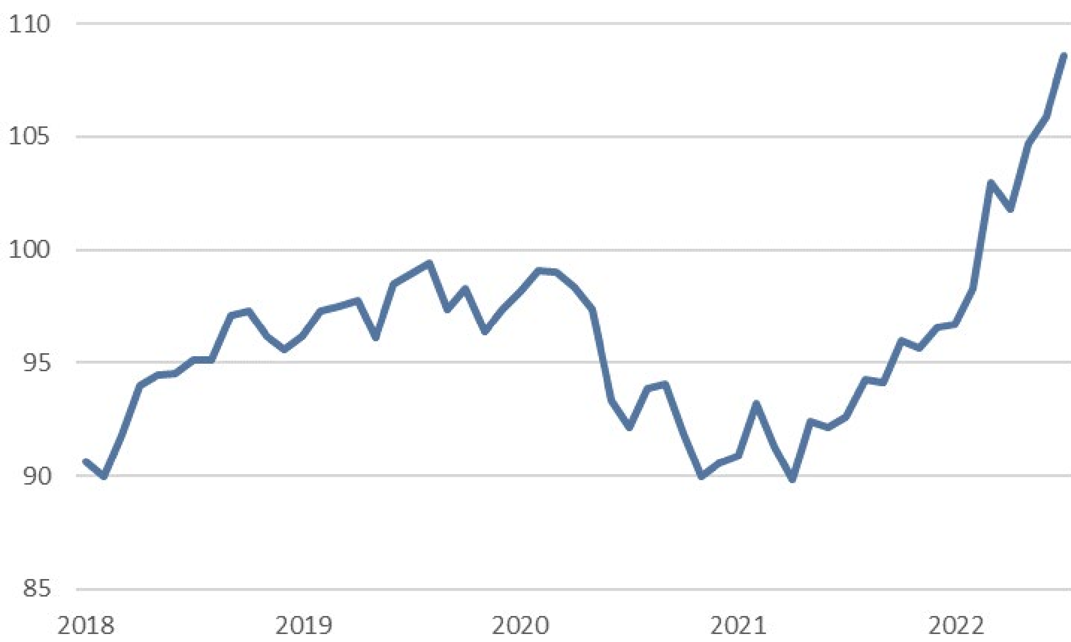
Source: Bloomberg, Mill Creek.

International Economic Review

- Inflation continues to run hot in the UK and Euro area. The Bank of England (BOE) and European Central Bank (ECB) are aggressively tightening policy rates.
    1. The BOE has predicted a lengthy recession for the United Kingdom.
    2. The ECB is quickly moving toward Fed-style 75bps hikes. The Euro area is also facing a recession in 2023.
- Russia and Europe continue the game of chicken around natural gas and energy. Following a series of "plausible deniability" explanations for supply cuts, Russia has reportedly stopped natural gas supply to Europe entirely. Russia has asked, particularly, for sanctions around high-tech imports to be relaxed. A combination of storage flows plus imports from other parts of the world may be insufficient to meet daily European needs in severe winter conditions.
- China continues to support economic stability through targeted fiscal stimulus while supporting the Yuan against a strong dollar (Fig. 2).
- China's commitment to a zero-COVID policy appears strong, despite the economic costs.
    1. The GDP share of cities now in lockdown is 35%, the highest since 2021.

2. The Communist Party's leadership congress begins on October 16th. President Xi Jinping is widely expected to win a third term. Some pundits expect the COVID policy to relax following the congress.

Fig. 2: The dollar continues to strengthen
US Dollar Index



Source: Bloomberg, Mill Creek.

Market Review

- Global equity markets declined slightly in August as central banks reiterated their intentions to remain hawkish. Emerging market equities finished slightly positive on the month but have underperformed year-to-date.
- US interest rates rose in August. The 10-year Treasury moved back above 3% (Fig. 3).
- Credit markets remain resilient. Corporate high yield credit spreads are not signaling signs of stress in the credit markets, nor are they wide enough to present a tactical opportunity.
- Commodity indices rose slightly over the last month. Softs – cotton, coffee, and sugar – rose over 10%. Oil and precious metals were laggards. Commodities continue to exhibit a bullwhip effect post-COVID. For example, lumber prices, which were in the news last year due to huge price increases, have declined back to 2019 levels.

Fig. 3: Treasury rates are once again over 3%
10- Year Treasury Yield

Source: Bloomberg, Mill Creek.

Our Perspective

- The current environment is progressing in line with what we laid out in our 3Q outlook, "The Volcker Playbook."
    1. The Fed will likely hike an additional 125-150 bps by the end of the year.
    2. The Fed remains data-dependent but with a hawkish tilt.
    3. We will need to see the labor market soften significantly before the Fed pauses. This softening is unlikely to happen without a minor recession in 2023.
    4. However, we're constructively optimistic. Increased labor force participation has scope to soften labor markets and consumers are uniquely resilient to rate hikes due to excess savings accumulated during 2020-2021, low revolving debt, and mortgages fixed at historically low rates.
- We believe 3.5% remains a reasonable end-of-2022 yield for the 10-year Treasury, but interest rates are likely to remain volatile.
- Inflation expectations are dissipating. Market participants expect inflation to average 2.6% over the next two years, and the Fed's Five Year Forward Breakeven Inflation rate has remained well anchored below 2.5%.

- Equity markets will likely struggle to sustain rallies during this hiking cycle, but —if the Volcker history is a guide — risk assets will do well once Powell signals the all-clear.
- A full summary of our views and positioning can be found here: Quarterly Outlook: Mill Creek House View (page 4).

QUICK LINKS

- Credit Markets: What We Are Watching Now
- Cash--Not quite trash
- How Will Investors Face Q2 Valuations?
- Earnings Rise Albeit at a Slower Pace Than Prior Quarters

This week's contributor: *Michael Crook, CAIA*