OBSERVATIONS: *Markets up, upside surprise to GDP, PCE inflation moving lower*.

- The S&P 500 posted its 5th consecutive positive week after gaining +1.0% and small cap stocks (Russell 2000 Index) added +1.1%. The 10-year US Treasury yield finished the week at 3.96%, up +12 bps on the week.[1]
- The initial estimate for Q2 GDP growth surprised to the upside after registering +2.4%, which was higher than Q1 growth of +2.0%. This suggests that despite the continued Fed hiking of interest rates the economy is modestly accelerating back towards its long-run trend of between 2.5% to 3.0% real GDP growth.[1]
- New orders for durable goods also came in better than consensus expectations registering a +4.7% increase month-over-month (MoM) in June over May. Excluding the volatile transport sector—autos and aircraft—new orders for durable goods was up +0.6% MoM in June, which was also better than the expectations.[1]
- New home sales declined in June to 697,000 (seasonally adjusted annualized rate), which is down -2.5% from May's figure, but around +24% better than last year's mid-summer lows.[1]
- The Fed's preferred measure of inflation core-PCE (Personal Consumption Expenditures ex food and energy) came in at 4.1% year-over-year (YoY), down from May's 4.6% YoY figure. While the employment cost index—a quarterly measure of wage growth in the economy—came it at 1.0% quarter-over-quarter or about 4.0% annualized which is not too far from the Fed's informal target for this measure of about 3.5% YoY.[1]

EXPECTATIONS: *Busy central bank week and China talks stimulus.*

- As expected, the Federal Reserve lifted its policy rate by +25 basis points (bps) to a new range of 5.25% and 5.50%. Chair Powell noted that the Fed will continue to make decisions on a "meeting-by-meeting" basis. The Fed staff no longer projects a recession at the end of this year. The next monetary policy meeting is scheduled for September where markets are currently pricing less than a 25% chance for a rate hike.[1]
- The European Central Bank (ECB) also raised rates by +25bps to 3.75%—back to a record high first recorded in 2001—and similarly signaled that the ECB would be data dependent in determining if further hikes were needed or a pause in ECB activity was warranted.[1]
- The Bank of Japan (BoJ) also made headlines last week, as the BoJ made a surprise announcement that widened the band that a Japanese 10-year bond could trade and yields on 10-year bonds quickly repriced from 0.45% to nearly 0.6%--the highest yield since 2014—and rippled through global financial markets.[1]
- Beijing held its mid-year Politburo policy meeting last week which focused on economic policies to buttress domestic demand and provide further targeted support to the property sector and local government finances as well as other pro-growth fiscal and monetary measures. Formalized measures implementing the goals of the recent meeting may start to be outlined as early as this week as Chinese stocks staged their largest one-day rally last Wednesday since November-2022 in the aftermath of Xi Jinping's re-installment for an unprecedented third, 5-year term in office.[2]
- With over half the S&P reporting earnings, 80% are reporting positive earnings surprises, which is better than the 5- and 10-year averages for earnings beats. The blended rate for Q2 earnings for the index is now -7.3% YoY. Another 170 firms will report Q2 earnings this week.[3]

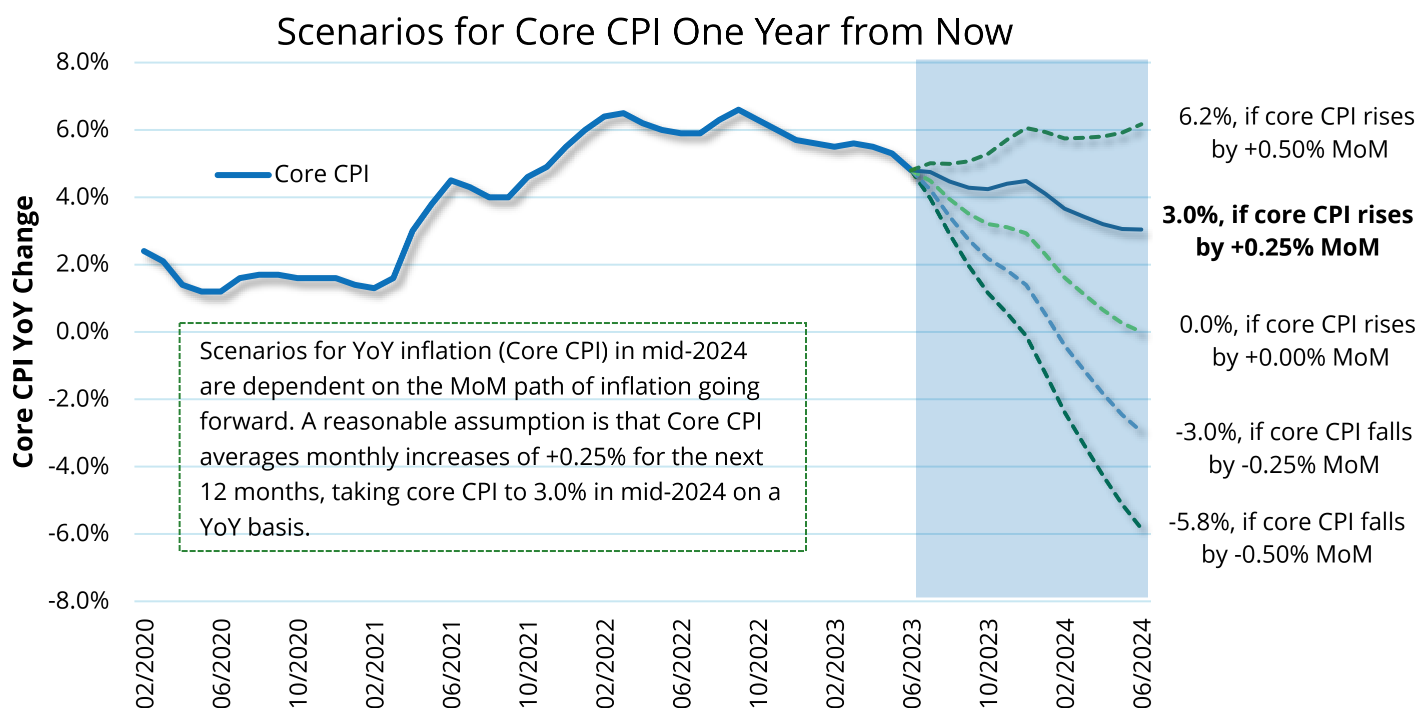
ONE MORE THOUGHT: *Scenarios for inflation in 2024 and potential consequences for Fed Policy.*[1]

Recent inflation readings point to what some are dubbing as "immaculate disinflation", a narrative in which the Fed achieves its goal of bringing down the rate of inflation without unduly harming the economy and avoiding an

[1] *Bloomberg LP*
[2] *https://www.ft.com/content/7384e5f8-47f1-4f9a-80d9-2ba688550283*
[3] *FactSet Earnings Insight 7/28/2023*

outright deflationary scenario in which prices are generally falling. The path for inflation in the next twelve months is likely to have monetary policy implications and markets seem to be anchored around inflation "naturally" drifting lower towards the Fed's target and by extension markets are no longer materially pricing in additional rate hikes beyond last week's +25bps rate hike. Since core CPI peaked in September 2022 at 6.6%, it has steadily fallen to today's reading of 4.8%, much of which is a result of base effects along with MoM core CPI averaging +0.3% to date. Projecting forward, we can apply estimates for expected future MoM readings to establish a baseline scenario for where this core inflation figure may rest this time next year. If we assume that future MoM core CPI readings look similar (i.e., +0.25% MoM core CPI) to the recent past (which is a reasonable estimate in our view) we arrive at a core CPI estimate of roughly 3.0% YoY (Chart of the Week). With that view generally priced into markets, surprises to that path become instrumental in dictating how the Fed adjusts monetary policy—higher MoM readings may prompt additional tightening while downside surprises to MoM core CPI could eventually prompt the Fed to begin moving rates lower.

CHART OF THE WEEK



Source: Clearstead, Bloomberg LP, Macrobond, as of 7/24/2023

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