CITY NATIONAL ROCHDALE
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The Bottom Line

Relevant Insights for the Savvy Investor

Things Are Looking Up

The economy appears to be in a transition phase.

Economic data has been coming in stronger than expected (chart 1), while inflationary pressures are subsiding (chart 2). This has some economists pushing out their anticipated recession start, while others are beginning to think the economy may avoid a recession with just a "soft landing."

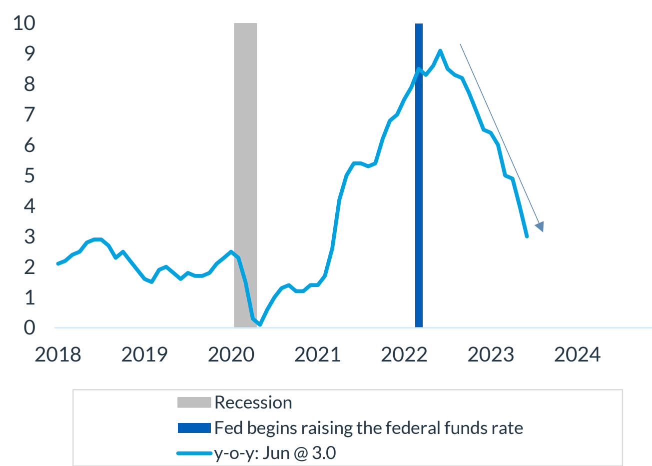
The more robust economic data is coming from two unlikely sources. Since the Federal Reserve (Fed) started tightening monetary policy in early 2022, the manufacturing and housing sectors have borne the brunt of the higher interest rates. But in recent months, they appear to have stabilized and reaccelerated. The economy is also benefiting from continued strength in personal spending.

But there is no denying that the big surprise has been the declining trend in inflation. In the past 12 months, the consumer price index (CPI) has moved to just 3% year over year (y-o-y) from a cycle high of 9.1% y-o-y. The initial catalysts for the drop in inflation were the energy and medical sectors, which have continued to fall. Neither of those sectors is influenced by Fed policy. Furthermore, these prices can move down just as quickly as they can move back up. This has given the Fed some uncertainty about the sustainability of the lower level of inflation. The Fed has been more focused on lowering inflation in other sectors of the economy in which it can influence demand and the price movement tends

CHART 1: Citi Economic Surprise Index
measures economic data surprises relative to market expectations

Source: Citibank Global Markets, as of July 21, 2023.

CHART 2: Consumer Price Index
% change, y-o-y, seasonally adjusted



Source: Bureau of Labor Statistics, as of June 2023.

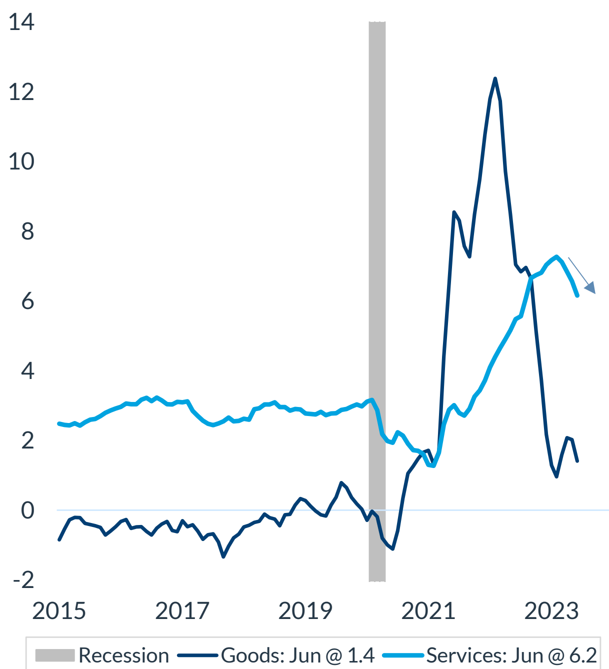
Information is subject to change and is not a guarantee of future results.

to be more "sticky." This is where the news has become far more favorable as of late. Service prices, which have been the major contributor to higher inflation in the past couple of years, are beginning to turn (chart 3). The major portion of service costs is shelter (housing) costs, which have been moving down recently. The three-month annualized change has fallen to 5.5%, a significant decline from the cycle high of February's 9.5% (chart 4). Also, the Fed's "super-core" inflation metric, which measures service costs without housing and tends to be the cost of high labor-intensive services that reflect the cost of labor, is also declining.

Some are crediting the Fed with pulling off "immaculate disinflation," through which the Fed has been able to reverse the direction of inflation, which was at the highest level in four decades, without a massive increase in the unemployment rate.

CHART 3: Core CPI – Goods and Services

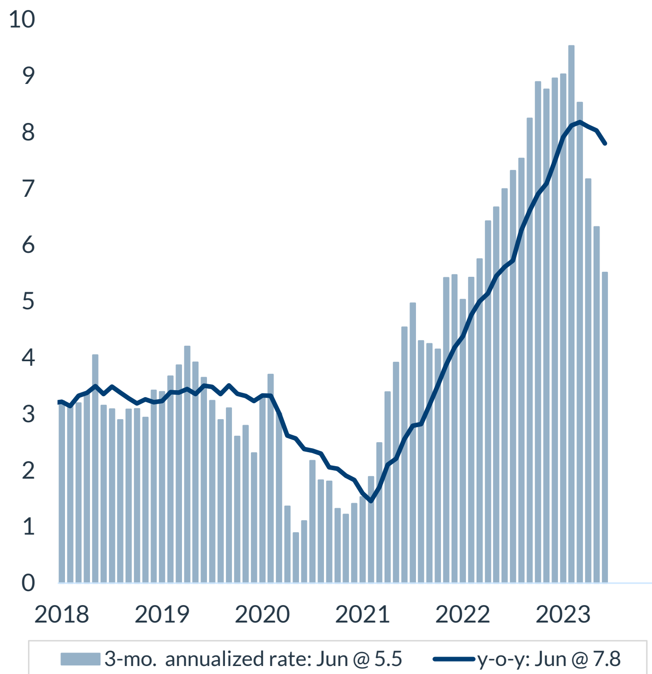
% change, y-o-y, seasonally adjusted



Source: Bureau of Labor Statistics, as of June 2023.

CHART 4: CPI – Shelter

% change, seasonally adjusted



Source: Bureau of Labor Statistics, as of June 2023.

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Market Trends

US stocks have continued their march higher in July, adding to 2023's impressive gain that now has the S&P 500 within 6% of the all-time high. However, stretched valuations and optimistic sentiment about economic growth and the path of interest rates leave markets at risk for a correction or pullback. We expect a less supportive environment in the coming months as the Fed maintains its hawkish tilt, recessionary pressures build and earnings estimates are revised lower.

LABOR

Despite the Fed raising interest rates by 525 basis points, pent-up demand for workers continues, and the unemployment rate hovers around 50-year lows.[1]

THE FED

The Fed has moved the overnight federal funds rate to the median level of 5.375%, the highest level since 2001; it is probably nearing the peak in rates.[2]

HOUSING

Despite mortgage rates near the highest level in about 20 years, demand for homes has been firming, especially new homes, which is a robust job creator.[3]

PERSONAL INCOME

After adjusting for inflation, there were about two years of spending outpacing income. But since February, with inflation falling, income has been outpacing spending.[4]

INFLATION

At 3%, after declining from 9.1% a year ago, the inflation rate is nearing the Fed's target level of 2%, but the Fed will remain vigilant to ensure pricing pressures do not resurge.[5]

AUTO SALES

Auto sales have been on an upward trend over the past year due to pent-up demand and inventory levels nearing normal, despite 20-year high rates on auto loans.[6]

Sources

1. Bureau of Labor Statistics, June 2023
2. The Federal Reserve, July 2023
3. US Census Bureau, Freddie Mac, June 2023
4. Bureau of Economic Analysis, May 2023
5. Bureau of Labor Statistics, June 2023
6. Ward's Automotive Group, Bankrate.com, June 2023

Index Definitions

The consumer price index (CPI) measures the monthly change in prices paid by US consumers.

The S&P 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the US.

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