STATE STREET GLOBAL ADVISORS

July 12, 2024
Commentary

Weekly Economic Perspectives

Contents

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The Economy

Inflation relief boosts rate cut expectations and markets alike.

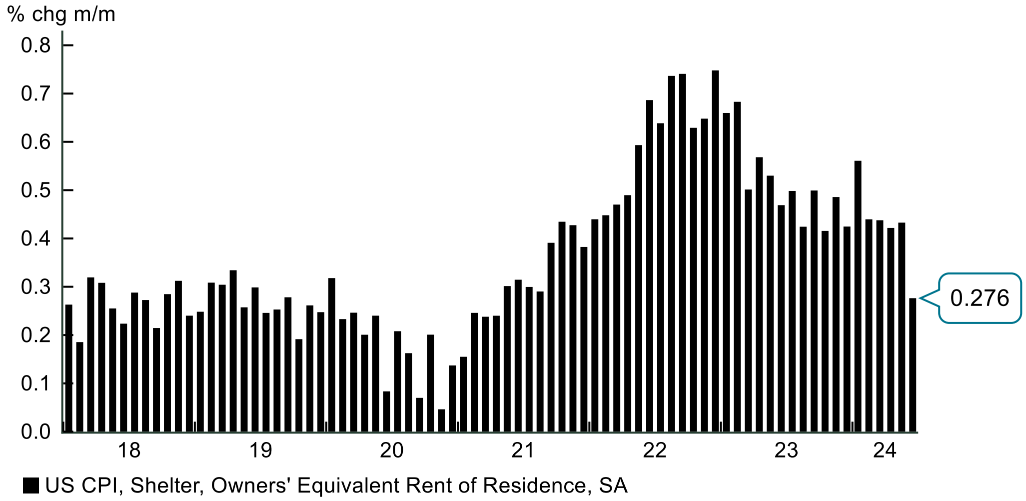
US

The very good May inflation report was followed by an even better June inflation report, such that—if not for the unfortunate shift to a single rate cut in the June FOMC Summary of Economic Projections—a July cut might be a live possibility. As things stand, the market is now fully pricing a first cut in September and looking for nearly 2.5 cuts before year end. We had long favored June or July as the start of the cutting cycle, partly because beginning to ease right before the election is not ideal. However, if the choice is between September and November, the unemployment rate at 4.1% says “do not delay”.

The June inflation report was excellent…but do not expect a full repeat in coming months. Overall prices actually declined 0.1% m/m, lowering headline inflation from 3.3% to 3.0% y/y, the lowest in a year. Core prices (excluding food and energy) rose a soft 0.1%, lowering the core inflation rate by a tenth to 3.3%.

By far the most important piece of the report was the moderation in shelter inflation.

Figure 1: Finally, A Clear Step Down In US Shelter Inflation

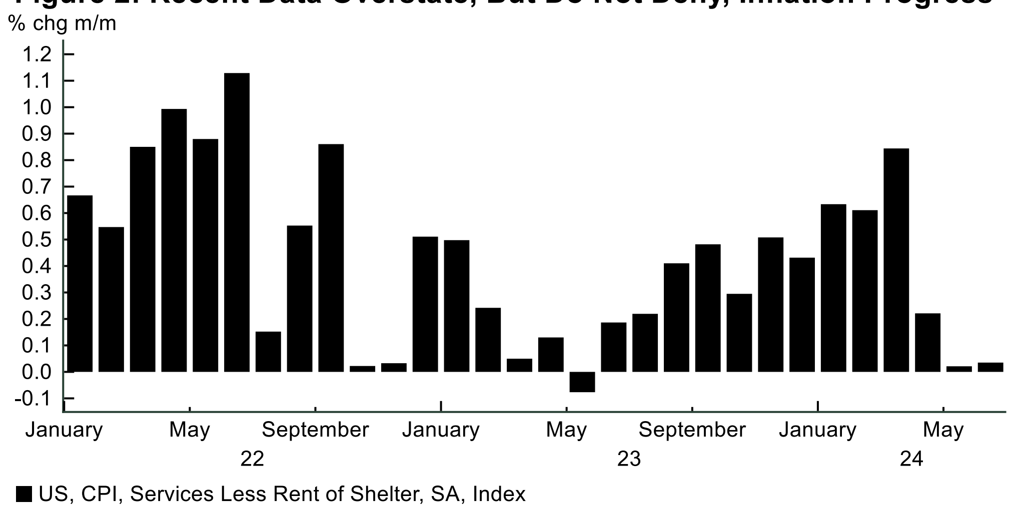


Sources: Macrobond, SSGA Economics, BLS
Updated as of 7/11/2024

Rent of shelter costs increased by only 0.2% m/m—the least since August 2021—as rent of primary residence and owners’ equivalent rent rose 0.3% m/m, and lodging away from home declined 2.0% m/m (the most since October). This may not be repeated so we are reluctant to pencil in equally good reading on overall shelter for the next few months, but we believe that the downshift in primary residence rent and owner’s equivalent rent has staying power. Even lodging away from home could remain under pressure both from a pullback in travel-related spending by more cost conscious consumers, and some possible immigration-related relief. The latter is extraordinarily hard to quantify, but we remain open to the possibility. The snail-pace improvement in shelter inflation has been frustrating to witness given the more benign market-based readings of rent inflation, but at least the progress continues. We look for shelter inflation to slow about one percentage point through year end, from June's 5.2% y/y to 4.3% y/y by December. We see potential for even better outcomes, but prefer to remain cautious.

Inflation was heavily flattered in June by lower energy prices, which slid 2.0% m/m on a 3.8% m/m plunge in gasoline prices. This will not be the case again in July. Food prices increased 0.2%, driven primarily by the "food away from home" category. Broad service categories were very well behaved, likely overstating the sustainable run rate for these categories (Figure 2). Medical services, recreation, education and communication, all posted modest gains or even outright declines. We look for a sequential acceleration near-term, but the fact that we have two months now that "broke" the steady prior uptrend is important. As for motor vehicle insurance—a key driver of higher services inflation lately—prices rose m/m following May's unusual decline, but did so at a much slower pace than through much of the past year. Some relief may be in the pipeline in this segment as premiums catch up with previous increases in underlying replacement costs.

Figure 2: Recent Data Overstate, But Do Not Deny, Inflation Progress



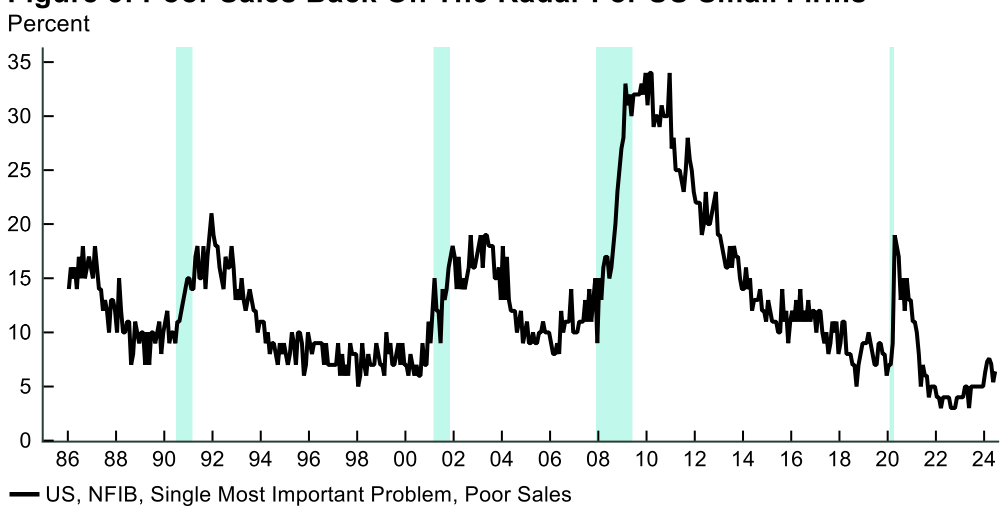
Sources: Macrobond, SSGA Economics, BLS
Updated as of 7/12/2024

Even as inflation is coming down, the **Michigan consumer sentiment index** has failed to meaningfully rally, suggesting a broader sort of malaise taking hold. In the preliminary reading for July, the headline unexpectedly dropped 2.2 points to an eight-month low of 66. Consensus expectations had been for an incremental improvement. Notably, the current situation metric declined to its lowest level since December 2022; expectations declined to a seven-month low. The good news is that Inflation expectations eased in what is primarily a delayed reaction to lower gasoline prices in May and June. Short-term (1 year) inflation expectations eased a tenth to 2.9%, which marks the lowest level since 2020 and a level that had since been reported previously just in January and March this year. Long-term (5-10 year) inflation expectations eased a tenth to 2.9%.

This dynamic is to some degree reflected in the **NFIB (National Federation of Independent Business) index**, which measures sentiment among smaller firms. Thyis metric has languished throughout the Covid recovery even as other macro indicators surged. The two main reasons were the intense competition for labor and the surge in inflation, which smaller businesses are generally not as well equipped to handle than their larger counterparts. Both of those concerns have faded notably, however, yet small business sentiment is still quite subdued. Why? Part of the story is that those earlier concerns about inflation and difficulty finding workers are gradually being replaced by another, perhaps even more ominous: lower sales. The deterioration in the sales outlook is in a fairly incipient stage, but bears close watching because in prior cycles it has prefaced a recession. Small businesses have a higher exposure to the average consumer and so the demand outlook may be dimming a little faster now that lower-income consumers are tightening their belts.

Admittedly, the headline NFIB index rose 1.0 point to a six-month high of 91.5, and the outlook for general business conditions improved to the highest since early 2022. We take this to reflect lower inflation and more ease in finding workers. Indeed, the share of respondents saying they have job openings that are hard to fill declined to match the lowest level since January 2021. Similarly, the share of respondents saying inflation is their biggest problem declined sharply. Meanwhile, profits were little changed while hiring and capex plans were steady.

Figure 3: Poor Sales Back On The Radar For US Small Firms



Sources: Macrobond, SSGA Economics, NFIB
Updated as of 7/12/2024

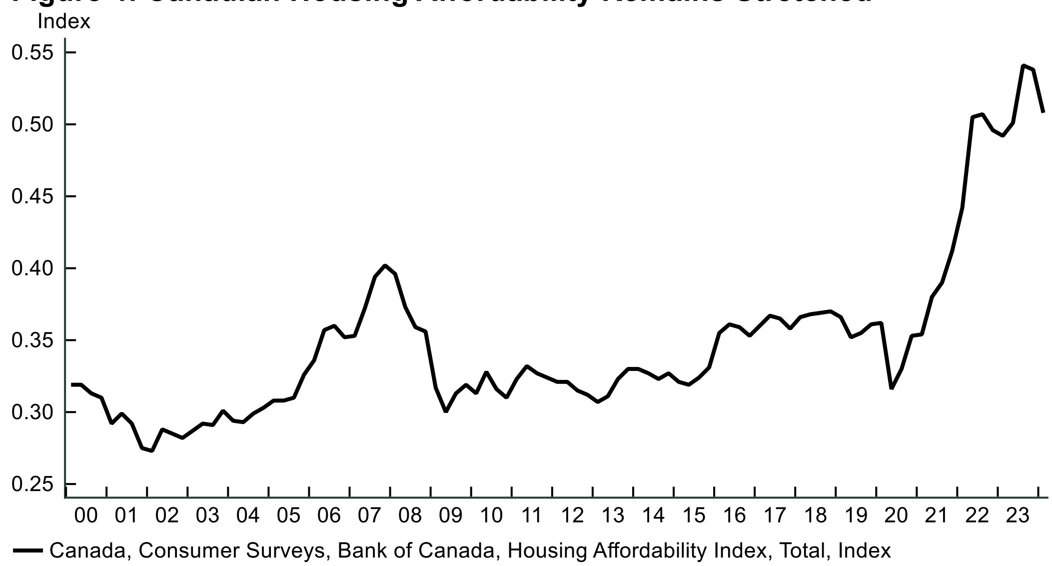
It is in this context that **unemployment claims** are becoming a more relevant indicator than they have been for a while. Initial claims retreated 17k to 222k in the week ended July 5, but continuing claims were little changed and the four-week moving average of continuing claims rose to the highest level since December 2021.

Consumers have been more frugal lately, especially with their use of credit. Total **consumer credit** rose by 11.4 billion in May, with about two thirds of that accounted for by revolving credit (mostly credit cards) and the rest non-revolving credit (student and auto loans). High interest rates are discouraging consumers from using revolving credit: the three-month annual growth rate of revolving credit slowed to 4.2% y/y in May, the slowest increase since May 2021.

Canada

Housing activity showed some signs of recovery, with sales increase supported by lower interest rates and improved supply. **Existing home sales** rose decently 3.7% m/m in June, driven by gains in Ontario, Quebec, B.C., and Alberta. This left the current existing home sales 8% below their pre-pandemic level. Meanwhile, new listings were up 1.5% m/m, leading sales-to-new listings ratio tightening by about 1.0 ppt to 53.9%, below the long-run average. Importantly, the national Composite MLS® Home Price Index (HPI) inched up 0.1% m/m in June. Although the increase was modest, it was the first month-on-month increase in 11 months. Affordability conditions will likely remain challenging in the second half of the year; however, we expect the market will get stronger given that more significant rate cuts are delivered.

Figure 4: Canadian Housing Affordability Remains Stretched



Sources: Macrobond, SSGA Economics, BoC
Updated as of 7/12/2024

Building permits fell 12.2% m/m in May, following a 20.5% surge in April, and largely above market expectations of a 5.2% contraction. The decline was led by sharp drop in construction intentions in British Columbia which experienced a strong increase in building permits in previous month. Excluding British Columbia, the total value of building permits for the other provinces and the territories declined 0.7% m/m in May.

UK

Following an unrevised 0.9% decline in April, **industrial production** rose 0.2% m/m in May. The increase was largely attributed to 0.4%m/m gain in manufacturing, followed by smaller contributing gains in water supply and sewerage (0.4%) and mining and quarrying (0.1%). Meanwhile, electricity and gas fell by 1.9% m/m.

Eurozone

German and French consumer price inflation ticked down marginally to 2.2% y/y in June, but the ECB will not feel that much urgency to follow up on June's first cut of this cycle so soon. Rather, we expect the Governing Council to hold policy rates steady this month and allow more data to flow through and inform the timing of future reductions. Time can also gain the ECB more company in the rate-cutting cycle. The Fed may have forgone the chance to cut in July when the June summary of economic projections shifted to a single cut this year. With much better data in hand, by September, when we expect the ECB to cut again, the Fed will likely step in the ring as well.

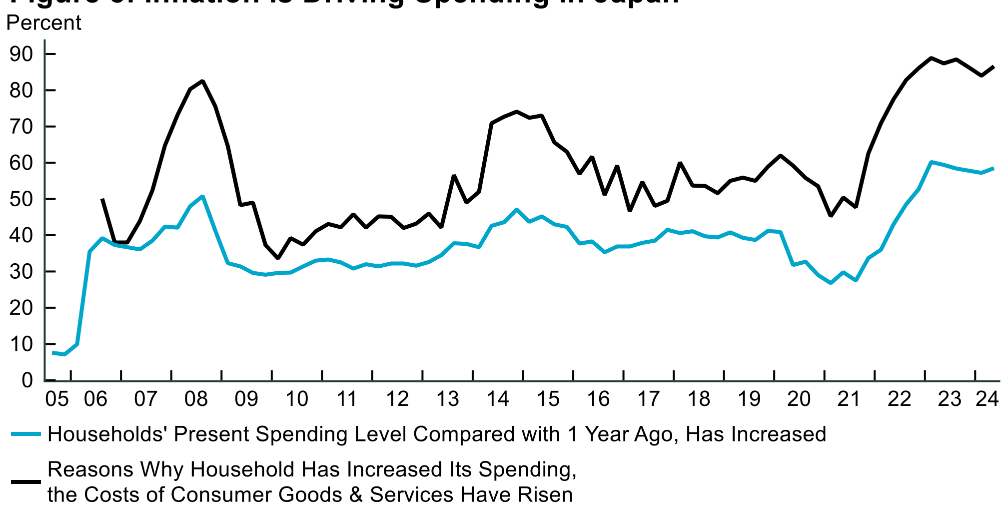
Japan

Household **inflation expectations** rose sharply in the Bank of Japan's (BoJ) Q2 survey of households; average expectations over the next one and five years have risen to all time highs of 11.5% and 8.7% respectively. A record 87.5% and 82.0% of those surveyed expect higher inflation over the next one and five years respectively. This comes just a week after the Tankan report highlighted higher inflation expectations among businesses.

While higher inflation expectations is a great development, a sense of pessimism is gripping households, as spending is driven largely by higher prices. 58.8% of those surveyed are spending higher than they did a year ago, but 86.6% of them say they spend higher because prices have risen (figure 3). Furthermore, only 7.7% saw improved economic conditions from last year, while only 7.9% see them improving in the next year.

Notably, the majority of the people (51.7%) see interest rates as too low, and 58.8% (record high) are not confident in the BoJ as they believed that the Bank is not delivering on its price stability target.

Figure 5: Inflation Is Driving Spending In Japan



Sources: SSGA Economics, BOJ, Macrobond
Updated as of 7/12/2024

The yen rallied this week after a weaker than expected CPI print in the US, up to

157.8, from 159.5 against the USD, and may have resulted in an intervention, according to Asahi. Either way, the yen could remain volatile in the next term and upside risks seem more pronounced, as US CPI could remain on a downtrend. The intervention, if proven true, underscores our view that the primary objective of authorities is to curtal volatility, and not necessarily a weaker yen.

Nominal wages in May accelerated to 1.9% y/y, below consensus and up from a downwardly revised 1.6% (from 2.1%) last month. This is mainly a reflection of a decline in special wages, by -8.5%. A closer look reveals that basic wages rose 2.5%, up from 1.8% in April, marking the strongest growth since January 1993! On a constant sample basis, wages jumped by 2.7%, five-tenths above the consensus (April 2.3%). The data flags upside risks to our bullish views on wage growth in Japan. Separately, **goods PPI** rose 2.9% y/y, the fastest pace in a year. This adds to expectations that inflation will more or less remain above the Bank's 2% target.

The BoJ met with bond market representatives, and the large banks are said to have called for deep cuts to the Bank's JGB purchases. Regular readers will recall that we have been expecting domestic institutions, especially banks, to improve their JGB holdings. Overall, the takeaway for us is that financial institutions are asking for considerable action from the BoJ. Japan's Government Pension Investment Fund's (GPIF) JGB holdings rose by 25% to 50.3 trillion yen in FY 2024, as reported by Bloomberg, and is expected to serve as an important support to the bond market, as the biggest buyer (BoJ) slowly steps down.

We see the next BoJ meeting as a landmark and expect a loud and clear pivot from the Bank. We expect the policy rate to be raised to 0.25% and bond purchases to be cut significantly. Next week, we expect national CPI to have topped 3.0% y/y.

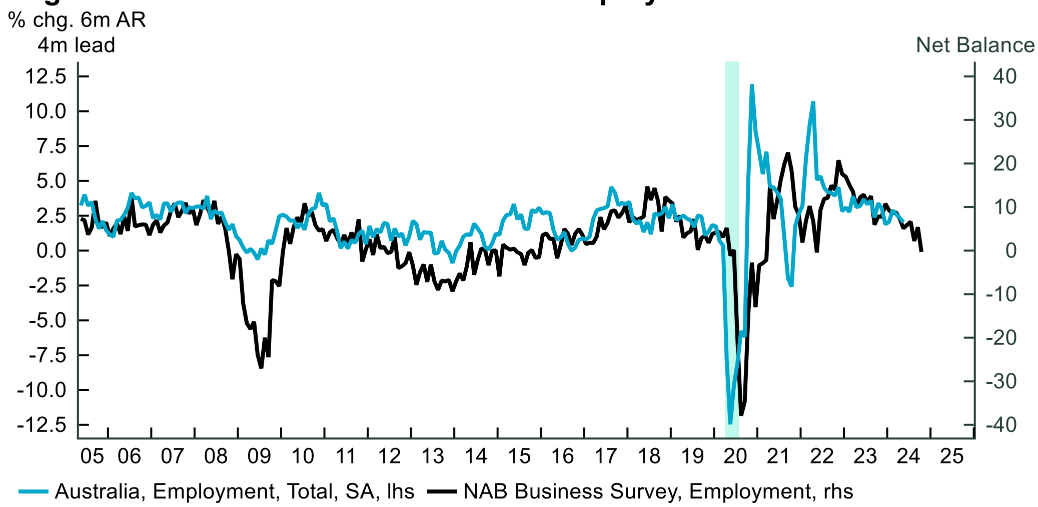
Australia

Home loan approvals declined -1.7% m/m in May, bucking consensus expectations for an increase of similar magnitude. This is a broad-based decline with weaknesses across categories, as investor lending (-1.3%) and owner-occupier (-2.0%) declining. The housing sector remains in focus in Australia, and is acting as a primary channel through which monetary policy transmission is happening.

The **Westpac-Melbourne Institute Consumer Sentiment** declined 1.1% m/m in July, and the index level of 82.7 remains quite pessimistic. Consumers worried about persistent inflation and high interest rates. *60% of those surveyed expected higher mortgage rates in the next 12 months, up from 48.3% last month*.

Separately, the **NAB Business Survey** showed that the business conditions index fell 2 points to +4, with worrying underlying details. The employment index plunged 6 points to 0, the lowest in nearly three years. There is a decent correlation between the NAB employment index and the employment data (figure 4).

Figure 6: Downside Risks For Aussie Employment



Sources: SSGA Economics, ABS, NAB, Macrobond
Updated as of 7/12/2024

However, most of the employment growth has been concentrated in government and healthcare industries and muted in the rest. The NAB index from a design angle overstates the weaknesses in the broader industries. So, there is still a chance that employment data next week may show an upside surprise. However, as we have argued earlier, the Beveridge Curve indicates that the unemployment rate may increase from now on, as job openings have been declining for some time.

The NAB survey's prices metrics eased considerably too; labor costs (-0.4 pts to 1.8% q/q), purchase costs (-0.4 pts to 1.3%) and final production prices, all have slowed. The prices index has halved from the recent highs to 0.7%, meaning that disinflation has been happening after all in Australia. Our call of no further RBA hikes, but rather, the first rate cut in November remains intact. Next week, we expect total employment to have risen just 15k in June.

Week in Review (Jul 08 – Jul 12)

Country	Release (Date, format)	Consensus	Actual	Last	Comments
Monday, Jul 08					
US	Consumer Credit (May, $ bn)	8.850	11.354	6.485 (↑)	Revolving credit growth has slowed.
JN	Labor Cash Earnings (May, y/y)	2.1%	1.9%	1.6% (↓)	Constant sample basis, wages rose significantly.
AU	Westpac Consumer Conf Index (Jul)	na	82.7	83.6	Rate hike fears.
AU	NAB Business Confidence (Jun)	na	4	-2 (↑)	Business conditions (concurrent signal) declined.
Tuesday, Jul 09					
US	NFIB Small Business Optimism (Jun)	90.2	91.5	90.5	Marginal improvement, mixed details.
JN	PPI (Jun, y/y)	2.9%	2.9%	2.6% (↑)	Good. But, how much is driven by the yen?
Wednesday, Jul 10					
IT	Industrial Production (May, m/m)	0.0%	0.5%	-1.0%	Good data.
JN	Core Machine Orders (May, m/m)	0.8%	-3.2%	-2.9%	Soft.
Thursday, Jul 11					
US	CPI (Jun, y/y)	3.1%	3.0%	3.3%	Pleasant surprise, but overstates progress.
US	Initial Jobless Claims (Jul 06, thous)	235	222	238	Modest pullback.
US	Continuing Claims (Jun 29, thous)	1,860	1,852	1,856 (↓)	4-week moving average ticked higher.
US	Monthly Budget Statement (Jun, $ bn)	-76.1	-66.0	-347.1	Surprisingly benign.
UK	Industrial Production	n/a	0.2%	-0.9%	Modest increase.
GE	CPI (Jun, y/y, final)	2.2% (p)	2.2%	2.4%	Fine.
Friday, Jul 12					
US	PPI Final Demand (Jun, y/y)	2.3%	2.6%	2.4% (↑)	Driven by services.
US	U. of Mich. Sentiment (Jul, prelim)	68.5	66.0	68.2	Inflation expectations eased.
CA	Building Permits (May, m/m)	-5.2%	-12.2%	20.5%	British Columbia led the decline.
CA	Existing Home Sales (Jun, m/m)	na	3.7%	-0.6%	Welcome improvement.
FR	CPI (Jun, y/y, final)	2.1% (p)	2.2%	2.3%	Fine.
JN	Industrial Production (May, m/m, final)	2.8% (p)	3.6%	-0.9%	Fantastic upside revision.
JN	Capacity Utilization (May, m/m)	na	4.1%	0.3%	Notable improvement.

Source: for data, Bloomberg®; for commentary, SSGA Economics.

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2022.

† This figure is presented as of June 30, 2023, and includes approximately $63 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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