Industry Snapshots

Arrow denotes 12-month moving total/average direction.

RETAIL SALES	Steep Rise
WHOLESALE TRADE	Steep Rise
AUTO PRODUCTION	Flat
MANUFACTURING	Mild Rise
ROTARY RIG	Mild Rise
CAPITAL GOODS	Mild Rise
NONRESIDENTIAL CONSTRUCTION	Mild Rise
RESIDENTIAL CONSTRUCTION	Steep Rise

Steep Rise · Mild Rise · Flat · Mild Decline · Steep Decline

Macroeconomic Outlook

Slowing growth is the prevailing trend for the US economy right now. Whether looking at the industrial sector, business-to-business spending, the housing market, or consumer spending, we are seeing growth decelerate. We expect the economy to move along the back side of the business cycle into the latter half of next year as demand cools and the effects of stimulus fade.

US Real GDP's first-quarter decline – driven by inventories, net exports, and other factors outside of domestic consumption – has raised speculation regarding the bottom of the business cycle. Will there be a soft landing (slowing growth) or a hard landing (recession)? To answer that, let's examine the health of the US economy.

The US Consumer Price Index rose 8.6% from May 2021 to May 2022, the fastest pace of rise since 1981. The Federal Reserve Board has acted forcefully in its attempt to temper rising prices, raising the federal funds rate by 75 basis points – a first since 1994 – in its most recent meeting. Meanwhile, permits for new single-family homes came in weak in both April and May as mortgage rates moved higher.

> *"We are calling for Real GDP to trend relatively flat at the bottom of this business cycle"*

In light of this and other datapoints, such as low consumer confidence and Wall Street's bear market, news outlets have expressed heightened concern over a potential recession. But these are far from ironclad indications of recession. While we are watching risks closely, our latest analysis suggests that if a technical recession (two consecutive quarters of GDP decline) occurs, it will be exceedingly mild. Real Personal Income (excluding current transfer receipts such as stimulus, tax credits, etc.) continues to rise. The percentage of income dedicated to debt payments is also exceedingly low. These trends bode well for the consumer, who drives roughly two thirds of the US economy. More broadly though, we are calling for Real GDP to trend relatively flat at the bottom of this business cycle. Ask yourself whether your business decisions would materially change if you expected the economy to contract 0.1% versus grow 0.1%.

We think the media's fixation on recession probability has obscured the more important factor of this business cycle: margin pressures. We expect labor to remain scarce and inflation to stay elevated (despite some easing from late 2022 through 2023) for at least the next three years. Rents are rising. Input costs are higher. Interest rates are up. Controlling costs, becoming more efficient, and being ready to capitalize on the consumer and business strength inherent to this business cycle should be the focus for most firms at this time. A final note: it will be especially important this cycle to know the trajectory of your own individual markets, as some will be more likely to contract than others. If you need help with this, reach out to us.

Plan. Implement. Excel.

Make Your Move

Relative to the norms of the past decade, inflation will remain elevated through at least 2024. Ensure you are evaluating your business on a volume basis as well as a revenue basis, as volatile prices may skew your data.

Investor Update

The S&P 500 ended May essentially even with the prior month, but the month-to-month flatness obscures elevated volatility. We are at heightened risk for more bumps and bruises in the market for at least the beginning of summer and potentially as far out as the end of the year. However, those who exit the market today risk missing out on the rally that will occur when the headwinds begin to fade.

ITR Economics Long-Term View

2022	2023	2024
SLOWING GROWTH	SLOWING GROWTH	GROWTH

Leading Indicator Snapshot

	3Q2022	4Q2022	1Q2023
ITR Leading Indicator™	🔴	🔴	⚪
ITR Retail Sales Leading Indicator™	🟢	🟢	🔴
US OECD Leading Indicator	🔴	🔴	⚪
US ISM PMI (Purchasing Managers Index)	🔴	🔴	🔴
US Total Industry Capacity Utilization Rate	🔴	🔴	⚪

🟢 *Denotes that the indicator signals cyclical rise for the economy in the given quarter.*

🔴 *Denotes that the indicator signals cyclical decline for the economy in the given quarter.*

⚪ *N/A*

KEY TAKEAWAYS

- Ongoing descent in the majority of leading indicators suggests the nascent slowing growth trend in US Industrial Production is likely to hold.
- The preponderance of leading indicators are exhibiting cyclical trends that signal Production will be on the back side of the business cycle into at least early next year.
- We expect a soft landing – or no-recession scenario – for the US industrial sector this cycle given the financial health of consumers and businesses, as well as ongoing interest in reshoring and shortening supply chains.

onDemand

Industry Analysis

RETAIL SALES

- US Total Retail Sales in the 12 months through April came in at $7.750 trillion, up 14.1% from the same period one year ago; growth is slowing
- We expect slowing growth to persist through at least the next two to three quarters given declining leading indicators, fading stimulus effects, and rising interest rates
- Strong consumer fundamentals (e.g., low debt-to-income ratios and a strong labor market) and inflationary pressures suggest that Retail Sales will avoid outright contraction this cycle

AUTO PRODUCTION

- North America Light Vehicle Production in the 12 months through April was down 6.5% from the year-ago level
- Production is trending below the year-ago level largely because last year's brief ramp-up is now the basis for comparison
- While the semiconductor shortage is still a major pain point, supply constraints are starting to ease relative to 2021 conditions, and the industry Capacity Utilization Rate is rising

ROTARY RIG

- The US Rotary Rig Count in the three months through May averaged 690, up 59.5% from the same three months one year earlier
- Elevated oil and gas prices and low inventories illustrate a need for additional active rigs
- However, the industry is contending with a lack of quality acreage, labor shortages, and materials shortages, as well as E&P firms' disciplined spending practices

TOTAL NONRESIDENTIAL CONSTRUCTION

- US Total Nonresidential Construction in the 12 months through April totaled $821.4 billion, up 1.7% from one year ago
- Accelerating growth in US Architecture, Engineering, and Related Services Revenue, a leading indicator to Construction, signals cyclical rise in Construction will persist in at least the coming quarters
- The US New Nonresidential Construction Producer Price Index in May was 18.4% above the May 2021 level; those in the nonresidential construction space should carefully track activity as well as dollars

WHOLESALE TRADE

- US Total Wholesale Trade during the 12 months through April totaled $7.578 trillion, up 23.8% from one year ago; this marked a tentative transition to slowing growth
- Our analysis indicates that this transition is likely to hold
- Elevated prices are leading to very high growth rates in war- and sanctions-impacted segments such as raw food and petroleum products; the auto segment is rising at a single-digit pace as volume suffers amid supply chain constraints

MANUFACTURING

- Annual US Total Manufacturing Production during the 12 months through May was up 5.6% from one year ago; Production growth is slowing from a March business cycle peak
- The ITR Checking Points™ system, as well as trends in the ITR Leading Indicator™, points to slowing growth in the coming quarters
- Renewed investment in US industry will likely boost output in the coming years and supports our expectation for a soft landing for US manufacturing in this business cycle

CAPITAL GOODS NEW ORDERS

- US Nondefense Capital Goods New Orders (excluding aircraft) during the 12 months were up 12.6% from one year ago
- The increased need for automation and strong consumer trends will likely push New Orders higher in the coming quarters, but growth will slow as the macroeconomy softens and firms increase scrutiny on expenditures
- Inflation is skewing this dataset; businesses should track volume, not just sales

TOTAL RESIDENTIAL CONSTRUCTION

- US Total Residential Construction in the 12 months through April totaled $827.7 billion, up 21.9% from one year ago
- The US Homeowner Vacancy Rate was at a record-low 0.8% in the first quarter of 2022, underscoring the need for more housing stock
- Rising mortgage rates, now threatening to breach the 6% mark, will slow the pace of building in the future, but the acute need for housing this cycle puts the industry in a very different situation than in 2006–07

A Closer Look: The US Economy

Where We Are on Inflation, How We Got There, and What's Coming

BY: JACKIE GREENE

What you need to know: Inflation will peak soon, but prices will continue to rise

Inflation is high in everyone's mind. We are frequently being asked: "When will inflation go back to normal?"

Let's start there. Inflation, as measured by the Consumer Price Index (CPI), is not projected to return to the pre-COVID five-year average of 1.5% during the next three years. The economic and political landscape has shifted, and we are in an updated version of the Roaring Twenties – this is a decade we have long said would be one of overall growth but also of higher inflation.

WHERE IS INFLATION GOING?

Inflation – the rate of rise in prices – will not increase forever. One of the primary culprits that caused our current high inflation – the supply chain – is showing signs of easing. The New York Federal Reserve's Global Supply Chain Pressure Index, which leads inflation through the business cycle, is starting to ease, though it remains very elevated.

Because of this and other factors, like slowing macroeconomic growth, we expect that inflation on a 3/12 basis (i.e., the percentage change between the most recent three months of Consumer Prices and the same three months one year earlier) will peak around the third quarter of 2022 at roughly 9.1%. We expect a disinflationary trend will emerge by the end of this year and persist into the second half of 2023. Disinflation is not the same as deflation. During disinflation, prices are rising, but the rate at which they are rising is easing. We are projecting that inflation will recede to a low of approximately 3.2% during the second half of 2023.

This outlook is noticeably higher than what you would have heard from us just one year ago. At that point, we were calling for the CPI 3/12 to peak at 4.4% and for the subsequent low to bring the inflation rate down to 2.3%.

WHAT HAPPENED?

1. In July 2021, we issued a revised CPI forecast calling for a CPI 3/12 peak of 5.8% in the fourth quarter of 2021. In December 2021, we lifted the forecast further, changing our expectation for the timing of the CPI 3/12 peak to the first quarter of 2022 and raising the expected magnitude to 6.7%. The increases in this forecast were largely due to the unprecedented level of stimulus and its boost to the consumer's ability to spend while the supply chain was still quite constrained. The forecasts were based on economic fundamentals; however, even based on these fundamentals, we underestimated what the inflation rate would be.

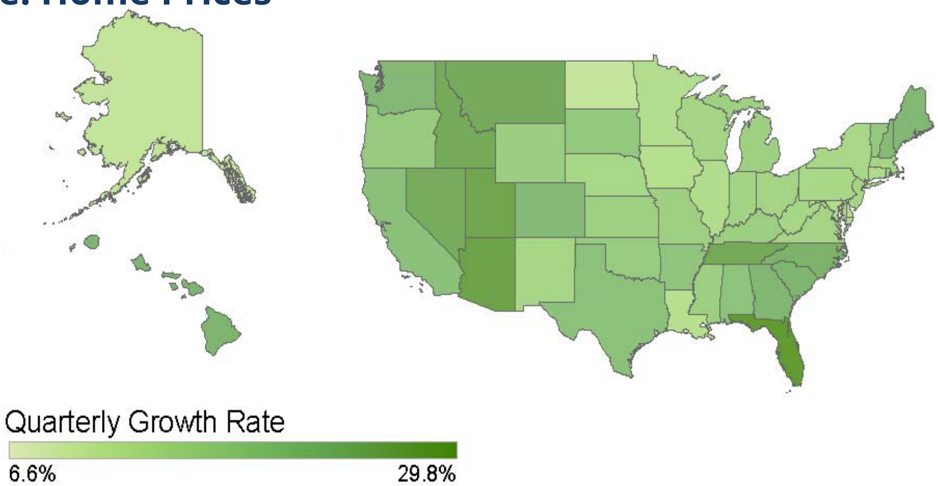
2. In March 2022, we issued a new CPI forecast that called for an inflation peak of 8.4% to occur in mid-2022. That forecast was produced to account for the unfolding developments around Russia's invasion of Ukraine and renewed COVID-related shutdowns in China. These non-economic events are impacting inflation in the following ways:

a. Supply chains – We had previously expected that supply chains would be easing as we traversed 2022. China's shutdowns have both reduced capacity and elongated the shipping times for goods out of China. The Ukraine war has reduced the supply of select goods (wheat, neon, soda, ash, etc.) altogether.

b. Commodity prices – In some instances, supply chain issues and a lack of processing capacity are hindering commodities, but the greater factor is fear and war-related sanctions, which caused an overnight increase in oil and natural gas prices that led to increases for other commodity prices as well. The price increases in oil and gas as energy inputs and other commodities as general inputs have a wide ripple effect on overall pricing that makes its way to the consumer.

3. As war in Ukraine persists, we have judged it necessary to update our CPI forecast more frequently than normal, in alignment with our previous decision to provide you with "wartime forecasts." The ongoing war is proving to have a more severe impact on the supply chain than we had previously anticipated, and we expect commodity prices to remain elevated accordingly. We will continue to monitor the situation.

State-by-State: Home Prices



- US Home Prices were up 18.9% in the first quarter compared to the first quarter of 2021.
- Prices rose at double-digit rates in every state; Prices rose the slowest (6.6%) for the District of Columbia.
- The steepest Prices rise was generally concentrated in states in the Mountain West, northern New England, and Southeast, reflecting intra-US demographic and migration trends. Accordingly, Prices rise was typically more muted than the national average in the Mid-Atlantic, Great Lakes, and Central region states.
- We are likely to see less robust rise in Home Prices in the coming quarters as rising mortgage rates cool some demand for homes, but the housing shortage and strong labor market signal that sharp contraction would be improbable.

Reader's Forum

The Federal Reserve's monetary policy is raising my borrowing costs. Does it still make sense to borrow to invest in my business?

John Olson, Economist at ITR Economics™, answers:

During the pandemic, corporate borrowing costs fell to unprecedented lows, with monthly US Corporate AAA Bond Yields reaching roughly 2% in mid-2020. Since then, Yields have more than doubled, surpassing 4% in May and June of this year. Yields are likely to continue to rise as the Federal Reserve issues more hikes to the federal funds rate in order to tame high inflation. As a result, borrowing costs for many businesses are likely to continue to rise. However, Yields are relatively low compared to historical levels. One needs only go back to 2013 to see Yields at a higher level, and the 2014–2018 period includes multiple instances of 4+% Yields.

Just as importantly – or even more importantly – interest rates are much lower than inflation. Borrowing now to become more efficient and save on costs later is an option worth pursuing. We encourage businesses to perform ROI analyses for any potential investments. Expenditures which are likely to create efficiency gains and save on labor costs may be the most prudent, as we expect labor costs to continue to rise in this tight labor market. Don't wait too long, though. If you have determined that such a project is right for you, then run – don't walk – to your banker.

Please send questions to: questions@itreconomics.com