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In the Markets Now

An economic conundrum

We believe in the old saying: a picture is worth a thousand words. Here, we aim to recap recent market action and provide some perspective to investors.

PWM Equity & Fixed Income Research
Ross Mayfield, CFA
Investment Strategy Analyst

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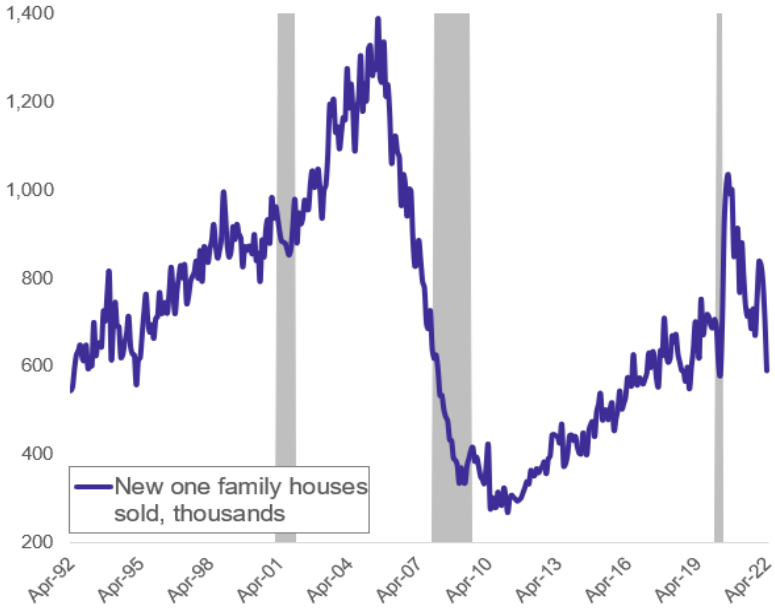
WHY A "SOFT LANDING" IS A CHALLENGE

Of the many headwinds facing the market, the largest is the rapid shift in expectations for monetary policy at the Federal Reserve. In the early part of the pandemic, the Fed let the economy run hot to get the unemployment rate down from 15%. They succeeded, but in some ways rising inflation has been the price paid. So (while somewhat behind the curve), the Fed has officially shifted into inflation-fighting mode. They do this primarily by raising interest rates to stymie demand – less borrowing, less spending, less hiring, etc. At a high level, curbing demand should cool the economy and moderate inflation. However, it's a tightrope act – a step too far and you can induce an economic slowdown or worse, recession (which many past instances have, in fact, preceded).

The Fed is also limited by only being able to influence the demand side of things; the supply side of the equation is largely out of their control. War in Ukraine is roiling commodity markets, China's Covid-19 policy is causing a redux of the early-pandemic supply chain turmoil, and other strains across the globe persist. **In the end, this is why a "soft landing" – i.e. curbing inflation without inducing a recession – is incredibly difficult.** To stop inflation, the Fed must intentionally cool our economy. But without some supply-side help, the task of doing so succesfully becomes inifinitely more challenging.

An example playing out before our eyes is in the housing market. The pandemic and demographics stimulated housing demand, while record low mortgage rates helped juice the activity. At the same time, housing supply was limited by underinvestment post-2008, as well as global supply chain problems and labor shortages. This created an unsustainably hot housing market, fueling the sort of sticky inflation the Fed wants to curb. And sure enough, as the Fed has pivoted, mortgage rates have spiked to decade highs**.** That leads us to this week's housing data: sales of newly built homes dropped 17% m/m in April, far more than expected, and are down 27% y/y. That is the slowest pace since April 2020. As our partners at Strategas wrote, "parts of the U.S. economy that have been strong (e.g., housing) have invited a more aggressive Fed response. Some moderation [in the housing market] is likely welcome at the central bank, as it reflects the transmission of tighter policy." **What may be seen as a success for the Fed represents a challenge for the actual economy. This is the conundrum we face.**



On the brighter side, there are a few items that suggest a recession (if it's to occur) could be milder in nature. The US consumer has accumulated over $2 trillion in excess savings over the last few years. The labor market is as hot as it's been in decades. Corporate earnings are still growing. There are reasons for optimism. But there is also little doubt that markets face a uniquely challenging near-term environment. **So in these times of discomfort, much like the many we have faced before, it pays to zoom out, focus on your long-term plan, control the things you can, and lean on your Baird Advisor above all else.**

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