GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—February 28th, 2022

The tumultuous start to 2022 is getting even more chaotic as the Russian invasion of Ukraine is sending shock waves through the financial markets, upending forecasts of global growth, inflation and government policies and, most importantly, sowing confusion and uncertainty on Wall Street. This is not a time for the faint of heart, nor is it advisable to hold firm convictions over what will happen next. So far, some of the immediate effects of the outbreak have been predictable. Oil prices shot through the roof on Thursday, with crude quotes surpassing $100 barrel for the first time since 2014, which not coincidentally was when Russia invaded Ukraine and seized control of Crimea, before skidding back under that threshold later in the day.

One question on many minds is whether the military conflagration will alter the Fed's rate-hiking plan that is poised to begin next month. Until this week, the focus of attention was whether the first increase would be 25 or 50 basis points, with a growing fraction of forecasters moving to the 50 basis point camp as inflationary pressures continued to gain traction. Although some Fed officials pushed back on that notion earlier this week, the Russian invasion drove a deeper wedge into the forecasting community regarding the Fed's next move. For sure, the spike in oil as well as an array of other commodity prices, including food, heightened near-term inflationary expectations and prompted widespread upgrades to the inflation outlook for 2022. That, in turn, solidified expectations on Wall Street of a 50 basis point move next month.

But there is more than trivial concern over the growth-dampening effects that heightened geopolitical tensions could have on economic activity, reinforcing the drag from ongoing pandemic-related influences. Household sentiment is already sinking, as inflation is taking a big bite out of incomes. Higher gasoline prices are another tax on incomes that is likely to sap discretionary spending, particularly among lower-income individuals. And while stock prices have rebounded admirably on Thursday and Friday, the shock effects from a protracted war could yet undercut investor confidence and send the market into a tailspin. The potential for large-scale wealth destruction would further undercut consumer spending.

At this juncture, Fed officials are standing firm on their plans, as several have commented in recent days that they would not be deterred in their inflation-fighting efforts by the Russian invasion. Whether market participants are buying into that assurance is open to question. Some analysts believe that that the astonishing rally in stock prices late in the week reflects expectations of a slower path of rate increases than prevailed before the invasion. From our lens, the uncertainty ignited by the Russian invasion of Ukraine will likely inject some caution into the Fed's thinking at the mid-March policy meeting and keep the initial rate hike at 25 basis points. That said, we believe that the fallout from the Russian invasion will be less damaging to the U.S. economy than for other nations. Indeed, the impact in boosting inflation should outweigh the negative impact on growth.

Hence, we believe the economy has enough momentum to withstand a steady dose of rate increases over the course of the year. Barring an unexpected weak reading on the job market for February, the Fed will be looking at considerably stronger data for the first quarter than thought a month or so ago at its March 15-16 policy meeting. This week's batch of data, particularly on personal incomes and consumption, confirms that the year got off to a solid start. As indicated by the retail sales report released last week, the economy's main growth driver, consumer spending, powered through the Omicron headwinds and advanced strongly in January.

Importantly, the increase in personal consumption last month exceeded the rise in prices, as real spending rose by healthy 1.5 percent, the strongest since March of last year when the last stimulus payments reached household bank accounts. The gain was paced by a sharp increase in outlays for autos and other durable goods, but consumers also opened their wallets for clothing and household furnishings. As expected, the Omicron variant suppressed activity for in-person services, particularly dining out at eating and drinking establishments. But weekly data indicates that transactions in services picked up later in the month, reflecting the rapid decline in Covid case counts. The continued improvement on the health front is a positive sign for this month as well.

However, it's questionable if the buoyant spending of households in January can be sustained over the course of the year. No doubt, with the improving health situation and relaxation of pandemic restrictions, people will resume spending on in-person services, such as dining out, attending concerts, theaters and sporting events. But pocketbook issues are becoming a headwind, which should have a restraining effect on overall spending. On a positive note, the robust job market is generating healthy paychecks for workers. Wages and salaries increased by sturdy 0.5 percent in January, which just about offset the loss of government benefit payments during the month. But that tradeoff meant that personal incomes failed to increase for the first time in four months.

What's worse is that income growth stalled while inflation accelerated. The personal consumption deflator shot up to 6.1 percent from a year earlier from 5.8 percent in December while the annual increase in the core PCE, which excludes food and energy, also firmed by 0.3 percent to 5.2 percent. Both price measures posted the fastest annual increases since the early 1980s echoing the trend in the consumer price index. As a result, inflation took an ever-greater toll on household purchasing power. Indeed, real disposable income plunged by nearly 10 percent in January from a year earlier, the steepest annual decline ever recorded.

With spending outpacing income growth, households had to dip further into savings to finance purchases. The personal savings rate skidded to 6.4 percent, the lowest level since December 2013 and quite a shrinkage from the elevated average monthly rate of 14.7 percent since the onset of the pandemic 22 months ago. To be sure, households still have a formidable financial cushion built up during the pandemic, thanks to the surge in asset values over the past two years. But the massive government transfer payments that padded savings accounts during the period have been all but used up. Between February 2020 and March of last year, personal savings swelled by $4.4 trillion. Over the past 10 months, however, personal savings have shrunk by $4.6 trillion.

With the end of fiscal support and the Fed about to start tightening credit conditions, the economy will have to power ahead on its own two feet. The good news is that it has some tailwinds at its back as the private sector is taking up the slack. The job market remains strong and wages should continue to advance at a healthy clip, providing households with necessary firepower to keep the spending spigot open, albeit less wide than last year. Meanwhile, businesses are opening their budgets for capital spending, striving to augment scarce labor with productivity-enhancing machinery and equipment. More evidence of that trend was revealed this week, as the Commerce Department reported another hefty increase in capital goods orders for January. The 0.9 percent advance lifted the total 10.5 percent ahead of the year-earlier level.

The Russian invasion may extend the supply constraints that are holding back output. But its inflationary impact together with the still-firm economic underpinnings should encourage the Fed to take the first step in the tightening cycle next month.

FINANCIAL INDICATORS

INTEREST RATES	Feb 25	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.32	0.35	0.20	0.04
6-month Treasury bill	0.69	0.63	0.43	0.05
3-month LIBOR	0.51	0.48	0.30	0.19
2-year Treasury note	1.58	1.47	1.16	0.14
5-year Treasury note	1.87	1.82	1.62	0.75
10-year Treasury note	1.97	1.93	1.77	1.44
30-year Treasury bond	2.28	2.25	2.08	2.17
30-year fixed mortgage rate	3.89	3.92	3.55	2.97
15-year fixed mortgage rate	3.14	3.15	2.80	2.34
5/1-year adjustable rate	2.98	2.98	2.70	2.99

STOCK MARKET				
Dow Jones Industrial Index	34,058.75	34,079.18	34,725.47	31,496.30
S&P 500	4,384.65	4,348.87	4,431.85	3,841.94
NASDAQ	13,694.62	13,548.07	13,770.57	13,192.35

COMMODITIES				
Gold ($ per troy ounce)	1,890.10	1,900.80	1,792.90	1,742.85
Oil ($ per barrel) - Crude Futures (WTI)	91.94	91.66	87.31	62.30

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Confidence Index (February)	110.5	111.1	115.2	111.7
Durable Goods Orders (January) - % chg	1.6	1.2	3.2	1.2
Personal Income (January) - % change	0.0	0.4	0.6	0.2
Personal Consumption (January) - % chg	0.5	0.7	0.7	0.7
Personal Savings Rate (January) - Percent	6.4	8.2	7.2	7.8
New Home Sales (January) - 000s	801	839	749	742