GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—March 14th, 2022

With the war still raging in Ukraine, more heat added to already sizzling inflation, the Federal Reserve poised to hike interest rates and U.S. stocks in correction territory, about the only bit of good news this week was that the baseball strike ended, promising fans a full 162-game season. Of note is that the minimum annual wage for baseball players was raised from $570 thousand to $700 thousand immediately, a 23 percent boost that far exceeds inflation. Unfortunately, that distinction does not extend to most armchair buffs that eagerly follow the sport. If there's any consolation, the pact provides for an increase to $780 thousand over the next three years, a boost that comes to less than 4 percent a year, which can be readily matched by workers in today's tight labor market.

The question is, where will inflation be heading over the next 3-5 years? Prior to the Russian invasion, most expected that the pandemic-driven spiral in prices would be peaking by now as health conditions improved and supply-chain stresses eased. Helped by favorable base effects, slowing economic growth underpinned by the withdrawal of monetary and fiscal stimulus, and shifting consumer demand away from goods to services, the year-over-year inflation rate was expected to slide below 3 percent by year's end. That's no longer the most likely prospect. Far from peaking, price gains are accelerating and expectations of future inflation are picking up. In the bond market, the 5-year break-even rate is rapidly climbing, reaching 3.42 percent on Thursday, a record high for this series going back to 2003 and up by more than half-percent over the past month.

To be sure, inflation was gaining traction and running ahead of expectations well before the Russian invasion. But the war has sent it into a higher gear, driving oil, food and commodity prices spiraling to levels not imagined a few weeks ago. What's more, the war – like the pandemic – may have a lasting effect on inflation even after it is over. Not only may sanctions stay in place for a variety of geopolitical reasons. The U.S. and its allies are rethinking how it obtains critical resources needed for production with an eye towards making the domestic economy less reliant on goods provided by other, less reliable, nations. While this prospective move towards deglobalization may provide more security, it would also increase production costs and elevate inflation over what it otherwise would be

This week's consumer price reports starkly highlighted the war's near-term impact on inflation. The consumer price index jumped by a sizzling 0.8 percent in February, lifting it 7.9 percent over the past twelve months. That's the highest annual inflation rate since January 1982. The biggest contribution came from spiraling energy and food prices, where supply disruptions are directly linked to the war. Russia is the world's third largest producer of oil and Ukraine is the third largest exporter of wheat. But inflation's tentacles are spreading, as the core CPI, which excludes food and energy items, increased by 6.9 percent in February from a year ago, up from 6.4 percent in January and the fastest since August 1982.

The war's endgame is unclear, but it has compounded supply-chain disruptions that will push out the near-term peak of inflation and slow its descent after the hostilities are over. Indeed, the February CPI report does not capture the rapid increase in oil prices that has taken place so far in March. Food prices are also continuing to climb and taking a big toll on household sentiment, which, according to the latest University of Michigan latest survey, fell to the lowest level since 2011 in early March. Interestingly, consumers are finding little relief from the substitution effect, as less expensive food items are rising at a faster clip than costlier ones. In February, prices of chickens and eggs, two cheaper protein sources, rose by 1.8 percent and 2.2 percent, respectively, more than twice as fast as beef and veal prices, extending a trend underway for the past three months.

And unlike the generous pay package obtained by baseball players, most workers are hard-pressed to keep up with inflation. The outsize increase in consumer prices last month took another bite out of worker purchasing power. Adjusted for inflation, average hourly earnings for all private-sector workers fell by 2.6 percent from a year ago in February. That's the eleventh consecutive month of declining real earnings, the longest stretch of shrinking purchasing power since 2011-2012. The good news is that lowest paid workers are receiving bigger pay raises than their higher-earning colleagues. The bad news is that even their raises are not keeping pace with inflation. The wage tracker compiled by the Federal Reserve Bank of Atlanta shows that earnings of lowest paid workers increased by 5.9 percent over the past twelve months.

Despite the decline in purchasing power and slipping confidence, households continue to spend at a healthy pace, providing fuel for the economy's growth engine. That combination will undoubtedly spur the Federal Reserve to follow through with the first rate increase in more than three years at its upcoming policy meeting next week. We expect the Fed to start with a conservative 25 basis point hike due to the uncertainties surrounding the war, but follow up with a series of increases over the balance of the year to short-circuit inflation before it gains even more traction. Some are questioning whether the economy can withstand the 5 to 7 increases that the markets and consensus of forecasters believe will be forthcoming in 2022, given sagging household purchasing power and the absence of fiscal aid that was a critical source of support over the past two years.

Those negative influences will undoubtedly weigh on consumption, but the drag should be significantly offset by the muscular growth in jobs that will continue to boost wages as well as the healthy financial condition of most households. Thanks to surging home values and stock prices, household net worth grew by $5.3 trillion in the fourth quarter of last year, according to just-released data by the Federal Reserve, lifting the total to a fresh record of $150 trillion. The wealth run-up far and away outpaced the increase in disposable income, giving households a formidable financial cushion to support spending. Homeowners have also seen their stake in homes rise to the highest level since 1986, maintaining an equity share of 69.2 percent at the end of last year. That equity cushion could be converted to cash via home-equity loans should additional funds be needed to finance purchases.

There is some evidence that the bulge in home equity – as well as in overall wealth – is encouraging early retirements among aging baby boomers, something that is holding back the labor force participation rate. To that extent, it is also contributing to the tightness in the labor market and sustaining upward pressure on wages. It could also contribute to the housing shortage that is propelling home prices upward. Ordinarily, homeowners would use their built-up equity cushion to trade up to a more expensive home, putting their existing home on the market. But with mortgage rates rising and confidence in the economy slumping, they may be reluctant to give up the low rate locked in from the original purchase as well as the equity cushion for a down payment that may be needed to meet future expenses.

That said, the remarkable increase in housing wealth is undoubtedly a positive influence in the outlook. Even if it doesn't lead to increased turnover in the housing market, it does give homeowners a firmer sense of financial well-being, as home values usually do not fall abruptly. The conditions that precipitated the housing collapse in 2007 were unusual and are clearly not a threat at the present time. That's not the case for the other source of burgeoning household net worth, the eye-opening appreciation in stock prices. History is replete with episodes of sharply falling stock prices that undercut household confidence and contributed to recessions. What makes that prospect concerning is that stock holdings account for a record 42 percent share of financial assets held by households, which makes them highly vulnerable to a severe market downturn. In light of the dismal performance of the stock market so far this year and the challenging set of circumstances ahead, that's not a trivial risk to the outlook.

It's also important to remember that the enormous wealth gains in recent years have accrued mostly to upper-income households. A large segment of the population is shut out from either owning stocks or a home and relies mainly on paychecks gained through employment. That puts the Federal Reserve is a tricky spot as it sets out on a course of inflation-fighting hikes in interest rates. The objective is to gradually cool off demand and give time for supply to catch up, hoping to glide the economy onto a soft landing.

However, the first to be punished by an overly aggressive policy tightening would be lower-wage workers, as they are the first to be laid off when the economy slows too abruptly. We believe that Fed officials have the tools, knowledge and flexibility to avoid that pitfall. That said, the war in Ukraine and the uncertain impact it will have on growth and inflation heightens the odds of a policy mistake.

FINANCIAL INDICATORS

INTEREST RATES	Mar 11	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.39	0.33	0.36	0.04
6-month Treasury bill	0.75	0.64	0.70	0.06
3-month LIBOR	0.80	0.58	0.39	0.19
2-year Treasury note	1.75	1.49	1.52	0.14
5-year Treasury note	1.95	1.64	1.87	0.85
10-year Treasury note	2.00	1.73	1.94	1.64
30-year Treasury bond	2.36	2.16	2.25	2.40
30-year fixed mortgage rate	3.85	3.76	3.69	3.05
15-year fixed mortgage rate	3.05	3.01	2.93	2.38
5/1-year adjustable rate	2.97	2.91	2.80	2.77
STOCK MARKET				
Dow Jones Industrial Index	32,944.19	33,614.80	34,738.06	32,627.97
S&P 500	4,204.31	4,328.87	4,418.64	3,913.10
NASDAQ	12,843.81	13,313.84	13,791.15	13,319.86
COMMODITIES				
Gold ($ per troy ounce)	1,992.30	1,974.90	1,860.60	1,704.80
Oil ($ per barrel) - Crude Futures (WTI)	109.09	115.00	93.90	65.02

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (Feb) - % change	0.8	0.6	0.6	0.7
Core CPI - (February) - % change	0.5	0.6	0.6	0.5
Small Business Optimism Index (Feb.)	96.7	97.1	98.9	97.9

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