GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—March 28th, 2022

Actions speak louder than words in most cases. But the Fed is flipping the script, or at least massaging it a bit. Recognizing that policymakers waited too long to start reining in monetary stimulus, chair Powell is using the bully pulpit to make up for lost time. At this week's NABE conference in Washington, he promised in no uncertain terms to do whatever it takes to curb inflation, saying "In particular, if we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so. And if we determine that we need to tighten beyond common measures of neutral and into a more restrictive stance, we will do that as well." Simply put, Powell is signaling that the gently rising path of rate hikes outlined at the March 15-16 policy meeting is probably too timid to counteract the inflationary pressures that continue to gain traction.

While nothing has substantively changed between the FOMC meeting and this week's conference, other Fed officials seconded Powell's more hawkish rhetoric. Their motivation is anyone's guess, but the next FOMC meeting is not until May 3-4, leaving plenty of time for bubbling oil and commodity prices, stoked by the war in Ukraine and China's swift lockdown response to another wave of Covid, to un-anchor inflation expectations. The message apparently got through to traders; the 2-year Treasury yield – which is highly sensitive to policy expectations – has spiked by 30 basis points since Powell's speech on Monday. That said, if Powell also wanted to curb the demand-boosting wealth effect from a surging stock market, his words had little effect, as stock prices continued to advance this week.

One development underpinning Powell's growing inflation fear is the ever-tightening labor market, which he views as an "unhealthy" trend. With 1.7 job openings for every unemployed worker, the latter is in a commanding bargaining position to demand bigger wage increases, which companies are passing through to consumers. This link is raising the specter of a wage-price spiral that the Fed wants to short-circuit before it gets off the ground. Powell sees an expanding labor supply, which would diminish worker bargaining power and curtail wage increases, as a possible solution. But there is an important offset to that notion. To the extent that an influx of more workers would lead to more paychecks, an expanding labor supply would also bolster demand through the income effect.

That said, incoming data continue to reveal the extent of labor shortages in the U.S. Among this week's slim batch of economic data releases, the Labor Department reported that new claims for unemployment benefits fell to the lowest level in more than 50 years in the latest week. The weekly figures are volatile, and the four-week average of 211 thousand is still about 30 thousand above that low. But the trend is moving decisively downward, having slid from a nearby peak of 255 thousand in the last week of January. The claims data say little about the strength of job growth, but it does mirror the struggle companies are having in filling positions. Competing amidst a shrinking pool of job applicants, they are desperately holding on to existing workers. And workers are voluntarily quitting their jobs at a record pace to obtain better-paying positions elsewhere, which adds further pressure on companies to avoid layoffs, reinforcing the downward trend in jobless claims.

Interestingly, the historically low level of new applicants for jobless benefits has opened up a debate as to what this implies for the business cycle. Some have noted that this is a common feature of a late-stage expansion. They point out that the last time jobless claims were as low as they are now, September 1969, the economy was just three months away from a recession that began in December of that year. However, this may reflect the fallacy of cherry-picking data to prove a point. For one, the oft-cited reference point, September 1969, was not the low for jobless claims; that occurred five months earlier. Hence, claims had already been trending higher by September, leading up to a recession that began a full 8 months after the low point was hit.

For another, that eight-month span between the trough in claims and the recession start was the second shortest since the Labor Department began compiling claims data in 1967. The exception was 1981, but that recession followed the shortest expansion on record from the 1980 recession, so there was hardly enough time for claims to establish a trend. Importantly, the time between the trough in claims and the next recession had been lengthening until the 2020 recession. Odds are, had the pandemic not abruptly cut off the expansion, that trend would have continued. A key reason jobless claims have been driven down so low is that there are about 600 thousand fewer workers in the labor force than before the pandemic. The shrinking labor force has contributed importantly to the worker shortage.

To be sure, there is logic to the notion that an ever-tightening labor market marks the beginning of the end of an expansion. But the endgame is a moving target, depending on the policy response as well as external influences, which are unpredictable. The tame inflation environment over the past 30 years enabled the Federal Reserve to move less aggressively to prevent rising prices from getting out of hand, allowing the economy, and job market, to run hotter for longer periods than otherwise. In some cases, the Fed also had some luck along the way. Powell likes to refer to the 1994-95 tightening cycle that kept inflation in check without causing a recession. But the temporary unleashing of strong productivity gains played a big role in restraining inflation during the latter part of that decade.

What's more, in the three successful inflation-controlling episodes Powell alluded to in this week's speech – the mid-1960s, 80s and 90s – the Fed's goal was to stop inflation from rising. The challenge facing the Fed now is to bring inflation down from a peak that is far higher than 3.8, 4.3 and 3.4 percent highs that prevailed in each of those episodes, respectively. Even worse is that the 7.9 percent year-over-year increase in the CPI through February is destined to go higher in coming months, thanks to ongoing pressure on oil and commodity prices from the Russian invasion. Monetary policy affects the economy with a lag; neither the 25 basis point increase just put into place, nor the next hike – whether it's 25 or 50 basis points – in May will do anything to prevent that from happening, as supply shocks are the primary catalysts driving the uptick.

Given this backdrop, investors are understandably expecting a more aggressive policy tightening than the Fed's latest projections indicate. The futures market is pricing in a 70 percent chance that the Fed funds rate will be above 2 ¼ percent at the end of this year, compared to the Fed's 2 percent median expectation. The biggest odds – 37.7 percent as of Friday – are that the funds rate will end the year between 2.50 and 2.75 percent. At the same time, the financial markets are becoming less sanguine that the economy can survive the looming tightening cycle. The spread between 10- and 2-year Treasury yields is often cited as a reliable forward indicator of recessions, pointing to a downturn soon after they are inverted. That point has yet to be reached, but the spread has narrowed to the slimmest point since the onset of the pandemic, less than 20 basis points from an inversion as of Friday.

To be fair, that indicator does not have a 100 percent foolproof record, and Fed chair Powell believes the spread between the 10-year and shorter-term term rates is a more reliable recession-tracking measure. By that yardstick, the yield curve is still unusually steep, as the increase in the 10-year yield has more than kept pace with the quarter-point hike in the federal funds rate this week. Importantly, Powell is probably not unhappy with that development, as rising long-term rates would be more effective in slowing growth – and contributing to the inflation fight – than higher short term rates. Indeed, one prime victim of the latter would be auto sales, as rates on auto loans are tightly linked to the Fed's short-term target rate. However, with auto sales already curtailed by scarce inventories, reflecting chip shortages needed for production, it's doubtful that crimping demand through higher auto loan rates would make that much of a difference.

Conversely, the swift rise in longer-term yields is having a meaningful impact on home sales, as it is driving up mortgage rates. True, the housing industry is also victimized by labor and material shortages that have impeded home construction and contributed to the rapid increase in home prices over the past year. But more recently, mortgage rates have been rising faster than home prices and pushing a broader swath of potential homebuyers out of the market. Higher home prices mean that buyers need to take out a larger loan to finance the transaction. Until recently, a buyer could afford a more expensive home by borrowing at historically low mortgage rates. With the 30-year mortgage rate climbing by nearly 1 ½ percent since late last year and hitting the highest level, 4.32%, since March 2019, that is no longer the case.

While the odds the Fed will tighten more aggressively than thought a few months ago have increased, we believe the economy has enough momentum to withstand the rate hikes that are likely to occur this year. There are no signs yet that the job market is cooling off, and sturdy wage increases combined with healthy balance sheets should keep consumer spending – the economy's main growth driver—on a firm footing. That said, the risk of an over-correction along with the withdrawal of fiscal aid does make the economy more vulnerable to a downturn in 2023.

FINANCIAL INDICATORS

INTEREST RATES	Mar 25	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.54	0.40	0.32	0.02
6-month Treasury bill	0.97	0.80	0.69	0.04
3-month LIBOR	0.97	0.93	0.51	0.19
2-year Treasury note	2.28	1.94	1.58	0.14
5-year Treasury note	2.55	2.14	1.87	0.85
10-year Treasury note	2.48	2.15	1.97	1.67
30-year Treasury bond	2.60	2.43	2.28	2.37
30-year fixed mortgage rate	4.32	4.16	3.89	3.17
15-year fixed mortgage rate	3.63	3.39	3.14	2.45
5/1-year adjustable rate	3.36	3.19	2.98	2.84
STOCK MARKET				
Dow Jones Industrial Index	34,861.24	34,754.93	34,058.75	33,153.21
S&P 500	4,543.06	4,463.12	4,384.65	4,019.87
NASDAQ	14,169.30	13,893.84	13,694.62	13,138.72
COMMODITIES				
Gold ($ per troy ounce)	1,954.60	1,921.50	1,890.10	1,731.80
Oil ($ per barrel) - Crude Futures (WTI)	112.62	105.10	91.94	59.95

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (February) - 000s	772	788	860	761
Median Sales Price (February) - $000s	400.6	427.4	399.1	416.0
Durable Goods Orders (February) - % chg.	-2.2	1.6	1.2	0.6

HEADQUARTERS:
2188 SW Park Place Suite 100
Portland OR 97205