

Weekly Economic Update—April 11<sup>th</sup>, 2022

The bond market experienced an attack of the Federal Reserve Bs –Brainard and Bullard – whose hawkish comments accelerated the upward move in long-term Treasury yields this week. Both advocated a more aggressive response to galloping inflation, cementing the prospect of a 50 basis point increase in the Federal funds rate at the early May policy meeting. What's more, St. Louis Fed president Bullard said he would like to see the rate go as high as 3.00– 3.25 percent over the second half of this year. For a market that had been pricing in about 100 basis points less, that's all it needed to drive the 10-year Treasury yield up to a three-year high of over 2.70 percent on Friday, about 30 basis points higher than a week earlier.

While these bold comments jolted the bond market, the minutes of the March 15-16 policy meeting released this week revealed that Fed officials were more receptive to the sentiment expressed by Brainard and Bullard than thought. Interestingly, the 2-year Treasury yield hardly budged during the week, which is somewhat perplexing since that rate is closely linked to investor expectations of policy changes. Its resistance meant that the 2-year/10-year inversion reached the previous week reverted to a positive slope, with the 10-year yield ending about 20 basis points higher on Friday after sinking nearly 10 basis points below the 2-year yield at one point last week.

The return of positive 10-year/2-year yield spread changes the narrative that had gripped the financial markets over the past two weeks. Since a yield inversion is widely viewed as a reliable portent of a recession, does its unwinding mean investors have more confidence the Fed can achieve a soft landing for the economy? Given the Fed's amplified message that it would pull no punches to rein in inflation, that doesn't seem likely. A more likely explanation is that the markets had already priced in a more aggressive rate-hiking cycle, which limited the rise in the 2-year yield, but not the more rapid pace of balance sheet reduction that was highlighted in the minutes and Brainard's comments, which spurred a bigger response in long-term yields. The huge \$4.5 trillion build-up in the Fed's balance sheet since the onset of the pandemic was designed to keep long-term interest rates low. Conversely, the planned \$1.1 trillion asset reduction over the coming year is expected to have the opposite effect.

To be sure, the Fed's last effort to unwind its bloated balance sheet in 2018 was short-circuited that December when stock prices plunged and bond yields spiked. Those catalysts are not likely to spook the Fed this time. For one, inflation in late 2018 was much less of a threat, with the core CPI topping out at 2.3 percent and inflation expectations remaining well anchored despite a brief spike in oil prices. For another, the economy was much more fragile in the fourth quarter of 2018, as the annual growth rate in real GDP slipped to under 1 percent for the period, even as employment growth slowed considerably in the three months through November. At the time, the Fed was more focused on promoting maximum employment than curbing inflation, and feared the negative wealth effect from the plunge in stock prices would undermine its efforts. Indeed, the Fed's abrupt about-face gave further credence to the view that the stock market could always rely on a so-called Fed 'put' if a market correction threatened to sink the economy.

The economic backdrop today couldn't be more different. True, the first quarter's GDP is likely to notch a slim growth rate of roundly 1 percent, but the headline number masks solid underpinnings. Importantly, the job market is red-hot and lighting a fire under worker wages, which are rising at a pace not seen since the wage-price spiral of the early 1980s. That, together with the formidable savings cushion built from unspent funds during the pandemic and generous government transfer payments, should provide considerable support to household spending in coming months. While the fiscal boost is waning and poised to morph into a drag later this year and in 2023, recent Treasury data indicates that the government's pandemic aid is still fattening household bank accounts.

According to the IRS, income tax refunds are running 15.4 percent ahead of last year, putting a cumulative \$35 billion more in taxpayer wallets through the week of March 25. Some of the bulge simply reflects the faster processing of tax returns, which was hampered by the pandemic last year. But the average size of individual refunds jumped by 12.4 percent, to \$3,263, which goes a long way to help budget-strapped families meet the surging costs of food and other essential purchases. Importantly, the larger refunds primarily reflects the expanded child tax credit enacted last year under the coronavirus relief bill, which provided families with a fully refundable tax credit of up to \$3600 a year per child. About half of the credits were paid out in monthly installments last year, but the rest are now coming back as refunds as people file their taxes.

But the tax credit is not a gift that keeps on giving, as the monthly payments stopped at the end of last year when Congress would not approve an extension. With the refund season winding down, the last vestige of the generous fiscal transfer payments will soon expire and the catalysts fueling demand will shift from the government to the private sector. As noted, the passing of the baton is progressing quite nicely, as increasing labor compensation is amply filling the void left by the withdrawal of government stimulus. The problem, of course, is that it is also stoking inflation, which the Federal Reserve is resolved to curb. Ideally, the Fed hopes to accomplish that feat without inflicting too much pain on the economy, including stifling job growth or, worse, completely lopping off the paychecks of lower-paid workers who would be the first victims of rising unemployment.

Clearly, the acceleration in labor costs is contributing importantly to the inflation surge seen over the past year. Just as important, however, is that companies are able to pass on the higher costs to consumers because the latter is willing – and able—to accept the increased prices. Indeed, prices are rising faster than labor costs, which plants the seeds for the dreaded wage-price cycle that the Fed is striving to stop before it gains more traction. The best-case scenario would be that consumer resistance to higher prices curbs business pricing power without a negative feedback to the labor force. That, in turn, would reduce inflation expectations among workers and curb their demands for catch-up wage increases. The Fed then would be under less pressure to engage in harsh growth-retarding measures, lessening the recession risk that has lately been rising.

To some extent, the current situation calls to mind the environment facing former Fed Chairman Alan Greenspan in 2004- 2005. At that time, labor costs and inflation were both on the rise, pressuring the Fed to slam on the brakes. Greenspan resisted for a while, famously noting that corporations were sufficiently flush with profits to absorb higher labor costs while holding the line on prices. The Fed ultimately did embark on a tightening cycle but his point was well taken, as profit margins stood at a record in the second quarter of 2004 on the way towards even higher levels before it all came tumbling down with the Great Recession. Powell could well beat the same drum if he so chooses, as nonfinancial corporations entered the year with the fattest profit margins on record.

If analysts earnings forecasts are any indication those margins should hold up over the foreseeable future; what's more, recession fears are clearly not running high among equity investors based on the stock market's sturdy performance over the past three weeks. With supply chain conditions continuing to deteriorate, oil prices still under pressure from the war in Ukraine, and labor shortages still enhancing worker bargaining power, inflation will likely get worse before receding, keeping the Fed's finger on the rate-hiking trigger. But there's growing evidence of consumers resisting price hikes, either by foregoing purchases or seeking out private-label cheaper substitutes, indicating that companies do not have an open-ended reservoir of demand that would accept higher prices. This, in turn, could prompt companies with fat profits to hold the line in order to maintain sales, which would lessen pressure on the Fed to curb demand -- and enhance its prospect of achieving a soft landing.

## FINANCIAL INDICATORS

INTEREST RATES	April 8	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.67	0.52	0.39	0.02
6-month Treasury bill	1.15	1.07	0.75	0.04
3-month LIBOR	1.00	0.97	0.80	0.19
2-year Treasury note	2.47	2.46	1.75	0.15
5-year Treasury note	2.69	2.57	1.95	0.87
10-year Treasury note	2.71	2.39	2.00	1.66
30-year Treasury bond	2.72	2.44	2.36	2.33
30-year fixed mortgage rate	4.72	4.67	3.85	3.13
15-year fixed mortgage rate	3.91	3.83	3.05	2.42
5/1-year adjustable rate	3.56	3.50	2.97	2.92

STOCK MARKET				
Dow Jones Industrial Index	34,721.12	34,818.27	32,944.19	33,800.60
S&P 500	4,488.28	4,545.86	4,204.31	4,128.80
NASDAQ	13,711.00	14,261.50	12,843.81	13,900.80

COMMODITIES				
Gold (\$ per troy ounce)	1,950.40	1,928.50	1,992.30	1,743.70
Oil (\$ per barrel) - Crude Futures (WTI)	97.90	99.42	109.09	59.37

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Services Index (March)	58.3	56.5	59.9	62.0
Consumer Credit (February) - \$blns	41.8	8.9	20.7	25.0

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