

Weekly Economic Update—April 25th, 2022

Since 2011 the 10-year Treasury yield has pierced 3.0 percent on rare occasions – a few brief months in the fall of 2018 and 1 or 2 daily forays in late 2013. It moved precariously close to that threshold's doorstep, trading at 2.96 percent on Thursday, before giving back some ground on Friday, but still surging nearly 60 basis points since the start of the month. Meanwhile, the stock market suffered a major blow this week, notching heavy losses punctuated by a plunge of nearly 3 percent in the major indexes on Friday. This pattern is counterintuitive, since the bond market is supposed to be a safe refuge for investors when losses on riskier assets, such as stocks, start to pile up.

But bonds have hardly been a safety net for investors this year, nor the time-honored ballast that traditionally made them a vital cog in portfolios designed to balance risk and reward. This departure from the norm echoes the unique circumstances that have buffeted the financial markets this year. If nothing else, the unusual pattern seen in recent months thoroughly validates the age-old expression that investors hate uncertainty – and that sentiment is as valid in the bond as well as the stock market. Importantly, one major uncertainty that has roiled the markets in recent months – the path of monetary policy – appears resolved, at least over the near term. At a panel hosted by the IMF this week, Fed chair Powell sent the strongest signal yet that a 50 basis point hike in the federal funds rate would be forthcoming at the FOMC meeting on May 3-4, which would likely be followed by another half-point rise in June.

Powell's endorsement of the most aggressive start to a rate-hiking cycle since 2000 reflects a desperate attempt to get ahead of the inflation curve, a tacit acknowledgement that he waited too long to start the process. Ironically, while questions regarding the near-term path of policy may have been answered, the Fed's actions raise a host of uncertainties likely to befuddle investors for the foreseeable future. The most critical unknown is whether policymakers can successfully rein in inflation without inducing a recession, accomplishing the elusive soft landing that has never been accomplished when inflation was as high as it is now. Clearly, bond investors are skeptical about the inflation side, as market-based inflation expectations surged this week, with the 10-year Treasury breakeven rate hitting a record 3.04 percent on Thursday. Notably, the market rate on that bellwether issue has just about caught up to expectations for the first time since the recovery from the pandemic-induced recession began in early 2020.

Whether the recent spike in inflation expectations added a sense of urgency to the Fed's thinking is unclear. Powell's comment at the IMF debate on Thursday, noting that front-end loading of monetary tightening is appropriate would seem to support that notion. From a macro perspective, a case can be made to accelerate the process rather than wait to see how conditions unfold. The economy has a formidable amount of firepower to withstand steeper rate hikes now rather than later. For one, households still retain a considerable amount of excess savings accumulated over the past two years from government stimulus payments and delayed spending during the pandemic. What's more, a larger portion of those savings resides in bank accounts of lower-income households than thought, and this segment of the population is more likely than wealthier individuals to spend these funds.

For another, the job market is running hot and stoking bigger wage increases that employers are able to pass on to customers. True, workers are still playing catch-up as earnings have lagged the increase in inflation over the past year. Real average hourly earnings of private-sector workers are no higher now than they were in February 2019. But that measure does not fully capture the aggregate income boost derived from the 1.7 million jobs created so far this year, as most of those new jobholders had no or little funds coming in while they were unemployed. For them, going from zero to a full paycheck amounts to a far bigger increase in purchasing power than the 5.6 percent increase in average hourly earnings obtained by existing

workers over the past year. Simply put, it's unlikely that the pending half-point hikes in rates will break the back of the recovery over the near term, as long as households have the financial resources and job security to sustain spending.

That said, it would be a mistake to minimize the headwinds that households face or that the economy is running at full speed. For the most part, companies are successfully passing on higher labor costs as a record 72 percent of small businesses have been raising selling prices, according to the March survey by the National Federation of Independent Businesses. What's more, the NFIB reports that fully 50 percent of their members plan to raise prices over the next three months, just shy of the record 54 percent set last November. But consumers are not exactly taking the increases lying down. A recent poll revealed that 84 percent of Americans plan to cut back spending because of rising prices. The March retail sales report showed that consumers are already curtailing some discretionary spending, as surging energy and food costs are eating into budgets.

We suspect that the inflation hurdle as well as the near-term rate hikes by the Fed will be surmounted in coming months, resulting in a healthy growth rate in GDP during the second quarter. Among the tailwinds propelling growth are the aforementioned robust job market, healthy household balance sheets and lingering benefits from last year's fiscal support, including a boost in tax refunds linked to the child tax credit. But it's important to remember that the effects of a tightening monetary policy weave through the economy with a lag, and the main impact will be felt later this year and next. This is where the Fed faces its most challenging task, deciding how much to tighten now without causing too much damage later on. Even as the markets are pricing in ever-higher inflation down the road, the consensus of economists see a growing risk of recession in 2023.

The war in Ukraine and renewed Covid-related lockdowns in China complicate matters even more, as these shocks amplify inflationary pressures even as they crimp growth. In its latest outlook, the IMF reduced its global growth forecast for 2022 by nearly 1 percent from its January estimate, with a larger haircut applied to economies overseas. But the U.S. is not immune to global weakness, as it points to weaker demand for American exports. Meanwhile, the shutdowns in China are exacerbating supply-chain disruptions, preventing much-needed goods from reaching factories in the U.S., crimping production and, hence, growth while keeping upward pressure on prices.

Like others, we see a higher risk of a recession occurring next year, reflecting uncertainties surrounding the war in Ukraine as well as a policy mistake by the Fed. The latter has a hard enough time calibrating policy with expected domestic influences, much less dealing with the fog of war and how other nations respond to Covid. Understandably, given the virulence of inflation now unfolding, the Fed would like to bring its policy rate up to at least a neutral level, around 2.5 percent, that neither stimulates nor retards economic activity as soon as possible. But the swift timetable may not align with how growth and inflation unfold later in the year, when the tightening policy will have an increasing impact on the economy.

It's interesting to recall former Fed Chair Alan Greenspan's lament in 2005 when he famously noted that the failure of a tightening monetary policy to lift long-term rates was a conundrum. At this juncture, that's not a concern for Chair Powell as the bond vigilantes have returned in force, driving long-term yields sharply higher and amplifying the restrictive effect that the Fed's rate hikes will have on the economy. Indeed, with mortgage rates surpassing 5 percent for the first time since 2011, the double-barreled blow to potential homebuyers has increased exponentially. For new buyers, the cost of servicing mortgage payments on a median priced home will rise by at least 20 percent due to higher financing costs. For existing homeowners the incentive to refinance a mortgage has plunged dramatically as more than 90 percent of outstanding mortgages yield less than 5 percent.

The freefall in refinancing activity that would lower mortgage payments removes a source of funds homeowners might use to support spending. But there are broader implications for the housing market, as higher mortgage rates discourage homeowners from trading up to a more expensive house. That, in turn, keeps more homes off the market and prolongs the housing shortage that has greatly contributed to the

surge in home prices. More than any other sector, housing is vulnerable to the stagflationary impact that a tightening monetary policy could bring about. The question that will linger in the financial markets is whether that affliction will spread to the broader economy.

FINANCIAL INDICATORS

INTEREST RATES	April 22	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.81	0.78	0.54	0.03
6-month Treasury bill	1.32	1.22	0.97	0.04
3-month LIBOR	1.18	1.06	0.97	0.18
2-year Treasury note	2.70	2.45	2.28	0.16
5-year Treasury note	2.93	2.79	2.55	0.81
10-year Treasury note	2.92	2.83	2.48	1.56
30-year Treasury bond	2.95	2.92	2.60	2.24
30-year fixed mortgage rate	5.11	5.00	4.32	2.97
15-year fixed mortgage rate	4.38	4.17	3.63	2.29
5/1-year adjustable rate	3.75	3.69	3.36	2.83

STOCK MARKET					
Dow Jones Industrial Index	33,811.40	34,451.23	34,861.24	34,043.49	
S&P 500	4,271.78	4,392.59	4,543.06	4,180.17	
NASDAQ	12,839.29	13,351.08	14,169.30	14,016.81	

COMMODITIES				
Gold (\$ per troy ounce)	1,933.00	1,977.30	1,954.60	1,775.90
Oil (\$ per barrel) - Crude Futures (WTI)	101.07	106.54	112.62	62.08

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (March) - 000s	1,793	1,788	1,679	1,712
Building Permits (March) - 000s	1,873	1,865	1,895	1,815
Existing Home Sales (March) - mlns	5.77	5.93	6.49	6.13

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