Weekly Economic Update—May 2nd, 2022

The soft landing crowd got a rude awakening this week when the Commerce Department reported that the economy contracted in the first quarter, the first downturn in GDP since the pandemic-induced recession in 2020. To be sure, the markets had no illusion that the annualized 1.4 percent setback meant the economy was in the throes of a recession. For one, the consensus of forecasters had already expected a soft reading for the first quarter, given the timid handover from late last year when Omicron sapped considerable strength from activity and supply shortages had a stifling affect on production. Our tracking models anticipated a growth rate of less than 1 percent.

Where the surprise came in was the exceptional drag from trade, as robust demand in the U.S. sucked in a hefty 17.7 percent increase in imports, while mounting weakness overseas weighed on U.S. exports, which fell by 5.9 percent. That combination produced a net deficit that sliced 3.2 percent from the economy's growth rate. What's more, businesses could not build up enough inventories to meet sales, and the smaller rise in stockpiles relative to the buildup in the previous quarter ($185 billion versus $213 billion) yields a negative second derivative that in effect subtracts from GDP. The main takeaway from these subtractions is they mask considerable strength in domestic demand during the period that puts the economy on a much firmer footing than portrayed by the headline GDP.

Indeed, the economy's main growth driver, consumer spending, gained strength in the first quarter, advancing by an annual rate of 2.7 percent compared to 2.5 percent in the previous quarter. Two other sources of domestic demand, business investment spending and residential outlays, also gave the economy additional heft, more than offsetting the drag from inventories and trade. Real final demand to domestic purchases, which strips out those two weak influences, rose by 2.6 percent, considerably stronger than the average 1.5 percent increase over the second half of last year. Unsurprisingly, the persistent strength in final demand amid supply shortages stoked the inflation embers during the period, as the personal consumption deflator rose by 6.3 percent from a year ago, the fastest since 1983.

Importantly, the stock market rallied on the day of the GDP release suggesting that investors wisely parsed the data and took stock of the economy's underlying strength. But equity investors are also keenly attuned to the profit-generating capacity of the economy; while earnings results for the first quarter that go into the GDP accounts were not available, nearly 80 percent of S&P 500 companies that have reported earnings so far delivered results that exceeded expectations. To be sure it's early, as only 20 percent of the companies in the index have revealed earnings for the period. What's more, the results presented to analysts and shareholders differ in concept from the economic profits that enter the GDP accounts. Still, the trends tend to converge, as the bottom line in both cases are driven by revenues derived from volume sales and the prices received on the goods and services that are sold.

When the second estimate of GDP is released a month from now, an accounting of corporate profits will be included. Odds are, it will mirror the outsize influence that inflation is having on the results. A glaring feature of the economy's performance in the first quarter is that while real GDP contracted by 1.4 percent (annualized), current-dollar GDP grew by 6.5 percent. That 7.9 percent discrepancy is the widest since 1981 and fully captures the ability of U.S. companies to pass on higher costs, and then some, to consumers. When prices rise faster than costs, profit margins expand – and that's precisely what has happened since the onset of the pandemic in 2020. No doubt, the profits surge over the past two years – with margins setting records in the second half of 2021 – has underpinned the remarkable increase in stock prices over the period.

HEADQUARTERS:
2188 SW Park Place Suite 100
Portland OR 97205

But the stock market is also forward-looking and – as the ubiquitous warning in investment literature proclaims – past performance does not guarantee future results. Indeed, the rally on GDP release day fully evaporated on Friday. It's important to remember that the success of companies to raise prices with abandon over the past year reflects in good part the powerful boost to demand provided by generous government stimulus payments and tax breaks. That, together with excess savings and the income and job security derived from a torrid labor market, has enabled households to accept higher prices. But the fiscal spigot is closing and consumers are spending more of their paychecks to support spending. The personal savings rate fell to 6.6 percent in the first quarter, below the 7.4 percent pre-Covid level and dramatically lower than the 26.1 percent peak in the second quarter of 2020 when the initial round of stimulus payments padded bank accounts.

What's more, the downward trend accelerated at the end of the quarter, as the personal savings rate fell to 6.2 percent in March, the lowest since December 2013. Admittedly, the savings rate measures flows – the change in the difference between incomes and spending from month to month – whereas households still retain a formidable stock of savings accumulated since the onset of the pandemic. But the shrinking savings rate is a sign that budgets are getting squeezed to meet current spending, as higher prices are eating into income gains and forcing households to tap into those savings. One way to view this development is to compare the dollar growth in disposable incomes with its inflation-adjusted, or real, growth. Since January 2020, just before Covid struck, current dollar after-tax incomes have increased five times faster than real DPI – 11.4 percent versus 2.2 percent. Since inflation began its rapid ascent last spring the gap has widened dramatically. Adjusted for inflation, household disposable incomes lost purchasing power whereas current dollar incomes eked out a small gain.

Even as inflation is taking an ever-bigger bite out of incomes, it is also accounting for a larger fraction of sales. In March, personal consumption increased by a sturdy 0.6 percent, but two-thirds of the increase reflected higher prices. Real spending grew by 0.2 percent. The question is, how much longer will consumers tolerate higher prices if they continue to climb faster than income? Not surprisingly, households are striving to catch-up with inflation, demanding – and getting -- bigger pay packages amid a worker shortage that is boosting their bargaining power. Wages and salaries increased by a healthy 1.1 percent in March and are up a vibrant 11.8 percent over the past year. Of course, this is an aggregate measure of wage growth that captures the outsize gains in employment over the past year as well as wage increases. The latter, as measured by average hourly earnings or other wage trackers, such as the Employment Cost Index or the wage tracker compiled by the Atlanta Fed, still lags inflation.

The erosion in household purchasing power contrasts with the expanding profit margins of companies, as most of the price increases have flowed to the bottom line. But labor costs are picking up and consumers are increasingly resisting higher prices, eschewing purchases deemed too expensive or opting for cheaper substitutes. It's only a matter of time before this trend eats into profits and weakens the pricing power of companies. To some extent, inflation sows the seeds of its own destruction. But that point is still a ways off, as the robust job market and accelerating wage gains should keep a floor under demand even as the economy struggles with supply restraints caused by Covid-related shortages and the war in Ukraine.

Hence, the Federal Reserve faces a tsunami of challenges as it strive to bring inflation under control. Given the bloated profit margins, it's fair too say that companies can absorb higher labor costs while holding the line on prices without suffering a major blow to balance sheets. It's also reasonable to assume that the Fed would not be overly concerned if the stock market responded adversely to the prospect of slimmer profits – something that might have sent prices tumbling on Friday. One objective of current policy is to achieve a tightening of financial conditions, which is facilitated by a weaker stock market. But the Fed also needs to take some froth out of demand, which entails curbing the rise in labor costs. This is where the rubber meets the road, as restricting labor gains inevitably leads to a rise in unemployment – and raises the odds of a recession. That's an outcome the Fed would like to avoid.

FINANCIAL INDICATORS

INTEREST RATES	April 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.81	0.81	0.52	0.03
6-month Treasury bill	1.40	1.32	1.07	0.04
3-month LIBOR	1.28	1.18	0.97	0.18
2-year Treasury note	2.65	2.70	2.46	0.16
5-year Treasury note	2.96	2.93	2.17	0.81
10-year Treasury note	2.86	2.92	2.39	1.56
30-year Treasury bond	2.93	2.95	2.44	2.24
30-year fixed mortgage rate	5.10	5.11	4.67	2.97
15-year fixed mortgage rate	4.40	4.38	3.83	2.29
5/1-year adjustable rate	3.78	3.75	3.50	2.83

STOCK MARKET				
Dow Jones Industrial Index	32,977.21	33,811.40	34,818.27	34,043.49
S&P 500	4,131.93	4,271.78	4,545.86	4,180.17
NASDAQ	12,334.64	12,839.29	14,261.50	14,016.81

COMMODITIES				
Gold ($ per troy ounce)	1,896.90	1,933.00	1,928.50	1,775.90
Oil ($ per barrel) - Crude Futures (WTI)	104.13	101.07	99.42	62.08

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (March) - 000s of units	763	835	845	789
Durable Goods Orders (March) - % change	0.8	-1.7	1.5	0.9
Consumer Confidence Index (April)	107.3	107.6	105.1	109.7
Real GDP (Q1) - % chg, Saar	-1.4	6.9	2.3	4.2