GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—September 12th, 2022

Following a slew of speeches and public comments by Fed officials, highlighted by chair Powell's appearance at the Cato Institute's monetary policy conference on Thursday, the Fed now enters its traditional quiet period until the September 20-21 policy meeting. But by all accounts the meeting will be anticlimactic, as the message conveyed by the Fed speakers this week strongly suggests that the FOMC will deliver another outsized 0.75- percentage point interest-rate increase. This, despite evidence that inflation and inflationary expectations have peaked, the economy is softening and recession fears are permeating corporate boardrooms and the mindset of households.

That said, while key inflation indicators may have reached inflection points, the pace of price increases still remains well above the 2 percent target. As a result, the Fed is intent on erring on the side of being overly aggressive. As Powell noted at the policy conference " the longer inflation remains well above target, the greater the risk the public sees higher inflation as the norm." Essentially, Powell confirmed remarks he made at the Jackson Hole symposium last month, when he strenuously fought back against growing investor expectations that policymakers would ease up – or even reverse – their rate-hiking campaign sooner rather than later. Instead, Powell stressed that "history suggest strongly against prematurely loosening policy."

Importantly, Powell forewarned that policy tightening will inevitably "bring some pain to households and businesses." Clearly, this warning is intended to prepare the public for some rise in unemployment, which the Fed chair hopes would curb the strongest wage increases in decades. While Powell applauds the gains that workers – particularly those on the lower spectrum of the income ladder – have achieved in the red-hot job market over the past two years, he also recognizes that employers have been able to pass on rising labor costs to consumers, and then some. The risk is that workers, with their enhanced bargaining power, will demand even faster wage increases to keep up with inflation, setting in motion the dreaded wage-price spiral that would require harsh recession-inducing rate hikes to combat it. Indeed, headline-grabbing data that shows workers losing ground to inflation – with real average hourly earnings of nonmanagement workers falling 2.3 percent over the past year – would seem to bolster that prospect.

However, we note that the headline loss of purchasing power this year overstates the damage inflation has inflicted on worker earnings. When measured against the near 80 percent of goods and services in the consumer price index – the core CPI that excludes food and energy items – worker earnings are still increasing faster than inflation. In fact, the 0.3 percent increase in real average hourly earnings in the year through July, while slowing, is just a tad under the average increase seen throughout the 10-year prepandemic expansion before the turbocharged job market in 2019 drove unemployment down to the lowest rate since 1969. To be sure, the pain households feel from the surge in food and energy prices cannot be downplayed, particularly since they constitute a larger share of budgets of lower-income individuals.

But energy prices have been falling sharply and food inflation has stabilized. What's more, broader price measures have been easing and should continue on a downward path in coming months. The headline consumer price index was unchanged in July, thanks mostly to the plunge in energy prices, while the increase in the core CPI slid to 0.3 percent from 0.7 in June and a 0.6 percent average over the previous three months. Energy prices have continued to fall in August and so far in September, while the ongoing easing of supply-chain bottlenecks points to a continued thawing of goods prices. In some places, outright deflation is taking hold. According to the Manheim index, used car prices have fallen in six of the past seven months, including a 4 percent drop in August.

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These decelerating price trends underpinned earlier market expectations that the Fed might soon ease the pace of tightening if not reverse course, a sentiment buttressed by slowing job gains and wage increases revealed in the August employment report. But Powell understandably stressed that credible evidence inflation is receding on a sustained basis requires more than one or two months of data. What's more, the recent slowing in broad price measures has mainly reflected the drag from goods prices, whereas service prices continue to advance at an elevated pace and are harder to tame. Shelter costs, paced by surging rents, have increased about 6 percent over the past year and accelerated to over 7 percent at an annual rate over the past three months.

One reason prices of services are harder to tame is because service providers rely more heavily on labor than goods providers, and labor costs are stickier than other employer expenses. In fact, prices of raw industrial materials and other supplies needed for the production of goods have been falling, reflecting in part the strong dollar that has depressed import prices. Freight charges have also been plunging recently, as logjams at major ports are clearing and companies that have overstocked merchandise in anticipation of shortages are reducing orders as demand has fallen short of expectations.

Unlike the inputs to production that are vulnerable to cyclical price declines, wages are not cut even when economic activity weakens. Hence, the main way companies can reduce labor costs is by reducing the workforce, leading to layoffs. Although the Fed still clings to the hope that it can bring inflation down to its target without causing a recession, Powell acknowledges that some increase in unemployment is probably in the cards. From our lens, the current and expected rate hikes should send the unemployment rate well above 4 percent by early next year, from the current 3.7 percent and the nearby low of 3.5 percent. Keep in mind that a recession has never been avoided when the rate has risen by at least a half-percent, a threshold that should readily be surpassed.

With the job market still tight, wage pressures are not likely to ease anytime soon. However, workers are clearly not as confident in job security as they were earlier in the year, as the quit rate is falling and job postings have come down from record highs. With reports of job offers being rescinded and recession fears rising – about half the adult population believes we are already in a recession – workers are understandably giving more importance to job security, which may be spurring a growing interest in joining a union. Historically, union members hold on to their jobs during recessions much better than nonunion workers.

Not coincidentally, the U.S. is seeing a revival in union membership. According to the National Labor Relations Board, petitions for union representation increased nearly 60 percent over the first three quarters of the current fiscal year. This trend should continue to gain traction, as the forces that have decimated unions over the past four decades are turning into tailwinds. For one, public opinion and the political response have soured on globalilization, which outsourced millions of union jobs overseas to exploit lower wages. For another, the war in Ukraine and pandemic-related supply shortages have encouraged businesses to obtain more secure supply-chains, including relying more on domestic production for critical components. A growing list of high-profile companies has already announced they are reshoring overseas production to the U.S., which should generate jobs that have traditionally gone to union workers.

That said, service workers, which are less vulnerable to globalization and supply-chain issues than factory workers, are the main impetus behind the current union drive. Importantly, a large share of these workers are lower paid and work in industries that rely heavily on discretionary spending – think restaurants and bars – which would be more deeply impacted by a recession than other forms of spending. Fed officials believe that not curbing inflation would be more harmful to workers over the longer run. The hope is that the short-term pain caused by the current rate-hiking campaign will prevent even deeper, more enduring, long-lasting pain.

FINANCIAL INDICATORS

INTEREST RATES	Sep 9	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.96	2.88	2.56	0.05
6-month Treasury bill	3.55	3.35	2.95	0.06
3-month LIBOR	3.24	3.14	2.91	0.11
2-year Treasury note	3.56	3.53	3.26	0.22
5-year Treasury note	3.40	3.30	2.99	0.81
10-year Treasury note	3.32	3.27	2.84	1.34
30-year Treasury bond	3.45	3.37	3.17	1.93
30-year fixed mortgage rate	5.89	5.66	5.22	2.88
15-year fixed mortgage rate	5.16	4.98	4.59	2.19
5/1-year adjustable rate	4.64	4.51	4.43	2.42
STOCK MARKET				
Dow Jones Industrial Index	32,151.31	31,318.34	33,761.05	34,607.72
S&P 500	4,067.36	3,924.26	4,280.15	4,458.58
NASDAQ	12,112.31	11,630.86	13,047.19	15,115.49
COMMODITIES				
Gold ($ per troy ounce)	1,727.60	1,722.60	1,818.90	1,788.20
Oil ($ per barrel) - Crude Futures (WTI)	86.10	87.25	91.88	69.71

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Service Sector Index (August)	56.9	56.7	55.3	56.7
U.S. Trade Deficit (July) - $blns	70.7	80.9	85.8	86.5
Consumer Credit (July) - $blns	23.8	39.1	23.5	33.1

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