

It was an uneventful week in terms of economic indicators, of which there were practically none. A hiatus was probably just what the financial markets ordered following last week's jolting and totally surprising strong jobs report. That said, the light data calendar did not provide investors with any sense of relief. Stock prices suffered the worst weekly loss in two months and bond yields climbed, led by a spike in the 5-year rate. Fed speak remained hawkish as officials gave little indication that they were about to stop raising rates, something that the markets had increasingly priced in prior to the blockbuster jobs report last week.

To be sure, Fed chair Powell did give the doves some encouragement in his press conference following last week's policy meeting as well as in his more casual comments before the Economic Club of Washington this week. In both instances, he noted that the "disinflationary process has begun" suggesting that policy could ease off the monetary brakes soon. Indeed, that's the main takeaway the bulls on Wall Street heard immediately following the policy-setting meeting, spurring a brief, but powerful, rally the day after. But the rally soon fizzled, as did the hopeful expectations of a Fed pivot anytime soon. What a deeper dive into Powell's comments, which has since been buttressed by a litany of other Fed officials, makes amply clear is that the central bank plans on keeping the pedal to the metal for as long as it takes to get the job done.

The blockbuster jobs report no doubt jolted investors into believing the central bank would stick to its plan. But they are still not entirely on board with the Fed's longer term expectation, provided in the Summary of Economic Projections at the December policy meeting. The markets apparently agree that another rate hike or two are in the cards in upcoming meetings. But a significant, although shrinking, contingent of traders still do not believe the Fed will keep rates elevated throughout the year as it intends, expecting a pivot towards cuts before the year is out. Simply put, the strong jobs report highlights the economy's resilience in the face of rapid rate increases, but markets are skeptical that it can withstand a steady dose of high rates much beyond the first half of the year.

We concur that strong hiring and historically low unemployment are injecting more life into economic activity than thought possible a month or so ago. Even if the outsized 517 thousand increase in nonfarm payrolls last month – more than double expectations – was an outlier, the labor market has retained far more vigor in the face of the Fed's growth-retarding rate hikes than anyone could have expected. Even more perplexing is that the robust demand for workers is coming amid weakening sales and a less-than-stellar outlook for the economy by leading CEOs. There are no simple answers for this apparent conundrum. Some believe that the acute labor shortages over the past two years are encouraging employers to hoard workers and continue adding to payrolls to avoid hiring difficulties when economic activity reaccelerates later on. Others note that several sectors, such as leisure and hospitality, health and education and social services, have still not recouped the loss of workers during the pandemic and need to fill tens of thousands of open positions to reach prepandemic staffing levels.

Indeed, the strong demand for workers in these sectors is more than offsetting the high-profile job cuts unfolding in the tech and financial sectors, underscoring the torrid payroll gains in recent months. The downsizing in the tech sector is a belated adjustment of the overstaffing that took place during the pandemic, as the torrid demand for tech products has fizzled along with the shift in household buying patterns towards services. Many of those laid-off workers have landed positions elsewhere. Importantly, rising wages and reduced fears of Covid infections are luring workers off the sidelines, easing the hiring efforts of labor-intensive service companies. The participation rate of prime-age women in the labor force, who account for the largest share of workers in the aforementioned services sectors, have returned to prepandemic levels whereas it still lags far behind for prime-age men.

The question is whether the resounding increase in jobs last month can continue – and sustain upward pressure on wages – amid a decidedly weaker trend in demand. Historically that has never been the case. True, job growth tends to lag economic activity, as companies are typically slow to lay off workers until they are sure that weaker sales will persist. On the heels of a prolonged period of labor shortages, that lag may be longer than usual this time. But at some point, keeping workers on payrolls amid weakening revenues becomes untenable, and slashing labor costs takes on more urgency. The deeper the sales – and revenue – slump, the greater the urgency. So far, the pullback in consumer spending is in its early stages – having fallen in each of the past two months – but the seeds for continued weakness have been planted. The fourth-quarter earnings season just completed was not a disaster, but many consumer-oriented companies reported narrower profit margins, thanks in good part to surging labor costs.

Granted, strong job growth is putting a floor under the consumer pullback. More paychecks mean more purchasing power that can flow into the spending stream. But the spending boost provided by worker earnings is being diluted by rising prices and shrinking pandemic-era savings. Most Americans believe that their financial situation will get worse not better later this year, something that argues for an increase in precautionary savings. Meanwhile, the dramatic increase in borrowing costs is deterring leveraged spending. The prolonged slump in home sales is the poster child of this feedback, but other big-ticket purchases, most notably auto sales, have also fallen victim to higher financing costs. In December, consumer credit increased by the smallest amount in two years.

Nor is it just demand that is falling under the weight of rising borrowing costs. Lenders too are becoming less willing to supply consumers with new credit. According to the latest Senior Loan Officer survey, the share of banks willing to extend credit to consumers is the smallest since the height of the pandemic. The tightening of lending conditions extends to business and mortgage loans as well, and is a vivid sign that banks see a heightened risk of default amid weakening economic prospects this year. Not surprisingly, the biggest layoffs are taking place among financial institutions as well as tech companies.

The good news is that the ever-tightening job market is not igniting the acceleration in wage growth that most concerns the Fed regarding inflation. By some measures, wage growth is actually decelerating, which underscores a growing perception by some that strong job growth can coexist with slowing wages and, hence, inflation. It's highly unlikely that the link between job growth and wages has been broken, although it may well have weakened in recent years, reflecting weaker bargaining power of workers. Over the past two decades labor's share of national income has declined notably while the share garnered by corporate profits has more than doubled. As noted by Fed chair Powell, companies have enough of a profit cushion to absorb higher labor costs without putting through fully offsetting price increases.

We believe that some redistribution of national income will unfold, as corporations opt to hold the line on price increases and absorb some portion of higher labor costs for the sake of preserving sales. This, in turn, should contribute to a milder recession than otherwise as jobs and real household income hold up better than is usually the case during downturns. That said, in the eyes of the Fed wage growth, though slowing, is still too high relative to its goal of 2 percent inflation and more rate hikes will be needed to cool off the job market. As the full impact of previous as well as prospective rate increases filter through the economy, a mild recession is likely to set in, probably sometime in the second quarter.

## FINANCIAL INDICATORS

INTEREST RATES	Feb 10	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.76	4.62	4.61	0.36
6-month Treasury bill	4.91	4.78	4.79	0.70
3-month LIBOR	4.87	4.81	4.83	0.39
2-year Treasury note	4.51	4.29	4.22	1.52
5-year Treasury note	3.93	3.66	3.54	1.87
10-year Treasury note	3.74	3.52	3.51	1.94
30-year Treasury bond	3.83	3.62	3.61	2.25
30-year fixed mortgage rate	6.12	6.09	6.33	3.69
15-year fixed mortgage rate	5.25	5.14	5.52	2.93

STOCK MARKET				
Dow Jones Industrial Index	33,869.37	33,926.01	34,302.61	34,738.06
S&P 500	4,090.46	4,136.48	3,999.09	4,418.64
NASDAQ	11,718.12	12,006.95	11,079.16	13,791.15

COMMODITIES				
Gold (\$ per troy ounce)	1,875.20	1,877.70	1,923.00	1,860.60
Oil (\$ per barrel) - Crude Futures (WTI)	79.81	73.27	80.06	93.90

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/Quarters Ago	Average-Past Six Months or Quarters
Consumer Credit (December) - \$billions	11.3	33.1	32.3	25.7

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