

The minutes from the Fed's policy-setting meeting early this month confirmed that the central bank is more concerned about inflation staying elevated than the economy slipping into a recession. Importantly, the meeting concluded three weeks ago when the economy looked much weaker than it does now and inflation had been retreating for most of the last half of 2022. Against that backdrop – which would understandably have justified a more lenient policy sentiment – there should be little question over what the Fed's next move will be, as incoming data since the meeting unambiguously supports a tougher Fed response. Unsurprisingly, subsequent comments by several Fed officials have sounded a more hawkish tone. In fact, the minutes revealed that two members of the FOMC would have voted for a half-point increase in the fed funds rate instead of the smaller quarter-hike that was triggered, although the more hawkish opinions were held by nonvoting members of the committee.

Following a steady string of upside surprises in the economic and inflation data for January, the sentiment for a more aggressive Fed response undoubtedly gained adherents among Fed officials. The extent of the spread will be revealed at the next meeting on March 21-22. Earlier this year, the debate was whether or not the Fed would pause after a likely quarter point increase at the upcoming meeting, leaving the top end of the Fed's benchmark rate at 5.0 percent, a shade lower than projected at the December FOMC meeting. Now the debate is whether the Fed would take a "shock and awe" approach, hiking by a half-point and signaling that more increases are coming to break the back of inflation.

Traders in the fed funds futures market are still pricing in a 70 percent probability of a quarter point move, but fresh data on Friday confirming vigorous consumer spending and hot inflation in January sent the two-year Treasury yield, which is highly sensitive to policy expectations, to the highest level since mid-2007. Longer-term yields also moved higher although not to the peak levels seen last fall, resulting in a steeper inversion of the yield curve that should reinforce recession expectations. That combination delivered a damaging blow to the stock markets, which suffered a major setback this week. The S&P 500 slipped 2.7 percent and is 5.0 percent lower since the Fed meeting on February 1, prior to the onslaught of data supporting the need for more rate hikes.

To be sure, the Fed is not unhappy with the tightening of financial conditions this month, as higher market rates and lower stock prices relieve policy makers from some of the heavy lifting aimed at cooling off the economy, something that it deems necessary to rein in inflation. If nothing else, the market moves enhance the prospect that the Fed will stick to a smaller quarter-point increase in the funds rate at the upcoming March meeting. But there are still two key economic reports on the job market and consumer prices due out before the March 21-22 meeting. If the February prints for those indicators surprise on the upside again, all bets are off as a half-point rate hike would clearly be on the table. At this juncture, we are in the quarter-point camp but expect more rate increases afterwards, lifting the target rate to a range of 5.25%-5.50% by the middle of the year from the current 4.50% to 4.75% range. The Fed will be releasing its quarterly summary of economic projections (SEP) at the March meeting, and it will be interesting to see how much more hawkish the committee members have become since the last SEP was released in December.

Though the Fed may welcome recent market developments, it can't be happy with the data instigating the moves. That includes the last significant economic report for January released on Friday, which amply highlights the vigor in consumer spending and the fire under inflation indicated by earlier data. As foreshadowed by last week's strong retail sales report, real consumer spending on goods and services increased by a robust 1.1 percent last month, the strongest increase since January 2021 following two months of contraction. Households spread out their purchases widely, with a sturdy gain in durable goods

leading the way, deflecting at least for this month the shift in consumer buying habits towards services. What's more, consumers had the financial muscle to go on a spending spree, as real disposable income increased by an even faster 1.4 percent, leaving some left over to build up savings. The personal savings rate increased to 4.7 percent from 4.5 percent; last June, the rate stood at 2.7 percent.

Both the income and spending sides came in above expectations, echoing a pattern seen with most other data during the month and confirming that the economy enjoyed a burst of momentum at the start of 2023. Granted, the caveat that clouded earlier data applies to the latest report as well. That is, how much of the strength can be attributed to quirky seasonal factors or other external influences, such as unusually warm weather in January that imparts an artificial boost to the data? No doubt, the burst in spending was inflated by those influences as well as a one-time boost from an outsized 8.7 percent increase in Social Security benefits. What's more, the savings buildup most likely padded the cushions of upper-income households, most of which will remain outside of the spending stream.

But an important source of consumer spending comes from paychecks and the latest report indicates that households are deriving considerable purchasing-power support from the job market. Wages and salaries increased by a torrid 0.9 percent in January, the strongest in 14 months and more than double the 0.4 percent average increase over the previous three months. The acceleration in collective paychecks of workers reflects the eye-opening 517 thousand increase in payrolls during the month, which more than offset the slower increase in average hourly earnings. In addition, workers put in more hours, as the average workweek jumped to 34.7 hours from 34.4 hours. That equals the biggest monthly jump on record outside of the pandemic-related bounce in May 2020.

This wage-induced jump in incomes will keep the Fed laser-focused on the job market in its rate-setting decisions. That's particularly the case since the same report that revealed the sturdy increase in wages also featured another round of unsettling increases in the Fed's preferred price measures. Both the overall personal consumption deflator and the core PCE that strips out volatile food and energy items came in above expectations, each rising by 0.6 percent. Most disturbingly, unlike the comforting slight deceleration in the annual CPI inflation rate, the year-over-year trend in both deflators increased last month. The overall PCE deflator rose to 5.7 percent from 5.6 percent and the core PCE increased to 4.7 percent from 4.6 percent.

The uptick in the inflation rate belies Fed chair Powell's assertion, noted in his post-meeting press conference, that the "disinflationary process has started", as the January deflators are now 0.1 percent further away from the Fed's 2 percent target. That said, if the focus is on the year over year trend his assertion will soon start looking very prescient, as the so-called base effects will start to kick in. In coming months prices will be compared to levels that were pumped up last spring by the onset of the war in Ukraine and lingering pandemic-related supply constraints. Hence, even if the month over month changes look strong, the comparisons with a year-ago will decelerate. The Fed, of course, will see through that anomaly but it will be interesting to see if the financial markets do as well. If the latter interprets the positive annual comparisons as a signal the Fed should pivot away from its current stance, the Fed may have to step on the brakes even harder to offset easing financial conditions.

## FINANCIAL INDICATORS

INTEREST RATES	Feb 24	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.82	4.82	4.67	0.32
6-month Treasury bill	5.11	5.03	4.84	0.69
3-month LIBOR	4.96	4.91	4.80	0.51
2-year Treasury note	4.80	4.63	4.20	1.58
5-year Treasury note	4.21	4.03	3.61	1.87
10-year Treasury note	3.95	3.82	3.51	1.97
30-year Treasury bond	3.93	3.87	3.62	2.28
30-year fixed mortgage rate	6.50	6.32	6.13	3.89
15-year fixed mortgage rate	5.76	5.51	5.17	3.14

STOCK MARKET				
Dow Jones Industrial Index	32,816.92	33,826.69	33,978.08	34,058.75
S&P 500	3,970.04	4,079.09	4,070.56	4,384.65
NASDAQ	11,394.94	11,787.27	11,621.71	13,694.62

COMMODITIES				
Gold (\$ per troy ounce)	1,818.00	1,851.30	1,927.60	1,890.10
Oil (\$ per barrel) - Crude Futures (WTI)	76.45	79.33	79.38	91.94

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/Quarters Ago	Average-Past Six Months or Quarters
Existing Home Sales (January) - mlns of units	4.00	4.03	4.12	4.34
Median Sales Price (January) - \$000s	359	367	373	375
Personal Income (January) - % change	0.6	0.3	0.3	0.4
Personal Spending (January) - % change	1.8	-0.1	-0.1	0.6
Savings Rate (January) - Percent	4.7	4.5	4.0	3.8

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