GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—March 20th, 2023

The financial market turmoil stoked by bank failures and contagion fears dominated the headlines over the past week and will clearly have an influence in the upcoming FOMC meeting. But even without that external catalyst, Fed officials are confronted with another sudden realization, namely that data dependency is a two-way street. It will take a while to sort out the banking issues, and the tremors could yet cause more financial and economic damage than is currently envisioned. The swift and aggressive response by policymakers to short-circuit contagion temporarily calmed investor fears, but slumping stock prices and the plunge in Treasury bond yields on Friday suggest that the markets are not convinced the crisis is over.

Importantly, the crosscurrents buffeting the statistical landscape adds another wrinkle to the near-term forecast as well as to the Fed's rate decision at next week's meeting. Prior to the financial tumult, the choices facing the data-dependent Fed were whether to hike rates by 25 or 50 basis points to rein in inflation amid an economy that still retained considerable momentum. Most incoming data supported a more aggressive approach, and Wall Street had increasingly priced in higher odds of a 50-basis point increase. The collapse of two major banks over the weekend, however, abruptly dialed down those expectations and by mid-week all thoughts of a 50-basis point hike were taken off the table. Indeed, the startling realization late in the week that bank borrowing at the Fed surged by a record $153 billion over the past week heightened uncertainty over how deep and pervasive the problems with the banking system might be. When loans to backstop the assets of the two failed banks seized by the government are included, the Fed's balance sheet ballooned by more than $300 billion, nearly half the financial support that was provided during the 2008 financial crisis.

We still expect the Fed to raise its policy rate by 25 basis points next week but also convey a less strident inflation-fighting message than thought a few weeks ago aimed at calming market anxiety. Clearly, progress on the inflation front is unfolding far too slowly for the Fed's comfort. The 0.1 percentage point slowdown in the overall consumer price index in February, reported this week, leaves the increase over the past year at a still lofty 6 percent. What's more, the underlying details of the CPI report are worrisome. The core inflation rate that excludes food and energy prices increased 0.5 percent during the month, greater than the 0.4 monthly increase in January. Compared to a year ago, the core CPI only slipped to 5.5 percent from 5.6 percent and core service prices, the stickier component that is the primary driver of overall inflation, increased faster in February than in January – 0.6 percent versus 0.5 percent. Surging shelter costs, paced by another buoyant 0.8 percent increase in rents, continues to be a stubborn and primary influence behind the sustained increase in service prices.

When shelter costs are excluded, service prices rose by a much more subdued 0.1 percent in February compared to 0.6 percent in January. But a similar one-month slowdown has occurred before only to be erased by a rebound in following months. To gain a better perspective of the trend, the three-month average increase in service prices excluding rents rose to an annual rate of 5.3 percent from 5.2 percent in January and 3.1 percent in December. This component of inflation is closely watched by the Fed because it is heavily influenced by labor costs, which remains stubbornly elevated. True, growth in average hourly earnings did retreat in February, but that slowdown was skewed by the changing composition of the workforce, with lower-paying jobs accounting for a larger share of payroll gains during the month. According to the Atlanta Fed's wage tracker, which is not distorted by compositional changes, wages increased 6.1 percent in February from a year ago, the same as in January.

The good news is that wage growth is not accelerating and the job market, while still tight, is showing signs of easing. While service prices remain stubbornly high, the runup in goods prices during the pandemic is

rapidly unwinding, as supply chain snarls are clearing up and pent-up demand is fading. Hence pipeline pressures are retreating dramatically; producer prices fell 0.1 percent in February, the second decline in the last three months, and the 4.6 percent increase over the past year is less than half the pace of a year ago and the slowest since March 2021. We suspect that the pullback in producer prices will continue in coming months and lead to a marked slowdown in consumer goods prices over the second half of the year. The overall inflation rate will be slower to recede, thanks to sticky service prices, but here too significant progress should be seen later this year and into 2024. The outsized increase in shelter costs is still being buoyed by leases signed earlier in the year, but current market rents are tailing off sharply and will soon constitute a major drag on overall prices.

Despite nascent signs of easing inflation, the Fed no doubt believes it is necessary to stay ahead of the inflation fight until conditions for a sustained disinflationary trend are in place. That would include, most notably, a decided downshift in employment growth, somewhere closer to 100 thousand a month, as well as meaningful signs of slowing wage gains. It is widely assumed that the Fed would continue raising rates until something breaks, which until this week referred mainly to the job market. But the central bank didn't see this week's rupture in the banking system coming and the potential fallout may prompt some Fed officials to reassess the wisdom of staying on the aggressive rate-hiking campaign they viewed as necessary a few short weeks ago.

If the market tumult subsides and the aftershocks are contained, the odds still favor a series of rate increases in coming meetings, including a 25-basis point hike next Wednesday. But the events of the past week will also set in motion a stealth tightening cycle that will amplify the growth-retarding effects of higher interest rates. Importantly, financial conditions are poised to tighten, as banks are likely to upgrade lending standards under the expected harsher glare of bank supervisors and the more risk-averse and discerning shareholders. That tightening would be reinforced if risk aversion spreads to the capital markets, causing a widening of yield spreads that undercuts the ability of lower-rated companies to raise funds.

And just as the Fed was surprised by the banking woes this week, it was also blindsided by a batch of softer data than expected. Retail sales fell by 0.4 percent in February, suggesting that consumers are stepping back after January's vigorous 3.2 percent gain in January. That's hardly a sign of retrenchment, as it still points to a robust spending increase for the first quarter. But the loss of momentum is expected to continue as consumers are growing weary of higher prices and higher borrowing costs. The University of Michigan reported on Friday that consumer sentiment fell to a four-month low in March -- and the survey was taken before the anxiety surrounding the banking system erupted. On the production side, industrial output was unchanged in February and, unlike consumer spending, is expected to contract in the first quarter. More broadly, the Conference Board's Leading Economic Index declined in February for the eleventh consecutive month, a trend consistent with a looming recession that we expect over the second half of the year.

That said, the Fed is likely to give more emphasis to the still-elevated pace of inflation revealed in the CPI report than the nascent weakness appearing in other economic data this week, underscoring our view that it will raise rates by 25 basis points at next week's meeting. While the banking woes will certainly command attention, we believe that it is not systemic but more of a liquidity issue that the Fed can contain with its lending facilities. The wildcard going forward will be the reaction in financial markets to ongoing developments in the banking sector as well as increasingly tight financial conditions driven by Fed policy.

FINANCIAL INDICATORS

INTEREST RATES	Mar 17	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.40	4.91	4.82	0.40
6-month Treasury bill	4.65	5.08	5.03	0.80
3-month LIBOR	4.96	5.15	4.91	0.93
2-year Treasury note	3.83	4.60	4.63	1.94
5-year Treasury note	3.51	3.97	4.03	2.14
10-year Treasury note	3.43	3.71	3.82	2.15
30-year Treasury bond	3.63	3.71	3.87	2.43
30-year fixed mortgage rate	6.60	6.73	6.32	4.16
15-year fixed mortgage rate	5.90	5.95	5.51	3.39
STOCK MARKET				
Dow Jones Industrial Index	31,861.98	31,909.64	33,826.69	34,754.93
S&P 500	3,916.64	3,861.59	4,079.09	4,463.12
NASDAQ	11,630.51	11,138.89	11,787.27	13,893.84
COMMODITIES				
Gold ($ per troy ounce)	1,993.70	1,872.70	1,851.30	1,921.50
Oil ($ per barrel) - Crude Futures (WTI)	66.33	76.68	79.33	105.10

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Consumer Price Index (February) - % change	0.4	0.5	0.1	0.4
Core CPI (February) - % change	0.5	0.4	0.4	0.4
Producer Price Index (February) - % change	-0.1	0.3	-0.2	0.2
Retail Sales (February) - % change	-0.4	3.2	-0.8	0.3
Housing Starts (February) - 000s of units	1,450	1,321	1,348	1,405
Building Permits (February) - 000s of units	1,524	1,339	1,337	1,438
Industrial Production (February) - % change	0.0	0.3	-1.4	0.3

DISCLAIMER: This communication has been prepared by Government Portfolio Advisors LLC solely for informational purposes for institutional clients. Sources for this commentary include Bloomberg and Oxford Economic/SMRA It is not an offer, recommendation, or solicitation to buy or sell, nor is it an official confirmation of terms. It is based on information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete or that any returns indicated will be achieved. Changes to assumptions may have a material impact on any returns detailed. Past performance is not indicative of future returns. Price and availability are subject to change without notice. Additional information is available upon request.

HEADQUARTERS:
6650 SW Redwood Ln Suite 365
Portland OR 97224