Weekly Economic Update—April 3rd, 2023

GPA GOVERNMENT PORTFOLIO ADVISORS

If ever there was a time when no news is good news for the financial markets, this is it. Clearly, the most encouraging news of the past week was the absence of more bad news on the beleaguered banking front. Importantly, no additional failures were reported, even as recriminations intensified on Capitol Hill over who was responsible for the panic that transpired over the previous three weeks. It's premature to conclude that the crisis is over given the outsize losses, mostly unrealized, on bank balance sheets that remain vulnerable to depositor flight. But the quick and forceful response by the Fed, Treasury and FDIC to contain the damage by providing much-needed liquidity to banks and assurances of depositor safety steadied a rocky boat and injected a note of optimism into the financial markets.

Indeed, a look back at the start of the just-concluded first quarter might give the impression that nothing of importance happened during the period. Since the first trading day in January, the S&P 500 notched a respectable 7 percent gain, the Treasury 10-year yield slipped a modest 25 basis points and that widely monitored recession indicator, the 2-year/10-year yield spread ended the quarter virtually spot-on with the 55-basis point inversion seen on the opening day of the year. That surface stability, of course, masks one of the most turbulent intra quarterly moves in recent memory, stoked by controversial Fed rate hikes, changing market perceptions regarding the economic outlook and, most notably, the banking kerfuffle that appears to have quieted down, at least for now.

With extraneous shocks receding from the headlines, investors can turn their attention back to the basics that stoked the market turbulence during the quarter. As was the case the prior week, the data calendar was light last week as well, but it conveyed some good as well as bad news. The highlight was the personal income and spending report for February that provides key details on consumer behavior, the economy's main growth driver. Nothing in the report changes our view that the economy is on a sturdy growth trajectory in the first quarter. Consumer spending did slow, as expected, and the entire increase in dollars spent was eaten up by higher prices, as real consumption slipped by 0.1 percent. But the retreat followed an upwardly revised January surge of 1.5 percent, which puts the two-month average growth in real consumer spending on track to exceed 4 percent in the first quarter.

However, the healthy quarterly growth is all front-loaded and the momentum behind consumer spending is fading. The January surge was driven by some temporary forces, including unusually warm weather, the boost to incomes from social security payments that were bloated by outsize cost of living adjustments and quirky seasonal adjustments to the raw data. Those catalysts are all in the rear-view mirror and the momentum they underpinned is facing stiffening headwinds. The spending retreat in February no doubt reflects a natural pullback from the artificial strength in January, but consumer fundamentals are poised to weaken in the months ahead. Credit-card interest rates have spiked, inflation is eating into household budgets, particularly among the lower and middle-income segment, credit availability is tightening due to the banking woes, and wage growth is slowing as employers focus more diligently on controlling labor costs. The sturdy first-quarter growth in consumer spending should be the high-water mark of the expansion as the economy moves towards a recession we expect to unfold over the second half of the year.

Ordinarily, weakening consumer spending would encourage the Fed to ease up on the rate-hiking campaign, particularly as further increases risk amplifying the stress on the banking system. Investors are betting that will turn out to be the case, as the markets are priced for the Fed to cut rates over the second half of the year. However, with the banking-induced turmoil under control for now, we suspect that the Fed will remain on its policy-tightening course until it drives a stake into the inflation dragon. The latest inflation numbers contained in the personal income and spending report revealed some progress on this front, but

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not enough to push the Fed to the sidelines. The 0.3 percent increase in the personal consumption deflator in February was a touch slower than expected and markedly lower than the 0.6 percent gain notched in January. But this price gauge is still running far too hot for the Fed's comfort, increasing 5.0 percent over the past year. That's down from the 5.3 percent pace in January but well above the Fed's 2 percent target.

Likewise, the core PCE deflator that excludes volatile food and energy prices increased by a slower 0.3 percent in February than the 0.5 percent January increase. But the 4.7 percent increase over the past year is only a tad slower than the 4.8 percent increase in January. What's more, the three-month average increase for both gauges is moving in the wrong direction, as they both accelerated in February. Importantly, the so-called super core inflation measure the includes the stickiest service prices, increased by 4.6 percent over the past year in February. That's the same as in January and up from 4.2 percent at the start of the year. The Fed is paying close attention to the super core rate as it is linked to wages in the service sector, which continue to rise strongly.

That said, the continued strength in wage growth is taking a toll on employers' bottom line and it remains to be seen how much longer the compression in profit margins will be tolerated before it spurs a big wave of layoffs. So far, the pink slips have proliferated in a few sectors, most notably tech, but the laid off workers have been quickly snapped up elsewhere, as claims for unemployment insurance continues to run at historically low levels. It's possible that hefty severance packages have held down the number of applicants filing for benefits; but hiring remains strong and companies continue to hold on to workers in the face of sagging sales, cutting their hours instead in the wake of widespread labor shortages over the past two years.

Odds are, their resistance will soon wear off, as higher labor costs – caused as much from reduced productivity as from rising wages – delivers a bigger blow to profits. That inflection point is drawing closer. In the fourth quarter of last year, corporate profits fell from a year ago for the first time since the recession. Historically, such a dip presages a recession within a couple of quarters. Unsurprisingly, profits at financial companies fell more than at nonfinancial firms. And while less than 10 percent of workers are employed by financial firms, they are victims of the very forces underpinning the reduced credit availability that will soon reverberate through the economy and, by extension, the workforce.

FINANCIAL INDICATORS

INTEREST RATES	Mar 31	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.76	4.65	4.85	0.52
6-month Treasury bill	4.89	4.71	5.13	1.07
3-month LIBOR	5.18	5.13	4.99	0.97
2-year Treasury note	4.03	3.78	4.87	2.46
5-year Treasury note	3.58	3.41	4.26	2.17
10-year Treasury note	3.48	3.78	3.96	2.39
30-year Treasury bond	3.65	3.65	3.88	2.44
30-year fixed mortgage rate	6.32	6.42	6.65	4.67
15-year fixed mortgage rate	5.56	5.68	5.89	3.83

STOCK MARKET				
Dow Jones Industrial Index	33,274.15	32,237.53	33,390.97	34,818.27
S&P 500	4,109.31	3,970.99	4,045.64	4,545.86
NASDAQ	12,221.91	11,823.96	11,689.01	14,261.50

COMMODITIES				
Gold ($ per troy ounce)	1,986.80	1,981.00	1,862.70	1,928.50
Oil ($ per barrel) - Crude Futures (WTI)	75.68	69.20	79.86	99.42

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average- Past Six Months or Quarters
Personal Income (February) - % change	0.3	0.6	0.3	0.5
Personal Consumption (February) - % change	0.2	2.0	0.0	0.5
Personal Savings Rate (February) - Percent	4.6	4.4	4.4	4.0