GPA SOLUTIONS

Weekly Economic Update—April 17th, 2023

GPA GOVERNMENT PORTFOLIO ADVISORS

Fed officials are still publicly taking a hard line on the inflation fight, with Fed governor Christopher Waller asserting on Friday that, "monetary policy will need to remain tight for a substantial period of time, and longer than markets anticipate". That hawkish stance, however, belies the message from incoming data showing an economy that is rapidly losing steam amid growing signs of slowing inflation. While some of Waller's colleagues have a more dovish preference, his remarks bolster the odds that another rate hike is likely to be taken at the next FOMC meeting on May 3. Indeed, the futures market is pricing in a greater than 80 percent probability that a quarter-point increase is in the cards.

That said, the odds that the next increase will be the last of the rate-hiking cycle are also increasing. To be sure, the economy's job-creating engine is still in high gear and the banking panic that restrained the Fed actions at its March 21-22 meeting has receded from the headlines. But even the red-hot labor market is showing signs of cooling, as job growth and wage increases are slowing. And while the banking panic has been defused for now, its aftershocks in the form of reduced credit availability have yet to fully play out. Understandably, the Fed is frustrated that inflation has not retreated as quickly as it hoped, given the aggressive policy tightening over the past year. But the disinflationary trend is well underway and questions about whether more rate hikes are needed to nudge it along are bound to gain traction after the May 3 meeting.

This week's benign reports on consumer and producer prices provide more ammunition for the dovish case. The headline consumer price index edged up by a slim 0.1 percent in March, smaller than the 0.2 percent expected, lowering the increase over the past year to 5.0 percent from 6.0 percent in February. This was the ninth consecutive month of slowing year-over-year price increases, the longest stretch of disinflation since 1984. For the first time in this inflationary cycle, the increase in the overall CPI over the past year is slower than the two other key components of the index – the core that excludes food and energy items and the core services that excludes housing – albeit the increases for those components also slowed in March.

However, the steeper decline in the headline CPI primarily reflects the drag from falling energy prices last month, including a 4.6 percent drop in gasoline prices. That retreat has since been reversed, thanks to production cuts recently announced by the OPEC-plus conglomerate. Crude oil quotes surged to the highest level of the year this week; at over $80, they are up about 25 percent from the low reached in mid-March, which should boost prices at the pump just as the driving season is about to get under way. The volatile nature of oil and food prices is the reason policymakers and economists strip away these items to get a better sense of the underlying inflation trend. While the stripped-down versions also depict a slowing trend, they are still running well above the Fed's 2 percent target. Simply put, getting the inflation rate down from 9 percent to 5 percent was a laudable accomplishment, but lowering it from 5 percent to 2 percent will be more of a grind.

The question is, how much pain is the Fed willing to inflict on the economy to reach that target? No doubt, some believe that rate hikes have caused only minimal damage so far, not nearly enough to dampen inflationary pressures. Governor Waller's comments this week would seem to bear out this sentiment. But the economy's main growth driver is clearly running on fewer cylinders as consumers are zipping up their wallets. Interestingly, the steep fall in gasoline prices last month, which is the equivalent of a tax cut, did little to boost spending at other retail establishments. Total retail sales fell 1.0 percent in March, about double expectations, but even excluding sales at service stations, retailers suffered a 0.3 percent drop in revenues during the month. The overall 1 percent decline followed a 0.2 percent fall in February, indicating that the pullback in consumer spending is accelerating. True, the retreat is coming off a spending surge in

January, when retail sales spiked 3.1 percent, putting the first quarter on track for a sturdy growth rate. But since the quarterly gain is so front-loaded it provides a rear-view image of the economy's strength.

Hence, the second quarter is starting with little momentum from consumers. To be sure, the retail sales report reveals spending mostly for goods, which consumers have been eschewing for some time as they pivot towards services in the evolving post-pandemic economy. But the pullback in goods spending is an indication that interest rate increases are taking a toll on household budgets. The biggest declines, aside from the price-driven slump in gasoline sales, occurred for goods that are highly interest-rate sensitive—including big-ticket products such as autos, furniture and building materials. Auto sales fell 1.6 percent following a 1.2 percent drop in February. With auto financing rates surging to levels not seen since before the Great Financial Crisis and banks tightening credit standards on auto loans, this industry faces some formidable headwinds.

Importantly, the pullback in goods purchases has far-reaching effects on the broader economy. Inventories have been piling up for several months and are outpacing sales, leading to cutbacks in new orders. That, in turn, reverberates down the production chain. Manufacturing output declined 0.5 percent in March, the first setback this year, and factories are operating at only 78.1 percent of capacity, which is below their long-term capacity utilization rates. This, of course, undercuts the need to keep employees on payrolls. So far, manufacturers have been holding on to workers, reducing staff by a mere 1 thousand in each of the past two months. But the incentive to retain workers will weaken as production continues to slide, which we expect as consumer spending on goods retrenches in the months ahead.

Indeed, manufacturers are also feeling the pinch from tightening credit conditions. Even before the banking turmoil emerged last month, lending standards to businesses had become more restrictive. That became even more of a reality following the panic as commercial and industrial loans at commercial banks plunged over the last two weeks of March. Importantly, lending to businesses has a critical influence on business investment spending. That influence may already be taking a toll. According to the industrial production report released on Friday, business equipment output fell 1 percent in March, the fourth decline in the past five months.

With inflation still running well above the Fed's 2 percent target and job growth continuing at a healthy pace, the Fed will likely bump up rates again at its May 3 meeting. However, mounting evidence that the disinflation trend is becoming firmly entrenched and nascent, albeit proliferating, signs that the economy is buckling under the weight of higher interest rates and reduced credit availability raise the odds that the next hike will be the last of the tightening cycle. As we get closer to that tipping point, the debate will shift towards whether the Fed will start cutting rates. Over the past fifty years, the median time between the last rate hike and the first rate cut has been about 4 months. We suspect that the lag will be longer this time, given the expected slow unwinding of inflation. That said, if the economy heads into a recession early in the second half of the year, as we expect, the first cut before the end of the year is a more than a trivial prospect.

FINANCIAL INDICATORS

INTEREST RATES	Apr 14	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.06	4.86	4.40	2.56
6-month Treasury bill	5.02	4.92	4.65	2.95
3-month LIBOR	5.26	5.20	4.96	2.91
2-year Treasury note	4.11	3.97	3.83	3.26
5-year Treasury note	3.61	3.51	3.51	2.99
10-year Treasury note	3.52	3.41	3.43	2.84
30-year Treasury bond	3.74	3.62	3.63	3.17
30-year fixed mortgage rate	6.27	6.28	6.60	5.22
15-year fixed mortgage rate	5.54	5.64	5.90	4.59

STOCK MARKET				
Dow Jones Industrial Index	33,886.47	33,485.29	31,861.98	33,761.05
S&P 500	4,137.64	4,105.02	3,916.64	4,280.15
NASDAQ	12,143.47	12,087.96	11,630.51	13,047.19

COMMODITIES				
Gold ($ per troy ounce)	2,017.60	2,023.70	1,993.70	1,818.90
Oil ($ per barrel) - Crude Futures (WTI)	82.18	80.46	66.33	91.88

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Consumer Price Index (March) - % change	0.1	0.4	0.5	0.3
Core CPI (March) - % change	0.4	0.5	0.4	0.4
Producer Price Index (March) - % change	-0.5	0.0	0.4	0.0
Retail Sales (March) - % change	-1.0	-0.2	3.1	0.2

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