Weekly Economic Update—May 8th, 2023

As expected, the Federal Reserve this week lifted its benchmark federal funds rate by another quarter-percentage point to the 5-5 ¼ percent range, the 10th hike in the most aggressive tightening campaign since the early 1980s. While the outcome was expected, the meeting was hardly a snooze-fest as it created more suspense over what comes next than seen following any of the previous nine gatherings. Whereas the previous confabs left little doubt that another rate hike was imminent, this one left open a range of possibilities – and a firestorm of speculation that will undoubtedly remain front and center for weeks to come. If there was one clear message that most commentators agree on, it is that the consecutive string of increases may have ended, as Fed officials signaled that a pause is likely at the June meeting.

But a pause is not the same a stop, and the jury is still out as to whether the rate-hiking campaign that began a little over a year ago has come to an end. Among the range of possibilities is a brief hiatus followed by further increases, an extended pause that keeps rates at elevated levels for the foreseeable future or a rate cut that begins sooner rather than later. All three options have advocates and all three are distinct possibilities depending on incoming economic and inflation data as well as financial conditions, most notably how severely credit availability will be reduced because of the stress on regional banks. Importantly, while rate hikes might stop or pause, their effects do not as the lagged impact of a 500-basis point surge in short-term rates over the past year will continue to reverberate through the economy in coming months.

At his post-meeting press conference, Fed Chair Powell addressed the issue of a pause, noting that “we feel like we’re getting closer, or maybe even there.”. But he understandably hedged his bets given the heightened uncertainty clouding the outlook. For good reason pundits dubbed the Fed’s message as a “hawkish pause” as Powell pointedly noted that rate cuts are not likely to happen in the near term because inflation continues to run far too hot. In that regard, the tension between the financial markets and the Fed remains as intense as ever since traders still expect the central bank to start cutting rates sometime later this year. The markets have been wrong before and the Fed’s plans often go awry, upended by unexpected developments on the economic front.

There is still a lot that can happen between now and the next policy meeting in mid-June that will determine if the Fed’s signal of a pause will hold. Until recently, we believed that another rate increase would be forthcoming, thanks to a resilient job market and an inflation rate that remained far above the Fed’s 2 percent target. It has been a widely held view that the Fed would keep the pedal to the metal until something breaks. While the real economy has held up better than expected, the unanticipated stress on regional banks has been the breaking point that is clearly softening the Fed’s stance. Recall that credit availability had been tightening even before the failure of three sizeable regional banks occurred over the past month. That tightening of financial conditions is set to become even more severe, which in the eyes of the Fed is the equivalent of at least one or two rate increases. For that reason, we also believe a rate increase next month has been taken off the table.

But assuming that the banking stress will be contained, the case for an imminent rate cut is hard to make. It’s no secret that the Fed is laser focused on the job market for several reasons. For one, as long as job growth is holding up and generating a solid stream of paychecks for households, the economy will continue to receive considerable support from its main growth driver, consumer spending. For another, the Fed’s overarching concern is reducing inflation and the main hurdle in accomplishing that goal is sticky service prices. Those prices, unlike the rapid unwinding of goods prices over the past year, are heavily influenced by labor costs, which continue to come under pressure from a tight job market. To be sure, there have been

signs of softening on the labor front; job vacancies have come down a bit, layoffs are rising, and workers are not quitting their jobs as frequently as last year.

But all those metrics are tapering from historically tight conditions and are still running far hotter than would be the case under a more balanced labor market. Importantly, the latest jobs report for April, released on Friday, reveal that we are still a ways from that condition. Indeed, the economy created a whopping 253 thousand net new jobs during the month, far greater than the 185 thousand expected and well above the 100 thousand that would align with the increase in the working-age population. The surprising strength in job growth was echoed on the other side of the ledger, as the unemployment rate fell from an already low 3.5 percent to 3.4 percent. That equals the lowest jobless rate in 50 years. Indeed, you would have to go back to the 1950s to find lower unemployment rate.

However, job growth for February and March was revised sharply lower, which takes some of the sting out of the stronger than expected increase in April. The revised figures erased 149 thousand jobs from the previous estimate for those two months. As a result, the trend is moving in the right direction, with the average increase over the past three months slowing to 222 thousand from 334 thousand at the start of the year. Still, that's well above the 164 thousand average monthly increase in payrolls seen during the last year of the pre-pandemic expansion. Recall that as recently as last year there were deep concerns about the army of potential workers remaining on the sidelines, particularly for those in the prime-age group. Not anymore. Indeed, the share of 25–54-year-olds holding jobs increased to 80.8 percent in April, the highest since the early 2000s, arguably the last time the consensus of economists agreed that the economy was at full employment.

Simply put, the jobs report doesn't change our view that the Fed will likely hold rates steady in June, as it signaled at its policy meeting this week. However, the Fed's telegraphed pause was a hawkish one, and if job and earnings growth don't moderate from the April pace, rate hikes could be back in play. Keep in mind though that the April jobs report is backward looking, with the Labor Department compiling data during the week of April 12, which only captures a portion of the recent stress in the banking system. We expect payroll gains will slow as the economy enters a mild recession in the second half of the year when the impact of cumulative rate hikes and a tightening in lending standards weigh on activity. From our lens, that indicates the Fed will keep its finger off the rate-hiking trigger. However, until more tangible signs of slowing inflation emerges, we do not see the Fed cutting rates before the end of this year.

FINANCIAL INDICATORS

INTEREST RATES	May 5	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.23	5.06	4.86	0.84
6-month Treasury bill	5.01	5.03	4.92	1.33
3-month LIBOR	5.23	5.30	5.20	1.37
2-year Treasury note	3.91	4.00	3.97	2.71
5-year Treasury note	3.41	3.49	3.51	3.08
10-year Treasury note	3.44	3.42	3.41	3.15
30-year Treasury bond	3.76	3.68	3.62	3.24
30-year fixed mortgage rate	6.39	6.43	6.28	5.27
15-year fixed mortgage rate	5.76	5.71	5.64	4.92
STOCK MARKET				
Dow Jones Industrial Index	33,674.38	34,098.16	33,485.29	32,899.37
S&P 500	4,136.25	4,169.48	4,105.02	4,123.34
NASDAQ	12,235.41	12,226.58	12,087.96	12,144.66
COMMODITIES				
Gold ($ per troy ounce)	2,024.90	1,999.20	2,023.70	1,882.10
Oil ($ per barrel) - Crude Futures (WTI)	71.33	76.63	80.46	110.60

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (April)	47.1	46.3	47.7	47.7
ISM Services Index (April)	51.9	51.2	55.1	53.0
Nonfarm Payrolls (April) - 000s	253	165	248	280
Unemployment rate (April) - Percent	3.4	3.5	3.6	3.5

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HEADQUARTERS:
6650 SW Redwood Ln Suite 365
Portland OR 97224