GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—May 22nd, 2023

With the clock ticking on the debt-ceiling saga, hopes are rising that negotiations will generate a last-minute compromise that avoids a default. More than anything, that prospect, until talks broke off late Friday, lifted market spirits this week, giving stock prices a sturdy boost and sending Treasury yields higher, with most maturities ending the period up 20- 25 basis points from last Friday. Importantly, market-based odds of a Federal Reserve rate hike at the mid-June policy meeting also rose to about 40 percent from 10 percent a week ago. That said, the markets still believe that what goes up, must come down; hence, futures traders continue to price in rate cuts before the end of the year, albeit they did move back the timing and pare the size of reductions compared to expectations of a few weeks ago.

The enhanced expectations of a more hawkish Fed had nothing to do with shifting economic or inflation developments during the week. Rather some Fed officials, most notably Dallas Fed president Lorie Logan, issued public comments suggesting that investors are underestimating the odds of a rate hike at the next FOMC meeting given the still high inflation rate and strong job market. Fed governor Jefferson also piped in with weakened support for a rate pause. No doubt, those messages from Fed officials contributed to the sizeable increases in market yields this week. But the lowered risk of a debt default also played a key role as it would remove a confidence-shattering hurdle posing an existential threat to the expansion.

On balance, the week's spate of economic reports neither invalidates nor supports the still-consensus view the Fed will hit the pause button at its policy meeting next month. The key growth driver, consumer spending, started the second quarter on a positive note, but retail sales in April was hardly a barn burner. In nominal dollars, sales rose 0.4 percent, below expectations but enhanced by upward revisions to February and March. Consumers are becoming much more selective in their purchases, as only seven of the 13 major retail groups saw an increase in sales. On a positive note, people still have discretionary funds to spend, as sales at restaurants and bars rose for the second consecutive month. But momentum is fading, as the increase from a year ago slowed to 9.4 percent from 12.5 percent in March. As recently as January, dining out sales were running 23.4 percent above year-earlier levels.

With job growth slowing, credit conditions tightening and excess savings from unspent pandemic-era funds dwindling, we expect discretionary spending to continue slowing in coming months. Another source of funds that provided heft to spending in 2021 and early 2022 is also disappearing, as housing equity extracted from a wave mortgage refinancing during that period has dried up. The sharp increase in mortgage rates over the past year has clobbered the incentive of homeowners to refinance their mortgages. That said, the reduction of monthly mortgage debt payments for those who did refinance will be a sustainable source of increased purchasing power.

While people continued to eat out more often last month, they also increased shopping over the Internet, as nonstore sales advanced by a sturdy 1.2 percent. Consumers are devoting an increasing share of their outlays to online vendors, as nonstore sales as a ratio of total retail sales increased to 16.42 percent in April – the highest share since December 2020 – marking the fourth consecutive increase from 15.87 percent at the start of the year. This trend is a significant reversal from the past two years as lessened health concerns and the reopening of the economy had encouraged households to return to malls and shopping centers for goods purchases as well as to unleash more spending on experiences and services. At the height of the pandemic in April 2020, online spending peaked at 19.82 percent of retail sales.

It’s unclear what’s behind the recent revival of Internet shopping. One possibility is the increasing bankruptcies and closing of physical stores, highlighted most recently by Bed, Bath and Beyond, that may be sending consumers back to the more convenient and accessible option of purchasing goods on their computers. However, Walmart and other large retailers are noting a distinct shift in consumer behavior on their earnings calls, reporting that customers are looking for bargains, substituting lower priced goods for more expensive items whenever possible. Such bargain-hunting is common behavior during recessions, but it also gains traction when inflation outpaces incomes in a slowing economy, which is currently the case. It may well be that price-conscious consumers are turning more to the Internet, where pricing transparency and broader purchasing options have been the key catalysts behind its explosive growth over the past decade.

It's important to note that consumers received less bang for the buck in their retail purchases last month, as the 0.5 percent increase in goods prices exceeded the increase in total retail sales, most of which is for goods. Hence, real sales likely fell for the third consecutive month. However, the control group of sales that excludes autos, building materials and gasoline, which feeds directly into the GDP accounts rose by a more robust 0.6 percent in April, which translates into a positive real gain. And as signaled by the 0.6 percent increase in sales at restaurants and bars, consumers are keeping their wallets open for services, which should contribute to an increase in real personal consumption for April in the more comprehensive income and spending report due out later this month.

The real gain in consumption in April should keep GDP on a positive growth trajectory in the second quarter. But the advance in consumer spending will slow markedly from the weather-fueled 3.7 percent surge in the first quarter. As noted, households are becoming more price conscious and less willing to accept the ever-larger price increases that businesses were able to push through in late 2021 and 2022. Some recent studies suggest that consumers willingly accepted those price increases because of acute product shortages that, in their minds, justified the increases. The copious fiscal transfer payments and torrid post-pandemic job growth also lowered their resistance to higher prices.

However, the virtual ending of supply constraints – except perhaps in the auto industry – removes a critical justification for businesses to raise prices. Some believe that businesses took advantage of the supply shortages to boost prices more than necessary, undergirding the expansion of profit margins and spurring a growing debate over whether inflation is being driven more by profits than by demand/supply imbalances. The concept of “greedflation” is not new; recall that back in the 1990s Fed chair Alan Greenspan opined that corporations could help keep inflation under control by accepting some reduction in their record profits. The current Fed chair, Jerome Powell, is not a fan of that concept and believes that more conventional influences, including excess demand and a strong labor market, are driving inflation. That perception is likely to keep Fed policy rates higher for longer than investors expect, which along with the tightening of credit conditions, will likely push the economy into a recession later this year.

GPA SOLUTIONS

FINANCIAL INDICATORS

INTEREST RATES	May 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.24	5.18	5.07	1.01
6-month Treasury bill	5.33	5.12	5.04	1.45
3-month LIBOR	5.38	5.32	5.27	1.50
2-year Treasury note	4.26	4.00	4.17	2.61
5-year Treasury note	3.74	3.45	3.67	2.82
10-year Treasury note	3.68	3.47	3.58	2.79
30-year Treasury bond	3.93	3.79	3.78	2.99
30-year fixed mortgage rate	6.39	6.35	6.39	5.25
15-year fixed mortgage rate	5.75	5.75	5.76	4.43

STOCK MARKET				
Dow Jones Industrial Index	33,426.63	33,304.00	33,808.96	31,262.90
S&P 500	4,191.98	4,132.50	4,133.62	3,901.36
NASDAQ	12,657.90	13,372.00	12,032.46	11,354.62

COMMODITIES				
Gold ($ per troy ounce)	1,979.40	2,016.20	1,994.10	1,845.10
Oil ($ per barrel) - Crude Futures (WTI)	71.71	70.08	77.95	112.70

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Housing Starts (April) - 000s	1,401	1,371	1,436	1,389
Building Permits (April) - 000s	1,416	1,437	1,482	1,417
Retail Sales (April) - % change	0.4	-0.7	-0.7	0.0
Industrial Production (April) - % change	0.5	0.0	0.0	-0.1
Capacity Utilization (April) - Percent	78.3	77.6	78.3	79.6

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