GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—June 12th, 2023

All eyes are on this week's economic releases, which will be chock full of reports on consumer spending, industrial production, inflation and, importantly, the highly anticipated Federal Reserve policy meeting. Investors are fully expecting the Fed to skip another rate hike at the gathering but are less convinced than a few months ago that it is poised to unleash a series of rate cuts in coming months. The markets are still betting that the central bank will cut rates before the end of the year, but no longer expects multiple reductions. The backward-looking consumer price report that will be released a day before the Fed's meeting concludes on Wednesday should not influence next week's decision one way or another.

That said, policymakers will be laser-focused on inflation at the meeting, with both the doves and hawks presenting compelling cases for their views. All would agree that inflation has fallen far more slowly than expected or hoped. The question is, how much pain will the central bank be willing to inflict on the economy to wrestle inflation down from its current 4 ½ to 5 percent pace to the 2 percent target? By pausing, as expected, at the meeting, the Fed recognizes that rate hikes affect the economy with long and variable lags, and it would be buying time to assess the impact that past rate increases are having. But a pause is not the same as stop, and several policy makers are strongly hinting that additional rate increases in July or later in the year are more likely than not. Those hints along with the economy's recent performance have no doubt swayed market sentiment away from expecting multiple rate cuts in coming months.

The doves on the rate-setting committee still cling to the hope that inflation can recede towards 2 percent without additional rate increases that would risk sending the economy into a recession. But that argument for what is being dubbed "immaculate disinflation" is becoming harder to defend given the resilience shown by consumers, the strength of the job market and the stickiness of inflation. To be sure, some doves argue that the very strength of the economy despite ten consecutive rate hikes over the past year indicates that the Fed is well on its way to bringing inflation under control without causing a recession, accomplishing that much-hyped "soft landing". From their lens, the journey may be taking a bit longer than expected, but patience would be rewarded because millions of jobs would be saved in the process.

But getting inflation down from a peak of 9 percent to 5 percent was the easy part, helped by the unclogging of bottlenecks caused by the pandemic, the return of normal spending patterns by consumers as the economy reopened and the weakening of rate-sensitive sectors, such as housing and manufacturing, in response to the Fed's tightening actions. Getting inflation from 5 percent to 2 percent will be much harder if the economy, and particularly the job market, continues to forge ahead. One reason is that the sticky components that are nurturing inflation, mostly in services, are linked to labor costs that are still rising too rapidly, regardless of which yardstick is used. This week, the widely followed wage tracker by the Federal Reserve Bank of Atlanta showed that wages were still rising at a 6 percent pace in May. While that's down from a 6.7 percent peak last July, the Fed believes that wages need to slow to around 3.5 percent which, after adjusting for 1 ½ percent productivity growth, would be consistent with a 2 percent inflation rate.

From the hawkish perspective, getting wage growth to slow that dramatically requires more tough love from the Fed. That means creating more weakness in the job market, undermining the bargaining power of workers. At its meeting next week, the Fed will be releasing an updated set of quarterly economic projections that will include a forecast of the unemployment rate. In its previous forecast, unveiled in March, the Fed expected the unemployment rate to rise to 4.5 percent next year, up from the current 3.7 percent. We'll see if that projections changes, but a rise of that magnitude has never occurred without the economy falling into a recession. It's important to note, however, that while the change would be dramatic, it is starting

from an historically low level. A 4.5 percent peak unemployment rate would still rank very low in the post war era.

While we don't believe the Fed can bring inflation down to its 2 percent target without sending the economy into a downturn, we also look for the recession to be relatively mild, with a peak to trough slide in GDP of roundly 1 ½ percent and the unemployment rate to peak at around 5 percent, which would be well below the cyclical highs of past recessions. Thanks to the surprising strength in consumer spending and job growth so far in the second quarter, we also pushed back the projected onset of the recession, from the third to the fourth quarter. A key reason why we expect the recession to be mild is that there are no glaring imbalances in household or corporate balance sheets that typically set off more severe downturns in the past.

Indeed, the Federal Reserve latest set of financial accounts (formerly known as the flow of funds accounts) released this week confirms that household balance sheets remain rock solid. Thanks to sturdy gains in stock prices that more than offset a decline in home values, household assets rose by 7.4 percent, lifting net worth by $3.5 trillion in the first quarter. What's more, disposable incomes rose even faster during the period, so net worth as a percent of disposable incomes actually slipped to 760 percent from 766 percent. While that is also lower than the 840 percent peak set a year ago, household net wealth is still comfortably higher than prepandemic levels. So far in the second quarter, stock prices have continued to rise and home prices appear to have bottomed out; in fact, the slim volume of homes for sale relative to demand has started to push home prices higher in many regions.

To be sure, the connection between expanding net wealth and spending is loose at best, depending on who is benefiting the most from the additional wealth. Clearly, upper income households reap most of the rewards when wealth is driven up by rising stock prices, as stock holdings are owned mostly by the rich. For the most part, wealthier households save their asset gains, which mainly bolster their net worth. Hence, the wealth effect on consumption is much less than it would be if the wealth gains accrued to lower income individuals who are more likely to convert the assets into spendable funds. However, for most households the main asset is their homes which, as noted, have lost value over the past year.

But while lower- and middle-income Americans have been mostly shut out from the stock market rally since the onset of the pandemic, their balance sheets have also swollen considerably, thanks to the copious infusion of cash from Washington via several rounds of stimulus checks. That, along with robust job and wage growth, has contributed mightily to consumer spending and enabled households to accept the ever-increases in prices over the past year. Not surprisingly, those savings have been whittled down considerably as inflation has outpaced income growth; but households still have a formidable cushion of excess savings left over, which should sustain their spending even as the lagged effects of higher interest rates starts to constrain job growth later this year. That spending cushion, in turn, is one reason we delayed the onset of the recession until the fourth quarter and poses an upside risk to another Fed rate hike after the expected pause next week.

FINANCIAL INDICATORS

INTEREST RATES	Jun 9	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.25	5.38	5.18	1.34
6-month Treasury bill	5.38	5.47	5.12	1.96
3-month LIBOR	5.54	5.50	5.32	1.72
2-year Treasury note	4.61	4.51	4.00	3.07
5-year Treasury note	3.92	3.85	3.45	3.27
10-year Treasury note	3.74	3.70	3.47	3.16
30-year Treasury bond	3.88	3.89	3.79	3.20
30-year fixed mortgage rate	6.71	6.79	6.35	5.23
15-year fixed mortgage rate	6.07	6.18	5.75	4.38
STOCK MARKET				
Dow Jones Industrial Index	33,876.38	33,762.76	33,304.00	31,392.79
S&P 500	4,298.86	4,282.37	4,132.50	3,900.86
NASDAQ	13,259.14	13,240.77	13,372.00	11,340.02
COMMODITIES				
Gold ($ per troy ounce)	1,975.30	1,964.60	2,016.20	1,875.20
Oil ($ per barrel) - Crude Futures (WTI)	70.35	72.00	70.08	120.49

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
ISM Services Index (May)	50.3	51.9	51.2	52.2
Consumer Credit (April) - blns of $s	23.0	22.8	8.2	21.1

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HEADQUARTERS:
6650 SW Redwood Ln Suite 365
Portland OR 97224