GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—June 20th, 2023

The Fed's decision to leave rates unchanged at its policy meeting this week came as no surprise, as it was strongly telegraphed in advance by Fed officials and had been fully priced into the financial markets. But the market's response to the hawkish pause -- so called because updated projections at the meeting pointed to two more rate hikes by year-end -- was probably not what the Fed expected – or desired. True, it successfully pushed back against investor expectations that rate cuts were in the offing over the second half of the year. Following the meeting, the futures market had priced in nearly a 100 percent probability that the Fed policy rate would be no lower at the of the year than it is now.

But while it finally got that message across after months of unsuccessfully trying, the Fed still could not prevent financial conditions from easing, something that runs counter to its efforts to tame inflation by slowing growth. In the two days following the conclusion of the FOMC meeting on Wednesday, the stock market continued to rally, Treasury bond yields fell, and the dollar weakened. These are all growth-stimulating influences that, if continued, would only make the Fed's task that much harder. If anything, easier financial conditions raise the odds that the Fed would need to step on the brakes more forcefully in coming months. That said, the tightening of bank lending standards following the recent banking turmoil dilutes some of the stimulatory effects linked to easier market conditions.

Clearly, the Fed is unhappy with the slow progress on the inflation front, which heightens the risk that more rate hikes are in the cards. In its updated set of projections, the FOMC lifted its forecast for growth, inflation and employment for 2023 relative to what it expected in March. The stronger outlook reflects the upside surprises in these metrics that have transpired so far this year. However, the past is not prologue, and we still believe that the Fed will keep its finger off the rate-hiking trigger for the rest of this year. Understandably, the Fed cannot take a victory lap on inflation, as it still has a ways to go before reaching the 2 percent target. But the trend is encouraging and likely sustainable, providing cover for policy makers to wait and see how their past actions are playing out.

The most encouraging news is the deep dive unfolding in the headline inflation rate, with the overall consumer price index edging up by a slim 0.1 percent in May, lowering the annual rate to 4.0 percent from 4.9 percent in April. That's the lowest year-over-year increase since March 2021 and less than half the 9.1 percent peak annual rate of this inflation cycle set in June of last year. But the dramatic fall in headline inflation primarily reflects plunging energy prices along with much slower food price increases. The Fed pays more attention to the trend in core inflation that excludes those volatile price movements. Here the story is not nearly as encouraging, as the core CPI rose by the same sturdy 0.4 percent pace as in each of the previous three months and five of the last six. The one departure over this span occurred in February, when the monthly increase in the core was an even larger 0.5 percent. Hence, in contrast to the plunge in the annual headline inflation rate, the core CPI displayed a much more grudging slowdown, slipping to 5.3 percent from a year ago from 5.5 percent in April.

The key source of upward inflation pressure is coming from the service side of the economy, where pricing power is bolstered by the reopening of the economy, the shift in consumer spending behavior away from goods and rising labor costs. But those influences have been waning for months and the main culprit that is now sustaining upward pressure on core inflation is housing costs, which account for 40 percent of the core CPI. Within housing, rents continue to lead the way, rising by 0.5 percent in each of the past three months and by 8.7 percent over the past year. But the rental gauge is a lagging indicator, as it includes all leases in effect over the past year. According to Zillow and other private industry sources, rental increases on new leases slowed considerably. As these contracts weigh more prominently in the BLS calculations,

rental inflation will come down faster. That trend has already begun, albeit modestly, as rent increases in the CPI have slowed to a 6.3 percent annual rate over the past three months.

Given the limited impact that monetary policy has on housing costs, the Fed is laser focused on service prices that exclude rents and volatile energy prices. This so-called supercore inflation measure has been stubbornly hot, which the Fed believes reflects underlying strength in the economy and, particularly, the job market, where sturdy wage increases have underpinned price pressures in the service sector. But more recently, the supercore inflation gauge has been slowing markedly, slipping to a 2.8 percent annual rate over the past three months. Unless this trend is reversed in coming months, it presents a strong argument against further rate increases this year. We see no reason for a reversal, although the recent pullback may be overdone.

Importantly, just as the post-pandemic inflation spiral has taken a toll on household budgets, the unwinding of inflation pressures is enhancing household purchasing power. For the first time since March 2021, worker earnings have caught up with inflation on a year over year basis. What's more, the catch-up has evolved for the right reasons. Both inflation and wage increases are slowing, but the slowdown in consumer price increases has been greater. Hence, real worker earnings turned positive in May, rising 0.2 percent compared to a year ago. To some extent, that may have contributed to the stronger than expected increase in retail sales last month.

To be sure, the plunge in energy prices in May contributed importantly to the pop in real earnings, as wage growth still lags the increase in core inflation. But with wage growth slowing, the odds of a wage-price spiral gaining traction are much lower than it would be if wage growth were accelerating. That should be comforting to the Fed, which still believes the job market is running too hot and generating stronger wage increases that is consistent with its 2 percent inflation target. However, in a slowing economy that faces strong headwinds from tighter credit conditions, higher interest rates and dwindling savings, businesses are having a harder time passing on these wage increases to consumers.

Nowhere is that more evident than it is among small businesses, which account for the lion's share of jobs in the U.S. For the past six months, small firms have been raising worker pay faster than they are raising prices. This reflects the greater difficulty smaller firms have in filling open positions than do larger companies. What's more, they do not have the pricing power that larger firms have. But that pricing power is dependent on the strength of the job market and the income-generating dynamic that underpins demand. As the squeeze on small firms continues, layoffs will spike and short-circuit demand, setting the stage for a mild recession – and lower inflation – that we believe will unfold later this year and into 2024.

FINANCIAL INDICATORS

INTEREST RATES	Jun 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.23	5.25	5.24	1.61
6-month Treasury bill	5.32	5.38	5.33	2.22
3-month LIBOR	5.51	5.54	5.38	2.06
2-year Treasury note	4.72	4.61	4.26	3.19
5-year Treasury note	3.98	3.92	3.74	3.35
10-year Treasury note	3.77	3.74	3.68	3.24
30-year Treasury bond	3.86	3.88	3.93	3.28
30-year fixed mortgage rate	6.69	6.71	6.39	5.78
15-year fixed mortgage rate	6.10	6.07	5.75	4.81

STOCK MARKET				
Dow Jones Industrial Index	34,299.12	33,876.38	33,426.63	29,858.78
S&P 500	4,409.59	4,298.86	4,191.98	3,674.84
NASDAQ	13,689.57	13,259.14	12,657.90	10,798.35

COMMODITIES				
Gold ($ per troy ounce)	1,970.70	1,975.30	1,979.40	1,843.80
Oil ($ per barrel) - Crude Futures (WTI)	71.44	70.35	71.71	109.91

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Consumer Price Index (May) - % change	0.1	0.4	0.1	0.3
Core CPI (May) - % change	0.4	0.4	0.4	0.4
Producer Price Index (May) - % change	-0.3	0.2	-0.4	-0.1
Industrial Production Index (May) - % change	-0.2	0.5	0.1	0.0
Retail Sales (May) - % change	0.3	0.4	-0.9	0.2

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