

If the U.S. economy is on the verge of a recession – which some time-honored indicators are clearly signaling – it is not swaying the Federal Reserve from its determined mission to contain inflation. That's the firm message conveyed by Fed Chair Jerome Powell in his semiannual testimony before Congress this week. Powell strongly suggested that more interest rate increases are on the way, perhaps as early as the next policy meeting on July 26 which, he exclaimed, will be “live” to that possibility. In light of the exceptionally hawkish rhetoric in his testimony, it is fair to wonder if the pause in rate hikes taken at the mid-June policy meeting was misguided.

Recall that policy makers supported a pause to assess the impact that past tightening moves were having on the economy. In the same breath, they predicted that two more rate increases would be taken this year. But if the intent was to wait another month to see if things would change, it's unlikely that they would gain much more information. True, another month of jobs and inflation will be available before the meeting, but those reports are backward looking and not likely to show much, if any, change in the economic landscape. If Powell is so concerned that inflation is not cooling fast enough, why not just hike rates now and get a head start.

To be sure, the forecasts issued at policy meetings have missed the mark more often than not, and that may turn out to be the case this time as well. Indeed, investors are still nonbelievers, with the financial markets pricing in an 80 percent chance of only one more rate increase, which is expected to be the last of the tightening cycle. While they no longer expect the Fed to start cutting rates this year, as they did a few months ago, the next move after the final hike is still expected to be down; only the timing was delayed until early next year. For its part, the Fed also expects to start reducing rates in 2024, but later and by less than investors anticipate.

Who will turn out to be right is an open question. At this juncture, the upside risk is more compelling, if only because the hard data continue to come in stronger than expected. That includes, most notably, the latest reports on jobs and consumer spending. These are two areas that the Fed believes must cool significantly more to bring inflation down. But many believe the Fed is ignoring forward looking signals at its peril. True, job growth has been stronger for longer than expected; but it is slowing and poised to decelerate at a more pronounced clip in coming months as the economy's growth engine downshifts. Companies are hoarding workers, fearing they would be difficult to rehire later when they are needed, reminiscent of the severe labor shortages during the post-pandemic rebound. Instead of reducing staff, employers are cutting worker hours, preferring to retain headcount that would be ready to punch longer hours on timecards when more output is needed.

But hoarding becomes more difficult – and expensive – in a slowing economy, and we suspect the reluctance to reduce payrolls will soon weaken. Indeed, there are signs that is already happening. New claims for unemployment benefits are rising, reaching the highest level since October 2021. The overall level is still low by historical standards, and at 264 thousand in the June 17 week, remains well below the 400 thousand typically associated with recessions. But the direction is unambiguous and pointing to easier labor market conditions over the second half of the year. From the Fed's perspective, that would be a precondition for a cooling off of wage growth, which the Fed believes is underpinning inflation in the labor-intensive service sector. Wages are still increasing in the 4 1/2-5 1/2 percent range, depending on the measure used, and the Fed believes that it needs to slow to 3 – 3 1/2 percent for it to be consistent with a 2 percent inflation rate, after accounting for 1 – 1 1/2 percent productivity growth.

In its economic projections unveiled at the June 16 policy meeting, Fed officials predicted that the unemployment rate would climb to 4.5 percent next year from the 3.7 percent in May. At the same time, the projections also peg GDP to grow a tad stronger next year than this, which assumes no recession is in the cards. But the economy has never avoided a recession when the unemployment rate has risen by more than 0.5 percent. Keep in mind that the climb in the unemployment rate would be even steeper when compared to the 3.4 percent low reached in April. Importantly, the projections also assume inflation would retreat to 2.5 percent at the end of next year and hit the 2.0 percent target in 2025. In essence, policymakers still believe that it can guide the economy onto a soft landing, reaching its inflation goal without causing a recession.

Achieving that objective is not out of the question, as inflation has been steadily retreating even as the economy has remained firmly on a positive growth trajectory. What's more, there is every indication that the disinflationary trend will benefit from some powerful tailwinds over the second half of the year. For one, rental inflation – which is the major source of upward pressure on service prices in the consumer price index – is poised to slow markedly, as new leases are carrying lower rents than those signed a year ago. That trend will only gain traction, as the apartment market is about to be flooded with additional supply later this year and into 2024. In May, nearly 1 million apartment units were under construction, a record high and up almost 20 percent over the past year. For another, the year-over-year inflation rate will slow starting this summer due to friendlier base effects. The torrid price increases last spring, reflecting supply-chain shortages, that boosted the price index level will be dropping out of the calculations starting in July.

But to squeeze out that last percentage point in the inflation rate to get it down to the 2 percent target will require more heavy lifting on the labor cost side. Despite the aforementioned signs that the job market is easing, there is a ways to go before worker bargaining power is defused enough to significantly cool off wage growth. For that to happen, the economy would need to weaken more than the Fed anticipates, prompting outright job losses that stokes worker insecurity and curbs wage demands. From our lens, that translates into a recession, which is a time-honored inflation reducer. As noted at the outset, the prospect of a downturn is being signaled by at least two historically reliable indicators. The inverted yield curve that has preceded every postwar recession is the steepest since 1981, with the Treasury's 2-year yield exceeding the 10-year yield by 100 basis points. Additionally, the Conference Board's index of leading economic indicators has declined for 14 consecutive months, which is the longest stretch since the Great Recession. The good news is that none of the monthly declines were as steep as the ones seen during the 2007-2009 recession, which supports our view that the recession, which we believe will start late this year or early in 2024, will be relatively mild.

FINANCIAL INDICATORS

| INTEREST RATES | Jun 23 | Week Ago | Month Ago | Year Ago |
|-----------------------------|--------|----------|-----------|----------|
| 3-month Treasury bill | 5.30 | 5.23 | 5.27 | 1.66 |
| 6-month Treasury bill | 5.41 | 5.32 | 5.40 | 2.49 |
| 3-month LIBOR | 5.54 | 5.51 | 5.46 | 2.20 |
| 2-year Treasury note | 4.75 | 4.72 | 4.56 | 3.08 |
| 5-year Treasury note | 3.99 | 3.98 | 3.93 | 3.19 |
| 10-year Treasury note | 3.74 | 3.77 | 3.81 | 3.13 |
| 30-year Treasury bond | 3.81 | 3.86 | 3.96 | 3.26 |
| 30-year fixed mortgage rate | 6.67 | 6.69 | 6.57 | 5.81 |
| 15-year fixed mortgage rate | 6.03 | 6.10 | 5.97 | 4.92 |

| STOCK MARKET | | | | |
|----------------------------|-----------|-----------|-----------|-----------|
| Dow Jones Industrial Index | 33,727.43 | 34,299.12 | 33,093.34 | 31,500.68 |
| S&P 500 | 4,348.33 | 4,409.59 | 4,205.45 | 3,911.74 |
| NASDAQ | 13,492.52 | 13,689.57 | 12,975.69 | 11,607.62 |

| COMMODITIES | | | | |
|---|----------|----------|----------|----------|
| Gold (\$ per troy ounce) | 1,929.90 | 1,970.70 | 1,946.70 | 1,828.10 |
| Oil (\$ per barrel) - Crude Futures (WTI) | 69.31 | 71.44 | 72.89 | 107.08 |

| ECONOMIC INDICATOR | Latest Month/Quarter | Previous Month/Quarter | Two-Months/Quarters Ago | Average-Past Six Months or Quarters |
|---|----------------------|------------------------|-------------------------|-------------------------------------|
| Existing Home Sales (May) - mlns of units | 4.3 | 4.3 | 4.4 | 4.3 |
| Housing Starts (May) - 000s | 1,631 | 1,340 | 1,380 | 1,414 |
| Building Permits (May) - 000s | 1,491 | 1,417 | 1,437 | 1,432 |

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