GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—March 18th, 2024

With spring just around the corner, the wintry mix of noisy data can soon be put in the rear-view mirror. Thanks to unpredictable weather, a leap year that added a day's worth of activity to February and the usual resetting of prices and wages early in the year, it is hard to separate the noise from the signal when parsing the data reported for January and February. That said, economists and policy makers must work with the cards they are dealt, and the hand so far clearly justifies a stand pat approach. For sure, the central bank's policy meeting next Wednesday will be a "hold 'em" affair, with the players keeping rates at the current 5.25 -5.50 percent range for a while longer.

Despite the noise, there is enough substance in the data to provide some clear messages. The economy is still chugging along, although at a slower pace, inflation continues to retreat, although not as rapidly as hoped, and some policy relief in the near future is warranted, although probably not as soon or as much as many had thought a few months ago. We still believe that the Fed will lower rates three times this year for a total of .75 percentage points, although the first cut may come later than sooner, perhaps at the June rather than the May policy meeting. If nothing else has been settled, the markets and the Fed at least are more in sync with that prospect, closing a wide divide that prevailed at the start of the year when the market priced in a far more aggressive easing cycle that is now expected to unfold.

This week's reports confirmed the economic backdrop outlined above and supports the sentiment, expressed by Fed chair Powell at his recent congressional testimony, that the Fed is in no hurry to cut rates, although the time is getting closer. The problem is that progress on the inflation front is taking longer to play out. For the second month in a row, the headline and core CPI came in hotter than expected in February. While the overshoot was not consequential, it reinforced the notion that the last mile towards the Fed's 2 percent inflation target will be a bumpy one. The overall CPI increased 0.4 percent last month, a touch faster than the 0.3 percent January increase, owing largely to higher gasoline prices. Excluding volatile gas and food prices, the core CPI rose by the same 0.4 percent as in January.

The longer perspective does not look much better. Compared to a year ago, the headline CPI ticked up to 3.2 percent from 3.1 percent in January. However, the core CPI did grind lower, slowing to an annual increase of 3.8 percent from 3.9 percent the previous month. The Fed's preferred price gauge, the personal consumption deflator, will be released later this month, but based on the linked components to the CPI and the producer price index, which also came in hotter than expected in February, we don't expect much improvement towards the 2 percent target to appear in the February data. That said, there is some good news under the hood.

For one, the biggest drivers of inflation – housing and sticky service prices – appear to be cooling. The owners' equivalent rental component of shelter prices (OER)– the rent that owners in occupied housing could receive – increased by a more modest 0.4 percent in February after posting a scary 0.6 percent increase in January. Rents on primary residences did tick up, to 0.5 percent from 0.4 percent in January, but slowed on a year-over-year basis, to 5.8 percent from 6.1 percent. That's the slowest annual increase since June 2022. Importantly, rental inflation is poised to slow further, as new lease signings are generating much smaller increases in recent month. In some regions, market rents are actually falling.

Of more concerning to the Fed is the sticky prices of core services outside of housing. This component – the so-called supercore inflation index – has been the biggest driver of inflation, increasing by 6.9 percent over the past year. The good news is that the February increase slowed to 0.5 percent from an eye-opening 0.9 percent in January. This is a highly volatile series, so it would be a mistake to attach much importance

to a one-month slowdown. Indeed, over the past three months, supercore inflation has averaged 4.65 percent at an annual rate, which is far too high for the Fed's comfort. This subindex accounts for 33 percent of the core CPI, so unless it downshifts considerably faster, progress towards the 2 percent target will be difficult to achieve.

But these service prices are closely linked to wages, which are flashing some encouraging signs that point to some easing of price pressures in coming months. For one, wage growth is cooling, albeit slowly, as reflected in both the broad measure of labor compensation, the quarterly Employment Cost index, as well as the average hourly earnings component of the monthly payroll report released last week. For another, workers are starting to place more importance on job security than pay raises. The most visible sign of this is the reduced rate at which they are voluntarily quitting their jobs. Indeed, the quits rate, at 2.1 percent in January, has returned to prepandemic levels, having tumbled from a high of 3.0 percent in late 2021.

Significantly, the incentive to quit for a new job has weakened considerably as the premium pay for job switchers over job stayers has narrowed significantly, according to the Federal Reserve Bank of Atlanta's wage tracker. Aside from one month in mid-2021, the current wage premium for job switchers is the slimmest since July 2019. That reduced pay gap is a sign that competition for workers is weakening, which is echoed in the reduced number of job openings reported in January. As the labor market continues to come into better balance, workers will have less strength in bargaining for higher wages, taking some of the steam out of wage-driven pressures on companies to raise prices. Small firms are already responding to the easing of labor shortages, as the percent of companies in the latest NFIB survey planning to raise prices fell to the lowest point since March 2021.

And while the inflation conversation has focused primarily on housing costs, wage pressures and supply-chain disruptions since the onset of the pandemic, attention should soon shift to the demand side of the ledger. No doubt, consumers have been grumbling about high prices for some time and pockets of resistance have shown up from time to time. Still, consumer spending has been remarkably resilient, driving the economy to much stronger growth rates than most forecasters had expected. Households still have considerable firepower, as the job market remains solid, balance sheets are in good shape and disposable incomes are outpacing inflation. But consumers started the year on a shakier footing, stumbling into retail stores with half-closed wallets and purses.

Retail sales did increase by a respectable 0.6 percent in February, rebounding from a 1.1 percent decline in January. But the entire two-month change – and then some – was eaten up by higher gasoline prices. Excluding sales at service stations, retailers in the aggregate saw their revenues decline since the end of last year. Importantly, the control group that excludes volatile sales items like gas, autos and building materials, which feeds into the GDP calculation was unchanged in February following a 0.3 percent decline in January. After adjusting for higher prices, these purchases have also declined over the first two months of the year. No doubt, the shortfall in retail sales, which are mainly for goods, will be more than offset by sales for services, and real personal consumption will remain on a positive growth trajectory in the first quarter. But the fire under the demand for goods and services is gradually cooling, reinforcing the weakening price pressures coming from labor costs and the ongoing healing of supply chains. Hence, the path towards lower inflation should resume, if erratically, in coming months, keeping the door open for the Fed to start cutting rates by the summer. While the upcoming policy meeting will be uneventful on the rate front, there is some suspense over whether the new set of projections provided at the meeting will feature fewer rate cuts than the three indicated in the last quarterly set of projections made at the December meeting.

FINANCIAL INDICATORS

INTEREST RATES	Mar 15	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.38	5.37	5.37	4.36
6-month Treasury bill	5.34	5.29	5.32	4.51
2-year Treasury note	4.74	4.49	4.64	3.81
5-year Treasury note	4.33	4.05	4.28	3.44
10-year Treasury note	4.32	4.08	4.28	3.39
30-year Treasury bond	4.43	4.25	4.43	3.60
30-year fixed mortgage rate	6.74	6.88	6.77	6.60
15-year fixed mortgage rate	6.16	6.22	6.12	5.90
STOCK MARKET				
Dow Jones Industrial Index	38,714.77	38,722.69	38,627.99	31,861.98
S&P 500	5,117.09	5,123.69	5,005.57	3,916.64
NASDAQ	15,973.17	16,085.11	15,775.65	11,630.51
COMMODITIES				
Gold ($ per troy ounce)	2,159.40	2,184.50	2,025.40	2,023.10
Oil ($ per barrel) - Crude Futures (WTI)	81.01	77.82	79.22	69.60

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average- Past Six Months or Quarters
Consumer Price Index (February) % change	0.4	0.3	0.2	0.3
Core CPI (February) - % change	0.4	0.4	0.3	0.3
Producer Price Index (February) - % change	0.6	0.3	-0.1	0.1
Retail Sales (February) - % change	0.6	-1.1	0.1	0.0

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