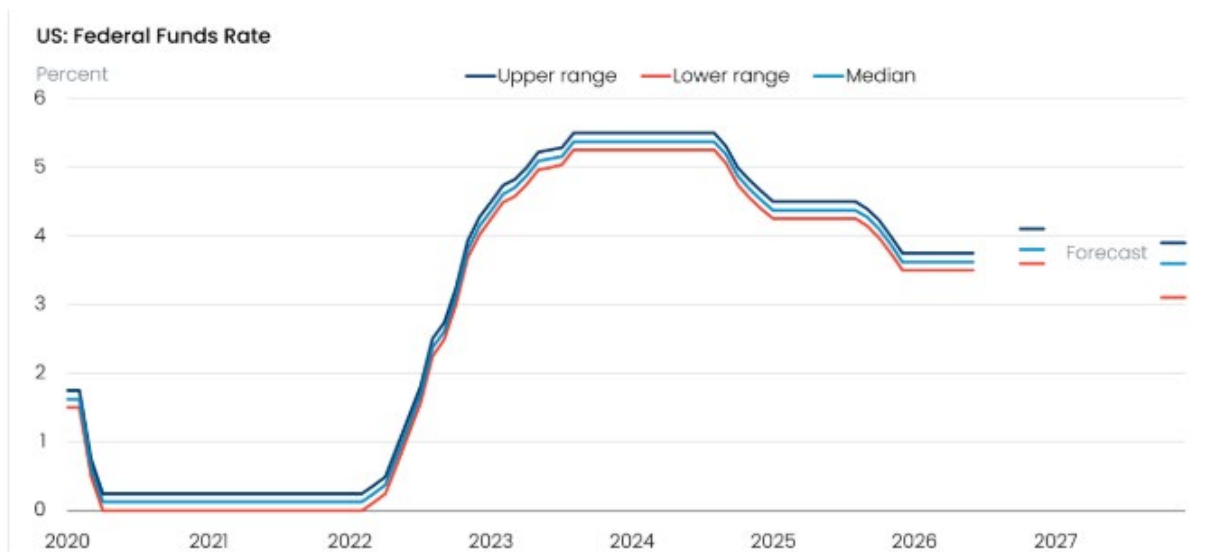


Amid a busy calendar of economic data, the Federal Reserve's policy meeting took center stage this week. The meeting was notable for several reasons including, 1) it was the first under the new Chair, Kevin Warsh, 2) It sounded a more hawkish tone than expected, and 3) it did not elicit a rancorous response on Truth Social, President Trump's favorite sounding board, which he has vociferously used to call for lower rates. As expected, Fed officials held rates steady at the meeting, keeping the federal funds rate at the current 3.50-3.75 percent range for the fourth consecutive meeting. Unlike previous meetings, the policy statement offered no forward guidance as to the probability of the next move – or even the conditions that would determine the move. This is a key change that Warsh has long advocated, believing that forward guidance locks the Fed into a position based on past data that can abruptly change, and unduly influences the financial markets. Warsh also believes market pricing should be based on how investors interpret data, which could be an important source of information to guide the Fed.

But while neither the policy statement nor Warsh at the post-meeting press conference offered any forward guidance, the meeting did significantly alter market perceptions of the Fed's next move. In the summary of economic projections, as many Fed officials expected a rate hike as holding them steady or cutting this year; that's a stark departure from three months ago, when the median expectation of Fed officials was for a rate cut. The market reaction was swift, as the futures market is now fully pricing in a 100 percent chance that the Fed will raise rates at least once this year. The two-year Treasury note, which is highly sensitive to Fed rate expectations, jumped by almost 20 basis points immediately following the meeting.

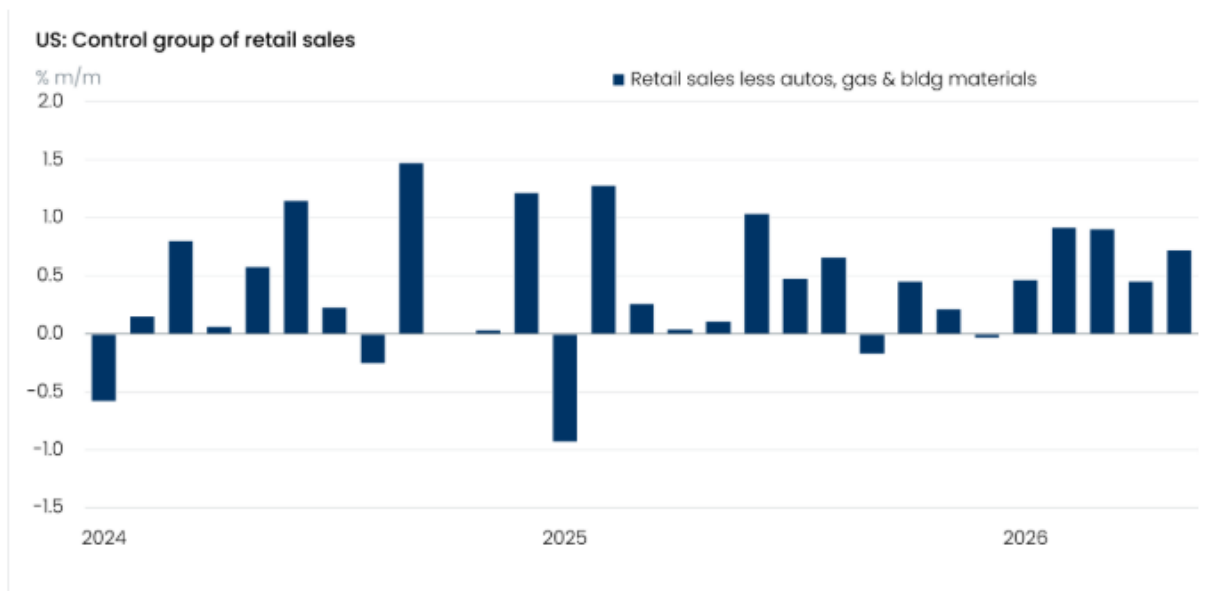


Warsh did not cast a vote at the meeting. But the policy statement as well as his comments at the press conference conveyed the strong impression that he firmly agrees with the notion that no easing of policy is warranted, emphasizing the importance of achieving price stability over anything else. The other half of the Fed's dual mandate, maximum employment, was barely mentioned, underscoring the lack of urgency for cutting rates. Indeed, the SEP lowered its projected unemployment rate to 4.3 percent from 4.4 percent three months ago, even as it raised the expected inflation rate to 3.6 percent from 2.7 percent. Those projections clearly reflect ongoing events since the previous SEP, most notably the inflation surge linked to the Mideast war that was in its early stage at the mid-March meeting.

We have little argument with the Fed's latest employment or growth projections but do believe the hawkish view on inflation is overblown, particularly if the tentative peace with Iran struck this week holds and the war winds down. The pending reopening of the Strait of Hormuz has already sparked a dramatic fall in crude oil prices to under \$75/barrel on Thursday from a war-time peak of over \$112 in early April. Gas prices at the pump are also coming down, falling to under \$4.00 this week from a nationwide average of \$4.48 in late May. Retail gas prices follow crude prices with a lag, so more declines are surely on the way unless hostilities flare up again. The knock-on effects from the earlier climb in oil prices and supply disruptions from the war will be slower to retreat, keeping food, fertilizer and chip prices, among others, elevated for a longer period. But we believe the inflation peak is behind us, and a sustained disinflationary trend has begun.

That, in turn, increases the odds the Fed can refrain from hiking rates this year. But the ongoing strength in the job market, the boost from AI-related investment spending and the resilience of consumers undercut the prospect of a near-term cut in rates. The surprising strength in consumer spending was once again on display this week, as higher prices did little to deter

households from shopping last month. Retail sales posted a solid 0.9 percent gain in May, with virtually all major sales categories sharing in the advance. Unsurprisingly, sales at service stations were the biggest gainers, owing to higher prices at the pump. But even excluding gas as well as other volatile components, the strong outcome was on full display. The core group of retail sales, which enters the calculation of consumer spending in the GDP accounts, rose by a sturdy 0.7 percent.

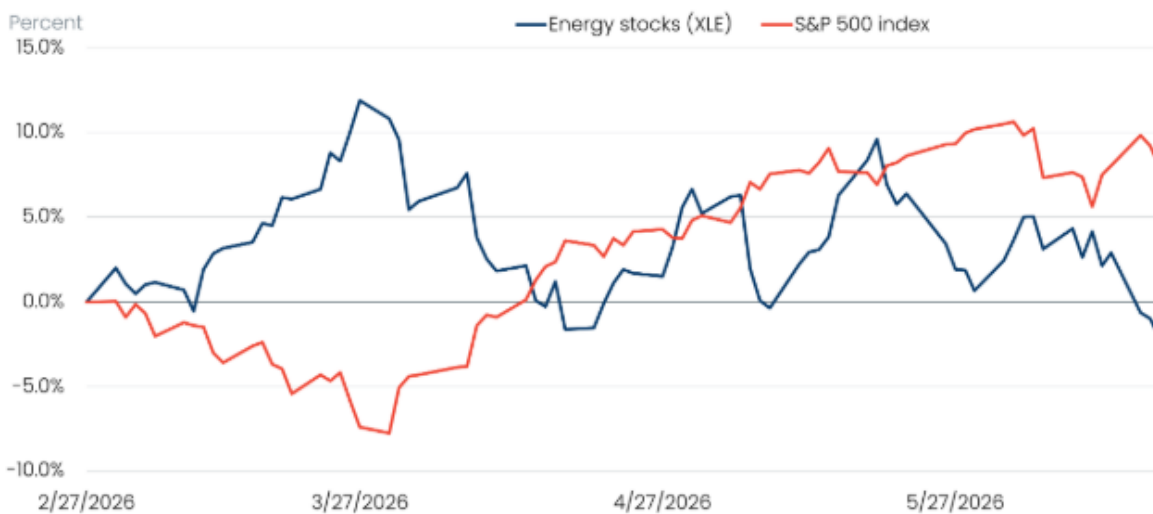


Both the overall and the core sales increase exceeded the rise in prices last month, so real goods purchases are on track for a solid increase in the second quarter. Consumer spending on services is not yet available, but the surprising strength in core retail sales indicates that overall consumer spending is tracking a 2.2 percent annual increase, well ahead of the 1.4 percent in the first quarter. Spending on services continue to be supported by high-net worth households who are financially equipped to withstand the higher prices on gas and other items, given the formidable wealth cushion built from hefty asset gains in recent years.

We note, however, that some of the steam will be taken out of consumer spending in coming months. For one, the tax refunds, which came in 20 percent higher than last year, will have been spent, something that likely provided a big source of spending for lower-income households. The increased purchasing power from tax refunds more than offset the drag caused by the rise in gas prices, the major catalyst behind the spike in inflation. To some extent, therefore, the withdrawal of tax refunds is being countered by the timely retreat in oil prices. Importantly, the war-induced climb in energy prices catapulted inflation over wage growth in the last two months, resulting in the first decline in real wages in three years. With prices at the pump now tumbling, that squeeze should lighten if not put real wages back on a positive growth path.

Interestingly, that's one instance of how the trajectory of energy prices both gives and takes. Another is how its impact is transmitted through the wealth chain. The surge in energy prices was a boon for holders of energy stocks, which no doubt resides mostly in the portfolios of wealthy households. Over the first six weeks of the war's outbreak, energy stocks handily outperformed the broader stock market, at one point outpacing the S&P 500 index by almost 20 percent. The market cap of all publicly traded energy companies is about \$4.6 trillion, so the 12 percent increase in their collective prices, as measured by the Energy Select Sector Spider Fund (XLE), amounts to more than chump change for shareholders. But as optimism over peace talks have gained traction in recent weeks, the fortunes have changed; energy stocks have lost all their earlier gains and then some even as the broader market recovered its losses. To be sure, both have been running in the black since the start of the year, but the abrupt swings over the past several months highlight the vulnerability of the market to unexpected shocks, and the volatility that can erode the asset gains of wealthy households just as swiftly as it bolsters it

US: Cumulative change in energy stocks and the S&P 500 index



FINANCIAL INDICATORS

INTEREST RATES	June 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.75	3.71	3.68	4.36
6-month Treasury bill	3.90	3.80	3.77	4.28
2-year Treasury note	4.18	4.10	4.13	3.96
5-year Treasury note	4.24	4.22	4.26	4.01
10-year Treasury note	4.46	4.49	4.56	4.41
30-year Treasury bond	4.90	4.97	5.07	4.90
30-year fixed mortgage rate	6.47	6.52	6.51	6.84
15-year fixed mortgage rate	5.81	5.84	5.85	5.97

STOCK MARKET				
Dow Jones Industrial Index	51,564.70	51,202.26	50,579.70	42,197.79
S&P 500	7,500.58	7,431.46	7,473.47	5,976.97
NASDAQ	26,517.93	25,888.84	26,343.97	19,406.86

COMMODITIES				
Gold (\$ per troy ounce)	4,227.90	4,233.00	4,510.50	3,453.00
Oil (\$ per barrel) - Crude Futures (WTI)	76.56	84.41	97.00	73.58

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (May - % change)	0.9	0.4	1.7	0.6
Industrial Production (May) - % change	0.1	0.9	-0.3	0.3
Housing Starts (May) - 000s of units	1,177	1,392	1,522	1,366
Building Permits (May) - 000s of units	1,413	1,423	1,363	1,436

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