WEEK OF APRIL 1, 2022

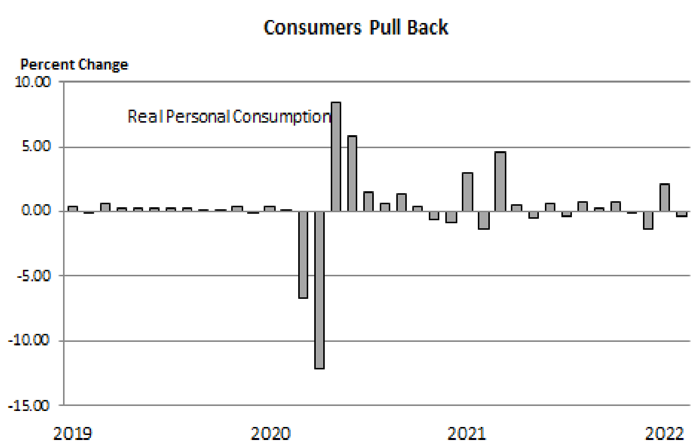
WEEKLY ECONOMIC COMMENTARY

With the calendar page turning to April, it's with great pleasure that we say good riddance to the first quarter. To be sure, not all the news was bad. The Omicron variant vanished as quickly as it appeared, although it has birthed a subvariant that may prove troublesome if it follows the path seen in China and other nations. But the good news on the domestic health front was overshadowed by a litany of downbeat developments casting a dark cloud over the start of the second quarter. The war in Ukraine has ushered in the worst humanitarian crisis since World War II, and the agony and suffering will persist long after a ceasefire is declared. Along with the human toll, the war is also wreaking havoc on the global economy by stoking inflationary pressures that were already raging under pandemic-related supply-chain stresses. Sanctions curtailing energy, food, and other critical resources will slow, if not reverse, growth in nations heavily dependent on these inputs.

The direct blow of the war is more significant for Europe and many developing nations than it is for the U.S., but the indirect effects here are palpable. It has accelerated the inflation trend that was well underway before the conflict erupted. That, in turn, has unleashed a more aggressive Federal Reserve response than was in train before the invasion. The more intense hawkish stance has contributed to a dismal performance in the financial markets. Depending on which measure is used, the bond market suffered its worst setback in at least 30 years, as yields across the maturity spectrum shot higher. Stocks also took it on the chin, although a sharp rally in March cut the losses by more than half of where it was at the low point early in the month, with the S&P 500 down by 5 percent for the quarter. Still, the combined losses in bonds and stocks were the deepest in more than 40 years.

Importantly, Main Street did not emerge from the first quarter unscathed. Household sentiment, as tracked by the University of Michigan Survey, tumbled to the lowest level in 11 years. Uncertainties over the war clearly played a role in the downbeat mood, as its inflationary impact left households expecting the direst prospects for living standards on record. Indeed, the fear that inflation is robbing them of purchasing power was starkly confirmed in February's income and spending report released this week. While personal income did grow by a healthy 0.5 percent during the month, prices increased even faster. The personal consumption price deflator increased by 0.6 percent, lifting the rate over the past year to 6.4 percent. Hence, adjusted for inflation, real disposable incomes slipped by another 0.2 percent in February, the seventh consecutive monthly decline. That's the longest stretch of declining purchasing power in nearly 50 years.

The combination of deteriorating sentiment and falling real incomes is having an impact on spending. Consumer outlays on goods and services edged up by a slim 0.2 percent in February, a sharp pullback from the robust 2.4 percent gain in January. What's more, shoppers got an even smaller bang for the buck as higher prices accounted for all of the increased spending and then some. Real consumption fell by 0.4 percent, the third decline in the past four months. If not for the 2.1 percent real spending increase in January, the economy would receive virtually no support for growth in the first quarter. As it is, real consumer spending is tracking a meager annual growth rate of 1.4 percent for the period based on the first two months of the quarter.



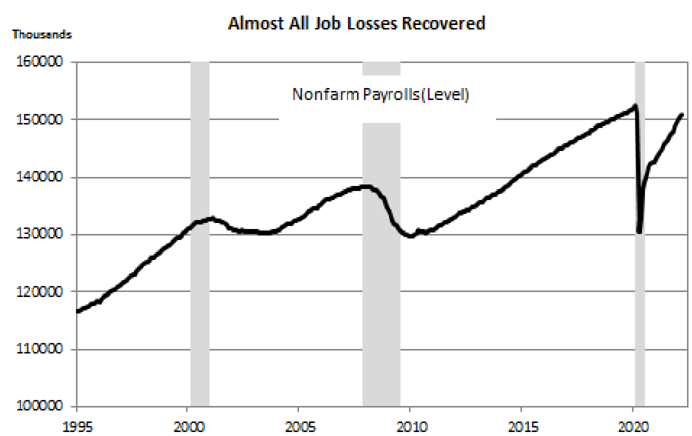
There is a silver lining in the spending patterns last month. The entire pullback was for goods purchases, most notably autos and household furnishings, where demand has been the strongest throughout the pandemic and shortages the most severe. Spending on big-ticket durable goods took the biggest hit, falling by 2.5 percent during the month. To the extent that consumers are shifting spending preferences towards services, it will contribute to an easing of inflationary pressures. Over the past year, goods prices have risen more than twice as fast as that for services – 9.6 percent versus 4.6 percent. In February, they were unchanged; the first time goods prices in the PCE deflator have not increased in 15 months. With the pandemic's grip on the economy easing, households shifted some of their purchases to services, which increased by 0.6 percent in real terms, the strongest since last July when Covid cases had fallen to the lowest point since the onset of the pandemic.

Assuming health conditions continue to brighten in the coming months, the shifting of household shopping preferences towards services should continue. While that would relieve some pressure on goods prices, it would hardly be enough to arrest the inflation spiral. As noted, the war in Ukraine is sustaining pressure on energy and commodity prices, which is expected to push out the inflation peak until later in the spring – and prompt the Federal Reserve to step harder on the monetary brakes. We now believe the Fed will trigger a half-point increase in its short-term target rate at its next meeting in May, and the odds are high for a similar hike in the following meeting. With these more aggressive moves looming ahead, the financial markets are increasingly pricing in higher odds of a recession. On Friday, the yield on 2-year Treasury notes moved decisively above the 10-year yield, an inversion that is widely viewed as a signal of a pending downturn.

We caution, however, that while every postwar recession has followed such an inversion, not every inversion has resulted in a recession unless you consider a lag time of almost three years as a confirming episode and ignore a false positive that occurred in the mid-1960s. Despite the pullback in consumer spending last month, the near-term fundamentals underpinning activity remain solid. It is almost inconceivable to think the economy is heading for a fall when the job market is running as hot as it is. While consumer spending hit a soft spot in the midst of the first quarter, no such weakness can be seen in any month during the period. True, the 431 thousand increase in nonfarm payrolls in March, reported on Friday, was the weakest of the period. But each of the previous two months was revised up by a combined 95 thousand, and the March tally may well be adjusted higher in the April jobs report.

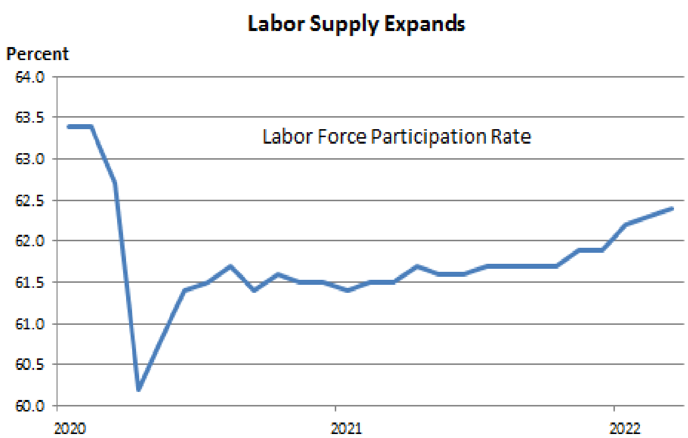
Even so, the gain of nearly a half-million workers is nothing to sneer at. Over the final two years of the expansion leading up to the pandemic-induced recession, payrolls increased by a monthly average of 191 thousand, less than half the current pace. Granted, the job market is still rebounding from the huge losses incurred at the height of the pandemic, when 22 million paychecks vanished in March and April of 2020. Bringing back those workers to accommodate a fiscally-turbocharged rebound in demand naturally spurred outsized increases in job growth. But the low-hanging fruit has been picked as more than 90 percent of those job losses have been recovered.

With the pool of job seekers much diminished – the unemployment rate fell to a post-pandemic low of 3.6 percent in March – the challenge of employers is to get workers off the sidelines. The jobs report suggests they are having some success; employment in the household survey, from which the unemployment rate is derived, surged by 736 thousand in March, far more than the 416 thousand increase in the labor force. This means employers are bringing back workers from outside the labor force, which lifted the labor force participation rate to a post-pandemic high of 62.4 percent from 62.3 percent. That's still a full percentage point below the prepandemic level. Still, the participation rate for prime-age workers, those between 25 and 54 years old, increased by a faster 0.3 percent last month and, at 82.5 percent, is only 0.5 percent below its prepandemic level.



A key feature of that trend is that women accounted for all of the increase in the participation rate among prime-age workers in March. The rate for women increased by 0.7 percent compared to a 0.1 percent *decline* for men. That's in line with the mix of job growth during the month, as service-sector jobs that draw a larger fraction of women than men led the gain in payroll employment, notching a formidable 336 thousand increase. The faster return of women to the labor force is a sign that the reopening of schools is easing childcare responsibilities, and the rapid drop in Omicron cases is lessening fears of infection at the workplace. As demand continues to shift towards services, the trend towards greater participation of women in the labor force should continue.

But as important as an improving health backdrop is to job growth, an even bigger pull to get workers off the sideline is the lure of higher wages. With companies struggling to fill open positions, they have no choice but to dangle more lucrative pay packages to get workers on board, including offering perks such as flexible hours and working from home. The fruits of enhanced worker bargaining power were further revealed in March, as average hourly earnings increased by a sturdy 0.4 percent, lifting the gain over the past year to 5.6 percent from 5.1 percent in February. The pandemic recovery has produced some wild swings in worker earnings from month to month, reflecting the ever-changing mix of job growth between high and low-paid workers. But the trend over the past year has been steadily upward, and wages are rising significantly faster than the 3-3 ½ percent pace seen in the year before the pandemic.



With worker pay advancing at a 5.6 percent pace – and poised to accelerate in coming months – against productivity gains of roundly 2.0 percent, that translates into a much higher inflation rate of 3.5-4.0 percent that the Federal Reserve is willing to tolerate. Hence, the impetus to slam on the brakes is rising, as is the risk of a marked slowdown later this year and into 2023. The financial markets are increasingly pricing in that risk, as evidenced by the inverted yield curve. Again, the tight labor market and substantial wage increases indicate that consumer spending will not fall off a cliff anytime soon, notwithstanding the soft report for February. However, there are also signs that households, particularly those on the lower rungs of the income ladder, are pulling back because of higher prices, and the savings cushion built up during the pandemic is starting to deflate. Other nascent signs of slowing growth are also popping up, including Friday's ISM manufacturing survey that showed a sharp drop in new orders and production in March. We believe the manufacturing sector, which added a sturdy 38 thousand jobs in March, still has a bright future, as production has a way to go to catch up with demand. But the Fed's task of bringing about a soft landing will become more challenging if signs of softening demand proliferate in the coming months.

FINANCIAL INDICATORS				
INTEREST RATES	April 1	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.52%	0.54%	0.33%	0.02%
6-month Treasury bill	1.07	0.97	0.64	0.04
3-month LIBOR	0.97	0.97	0.58	0.19
2-year Treasury note	2.46	2.28	1.49	0.19
5-year Treasury note	2.17	2.55	1.64	0.97
10-year Treasury note	2.39	2.48	1.73	1.72
30-year Treasury bond	2.44	2.60	2.16	2.35
30-year fixed mortgage rate	4.67	4.32	3.76	3.18
15-year fixed mortgage rate	3.83	3.63	3.01	2.45
5/1-year adjustable rate	3.50	3.36	2.91	2.84
STOCK MARKET				
Dow Jones Industrial Index	34818.27	34861.24	33614.80	33800.6
S&P 500	4545.86	4543.06	4328.87	4128.8
NASDAQ	14261.50	14169.30	13313.84	13480.11
Commodities				
Gold ($ per troy ounce)	1928.50	1954.60	1974.90	1726.05
Oil ($ per barrel) - Crude Futures (WTI)	99.42	112.62	115.00	60.66
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Personal Income (February) - % change	0.5	0.1	0.1	0.2
Personal Consumption (Feb.) - % change	0.2	2.7	-0.9	0.7
Personal Savings Rate (Feb) - Percent	6.3	6.1	8.4	7.3
Nonfarm Payrolls (March) - 000s	431	750	504	600
Unemployment Rate (March) - Percent	3.6	3.8	4.0	4.0
Average Hourly Earnings(March) - % chg.	0.4	0.1	0.6	0.4