

The trillion-dollar (nominal) question of the week is whether the 8.5 percent inflation rate recorded in March marks the peak of the cycle. The consensus seems to think it is, if only for statistical reasons. Most notably, the so-called base effects will start to kick in this month as comparisons with the inflated prices of a year ago point to slower increases in the coming months. Some help should also come from lower gasoline prices, as the decline in crude oil prices in recent weeks has already reduced the cost of filling up at the pump. That would significantly impact the headline change in consumer prices, as surging energy prices accounted for nearly three-quarters of the 1.2 percent increase in the consumer price index between February and March – the steepest monthly increase in more than 15 years.

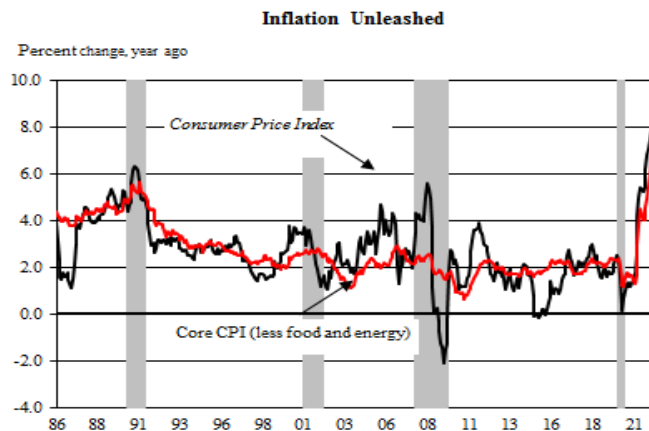
But oil prices are subject to myriad influences that could push them up as well as down beyond the next month. The war in Ukraine, of course, is the most obvious one, as the oil market is held hostage by developments on the battlefield as well as decisions by both oil consumers and producers. The EU is considering cutting off oil purchases from Russia, which would boost prices, even as oil drillers in the U.S. are poised to ramp up drilling in the Permian Basin. This, along with the administration's decision to release 1 million barrels a day from the Strategic Petroleum Reserve, would expand supply and ease price pressures. The war also significantly influences food prices – another volatile component of the CPI – as Russia and Ukraine are major exporters of wheat, corn, and barley in the global food markets.

Since food and energy prices could go either way, economists prefer to monitor the core CPI, which strips out these volatile components. In contrast to the headline CPI, this measure is showing an encouraging trend, increasing by a much more moderate 0.3 percent in March, the slowest in six months. The increase over the past year only edged up to 6.5 percent from 6.4 percent in February; the annual increase in the headline CPI jumped from 7.9 percent to 8.5 percent. But it would be a mistake to draw too much encouragement from the slowdown in the core CPI last month, as it was primarily dragged down by an outsized drop in used car prices. If not for the 3.8 percent plunge in previously owned vehicles, the core CPI would have increased by 0.5 percent. While prices of goods should ease as consumers shift their purchases towards services, service prices are climbing faster, particularly for airfares and other travel-related activities, such as lodging away from home. Core service prices rose 0.6 percent last month, the largest increase since the summer of 1992.

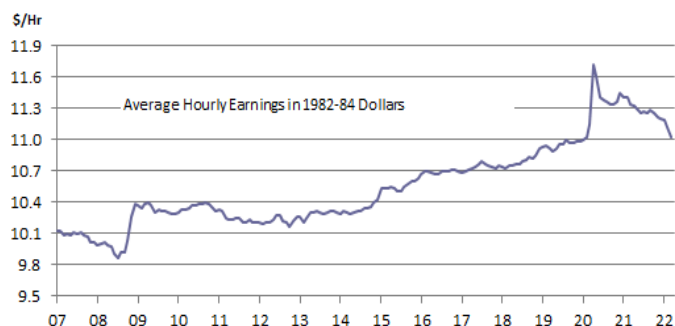
The jury is still out as to whether inflation has peaked at 8.5 percent. From our lens, the balance of risks still points to a modest further acceleration towards 9 percent. Not only are near-term pressures in the oil market still strong, but spreading Covid-related lockdowns in China also threaten to amplify supply-chain snarls, keeping pressure on goods prices. Notably, the retreat from peak inflation will start later and proceed more slowly than thought a few months ago and still wind up the year at an elevated 5 percent. That's considerably above the Fed's tolerance level, which will keep its finger on the rate-hiking trigger over the balance of this year and beyond. The Fed is expected to hike its short-term policy rate by 50 basis points at both its upcoming May and June policy meetings and start reducing its massive balance sheet holdings built up over the past two years.

The abrupt pivot from two years of a turbo-charged easy policy toward a firm application of the monetary brakes reflects the Fed's attempt to get ahead of the inflation curve without choking off growth. History is not on the Fed's side, as it never avoided bringing on a recession when inflation exceeded 5 percent in the postwar era. Key to its success this time will depend on how much demand destruction is caused by higher rates and lost purchasing power from inflation. While the Fed's hikes are still to come, longer-term rates have already increased significantly in anticipation of the policy moves. According to Freddie Mac data, mortgage rates have nearly doubled since last summer, with the 30-year fixed-rate hitting 5 percent for the first time since 2011. This, along with surging home prices, makes a purchase unaffordable for an ever-increasing swath of the population, as mortgage payments on a median-priced home have increased by 25 percent since the start of the year.

The housing market is the most interest-sensitive sector of the economy and typically leads the way into a downturn during a tightening cycle. The signs are not encouraging, with pending sales in the existing home market declining for four consecutive months. That said, there is still a substantial pent-up demand for homes that have been in short supply for the past two years, so a collapse in sales does not seem imminent. On a broader level, there are reasons to believe that household demand for goods and services can withstand higher rates, at least during the initial stages



Real Earnings Falling Behind



of the Fed's tightening cycle. For one, the job market remains robust, and workers are receiving sizeable wage increases. Average hourly earnings increased 5.6 percent in March from a year ago. Aside from an aberrational spike in April 2020, that was the most substantial increase since the summer of 1982.

The problem is that inflation is more than offsetting the gains in worker pay, resulting in a 2.7 percent decline in real purchasing power over the past year. Average earnings adjusted for inflation have been trending steadily lower since December 2020, and the average worker's paycheck buys nearly 6 percent fewer goods and services than was the case then. So far, the diminished bang for the buck has not had a meaningful impact on consumer spending, largely because generous pandemic-related fiscal aid and suppressed spending have significantly

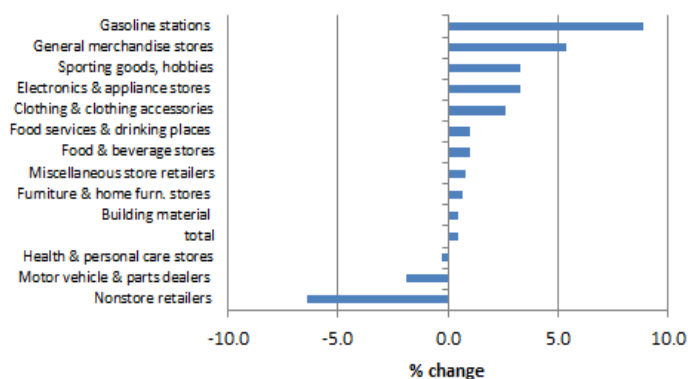
bolstered household balance sheets, including an estimated \$2.7 trillion of excess savings accumulated over the past year. A significant chunk of those surplus funds is still available for spending, which should keep consumer wallets open for the foreseeable future, particularly if job growth stays strong.

But households have been dipping into those savings and making greater use of credit cards to support purchases. This is not a sustainable combination of spending power, particularly as the cost of borrowing continues to increase and purchases become ever more expensive. A recent Harris Poll for Bloomberg revealed that 84 percent of households plan to curtail spending due to higher prices, with most of the cutbacks for discretionary purchases. That haircut on real purchases was starkly revealed in the latest report on retail sales. Households shelled out 0.5 percent more at retail outlets in March, but all of that, and then some, was accounted for by higher prices. The volume of goods purchased fell by 1.6 percent when adjusted for the 2.1 percent increase in prices for goods.

Not surprisingly, the most significant sales increase was for gasoline, which saw the biggest rise in prices (18.1 percent in March). Take out transactions at service stations, and the change in retail sales morphs from a positive 0.5 percent to a negative 0.3 percent. To be fair, 10 of the 13 major spending categories did increase during the month, so consumers did not go into hibernation. What's more, some expenditure gains exceeded price increases. Spending on apparel increased by 2.1 percent, much greater than the 0.6 percent increase in apparel prices during the month. People are going outdoors again, and with more workers returning to offices, they need to spruce up their wardrobe that languished during Covid lockdowns. Notably, most retail sales are for goods, which consumers are pivoting away from towards services as health conditions improve. But as noted earlier, the cost of services is also rising more rapidly, eroding the real gains that consumers are getting.

While higher prices combined with increasing borrowing costs will undoubtedly suppress demand, we do not expect it to be extinguished. Inflation may not start to recede for another month or two, but the peak is not likely to be much higher than it is now. Meanwhile, the job market, a lagging indicator, should remain hot for a lengthier time, keeping workers in a strong position to obtain faster wage increases. Hence, the gap between inflation and worker pay should narrow, keeping a floor under spending at least through the end of this year. At the same time, the Fed is striving to take some steam out of demand to bring inflation down, which becomes more difficult as growth in labor income accelerates. The risk is that the Fed overcorrects later in the year and stifles demand and job growth early in 2023, ushering in another recession. The elusive soft landing after inflation exceeds 5 percent may still be attainable if the Fed is nimble and more skillful than in the past – but some good luck on the geopolitical and health fronts might also be needed.

Higher Prices Boost Retail Sales



FINANCIAL INDICATORS				
INTEREST RATES	April 15	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.78%	0.67%	0.40%	0.02%
6-month Treasury bill	1.22	1.15	0.80	0.04
3-month LIBOR	1.06	1.00	0.93	0.19
2-year Treasury note	2.45	2.47	1.94	0.16
5-year Treasury note	2.79	2.69	2.14	0.83
10-year Treasury note	2.83	2.71	2.15	1.58
30-year Treasury bond	2.92	2.72	2.43	2.28
30-year fixed mortgage rate	5.00	4.72	4.16	3.04
15-year fixed mortgage rate	4.17	3.91	3.39	2.35
5/1-year adjustable rate	3.69	3.56	3.19	2.80
STOCK MARKET				
Dow Jones Industrial Index	34451.23	34721.12	34754.93	34200.67
S&P 500	4392.59	4488.28	4463.12	4185.47
NASDAQ	13351.08	13711.00	13893.84	14052.34
Commodities				
Gold (\$ per troy ounce)	1977.30	1950.40	1921.50	1777.3
Oil (\$ per barrel) - Crude Futures (WTI)	106.54	97.90	105.10	63.07
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer price Index (March) - % change	1.2	0.8	0.6	0.8
Core CPI (March) - % change	0.3	0.5	0.6	0.5
Producer Price Index (March) - % change	1.4	0.9	1.2	0.9
Retail Sales (March) - % change	0.5	0.8	5.1	1.0

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