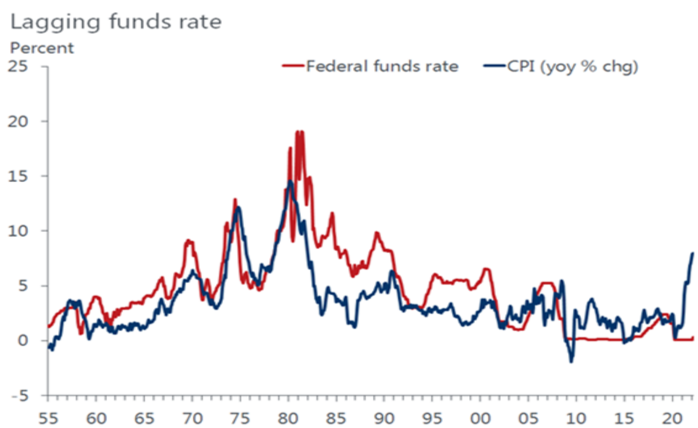
WEEK OF MARCH 18, 2022

WEEKLY ECONOMIC COMMENTARY

The Federal Reserve shared headlines with the war in Ukraine this week and, like the uncertain outcome of the Russian invasion, the endgame of the Fed's strategy is anything but settled. As it telegraphed weeks in advance, the Fed took the first step in its planned rate-hiking cycle at its policy-setting meeting this week, increasing the short-term rate target for the first time since December 2018. The cautious quarter-point increase came as no surprise in the financial markets. Still, Fed officials laid out a more hawkish strategy than had been expected, signaling six more rate increases this year for a total of 1 ¾ percentage points. If things go according to plan, the cycle will continue next year as well, leaving the fed funds rate at around 2.75 percent at the end of 2023.

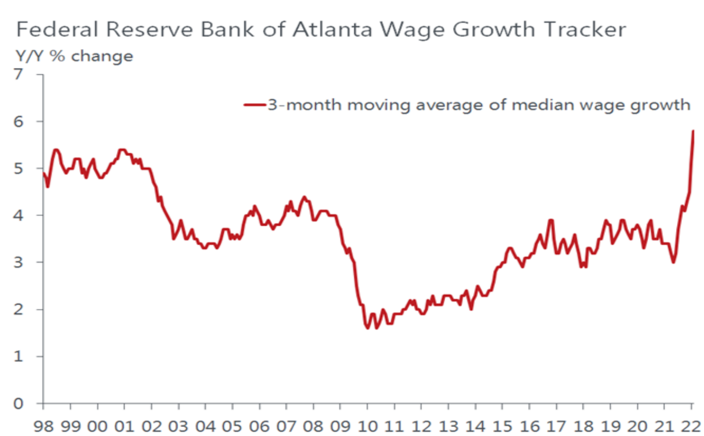
That's a far cry from the last set of quarterly projections made in December, when Fed officials expected to embark on a much shallower path of rate increases, consisting of three quarter-point increases this year and next. Of course, a lot has changed since then, as inflation, job growth, and wages have roared ahead faster than the Fed expected. Indeed, if not for the intervention of the Russian invasion and its uncertain ramifications for the economy, the first rate hike might have been 50 instead of 25 basis points. The financial markets, in fact, had increasingly been pricing in that more sizeable rate hike in the weeks leading up to the war.



Despite misgivings about the fallout from the war, the Fed has turned decisively into an inflation-fighting mindset. While most believe that it is the right course of action – with many fearing that the Fed waited too long to pivot away from its turbo-charged easy policy – many are also concerned that it will go too far. To bring inflation down from a 40-year high to the Fed's 2 percent target without sending the economy into a recession would be a gargantuan feat that is not likely to occur in their eyes. However, we caution that it is far too early to worry about the toll the Fed's planned rate hikes would take on the economy.

As long as interest rates are well below the inflation rate, there is a great incentive to borrow – and spend – as repayments would be made in cheaper dollars. By that standard, the time to worry about an overly restrictive policy is still some ways off. Following the quarter-point increase, the Fed's short-term policy rate remains nearly 8 percentage points below consumer price inflation – the widest gap on record. No doubt, if the sky-high inflation rate were thought to be a temporary fluke that was poised to collapse very soon, that incentive would be tempered, particularly if borrowers were concerned about jobs and overall economic prospects. But the perception that transitory forces are driving the current inflation spike was discarded some time ago, and even the Fed expects it to remain well above its 2 percent target for the foreseeable future. According to the Summary of Economic Projections presented at the latest meeting, the median forecast among Fed officials is that inflation will still hover just above 4 percent by the end of this year.

That said, while the rate of price increases is not keeling over anytime soon, this is not your garden-variety inflation. True, price pressures are being stoked by some time-honored forces that Fed policy is well equipped to counteract. Consumer demand, fueled by excess savings and robust job growth, continues to race ahead of supply, and wages are increasing at a rapid clip. The Atlanta Fed's wage growth tracker shows that worker pay increased by 5.8 percent in the year through February, the fastest pace since records began for this series in 1997. The Fed aims to increase interest rates and slow growth enough to subdue both of these demand-driven inflationary influences.



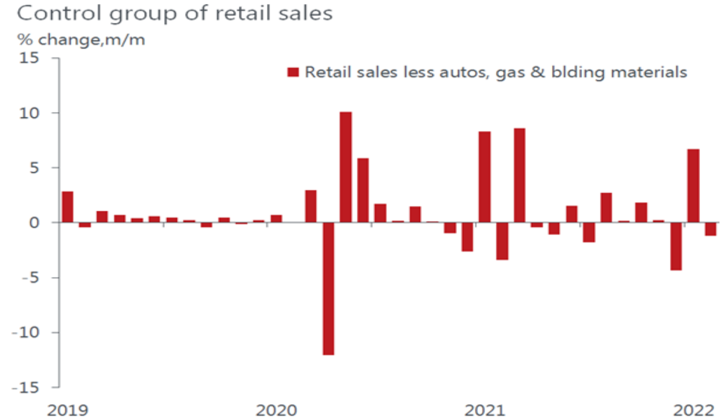
However, forces beyond the Fed's control are impacting the other side of the equation – supply – as the goods and services available to meet demand are being suppressed by the war in Ukraine (oil, wheat, nickel, and a range of commodities), the lingering impact of Covid in the U.S. (labor supply) and the nascent resurgence of virus cases overseas, particularly in China (factory shutdowns). Higher rates imposed by the Fed would not redress these supply disruptions, which are perpetuating the shortages that were already stoking inflation before the latest round of shocks appeared. Indeed, its efforts could actually further restrain supply in some sectors. For example, higher mortgage rates – which have climbed above 4 percent for the first time since May 2019 this week – could discourage homeowners from putting their homes on the market, as they would not want to lose the low rates locked in from a home purchase or earlier refinancing. That, in turn, would exacerbate the surge in home prices and its spillover effects on rents.

To be sure, the latest shocks to the system will fade at some point. The war will eventually end, and energy and other commodity prices linked to the hostilities will enter a disinflationary stage. A key unknown is how long sanctions remain in place, influencing the pace at which supply comes back online. Likewise, Covid's grip on the economy is easing, but rising cases overseas could spread to the U.S. and cause another flare-up. The question then is how authorities respond via restrictions and how household behavior would be affected. Unless the possible next wave turns out to be more severe than health officials expect, it should not spur a harsh government response nor derail efforts among households and businesses to restore normal activities.

Given the shortcomings in correcting supply shortages, the Fed's emphasis on curbing demand is its only option. However, there is a wide divergence in opinion over how high interest rates should be lifted. Some believe the economy cannot withstand a significant increase, much less the full brunt of the seven rate hikes the Fed envisions over the course of the year. Consumer spending is partly fueled by the enormous savings amassed during the pandemic, but those funds rapidly deplete as consumption is outpacing income growth. While wages are accelerating, they are still lagging inflation, and there are growing signs that the rapid climb in prices discourages some spending. From the Fed's perspective, that's a better alternative than if workers demanded more significant raises to compensate for higher prices, which would ignite an unwelcome wage-price spiral. It also suggests that fewer rate increases would be needed to slow growth.

The notion that consumers are already feeling the squeeze from higher prices received some support in this week's retail sales report, which revealed a distinct moderation in consumer goods purchases in February. Total sales edged up by a slim 0.3 percent during the month, a sharp falloff from the 4.9 percent gain in January. But all of the increase was due to higher prices, as goods prices rose 1.4 percent during the month. Adjusted for inflation, retail sales actually fell by 1.1 percent. Notably, the control group of sales, which feeds directly into personal consumption in the GDP accounts, contracted by 1.2 percent last month – before adjusting for inflation. The most significant sales gains, not surprisingly, were for goods whose prices are increasing the fastest, namely gasoline and food.

Control group of retail sales



To be fair, the February slowdown comes on the heels of a torrid spending increase in January, and the gain for that month was revised higher – to 4.9 percent from 3.8 percent. Hence, retail sales in February still stood a formidable 5.2 percent higher than in December. What's more, the retail report mostly tracks sales of goods, and there is every indication that the rapid fading of the Omicron variant in February encouraged a shift in consumer spending from goods to services. The one service component in the retail report, sales at bars and restaurants, rebounded 2.5 percent in February after slumping by 1 percent the previous month. The more comprehensive personal income and spending report released later this month, which includes spending on services, will better measure how consumer spending shaped up last month.

Simply put, the Fed is still gathering data, and, as Fed chair Powell noted at his post-meeting press conference, future moves will be highly data-driven. From our lens, the economy has enough forward momentum to withstand the series of rate increases indicated at the Fed's meeting, but recognize the downside growth risks coming from the Russian-Ukrainian war and the hit to consumer confidence from the accelerated pace of inflation. On balance, however, we believe that inflationary concerns outweigh the potential impact on growth that higher rates would bring about. With energy and commodity prices still under pressure, inflation will get worse before it gets better. We expect the annual rate of consumer price inflation to soar from the current 7.9 percent to 8.7 percent in the spring.

But as the expression says, the best-laid plans often go astray, and there is a wide divergence of opinion regarding the Fed's strategy. Since the Fed's meeting, the stock market has roared ahead, suggesting a positive endorsement of the policy course set at the confab. However, the bond market is more skeptical that the Fed can achieve its objectives without killing off growth. The sharp compression of the yield curve, with the 2-year Treasury yield a mere 25 basis points under the 10-year yield, indicates that the risk of a recession is rising in the eyes of bond traders. Even within the Fed, expectations of where the fed funds rate will wind up this year run the gamut, ranging from a low of 1.50 percent to a high of 3.25 percent. That's hardly a firm conviction as to what the future holds.

FINANCIAL INDICATORS				
INTEREST RATES	March 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.40%	0.39%	0.35%	0.01%
6-month Treasury bill	0.80	0.75	0.63	0.03
3-month LIBOR	0.93	0.80	0.48	0.19
2-year Treasury note	1.94	1.75	1.47	0.16
5-year Treasury note	2.14	1.95	1.82	0.9
10-year Treasury note	2.15	2.00	1.93	1.74
30-year Treasury bond	2.43	2.36	2.25	2.45
30-year fixed mortgage rate	4.16	3.85	3.92	3.09
15-year fixed mortgage rate	3.39	3.05	3.15	2.4
5/1-year adjustable rate	3.19	2.97	2.98	2.79
STOCK MARKET				
Dow Jones Industrial Index	34754.93	32944.19	34079.18	33072.88
S&P 500	4463.12	4204.31	4348.87	3974.54
NASDAQ	13893.84	12843.81	13548.07	13215.24
Commodities				
Gold ($ per troy ounce)	1921.50	1992.30	1900.80	1735.2
Oil ($ per barrel) - Crude Futures (WTI)	105.10	109.09	91.66	63.22
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (February) - % change	0.3	4.9	-2.7	1.0
Producer Price Index (February) - % change	0.8	1.2	0.4	0.8
Industrial Production (February) - % change	0.5	1.4	-0.4	0.4
Capacity Utilization (Percent)	77.6	77.3	76.3	76.5
Housing Starts (February) - 000s units	1769	1657	1754	1664
Building Permits (February) - 000s units	1859	1895	1885	1766