

This week, the inflation story continued to dominate headlines and stoke volatility in the financial markets. Stocks flirted with a bear market for a short time as the S&P 500 declined almost 20 percent from its nearby peak in early January, stopping just an eyelash short of that bear-delineating threshold on Thursday before rallying on Friday. Still, the index fell for the sixth consecutive week, which hasn't happened since 2011. The bond market fared only slightly better; the bellwether 10-year Treasury yield started the week a touch below the three-year high of 3.20 percent reached last week and slipped erratically below 3 percent by the end of the week.

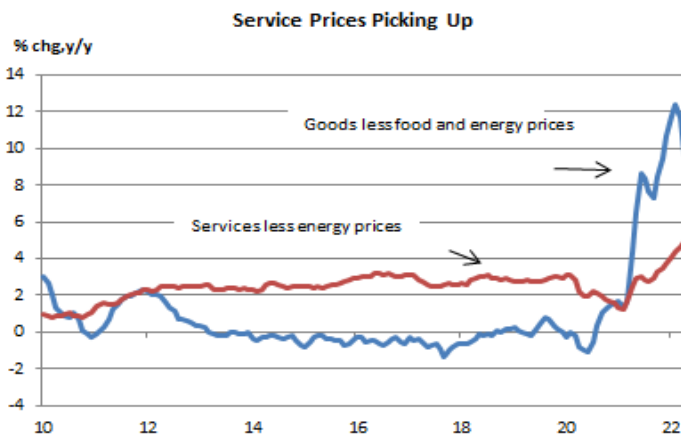
Investors had their eyes laser-focused on this week's consumer price report for April, which, as expected, continued to fly well above the Federal Reserve's comfort level and further backed up polls that indicate inflation is the primary concern of households. While the report contained few surprises, it supported both the half-empty and half-full crowd. The latter drew encouragement from the slower increase in the headline consumer price index, which notched a 0.3 percent gain during the month, the slimmest in eight months and sharply below the 1.2 percent surge in March. The easing month-over-month increase lowered the annual inflation rate to 8.3 percent from the 40-year high of 8.5 percent reached in March.

The headline slowdown, however, gives a false impression of easing price pressure. For one, a sharp 2.7 percent drop in energy prices, including a 6.1 percent retreat in gasoline prices, accounted for all of the April slowdown and then some. Without that drag from energy, the headline CPI jumps 0.6 percent during the month. What's more, the April setback in energy prices turned out to be only a temporary reprieve, particularly for drivers. Gasoline prices have rebounded this month, reaching a record nationwide average of \$4.50 a gallon in recent days. At the same time, the modest easing in the annual inflation rate reflects the picking of low-hanging fruit, as current prices are compared with the elevated prices of a year ago. That favorable base effect will continue through June, after which the year-ago comparisons become more difficult, as price increases slowed last fall.

Notably, the core inflation rate that excludes volatile food and energy prices accelerated in April, providing ammunition to the half-empty cohort. The core CPI increased 0.6 percent, double the 0.3 percent March gain. But the core also benefited from the base effect, and the annual inflation rate receded to 6.2 percent from 6.5 percent. On balance, it is hard to deduce from the April CPI report whether inflation has peaked at the 8.5 percent annual rate recorded in March. Much depends on the trajectory of oil and food prices that, in turn, are deeply influenced by external forces – i.e., the war in Ukraine, Covid, and, lately, extreme weather that is having a destructive impact on global crops – which are difficult to predict.

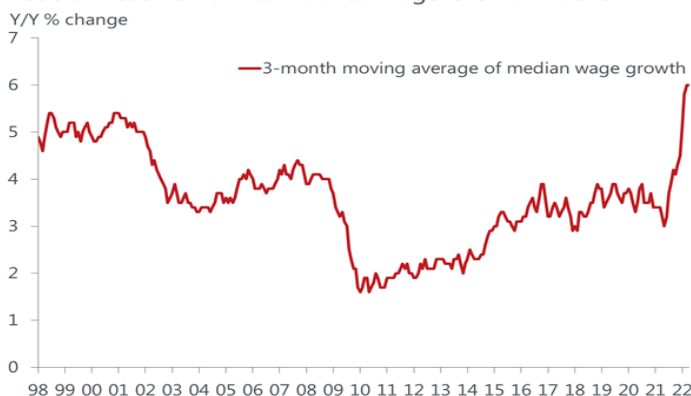
Some trends are playing out as expected. As the U.S. economy continues to reopen, people are shifting their buying preferences away from goods toward services. As a result, pressure on goods prices has eased considerably, with core commodity prices holding steady over the past three months, lowering the annual inflation rate from 12.4 percent in February to 9.7 percent in April. Unsurprisingly, however, pressure on service prices has increased. The 0.6 percent average increase in core services prices over the past three months, including a 0.7 percent increase in April, is 50 percent above the prior three-month average. Hence, the annual inflation rate in core service prices rose from 4.6 percent to 4.9 percent in April, a rate not seen since July 1991.

If, in fact, the peak inflation rate is behind us, the ongoing pressure on service prices strongly suggests that the retreat will be prolonged. For one, core service prices have three times more influence on inflation than core goods prices. For another, service prices overall are far stickier than goods prices. True, the cost of some services can change markedly over the short term in response to shifts in demand and cost pressures. Case in point is airfare, which soared 33.3 percent in April from a year ago owing to pent-up demand for travel and the spiraling cost of jet fuel. According to the Transportation Security Administration (TSA), checkpoint travel numbers increased 52 percent in April and are up another 40 percent in May. These eye-opening gains are not likely to be sustained for much longer as vacationers satisfy travel plans that were put off during the pandemic.



However, service prices that are less susceptible to short-term influences have a far greater impact on overall inflation. The biggest is shelter, which carries a 41 percent weight in the core consumer price index. Here the trend has been steadily increasing, advancing by an annual rate of 6.3 percent over the past three months, nearly double the 3.3 percent pace of a year ago. The main driver is rent, rising three times as fast as a year ago – 6.4 percent over the past three months versus 2.1 percent. This trend, which is linked to surging home prices, is poised to continue due to the housing market's demand-supply imbalance. What's more, rental leases signed six months ago carry as much weight in the CPI as those signed in the current month. Since current rents are accelerating, they will be a tailwind behind the inflation rate going forward.

Federal Reserve Bank of Atlanta Wage Growth Tracker



What's more, service providers rely heavily on labor, and they have less of an ability to offset labor costs with productivity gains than do goods producers. Hence, they have more incentive to raise prices in response to workers' demand for higher wages, which is getting steadily stronger. The Atlanta Fed's wage growth tracker climbed to 6 percent in April from 3.2 percent a year ago. With nearly two job openings for every worker seeking a position, workers' bargaining power remains strong. Not surprisingly, more of them are quitting to pursue better opportunities elsewhere. According to the Atlanta Fed wage tracker, these job switchers are being amply rewarded, gaining wage increases of 7.5 percent.

Despite improving paychecks, worker earnings overall are still not keeping pace with inflation. Average hourly earnings adjusted for inflation have declined for 13 consecutive

months, leaving them 2.6 percent lower than a year ago. It's no small wonder that inflation weighs heavily on the minds of households, particularly those on the lower end of the income scale. The University of Michigan's index of household sentiment shines a vivid spotlight on this deteriorating mindset, as the overall index plunged 6.1 points in early May to the lowest level since August 2011. Unlike then, when the economy was fitfully emerging from the Great Recession, households are not worried about an uncertain job market. Instead, they are concerned that inflation will continue to eat into purchasing power and put ever more stress on their financial condition in the coming months.

The Federal Reserve's challenge is to relieve that stress without elevating job worries to levels that would cause a recession. This will be a delicate balancing act, as growth-dampening measures that weaken the job market are clearly needed to rein in inflation. The financial markets are also grappling with that conundrum as recession fears are rising amid little consensus over how high interest rates need to go to restore price stability without choking off the recovery. The near-term course is evident given the still rampant inflation and the robust job market. The Fed is poised to hike short-term interest rates over the next several policy meetings, with sizeable 50 basis points increases expected at the June and July meetings.

From our lens, the economy has enough muscle to survive those increases and remain on a solid growth track over the remainder of the year. But things get dicey later this year and into 2023, when the bite from higher interest rates intersects with a fiscal drag and depleted household savings, leaving a more fragile economy vulnerable to unforeseen forces. If inflation starts to retreat on a sustained basis, the narrative regarding Fed policy could pivot from how restrictive it should become to when it can begin easing its foot off the brakes. But that shift in tone is still at least months away.

Households Feeling Low



FINANCIAL INDICATORS				
INTEREST RATES	May 13	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.93%	0.84%	0.78%	0.01%
6-month Treasury bill	1.44	1.33	1.22	0.03
3-month LIBOR	1.41	1.37	1.06	0.16
2-year Treasury note	2.52	2.71	2.45	0.15
5-year Treasury note	2.86	3.08	2.79	0.81
10-year Treasury note	2.82	3.15	2.83	1.63
30-year Treasury bond	2.99	3.24	2.92	2.35
30-year fixed mortgage rate	5.30	5.27	5.00	2.94
15-year fixed mortgage rate	4.48	4.52	4.17	2.26
5/1-year adjustable rate	3.98	3.96	3.69	2.59
STOCK MARKET				
Dow Jones Industrial Index	32196.66	32899.37	34451.23	34382.13
S&P 500	4023.89	4123.34	4392.59	4173.85
NASDAQ	11805.00	12144.66	13351.08	13429.98
Commodities				
Gold (\$ per troy ounce)	1810.30	1882.10	1977.30	1843.8
Oil (\$ per barrel) - Crude Futures (WTI)	110.18	110.60	106.54	65.51
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (April) - % change	0.3	1.2	0.8	0.7
Core CPI (April) - % change	0.6	0.3	0.5	0.5
Producer Price Index (April) - % change	0.5	1.6	1.1	1.0
Small Business Optimism Index (April)	93.2	93.2	95.7	95.6

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