

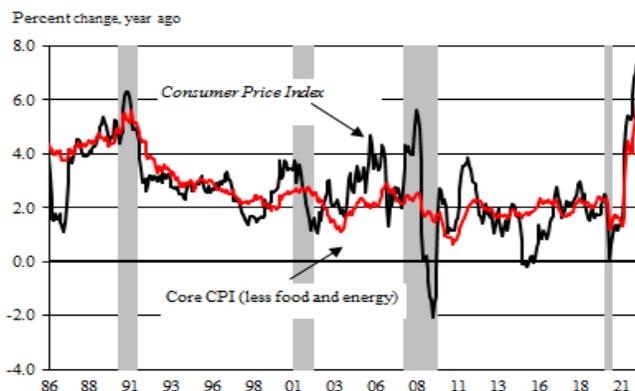
Last week the Biden administration basked in good news, thanks to a blockbuster jobs report that came in far stronger than expected. But what the economy gives with one hand, it takes with the other. This week, the news was not so great, as the Labor Department delivered another upsetting inflation report that adds fuel to the growing angst among voters who now rank escalating prices on just about everything as more of a problem than finding a job. If nothing else, the debunked Phillips curve may have regained some credibility as the link between labor market tightness and inflation is clearly not as broken as it had been since the Great Financial Crisis.

That said, it would be a mistake to lay full – or even most— of the blame for accelerating inflation on rising labor costs. Pandemic-related supply shortages, prompting households and businesses to bid up prices to satisfy demand, continue to be a key force driving inflation. Nowhere is that more evident than in the auto sector, where production constraints due to computer-chip shortages have spurred astonishing price increases. Used car prices are up 41 percent over the past year, contributing 1.1 percent to the 7.5 percent increase in the consumer price index over the period. That’s an outsize contribution from a sector that only accounts for 4.1 percent of the basket of goods and services included in the index.

The auto sector, of course, is the poster child for the notion the inflation surge reflects transitory forces that would fade when foundries ramp up chip production, allowing assembly lines to churn out enough vehicles to satisfy demand. But solutions to even transitory problems are taking longer to arrive, thanks primarily to the Omicron variant that has extended the pandemic. Meanwhile, the inflation scourge is affecting an ever-broader list of goods and services, and becoming more embedded in the economic landscape. Although the headline consumer price index is off the charts, surging by a 40-year high of 7.5 percent in the year through January, the core CPI that excludes volatile food and energy prices is not far behind, posting an annual increase of 6.0 percent, the fastest since August 1982.

Not surprisingly, prices of goods, where shortages are most acute, are leading the way up. Paced by the aforementioned used cars, prices for durable goods soared by 18.4 percent over the past year, the most substantial annual increase on record. The good news is that these price gains should be the first to slow in the post-pandemic environment, as consumers shift their purchasing preferences to in-person service activities. The easing of supply chain disruptions allows producers to ramp up output. This should ease pressure on goods prices. The bad news is that service prices, which take longer to unwind, are also rising at the fastest clip in nearly 30 years. The 4.6 percent increase over the past year is the steepest since July 1991.

**Inflation Unleashed**

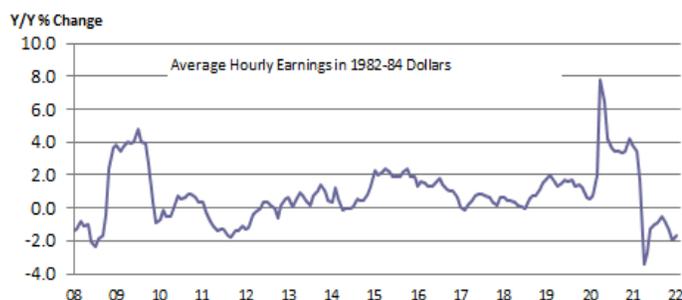


Just as the auto industry highlights the surge in goods prices, the cost of keeping a roof over your head is pacing the upward trend in service prices. Rental pricing, which accounts for 23 percent of the consumer price index, increased by 4.1 percent over the past year. While this seems mild relative to goods prices, it’s best to think of the cost of shelter as a floor under inflation, not only because of its outsized influence on the consumer price index. The forces driving up rents are unlikely to fade anytime soon, as soaring home prices make a home purchase unaffordable for an expanding swath of the population, forcing would-be buyers into rental units. With the supply of homes for sale at all-time lows and construction activity hobbled by labor shortages and rising costs of construction materials, home prices should remain high over the foreseeable future, sustaining the upward pressure on rents.

Notably, other services are becoming more expensive as well. Excluding rents, service prices increased by 4.7 percent over the past year, so the 4.1 percent advance in rents actually held back the rise in overall service prices. And whereas supply-chain disruptions are primarily causing the surge in goods prices, rising labor costs are more heavily influencing the increase in service prices. For the first time in four months, average hourly earnings for all workers increased faster than consumer prices – 0.7 percent versus 0.6 percent – in January. Hence, real earnings actually edged up by 0.1 percent during the month. There’s still a long way to go before worker pay catches up to inflation, as real earnings are still 1.7 percent lower than a year ago. But the tight job market is conferring greater bargaining power to workers, which should sustain upward wage pressures in the coming months.

But as long as rising prices erodes worker purchasing power, there will be no letup in the growing discontent among households. This was on vivid display in the latest University of Michigan survey, which revealed another sharp drop in household sentiment in early February. The sentiment index tumbled by 5.5 points to the lowest level since the fall

**Falling Real Wages**



2019 on Thursday. However, reeling stock prices during the week, punctuated by a deep dive on Friday, prompted a flight to safe government issues, causing the 10-year yield to retreat below 2 percent at the end of the week. The yield on the 2-year Treasury note, which is highly sensitive to Fed policy moves, also slipped on Friday, but not by nearly as much as the longer maturity, resulting in further compression of the yield curve. The spread between the 10- and 2-year yield narrowed from 60 to under 50 basis points during the week.

That’s still a distance from an inversion of the curve, which is a time-honored leading indicator of a recession. But the narrowing trend captures the ambivalent perception of future developments by investors. The short end of the curve points to several rate hikes by the Federal Reserve in the coming months, while the compression of the curve reflects heightened concerns of a policy mistake, i.e., that the Fed may overcorrect and risk sending the economy into a recession. Following the CPI report this week, the market priced in at least a 50 percent chance that the Fed would hike its policy rate by 50 basis points at its March 16 meeting instead of the usual quarter-point increase. Indeed, it would be the first time in more than 20 years that a half-percent increase was put into effect.

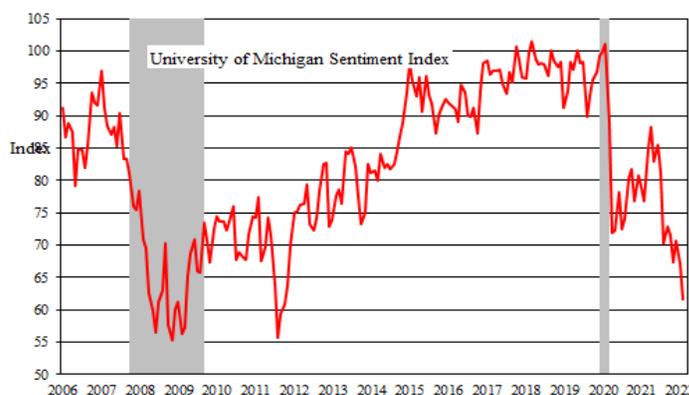
The expectation of a half-point rate hike was fueled by a number of hawkish comments by Fed officials this week, most notably from St. Louis Fed president Bullard who expressed comfort with a 100 basis point increase in the federal funds rate by July 1. We agree that the Fed will bump up the funds rate at its upcoming meeting, and the odds of a 50 basis point hike has increased. The Fed usually does not like to surprise the markets by doing something unexpected, which a half-point hike would have been a few weeks ago. But now that it is fully priced in, it would no longer be a surprise, giving the Fed the flexibility to follow through if it deems necessary at the meeting.

However, as disconcerting as the inflation surge has been, the Fed can take some comfort in the fact that inflation expectations have not become unanchored. For example, in the Michigan survey, household long-run inflation expectations held steady with January at 3.1 percent, which is certainly not alarming. Nor is the bond market becoming unnerved, as the 10-year breakeven rate – a measure of expected inflation over the next ten years – stood at a relatively benign 2.45 percent at the end of this week. With long-run inflation expectations still tolerable, the Fed may choose to take the more cautious path of gradually tightening policy rather than risk throwing the economy into a tailspin.

of 2011, when the economy was still struggling to emerge from the Great Recession. Significantly, the biggest drag on sentiment reflected an expected erosion of incomes due to inflation. What’s more, upper-income individuals, those with annual salaries of \$100 thousand and up, expressed the biggest fear of lost purchasing power. There is some statistical support for this angst, as earnings of lower-paid workers have not only been rising at a faster clip than those higher up the wage ladder but also outpacing inflation.

Not surprisingly, the latest CPI report on the heels of last week’s blockbuster jobs report is roiling the financial markets, as investors are pricing in a swifter move by policymakers to rein in inflation. Bond yields spiked during the week, with the bellwether 10-year Treasury yield moving above 2 percent for the first time since

**That Sinking Feeling**



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FINANCIAL INDICATORS				
INTEREST RATES	February 11	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.36%	0.23%	0.13%	0.04%
6-month Treasury bill	0.70	0.55	0.29	0.05
3-month LIBOR	0.39	0.32	0.24	0.19
2-year Treasury note	1.52	1.32	0.96	0.11
5-year Treasury note	1.87	1.77	1.56	0.5
10-year Treasury note	1.94	1.92	1.79	1.20
30-year Treasury bond	2.25	2.21	2.13	2.01
30-year fixed mortgage rate	3.69	3.55	3.45	2.73
15-year fixed mortgage rate	2.93	2.77	2.62	2.19
5/1-year adjustable rate	2.80	2.71	2.57	2.79
<b>STOCK MARKET</b>				
Dow Jones Industrial Index	34738.06	35089.74	35911.81	31494.32
S&P 500	4418.64	4500.53	4662.85	3906.71
NASDAQ	13791.15	14098.01	14893.75	14095.47
<b>Commodities</b>				
Gold (\$ per troy ounce)	1860.60	1808.30	1816.30	1816.35
Oil (\$ per barrel) - Crude Futures (WTI)	93.90	91.94	84.39	58.54
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (January) - % chg	0.6	0.6	0.7	0.6
Core CPI (January) - % change	0.6	0.6	0.5	0.5
Small Business Optimism Index (January)	97.1	98.9	98.4	98.6
Consumer Credit (\$blns)- December	18.9	38.8	14.7	20.1

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