APRIL 2022 ECONOMIC COMMENTARY by Colton Krueger, Economic Analyst

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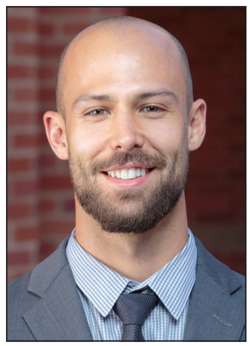
Over a month has now passed since the Federal Reserve raised interest rates for the first time since 2018. Since the meeting, Fed officials have indicated that they would have preferred to have begun with a 50-basis point hike if not for the uncertainty caused by the war in Ukraine. As time has passed and inflation continues accelerate, market participants now anticipate that that the Fed will likely hike rates 50-basis points at both the May and June Fed meetings. The expected target rate by the end of the year is now above 2.50 percent. Almost on a weekly basis, Fed officials continue to make hawkish statements that are pushing up expectations around how aggressive the Fed may act. Recently, the President of the St. Louis branch of the Fed, Jim Bullard, said he would like to see the rate go as high as 3.00% - 3.25% by year end. Such a rapid increase in interest rates comes as a shock to many given that last year people were locking up 30-year mortgages below 3 percent. Fast forward to today, and what was once the rate households were getting for 30-year mortgages may be the target overnight rate in the not-too-distant future. On top of rate hikes, the Fed is also expected to begin unwinding some of the $4.5 trillion build-up of its balance sheet and this will have further upward pressure on rates.



The reason for the aggressive course of monetary policy is due to inflation across all sectors of the global economy. Last month the Consumer Price Index (CPI) hit an annualized pace of 8.5 percent, and core CPI increased 6.5 percent. Economists are hopeful that this is near the peak inflation rate, as we have seen energy prices come down from their highs. However, supply chain disruptions caused by the lockdowns in China, persistent conflict in Ukraine, along with increased bargaining power of workers will continue to put upward pressure on inflation.

For now, the increase in inflation reflects a growing economy with strong demand. The Conference Board is projecting 3 percent GDP growth for the year, which is down from the 5.6 percent increase in 2021, but is still healthy growth. The Leading Economic Index (LEI) continues to advance, suggesting there is a good runway for the economy over the next 6 months. Finally, the labor market is incredibly strong. The unemployment rate fell to 3.6 percent in March even as the labor participation rate rose. This tight labor market can be a double edge sword. Workers can now command higher wages and earn more income, thereby allowing for more spending and economic growth, but higher wages contribute to higher inflation. Average hourly earnings are up 5.6 percent annually, but with inflation running at 8.5 percent, there has been a decline in real purchasing power. The decline in purchasing power will eventually place a strain on the consumer once surplus savings rates are depleted, but for now it's mostly rearing its head in declining consumer sentiment. With surplus savings, wages increasing, and job security, spending should be sustained through this year.

Where restrictive monetary policy will likely first be seen is in the housing market, which is an interest rate sensitive sector, and is also typically a leading indicator both in and out of recessions. Mortgage rates on 30-year loans have now topped 5%, and this increase in rates, coupled with higher median home prices, means the cost of housing has increased dramatically. This suggests that home prices may face downward pressure as homeownership is becoming increasingly out of reach for first time homebuyers. However, first time buyers are just a small subset of the housing market. Given that most homeowners mortgages are well-below the going 5% rate, people are disincentivized to trade up to a new home, which will likely cause the supply of housing to be further squeezed and may keep home values elevated.

The question is whether our economy can absorb the increase in interest rates without the Fed inducing a recession. In the past, when inflation has run as high as it is today, the Fed has never been able to curb inflation without causing a recession. This explains why we are experiencing some turbulence in both the equity and the bond market this year. The movement in these markets is reflective of what may happen in the future, not where our economy is today. Today our economy remains quite strong and tightening monetary policy will take time to take effect. Early in the restrictive monetary policy phase these rate hikes shouldn't take too much juice out of the economy. Consumer's still have a high level of savings, particularly lower income households who spend at a higher rate, and the labor market is strong, which should be enough to sustain spending and growth in the near term. Economist and many investment banks warn that the tightening taking place this year will increase the likelihood of a recession in 2023. The Fed of course is aware of this and is trying to act nimbly. Managing inflation without causing a decline in economic growth will be a challenge, and the Fed will need some better luck with geopolitics and supply chain than we are experiencing today.

ECONOMIC CHARTS