

Weekly Market Insights

April 4, 2022

A Directionless Market

Financial Markets

United States equity markets ended this past week almost unchanged, with the Dow down 0.12%, the S&P 500 up 0.06%, and the NASDAQ up 0.65%. With so many market moving events at play, short-term traders are having a hard time finding a consistent theme to follow. Utilities, Consumer Staples, and Health Care closed the week with gains while other sectors fell. Bringing up the rear were Financials, Materials, and Energy. The market's inconsistent behavior is understandable because of conflicting signals and the apparent dominance of short-term trading. Readers will find examples of conflicting signals when reading Ryan's Economic Indicator report.

Equity Markets

We wrote about mixed signals confusing investors and analysts alike. Four that come to mind are the war in Ukraine, inflation, Federal Reserve intentions, and, most recently, an inverted yield curve. This list is certainly not exhaustive, but it covers the most significant issues.

Investment analysts are really not in the business of analyzing the conduct and progress of wars. Instead, we are more information takers. The other three—inflation, Fed policy decision, and the inverted yield curve—are intimately related.

Just last week we wrote about inflation. Elevated inflation reports are distressing, but we think there are three primary factors—supply chain disruptions, restricted labor supply, and excess liquidity in the system.

It appears that the supply chain problems are slowly being resolved. Also, recent reports from the Labor

Department indicate that the labor supply is beginning to expand. Bringing the money supply down and reducing the Fed's balance sheet are more difficult and will take much longer. The Fed is, of course, very aware of this and communicates with investors on a frequent and consistent basis. They have a number of options when it comes to how rapidly they plan to move. Their decisions are in the realm of informed guesses. Certainly, they have access to some of the country's greatest economic minds, but they are still dealing in the future. As far as interest rates are concerned, we think the Fed chairman is taking the correct path. Chairman Powell argued at a meeting with the National Association for Business Economics (NABE) last week that they plan to raise interest rates in 25 basis point increments, but he also emphasized that they won't hesitate to up that number to 50 basis points if needed. This should be sufficient to bring down inflationary expectations without driving the U.S. economy into a recession. Alas, this is not the Fed's only problem to address. They have an enormously swollen balance sheet.

When it comes to the balance sheet, the Fed appears to have at least two choices—let the bonds they own mature or sell bonds over time. Letting bonds mature will work, but it will be a slow process. They can speed up the reduction instead by actively selling bonds. It seems reasonable that they will do the latter. The danger is that they become too aggressive.

Finally, the two and ten year spread on the yield curve turned slightly negative last week. This is widely considered a warning sign by investors. Next week, we will concentrate more on the yield curve.

Weekly Market Insights (cont'd)

March Economic Update

Economic indicators continue to suggest we are in a period of elevated inflation and a tight labor market. At the moment, reopening, core, and external factors are all contributing to rising prices. It is important now to focus on the drivers of more durable price increases in an effort to understand the path of inflation going forward. This matters because while a strong labor market will support consumer resilience for the time being, a sustained period of higher inflation could eventually lead to decreased demand and a slowdown in economic growth.

Inflation measures remain elevated relative to historical averages with the core Consumer Price Index (CPI) increasing 7.9% year-over-year and 0.8% from the prior month. Although lower than the CPI reading, the Personal Consumption Expenditures (PCE) Inflation Index is still elevated, rising 6.4% year-over-year and 0.6% month-over-month in the latest release. While supply chain disruptions and geopolitical events in Ukraine are having an upward impact on price levels, these effects will not be permanent, and focus should instead be placed on “stickier” inflation components like housing, rent, and wages to determine the durability of the current inflation environment. While not yet extreme, shelter prices have risen steadily, with monthly increases averaging just over 0.4% since September and February’s reading coming in at 0.5%.¹ Wages have exhibited a similar trend with hourly earnings also averaging 0.4% over the same period and rising 0.4% in the most recent release.² A few factors could lead to cooled inflation readings going forward, including base effects as we lap higher readings from 2021, continued improvements in labor supply, and reduced demand due to rising interest rates. As we have stressed before, more sustained price increases will heighten the risk of

inflation becoming entrenched in future expectations and the phenomenon known as the wage price spiral.³ We are still not dealing with the threat of unanchored expectations, but this is a critical aspect of the overall inflation picture.

We continue to see strong labor market statistics. Employers added 431,000 jobs in March with 91,000 in upward revisions to the January and February reports. Unemployment insurance claims are historically low, and job openings remain elevated. Despite there being 1.2 million fewer employed compared to before the pandemic, other indicators point to a surprisingly tight labor market. For one, the unemployment rate is 3.6%, nearing the pre-pandemic low of 3.5%, which, at the time, was the lowest reading since 1969. Furthermore, with 6 million unemployed and 11.3 million job openings, the number of unemployed per job opening sits a 0.5x—a historically low reading.⁴ However, as the health situation continues to improve, we are seeing the gradual return of labor supply. A recent *Wall Street Journal* article reported that the Omicron surge prevented 1.2 million people from searching for a job in February due to being sick or caring for others. The number declined to 900,000 in March and could be an early indicator of further labor supply increases in the future.⁵ This has also been the case with other COVID variants before Omicron, so less severe strains and improved immunity should lessen the negative impact on labor supply going forward. Furthermore, the removal of enhanced unemployment benefits and stimulus checks, along with increasing prices for everyday items like gasoline, food, and rent, is pressuring more individuals to rejoin the labor force to increase household incomes. Early retirees, significant contributors to the supply shortage, have not been

¹U.S. Bureau of Labor Statistics. (2022, March 10). *Consumer Price Index Summary – 2022*. U.S. Bureau of Labor Statistics. <https://www.bls.gov/news.release/cpi.nr0.htm>.

²U.S. Bureau of Labor Statistics. (2022, April 1). *Employment situation summary – 2022 Q1 results*. U.S. Bureau of Labor Statistics. Retrieved April 1, 2022, from <https://www.bls.gov/news.release/empsit.nr0.htm>.

³The idea that untethered inflation expectations could lead to a demand for higher wages, resulting in firms raising prices to offset increased input costs, causing workers to expect even higher wages, and so on.

⁴U.S. Bureau of Labor Statistics. (2022, April 1). *Employment situation summary – 2022 Q1 results*. U.S. Bureau of Labor Statistics. Retrieved April 1, 2022, from <https://www.bls.gov/news.release/empsit.nr0.htm>.

⁵Cambon, S.C. (2022, April 1). *U.S. March Jobs Report Shows Strong Hiring Momentum*. The Wall Street Journal. Retrieved April 1, 2022, from https://www.wsj.com/articles/march-jobs-report-unemployment-rate-2022-11648766857?mod=hp_lead_pos1.

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immune from inflation pressures. The share of retired workers re-entering the labor force increased to 3% in March, the highest rate since March of 2020, which could be an early sign of a return to pre-COVID trends.⁶ At 62.4%, labor force participation⁷ is still significantly below the February 2020 rate of 63.4%, so there is a long runway for improvement. We will watch for the continued recovery in labor supply as inflation pressures and the impacts of a more normalized post-COVID environment encourage further participation.

Consumption and spending metrics remain strong while consumer confidence continues to slide lower. Retail sales increased 0.3% in February after January's surprising 4.9% rise. Personal Consumption Expenditures also increased, rising 0.2% in February. There continues to be a divergence between what consumers are feeling and what they are doing with the Michigan Consumer Sentiment Index making a new pandemic low in March. Consumers are citing numerous reasons for pessimism with geopolitical tensions and inflation acting as the driving forces behind

depressed sentiment. When it comes to inflation, 32% of all consumers expect their overall financial position to worsen over the next year—the highest recorded level since the surveys began in the 1940's. Additionally, half of all households expect their inflation-adjusted incomes to decline in the year ahead. The job market seems to be the sole area of optimism with elevated job openings and low unemployment helping to offset some of the impact of higher prices. March's survey data suggests that U.S. consumers are undoubtedly feeling the pressures of higher inflation.⁸

From December to their latest March meeting, Fed projections for 2022 real GDP declined from 4.0% to 2.8% while their inflation forecast increased from 2.6% to 4.3%. We are undoubtedly in a period of higher inflation, but the question remains whether price pressures will continue for an extended period of time. While a strong labor market will buoy consumer spending for some time, the eventual easing of price pressures is paramount for future economic growth to continue.

⁶Ibid.
⁷Those employed or looking for work.
⁸*Surveys of Consumers – Final Results for March 2022*. University of Michigan. <http://www.sca.isr.umich.edu/>.

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