Weekly Market Commentary

May 15, 2023

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The Federal Reserve drew comfort from positive news on the inflation front this week, taking some of the sting out of the previous week's relatively strong jobs report. There's still another jobs and consumer price report due out before the next FOMC meeting that concludes on June 14, which could sway the Fed's decision whether to raise rates again or hit the pause button. Following the benign consumer price report on Wednesday, the market-based probability of a pause increased to almost 85 percent, according to the CME probability tool. We caution, however, that market sentiment can be highly fickle, and trader perceptions could turn on the dime if incoming data favors a different decision.

In addition to comforting inflation news, the financial markets were granted a brief reprieve from a prospective angst-ridden stalemate on debt-ceiling negotiations that were postponed from Friday to early next week. Whether the outcome will be any different is questionable, but the postponement suggests that the participants are making headway on some issues. The window to reach an agreement before June 1— the Treasury's projection of when it will run out of cash to pay its bills — is rapidly closing. As we get closer to that so-called X-date without an agreement, the prospect of extreme market disruptions looms large.

Although the Biden administration is insisting on a clean debt-ceiling increase with no strings attached, the prospect of a compromise that results in some fiscal austerity is gaining traction. Although that is not likely to have a near-term impact on the economy, it may contribute to reduced inflation expectations, something that would clearly sit well with the Federal Reserve and, perhaps, provide another impetus for it to refrain from raising rates at the mid-June policy meeting. As noted, the recent inflation data is encouraging, although not definitive enough to take future rate hikes off the table. Keep in mind that a "pause", which is likely at the upcoming meeting, does not mean "stop" so anything that portends a stalling out of the disinflationary trend could lead to another rate hike at subsequent meetings.

That said, Fed officials would clearly prefer to move to the sidelines for a while to assess the impact that past rate increases are having on the economy, as well as the possible damage expected from the tightening of credit conditions underway. Incoming data suggest that those influences are having their desired effects; the economy is cooling and inflation is tapering off, although still not fast enough to prompt the rate cuts that investors are expecting later this year. The headline consumer price report this week captures that ambiguity. Both the overall CPI and the core CPI that excludes food and energy items increased 0.4 percent in April, which is not much different from recent months but meaningfully slower than last year. Compared to a year ago, both inflation gauges continued to trend down — to 4.9 percent from 5.0 percent and to 5.5 percent from 5.6 percent, respectively — but remain far above the Fed's 2 percent target. Likewise, the supercore inflation measure — non-housing service prices, the sticky prices the Fed is closely monitoring — is also cooling, but far too slowly for the Fed's comfort.

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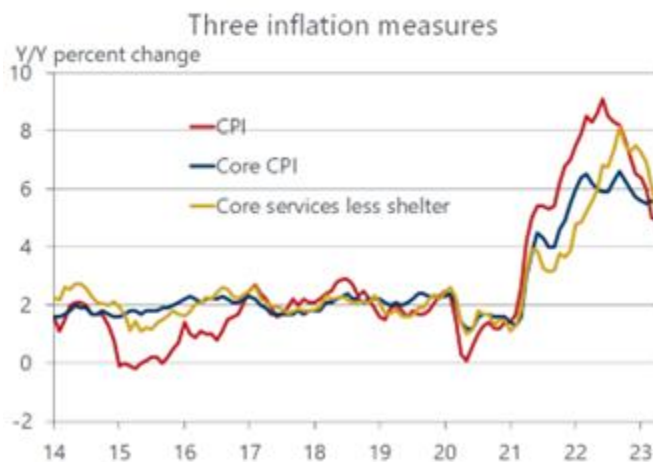


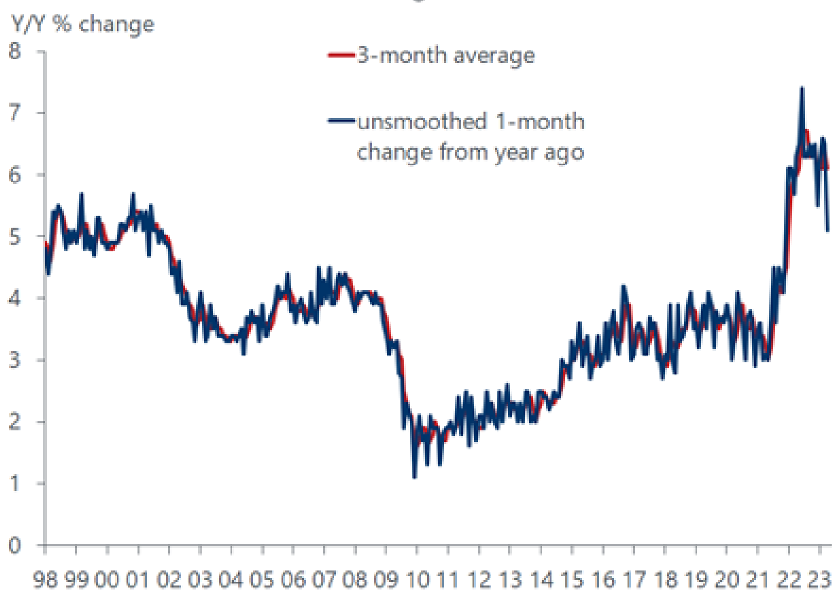
We expect the disinflation trend to continue as the economy's growth engine downshifts, leading to slower consumer spending, weaker job growth and, importantly, easing wage gains. The Fed is laser focused on the job market, where tamping down wage growth is considered essential to its anti-inflation efforts. Like the inflation measures, progress on the wage front has been slow but steady, although the extent of improvement depends on which of the several labor compensation measures are used as yardsticks. The average hourly earnings component of the jobs report is probably the least representative but the most current measure of wage trends that garners considerable attention in the financial markets. The trend here might be considered the best of all worlds, as it depicts slowing nominal wage growth but a pickup in real earnings, as the CPI has decelerated faster than wages in recent months. Indeed, workers have steadily been catching up with inflation this year, as real earnings in April were only 0.54 percent less than a year ago. That's the slimmest loss of purchasing power since September 2021.

Should this virtuous cycle of slowing nominal and growing real wages continue, the Fed's goal of achieving a soft landing in its inflation fight becomes more achievable. Consumers would then have the purchasing power to keep on spending while slower nominal wage growth would encourage the Fed to ease its foot off the monetary brake, removing a major impediment to the expansion. Indeed, Fed chair Powell has repeatedly stressed that wages — and, hence, inflation — can be brought under control without a recession if companies reduce hiring and labor supply increases, restoring more balanced demand/supply conditions in the labor market. Those conditions are closer to being met, as job openings have retreated in recent months, payroll growth is slowing and the labor force participation rate among prime-age workers has fully rebounded to prepandemic levels.

But the odds of the pieces falling into place in such a goldilocks manner are slim, as the headwinds facing the economy are gaining momentum. From our lens, the Fed is not likely to cut rates before 2024 and the lagged effects of past rate hikes combined with tightening credit conditions will stifle growth and drive-up unemployment. Signs of cracks in the job market are becoming more visible. In addition to the haircut in job openings, fewer workers are voluntarily quitting their jobs and layoffs are on the rise. The official unemployment rate has yet to lift off from its rock-bottom 50-year lows as laid-off workers are either finding jobs elsewhere or returning to school. But initial claims for unemployment benefits are on the rise, hitting the highest level since October 2021 in the May 5 week, and many of the laid-off workers in the high-paying tech sector may be settling for lower-paying jobs in other sectors.

To be sure, the case for a Fed pivot towards ease sooner than we expect is strongly supported in the financial markets. Investors are betting that inflation will subside more quickly than Fed officials expect and see the economy faltering more severely than assumed in the Fed's most recent forecast, although the Fed's staff of economists is forecasting a recession over the second half of the year (which Fed chair Powell disagrees with). While we do not expect the Fed to cut rates this year, we believe the quarter point increase taken last week represents the last of the rate-hiking cycle. The risks of another increase versus a cut are about evenly balanced, and the trend in jobs and wages will likely be a deciding influence.

As already indicated, average hourly earnings are the least reliable measure of wage trends because it is heavily influenced by changes in the composition of jobholders between low and higher earners. However, a wage tracker compiled by the Federal Reserve Bank of Atlanta, which adjusts for compositional changes, is slowing markedly. The tracker for April slowed to 6.1 percent from 6.4 percent in March. This gauge tracks the annual growth rate in the three-month average of wages to smooth out volatile monthly changes. However, we note that unsmoothing the results reveals an eye-popping drop in April — to 5.1 percent from 6.5 percent in March. That's the steepest fall-off for a month since the series began in 1997. If the March descent is not an outlier but the start of a trend, the Fed may rethink its plans.


Atlanta Fed wage tracker
Y/Y % change
3-month average
unsmoothed 1-month change from year ago
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