ECONOMIC AND FINANCIAL DIGEST

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Oil, War, and Uncertainty: The Economy's Latest Test

As this is being written, the Mideast war is still raging, oil prices are skyrocketing, and heightened uncertainty is battering the financial markets. This is just the last of multiple shocks since the pandemic to cast a cloud over the U.S. economy, including a chaotic tariff rollout, an immigration crackdown, a previous oil shock linked to the Russia/ Ukraine conflict, and a government shutdown. As Federal Reserve chair Powell noted, no one knows how the Mideast war will end or how it will impact the economy. That uncertainty has put policy on hold until a clearer vision of how things will work out comes into focus, something that probably won't happen until the war ends and the oil spigot reopens.

The economy has weathered previous storms admirably, despite many forecasts that it would buckle and flirt with a recession, if not descend into one. Its resilience is being tested again, and we suspect that it will survive this time as well. That said, the pain from higher energy costs is already spreading, hitting middle and lower-income households, whose budgets are increasingly being squeezed by bigger utility bills, elevated food prices and now most visibly, sharply higher prices at the pump. Wealthier households are in better shape, but their main cushion against rising energy-related costs is also vulnerable as the war is taking a toll on both stocks and bonds, a key component of their spending power.

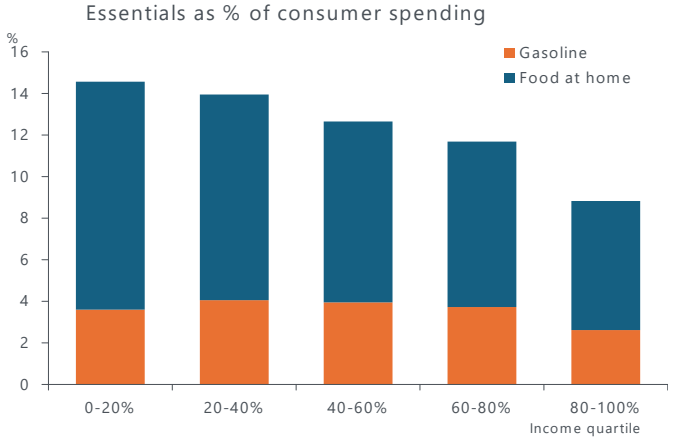
Even assuming, as we expect, the Mideast war winds down within the next few weeks, the economy would not be out of the woods. Thanks in part to the government shutdown, GDP almost stalled out in last year's fourth quarter, rising by a meager 0.7 percent. The shutdown losses are being recouped, but consumer spending – the economy's main growth driver—also slowed considerably in the final months of last year. Worse, the large refunds expected from last year's tax cut bill has been completely erased by higher gasoline costs, removing a major stimulus that was expected to boost spending over the first half of this year. Hence, the economy is limping into the spring, and the still elevated inflation is preventing the Federal Reserve from cutting rates to help out, lest it adds fuel to the inflation fire. Reconciling the tension between weaker growth and inflation has been a yearslong challenge for the Fed, but the latest oil shock adds another layer of complexity for policy makers to deal with.

Oil's impact: it's not just inflation

The disruption in the oil markets since the war's outbreak has been historically swift and deep, comparable to previous oil shocks in the 1970s and following Russia's invasion of Ukraine in February 2022. Its impact on broader inflation and economic activity, however, has been milder, primarily because the economy has become less energy intensive than it was fifty years ago and is in better shape to absorb the shock than in 2022, when it was still licking its wounds from the pandemic. If the war winds down within the next month or so and the Strait of Hormuz reopens, the lingering damage should be contained, setting the stage for a rebound in the second half of the year even as inflation eases amid falling oil prices.

However, if the war and the squeeze on oil supplies last longer, the pain will be deeper – both on the inflation and growth sides of the ledger. Higher oil prices bleed into other goods and services, including food and groceries by increasing the cost of fertilizer and running farm machinery, home heating, manufacturing costs, and many services, most visibly airfares. Hence, over time broader inflation would increase which, in turn, drives interest rates up; indeed, bond yields - and mortgage rates - have already risen markedly from levels that prevailed before the war.

Importantly, higher energy prices, particularly at the pump, will force households to make difficult trade-offs. Consumers are likely to cut back on other purchases and draw down savings to sustain spending. But with personal savings rates already at historically low levels, those buffers are already thin so overall spending will suffer, posing a drag on economic growth. What's more, the pain from higher gas prices affects lower- and middle-income consumers the most. The bottom 80% of households by income spend close to 4% of their budget on gasoline, while higher-income consumers spend significantly less. The knock-on impacts on both energy and food prices would disproportionately burden lower-income households, deepening the bifurcation of the consumer that we've seen over the past several years.



Elections could be affected

It's still early days, but the campaign season for the midterm elections is about to heat up, and one of the most critical issues that worry politicians is affordability. Whether they remain a thorn in the side of incumbents depends on how soon the war ends and how quickly oil prices retreat. There is an old adage that oil prices rise like a feather, but descend like a staircase, so the quicker the better for officials currently in office and having to defend high prices.

To be sure, midterm voters tend to form their opinion about the economy in the summer and fall, so it would be a mistake to exaggerate the impact that current headlines will have in November. That said, history strongly suggest that a divided government is the most likely outcome. Since World War II the president's party has, on average, lost 26 House seats and 4 Senate seats. Republicans currently hold such razor thin majorities that they can't afford to lose more than two House seats and three Senate seats if they are to maintain control of Congress. Prediction markets, as of late March, are assigning a three-quarters probability that Democrats flip the House, but less than a one-third probability that they will win back the Senate.

Importantly, while a divided government is the most probable outcome of the midterm elections, nothing is ever certain until election day. Since investors loath uncertainty, this is likely to stir up more volatility in the financial markets as we move closer to the election. But if a divided government is the outcome, investors – particularly in stocks – should be optimistic. Historically, stocks did well under a unified Republican control of government, but they have done even better under a divided government. That's because it usually ushers in policy gridlock, which prevents the most controversial policies of either party from becoming law.

The Fed on hold

The Federal Reserve decision to leave interest rates unchanged at its mid-March meeting was never in doubt, so the interest was all in the updated policy statement, accompanying economic and interest rate projections and post-meeting press conference. But the uncertain scale and duration of the energy price shock facing the economy means the updated economic projections could change significantly depending on the course of the war. Indeed, at the post-meeting press conference, Fed chair Powell wryly noted that if there was one time that the Fed could have skipped making projections, this was probably it.

Still, the economic projections, made in quarterly intervals, does provide useful guidance into the Fed's thinking, which can either confirm or refute prevailing expectations. Despite the obvious inflationary impact from the oil shock, the Fed's projection still calls for a rate cut later this year and another in 2027. Underpinning that forecast is the belief that the oil shock is causing a one-time boost in prices, not a sustained pickup in inflation that would involve recurring price increases. The Fed believes that once the conflict ends, oil prices will recede and bring down overall inflation. It can then turn its attention to the growth side of the ledger, which has been weakening amid slowing job growth and the hit to incomes from higher energy and oil prices.

At first, the financial markets aligned with the Fed's forecast and even priced in more than one rate cut, believing the downside risk to growth was greater than the upside risk to inflation. More recently however, that sentiment has pivoted to the other direction, with the markets even pricing in a small – but growing – probability of a rate hike this year. That pivot may or may not come to pass, but it has real time consequences for investors, as market yields have increased since the Fed meeting and stock prices have floundered.

Avoiding a repeat

For its part, the Fed is keenly aware of the mistake it made in 2022, when it waited too long to raise rates amid the worst inflation flareup since the 1970s, believing that it would be transitory. Chair Powell acknowledged that there was some discussion of a rate increase at the mid-March meeting should certain conditions evolve. But those conditions are far from being in place, and the prevailing view among policymakers was that they are not likely to evolve.

We agree with that sentiment for a number of reasons. Most important, the inflationary backdrop is less troubling than in 2022. For one, labor market conditions are far weaker and less likely to stoke a spike in wages than in 2022 when lingering pandemic fears created severe labor shortages. For another, supply chains are less stressed as the product shortages caused by pandemic related factory shutdowns no longer exists. Finally, housing inflation is retreating, unlike the spiral following the pandemic when remote work drove households to seek larger spaces further away from offices, creating a demand for homes that greatly exceeded the available supply.

It would be a mistake to view the current oil shock becoming a one-time price boost that will completely unwind when the conflict ends. As noted, oil prices are not likely to come down as rapidly as they rose and the knock-on effects on broader inflation have yet to fully play out. Inflation will be higher this year than expected before the Mideast war, and the buffers keeping the economy afloat should give the Fed leeway to keep rates unchanged for a while longer. But the job market is highly fragile; except for the blip during the Covid recession, hiring is at the lowest point since 2013 and jobseekers are struggling to find a position. Once inflation fears and headline-grabbing chatter over high energy prices subside with the end of the conflict, the Fed can pivot away from the risk of a sustained inflation pickup and towards the downside risks facing the economy from the income-draining impact of the oil shock. Given the fog of uncertainty that currently prevails, nothing is cast in stone. But the stage should be set for the Fed to resume rate cuts over the second half of the year to prevent the downside risks to the economy from descending into a recession.

KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	February	January	December	November	October	September	August	12-Month Range High	12-Month Range Low
Prime Rate	6.75	6.75	6.83	7.00	7.23	7.38	7.50	7.50	6.75
3-Month Treasury Bill Rate	3.57	3.57	3.59	3.78	3.82	3.92	4.12	4.25	3.57
5-Year Treasury Note Rate	3.78	3.78	3.70	3.67	3.65	3.66	3.79	4.04	3.65
10-Year Treasury Note Rate	4.21	4.21	4.14	4.09	4.06	4.12	4.26	4.42	4.06
30-Year Treasury Bond Rate	4.84	4.84	4.80	4.70	4.64	4.74	4.87	4.92	4.60
Tax-Exempt Bond Yield	4.77	4.79	4.80	4.77	4.77	4.96	5.22	5.27	4.30
Corporate Bond Yield (AAA)	5.34	5.34	5.31	5.26	5.13	5.21	5.35	5.54	5.13
Conventional 30-Year Mortgage Rate	6.10	6.10	6.19	6.24	6.25	6.35	6.59	6.82	6.10
Dow Jones Industrial average	49138	49138	48119	47016	46710	45908	44765	49138	39876
S&P 500 Index	6929	6929	6853	6741	6736	6584	6409	6929	5370
Dividend Yield (S&P)	1.16	1.15	1.15	1.16	1.16	1.19	1.21	1.43	1.15
P/E Ratio (S&P)	26.9	27.7	27.3	27.2	28.4	27.8	26.8	28.4	23.8
Dollar Exchange Rate (vs. Major Currencies)	119.2	119.2	120.6	121.8	121.2	120.5	121.0	126.5	119.2

* Monthly Averages

Economic Indicators

	February	January	December	November	October	September	August	12-Month Range High	12-Month Range Low
Housing Starts (Thousands of Units)		1487	1387	1324	1272	1328	1291	1490	1272
New Home Sales (Thousands of Units)		587	712	764	650	719	706	764	587
New Home Prices (Thousands of Dollars)		401	419	405	404	417	418	425	397
Retail Sales (% Change Year Ago)		3.2	2.4	3.2	3.2	4.1	5.0	5.10	2.4
Industrial Production (% Change Year Ago)	1.4	2.3	1.3	2.1	1.7	1.9	1.2	2.3	0.1
Operating Rate (% of Capacity)	76.3	76.3	75.8	75.6	75.6	76.1	76.1	76.4	75.6
Inventory Sales Ratio (Months)			1.36	1.37	1.38	1.37	1.37	1.39	1.36
Real Gross Domestic Product (Annual % Change)			0.7			4.4		4.4	-0.6
Unemployment Rate (Percent)	4.4	4.3	4.4	4.5	4.5	4.4	4.3	4.5	4.1
Payroll Employment (Change in Thousands)	-92	126	-17	41	-140	76	-70	126	-140
Hourly Earnings (% Change Year Ago)	3.8	3.7	3.7	3.9	3.9	3.8	4.0	4.2	3.7
Personal Income (% Change Year Ago)		4.4	4.6	4.7	4.7	5.4	5.4	5.6	4.2
Savings Rate (Percent of Disposable Income)		4.5	4	4	4.0	4.3	4.4	5.5	4
Consumer Credit (Change in Blns. Of Dollars)		8.1	25.2	2.6	7.3	15.3	0.8	64.0	-5.3
Consumer Prices (% Change Year Ago)	2.4	2.4	2.7	2.7	2.7	3.0	2.9	3.0	2.3
CPI Less Food & Energy (% Change Year Ago)	2.5	2.5	2.6	2.6	2.6	3.0	3.1	3.1	2.5
Wholesale Prices (% Change Year Ago)	3.5	3.4	3.4	3.6	3.4	3.0	3.0	3.6	2.4

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