

Perception Versus Reality

For economists and policy makers, waiting for inflation to subside is like waiting for Godot. But that time may finally have arrived, as the consumer price index rose less than expected in April. It was the first time this year that inflation did not surprise on the upside, giving hope that the strenuous efforts by the Federal Reserve over the past two years are finally bringing results. For sure, one month does not represent a trend and the tame inflation reading in April will not prompt the central bank to start unwinding the steep interest rate hikes it put into effect from March 2022 to July of last year. But it at least stifles concern in some quarters that more rate hikes might be needed to finish the job.

Unsurprisingly, the good news on the inflation front stoked a joyous response in the financial markets. Stocks raced to new highs shortly after the CPI report was released on May 16, and market yields erased some of the runup that occurred prior to the release. If those trends stick, the beleaguered housing market would benefit from lower mortgage rates and low and middle-income borrowers would gain some relief from lower debt servicing charges on credit cards and auto loans. But markets are fickle and if the next wave of data reveals that the April inflation report was a fluke, the celebration will fizzle quickly. Simply put, patience is needed to gain a more conclusive understanding of unfolding events.

That said, there are reasons to be cautiously optimistic that the steep inflation retreat last year will resume, after being rudely interrupted over the first three months of this year. For one, some temporary forces boosted inflation early this year that are already fading. For another, consumers are not as accepting of higher prices as they were earlier in the inflation cycle when they were flush with enormous government stimulus payments that bloated bank accounts. Finally, inflation is fueled by imbalances between demand and supply in the product and labor markets. Both are getting into better balance, and the rebalancing should continue. It's taking longer than most expected, but the conditions for sustained lower inflation are falling into place, setting the stage for belated rate cuts before the end of the year.

The Disconnect

Pundits have been scratching their heads over a headline-grabbing disconnect regarding the health of the economy over the past three years. Over that period, almost 15 million jobs have been created, unemployment has remained under 4 percent for 27 straight months, the longest stretch since the 1960s, and household net worth has ballooned, juiced by a strong stock market and surging home values. Yet, survey after survey reveal that the public is in a dismal

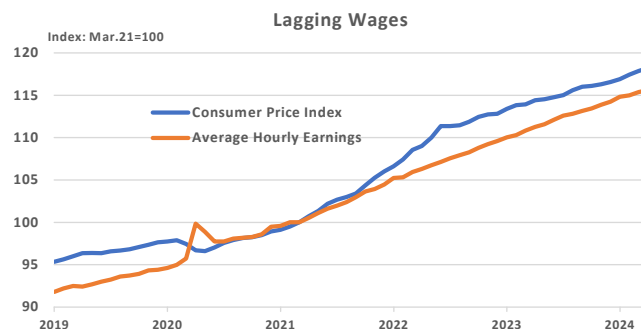
mood, feeling as downbeat about economic conditions as during previous recessions and convinced that the economy is heading in the wrong direction.

A disconnect between perception and reality is not unusual and is often downplayed by economists because people do not always behave as they feel. However, the unusually wide gulf this time is hard to explain. Many commentators chalk it up to politics, noting the highly polarized state of the U.S. electorate. No doubt, that is having an influence, as these same polls reveal vastly different sentiment readings among Democrats and Republicans, with the former viewing conditions through a much brighter lens than the latter. That said, pocketbook issues clearly play a dominant role in how people feel regardless of party affiliation, and the one negative impulse that affects everyone is inflation. People feel bad when things cost more, particularly if prices increase faster than wages.

That, in turn, may well be the overarching anchor that is sinking the mood of households. To be sure, measuring inflation against worker earnings is not a clearcut exercise. It depends on what time frame you are looking at. If you go back to the start of the pandemic in early 2020, worker earnings have kept pace—and even exceeded by a tad—inflation. But a more representative period to measure public angst should begin when inflation started to take off in the spring of 2021. Over this 3-plus years, average hourly earnings grew by 15.6 percent, but consumer prices have risen by 18.2 percent. Hence, despite sturdy gains in workers' pay, they have still not caught up with the rise in prices. In fact, average hourly earnings adjusted for inflation for all workers fell to \$11.02 this April from \$11.35 in March 2021.

Level Versus Change

The decline in real earnings explains why the hot job market



and solid nominal wage increases have not prevented spirits from sinking, even though inflation has retreated from a peak of 9.1 percent in mid 2022 to 3.4 percent currently. Price increases are slowing, but the cost of goods and services is still taking a bigger bite out of budgets than was the case three years ago. What's more, lower-income households have suffered the biggest decline in purchasing power because they spend more on essentials – food, gasoline, and rents – whose prices have gone up faster than the average of all prices. Groceries, for example, cost 21 percent more than three years ago and gasoline 40 percent more.

The good news for low and middle-income households is that price increases for essentials are leading the way lower. Grocery prices have been falling for the past three months and are virtually unchanged from a year ago. Gasoline prices, meanwhile, are declining even faster, and are 15 percent below where they were last September. The one big exception in this group of essentials is rents, which continues to be a key influence lifting the consumer price index. But the CPI, which includes all rents over the past year, is not capturing the much slower increases on new leases that are currently taking place.

These declines are a sure-fire signal that consumers are becoming less tolerant of higher prices than they were earlier in the inflation cycle when their purchasing power was supplemented by the government's pandemic relief programs. Those programs have mostly ended and the cash cushions they provided are mostly depleted. Importantly, major retailers recognize the squeeze on budgets that a broadening swath of their customers are experiencing. In recent weeks, several large chains and big box stores, including most recently Target, announced that they are slashing prices on groceries and thousands of other essential goods that will extend at least through the summer months.

Long Memories

The question is, when will the public recognize and applaud the slower price increases over the past year. That, in turn, brings up another disconnect that bedevils the White House and policy makers. People have long memories; they remember what prices were three years ago and are more chagrined over the near 20 percent more they are paying for goods and services than the fact that those prices are now increasing at a much slower pace than before. No doubt, if income growth had outpaced inflation over the past three years, people would be less upset over the higher prices. But if incomes had increased faster, so too would demand and, hence, inflation, prompting the Fed to hike interest rates even higher.

That, in turn, would have made the prospect of a hard landing for the economy more likely. It's unclear when the current slowdown in price increases will outweigh the higher level of prices relative to three years ago in the minds of households. The timing, however, is important because the longer consumers fret over high prices, the greater the odds they will cut back spending, particularly if anxiety over job security increases. That prospect, moreover, would become likelier if the Fed continues to prioritize reaching its 2 percent inflation target over causing a recession by keeping rates high for too long.

The best-case scenario would be that the relationship between wage growth and prices seen over the past three years flips. Instead of an unequal rise wherein inflation outpaces wage growth, the Fed would like to see an unequal decline, wherein inflation slows more than wage growth. That would leave workers with more purchasing

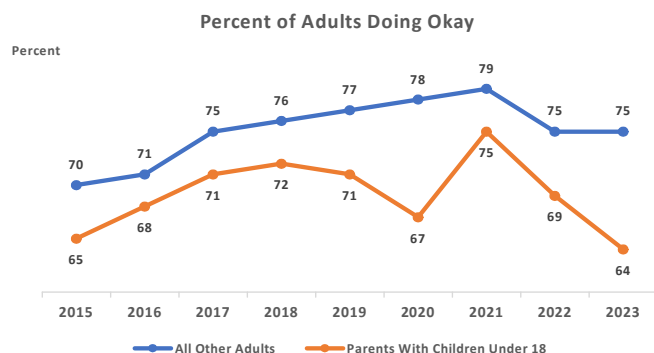
power and allow the Fed to start cutting rates, staving off a possible recession. This describes the heralded soft landing that the financial markets are pinning for, and the Central Bank is hoping to achieve.

Parents Feeling More Pain

Granted, there is no rush to cut rates, as the economy is still holding up quite well despite the public's grim perception of conditions. The economy's growth engine did downshift in the first quarter thanks mainly to a pullback in inventories and a wider trade deficit. But the slowdown in GDP growth to 1.6 percent from 4.2 percent over the second half of 2023 masked stronger consumer spending and business investment. Still, the first-quarter's performance was marred by an upturn in inflation that put the markets and the Federal Reserve on edge.

From our lens, a major risk is that the Federal Reserve will be overly influenced by the backward-looking inflation data that, as noted earlier, were skewed by some unusual forces. Notably, a surge in insurance costs – on autos, healthcare, and homes – gave inflation a big boost early in the year. But these increases reflect a one-time resetting of prices to cover unusually large cost increases that occurred in 2023. For example, car prices and the cost of auto repair jumped last year, prompting insurers to pass on those costs to customers in the form of higher insurance prices. But that inflation boost is already fizzling, as auto prices have declined in every month so far this year.

One cost that continues to squeeze households – and threatens to undercut spending – is childcare expenses. According to a recent Federal Reserve survey, a much higher percent of parents of children under 18 suffered a significant decline in their financial well-being last year. In contrast, the percent of all other adults who felt they were financially OK was virtually unchanged from the previous year. Childcare is one major cost item that is not likely to decline in the near future, given the shortage of workers in this sector that is driving up labor costs. This is also one area where perception and reality converge and adds to the financial burden that is weighing ever-more heavily on low and mid-income households. But child-care costs may become more of a burden on upper-income households as well, particularly if the job market softens and closes the door for parents to work remotely from home. In that case, the downbeat mood of households would become more of a threat to the broader economy as people are more likely to behave as they feel. The Fed has little control over childcare costs and should start cutting rates before they drag the economy into a recession.



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	<u>April</u>	<u>March</u>	<u>February</u>	<u>January</u>	<u>December</u>	<u>November</u>	<u>October</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
Prime Rate	8.50	8.50	8.50	8.50	8.50	8.50	8.50	8.50	8.23
3-Month Treasury Bill Rate	5.24	5.24	5.24	5.22	5.24	5.27	5.34	5.34	5.14
5-Year Treasury Note Rate	4.56	4.20	4.19	3.98	4.00	4.49	4.77	4.77	3.59
10-Year Treasury Note Rate	4.54	4.21	4.21	4.06	4.02	4.50	4.80	4.80	3.57
30-Year Treasury Bond Rate	4.66	4.36	4.38	4.26	4.14	4.66	4.95	4.95	3.86
Tax-Exempt Bond Yield	3.87	3.54	3.53	3.36	3.36	3.83	4.13	4.13	3.36
Corporate Bond Yield (AAA)	5.28	5.01	5.03	4.87	4.74	5.28	5.61	5.61	4.65
Conventional 30-Year Mortgage Rate	6.99	6.82	6.78	6.64	6.82	7.44	7.62	7.62	6.43
Dow Jones Industrial average	38401	39106	38721	37764	36948	34705	33319	39106	33317
S&P 500 Index	5112	5171	5012	4804	4685	4460	4269	5171	4146
Dividend Yield (S&P)	1.39	1.37	1.42	1.47	1.48	1.54	1.61	1.65	1.37
P/E Ratio (S&P)	24.1	25.1	24.3	23.4	23.0	22.0	20.6	25.1	20.0
Dollar Exchange Rate (vs. Major Currencies)	122.5	121.0	121.4	120.6	120.2	121.7	123.9	123.9	118.6

* Monthly Averages

Economic Indicators

	<u>April</u>	<u>March</u>	<u>February</u>	<u>January</u>	<u>December</u>	<u>November</u>	<u>October</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
Housing Starts (Thousands of Units)	1360	1287	1546	1376	1568	1510	1365	1583	1287
New Home Sales (Thousands of Units)		693	637	671	654	609	670	728	609
New Home Prices (Thousands of Dollars)		431	407	421	418	430	418	440	407
Retail Sales (% Change Year Ago)	3.0	3.8	2.0	0.2	5.0	3.6	2.2	5.00	0.2
Industrial Production (% Change Year Ago)	0.4	0.1	0.1	-0.7	1.1	-0.1	-0.8	1.1	-0.8
Operating Rate (% of Capacity)	78.4	78.5	78.2	78.0	78.7	79.0	78.8	79.5	78.0
Inventory Sales Ratio (Months)		1.37	1.37	1.38	1.37	1.36	1.37	1.40	1.36
Real Gross Domestic Product (Annual % Change)		1.6			3.4			4.9	1.6
Unemployment Rate (Percent)	3.9	3.8	3.9	3.7	3.7	3.7	3.9	3.9	3.5
Payroll Employment (Change in Thousands)	175	315	236	256	290	182	165	315	165
Hourly Earnings (% Change Year Ago)	3.9	4.1	4.3	4.4	4.3	4.3	4.3	4.7	3.9
Personal Income (% Change Year Ago)		4.7	4.7	4.9	4.9	4.7	4.4	5.7	1.4
Savings Rate (Percent of Disposable Income)		3.2	3.6	4.1	3.9	4.0	4	5.3	1.37
Consumer Credit (Change in Blns. Of Dollars)		6.2	15.0	18.3	3.2	17.8	9.0	18.3	-0.9
Consumer Prices (% Change Year Ago)	3.4	3.5	3.2	3.1	3.4	3.1	3.2	4.0	3.0
CPI Less Food & Energy (% Change Year Ago)	3.6	3.8	3.8	3.9	3.9	4.0	4.0	5.3	3.6
Wholesale Prices (% Change Year Ago)	2.2	1.8	1.6	1.0	1.1	0.8	1.1	2.2	0.3



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\$6.2 billion	Total credit union DTC and custodial issuance.
1,704	Number of credit unions that have issuance agreements in place, prepared to issue share certs, should the need arise.
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