

Bond Yields Climb on More Inflation Evidence

Friday's slate of economic data threw more gas onto the inflation bonfire, sending bond yields higher and elevating talk of a 75 basis point hike from the Fed this week. The primary culprit was the employment cost index which surged +1.4% in the first quarter, the most in the 21-year history of this series and quite a bit more than the +1.1% median estimate in Bloomberg's survey. The ECI is closely watched by economists and the Fed because it controls for compositional shifts in the labor force, a factor that has skewed the employment report's average hourly earnings data over the last two years. In addition to wages and salaries, the ECI also captures benefit costs, so it's more reflective of employers' total compensation expenses.

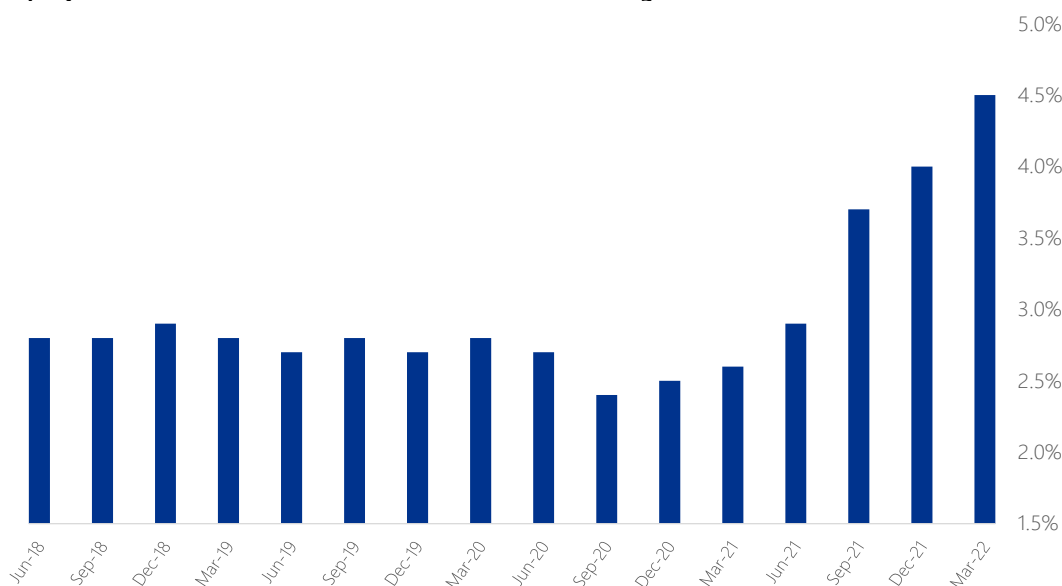
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Employment Cost Index (Year-over-Year Percent Change)



Source: Bureau of Labor Statistics

In Q1, wages and salaries rose +1.2%, a bit softer than the +1.5% observed in last year's Q3 but a big increase from Q4's +1.0%, indicating that wage pressures are not easing even as labor force participation has improved. Over the past year, wages and salaries are up +4.7%. Benefit costs jumped +1.8% during the first quarter and are up +4.1% year-over-year. Taken together, total compensation costs have risen +4.5% over the last twelve months and are well above levels consistent with the Fed's 2% inflation target. Last December, after the Fed accelerated the pace of its tapering plans, Chair Powell cited October's surprising +1.5% jump in the ECI as a primary factor. Q1's jump is likely to make the Fed even more uneasy.

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The Fed won't find much comfort in the personal consumption expenditures index either. The headline PCE rose +0.9% in March while core PCE (excluding food and energy) was up +0.3%, taking the year-over-year gains to +6.6% and +5.2% respectively. March's sharp rise in gasoline prices was a primary factor in the headline increase. If there's any good news to be found here, it's that the PCE data was in line

with expectations. And with energy prices easing in April, it's possible we may have finally seen the peak in inflation.

The data on personal income and spending were a bit mixed. Personal income was up +0.5% in March while personal spending rose +1.1%. It's notable, however, that real spending, adjusted for inflation, rose a modest +0.2% while real personal disposable income fell -0.4%. The implication here is that despite gains in wages and salaries, income is not keeping pace with inflation. Consumers are dipping into savings to maintain their spending in the face of higher prices as the savings rate fell from 6.8% to 6.2%, the lowest since 2013.

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The bottom line is that inflation remains a big problem. The jump in the ECI was enough to renew speculation that the Fed might consider a 75 basis point hike at one of its upcoming meetings. Fed funds futures are fully priced for a 50 basis point hike after Wednesday's FOMC meeting, and roughly split between a 50 and a 75 basis point hike at the June 15 meeting.

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After staging a brief rally early in the week, bonds succumbed to selling pressure, pushing yields higher yet again. The two-year Treasury note closed Friday yielding 2.72%, an increase of 38 basis points on the month. The two-year yield is now just 25 basis points below the 2.97% highpoint reached in December 2018. The 10-year T-note rose 60 basis points to 2.93% during April, closing just a tick away from the highest since December 2018.

Market Indications as of 8:45 A.M. Central Time

DOW	Down -49 to 33,426 (HIGH: 36,800)
NASDAQ	Up 30 to 12,364 (HIGH: 16,057)
S&P 500	Up 4 to 4,136 (HIGH: 4,797)
1-Yr T-bill	current yield 2.05%; opening yield 2.00%
2-Yr T-note	current yield 2.72%; opening yield 2.74%
3-Yr T-note	current yield 2.90%; opening yield 2.90%
5-Yr T-note	current yield 2.99%; opening yield 2.96%
10-Yr T-note	current yield 2.98%; opening yield 2.93%
30-Yr T-bond	current yield 3.04%; opening yield 3.00%

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