SMITH AFFILIATED CAPITAL

WEEKLY ECONOMIC COMMENTARY

"The Fed, Real GDP, Savings, Labor and Inflation Expectation"

The goals of the nation's policymakers and the means of accomplishing them were in full view this week, with the President presenting his case for another blockbuster economic package before a joint session of Congress and the Federal Reserve providing its latest missive on monetary policy. Neither struck a particularly surprising or discordant note in the financial markets, as the S&P 500 ended the week virtually unchanged from the previous week and bond yields moved just slightly higher. Investors also digested a busy calendar of economic reports, which were primarily upbeat as expected.

The Fed

While overshadowed by the President's nationally televised address on Wednesday night, the Federal Reserve made its presence felt earlier that day, reminding everyone that it stands side-by-side with the Federal Government in the stimulus camp. As expected, no new measures were announced, but there was some speculation that the Fed might provide a hint as to when it would start reining in its turbo-charged easy policy. Despite the somewhat more bullish sentiment of economic activity expressed by Fed officials, no such guidance was provided. Still, in his post-meeting press conference, Chairman Powell confirmed that he is not even thinking about raising interest rates, noting that risks to the economy from the ongoing pandemic remain palpable, and the series of strong economic reports in recent months are not enough to sway policy from its present course.

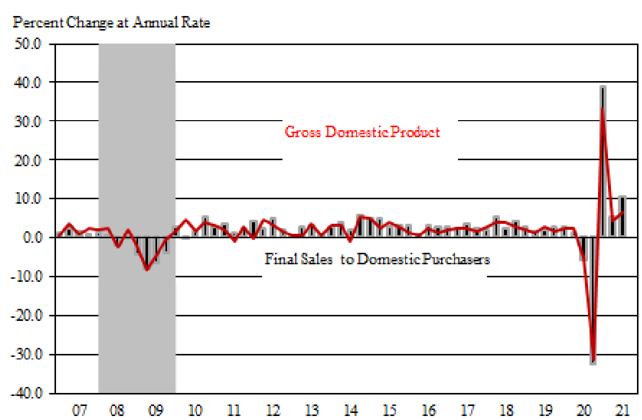
Powell acknowledged that the strong rebound in demand is racing ahead of the ability for companies to hire and produce, putting upward pressure on prices. But he retains the position that these upward pressures are "***transitory"*** and will recede as pent-up demand is satisfied and supply expands later this year and next. We concur with that position but recognize that the Fed's patience will be sorely tested by the muscular rebound in activity now unfolding as the economy, fueled by a massive fiscal stimulus, emerges from pandemic constraints.

Real GDP

The government's report card on the economy's first-quarter performance provided an eye-opening illustration of this development. Propelled by an outburst of consumer spending, real GDP increased by an annual rate of 6.4 percent during the period, the second strongest quarterly increase since the third quarter of 2003.

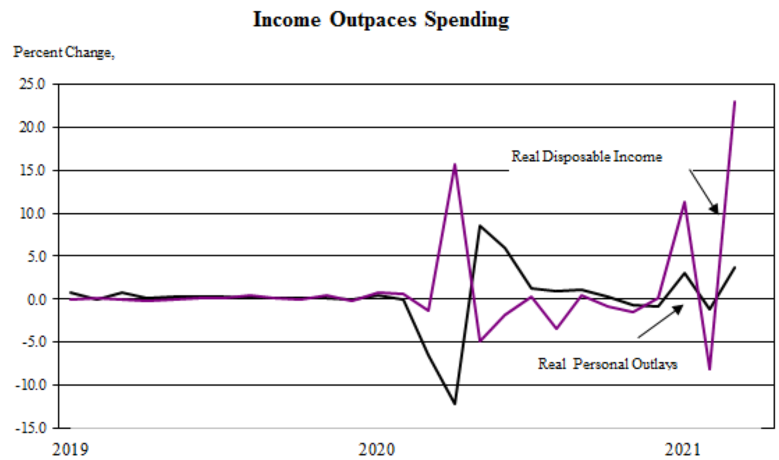
What's more, growth would have been even stronger if output kept pace with demand. Instead, companies were forced to draw down inventories, which sliced the growth rate by several percentage points during the period. Final sales to domestic purchasers actually expanded by 10.6 percent. But the inventory draw-down also heightens the need to rebuild stocks going forward, providing more juice to growth in the second quarter. Indeed, it's questionable if inventories could be rebuilt fast enough to accommodate the explosive increase in demand that is likely to unfold over the summer months. While households were the main drivers of growth in the first quarter, expanding consumption by a 10.7 percent annual rate, they still have an enormous amount of firepower in reserve. The $1400 stimulus checks sent out in the latter half of March were only partially spent as most reside in savings accounts. The personal savings rate ballooned to 27.6 percent last month, nearly double the February level. That said, consumers spent lavishly in March, encouraged not only by the income support provided by the government. Warmer weather combined with the accelerated pace of vaccinations and declining cases of infections provided households with plenty of incentives to open their wallets and purses. And they did not disappoint. Personal consumption increased by 4.2 percent, the strongest increase since last June. Indeed, the consumption recovery from the pandemic is now complete, as the March increase boosted the level of real spending above its pre-pandemic peak. As has been the case throughout the past year, most of the increase in March was for goods – particularly durable goods such as autos and household furnishings – as options in the service sector remained limited by state and local restrictions.

GDP Stronger Than It Looks



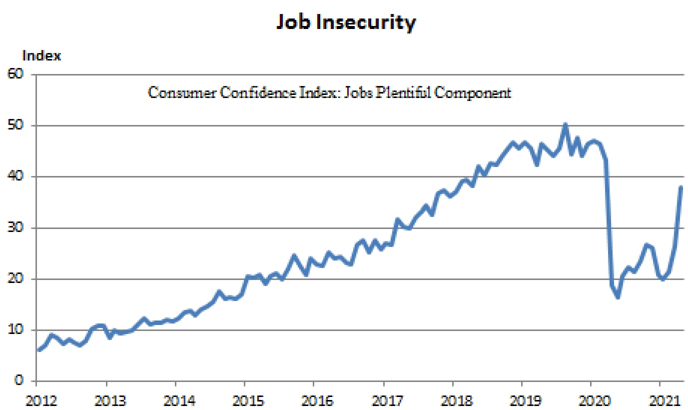
Personal Savings

The amount of funds in reserve is nothing short of astonishing. Personal savings totaled $6 trillion at the end of March, up from $1.4 trillion last February, just before the pandemic hit. Notably, that enormous buildup reflects the stimulus-fueled surge in incomes that far outpaced the increase in spending. Except for the spending collapse last April, the gap between the rise in real disposable incomes and outlays has never been as wide as it was in March.



Understandably, some prominent commentators believe that the unleashing of this huge firepower into the spending stream will push the economy to its capacity limits and stoke an inflation outbreak, forcing the Fed's hand sooner rather than later. While the risk for stronger growth and inflation has undoubtedly risen, it's important not to overstate the spending potential of the savings buildup. For one, most of the savings increase has accrued to upper-income households with a lower propensity to spend than the rest of the population. While this group also has pent-up demand and will likely spend more than otherwise as services become more available, most of the excess savings will be treated as wealth and remain unspent.

Labor



For another, while the economy has recovered most of its lost output from the pandemic, the labor market has not. More than 8 million jobs lost during the health crisis have still not been recovered, not to mention the additional jobs that would have been created had the pandemic never occurred. What's more, despite the significant progress in the vaccination rollout and decline in infections, we are still months away from herd immunity. The risk that variants could spread more rapidly and prolong the health crisis is not trivial, and is undoubtedly weighing on the minds of households whose job security is already tenuous. Simply put, even the less wealthy segment of the population is likely to maintain a higher level of precautionary savings to guard against another adverse shock.

To be sure, consumers are becoming more upbeat about their economic prospects. Both the Conference Board and the University of Michigan surveys released this week reveal a big increase in their confidence indexes in April. However, both are still significantly lower than the peaks reached before the pandemic. What's more, households are less bullish about the future than they are about the current state of the economy, which is being pumped up by the massive stimulus checks now bloating bank accounts. And while the strengthening job market buoys households, they are still not as confident about finding a job as they were before the pandemic. The Conference Board's jobs plentiful gauge remains well below its pre-pandemic peak.

Inflation Expectations

From our lens, this confirms the Fed's assessment that the labor market is far from healed, cementing its conviction that it is too early to take its foot off the accelerator. The Fed is also closely monitoring indicators of inflation expectations to guide its policy decisions. For the most part, market and survey-based measures indicate that long-term inflation expectations remain well-anchored around the Fed's 2 percent target. The 5-year, 5-year forward inflation expectation rate stands at 2.28 percent and the University of Michigan's five-year inflation expectation rate actually fell 0.1 percent to 2.7 percent in April.

FINANCIAL INDICATORS				
INTEREST RATES (yield)	**April 30**	**Week Ago**	**Month Ago**	**Year Ago**
3-month Treasury bill	0.02%	0.03%	0.02%	0.12%
6-month Treasury bill	0.03	0.04	0.04	0.12
3-month LIBOR	0.18	0.18	0.19	0.99
2-year Treasury note	0.16	0.16	0.19	0.2
5-year Treasury note	0.85	0.81	0.97	0.36
10-year Treasury note	1.63	1.56	1.72	0.64
30-year Treasury bond	2.29	2.24	2.35	1.27
30-year Fixed Mortgage Rate	2.98	2.97	3.18	3.23
15-year Fixed Mortgage Rate	2.31	2.29	2.45	2.77
5/1-year Adjustable Rate	2.64	2.83	2.84	3.14
STOCK MARKET		**1 Week Return (%)**	**1 Month Return (%)**	**1 Year Return (%)**
Dow Jones Industrial Index	33,874.85	-0.5	2.78	42.11
S&P 500	4,181.17	0.04	5.34	45.97
NASDAQ	13,962.68	-0.38	5.43	58.35
COMMODITIES				
Gold ($ per troy ounce)	1,768.80	1,775.90	1,726.05	1,686.25
Oil ($ per barrel) - Crude Futures (WTI)	63.49	62.08	60.66	15.71
ECONOMIC INDICATOR	**Latest Month/ Quarter**	**Previous Month/ Quarter**	**Two-Months/ Quarters Ago**	**Average-Past Six Months/Quarters**
Orders for Durable Goods (March) - % chg.	0.5	-0.9	3.6	1.3
GDP (Q1) - % change, Saar	6.4	4.3	33.4	1.7
Personal Income (March) - % chg.	21.1	-7.0	10.3	3.8
Personal Consumption (March) - % chg.	4.2	-1.0	3.4	0.9
Personal Savings Rate (March) - Percent	27.6	13.9	20.0	16.8