WEEKLY ECONOMIC COMMENTARY

Has the tapering begun? No, the question is not about monetary policy, but whether the blistering inflation rate seen in recent months is starting to ease up. Of course, the answer to that question feeds directly into the tapering issue at the forefront of the Federal Reserve's current deliberations. Unfortunately, recent events do not make the task any easier. Both the hawks advocating an early tapering of asset purchases and the doves arguing for more patience can draw support from the latest batch of data as well as unfolding developments.

The case for the hawks is clear-cut: The forces underpinning the current upsurge in inflation – a booming economy, rising labor and material costs, massive fiscal stimulus, supply restraints, and healthy household balance sheets – remain firmly embedded in the economic landscape. Unless policy starts to lean against these inflationary tailwinds, they will seep into consumer and business expectations and set in motion a vicious self-perpetuating cycle that will ultimately require recession-inducing policies to bring it under control. While acknowledging that the inflation upsurge reflects transitory forces linked to the economy's reopening from the pandemic, they believe there is enough firepower to sustain price pressures even after pandemic-related dislocations unwind.

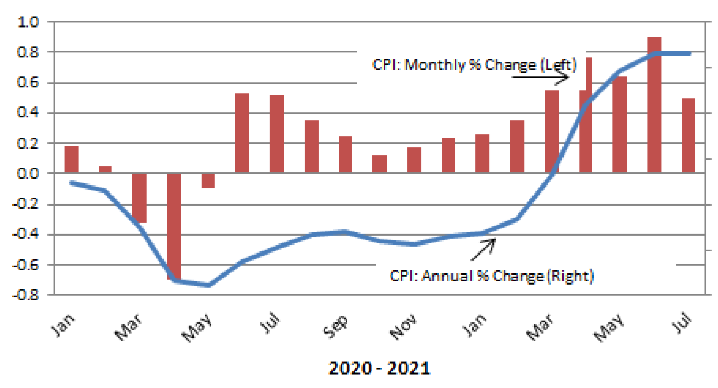
The doves, however, are not convinced that it is time to start pulling back support. Here too, the argument has roots in unfolding developments. Their longstanding view is that the inflation spiral is the product of transitory forces linked to the rapid reopening of the economy. Once the economy normalizes and supply catches up with demand, price pressures will ease, and the inflation rate will glide back towards a more manageable pace. Some prices have already come off the boil, most notably for lumber and other commodities, and the spread of the Delta variant poses a critical threat to demand. In addition, by keeping to the current policy stance a bit longer, the labor market will have more time to heal, recovering the 5.8 million jobs that are still missing from the pandemic losses, not to mention the sidelined workers that are reluctant to join the labor force out of health concerns or child care responsibilities.

From our lens, the hawks do have a compelling case that inflation will remain elevated for a more extended time than the Fed currently expects, thanks to lingering supply restraints (particularly for semiconductor chips), shipping bottlenecks at clogged ports as well as a shortage of containers, and the still-unfolding wage adjustments in low-paying industries that have yet to feed through into higher prices. However, we don't believe these influences will ignite a self-perpetuating inflationary spiral requiring harsh corrective measures by the Fed. Indeed, the July consumer price data released this week suggests that the peak inflation rate is already behind us.

To be sure, the annual inflation rate is still alarmingly high. Compared to a year ago, the overall consumer price index increased by 5.4 percent in July, virtually the same as the previous month and well above the pace the Fed would tolerate on a sustained basis. But the so-called base effects linked to the sectors most impacted by the pandemic account for much of the annual surge. During the worst of the health crisis last spring, prices of used cars and airline fares were dropping like a stone as demand for rental cars and travel dried up. As the economy reopened and people emerged from their homes, rental car companies and airlines were unprepared to meet the torrid pent-up demand for their services, and prices shot back up to pre-pandemic levels. Used car prices are up 41.7 percent from a year ago, and airline fares are nearly 20 percent higher.

But as they say in politics, it's what you have done lately that counts. Here the message is less ominous, as the year-over-year comparisons mask a decidedly more subdued shift in month-to-month changes. Following four months of outsized increases, including a 13-year high of 0.9 percent in June, the increase in the overall CPI slowed to 0.5 percent in July. That's still well above the 0.2 percent average monthly increases seen over the previous 30 years. However, the move is in the right direction and reflects the unwinding of some of the more extreme pandemic-related increases. Prices of used cars, for example, rose by just 0.2 percent during the month while rental car prices plunged by 4.6 percent.

Consumer Prices: Starting to Taper



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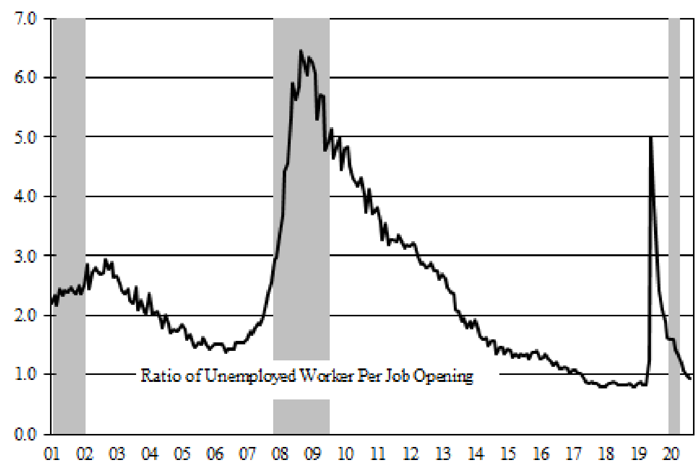
The core consumer price index that strips out often-volatile food and energy prices shows an even greater degree of moderation, sliding from June's 0.9 percent increase to 0.3 percent in July. The monthly slowdown had a visible impact on the annual inflation rate, as the 12-month increase in the core CPI slipped from 4.5 percent to 4.3 percent. However, not all of the news is positive. As the largest component of the core index, housing costs continue to increase at an uncomfortably high pace that will likely persist for the foreseeable future. With home prices surging and shoving broad swaths of the population out of the market, the demand for rental units is strengthening, underpinning continued increases in rental costs.

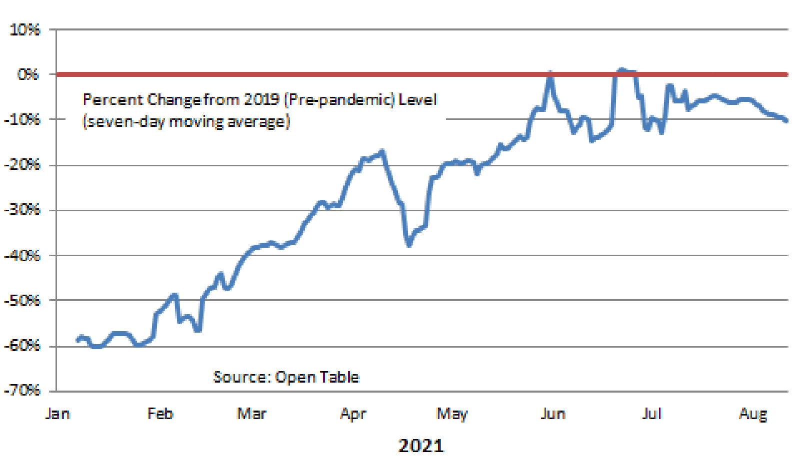
It will take time for the demand/supply imbalances in the economy to unwind fully, therefore, limiting the deceleration in inflationary pressures in the coming months. The computer chip shortage, for example, is expected to persist through at least early next year, which will impede auto production and constrain the supply of cars on dealer lots. But there is a limit to consumer tolerance for higher prices. Motor vehicle sales are falling precipitously, and the unfolding weakness probably reflects ticker shock deterring demand as well a shortage of inventory. As noted, spiraling home prices along with a limited supply of homes are crimping home sales, driving people into rental units. But housing inventory has increased in each of the last three months and, as noted, lumber prices are plummeting, easing the costs of homebuilding. In time, housing inventory will expand, and prices will level off, drawing buyers back to the market and relieving upward pressure on rents.

Workers Are Becoming Scarce



The demand side is somewhat more complicated, as conflicting influences are clouding the outlook. Collectively, households are in fine financial shape, as their balance sheets have been swollen by muscular gains in asset values (stocks and homes), elevated savings from unspent funds during the pandemic, and copious government transfer payments that have been used to pay down debt and cover essential purchases for millions of low-income Americans. Demand is also getting a lift from the rebounding labor market, which has generated 2.5 million net new jobs over the past three months and where there are more job openings than job seekers for the first time since before the pandemic. The competition for workers is spurring accelerated wage increases, particularly in low-paying industries absorbing the brunt of pent-up demand from the reopening economy.

Seated Diners from Online, Phone, and Walk-in Reservations



But even as stronger financial underpinnings are boosting demand, the resurgence of the health crisis has the opposite effect. The dispiriting rapid spread of the Delta variant has not yet pierced headline economic reports, but high-frequency data indicates that the effects are becoming palpable. The variant's namesake airline, Delta, reported this week that bookings are slowing and cancellations are increasing, indicating that would-be travelers are having second thoughts about the safety of taking trips in crowded planes. Likewise, diners are starting to shun restaurants where gatherings of people in indoor spaces heighten the contagion risk. When encouraging reports of vaccination rates and covid cases were prevalent during the spring, restaurants served as many customers as before the pandemic.

But since the emergence of Delta, diners' appetite for food away from home has waned, and traffic at restaurants has once again fallen below pre-pandemic levels.

It's unclear how the tug of war between the Delta variant and the reopening economy will play out. While case counts have surged to a seven-day average of over 100 thousand, the symptoms of afflicted patients are much less severe than in the previous waves of the virus. Hospitalizations and deaths are much lower, and the reaction of state and local governments is less strident. We do not expect the variant to spur harsh lockdown restrictions that would seriously threaten the recovery.

That said, people are turning wary, as reflected in the collapsing sentiment of households to a ten-year low reported by the University of Michigan on Friday, which poses a downside risk to demand going forward. We remain cautiously optimistic that improving vaccination rates and modest behavioral changes will limit the damage from the variant and keep the economy's growth engine running at a robust pace over the remainder of the year. As long as the variant remains front and center, the Fed will likely keep its finger on the pause button until the economic response comes into clearer focus. Barring an unexpected damaging blow, we expect the Fed to start tapering its asset purchases in early 2022 as the need to support demand gradually wanes and to stave off an unwelcome increase in inflation expectations.

FINANCIAL INDICATORS				
INTEREST RATES	**August 13**	**Week Ago**	**Month Ago**	**Year Ago**
3-month Treasury bill	0.06%	0.06%	0.05%	0.10%
6-month Treasury bill	0.05	0.06	0.05	0.12
3-month LIBOR	0.12	0.13	0.13	0.28
2-year Treasury note	0.21	0.22	0.24	0.14
5-year Treasury note	0.78	0.77	0.78	0.29
10-year Treasury note	1.29	1.31	1.29	0.71
30-year Treasury bond	1.93	1.95	1.92	1.45
30-year Fixed Mortgage rate	2.87	2.77	2.88	2.96
15-year Fixed Mortgage rate	2.15	2.10	2.22	2.46
5/1-year Adjustable rate	2.44	2.40	2.47	2.90
STOCK MARKET				
Dow Jones Industrial Index	35515.38	35208.51	34687.85	27931.02
S&P 500	4468.00	4436.52	4327.16	3372.85
NASDAQ	14822.90	14835.76	14427.24	11019.30
COMMODITIES				
Gold ($ per troy ounce)	1779.80	1762.00	1812.10	1944.75
Oil ($ per barrel) - Crude Futures (WTI)	68.88	68.08	71.42	42.08
ECONOMIC INDICATOR	**Latest Month/Quarter**	**Previous Month/ Quarter**	**Two-Months/ Quarters Ago**	**Average-Past Six Months or Quarters**
Consumer Price Index (July)- % change	0.5	0.9	0.6	0.6
Core CPI (July) - % change	0.3	0.9	0.7	0.6
Producer Price Index (July) - % change	1.0	1.0	0.8	0.8
Small Business Optimism Index	99.7	102.5	99.6	99.3