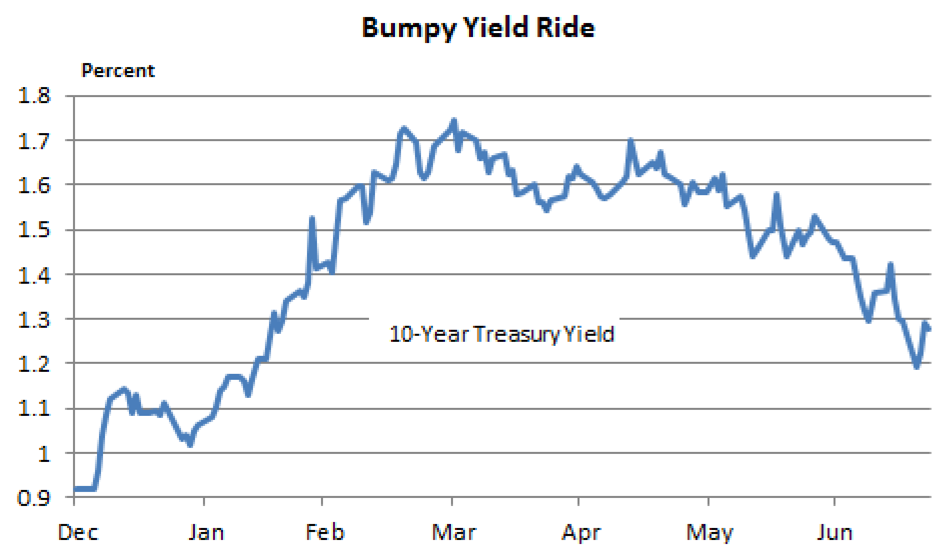
WEEKLY ECONOMIC COMMENTARY

While there was no market-moving data released this week, investors nonetheless experienced one of the more turbulent rides seen this year. The roller coaster moves in both stocks and bonds reflect the dizzying array of uncertainties that overhangs the economic landscape. Topping the list – and casting a shadow over the other influences – is the volatile path of the health crisis. With vaccination rates stalling and the Delta variant gaining a foothold in the nation, what seemed like a successful campaign to extinguish Covid-19 has suddenly run into trouble. More than anything, news of rising infections and the growth-dampening prospect implied sent stock prices and bond yields tumbling early this week, with the 10-year Treasury yield hitting its lowest point since February.

Until Delta fears took center stage, inflation worries commanded most of the attention in the financial markets. Like the rise in Covid cases, the upsurge in inflation has become more than just a threat, as it is accelerating at the fastest pace in more than a dozen years and impacting the lives of millions of Americans. People are paying up for food, rent, autos, and recreational services even as supply constraints drive up the cost of labor and materials for businesses. Like the spreading fears over rising infection rates, the inflation spike had injected turmoil in the financial markets, particularly in the bond sector, where yields surged through the spring, hitting the highest level in over a year. However, at its low point early this week, more than half of the increase in the 10-year Treasury yield this year had been erased due mainly to growing concerns surrounding the Delta variant.

With the administration and health officials ramping up efforts in the media to urge residents to get vaccinated, the virus will continue to command attention and cast a dark shadow over the economy. But the shock effect from the spike in infection rates quickly faded as the markets stabilized over the week. Bond yields bounced off their lows and ended the week mostly unchanged, while stocks recovered all of their early-week losses and then some. The tug-of-war between the virus and the economy's resilience is ongoing and will undoubtedly continue to buffet markets over the foreseeable future. For now, investors appear to be taking the latest health scare in stride, downplaying its potential effect on the economy.



That complacency may well be upended if the revival of the pandemic intensifies and causes lockdowns and other restrictions that destroyed the economy last year. But most state and local authorities are taking a hands-off approach so far, believing that the negative economic consequences of taking action outweigh the health risks posed by the spread of the virus. For one, the Delta variant mainly affects unvaccinated people, with only a tiny fraction of the vaccinated population getting sick. And while case counts are rising, deaths and hospitalization rates have remained low. Among those affected, the symptoms are far milder than was the case with the original Covid variant; meanwhile, health officials have gained more experience, tools, and knowledge regarding treatment.

From our lens, the Delta variant has heightened the downside risks to the economic outlook. Still, unless household and business behavior changes dramatically over the next several months, the economy should remain on a firm recovery path. By all accounts, the urge to return to everyday life remains strong. People are flocking to restaurants, taking vacations, going to sporting events (the Tokyo Olympics notwithstanding), and engaging in other recreational activities that were denied them during the pandemic. Pent-up demand fueled by massive fiscal support propels the economy through a spring/summer resurgence that is expected to deliver the second strongest annual growth rate since 1950.

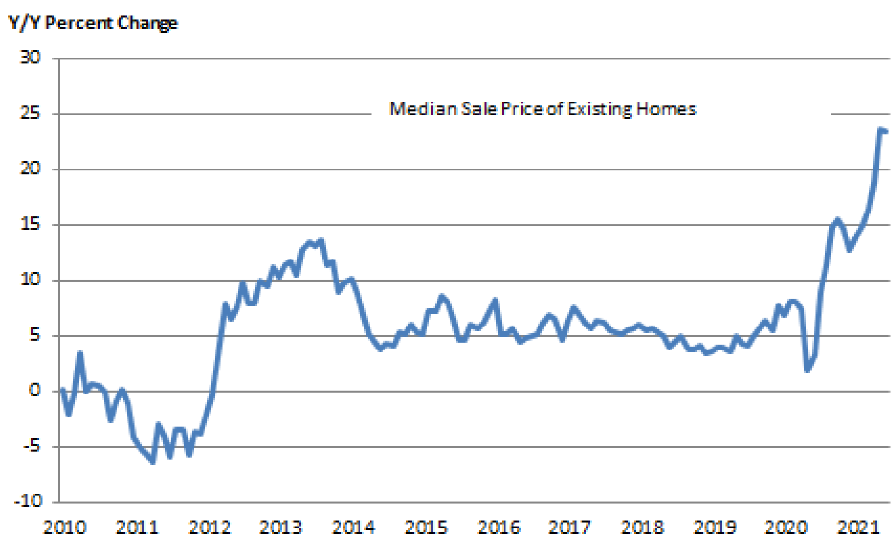
Hence, the strains and stresses that emerged before the Delta variant took hold are still very much at the forefront, and it's unclear how they will be resolved. They also pose challenging questions for the Fed, which will undoubtedly occupy much of the discussion at next week's policy meeting. While the doves will likely use the rising infection rate as another reason to keep a turbo-charged easy policy in place, the strong rebound in economic activity together with resurging inflation are more likely to convince the majority of Fed officials to pivot further away from their highly dovish stance. No meaningful turn of events is expected; the Fed will retain a dovish policy and keep rates at near zero for the foreseeable future. However, it is likely to ramp up discussions about when to start reducing its purchases of Treasury and mortgage-backed bonds.

We expect the Fed to start the tapering process next year but hold off any rate increases until 2023. While such a pivot will be necessary to keep inflation expectations anchored, it will probably underpin some cognitive dissonance in the financial markets as they move to a less accommodative policy that will coincide with slowing growth and inflation. The slowdown in economic activity should be palpable by the fourth quarter, when most pent-up demand will be satiated, and fiscal stimulus fades. With demand losing some momentum, the supply pressure should also diminish and lead to slower inflation.

However, the economy will slow down earlier than inflation, which should remain supported by some stickier influences. Companies will strive to pass on higher labor and material costs to consumers who, given their elevated savings and improving job prospects, are likely to be less resistant to higher prices for a while. But that acceptance is not open-ended; indeed, households are already starting to rebel against rising prices. The latest University of Michigan Survey revealed a sharp drop-off in buying plans for big-ticket items, such as autos, homes, and appliances. Hence, rather than feeding into higher longer-term inflation expectations, which would nurture a self-fulfilling wage-price cycle, the current surge in prices is acting as a brake on growth.

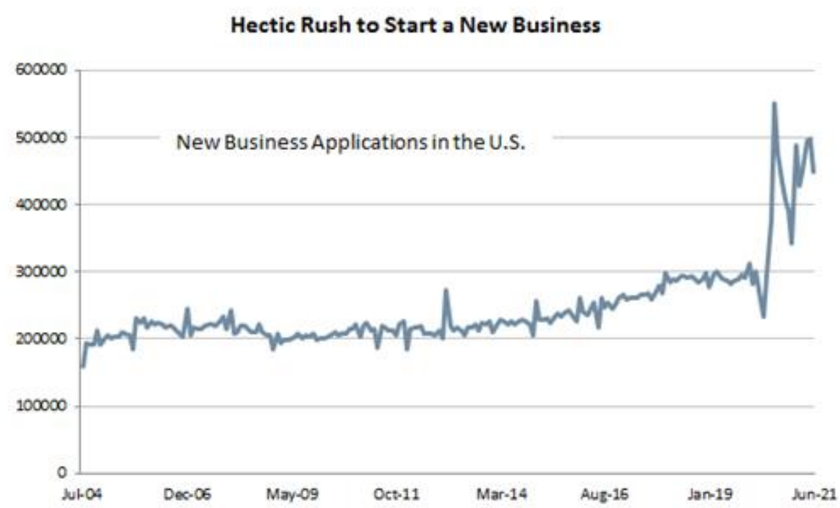
The housing market starkly captures the crosscurrents that spiraling prices bring about. Home prices have been on a tear for the past year, as low mortgage rates and the pandemic-induced surge in demand for bigger homes in less densely populated areas have outstripped the supply of homes on the market. In June, the median price of an existing home hit a record high of $363 thousand, an astonishing 23.4 percent increase over the past year, also a record. The skyrocketing prices have produced a dual dynamic. On the one hand, it has pushed many prospective homebuyers out of the market, contributing to a steep falloff in sales this year. The slim 1.4 percent increase in existing home sales in June followed four consecutive monthly declines. However, the slide reflects the slim inventory on the market as much as a falloff in demand from price-conscious buyers.

Soaring Home Prices



On the other hand, the surge in home prices has added $2.5 trillion to housing equity since the onset of the pandemic lifting the equity stake of homeowners in their properties to 67.3 percent in the first quarter, the highest equity cushion in more than 30 years. That share increased further in the second quarter, boosted by the aforementioned increase in home prices through June. It is unclear how much of a wealth boost to consumption this surge in housing equity has provided, but it does represent a counterpoint to the demand falloff caused by higher home prices. Interestingly, while the increased housing equity may be contributing to the wave of early retirements among aging baby boomers, it could also be contributing to the surge in new business formations over the past year.

According to the latest Census data, there were 448 thousand applications to start a business in June. That's down from the record 489 thousand in January, but is still running more than 20 percent above the total from a year ago. Some of these startups may be funded with cash obtained through refinancing loans, with bloated home equity used as collateral. Could the surge in new business formations include workers quitting their jobs to become self-employed? If so, that could also be contributing to the worker shortage seen in many industries.



FINANCIAL INDICATORS				
INTEREST RATES	**July 23**	**Week Ago**	**Month Ago**	**Year Ago**
3-month Treasury bill	0.05%	0.05%	0.06%	0.11%
6-month Treasury bill	0.05	0.05	0.06	0.13
3-month LIBOR	0.13	0.13	0.15	0.27
2-year Treasury note	0.21	0.24	0.28	0.14
5-year Treasury note	0.72	0.78	0.93	0.29
10-year Treasury note	1.28	1.29	1.53	0.64
30-year Treasury bond	1.92	1.92	2.15	1.33
30-year Fixed Mortgage rate	2.78	2.88	3.02	2.98
15-year Fixed Mortgage rate	2.28	2.22	2.34	2.48
5/1-year Adjustable rate	2.49	2.47	2.52	3.06
STOCK MARKET				
Dow Jones Industrial Index	35061.55	34687.85	34433.84	26671.95
S&P 500	4411.79	4327.16	4280.70	3224.73
NASDAQ	14836.99	14427.24	14360.39	10503.191
COMMODITIES				
Gold ($ per troy ounce)	1801.90	1812.10	1781.800	1807.35
Oil ($ per barrel) - Crude Futures (WTI)	72.95	71.42	74.00	40.57
ECONOMIC INDICATOR	**Latest Month/Quarter**	**Previous Month/ Quarter**	**Two-Months/ Quarters Ago**	**Average-Past Six Months or Quarters**
Housing Starts (June) - 000s	1643.0	1546.0	1514.0	1583.0
Building Permits (June) - 000s	1598.0	1683.0	1733.0	1730.0
Existing Home Sales (June)- 000s	5860.0	5780.0	5850.0	6067.0