WEEKLY ECONOMIC COMMENTARY

The economy delivered a red-hot performance in the just-completed second quarter, but investors are not feeling the sizzle. With a nod to Peggy Lee, market participants ask, “Is that all there is?” Such a question would have been unthinkable a short while ago when the economy seemed to be riding a clear path towards a hot summer, resulting in overheated conditions that would stoke an undesirable inflation outbreak. Worse, the Federal Reserve, the nation’s primary defender of stable prices, appeared to be looking the other way. They are willing to accept higher inflation for the sake of more employment, particularly among marginal, less educated, and low-skilled workers - who were severely impacted by the pandemic.

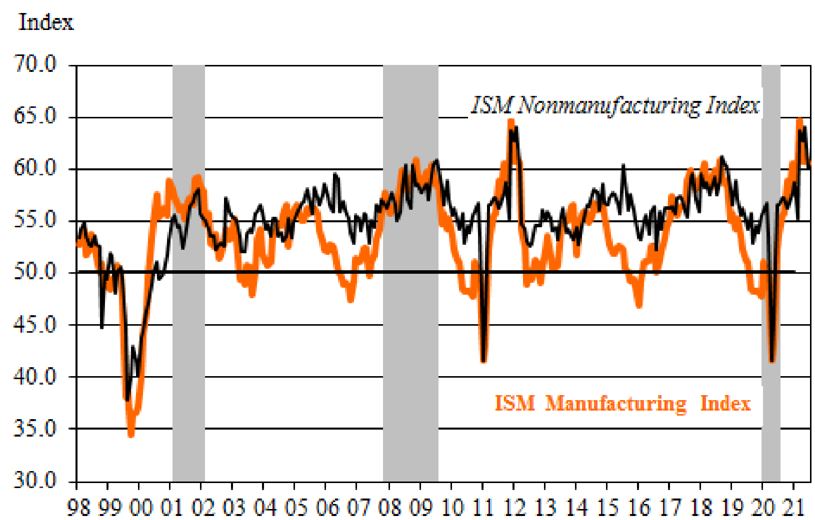
But that mindset has been turned on its head in recent weeks. The so-called reflation trade that gained traction as vaccination rates accelerated and the doors reopened for consumers to unleash a torrent of pent-up demand has suddenly hit a wall. After surging from under 1.0 percent at the start of the year to 1.74 percent in mid-March, the 10-year Treasury yield has since rolled over, slipping to within a narrow band around 1.50 percent throughout June. The descent has gained momentum so far in July, tumbling to as low as 1.26 percent this week before ending on Friday at 1.36 percent. Other market-based inflation indicators have followed a similar pattern, pricing in lower inflation expectations than a few months ago, although at a still considerably higher pace than during the pandemic last year.

The abrupt shift in market perceptions has sparked a feeding frenzy of explanations among commentators. As Ms. Lee intoned, some believe that the inflation build-up has less staying power, and its hawkish adherents are in for a huge disappointment. Most Fed officials are fans of this assessment, although a growing minority wants to validate that prospect by shifting to a less accommodative policy sooner rather than later. This narrative reflects two potential developments. First, the pandemic-related forces stoking the current inflation upsurge will dissipate in the coming months, as supply-chain disruptions ease, pent-up demand is satiated, and fiscal stimulus fades. As supply catches up with demand, market-clearing prices will come under less pressure, and inflation will gradually recede towards the Fed’s 2 percent target by next year.

Second, the economic heat generated during the second quarter is set to fizzle, perhaps sooner than expected. Some recent data support that view, including two consecutive months of weak auto sales and a steep decline in home sales. To be sure, these setbacks partly reflect high prices that have discouraged demand. But that endogenous response just validates the transient nature of the recent inflation spike, as it highlights the self-correcting forces that come into play when consumers do not accept higher prices. The latest surveys by the Institute for Supply Management (ISM) provide further evidence that the peak growth is behind us. On the heels of last week’s softer than expected survey of manufacturing activity, the ISM released its index of nonmanufacturing activity this week, indicating that the much larger services sector of the economy lost more momentum in June than expected.

The softer readings on economic activity unveiled in recent weeks are more a reflection of supply constraints than weakening demand from our lens. We suspect that as bottlenecks ease and the health crisis continues to ebb, the spring revival in activity will regain momentum and result in another vigorous quarter of growth, although modestly slower than the red-hot pace expected for the second quarter. While that prospect is clearly not reflected in the recent behavior of the financial markets, many believe that the unwinding of the reflation trade has been overdone, perhaps exacerbated by the short-covering of investors who were on the losing side of that trade. The abrupt reversal of bond yields on Friday, with the 10-year Treasury yield rebounding more than 10 bps. from Thursday’s low, may be a sign of that capitulation, although at 1.34 percent, it remains well below the level of a few weeks ago.

Tapering Growth



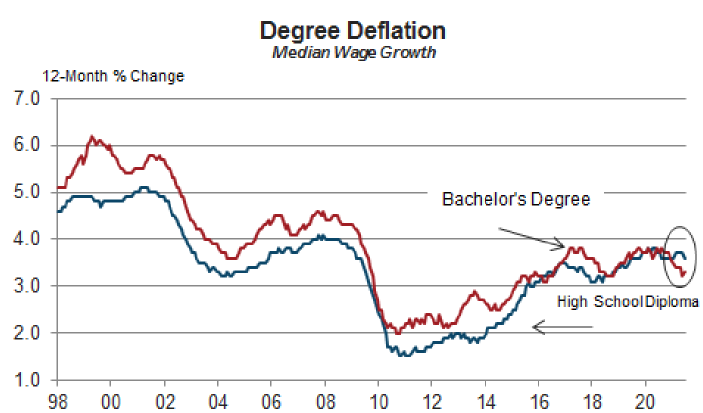
Significantly, the Federal Reserve itself has contributed to the reduction in inflation fears. By pivoting to a less dovish stance at the mid-June policy meeting, concerns that the Fed was falling behind the inflation curve receded. At that meeting, the median forecast for a rate liftoff was pulled forward into 2023, and several officials saw rate hikes occurring as soon as next year. Meanwhile, talk of when to start reducing asset purchases, currently at $120 billion a month, has begun; many believe that Fed Chair Powell will make a formal announcement regarding the tapering process at the August Jackson Hole Symposium. We expect tapering to begin next year, followed by two quarter-point rate hikes in 2023.

That said, nothing is set in stone, and expectations regarding growth and inflation –among investors and policymakers – can shift on a dime. Amidst an unpredictable recovery from an unprecedented health shock, the economy faces several unknowns. Perhaps the most immediate threat to the recovery is the emerging Delta variant that is now the dominant form of new cases gaining a foothold in the nation. Most of the adult population has been inoculated. However, vaccine hesitancy and low vaccination rates are still prevalent in many states where case counts are rising, and government protective measures are lax. Additionally, with schools poised to reopen, returning unvaccinated children could potentially spread the virus to adults and speed up transmissions.

Another unknown that could determine the economy's performance is how households use the huge volume of excess savings accumulated since the onset of the pandemic. The estimated $2.5 trillion built up when people were stuck in their homes with limited things to buy represents a massive blast of purchasing power that, if fully unleashed quickly, could well send the economy into overdrive and add fuel to the inflation fires. Conversely, if savers view those funds as additional wealth rather than spending money, the economic boost from consumption would be considerably less. With government transfer payments about to fade, households will be relying more on these savings as well as wage growth to drive spending. We suspect that a robust pace of job creation will underpin faster wage growth going forward, but households will hold more savings in reserve than they have in the recent past. The reason: following two major shocks in a little more than a decade and the still precarious state of the health crisis, people will prefer to hold more precautionary funds to guard against adversity.

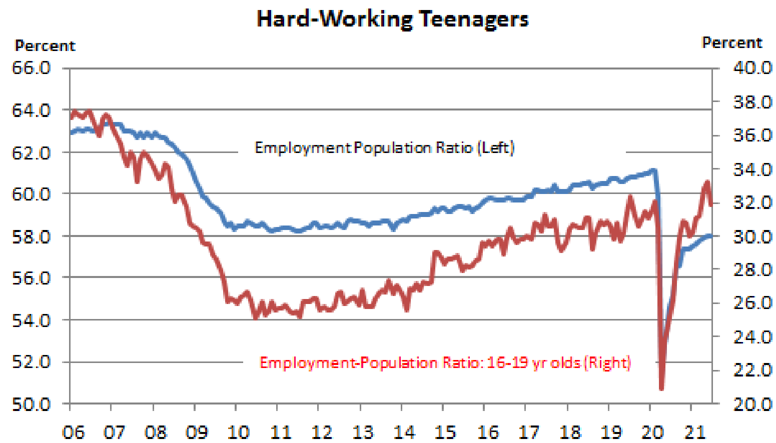
That said, with the savings rate well above historical norms and little monetary reward for keeping the funds in liquid form, we expect households to steadily draw on their balances to help sustain a healthy pace of spending over the balance of the year. The question is, will businesses expand output fast enough to accommodate demand and limit the upward pressure on prices? While we expect supply to catch up eventually, the duration of the lag will determine how quickly inflationary pressures recede. Keep in mind that supply bottlenecks are only one source of upward price pressures. Labor shortages constitute the other, as a wide swath of businesses report that they cannot find enough workers to expand output. In April, the Labor Department reported a record 9.2 million jobs waiting to be filled, even as 9.3 million people remain unemployed.

This striking anomaly is one of the more perplexing issues the Federal Reserve needs to sort out before deciding on its next policy move. Under the overhauled framework adopted last summer, the Fed is willing to let inflation exceed its 2 percent target for a period of time to allow the labor market to reach maximum employment. But at what point would that status be achieved? Recall that Chair Powell has repeatedly stressed the importance of restoring jobs for workers with fewer skills and less education left behind when the job market is not fully healed. The lesson learned from pre-Covid experience is that unemployment could fall to as low as 3.5 percent without stoking a flare-up in wage-price inflation. By that yardstick, the healing process has a ways to go, as the current rate stands at 5.9 percent, and the labor force participation rate is well below its pre-pandemic level.



But there's a question as to whether standard measures of labor market health should be applied to the current environment, which features an unusual recovery pattern among workers. The reopening of the economy that has unleashed pent-up demand for services has also spurred a torrid increase in demand for the very workers that in the past were the least employable, namely the less educated with fewer skills. But if pay raises are a marker for how this segment of the population is doing, the labor force may be tighter than expected. According to wage tracking measures compiled by the Federal Reserve Bank of Atlanta, workers with no more than a high school diploma are outperforming college graduates by the largest margin on record. Over the last two months, they received a median average annual pay raise of 3.7 percent compared to 3.3 percent for workers with a bachelor's degree.

Other segments of the workforce that usually struggle in the aftermath of a recession have also benefited mightily during the current recovery. Teenagers, for example, have recovered all of the pandemic job losses, whereas overall payrolls are still 6.8 million below the pre-pandemic level. If looked at another way, the employment-population ratio for 16-19-year-olds in May hit the highest level in thirteen years before slipping in June. However, the ratio for all workers is still more than 3 percentage points below its pre-covid level. No doubt, this age disparity may simply reflect the fact that older workers are shunning jobs at low pay that teenagers are willing to accept. But that too is a sign that the job market is tighter than standard measures imply.



It will not be easy for the Fed to dissect trends in the job market next year. If it waits too long based on traditional measures of employment, it could well fall behind the inflation curve if those measures do not reflect the true health of the labor market. Suppose it moves too early based on an incorrect interpretation of how certain segments of the labor force are performing. In that case, it could choke off the recovery and victimize the very segment it is striving to help.

FINANCIAL INDICATORS				
INTEREST RATES	**July 9**	**Week Ago**	**Month Ago**	**Year Ago**
3-month Treasury bill	0.05%	0.04%	0.03%	0.13%
6-month Treasury bill	0.05	0.05	0.04	0.15
3-month LIBOR	0.12	0.14	0.12	0.30
2-year Treasury note	0.22	0.24	0.17	0.16
5-year Treasury note	0.79	0.86	0.74	0.3
10-year Treasury note	1.36	1.44	1.45	0.65
30-year Treasury bond	1.99	2.05	2.14	1.33
30-year Fixed Mortgage rate	2.90	2.98	2.96	3.03
15-year Fixed Mortgage rate	2.20	2.26	2.23	2.51
5/1-year Adjustable rate	2.52	2.54	2.55	3.02
STOCK MARKET				
Dow Jones Industrial Index	34870.16	34786.35	34479.60	26075.3
S&P 500	4369.55	4352.34	4247.44	3185.04
NASDAQ	14701.92	14639.43	14069.42	10617.445
COMMODITIES				
Gold ($ per troy ounce)	1808.80	1788.20	1879.50	1803.1
Oil ($ per barrel) - Crude Futures (WTI)	74.67	75.08	70.78	40.44
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
ISM Nonmanufacturing Index (June)	60.1	64.0	62.7	60.8
Consumer Credit (May) - $blns	35.3	20.0	19.3	17.4