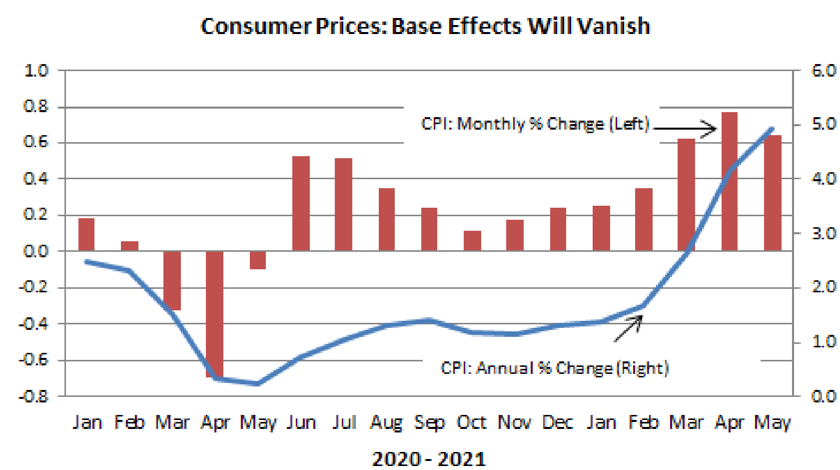
WEEKLY ECONOMIC COMMENTARY

"Labor and Inflation"

The heated debate over whether inflation is running amok or taking a brief fling got even hotter this week. Inflation alarmists were buoyed by the latest consumer price report, which revealed an accelerating inflation rate, that is running well ahead of expectations. The outsized 0.6 percent increase in consumer prices reported for May followed an eye-opening 0.7 percent increase in April and lifted the annual rate to a 13-year high of 5.0 percent from 4.2 percent the previous month. While the inflation pick-up was widely expected, it exceeded most forecasts. This pick-up is luring more commentators into the hawkish camp, arguing that the Federal Reserve needs to start unwinding its turbo-charged easy policy sooner rather than later lest it falls further behind the inflation curve.

The Fed's policy-setting committee meets next week, but we doubt that any meaningful shift away from its long-standing dovish stance will occur. For sure, the recent escalation in key price indicators is not going unnoticed by Fed officials. Chair Powell acknowledged that several Committee members were already thinking about when to start tapering its asset purchases. The subject is likely to receive more attention at the upcoming meeting. But while the Fed is diligently monitoring inflation trends, it continues to believe that transitory forces are primarily responsible for the inflation spike now underway. The financial markets seem to agree with that assessment, as neither the stock nor bond market showed any adverse reaction to the recent inflation data. The S&P 500 forged to new highs, and the bellwether 10-year Treasury yield slipped to a three-month low the day of the CPI release.

We concur with the Fed's view that the forces pushing up prices will ease in the coming months, although we believe that inflation this year and next may turn out to be stickier than policymakers expect. One upside influence that will dissipate almost immediately is the so-called base effect. At the height of the pandemic last year, prices fell for three consecutive months, reflecting the collapse in demand forced by the economic shutdown, which distorts year-over-year comparisons. Last May was the final month of the declines; therefore, the annual comparisons in the future will be far less impacted by the depressed prices of a year ago. Indeed, the CPI jumped 0.5 percent last June and July, the steepest consecutive monthly increases in 30 years.



But while the base effects will fade, the transitory forces lifting inflation still have legs. The rapid progress on the health front, pent-up demands, elevated savings, and ongoing fiscal stimulus continue to stoke demand while supply struggles to keep up. Hence, the most significant price increases are occurring among the goods and services that pandemic disruptions have mainly impacted. For example, prices of used cars and trucks surged 7.3 percent in May, accounting for one-third of the CPI increase. A shortage of new car inventory is bloating demand for used vehicles, as a shortage of semiconductor chips constrains automakers. Meanwhile, logjams at ports and the scarcity of shipping containers impede the delivery of vital materials and supplies needed by a wide range of manufacturers to complete production.

Nor is it just the difficulty of obtaining goods that are holding back supply. As the economy is reopening at a breakneck pace, businesses are struggling to find workers. The number of job openings surged to a record high of 9.3 million in April, up 1 million over the previous month. Not only are new hires hard to get, but companies are having trouble retaining existing workers, as the rate at which workers are quitting their jobs also surged to new records. The quit rate is particularly high in industries experiencing the strongest rebound in demand as the economy reopens. People are flocking back to restaurants, bars, amusement parks, vacation spots, and sporting events, all activities that were suppressed during the pandemic. As demand for these services skyrockets, so too has the competition for workers intensified, driving up turnover within the workforce. The churn is exceptionally high in the leisure and hospitality sector, where the quit rate stands at 5.4 percent, which towers over the overall rate of 2.7 percent.

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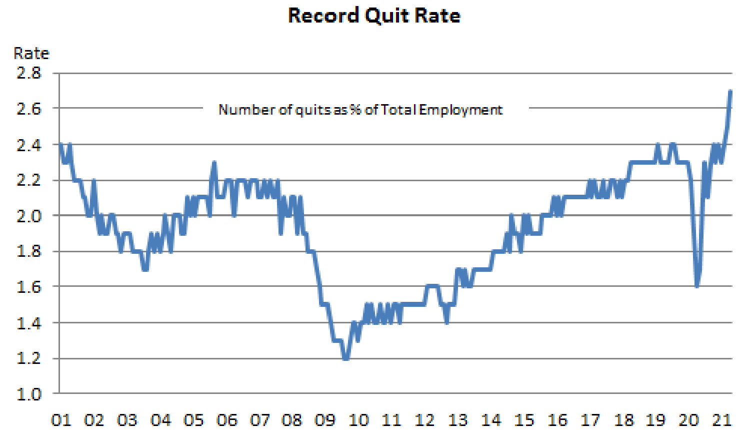
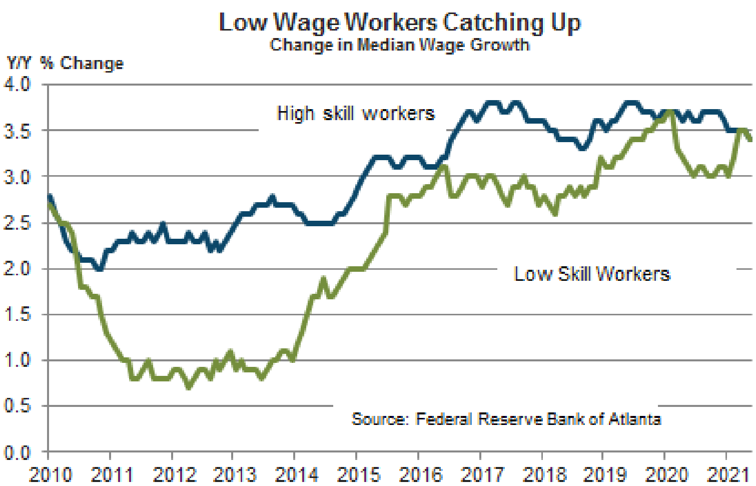
Notably, the resurging demand for workers has not yet had a meaningful impact on wages. While average hourly earnings did increase by a robust 0.7 and 0.5 percent in April and May, which barely compensates for the weak earnings during the earlier stages of the pandemic. In January through May of this year, wages increased by 2.0 percent - which is at the low end of the range over the past 30 years. What's more, the changing composition of job gains over the past year skews the earnings trend, reflecting the ebb and flow of low-wage workers into and out of the workforce. On the surface, 2.0 percent pay increases would hardly constitute wage inflation, prompting the Fed to worry about labor cost pressures.



However, the fierce competition for workers in leisure and hospitality, and other service sectors is helping the Fed meet one of its key objectives. This objective is to enable low-wage and low-skilled workers to regain the bargaining power they had finally achieved during the red-hot job market before the pandemic. Just as the pandemic took its most significant toll on this segment of the workforce, the post-pandemic reopening of the economy provides these workers with the biggest rewards in terms of pay increases. As we noted in last week's discussion of the jobs report, the increase in hourly earnings in the leisure and hospitality sector was significantly faster than for all workers. For the most part, the more significant gains reflected what companies needed to do to hire workers to fill open positions.



However, the Federal Reserve Bank of Atlanta data reveals that it is not only new hires reaping the rewards but existing workers as well. The bank has a wage tracker that follows changes in the median wage of workers on the same job over the past twelve months. The data is sliced and diced in myriad ways, but for our purposes, we looked at changes in the median wage over the past twelve months for workers at various skill levels. A key observation is that low-skilled workers are finally achieving the same increases in hourly earnings as high-skilled workers after trailing significantly behind throughout most of the pandemic. Interestingly, while pay raises for low-skilled workers have increased over the past several months, there has been no trickle-up effect. In fact, high-skilled workers have received smaller pay increases over the same period.

To be sure, there is still a wide gap between the average pay of high versus low-skilled workers, echoing the disparity among educational levels as well as between White and minority groups. But with the worker shortage most acute in sectors that employ low-skilled labor and where pent-up demand is the strongest, we suspect that the earnings gap will continue to narrow in the coming months. Over time, this will help ease the shortage, as higher pay packages and the expiration of weekly supplements to unemployment benefits will lure workers off the sidelines. What remains to be seen is how much of the increased labor costs incurred by firms in the service sector will be passed on to consumers.

In light of the formidable financial resources accumulated by households over the past year, thanks mainly to generous government transfer payments, much of which still reside in savings accounts, it is likely that consumers will accept higher prices than otherwise in the coming months. The outsized increases in airfares, hotels, rental cars, and even apparel as workers return to offices that are already underway should continue for a while. But as pent-up demand is satisfied and savings are drawn down, demand for these services will subside, and price pressures should ease.

What's more, capacity is slowly but steadily coming back online, and that trend should pick up as company access to global supplies improves. The yearlong surge of many commodity prices has already run its course, and many are turning down, including lumber, steel, iron ore, and some agricultural prices.

We suspect that the Fed will again hint that it is poised to slow its asset purchases at its upcoming policy meeting and that Powell will formally announce it at the Jackson Hole conference in August. The actual tapering should begin in early 2022, but rate increases will be delayed until 2023 when we expect two quarter-point increases. Based on the performance of the financial markets, investors seem to be okay with that timetable.

FINANCIAL INDICATORS				
INTEREST RATES	**June 11**	**Week Ago**	**Month Ago**	**Year Ago**
3-month Treasury bill	0.03%	0.02%	0.01%	0.16%
6-month Treasury bill	0.04	0.04	0.03	0.18
3-month LIBOR	0.12	0.13	0.16	0.32
2-year Treasury note	0.17	0.15	0.15	0.19
5-year Treasury note	0.74	0.78	0.81	0.33
10-year Treasury note	1.45	1.55	1.63	0.71
30-year Treasury bond	2.14	2.23	2.35	1.45
30-year Fixed Mortgage rate	2.96	2.99	2.94	3.21
15-year Fixed Mortgage rate	2.23	2.27	2.26	2.62
5/1-year adjustable rate	2.55	2.64	2.59	3.10
STOCK MARKET				
Dow Jones Industrial Index	34479.60	34756.39	34382.13	25605.54
S&P 500	4247.44	4229.89	4173.85	3041.31
NASDAQ	14069.42	13814.49	13429.98	9588.81
COMMODITIES				
Gold ($ per troy ounce)	1879.50	1894.10	1843.80	1733.5
Oil ($ per barrel) - Crude Futures (WTI)	70.78	69.38	65.51	37.87
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Consumer Price index (May) - % change	0.6	0.8	0.6	0.5
Core CPI (May) - % change	0.7	0.9	0.3	0.4
Trade Deficit (April) - $blns	68.9	75.0	70.6	69.1