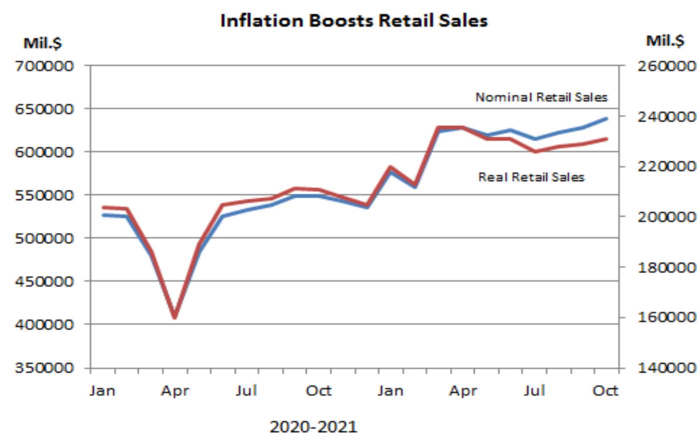
WEEK OF NOVEMBER 19, 2021

WEEKLY ECONOMIC COMMENTARY

Households may be unhappy about several things – high inflation, dissatisfaction with government, product shortages, to name a few – but they appear to be consoling themselves by buying stuff. To be sure, the increasingly grimmer mindset of households – as manifested by plummeting sentiment readings – juxtaposed with freewheeling spending is another example of people acting differently from the way they feel. This is a time-honored conflict that is fodder for behavioral economists but toxic for policymakers who rely on rational models for decision-making purposes. The Federal Reserve is an avid data cruncher; it is also keenly sensitive to how people feel, particularly regarding purchasing plans and inflation.

Odds are, inflation and product shortages – two contributors to the downbeat mood of households– are more critical factors influencing spending than the urge to compensate for inconsolable feelings. Notably, the inflation influence has two components, each of which portends a different future. If consumers are buying more now, before they become even more expensive down the road, that could jump-start a dangerous inflationary cycle built on heightened inflationary expectations. That's something to which the Fed would likely respond. Still, the evidence so far is that household inflation expectations have risen modestly over the short term, probably reflecting this year's inflation surge, but remain well-anchored over the longer term – a backdrop that should not elicit a knee-jerk reaction from the Fed.

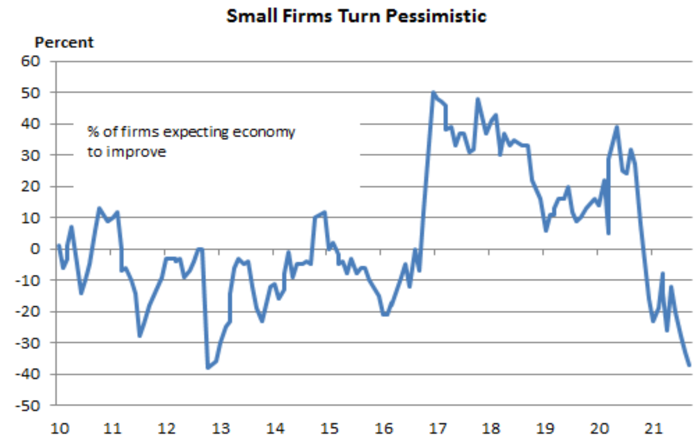
Conversely, the other inflation influence probably has a more significant impact on household psychology, namely its negative effect on purchasing power. Consumers are spending more on goods and services, but a good portion of the increase reflects higher prices. While retail sales for October came in way above expectations, surging by 1.7 percent, more than double the consensus forecast, so too did consumer prices that month, which ate up more than half the nominal increase in sales. No doubt, the healthy financial condition of households, flush with more than $2 trillion in excess savings, made them more willing to accept higher prices. But those funds are rapidly depleting (the personal savings rate fell to its pre-pandemic level of 7.5 percent in September). A growing swath of the population reports that higher prices are becoming more a deterrent than an incentive to spend.



But while inflation's impact on spending may be ambiguous at this juncture, the product shortages stemming from the various supply-chain disruptions are prompting more consumers to shop ahead of the holiday gift-giving season. To what extent early shopping added fluff to October's retail sales report is hard to measure. But the drumbeat of media reports suggesting that shelves might be bare in the weeks leading up to Christmas is undoubtedly having an effect. Among the most substantial sales gains in October were for goods typically purchased during the holidays – at electronics and appliance stores (+3.8%) and for sports, hobbies, books, and music (1.5% following an outsized 4.5% increase in September). Lingering health concerns (i.e., the Delta variant) no doubt prompted many individuals to eschew shopping at stores and purchase goods on the Internet; online sales jumped by a robust 4.0 percent in October.

Notably, the urge to shop early is not an unambiguous positive for holiday sales. To the extent consumers are pulling forward purchases to avoid shortages, some payback could be expected in subsequent months. And, given that the seasonal pattern of sales points to solid increases in November and December, any shortfall in demand due to payback from early shopping would translate into weak sales reports for those months on a seasonally adjusted basis. Likewise, there could be a whipsaw effect on inflation. By adding to demand pressures, the early shoppers amplify the demand/supply mismatch and contribute to the ongoing inflation surge. But if there are a significant payback and demand slumps in the coming months, stores will be stuck with unsold goods, which could lead to price cuts.

In this regard, it is noteworthy that many high-profile sellers, including Target, TJ Maxx, and Home Depot, announced this week that they have plenty of inventory to satisfy customers. These, along with a number of other large, well-funded, firms can circumvent the container shortage and bottlenecks at major ports by chartering their own ships and offloading goods at less congested docking stations. Unfortunately, small firms do not have the financial resources to pull this off, putting them at an even greater disadvantage in coping with the myriad headwinds they face. In addition to the inability to stock goods, these firms are either unable to find workers to fill open positions or can't afford to pay the higher wages needed to attract them. Not surprisingly, small firms are turning more pessimistic about the future.



According to the October survey by the NFIB, the share of small businesses expecting a better economy fell to the lowest level since 2012.

Regarding workers, Fed chair Powell is correct that there is still much ground to make up before the labor force reaches maximum employment. He is referring to the more than 4 million jobs still missing from the 22.3 million lost during the worst of the pandemic last March and April. Other measures that also point to a less than full recovery in the job market include a labor force participation rate and the employment to population ratio, both of which are well below pre-pandemic levels. Powell is hesitant to take more drastic policy measures to stifle inflation in good part out of fear that they would choke off the jobs recovery before the missing jobs are recovered. Most workers on the sidelines are low-paid, unskilled workers who are better able to find positions when the job market is running hot.

That said, workers are also falling behind the inflation curve, highlighting the conundrum the Fed is dealing with. True, wage growth has accelerated as companies compete fiercely in a labor market with more job openings than unemployed workers. However, inflation has raced ahead even faster, resulting in declining real wages. The good news is that low-paid workers are obtaining the most robust wage gains. In some instances, such as in the leisure and hospitality sector, the increases are far outstripping inflation. The bad news is that these workers are quitting their jobs in droves to obtain better positions elsewhere. This record-high quit rate is putting more upward pressure on labor costs but also imparts more of a squeeze on small businesses.

Some believe accelerated wage gains amid a tightening job market threaten to bring about a wage-price spiral that will ultimately force the Fed to slam on the brakes, inducing a recession. From our lens, the lopsided mix of wage increases reflects a releveling of earnings for low-paid workers who have long been left behind rather than a sustained upward shift in pay raises for most workers. According to the Atlanta Fed's wage tracker, the median wage growth for workers in the upper brackets has declined this year. For the highest earners, wages have increased by 2.7 percent over the past twelve months, the slowest since 2015.

Just as encouraging as the faster wage increases for low-paid workers, less-educated workers are joining the ranks of the employed at a faster rate than educated workers over the past six months. To be sure, less educated and low-paid workers generally fall in the same category, so the two trends would logically be linked. But the faster pace of employment gains for less-educated workers hints at a more important trend that may be unfolding. Simply put, it may reflect a lowering of educational standards for companies that would otherwise require a college degree for employment. If the tightening labor market were leading to a broad rethinking of academic standards among businesses, it would open the door for millions of workers who would otherwise be stuck on the sidelines or in low-paying jobs.

This encouraging prospect argues for a more patient Fed than otherwise as it strives to see how events on the inflation and employment fronts unfold. Still, the reality is that high inflation is the uppermost issue of the day. There's a growing risk that it will persist beyond the Fed's comfort level, resulting in a swifter withdrawal of monetary support than is currently planned. Indeed, the financial market is already pricing in more rate hikes next year than the one increase the Fed planned at its last policy meeting. It will be interesting to see if the policy statement at the next FOMC meeting on December 14-15 veers away from that plan.

FINANCIAL INDICATORS				
INTEREST RATES	November 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05%	0.05%	0.06%	0.07%
6-month Treasury bill	0.06	0.07	0.07	0.1
3-month LIBOR	0.16	0.16	0.12	0.21
2-year Treasury note	0.52	0.52	0.46	0.16
5-year Treasury note	1.22	1.23	1.20	0.38
10-year Treasury note	1.55	1.57	1.64	0.83
30-year Treasury bond	1.91	1.93	2.08	1.53
30-year fixed mortgage rate	3.10	2.98	3.09	2.72
15-year fixed mortgage rate	2.39	2.27	2.33	2.28
5/1-year adjustable rate	2.49	2.53	2.54	2.85
STOCK MARKET				
Dow Jones Industrial Index	35601.98	36100.31	35677.02	29263.48
S&P 500	4697.96	4682.85	4544.90	3557.54
NASDAQ	16057.44	15860.96	15090.20	11854.97
Commodities				
Gold ($ per troy ounce)	1848.50	1867.70	1793.10	1875.7
Oil ($ per barrel) - Crude Futures (WTI)	76.11	80.69	83.98	41.52
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (October) - % change	1.7	0.8	1.2	0.3
Industrial Production (October) - % change	1.6	-1.3	0.0	0.4
Capacity Utilization (October) - Percent	76.4	75.2	76.2	75.8
Housing Starts (October) - 000s of units	1520	1530	1573	1573
Building Permits (October) - 000s of units	1650	1586	1721	1644